

# WHAT'S IN A NAME?: THE ROLE OF *DANIELSON* IN THE TAXATION OF CREDIT CARD SECURITIZATIONS

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\*Assistant Professor, the University of Alabama School of Law. Work on this paper was partially funded by a grant from the University of Alabama School of Law. Versions of this paper were presented to the faculty at the University of Alabama School of Law, Barry University School of Law, The University of Kentucky College of Law, University of Pittsburgh School of Law, Texas Wesleyan School of Law, and The University of Toledo College of Law. Versions of this paper also were presented at The Law and Society Association's Annual Meeting and as part of the Southeastern Association of Law Schools New Scholar Workshop. I would like to thank my colleagues, and particularly Dean Ken Randall, for their support. I received valuable comments from Shahar Dillbary, Bill Henning, Paul Horwitz, Dan Joyner, Ronald Krotoszynski, Leandra Lederman, Veronica Lei, Michael Pardo, David Patton, Meredith Render, Ken Rosen, Sarah Sandusky, Norman Stein, and Fred Vars. Matt Creel, Ben Dean, Sherri Thomas and Sarah Phillips Davis provided valuable research assistance, as did the staff of the Law Library at the University of Alabama School of Law.

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## I. INTRODUCTION

In late 2007, the bottom dropped out of the financial markets, precipitating what some have called the “worst financial crisis since the Great Depression.”<sup>1</sup> Although scholars still are attempting to explain the reasons for this sudden decline, one culprit that has been named repeatedly is the securitization market, in which banks and other financial players

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<sup>1</sup> Jon Hilsenrath, Serena Ng & Damian Paletta, *Worst Crisis Since ‘30s, with No End Yet in Sight*, WALL ST. J., Sept. 18, 2008, at A1 (quoting Mark Gertler, New York University).

“sliced, diced and puréed individual debts to synthesize new assets.”<sup>2</sup> Critics argue that securitization encouraged reckless behavior because lenders who securitized their loans were arguably less susceptible to financial loss in the event of default and therefore were less concerned with the creditworthiness of borrowers.<sup>3</sup> This financial crisis comes less than ten years after the accounting scandals of Enron, Worldcom, Tyco and HealthSouth, among others, in which companies hid crippling losses from investors through “creative” (and occasionally fraudulent) accounting practices.<sup>4</sup>

This increased scrutiny of both accounting practices in general, and securitization in particular, creates a Sword of Damocles for credit card issuers who securitize their receivables. Not only are credit card issuers exposed to the general attacks leveled against securitization by those who believe the process of packaging receivables for sale to investors creates only economic harm, but they are also susceptible to attacks based on their accounting methods, which employ some of the features that came under fire post-Enron, like the use of special purpose vehicles.<sup>5</sup> The current tax treatment of these credit card securitizations may be particularly vulnerable to criticism since the Internal Revenue Code (Code) and Treasury Regulations do not address the taxation of these vehicles specifically, as

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<sup>2</sup>Paul Krugman, *The Market Mystique*, N.Y. TIMES, Mar. 27, 2009, at A29. See also Tom Petrino, *They Gambled with Our Home Loans, but the Game Must Go On*, LOS ANGELES TIMES, Feb. 9, 2008, at C1 (“Rightly or wrongly, to some extent securitization was seen as feeding this monster.” (quoting Bianca A. Russo, JPMorgan Chase & Co.)).

<sup>3</sup>See Krugman, *supra* note 2, at A29. See also Kathy Chu & Byron Acohido, *Why Banks Are Squeezing Credit Card Holders: Investment Tactics Threaten to Create Another Type of Financial Crisis, Analysts Say*, USA TODAY, Nov. 10, 2008, at 1A (“[B]eing able to securitize debt . . . weakens underwriting discipline . . . [w]hether it’s credit cards or mortgages, this dynamic needs to be dealt with.” (quoting Sheila Bair, chairman of the Federal Deposit Insurance Corp.). “Securitization has increased the willingness of credit card companies to offer riskier loans.” (quoting Travis Plunkett, legislative director for the Consumer Federation of America)).

<sup>4</sup>See *Where Recent Scandals Stand*, USA TODAY, Sept. 29, 2003, at 3B.

<sup>5</sup>See VINOD KOTHARI, *SECURITIZATION: THE FINANCIAL INSTRUMENT OF THE FUTURE* 3434 (John Wiley & Sons (Asia) Pte Ltd. 2006). A special purpose vehicle, also known as a special purpose entity, is “[a] business established to perform no function other than to develop, own and operate a large, complex project . . . esp. so as to limit the number of creditors claiming against the project.” BLACK’S LAW DICTIONARY 1526 (9th ed. 2009). Arguably, the sword has now fallen with the Financial Accounting Standards Board’s issuance of Statement of Financial Account Standards No. 166 (“FAS 166”), discussed in more detail in the Postscript. See *infra* Part VII.

they do with mortgage securitizations.<sup>6</sup>

This silence by the taxing authorities is glaring, particularly in light of the fact that the way credit card securitizations are treated for tax purposes (as loans) appears to conflict with the way they are treated for accounting purposes (as sales).<sup>7</sup> This discrepancy seems to violate what is known commonly as the *Danielson* rule, which states that once a taxpayer has chosen the form of his transaction for tax purposes, he may not “disavow” that form by arguing that it differs from the transaction’s substance.<sup>8</sup> However, as can be seen upon a careful reading of the case law, when the Code discusses “form,” it means form as used for tax purposes and not form as used in other areas, such as accounting.<sup>9</sup> As a result, credit card securitizations do not involve a “disavowal” of form at all and therefore do not violate the *Danielson* rule.

By failing to clarify that form for tax purposes does not equate necessarily with form for accounting purposes, the Internal Revenue Service (Service) leaves open the possibility that some credit card securitizations could be taxed as equity rather than as debt. Only a portion of credit card securitizations face the risk of recharacterization, since others have recently adopted a new structure that allows them to issue instruments that are called notes, indicating debt, rather than certificates, which suggest equity.<sup>10</sup> These new securitizations may avoid scrutiny by the Service even when they share more characteristics akin to equity than their older counterparts.<sup>11</sup> In other words, by focusing solely on the name given to an instrument under *Danielson*, the Service may shift its focus away from the

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<sup>6</sup> See I.R.C. §§ 860A–G (2006) and related Treasury regulations for rules regarding Real Estate Mortgage Investment Conduits, which are used in mortgage securitizations.

<sup>7</sup> See *infra* Part III. This conflict may be resolved by FAS 166, which raises the standards for treating credit card securitizations as sales for accounting purposes. See *infra* Part VII.

<sup>8</sup> See *Comm’r v. Danielson*, 378 F.2d 771, 777 (3d Cir. 1967); see also *infra* Part IV. The consequences of disavowing form are also addressed by the strong proof rule, which some courts have adopted as an alternative to the *Danielson* rule. See *infra* Part IV.

