

THE FEDERAL INCOME TAX AND STATE LAW

by

*Boris I. Bittker**

I count it a privilege to join in the Southwestern Law Journal's tribute to Dean Galvin as he drops the reins of administration. It is gratifying to know that he will continue as an active teacher and legal scholar—roles that he successfully pursued during his long tenure as dean of the Southern Methodist University School of Law, despite the centrifugal forces that inevitably pull educational administrators away from the classroom and library.

*My own association with Dean Galvin goes back many years, almost to a time whereof the memory of man runneth not to the contrary, namely, the end of World War II. Our closest encounters, however, occurred in two debates in the late 1960's. The first was conducted in the pages of the Harvard Law Review (volumes 80 and 81), where, with Joseph A. Pechman and Richard A. Musgrave, we debated the merits of a comprehensive income tax base. Such was the force of our rhetoric that each of us succeeded, at least in his own opinion, in defending his original territory. In one of his sallies, Dean Galvin suggested, indeed expressed the hope, that the existing tax structure would sink into "a dank, miasmatic, myxomycetous sump" so that we could make a new start; but with admirable realism, he also predicted that we would have to make do with the quagmire for the foreseeable future. In our other debate, recorded in book form as *The Income Tax: How Progressive Should It Be?*, we again grappled with slippery imponderables in an argument that furthered my own education and that, I hope, others found useful.*

In offering the remarks below to this testimonial in Galvin's honor, I look forward once again to his comments, criticisms, and corrections.

THE Internal Revenue Code is a national law, but it taxes transactions whose legal effects are almost always prescribed by state rather than federal law.¹ Without this body of state law to prescribe the rights and liabilities arising from the daily activities of millions of taxpayers, the federal tax collector would be a fish out of water. For example, so simple a matter as the deduction of a worthless debt under I.R.C. § 166(a)(1) on the

© Copyright 1979 by Boris I. Bittker.

* A.B., Cornell University; LL.B., Yale University. Sterling Professor of Law, Yale University.

1. See generally Paul, *The Effect on Federal Taxation of Local Rules of Property*, in *SELECTED STUDIES IN FEDERAL TAXATION* 1 (R. Paul ed. 1938); Cahn, *Local Law in Federal Taxation*, 52 *YALE L.J.* 799 (1943); Cahn, *Federal Taxation and Private Law*, 44 *COLUM. L. REV.* 669 (1944); Teschner, *Property Concepts and Nonproperty Taxes*, 44 *U. COLO. L. REV.* 323 (1973).

For articles discussing the conclusiveness of state court litigation in determining the federal tax effect of transactions, see note 43 *infra*.

ground that the taxpayer's claim against the debtor is barred by the statute of limitations depends on the length of the state's limitations period, the effect of a seal or recordation, the effect on the statute of limitations of an oral acknowledgment of the debt, and other factors that are governed by state law and vary from one state to another. Before the federal tax effect of a transaction can be determined, a host of threshold determinations of this type are almost always required. The answers to these preliminary questions are often so clear as to be taken for granted. This does not mean that the Code is independent of state law, but only that its reliance on state law is so pervasive that it rarely rises to the conscious level.

The notion that state law plays a secondary role, however, is widespread. For the most part, this misapprehension is traceable to cases like *Lucas v. Earl*,² holding that a married man performing personal services is taxable on his earnings in their entirety, even though one-half of these earnings had been assigned by him to his wife under a contract that was valid under state law.³ Because the contract transferred to the taxpayer's wife the right to collect and retain one-half of his salary as a matter of state law, but failed to relieve him of the obligation to pay federal income taxes on that amount, the decision may seem at first blush to reject state law in favor of an overriding federal legal structure. This impression is strengthened by the Supreme Court's statement that "this case is not to be decided by attenuated subtleties."⁴ In point of fact, however, in deciding that the revenue act in question taxed salaries to those who earned them, not to their assignees, the Court in no sense rejected any state law. Indeed, state rather than federal law supplied the very foundation of the decision by establishing that the amount divided between the taxpayer and his wife under the agreement was compensation for his services rather than, for example, a gift or a loan, that it was earned by him rather than by his wife or someone else, and that in the absence of the agreement he would have been entitled to collect and retain the entire amount paid by the employer.

The Supreme Court's holding in *Helvering v. Clifford*,⁵ requiring the grantor of a trust rather than the fiduciary or the beneficiary to report the trust income, is another case that, superficially viewed, seems to discard state law in favor of a uniform federal rule. The taxpayer in *Clifford* created a trust to last for five years, at which time the accumulated income was payable to the wife and the corpus was to revert to the taxpayer. The grantor designated himself as trustee, retaining unusually broad powers to manage the trust corpus and the right, in his sole discretion, to pay the trust income over to his wife prior to termination. Despite his wife's undisputed legal right under state law to receive and retain the trust income, the income was taxed to the grantor of the trust. Nevertheless, *Clifford* is not

2. 281 U.S. 111 (1930).

