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# The Binding Effect of a Nonadversary State Court Decree in a Federal Tax Determination

suit in Pennsylvania an unreasonable burden on the defendant. Even if the garageman had sold the tires to other Pennsylvania tourists, thereby increasing his contacts with the state, an evaluation of the nature of his business should be a prerequisite to allowing suit in the state. Factors such as the interest of Pennsylvania and the foreseeability of consequences in Pennsylvania should be weighed against compelling a small, purely local businessman to defend a suit in a distant but foreseeable forum.

### VIII. Conclusion

New York can be expected to push its tortious act provision to the limits of due process. Supreme Court decisions have indicated due process is not denied to a defendant unless it would be unfair to bring him to the forum state. A flexible standard which will allow weighing reasonableness to subject the defendant to the forum should therefore be adopted. Factors which should be used to determine jurisdiction include the interest of the state, the plaintiff's residence, the hardship to the plaintiff in bringing suit elsewhere, the nature of the injury, and the convenience and fairness to all parties.

## THE BINDING EFFECT OF A NONADVERSARY STATE COURT DECREE IN A FEDERAL TAX DETERMINATION

Where a federal tax statute "expressly or impliedly prescribes the taxpayer's property right as the test of taxability . . . the existence of that right [is determined] . . . under the controlling local law."[1] The court, in a federal tax proceeding, is, therefore, required to give binding effect to a prior state decree which meets certain requirements.[2] The decree[3] must be final,[4] deter-

1. 5 Rabkin & Johnson, Federal Income, Gift and Estate Taxation § 71.03(2) (1964). For specific references to state law in the Internal Revenue Code see, e.g., Int. Rev. Code of 1954, § 2034 (dower and curtesy); § 2040 (joint interests); § 2053(a) (deductions allowable under state law); § 2053(c)(2) (definition of property subject to claims); § 2056(c)(2)(B) (marital deduction); § 2106(a)(2) (charitable deduction). See also 1 Mertens, Law of Federal Gift and Estate Taxation § 10.01 (1959) [hereinafter cited as Mertens]. In addition to these specific references the courts have often implied a congressional intent to have state law control. In determining an implied congressional intent the courts have followed certain tests. "Among these are: that State law does not control 'unless the language or necessary implication' of the revenue statutory provision so requires; . . . whether, as to such provision, a uniform application of a nation-wide scheme of taxation would be interfered with if State law was the criterion; . . . and whether the purposes of the taxing act would be avoided or defeated by applying the State law." Doll v. Commissioner, 149 F.2d 239, 242 (8th Cir.), cert. denied, 326 U.S. 725 (1945).

2. See Freuler v. Helvering, 291 U.S. 35 (1934); Poe v. Seaborn, 282 U.S. 101 (1930); 1 Mertens, § 10.01; Sonnenschein, The Binding Effect of a State Court Decree With Reference to Property Rights Affected by Federal Taxation, 7 Fed. B.J. 251 (1946). But see Sharp v. Commissioner, 91 F.2d 802 (3d Cir. 1937), rev'd per curiam, 303 U.S. 624 (1938).

minative of the matters upon which the tax assessment depends,[5] and free from collusion. It is with respect to this last requisite, and to the nature of a nonadversary decree, that the federal circuit courts cannot agree.

For example, a trust beneficiary, wishing to assign his rights to income to his children, asks the trustee to bring an action to construe the terms of the trust. The state court, in an uncontested suit, reaches a decision validating the assignment. The Commissioner subsequently assesses a tax upon the income from the trust to the father, and he appeals. The question is whether this nonadversary decree is collusive.

Although some circuits view nonadversity as presumptively collusive,[6] others, recognizing the inequity of assessing a taxpayer on rights which he no longer possesses because of a state decision, view nonadversity as merely evidence of collusion.[7] The controversy, therefore, resolves itself to a matter of definition. The courts which view nonadversity as merely evidence of collusion define the latter in its traditional sense as involving fraud.[8] The courts which equate nonadversity with collusion, however, define that term in a manner similar to that advanced by the Commissioner in the Supreme Court case of *Freuler v. Helvering*.[9]

The existence of a split among the circuits is due largely to the lack of clarity in two decisions of the Supreme Court. In *Freuler*, a case concerning distributable income under a trust, the definition of collusion accepted by the majority of the circuits was advanced by the Commissioner for the first time, *i.e.*, "all the parties joined in a submission of the issues and sought a decision which would adversely affect the Government's right to additional income

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If the taxpayer was not a party to a state suit concerning the property right in question, the federal court is free to make a general examination of state law. Cf. Spiegel v. Commissioner, 335 U.S. 701 (1949); Helvering v. Stuart, 317 U.S. 154, modified, 317 U.S. 602 (1942). For a thorough discussion of examination of state law, see 1 Mertens, §§ 10.04-.08.