<sup>9</sup> See *Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252, 255 (1939); *Palmer v. Comm’r*, 354 F.2d 974, 975 (1st Cir. 1965); *Lubin v. Comm’r*, 335 F.2d 209, 213 (2d Cir. 1964); *Ruoff v. Comm’r*, 277 F.2d 222, 229 (3d Cir. 1960).

<sup>10</sup> See ACCOUNTING FOR TRANSFERS OF FIN. ASSETS AN AMENDMENT OF FASB STATEMENT NO. 140, Statement of Fin. Accounting Standards No. 166, § 1–2 (Fin. Accounting Standards Bd. 2009). Moreover, FAS 166 essentially prohibits future credit card issuers from characterizing their securitizations as sales for accounting purposes unless additional criteria are met, potentially eliminating the need for credit card issuers to classify these transactions as sales at all. See *id.*

<sup>11</sup> See *id.*

factors that are truly important when determining whether a transaction should be treated as debt or equity for tax purposes.

This Article demonstrates why the difference between characterization for accounting purposes and characterization for tax purposes does not represent a difference between substance and form, particularly in the area of credit card securitizations, and explains why the Service needs to issue a statement to this effect. Part II of the Article explains how securitizations in general and credit card securitizations in particular operate. Part III explains why credit card securitizations should be treated as debt rather than equity for tax purposes. Part IV describes the *Danielson* rule as well as a variation known as the “strong proof rule” and explains how the Service might use these two principles to challenge the generally prevailing tax treatment of credit card securitizations. Part V describes how the Code has treated book-tax differences in other contexts and explains why credit card securitization should be treated similarly without being subject to *Danielson* and the strong proof rule. Part V also explains why attempts by prior cases and commentary to place limitations on the application of *Danielson* and the strong proof rule to book-tax differences have been inadequate thus far and why attempts to avoid application of these rules on the basis of ambiguity have fallen short of this goal. Part VI concludes by explaining why application of the *Danielson* rule could have a greater impact on smaller credit card companies and distract the Service from focusing on the factors that are truly important in a debt-equity context.

## II. BACKGROUND

### A. *Securitization in General*

Securitization refers to the process by which currently illiquid assets, like receivables, are pooled so that the rights to the incoming cash flow can be sold as securities to third-party investors.<sup>12</sup> Generally, a securitization occurs when an entity “pool[s] together its interest in identifiable cash flows over time, transfer[s] the same to investors either with or without the support of further collaterals, and thereby achieve[s] the purpose of

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<sup>12</sup>See KOTHARI, *supra* note 5, at 9–10; JAMES M. PEASLEE & DAVID Z. NIRENBERG, *FEDERAL INCOME TAXATION OF SECURITIZATION TRANSACTIONS* 1 (Frank J. Fabozzi ed., 2001) (describing a typical securitization transaction as one in which “an owner of a pool of receivables conveys them, directly or through an intermediary, to a trust or other legal entity, which in turn issues securities backed by those assets.”).

financing.”<sup>13</sup> In other words, if multiple customers owe a company money, securitization allows that company to access the securities markets to get a loan secured by the aggregate value of these customer accounts.<sup>14</sup>

When receivables are used as part of a securitization, the money collected on these receivables is used to pay the investors directly.<sup>15</sup> A securitization therefore may be viewed as a “prepaid” loan, since the receivables that will be used to pay back the investor are transferred to a special purpose vehicle at the beginning of the transaction.<sup>16</sup> This special purpose vehicle is almost always a bankruptcy remote vehicle, which means both that in the event of bankruptcy, the vehicle’s creditors (i.e., the investors in the securitization) do not have recourse to the assets of the company at large in the event the cash flow from the receivables is insufficient to pay them back, and that the company’s creditors do not have recourse against the special purpose vehicle’s assets.<sup>17</sup> As a result, the special purpose vehicle will often have a higher credit rating than the issuer as a whole. This allows the issuer to borrow money at a more favorable rate than it would otherwise.<sup>18</sup>

Because the receivables have been transferred to a separate entity, the issuer can remove them from its balance sheet in a process known as “off-balance sheet financing.”<sup>19</sup> Issuers generally prefer off-balance sheet financing because this allows them higher returns on their assets and equity without affecting their debt-equity ratios.<sup>20</sup> In other words, companies that securitize are able to monetize their future assets without a corresponding obligation on their books that must be recorded on their balance sheets, thereby improving their financial ratios.<sup>21</sup>

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<sup>13</sup> KOTHARI, *supra* note 5, at 5.

<sup>14</sup> *See id.*

<sup>15</sup> *See id.* at 8–9.

<sup>16</sup> *See id.* at 8.

<sup>17</sup> *Id.*

<sup>18</sup> *Id.* at 97; SECURITIZATION OF FINANCIAL ASSETS § 1.01 (Jason H.P. Kravitt, ed., Aspen Publishers 2d ed. 2008) (1992) [hereinafter KRAVITT] (quoting J. ROSENTHAL AND J. OCAMPO, SECURITIZATION OF CREDIT: INSIDE THE NEW TECHNOLOGY OF FINANCE 3 (1988)).

<sup>19</sup> *See* KOTHARI *supra* note 5, at 99; KRAVITT, *supra* note 18, § 1.01. The issuer may remove these receivables from its balance sheet because it no longer has a direct obligation to repay the debt. *See* Peter Jeffrey, *International Harmonization of Accounting Standards, and the Question of Off-Balance Sheet Treatment*, 12 DUKE J. COMP. & INT’L L. 341, 342–43 (2002).

<sup>20</sup> KOTHARI, *supra* note 5, at 99.

<sup>21</sup> *See* Jeffrey, *supra* note 19, at 342–44. In addition to providing off-balance sheet financing and the opportunity to borrow money at lower rates, securitization also allows companies to attract

Securitization has been around since 1970, when the Government National Mortgage Association first packaged its mortgages and sold them to investors.<sup>22</sup> The first publicly issued securitization occurred in 1985, when Sperry Corporation issued \$192.5 million of securities backed by computer lease receivables.<sup>23</sup> Securitization thrived through the early part of the twenty-first century. In 2002,<sup>24</sup> the asset-backed security market held over fifty-nine billion dollars. However, the rate of securitization has slowed considerably since that time, in part due to criticisms that the overuse of securitizations, particularly mortgage securitizations, helped fuel the current economic downturn.<sup>25</sup> A small number of banks, like Superior Bank of Chicago, failed in part because they securitized high-risk loans that initially gave them high returns but eventually fizzled.<sup>26</sup> More failures may be expected as banks face rising levels of defaults, bankruptcies and charge-offs (i.e., uncollectible expenses).<sup>27</sup>

### B. Credit Card Securitizations

This section describes a particular variant of securitizations—credit card securitizations—in which a credit card issuer securitizes the receivables from its cardholder accounts.<sup>28</sup> Although credit card securitizations are conceptually similar to securitizations of other types of receivables, such as mortgages and automobile loans, they are unique in that credit card receivables have a short period of liquidation that rarely extends beyond forty-eight months.<sup>29</sup> Unlike mortgage-backed securitizations, which seek

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investors who may otherwise be uninterested in the issuer's securities. KRAVITT, *supra* note 18, § 1.01. Another final benefit of securitization is relief from regulatory capital requirements due to the transfer of assets off the issuer's balance sheet. See Jeffrey, *supra* note 19, at 342–44, 351.