3. The taxable years before the Court were 1920 and 1921, long before the enactment of the optional joint return that now provides essentially the same tax effect that was claimed by the couple in *Lucas*.

4. 281 U.S. at 114.

5. 309 U.S. 331 (1940).

inconsistent with applicable state rules. Despite its dismissal of the “niceties of the law of trusts or conveyances, or the legal paraphernalia which inventive genius may construct as a refuge from surtaxes,”⁶ the factors listed by the Court as requiring the grantor to report the income—the fact that it was payable to a member of his immediate family, the breadth of his powers as trustee, the relative insignificance of the restraints on his ability to use the corpus for his personal benefit—all had their origin in the trust indenture, whose legal effect in turn depended on state law. Only two years after *Clifford*, the Supreme Court acknowledged the importance of state law in another grantor trust case:

Grantees under deeds, wills and trusts, alike, take according to the rule of the state law. The power to transfer or distribute assets of a trust is essentially a matter of local law. . . . Congress has selected an event, that is the receipt or distributions of trust funds by or to a grantor, normally brought about by local law, and has directed a tax to be levied if that event may occur. Whether that event may or may not occur depends upon the interpretation placed upon the terms of the instrument by state law. Once rights are obtained by local law, whatever they may be called, these rights are subject to the federal definition of taxability.⁷

Lucas v. Earl and *Helvering v. Clifford* are examples of a common phenomenon in federal tax law. Both illustrate a decision by the Court to attach more weight to one set of substantive rights created by state law than to another set, also arising under state law, in deciding which of several persons should be taxed on a particular item of income. In *Lucas* the fact that the income was compensation for the taxpayer's services was regarded as more significant for federal tax purposes than his contract with his wife. In *Clifford* the grantor's control over the trust income and corpus and his legal relationship to the beneficiary were held to be more important than the latter's right to receive the income. Such a choice among competing state created substantive rights is often unavoidable. In *Clifford*, for example, a decision in favor of the taxpayer would have elevated the wife's right to receive the income on the trust's termination to a position of greater importance for federal tax purposes than the husband's virtually unfettered right in the interim to manage the corpus and accumulated income and to advance income to his wife in such amounts and at such times as his fancy dictated.

In a similar context, Judge John R. Brown has spoken of “ignoring the flyspeck of legal title under state law” in favor of the taxpayer's other rights, stemming from the same body of state law, in deciding that a taxpayer could not deduct as rent under I.R.C. § 162 payments to a trust for the use of business property previously transferred to a trustee for the benefit of his children.⁸ Finally, the judicial process employed in both *Lucas*

6. *Id.* at 334.

7. *Helvering v. Stuart*, 317 U.S. 154, 161-62 (1942) (citations omitted; footnote omitted).

8. *Mathews v. Commissioner*, 520 F.2d 323 (5th Cir. 1975), *cert. denied*, 424 U.S. 967

and *Clifford* is not restricted to federal tax cases, but is employed by state courts in applying their own tax laws to similar transactions, and by both federal and state courts in deciding nontax cases involving the application of regulatory statutes.

In these cases, and in many others like them, the courts were compelled to decide the issues before them without much aid from the statutory language of the Internal Revenue Code. Although the Code is usually prolix rather than concise, it provided no explicit guide for the Court in *Lucas*; the controlling provisions were § 211(a) and § 213(a) of the Revenue Act of 1918,⁹ imposing a tax on "the net income of every individual" and defining income in the broad terms that are now found, with minor variations, in I.R.C. § 61(a). Given the husband-wife agreement to divide their earnings equally, the Court had to decide whether the wife's share of the husband's salary was income "of" the husband, who had performed the personal services, or "of" the wife, who was entitled to receive it under the marital agreement. As suggested above, state law was important, indeed indispensable, to the result reached by the Court; but this was not because state law shed any light on the meaning of the naked term "of" as used in the Revenue Act of 1918. The same can be said of the landmark case of *Poe v. Seaborn*,¹⁰ holding that one-half of the community income of a couple living in a community property state was taxable to each spouse. Even though the income was attributable to the husband's personal services and was subject to his management, the Court held that the wife's rights under local law were so weighty that one-half of the earnings constituted income "of" the wife.

Elsewhere in the Internal Revenue Code, however, terms taken from state law, including for example trust, marriage, corporation, contract, debenture, lease, and real property, occur in profusion.¹¹ Since terms like these can have one meaning in New York and another in Hawaii, how should they be interpreted when used in a national law taxing transactions whose substantive legal results are almost always prescribed by state law?

In *Burnet v. Harmel*,¹² a leading case discussing this issue, the Supreme Court stated:

(1976). See also *Doll v. Commissioner*, 149 F.2d 239 (8th Cir.), cert. denied, 326 U.S. 725 (1945) (husband-wife partnership disregarded for federal tax purposes). In *Doll* the court stated:

[W]here the issue is the existence of a legal status left by the taxing statute to the determination of State law, the decision of a State court is controlling. Here, the real issue is whether a contract which has created such a legal status has effected "any substantial change in . . . economic position."