Res judicata has been explicitly rejected as the reason for the binding effect of the state court decree. The courts have placed emphasis on the injustice of taxing petitioner on rights he did not possess or enjoy under state law. See Freuler v. Helvering, supra at 43; Colowick, The Binding Effect of a State Court's Decision in a Subsequent Federal Income Tax Case, 12 Tax L. Rev. 213, 217 (1957).

3. The federal court should determine the jurisdiction of a state court by looking to the relevant state statutes and prior state decisions concerning jurisdiction. See Brodrick v. Moore, 226 F.2d 105 (10th Cir. 1955); Gallagher v. Smith, 223 F.2d 218 (3d Cir. 1955); Goodwin's Estate v. Commissioner, 201 F.2d 576 (6th Cir. 1953); Tooley v. Commissioner, 121 F.2d 350 (9th Cir. 1941); 1 Mertens § 10.11.

4. Id. § 10.12.

5. Id. § 10.14.

6. See notes 16-21 infra and accompanying text.

7. See notes 22-34 infra and accompanying text.

8. The traditional legal definition of collusion is "an agreement between two or more persons to defraud a person of his rights by the forms of law . . . ." Black, Law Dictionary 331 (4th ed. 1951).

9. 291 U.S. 35, 45 (1934).

tax."[10] The Court found no collusion in that particular case but failed to accept or reject the definition itself.[11] In so doing, it left to the circuit courts the decision of whether to apply this definition or to formulate a definition of their own.

The second case, *Blair v. Commissioner*,[12] did little to clarify the situation. Citing *Freuler*, the Court merely stated that there was no "basis for a charge that the suit was collusive and the decree inoperative."[13] A significant fact, however, is that the *Blair* case was clearly nonadversary[14] and yet the state decree was upheld on the basis

> that [the state] court entertained the suit and the [state] appellate court, with the first decision of the Circuit Court of Appeals before it, reviewed the decisions of the Supreme Court of the State and reached a deliberate conclusion. To derogate from the authority of that conclusion and of the decree it commanded, so far as the question is one of state law, would be wholly unwarranted in the exercise of federal jurisdiction.[15]

## I. THE *Saulsbury* RULE

Although there is no express endorsement by the Supreme Court of the Commissioner's definition, the majority of the circuits have chosen to adopt the standard of *Saulsbury v. United States*.[16] Ignoring the facts of the *Blair* case, they have applied the definition to deny the binding effect of a state court decree merely because it is nonadversary. *Saulsbury*, the leading case in these circuits, paraphrases the Commissioner's definition as follows: "By the word collusion, we do not mean to imply fraudulent or improper conduct, but simply that all interested parties agreed to the order and that it was apparently

10. Id. at 45. It is interesting to note the origin of this definition of collusion. Before the Board of Tax Appeals, the Commissioner suggested that the suit was friendly. Marguerite T. Whitcomb, 22 B.T.A. 118 (1931), rev'd, 65 F.2d 803 (D.C. Cir. 1933). A friendly suit is one "instituted by agreement between the parties to obtain the opinion of the court upon some doubtful question in which they are interested." Black, Law Dictionary 795 (4th ed. 1951). The court accepted the fact that the state decree might have been friendly, but saw no drastic consequence as a result of this since the friendly nature of the state suit did not preclude the state tribunal from rendering an opinion which bound the parties. 22 B.T.A. at 125. The Commissioner then turned to the definition of collusion set forth in the text.

11. 291 U.S. at 45.

12. 300 U.S. 5 (1937).

13. Id. at 10.

14. See Blair v. Commissioner, 83 F.2d 655, 657 (7th Cir. 1936), rev'd, 300 U.S. 5 (1937); Blair v. Linn, 274 Ill. App. 23 (1934).

15. 300 U.S. at 10.