<sup>22</sup>KOTHARI, *supra* note 5, at 110.

<sup>23</sup>*Id.*

<sup>24</sup>Edward J. O'Connell & Katherine Bushueff, 2003 *Developments in Credit Card Securitization*, 20 S&P'S THE REVIEW OF BANKING AND FINANCIAL SERVICE 30L, 1–2 (Feb. 2004).

<sup>25</sup>See KOTHARI, *supra* note 5, at 33–36.

<sup>26</sup>See *id.* at 25–36.

<sup>27</sup>See Jennifer O. Quisenberry, *Securitization of Non-Traditional Asset Types: An Investor's Perspective*, in HANDBOOK OF STRUCTURED FINANCIAL PRODUCTS 21, 24 (Frank J. Fabozzi ed., 1998).

<sup>28</sup>KOTHARI, *supra* note 5, at 387.

<sup>29</sup>KRAVITT, *supra* note 18, § 3.03[A]. In addition, unlike mortgages and automobile loans, credit cards are unsecured, revolving obligations and therefore have a relatively low rate of recovery in the event of default. ASSET FIN. GROUP, THE FIRST BOSTON CORP., THE ASSET

to transfer risk of prepayment and related risks from sponsors to investors, credit card securitizations seek “to raise funds by issuing securities that resemble (and can be priced almost as cheaply as) conventionally high-quality debt instruments, while at the same time removing a corresponding interest in the receivables from the sponsor’s balance sheet for financial and regulatory accounting, and regulatory capital, purposes.”<sup>30</sup>

Given the unique challenges associated with securitizing credit card receivables, such transactions did not occur until 1986, over fifteen years after the first mortgage securitizations.<sup>31</sup> Nonetheless, credit card securitizations became increasingly popular in the years preceding the economic downturn and at one point constituted the largest segment of the asset-backed security market.<sup>32</sup> About \$400 billion of asset-backed financing came from securities backed by credit card receivables, with the amount of issuances per year more than doubling, from \$25 billion to \$58 billion between 1991 and 2001.<sup>33</sup>

### 1. Structure of a Credit Card Securitization

In a credit card securitization, an issuer creates a special purpose vehicle, typically a trust, to hold the receivables generated by some of its credit card accounts.<sup>34</sup> The trust then issues debt instruments to investors

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SECURITIZATION HANDBOOK 110, 118 (Phillip L. Zweig, ed. 1989).

<sup>30</sup>PEASLEE & NIRENBERG, *supra* note 12, at 16. The goal of removing receivables from the balance sheet has been hindered, and may have been thwarted altogether, by FAS 166. *See infra* Part VII.

<sup>31</sup>*See* KOTHARI, *supra* note 5, at 388.

<sup>32</sup>*See* CHARLES AUSTIN STONE & ANNE ZISSU, *THE SECURITIZATION MARKETS HANDBOOK* 197 (Bloomberg ed., 2005).

<sup>33</sup>Mark Furlotti, *An Overview of Credit Card Asset-Backed Securities*, FED. RESERVE BANK OF PHILADELPHIA, 2–3 (2002), <http://www.philadelphiafed.org/pcc/workshops/workshop11.pdf>. The amount of publicly-issued securities backed by credit card receivables also grew during that time, from \$45 billion in 2000 to over \$54 billion in 2002. Edward J. O’Connell & Katherine Bushueff, *Developments in Credit Card Securitization*, 19 S&P’S REV. OF BANKING AND FIN. SERVICE 26A (Jan. 2003). Several of the country’s largest credit card issuers, including Bank of America, Citigroup, Discover and Washington Mutual securitized more than half their credit card portfolio in 2007, and Capital One securitized almost three-fourths of its portfolio that year. *See* Chu & Acohido, *supra* note 3. The rate of credit card securitization has slowed down greatly since 2007, in part because of the recent economic downturn and in part due to concerns about the potential impact of recent regulations, like FAS 167. *Exodus Begins as Accounting Threats Grow*, ASSET-BACKED ALERT, Sept. 18, 2009, <http://securitization.net/article.asp?id=1&aid=9237>.

<sup>34</sup>PEASLEE & NIRENBERG, *supra* note 12, at 123. In most cases, this trust will be a “master



entitling them to a return of their principal plus interest set at a predetermined rate.<sup>35</sup> Although these instruments may be denominated as either certificates or as notes, their effect on investors and their treatment by the trust remains the same.<sup>36</sup> The trust pays the principal amount of these instruments using the payments made by cardholders on the underlying accounts; as a result, the instruments are often called “pass-through” securities.<sup>37</sup> Often, a trust will issue multiple classes of instruments (e.g., Class A, Class B, Class C) with the lower classes entitled to payments of interest and principal only after the higher classes have been repaid in full.<sup>38</sup>

A credit card securitization consists of two phases: a revolving period and an amortization period.<sup>39</sup> During the revolving period, which generally lasts about one year, investors receive interest payments from the trust but do not receive any return of principal (nor is any money set aside by the trust to make principal payments later).<sup>40</sup> The trust makes these interest payments from the interest charges and late fees that it receives from cardholders. Any excess interest charges and late fees are either applied to other securitizations or are returned to the credit card issuer.<sup>41</sup> Principal payments, on the other hand, generally are reinvested in new securitizations

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trust” that holds the receivables for all the issuer’s credit card securitizations, with each individual securitization, commonly called a series, receiving a pro rata claim to the cash generated by the credit card receivables. See KOTHARI, *supra* note 5, at 391; KRAVITT, *supra* note 18, § 4.03[C]; PEASLEE & NIRENBERG, *supra* note 12, at 38. This master trust structure eliminates performance differentiations across series and reduces transaction costs, in part because a single registered master trust may issue multiple series of certificates without having to register again. Andrew M. Faulkner, *Credit Card Securitization*, NUTS AND BOLTS OF FINANCIAL PRODUCTS 484 (2009).

<sup>35</sup> See PEASLEE & NIRENBERG, *supra* note 12, at 38–39.

<sup>36</sup> See *id.*

<sup>37</sup> See STONE & ZISSU, *supra* note 32, at 208; BLACK’S LAW DICTIONARY 1477 (9th ed. 2009).