149 F.2d at 244 n.10.

9. Revenue Act, ch. 18, §§ 211(a), 213(a), 40 Stat. 1057 (1918).

10. 282 U.S. 101 (1930).

11. The Code also uses terms of its own invention that are akin to, but not identical with, state law terms. Thus, "earnings and profits" as used in I.R.C. § 316(a) is not a state law term, though it bears a resemblance to the state law concept of "earned surplus." There is a similar relationship between the "complete liquidation" of a corporation as used in I.R.C. § 331 and the "dissolution" of a corporation under state law.

12. 287 U.S. 103 (1932).

The exertion of [Congress's power to tax income] is not subject to state control. It is the will of Congress which controls, and the expression of its will in legislation, in the absence of language evidencing a different purpose, is to be interpreted so as to give a uniform application to a nationwide scheme of taxation. . . . State law may control only when the federal taxing act, by express language or necessary implication, makes its own operation dependent upon state law. . . .

. . . The state law creates legal interests but the federal statute determines when and how they shall be taxed.¹³

The issue before the Court in *Harmel* was whether a transfer of oil and gas rights constituted a "sale or exchange" of "capital assets" under what is now I.R.C. § 1222. The arrangement was characterized by local law as a sale of the oil and gas in place, although it had substantially the same economic effect as a lease. Since mineral leases were not treated as sales under several earlier revenue acts, the Court concluded that the revenue act before it used the term "sale" in this established sense, thus disqualifying a mineral lease even though classified as a sale by local law.

If a transaction or event has identical legal consequences in substantially all states, but is given a peculiar label by the law of a particular locality, it is easy for the courts to conclude that local usage is not controlling, and that the federal tax liability generated by the transaction should be uniform across the nation. But if there are substantive differences in the legal rights attached by local law to the activity, it is far less clear whether Congress intended to adopt or disregard the local usage. The *Harmel* case establishes a presumption in favor of "uniform application." This seems plausible, but there are, unfortunately, at least two types of uniformity.

The competing possibilities can be illustrated by the problem created by the personal earnings of minor children. In some states they are entitled to retain the earnings for themselves, while in other states they must pay the earnings over to their parents. Before the enactment of the statutory predecessor of I.R.C. § 73 in 1944,¹⁴ the Internal Revenue Code did not state explicitly whether the child or the parent was required to report this type of income, and the controlling provision was I.R.C. § 1, imposing a tax on the income "of" every individual. If this vague term were interpreted to require children to report their wages and other earnings whether they were entitled to retain them under local law or not, national uniformity would be achieved in the sense that the income of minors would be taxed everywhere to the person performing the services. On the other hand, if

13. *Id.* at 110 (citations omitted). Later decisions quoting or paraphrasing *Harmel* include *Helvering v. Stuart*, 317 U.S. 154 (1942) (Congress intended to adopt state law); *Morgan v. Commissioner*, 309 U.S. 78 (1940) ("general power of appointment" as used in § 302(f) of the Revenue Act of 1926 as amended by the Revenue Act of 1932, § 803(b)); *Lyeth v. Hoey*, 305 U.S. 188 (1938) ("inheritance" as used in I.R.C. § 102(a) includes an amount received in the compromise of a will contest, even though not so defined by state law); *Heiner v. Mellon*, 304 U.S. 271 (1938) (use of the term "trustee" by state law not conclusive); *Blair v. Commissioner*, 300 U.S. 5 (1937) (validity of certain assignments dependent on state law).

14. The predecessor to I.R.C. § 73 was § 22(m) of the Internal Revenue Code of 1939, ch. 210, § 7, 58 Stat. 235 (1944).

the earnings were taxed to whichever person was entitled by local law to receive and spend them, another type of national uniformity would be achieved; the governing factor, nationwide, would be legal control over the funds in question.¹⁵ The *Harmel* presumption in favor of uniform application does not resolve this conflict between two types of uniformity.

The *Harmel* formulation is also ambiguous in stating that “[s]tate law may control only when the federal taxing act, by express language or necessary implication, makes its own operation dependent upon state law.”¹⁶ In an ultimate sense, of course, state law *never* controls; even when the Code expressly adopts state law for some purpose, this is done by Congress, which may revoke its acceptance of the state rules whenever it chooses. Occasional complaints that disregarding state law violates the tenth amendment, which reserves to the states or the people any powers not delegated to the United States by the Constitution, miss the basic point. The issue before the federal courts is the taxpayer’s liability for federal income tax, the imposition of which is a federal responsibility.¹⁷ Indeed, any attempt by a state to prescribe or alter the scope of the federal income tax or to exempt transactions from its reach would violate the supremacy clause of the Constitution, which provides that “the Laws of the United States which shall be made in Pursuance [of the Constitution] . . . shall be the supreme Law of the Land.”¹⁸ In point of fact, in the cases under discussion, state law is treated no more cavalierly than the federally prescribed private law of the District of Columbia, and the same process is also employed in deciding tax cases involving rights created by the federal patent and copyright laws.¹⁹