16. 199 F.2d 578 (5th Cir. 1952), cert. denied, 345 U.S. 906 (1953). The Circuits holding nonadversary decrees automatically ineffective are the First, Second, Fourth, Fifth, Seventh, and Tenth. See, e.g., Estate of Faulkerson v. United States, 301 F.2d 231 (7th Cir.), cert. denied, 371 U.S. 887 (1962); Estate of Stallworth v. Commissioner, 260 F.2d 760 (5th Cir. 1958); Estate of Sweet v. Commissioner, 234 F.2d 401 (10th Cir.), cert denied; 352 U.S. 878 (1956); Pitts v. Hamrick, 228 F.2d 486 (4th Cir. 1955); Channing v. Hasset, 200 F.2d 514 (1st Cir. 1952); Kelly's Trust v. Commissioner, 168 F.2d 198 (2d Cir. 1948).

to their advantage from a tax standpoint to do so."[17] As a result of the express deletion of the element of fraud from the definition of collusion, *Saulsbury* and cases using the same rationale have logically concluded that a nonadversary suit, albeit in good faith, is ineffective by its very nature.

It is submitted that this is a misinterpretation of the Supreme Court decisions. The *Freuler* Court, pointing out that the Commissioner's definition did not apply to the case at hand, stated: "The [state] decree purports to decide issues regularly submitted and not to be in any sense a consent decree."[18] Thus, the Court seemed to indicate that it would define collusion in terms of a consent decree, *i.e.*, one which does not purport to represent the court's judgment but merely records the agreement of the parties.[19] Such a definition would be commensurate with the rationale of *Blair* which requires a deliberate conclusion by the state court.[20] The consent decree definition posits acquiescence rather than deliberation. Also, a consent decree would amount to an agreement to "adversely affect the Government's right to additional income tax,"[21] and would more closely approximate the traditional notion of collusion.

## II. THE *Gallagher* RULE

The problem of nonadversity has been treated quite differently by the Third Circuit.[22] There the view has been taken that the nonadversity of the decree is not sufficient to nullify the decree's binding effect, but is "evidence of collusion."[23] While several early cases seem to have utilized this approach,[24] its first notable exposition was in *Gallagher v. Smith*.[25] The proceeding was nonadversary[26] but the court felt that:

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17. 199 F.2d at 580. (Italics omitted.)

18. 291 U.S. at 45.

19. See Carpenter v. Carpenter, 213 N.C. 36, 195 S.E. 5 (1938); Stannard Supply Co. v. Delmar Coal Co., 110 W. Va. 560, 158 S.E. 907, (1931).

20. 300 U.S. at 10.

21. 291 U.S. at 45.

22. The Third Circuit's approach has also been employed in the Sixth, Eighth and Ninth Circuits. See Goodwin's Estate v. Commissioner, 201 F.2d 576 (6th Cir. 1953); Estate of Peyton v. Commissioner, 323 F.2d 438 (8th Cir. 1963); Flitcroft v. Commissioner, 328 F.2d 449 (9th Cir. 1964).

23. Gallagher v. Smith, 223 F.2d 218, 225 (3d Cir. 1955); see Flitcroft v. Commissioner, 328 F.2d 449 (9th Cir. 1963); cf. Goodwin's Estate v. Commissioner, 201 F.2d 576 (6th Cir. 1953).

24. See Goodwin's Estate v. Commissioner, 201 F.2d 576 (6th Cir. 1953), reversing 10 CCH Tax Ct. Mem. 1244 (1951); Eisenmenger v. Commissioner, 145 F.2d 103 (8th Cir. 1944), reversing 44 B.T.A. 489 (1941); Sharpe v. Commissioner, 107 F.2d 13 (3d Cir. 1939), cert. denied, 309 U.S. 665 (1940); Bullard v. Commissioner, 90 F.2d 144 (7th Cir. 1937), rev'd on other grounds, 303 U.S. 297 (1938); Janes v. Reynolds, 57 F. Supp. 609 (D. Minn. 1944).

25. 223 F.2d 218 (3d Cir. 1955).

26. Id. at 224-26. The beneficiary of a trust disclaimed all rights under the trust in excess of a one-thirteenth share of the income. On an auditing and account by the Orphans' Court of Philadelphia County, that tribunal in an admittedly nonadversary proceeding

if the question at issue is fairly presented to the state court for its independent decision . . . the fact that the parties all favored the same result in the state court is relevant only so far as it is evidence of collusion and should not in and of itself vitiate in the federal court such conclusive effect as the state law gives to the judgment with respect to the property rights determined by it. For if in the absence of fraud such a judgment does determine the rights of the parties in the property they must thereafter live with it so far as their enjoyment of the property is concerned.[27]

The *Gallagher* court's position is preferable for several reasons. First, it recognizes both the need for a deliberate conclusion by the state court and the possibility of reaching such a conclusion in a nonadversary proceeding. In doing so the court seems to be in accord with the *Blair* rationale.[28] Second, the court recognizes the injustice of taxing the petitioner with respect to property rights which he does not possess or enjoy under state law, the underlying basis for the *Freuler* decision.[29] Third, and most importantly, the court, by refusing to invalidate the decree on the mere fact of nonadversity, reserves the right to make an independent examination of the presence or absence of a collusive motive.[30]