<sup>38</sup> See Charles N. Schorin, *Credit Card Asset-Backed Securities*, in HANDBOOK OF STRUCTURED FINANCIAL PRODUCTS 153, 167 (Frank J. Fabozzi ed., 1998). The existence of these subordinated instruments provides a level of credit enhancement to the higher classes of notes, as is explained later in this section. KOTHARI, *supra* note 5, at 212–213. The issuer usually maintains the lowest class of instruments, which are not sold to investors. PEASLEE & NIRENBERG, *supra* note 12, at 38. This “seller’s interest” can then absorb any fluctuations in the balance of the receivables so that the series of certificates financing the investors’ interest can remain constant. STONE & ZISSU, *supra* note 32, at 204.

<sup>39</sup> See STONE & ZISSU, *supra* note 32, at 203–04.

<sup>40</sup> See KRAVITT, *supra* note 18, § 4.03[C]; PEASLEE & NIRENBERG, *supra* note 12, at 134; STONE & ZISSU, *supra* note 32, at 208.

<sup>41</sup> See PEASLEE & NIRENBERG, *supra* note 12, at 134; STONE & ZISSU, *supra* note 32, at 208.

during the revolving period.<sup>42</sup> In most instances, the trust also will provide its investors with additional assurance of repayment in some form of separate credit enhancement, for example a cash reserve account, that it may use in case it does not have enough money available from the interest charges and late fees to pay interest to investors.<sup>43</sup> An amortization period follows the revolving period, during which the trust uses the principal payments it receives from cardholders to return the investors' principal in installments.<sup>44</sup> Alternatively, the trust may accumulate these principal payments in an account that will be used to return investors' principal in one lump sum at the end of the securitization.<sup>45</sup>

In order to protect investors from losses and ensure they will be paid, the trust generally must provide some form of credit enhancement to "bridge the gap between the stand-alone quality of the [receivables], and the [desired] target rating of the instrument."<sup>46</sup> The trust may provide such credit enhancement by borrowing money from a third party and keeping it in a separate account, called a cash collateral account. The company may then use the money in this account if the cash flow from the receivables is insufficient to pay investors their interest or principal as due.<sup>47</sup> The credit card issuer may also transfer to the trust more receivables than it expects to need to pay back investors; this process is referred to as overcollateralization.<sup>48</sup> Finally, investors who purchase the higher-class instruments in a credit card securitization receive additional protection from loss because they will be paid before the holders of the lower class, or

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<sup>42</sup> See PEASLEE & NIRENBERG, *supra* note 12, at 134–35. The credit card company may also add receivables to or withdraw receivables from the trust during this revolving period. *Id.*

<sup>43</sup> *Id.*

<sup>44</sup> KRAVITT, *supra* note 18, § 3.03[A]; STONE & ZISSU, *supra* note 32, at 207–08. The amortization period is scheduled to begin at a predetermined time, but may begin earlier in the case of certain designated events, such as the yield on the receivables falling below a specified level. PEASLEE & NIRENBERG, *supra* note 12, at 134–35.

<sup>45</sup> KRAVITT, *supra* note 18, § 3.03[A].

<sup>46</sup> KOTHARI, *supra* note 5, at 210. All credit card securitizations provide some credit enhancement through the excess spread, which consists of the difference between the inherent rate of return of the portfolio over the expenses related to the transaction and the interest paid to investors. See *id.* at 212–13. However, excess spread generally only protects against expected losses; investors generally will want some protection against unexpected losses as well. See *id.* at 213–14.

<sup>47</sup> See Schorin, *supra* note 38, at 168; KOTHARI, *supra* note 5, at 212–13.

<sup>48</sup> See Joseph D. Smallman & Michael J. P. Selby, *Securitizing Nontraditional U.S. Assets for European Markets*, in HANDBOOK OF STRUCTURED FINANCIAL PRODUCTS, *supra* note 27, at 32.

subordinate, interests.<sup>49</sup> The subordinated classes “provide enhancement by having principal cash flow available to cover losses on the senior piece that is not covered by the excess spread or by more subordinate enhancement.”<sup>50</sup>

## 2. Treatment of Credit Card Securitizations Under Accounting Rules<sup>51</sup>

Although the credit card issuer almost always will want a securitization to be treated as a loan for tax purposes, it also wants the transaction to be treated as a sale for accounting purposes so that it may add the proceeds from the sale to its assets while removing the assets themselves, along with their accompanying liabilities, from its balance sheet.<sup>52</sup> A sale occurs only if the assets have been transferred to a separate entity and ownership of this entity has been transferred, at least in part, to outside investors.<sup>53</sup> A transferor usually meets these criteria by transferring the assets to a bankruptcy remote special purpose vehicle, such as the trust described in subpart II.B.1, that is disregarded for tax purposes.<sup>54</sup> Prior to 2010, Generally Accepted Accounting Principles (GAAP) emphasized that a transferor’s retention of rights of control over the transferred assets is indicative that a loan rather than a sale has taken place.<sup>55</sup> By contrast, the Code looks to the benefits and burdens of ownership, which also may be viewed as the retention of risk, in determining whether a transaction constitutes a sale or a loan.<sup>56</sup>

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<sup>49</sup> See Schorin, *supra* note 38, at 167–68. These interests may be held by other investors or by the credit card issuer itself. See *id.* at 168.

<sup>50</sup> *Id.* at 167. In return, investors in subordinated classes receive a higher interest rate on their loan.

<sup>51</sup> Because FAS 166 only recently took effect and the extent of its impact is still unclear, the following discussion focuses on its predecessor, FAS 140, which was in effect from March 31, 2001 through January 1, 2010. See *infra* Part VII.

<sup>52</sup> See DAVID C. GARLOCK, *FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS* 1042 (5th ed. 2006). The issuer then recognizes a gain or loss for the difference between its basis in the assets sold and the proceeds from the sale. PEASLEE & NIRENBERG, *supra* note 12, at 38.

<sup>53</sup> GARLOCK, *supra* note 52, at 1041.

<sup>54</sup> See *id.* at 1041–43.

<sup>55</sup> See PEASLEE & NIRENBERG, *supra* note 12, at 34 (citing Statement of Fin. Accounting Standards No. 140, § 46 (Fin. Accounting Standards Bd. 2000)).

<sup>56</sup> *Id.* at 57 (stating that “a party that has legal title to property and claims to be the owner for some substantial non-tax reason will be recognized to be the owner unless the allocations of burdens and benefits is clearly inconsistent with that result” (citing *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978))). See also KRAVITT, *supra* note 18, § 19.01[C][2] (“FAS 140’s

The Statement of Financial Accounting Standards No. 140 (FAS 140) describes the standards for what constitutes a sale under GAAP<sup>57</sup> According to FAS 140, a transfer of financial assets constitutes a sale if and only if the transferor “surrenders control” over those assets.<sup>58</sup> In order for a surrender of control to occur, all three of the following conditions must be met:

- (1) The assets have been isolated from the transferor, put presumptively beyond the reach of the transferor, its affiliates, and their creditors, even in bankruptcy or other receivership;
- (2) Either (1) each transferee obtains a right to pledge or exchange the transferred assets, and no condition both constrains the transferee from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor, or (2) the transferee is a qualifying special purpose entity (QSPE) and the holders of beneficial interests in that entity have a similarly unconditional right to pledge or exchange those interests; and
- (3) The transferor does not maintain effective control over the transferred assets through either (1) a repurchase agreement that both entitles and obligates the transferor to

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conceptual basis does not relate directly to retention of risk but, instead, to retention of control”). Peaslee & Nirenberg also note that the principal burdens and benefits for a debt instrument:

[T]he right to share in increases in market value (attributable to decreases in market rates generally or in required spreads for a particular quality credit, improvements in credit quality, any contingent payment features, or a favorable change in prepayment expectations), the risk of sharing in spreads defaults or other deteriorations in credit quality, or an unfavorable change in prepayment expectations, and the power to control the instrument.