Moreover, the reference in *Harmel* to state law that is adopted by “express language or necessary implication” seems, at first blush, to suggest that most legal terms used by the Code have an independent national meaning, and that only a few are used in their local sense. Precisely the opposite is true. The Internal Revenue Code attaches tax significance to state created legal rights, and most legal terms are used as abbreviated references to these substantive rights. This is why Randolph Paul wrote almost forty years ago that “much of our federal tax law is not federal tax law at all, but non-tax state law.”²⁰

Paul’s observation is illustrated by the Supreme Court’s 1965 decision in *Commissioner v. Brown*,²¹ holding that the term “sale” in I.R.C. § 1222(3)

15. See also note 29 *infra*.

16. 287 U.S. at 110.

17. See *Phillips v. Commissioner*, 283 U.S. 589 (1931) (transferee liability held constitutional); *Kieferdorf v. Commissioner*, 142 F.2d 723 (9th Cir.), *cert. denied*, 323 U.S. 733 (1944) (federal tax lien superior to rights created by state exemption statute).

18. U.S. CONST. art. VI, cl. 2.

19. See, e.g., *Herwig v. United States*, 105 F. Supp. 384 (Ct. Cl. 1952), in which the transfer of motion picture rights in a novel was held to be a “sale” for federal tax purposes, although characterized as a “license” by federal copyright law. The case is especially noteworthy because the taxpayer, rather than the Government, was endeavoring to escape from the private law classification of the transaction.

20. Paul, *supra* note 1, at 5.

21. 380 U.S. 563 (1965).

(referring to “the sale or exchange of a capital asset”) was used in its customary sense, rather than in a special tax sense:

The transaction was a sale under local law.

. . . .

“Capital gain” and “capital asset” are creatures of the tax law and the Court has been inclined to give these terms a narrow, rather than a broad, construction. . . . A “sale,” however, is a common event in the non-tax world; and since it is used in the Code without limiting definition and without legislative history indicating a contrary result, its common and ordinary meaning should at least be persuasive of its meaning as used in the Internal Revenue Code.²²

Though not in direct conflict, *Harmel* and *Brown* manifest divergent approaches to the meaning of common legal terms, although both opinions interpret the word sale as used in the same provision of the Internal Revenue Code. *Harmel* suggests that a uniform national tax definition should be adopted unless “express language or necessary implication” assigns a dominant role to the state definition, while *Brown* implies that the term’s nontax meaning, which necessarily comes from state law, should ordinarily control. Against this background, it is useful to examine the two possible extremes and then the middle ground, namely, (a) provisions of the Internal Revenue Code explicitly imposing a uniform national definition on a familiar state law term, (b) provisions of the Code that explicitly subordinate national uniformity to state law, and (c) the broad intermediate area, illustrated by both *Harmel* and *Brown*, in which the Code uses legal terms without explicitly indicating whether they are to retain their customary local sense or be given a uniform national interpretation.

Federal Definitions Superseding State-law Terms. The Internal Revenue Code contains a few provisions that supersede the usual local meaning of familiar legal terms by substituting a uniform federal definition.²³ An example is I.R.C. § 704(e), which attaches certain tax consequences to partnership interests created by “gift” and further provides: “For purposes of this section, an interest purchased by one member of a family [as defined] from another shall be considered to be created by gift from the seller”²⁴ Another example is I.R.C. § 6013(d)(2), providing that a person “legally separated from his spouse under a decree . . . of separate mainte-

22. *Id.* at 569-71. See also *Crane v. Commissioner*, 331 U.S. 1 (1947). The *Crane* Court stated that “the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses.” *Id.* at 6. These references to common usage do not explicitly defer to the meaning of the particular term under the governing state law, but when the term is a legal one, state law is the usual source of its meaning.

23. Section 7701 also defines a few statutory terms, but the definitions are often incomplete. I.R.C. § 7701(a)(3) thus provides that, if not “manifestly incompatible with the intent” of the Code, “[t]he term ‘corporation’ includes associations, joint-stock companies, and insurance companies,” but it does not state whether the term embraces all entities that are called corporations by the state by which they are chartered, or only those having a particular set of corporate indicia. See also 1 U.S.C. §§ 1-5 (1976), providing rules of construction and defining the terms “company” and “association.”

24. I.R.C. § 704(e)(3).

nance shall not be considered as married." This prevents a couple from filing a joint return under I.R.C. § 6013(a), even though they are married under the law of the marital domicile for local law purposes. A third example of the substitution of a federal definition for the state law meaning of a familiar legal term is I.R.C. § 318, providing that a taxpayer shall be "considered as owning" stock owned, directly or indirectly, by his spouse, children, and certain related entities, such as trusts, estates, and controlled corporations, even though he is not the owner so far as state law is concerned.