It has been suggested that "where all the parties on one side join freely to express their views, the [state] court is bound to believe that all the equities are on that side,"[31] and, therefore, the Commissioner will be prejudiced in the federal tax proceeding. Although this danger exists, adherence to the *Gallagher* rule will not make the danger so prevalent as to warrant the abandonment of a rationale which is otherwise sound. In *Peyton v. Commissioner*,[32] although the federal court viewed nonadversity only as "evidence of collusion," this finding did not preclude the court from refusing to give effect to a decree which clearly emanated from a tax avoidance motive.[33] Controlling in this determination were

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confirmed the account (including the disclaimer) and awarded the balance of the income to the testator's twelve children. The Commissioner, however, taxed the petitioner on the entire trust income. In an action to recover the taxes paid, the federal district court held that they were not bound by the state decree since "the proceedings in the Orphans' Court were of a nonadversary nature" Gallagher v. Smith, 119 F. Supp. 360, 361 (E.D. Pa. 1953)

27. 223 F.2d at 225.

28. Blair v. Commissioner, 300 U.S. 5, 10 (1937).

29. Freuler v. Helvering, 291 U.S. 35, 45 (1934).

30. An example of such an examination can be seen in Estate of Darlington v. Commissioner, 302 F.2d 693 (3d Cir. 1962), where the court upheld the state decree, although nonadversary, on the basis that all parties were summoned and appeared with counsel (with one exception); the matter was presented in open court at regular session; and the decree was binding on the parties. Id. at 695.

31. Colowick, supra note 2, at 218. The Commissioner has also contended that acceptance of nonadversary decrees will open the floodgates of litigation. In Lindley v. United States, 57-2 U.S. Tax Cas. ¶ 9893, at 58184, 58188 (D. Minn. 1957) (memorandum decision), the court answered that "Congress has never seen fit to exercise plenary powers in this field and under the circumstances presented here, no good reason is made to appear why this Court should not recognize the findings of the State Court as determinative of this matter."

32. 323 F.2d 438 (8th Cir. 1963).

33. Id. at 446.

the facts that counsel conferred with the judge before the final ruling, and counsel for the estate also acted for the widow, even though the issue placed them on opposing sides.[34]

It would seem, then, that the *Gallagher* rule, if applied intelligently, will prevent the taxpayer from defrauding the Government by merely entering into a sham state proceeding. Furthermore, its use is far more equitable than the *Saulsbury* rule which would "bar acceptance on some generalized definition of collusion which automatically excludes nonadversary adjudications."[35]

## III. The Effect of a State Appeal

The fact that the state court adjudication was appealed from has weighed heavily with the circuit courts, especially those adhering to the *Saulsbury* rule, as evidencing a noncollusive state decree.[36] This effect was explicitly sanctioned in *Kelly's Trust v. Commissioner*.[37] The state suit involved a clearly nonadversary proceeding which the Tax Court felt was a "consent judgment,"[38] and, as such, invalid. The circuit court, however, overruled the Tax Court[39] and reinstated the state court decree solely on the basis that the state judgment had been appealed. The court reasoned that regardless of "the nature of the state-court suit in its inception . . . the fact that the appeal was considered shows that the judgment was not by consent, for a consent judgment by its nature precludes an appeal."[40] This "magical effect of appeal" has been criticized as unfair to the Commissioner,[41] but despite this it appears that the "collusive" nature of a suit may be cured by taking an appeal.

## IV. Burden of Proof

Apart from the effect to be given a state court decree in a federal tax proceeding, the question of who has the burden of proving the validity, *i.e.*, freedom from collusion, of the state decree has generated additional problems. The Fifth Circuit, places the burden on the taxpayer, noting that it did not "affirmatively appear that said order was obtained in an adversary proceeding and that there was no collusion."[42] However, the Tenth Circuit in *Brodrick v. Gore*[43] rejected the Fifth Circuit view and placed the burden on the Com-

34. Ibid.

35. 1 Mertens § 10.15, at 648-49.

36. See Estate of Faulkerson v. United States, 301 F.2d 231 (7th Cir. 1962); Brainard v. Commissioner, 91 F.2d 880 (7th Cir. 1937), appeal dismissed mem., 303 U.S. 665 (1938); Second Nat'l Bank v. United States, 222 F. Supp. 446, 456 (D. Conn. 1963); McHarg v. Fitzpatrick, 45 Am. Fed. Tax R. 1028 (D. Conn. 1953), aff'd, 210 F.2d 792 (2d Cir. 1954).