PEASLEE & NIRENBERG, *supra* note 12, at 57–58.

<sup>57</sup> See ACCOUNTING FOR TRANSFERS AND SERV. OF FIN. ASSETS AND EXTINGUISHMENTS OF LIABS., Statement of Fin. Accounting Standards No. 140, § 9 (Fin. Accounting Standards Bd. 2000). FAS 140, which was issued in September 2000, replaced Financial Accounting Standards Board Statement No. 125 and took effect for all transfers that took place after March 31, 2001. *Id.* FAS 166 recently superseded FAS 140, discussed further in the Postscript. See *infra* Part VII.

<sup>58</sup> See ACCOUNTING FOR TRANSFERS AND SERV. OF FIN. ASSETS AND EXTINGUISHMENTS OF LIABS., Statement of Fin. Accounting Standards No. 140, § 9 (Fin. Accounting Standards Bd. 2000).

repurchase or redeem the assets before their maturity or  
(2) the ability to unilaterally cause the holder to return  
specific assets, other than through a clean-up call.<sup>59</sup>

Because the trust used in a typical credit card securitization is a bankruptcy remote entity, the first requirement is met easily.<sup>60</sup> Because the trust will also generally be a QSPE, the second requirement will be met so long as the holders of a beneficial interest in the trust have an unconditional right to pledge or exchange those interests.<sup>61</sup> Finally, the typical credit card securitization will not allow the credit card company to repurchase the underlying receivables prior to maturity and will not allow the trust to return specific receivables other than through a clean-up call; as a result, the third requirement generally will be met.<sup>62</sup>

Because the trust used in a credit card securitization almost invariably will be a subsidiary of the credit card company, the fact that the credit card receivables were transferred to the trust in a sale is not sufficient to create a sale for accounting purposes; the credit card company also must show that the trust should not be consolidated with the credit card company on its books.<sup>63</sup> Until this past year, FAS 140 stated that a QSPE would never be consolidated with a transferor that met certain qualifications; because the trust used in a credit card securitization was generally a QSPE, credit card issuers were assured that they did not have to consolidate the trust with the company on their books.<sup>64</sup>

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<sup>59</sup> *Id.*

<sup>60</sup> See KOTHARI, *supra* note 5, at 8.

<sup>61</sup> See ACCOUNTING FOR TRANSFERS AND SERV. OF FIN. ASSETS AND EXTINGUISHMENTS OF LIABS., Statement of Fin. Accounting Standards No. 140, § 9 (Fin. Accounting Standards Bd. 2000). Peaslee and Nirenberg note that, “because of the passivity of a QSPE . . . the drafters of FAS 140 effectively equated a pledge or exchange of interests in a QSPE holding transferred assets with a pledge or exchange of those assets . . .” PEASLEE & NIRENBERG, *supra* note 12, at 65. The Financial Accounting Standards Board amended FAS 140 to eliminate the notion of a QSPE. See ACCOUNTING FOR TRANSFERS OF FIN. ASSETS: AN AMENDMENT OF FASB STATEMENT NO. 140, Statement of Fin. Accounting Standards No. 166, § 1–2 (Fin. Accounting Standards Bd. 2009). As a result, a credit card securitization will meet the second condition only if each transferee obtains a right to pledge or exchange the transferred assets. See *id.* These new amendments took effect on January 1, 2010; what effect, if any, these new standards will have on credit card securitizations is still unclear. See *id.*; see also *infra* Part VII.

<sup>62</sup> See PEASLEE & NIRENBERG, *supra* note 12, at 65.

<sup>63</sup> See *id.* at 67–68.

<sup>64</sup> See ACCOUNTING FOR TRANSFERS AND SERV. OF FIN. ASSETS AND EXTINGUISHMENTS OF LIABS., Statement of Fin. Accounting Standards No. 140, §§ 86, 93 (Fin. Accounting Standards

The standards for a sale under GAAP differ from those under the tax rules in part because GAAP places a greater emphasis on the retention by the transferor of rights of control over the transferred assets.<sup>65</sup> For example, while a fixed-price call option on a group of unique assets would be inconsistent with a sale under GAAP, such an option generally is allowed in a tax sale.<sup>66</sup> Similarly, while FAS 140 requires the transferee (or its holders, in the case of a QSPE) to be allowed to pledge or transfer acquired assets in order for a sale to have taken place, the tax rules have no such requirement for a sale.<sup>67</sup>

Under GAAP, the party that controls the assets should report them on its balance sheet regardless of whether that party also bears the risks associated with that asset.<sup>68</sup> As a result, the parties to credit card securitizations regularly seek to transfer control over the receivables to the buyer while leaving the meaningful portions of the risk associated with those assets with the credit card issuer.<sup>69</sup> Because the definition of control under GAAP differs from the definition of ownership for tax purposes, a transfer may be respected as a true sale for accounting purposes, even though it is treated as a loan for tax purposes.<sup>70</sup>

### 3. Recent Changes to Credit Card Securitizations

Prior to 2001, sale treatment under GAAP was not allowed unless, in addition to the criteria listed above, the securities issued to investors were called “certificates,” indicating that they represented equity interests.<sup>71</sup> The

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Bd. 2000). FAS 166 revises the current standards by changing the accounting standards used to determine whether a transfer of receivables should be treated as a sale or as a financing and by eliminating the concept of a qualified special purpose vehicle which, as noted above, could be removed from the issuer’s balance sheet. ACCOUNTING FOR TRANSFERS OF FIN. ASSETS: AN AMENDMENT OF FASB STATEMENT NO. 140, Statement of Fin. Accounting Standards No. 166, § 1 (Fin. Accounting Standards Bd. 2009); *see infra* Postscript, Part VII.

<sup>65</sup> PEASLEE & NIRENBERG, *supra* note 12, at 67.

<sup>66</sup> *Id.* FAS 166 tightens this restriction by requiring the transferee itself to be given the right to pledge or transfer acquired assets in order for the transfer to be treated as a sale. ACCOUNTING FOR TRANSFERS OF FIN. ASSETS: AN AMENDMENT OF FASB STATEMENT NO. 140, Statement of Fin. Accounting Standards No. 166, § 4(z) (Fin. Accounting Standards Bd. 2009).