None of these federal definitions purports to alter the substantive legal rights created by state law: a "purchase" under state law remains a purchase for local purposes, despite its treatment as a gift by I.R.C. § 704(e)(3); a couple separated under a legal decree remain married for local purposes if the law of their marital domicile so provides, even though they are not allowed to file a joint federal tax return; and a taxpayer does not become the owner of his children's stock under local law, even though he is treated as the owner by I.R.C. § 318 for federal tax purposes. Thus, the federal definition does not violate, or even disregard, state law; instead, it treats some of the substantive legal rights created by state law as irrelevant to a particular issue of federal tax liability.

In doing so, federal definitions put two groups of taxpayers in the same boat although their rights under state law are divergent. This may raise a due process issue, especially if the juxtaposition simultaneously separates either group from a third group of taxpayers with whom they have much in common under local law. Thus, I.R.C. § 6013(d)(2) denies married persons subject to a separate maintenance decree the right to file joint tax returns, thus putting them in the same position as unmarried taxpayers for filing purposes and simultaneously denying them a right that is granted to other married couples. Similarly, I.R.C. § 704(e)(3) imposes identical treatment on persons acquiring partnership interests by gift and those acquiring the interest by purchase from a member of the same family, but refrains from imposing this treatment on persons acquiring partnership interests by purchase from a more distant relative, or by bequest from a member of the immediate family. Whether these legislative classifications violate due process depends on whether the classification is reasonable, and the courts almost always have bowed to the judgment of Congress when passing on the reasonableness of decisions of this type.

Another point to be noted about the foregoing provisions of the Code is their continued reliance on state law in the very process of substituting a general uniform federal definition for the particular legal term's meaning under state law. Section 6013(d)(2), for example, is concerned only with "an individual who is legally separated from his spouse under a decree of divorce or of separate maintenance," and this language clearly looks to state judicial decrees in describing the persons who are not to be "considered as married." In the same vein, I.R.C. § 704(e)(3) applies only to "purchases" and not to other forms of acquisition, such as bequests, with-

out any suggestion that this distinction is to be administered by creating a uniform federal definition of the term purchase rather than by reference to its state law meaning. The same inescapable link to state law may be found even in I.R.C. § 318, attributing to the taxpayer property that is in fact owned by specified members of his family or related entities. Before attributing any stock to the taxpayer under this provision, a determination must be made that it is "owned" by the related person, and this threshold issue can be resolved only by looking to state property law. Nothing demonstrates so clearly the pervasive presence of state law than its continued importance even when the Code seeks to substitute a uniform national rule for terms with divergent local meanings.

Explicit Federal Adoption of State Law. At the other end of the spectrum from the relatively scarce federal definitions that supersede the local meaning of a legal term are some uncommon Code provisions explicitly providing that a state usage or determination is controlling. Thus, if a married couple is not divorced, legally separated, or subject to a written separation agreement, payments by one spouse to support the other are deductible by the payer and taxable to the recipient only if there is "a decree entered after March 1, 1954, requiring the husband to make the payments for [the wife's] support or maintenance."²⁵ Section 368(a)(1)(A) of the Code defines the term "reorganization" to include statutory mergers and consolidations, thus embracing transactions effected under state statutes, but excluding mergers effected under the laws of foreign countries as well as "practical" mergers.²⁶ Under I.R.C. § 164(d)(2)(A) the deductibility of real property taxes explicitly depends on the local rules allocating the tax between the buyer and seller of property and fixing the time when it becomes a lien on the property.

A more unusual example of explicit federal deference to state law is to be found in I.R.C. § 162(c)(2), providing that a bribe, kickback, or other payment may not be deducted as a business expense if it violates a state criminal or occupational licensing law, "but only if such State law is generally enforced."²⁷ Deference to a state administrative agency's determinations is illustrated by I.R.C. § 48(h)(12)(B), under which the taxpayer's right to an investment credit for water pollution control facilities depends, among other things, on a certification by the appropriate state pollution

25. *Id.* § 71(a)(3).

26. A practical merger is an acquisition by one corporation (the acquiring corporation) of substantially all the properties of another corporation, in exchange solely for voting stock of the acquiring corporation or its parent, or in exchange for such voting stock and a limited amount of money or other property. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 14.14 (4th ed. 1979).

27. This provision is another example of the ambiguity inherent in the concept of "uniform national application" of the revenue laws. It treats alike all taxpayers who violate state laws that are generally enforced by the particular state where the activity occurs. This uniformity, however, is achieved at the cost of treating differently taxpayers who engage in identical illegal activities in states that are lax in enforcing their laws.

agency that the property is "in conformity with the State program or requirements for control of water pollution."

While this list of Code provisions explicitly bowing to state common law, statutes, or agency determinations could be extended,²⁸ even the most complete catalogue would be a thin pamphlet. In the overwhelming majority of cases, when the Internal Revenue Code uses a familiar legal term, it neither explicitly adopts its local meaning, nor explicitly supersedes it with a uniform national definition.