37. 168 F.2d 198 (2d Cir. 1948).

38. Ibid.

39. Garrard E. Kelly Trust 2, 8 T.C. 1269 (1947).

40. 168 F.2d at 198-99.

41. Colowick, supra note 2, at 226.

42. Saulsbury v. United States, 199 F.2d 578, 580 (5th Cir. 1952).

43. 224 F.2d 892 (10th Cir. 1955).

missioner to prove that the state decree pleaded, in the complaint, was collusive.[44] The suggestion has also been advanced that the burden of proof should fall on the person rejecting the state decree.[45] This, of course, would place the burden in most cases on the Commissioner. Since a state decree is valid in the absence of collusion,[46] the last suggestion would seem the most reasonable.

## V. Conclusion

A majority of the recent cases have utilized the *Gallagher* rule[47] which views nonadversity as merely evidence of collusion; while in the past the *Saulsbury* rule which equates a nonadversary decree with collusion had been more popular. In this connection, it is especially noteworthy that the Ninth Circuit, in *Flitcroft v. Commissioner*,[48] seems to have reversed its stand[49] and now employs the *Gallagher* test.[50] In the words of the *Gallagher* court:

> If the questions are fairly posed to the [state] court and the tribunal is left free to decide them according to its own independent judgment it should not be necessary for the parties to take formal adversary positions and engage in legal shadow boxing in order that the judgment of the court should have conclusive effect, taxwise as well as propertywise.[51]

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44. Id. at 896.

45. See Helvering v. Rhodes' Estate, 117 F.2d 509 (8th Cir. 1941); Estate of Frederick R. Shepherd, 39 B.T.A. 38 (1939).

46. Freuler v. Helvering, 291 U.S. 35 (1934).

47. See Flitcroft v. Commissioner, 328 F.2d 449 (9th Cir. 1964); Estate of Peyton v. Commissioner, 323 F.2d 438 (8th Cir. 1963); Estate of Darlington v. Commissioner, 302 F.2d 693 (3d Cir. 1962); Northwest Security Nat'l Bank v. Welsh, 203 F. Supp. 263 (D.S.D.), appeal dismissed on stipulation, 308 F.2d 367 (8th Cir. 1962). Contra, Estate of Faulkerson v. United States, 301 F.2d 231 (7th Cir. 1962); Second Nat'l Bank v. United States, 222 F. Supp. 446 (D. Conn. 1963). It is interesting to note that Faulkerson, while requiring an adversary decree, cites Gallagher in support of its position. Estate of Faulkerson v. United States, supra at 233.

48. 328 F.2d 449 (9th Cir. 1964).

49. The court had previously ruled in Wolfsen v. Smyth, 223 F.2d 111 (9th Cir. 1955) and Newman v. Commissioner, 222 F.2d 131 (9th Cir. 1955), that nonadversary decrees were ineffective. In Flitcroft v. Commissioner, 328 F.2d 449, 458 (9th Cir. 1964), the court stated: "While there is language in both Newman v. Commissioner and Wolfsen v. Smyth which supports respondent's position here, both cases are factually distinguishable from the instant case . . . ."

50. "The mere fact that the action instituted by the trustees was not resisted by the trustors . . . does not in itself make the decree collusive. It is one factor to be considered." 328 F.2d at 455. (Footnote omitted.) Another interesting case is Parkersburg Nat'l Bank v. United States, 228 F. Supp. 375 (N.D. W. Va. 1964), where the court limited the meaning of "nonadversary" to reach substantially the same result as Gallagher.

51. 223 F.2d at 225. The decisions in Freuler and Blair have elicited mixed reactions. One commentator has suggested that the state decree should have no binding effect whatsoever. This view would allow the state adjudication only precedential value which could be negated by a general examination of state law. Cardozo, Federal Taxes and the Radiating Potencies of State Court Decisions, 51 Yale L.J. 783, 797 (1942). Another author feels that

In *Blair*, the Court granted certiorari because of "an asserted conflict . . . with decisions of circuit courts of appeals . . . ."[52] This conflict, far from being resolved, has become more pronounced. The Supreme Court's consistent refusal to grant certiorari to cases involving nonadversary state decrees should end.

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although the rules are at times in confusion, "there are definite guides which counsel may look for . . . ." Colowick, supra note 2, at 235. It should be noted that Mr. Colowick is generally critical of the Gallagher rule. See id. at 218-20.

52. Blair v. Commissioner, 300 U.S. 5, 8 (1937).