<sup>67</sup> PEASLEE & NIRENBERG, *supra* note 12, at 67.

<sup>68</sup> KRAVITT, *supra* note 18, § 19.01[C][2].

<sup>69</sup> *Id.*

<sup>70</sup> *See* GARLOCK, *supra* note 52, at 1041; PEASLEE & NIRENBERG, *supra* note 12, at 67.

<sup>71</sup> *See* O’Connell & Bushueff, *supra* note 33.

name given to these securities, while consistent with how they were treated for accounting purposes, conflicted with how they were treated for tax purposes.<sup>72</sup> After 2001, however, special purpose vehicles were allowed to issue notes to investors as part of a securitization and still treat the transfer as a sale for accounting purposes.<sup>73</sup> In response, some credit card issuers restructured their securitizations to begin issuing notes, using what is called a “note issuance trust.”<sup>74</sup> The primary innovation of the note issuance trust is that it allows the issuance of separate classes of notes on an individual basis.<sup>75</sup> In other words, if investors are interested only in purchasing a higher class of notes, the issuer can issue such notes separately; under the prior structure, all the classes of notes in a series had to be issued simultaneously.<sup>76</sup> This allows a credit card company to tailor an individual series of notes to meet the needs of an individual investor in terms of interest rate and risk level without simultaneously having to issue an accompanying set of notes.

Credit card issuers that were interested in switching to a note issuance trust faced one primary obstacle: they already had committed many of their accounts to their existing trusts, which were structured to issue certificates

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<sup>72</sup> See *infra* Part III.C.

<sup>73</sup> See O’Connell & Bushueff, *supra* note 24, at 2; O’Connell & Bushueff, *supra* note 33. FAS 166, while placing further restrictions on when a credit card issuer may treat a securitization as a sale for accounting purposes, continues to allow the use of the term “notes” even when the transfer is treated as a sale. See generally ACCOUNTING FOR TRANSFERS OF FIN. ASSETS: AN AMENDMENT OF FASB STATEMENT NO. 140, Statement of Fin. Accounting Standards No. 166, (Fin. Accounting Standards Bd. 2009).

<sup>74</sup> See O’Connell & Bushueff, *supra* note 24, at 2.

<sup>75</sup> See *id.*

<sup>76</sup> See KOTHARI, *supra* note 5, at 391; STONE & ZISSU, *supra* note 32, at 225. Previously, a master trust was required to issue matching amounts of securities simultaneously—e.g., one series of Class B certificates for each series of Class A certificates. See STONE & ZISSU, *supra* note 32, at 225. The note issuance trust, on the other hand, uses a single “pot” for all its funding and, as a result, may issue Class A notes separately as long as the value of the assets in the pot exceeds the amount necessary to fund the Class A notes. See O’Connell & Bushueff, *supra* note 33. Notes also present an advantage because they are eligible for benefit plans governed by the Employee Retirement Income Security Act (ERISA). See O’Connell & Bushueff, *supra* note 24, at 3. Because ERISA equates the purchase of a beneficial interest in a trust with an equity investment, a benefit plan that invests in certificates in a traditional master trust is viewed as owning, not only the certificates, but also the underlying assets. See *id.* In order to avoid the restrictions associated with ownership of these assets, many credit card issuers, including Fleet Bank N.A., MBNA America Bank, National Association and Citibank, N.A. received exemptions from the Department of Labor. KRAVITT, *supra* note 18, § 17.01[F][2][d].

rather than notes.<sup>77</sup> Initially, only a few issuers, generally the largest banks, adopted this new structure due to the high costs associated with its implementation.<sup>78</sup>

### III. TAXATION OF CREDIT CARD SECURITIZATIONS

Although the characterization of credit card securitizations for accounting purposes focuses on who has control over the receivables, their characterization for tax purposes focuses on who has the benefits and burdens of ownership. A credit card securitization may be taxed as either a loan (i.e., debt) or a sale (i.e., equity).<sup>79</sup> In order to achieve the maximum tax benefits from the transaction, the credit card company must be treated under tax law as borrowing money from investors by issuing debt instruments, which allows them to deduct a portion of the money paid to investors as interest under Section 163 of the Code.<sup>80</sup> If the transaction is treated as a sale rather than a loan, then payments made to investors are nondeductible dividends for tax purposes, resulting in double taxation at both the company and investor level on any income generated by the receivables.<sup>81</sup>

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<sup>77</sup> KRAVITT, *supra* note 18, § 4.03[C]. Rather than create an entirely new structure, the issuers created a new trust that would receive a “collateral certificate” from the existing master trust. *Id.* Essentially, this collateral certificate gave the new trust, generally called a note issuance trust, the same interest in the master trust as an investor in the master trust. *Id.* The trusts could then issue multiple series of notes backed by the collateral certificate. *Id.*; *see also* STONE & ZISSU, *supra* note 32, at 205.

<sup>78</sup> KRAVITT, *supra* note 18, § 4.03[C]. As of 2003, only Citigroup, MBNA, Bank One, and Capital One had adopted the new structure, although Washington Mutual, Bank of America, Discover, JP Morgan Chase and American Express have adopted the new structure since. *See* STONE & ZISSU, *supra* note 32, at 232. The Financial Accounting Standards Board recently released amendments to its financial accounting standards that change the standards under which companies may achieve sale treatment in securitizations. *See generally* ACCOUNTING FOR TRANSFERS OF FIN. ASSETS: AN AMENDMENT OF FASB STATEMENT NO. 140, Statement of Fin. Accounting Standards No. 166 (Fin. Accounting Standards Bd. 2009). These new amendments took effect on January 1, 2010. What effect, if any, these new standards will have on credit card securitizations is still unclear. *See generally id.*

<sup>79</sup> *See* GARLOCK, *supra* note 52, at 1041.

<sup>80</sup> *See id.* at 1052.

<sup>81</sup> *See id.* at 1052–53. Recharacterization as equity actually may benefit investors, since they could be more favorably taxed on dividend income than on interest income. KRAVITT, *supra* note 18, § 10.03[B]. In addition, because the trust used in the securitization could elect to be classified as a partnership for tax purposes, the investors could recognize the income from the securitization as partnership income rather than as interest, leaving them in essentially the same position as



Unlike securitizations of other types of assets, such as mortgages, the tax treatment of credit card securitizations essentially has developed on an ad hoc basis and therefore is not addressed in any specific sections of the Code, nor have any cases or rulings definitively determined how credit card securitizations should be treated for tax purposes.<sup>82</sup> Therefore, to determine which characteristics are important to a tax analysis of credit card securitizations, we must look at what characteristics generally have been considered important when exploring debt-equity issues, as well as what characteristics have been considered important when analyzing transfers of receivables in general or when analyzing other types of securitizations.