The Code's Use of Legal Terms Without Explicitly Endorsing or Supplanting Their State Meanings. Often the Code uses a legal term, but neither adopts its meaning as used by the state common law or statutory law nor explicitly supplants the local meaning with a uniform federal definition. Since statutory construction is an art rather than a science, generalizations about the meaning of such terms when used in the Internal Revenue Code are perilous and must always be accompanied by an acknowledgment that exceptions are bound to occur. With this caveat, and in the absence of an actual word count by a lexicographer, I venture to assert that when the Code uses familiar legal terms, it rarely infuses them with a national meaning, but instead ordinarily defers to state law by employing the terms as abbreviated ways of designating the events and relationships that create taxable income, deductions, and other tax consequences. Indeed, the only alternative to these shorthand expressions would be detailed descriptions in the Code of the underlying facts triggering federal tax consequences, a practice that might increase the clarity of the Code but would require a far wordier statute than Congress has ever seen fit to enact. Thus, a Code provision referring to "contracts" conveys in a single word a meaning that would, in the alternative, require paragraphs of black-letter law describing the concepts of offer, acceptance, consideration, capacity to contract, and the like. Moreover, the use of such terms ordinarily points to the state law applicable to a particular set of facts, rather than to a more generalized national standard. Turning to a more specific illustration, the intended referent of the term "partnership agreement" as used in I.R.C. § 704(b) is almost certainly an arrangement among the partners made under the applicable state law, which governs their relationships as partners to each other, and excludes arrangements that have no legal effect in the partners' state or that regulate their personal or other nonbusiness relationships.

Common legal terms may be employed by Congress not only to incorporate by reference a complex set of facts, but also as a way of attaching tax consequences to the facts only if they have a particular legal effect under state law. In these instances, the term refers to the legal result and implies the existence of the underlying facts. For example, the references in I.R.C. § 642(c)(2) to "mental disability" to change a will or trust refer to a want of

28. See, e.g., I.R.C. § 3121(d)(2), which adopts "the usual common law rules applicable in determining the employer-employee relationship" in imposing social security taxes on employees.

legal power under the applicable state law, by reason of mental deficiency, to perform the specified acts. Thus, a person would be embraced by the statutory phrase if his attempt to change a will or trust would be ineffective in his own state, even if his emotional or cognitive disorientation would be characterized as mere eccentricity in a more tolerant state. Conversely, a person whose behavior did not fall below the legal standard in his own state would presumably not suffer from mental disability within the meaning of I.R.C. § 642(c)(2) even if he would be stigmatized as non compos mentis in a more finicky state.²⁹

The principal exception to this common use of legal terms as abbreviated references to the taxpayer's state prescribed legal rights, liabilities, or status occurs when the applicable state law attaches an unconventional meaning to the term. If used as an idiosyncratic label³⁰ for a transaction, event, or status that seems to be outside the intended reach of the tax provision in question, the local term may be rejected in favor of a more conventional, nationally uniform definition. Conversely, the taxpayer's rights, liabilities, or status will be subjected to a tax provision if within its intended scope, even if they are denoted by an unconventional local label that differs from the term used by the Code. What is important in these circumstances is not that the state in question attaches different legal consequences to an activity or set of facts than do other states, but that its label clashes with the term employed by the Code, either because the Code's term is used locally to denote legal results that the Code provision was not intended to comprehend, or because a different label is used locally for results within the Code's intended scope.

A leading illustration of this point is *Morgan v. Commissioner*,³¹ in which the Supreme Court interpreted the term "general power of appointment," as used in the estate tax provisions of the Revenue Act of 1932. At the decedent's death, she possessed the power to appoint by will the property of two trusts created by her father. The terms of the trusts permitted her to appoint to anyone, including her own estate and creditors, but the powers were exercisable only by will. Because she could not have exercised the powers during her life, the executor contended that they were special rather than general powers of appointment under the law of Wisconsin, where both the decedent and her father were domiciled. This version of Wisconsin law was disputed by the Government, but the Court found it unnecessary to resolve this issue:

29. The conclusions in the text are qualified by the word "presumably" because I.R.C. § 642(c)(2) is used here solely to illustrate a general principle, divorced from the provision's legislative history.

30. It should not be forgotten, however, that names may be more than mere labels, as pointed out by Cahn, *Local Law in Federal Taxation*, 52 YALE L.J. 799, 803 (1943): "Names in law are heavily encrusted with real distinctions and implications. Where nomenclature ends and substantial difference begins—that is the question." To some tax theorists, for example, "community property" is a mere label for rights that are virtually identical with the rights of married couples in common law states; to others, there is a world, or at least a continent, of difference.

31. 309 U.S. 78 (1940).

[W]e hold that the powers are general within the intent of the Revenue Act [of 1932], notwithstanding they may be classified as special by the law of Wisconsin.

State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed. Our duty is to ascertain the meaning of the words used to specify the thing taxed. If it is found in a given case that an interest or right created by local law was the object intended to be taxed, the federal law must prevail no matter what name is given to the interest or right by state law.³²

Although it refused to be bound by the state's label, the Court in *Morgan* did not reject—indeed, it affirmed—the central importance of state law in applying the Internal Revenue Code. First, the reference in the extract above to “an interest or right created by local law” acknowledges that the subject matter of federal taxation is almost always a right, liability, status or other legal interest created by state law. Second, after holding that Wisconsin's label was not controlling, the Court went on to say:

None of the revenue acts has defined the phrase “general power of appointment.” The distinction usually made between a general and a special power lies in the circumstance that, under the former, the donee may appoint to anyone, including his own estate or his creditors, thus having as full dominion over the property as if he owned it; whereas, under the latter, the donee may appoint only amongst a restricted or designated class of persons other than himself.

We should expect, therefore, that Congress had this distinction in mind when it used the adjective “general.”³³

The only source of the “distinction usually made between a general and a special power” is, of course, state law. Thus, in interpreting the phrase as used by Congress in the Revenue Act, the Court in effect turned from its meaning in a particular state to its meaning as used in the average state. Finally, the Court distinguished two other cases relied on by the taxpayer, saying, with evident approval:

We think it clear that, in both cases, the courts examined the local law to ascertain whether a power would be construed by the state court to permit the appointment of the donee, his estate or his creditors, and on the basis of the answer to that question determined whether the power was general within the intent of the federal act.³⁴

The bulk of federal tax cases that seem, at first blush, to dismiss state law in favor of a federal rule turn out, on analysis, to be less dramatic. They ordinarily resemble the *Morgan* case in looking to the law of the taxpayer's own state to determine the legal consequences of his activities, while rejecting that state's label for the legal rights in question in order to

32. *Id.* at 80-81 (footnote omitted).

33. *Id.* at 81 (footnote omitted). The Court also cited the legislative history of the Revenue Act of 1918 and the Treasury Regulations as independent authorities for this interpretation of the disputed statutory phrase.

34. *Id.* at 82.

give the federal statutory phrase a more general or familiar definition.³⁵ But even this appeal from the particular to the general usually relies on state law, albeit it is the "majority rule" or other evidence of widespread custom.

Since the labels employed by a particular state's common or statutory law are not controlling, it should occasion no surprise that the federal courts are not bound by the labels that taxpayers chose to employ to characterize a contract or transaction. Thus, a transaction may be treated as a mortgage for federal tax purposes, even though the documents consistently describe it as a sale of the property coupled with a leaseback by the buyer to the seller. When a label used by the parties does not accurately denote the transaction's legal consequences under state law, a different characterization in applying the Internal Revenue Code may actually conform to, rather than depart from, the characterization that would be adopted for local purposes by the state courts.

Finally, it is necessary to acknowledge that a few legal terms used in the Code have been the subject of extensive interpretation in federal tax litigation, in which nationally applicable principles have been developed, with minimal reliance on state law. This is most likely to occur with broad, amorphous terms whose local meanings developed for purposes far removed from the federal tax issues created by their use in the Code. The Supreme Court, for example, has held that the term "gift" as used in I.R.C. § 102(a), which excludes "the value of property acquired by gift" from the donee's gross income, is not used "in the common-law sense."³⁶ This conclusion is quite understandable. Federal tax problems involving the meaning of gift arise most frequently in transactions that have a compensatory flavor, leading the IRS to assert that the transfer was not a tax free gift but a receipt of taxable compensation. For private law purposes, however, the principal situation invoking the term gift is a transfer of property that the purported donor or, more frequently, his executor seeks to recover. In deciding whether the transferee is entitled to retain the property under state law, it is not necessary to distinguish between gifts and payments of compensation, since in either case the transfer is legally effective. For this reason, there is little reason to delineate a distinction between gifts and compensation for private law purposes. By contrast, in applying I.R.C. § 102(a), this distinction is all-important. It is, therefore, not surprising that the federal tax cases interpreting the term gift as used in I.R.C. § 102(a) give little attention to local law.

Ascertaining Local Law When Relevant to Federal Tax Liability—The Effect of State Adjudications. As pointed out earlier, for virtually every federal income tax question, there are threshold issues of state law since the tax-

35. For example, in a series of cases involving the federal tax status of state-chartered professional corporations, the entity's local label was sometimes mentioned, but the court then went on to examine the legal rights created by local law and to compare them with conventional corporate characteristics.