### A. *The Debt-Equity Distinction*

Broadly speaking, debt is defined as “an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest,” while equity is considered an investment in the venture itself, “taking the risks of loss . . . that [the investor] might share in the profits of its success.”<sup>83</sup> While no definitive set of rules exists that

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would have been the case without recharacterization. *Id.* Nonetheless, investors may still be adversely affected if the entity is classified as a publicly traded partnership or if some of the investors are either foreign or tax exempt. *See* PEASLEE & NIRENBERG, *supra* note 12, at 40–41.

<sup>82</sup> *See* PEASLEE & NIRENBERG, *supra* note 12, at 56–57, 103. The Treasury Department attempted to address the taxation of credit card securitizations in what were commonly referred to as “FASIT regulations” in 1996. GARLOCK, *supra* note 52, at 1051. The term FASIT refers to “Financial Asset Securitization Investment Trusts.” *Id.* The Small Business Job Protection Act originally implemented the FASIT rules in 1996. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1621(a), 110 Stat. 1755, 1858–68 (adding §§ 860H–860L). The rules in part were enacted to provide credit card issuers with a structure, similar to REMICS for mortgages, that would allow them to receive their desired tax treatment by complying with requirements laid out in the Code. *See* GARLOCK, *supra* note 52, at 1051. However, the FASIT rules generally were viewed as being overly restrictive. Moreover, the tax benefits they provided often were outweighed by the fact that they were subject to recognition of taxable gain on a contribution of assets. *See* PEASLEE & NIRENBERG, *supra* note 12, at 46–47. Finally, FASITs required a single ownership interest, whereas many credit card securitizations employed master trusts that had more than one sponsor or owner. *See id.* These and other disadvantages prevented FASITs from ever gaining popularity among credit card issuers, and the FASIT rules ultimately were repealed by the American Jobs Creation Act of 2004. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 835(a), 118 Stat. 1418, 1593–94; *see* GARLOCK, *supra* note 52, at 1051–52; PEASLEE & NIRENBERG, *supra* note 12, at 46–47.

<sup>83</sup> *See* Farley Realty Corp. v. Comm’r, 279 F.2d 701, 704 (2d Cir. 1960); United States v. Title Guarantee & Trust Co., 133 F.2d 990, 993 (6th Cir. 1943); GARLOCK, *supra* note 52, at 1015 (citing Gilbert v. Comm’r, 248 F.2d 399, 402 (2d Cir. 1957)). *See also* KRAVITT, *supra* note

determines whether a loan or a sale has taken place, various cases and rulings have considered the issue of whether ownership of an asset has passed to a transferee.<sup>84</sup> Notice 94-47 lists the following factors as relevant to the debt-equity analysis:

- (a) [W]hether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future;
- (b) whether holders of the instruments possess the right to enforce the payment of principal and interest; (c) whether the rights of the holders of the instrument are subordinate to the rights of general creditors; (d) whether the instruments give the holders the right to participate in the management of the issuer; (e) whether the issuer is thinly capitalized; (f) whether there is identity between holders of the instruments and stockholders of the issuer; (g) the label placed upon the instruments by the parties; and (h) whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.<sup>85</sup>

The most important of these factors for the purpose of analyzing credit card securitizations is the last: how the instruments are treated for non-tax purposes.<sup>86</sup> However, the Notice emphasizes that “[n]o particular factor is conclusive in making the determination of whether an instrument constitutes debt or equity” and that “[t]he weight given to any factor depends upon all the facts and circumstances and the overall effect of an

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18, § 10.03[C]; PEASLEE & NIRENBERG, *supra* note 12, at 100–01 (“[Debt] connotes an instrument that provides for an unconditional obligation of the borrower to repay in cash, on or before a fixed date not unreasonably far in the future, or on demand, principal together with interest thereon at a fixed rate or at a rate based on an interest rate index.”).

<sup>84</sup>PEASLEE & NIRENBERG, *supra* note 12, at 56–57. Although the Service did attempt to implement regulations governing the debt-equity distinction in 1980, these regulations eventually were withdrawn on the basis that they did not reflect fully the views of the Service or the Treasury Department. See T.D. 7920, 1983-2 C.B. 69–70.

<sup>85</sup>I.R.S. Notice 94-47, 1994-1 C.B. 357. A notice is defined in the Internal Revenue Manual as “a public pronouncement by the Service that may contain guidance that involves substantive interpretations of the Internal Revenue Code or other provisions of the law.” INTERNAL REVENUE MANUAL § 32.2.2.3.3 (2004), [http://www.irs.gov/irm/part32/irm\\_32-002-002.html](http://www.irs.gov/irm/part32/irm_32-002-002.html).

<sup>86</sup>KRAVITT, *supra* note 18, § 10.03[C].

instrument's debt and equity features must be taken into account."<sup>87</sup>

One factor mentioned in Notice 94-47 is the issuer's debt-equity ratio.<sup>88</sup> As noted by Peaslee and Nirenberg, "[t]oo high a ratio (thin capitalization) suggests that a purported creditor is accepting the risks of the debtor's business and should therefore be regarded as a proprietor rather than a creditor."<sup>89</sup> The situation becomes more complicated, however, when the debtor is a special purpose vehicle whose business consists of holding a largely fixed pool of debt instruments, since the risks of the borrower's business essentially become the risks of the creditor as well.<sup>90</sup> According to Peaslee and Nirenberg, "where a borrower's activities are limited to holding a static pool of debt obligations [i.e., receivables], a creditor's claim against the issuer should be at least as 'debt-like' economically as the underlying assets, unless perhaps the risks of the pool are concentrated in one class through subordination."<sup>91</sup> In other words, if those who owe money to the borrower default, any creditor whose loan to the borrower is served by these debts also risks suffering the defaults; if the risk to the creditor equals the risk to the borrower, then the creditor has essentially bought the loans from the borrower. The following section examines more closely how taxing authorities have viewed such transfers of receivables.

### *B. Tax Treatment of Transfers of Receivables*

Although the Code does not directly address the issue of how a transfer of receivables should be treated for tax purposes, we can adduce some general principles by examining prior rulings and case law.<sup>92</sup> Generally, sales of receivables are considered loans for tax purposes unless the investor receives benefits in addition to those it would receive as a lender.<sup>93</sup> The investor usually benefits only as a lender when the purchase price for the investment is tied to a predetermined interest rate and when the transaction documents contain restrictions on the alienability of the receivables.<sup>94</sup>

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<sup>87</sup> I.R.S. Notice 94-47, 1994-1 C.B. 357.

<sup>88</sup> *See id.*; *see also* PEASLEE & NIRENBERG, *supra* note 12, at 103.

<sup>89</sup> PEASLEE & NIRENBERG, *supra* note 12, at 103.

<sup>90</sup> *Id.*

<sup>91</sup> *Id.* at 108.

<sup>92</sup> *Id.* at 100.

<sup>93</sup> KRAVITT, *supra* note 18, § 10.03.