36. *Commissioner v. Duberstein*, 363 U.S. 278, 285 (1960).

payer's rights, liabilities, and status under local law are the infrastructure on which federal tax liability rests. For example, whenever the federal tax consequences of a contract must be determined, whether by the Internal Revenue Service at the audit level or by the federal courts in a litigated case, there must be either an implicit assumption or an explicit determination that the parties to the agreement had legal capacity to contract, that the Statute of Frauds was either inapplicable or satisfied, that enforcement of the obligations was not barred by the statute of limitations or laches, and that the contract in all other respects was valid and subsisting. In the overwhelming bulk of tax matters, private law issues like these are conceded rather than contested, but there are enough residual disputes about the status of a transaction under local law to support Randolph Paul's previously quoted assertion that "much of our federal tax law is not federal tax law at all, but non-tax state law."³⁷

When a legal issue arising under state law must be decided in the course of a federal tax case, the federal court performs substantially the same function as when it decides a similar state issue in a diversity of citizenship case, and hence it "may be said to be, in effect, sitting as a state court."³⁸ In this capacity, and in the absence of an authoritative decision by the highest state court, the federal court must give "proper regard," but not conclusive force, to decisions of the state's trial and intermediate appellate courts when determining how the local issue would be decided by the highest state court.³⁹ In unusual circumstances, a state law issue may be certified by the federal court to a state court for an authoritative ruling.⁴⁰

What if the local issue that is being disputed in the federal tax proceeding has already been decided by a state court in litigation by which the taxpayer is bound? Assume, for example, that the taxpayer seeks to deduct a debt as worthless under I.R.C. § 166 (a) (1), offering as evidence of worthlessness a state court judgment in a suit brought by him against the debtor that collection is barred by the statute of limitations. If the Government asserts that the debt is not yet worthless because the state court applied the wrong statute of limitations,⁴¹ much can be said for treating the

37. Paul, *supra* note 1, at 5.

38. *Commissioner v. Estate of Bosch*, 387 U.S. 456, 465 (1967). The "state court" analogy, however, does not hold for the Supreme Court, which will ordinarily not re-examine a federal appellate court's determination of local law. *Id.* at 462.

39. *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967); *Linder v. Commissioner*, 68 T.C. 792 (1977) (Tax Court effort to determine whether New Jersey Supreme Court would follow an earlier outmoded decision); *Newman v. Commissioner*, 68 T.C. 494 (1977) (effect of retroactive state court rulings). See also C. WRIGHT, HANDBOOK OF THE LAW OF FEDERAL COURTS § 58 (3d ed. 1976); Friendly, *In Praise of Erie—And of the New Federal Common Law*, 39 N.Y.U.L. REV. 383 (1964).

40. See *Imel v. United States*, 523 F.2d 853, 857 (10th Cir. 1975).

41. Since the Commissioner cannot be a party to a private lawsuit, the judgment is not res judicata as to the Government, nor does the principle of collateral estoppel apply. See Stephens & Freeland, *The Role of Local Law and Local Adjudication in Federal Tax Controversies*, 46 MINN. L. REV. 223, 250-51 (1961). For a discussion of the possibility of a certification of the state issue by the federal court to the local courts, see Wolfman, *Bosch, Its Implications and Aftermath: The Effect of State Court Adjudications on Federal Tax Litigation*, in 3 INST. EST. PLAN., U. MIAMI L. CENTER ¶ 69.205.4 (1969).

issue as foreclosed by the state judgment since it is binding on the taxpayer, whether it correctly interprets state law or not. If the debtor happens to be the taxpayer's child, however, the taxpayer may not have prosecuted the case as vigorously as possible, and may even have preferred to lose than to win. In such a nonadversary situation the local judgment may be tantamount to a consent decree, entered without much attention to the issues by a busy judge eager to clear his docket.

The tension between the state judgment's conclusive determination of the taxpayer's private law rights under local law and the possibility of perfunctory decisions, collusion, and even fraud in nonadversary local proceedings has generated a series of dramatic cases in the Supreme Court. In *Commissioner v. Estate of Bosch*,⁴² the most recent of these cases, the Court apparently disregarded both of these factors by announcing that the federal court must follow the same procedure in ascertaining state law when the taxpayer's rights have already been determined by a state court as it would in the absence of such a specific determination. The result, evidently, is that a decision of the highest state court is controlling even if the lawsuit was of a nonadversary nature, while decisions of the state trial and intermediate appellate courts are to receive proper regard, but are not conclusive even if rendered in an adversary lawsuit.⁴³

42. 387 U.S. 456 (1967).

43. *Id.* at 465. Although the Court cited the legislative history of the tax provision in dispute (the marital deduction authorized by I.R.C. § 2056 of the estate tax law) as authority for its conclusion about the effect of state law, the opinion seemingly stakes out a much wider area of application; and the three dissenting opinions so construe it, as do the principal commentators. See Wolfman, *supra* note 41, ¶ 69.200; Sobeloff, *Tax Effect of State Court Decisions—The Impact of Bosch*, 21 TAX LAW. 507 (1968); Note, *Bosch and the Binding Effect of State Court Adjudications Upon Subsequent Federal Tax Litigation*, 21 VAND. L. REV. 825 (1968). For earlier discussions, see Cardozo, *Federal Taxes and the Radiating Potencies of State Court Decisions*, 51 YALE L.J. 783 (1942); Stephens & Freeland, *supra* note 41; articles cited *supra* note 1.