<sup>94</sup> *Id.*

In Revenue Ruling 54-43, the transfer of receivables from a merchant to a bank was treated as a sale because the merchant no longer had an unconditional risk of loss on the receivables.<sup>95</sup> Conversely, in *Town & Country Food Co. v. Commissioner*, the court determined that a taxpayer had not disposed of its obligations when it “merely subjected the obligations to a lien for the payment of indebtedness.”<sup>96</sup> According to the court, “a disposition involves the relinquishment of the substantial incidents of ownership of the obligations.”<sup>97</sup> In support of its conclusion, the court noted several key points:

The amounts which the petitioner obtained as loans . . . bore no direct relationship to any particular installment obligation or the aggregate of them. It did not realize the cash equivalent of the obligations as they became subject to the lien. Furthermore, the repayment of the petitioner’s indebtedness . . . was not geared to the petitioner’s collections upon its installment obligations. The petitioner retained title to, and possession of, the installment obligations. It collected payments as they became due and deposited them in its own bank account. Only in the event of a default by petitioner on its indebtedness to [the lender] could [the lender] obtain possession of the installment obligations, and then only for the purpose of satisfying its loan to the petitioner. If the installment obligations were sold upon default any amount received in excess of the amount necessary to satisfy such indebtedness was required to be remitted to petitioner.<sup>98</sup>

Although the court upheld indebtedness treatment in that instance, it also noted that “[i]t may well be that in some instances involving claimed borrowing arrangements the taxpayer parts with such a substantial portion of his ownership rights in the obligations as to require the conclusion that he has, in effect, sold or otherwise disposed of the obligations.”<sup>99</sup>

Similarly, in *United Surgical Steel v. Commissioner*, the court held that a pledge of installment obligations was a loan because, “while the bank

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<sup>95</sup> See Rev. Rul. 54-43, 1954-1 C.B. 119, 120–21.

<sup>96</sup> 51 T.C. 1049, 1057 (1969).

<sup>97</sup> *Id.*

<sup>98</sup> *Id.*

<sup>99</sup> *Id.*

assumed no risk, other than as a lender of money to the petitioner, the bank could realize no gain except as interest on that loan.”<sup>100</sup> The court in that case rejected the government’s argument that a loan in an amount “substantially equal” to the collateral constituted a disposition, noting that “there is no basis in law upon which to conclude that merely because the amount borrowed is substantially equal to the face amount of the collateral, the taxpayer has thereby disposed of the collateral.”<sup>101</sup> The court unequivocally found “that the transaction between the petitioner and the bank was in form, as well as substance, a loan and not a sale of collateral.”<sup>102</sup> In particular, the lack of contact between the petitioner’s customers, and the bank and the fact that the bank could only look to the petitioner for payment, supported characterization of the transaction as a loan rather than a sale.<sup>103</sup>

In General Counsel Memorandum 34,602, the Service declared its intent to focus on economic risk of loss when determining whether a transfer of receivables constituted a loan or a sale:

[T]he simple fact is that a merchant who transfers installment obligations in a situation where the bank, finance company, or credit subsidiary retains a holdback more than sufficient to protect it from economic loss under the collection experience of the merchant, retains the principal economic benefits and burdens of ownership; it receives the benefit of the obligations being paid (by being relieved of its obligation to either repurchase or have its holdback debited) and suffers the loss if they are not

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<sup>100</sup> 54 T.C. 1215, 1229 (1970).

<sup>101</sup> *Id.* at 1228.

<sup>102</sup> *Id.* at 1229.

<sup>103</sup> *Id.* at 1229–30. The court also noted certain restrictions, which in its words were “wholly inconsistent with the view that the transaction was not a loan by the bank to the petitioner:”

[T]he petitioner was required to keep its records in a manner satisfactory to the bank; the bank had the right to audit the books of petitioner; the petitioner had to furnish the bank periodically with financial statements of its operations; the petitioner had to pay all its taxes as such taxes came due; the petitioner had to keep its property insured; the petitioner could not purchase any additional fixed assets other than automobiles and individual purchases of less than \$1,000 without prior approval of the bank; and, the petitioner was restricted in the payment of compensation, the creation of other indebtedness, and the payment of dividends.

*Id.* at 1230.

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paid.<sup>104</sup>

In instances where the holdback exceeds the historical default rate by a sufficient amount, the Service indicated it would have a hard time concluding that the risk of loss had in fact passed to the buyer.<sup>105</sup> Even where there was a guarantee against loss, however, the transaction could still be a sale where the transfer both occurred at a fixed price and shifted the “substantial incidents of ownership” to the transferee.<sup>106</sup>

The Service noted additional factors that may indicate whether a loan or a sale had taken place:

(1) Whether the merchant or transferee is obligated to collect the accounts and bear the expenses in connection with their collection; (2) Whether the merchant or transferee is liable with respect to all property, excise, sales or similar taxes; (3) Whether the agreement provides for the merchant to hold the transferee harmless from and against any action brought against the transferee that might arise out of the merchant acting as agent for the transferee in making the collections; (4) Where the transferee is a credit subsidiary of the merchant, whether the subsidiary is primarily a shell corporation or has independent employees, officers and facilities, as well as the means to obtain capital to purchase the obligations; (5) Whether the customers of the merchant are notified of the change in ownership; (6) Whether the transferee retains the right to inspect the records and books of the merchant at any time; and (7) Whether the servicing of the accounts is performed by the merchant and, if it is, whether the transferee supervises

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<sup>104</sup> I.R.S. Gen. Couns. Mem. 34,602 (Sept. 9, 1971).

<sup>105</sup> See *id.*

<sup>106</sup> *Id.* The Service compared the situation described in the memorandum, which involved a department store transferring customer obligations to a subsidiary, to a purchase of property that was financed entirely by a nonrecourse loan from the seller. It noted that if the purchase of property is financed entirely by a nonrecourse loan from the seller and the property declines in value below the outstanding principal amount of the nonrecourse loan to the seller, the purchaser will reconvey the purchased property to the seller. Nonetheless, the purchaser is treated as the owner because of the ability of the purchaser to benefit from appreciation in the property. Similarly, if the purchaser of receivables has the potential to benefit in a capacity other than as a lender, the transaction still could be a sale despite protection against loss. *Id.*

the merchant's operations.<sup>107</sup>

Having identified some of the features that are deemed important when analyzing a transfer of receivables in general, we can now turn to how the Service has viewed securitizations, which constitute a particular type of transfer of receivables.

### *C. Tax Treatment of Securitizations*

The Service has not addressed the taxation of credit card securitizations publicly in a case, ruling or memorandum.<sup>108</sup> However, the Service has addressed the taxation of automobile loan securitizations, in Technical Advice Memorandum 98-39-001, and the taxation of mortgage securitizations, in Field Service Advice Memorandum 200130009.<sup>109</sup> The factors considered relevant in these memoranda may help determine how the Service should view credit card securitizations.

Technical Advice Memorandum 98-39-001 was one of the first indications from the Service regarding how it would treat securitizations as a unique means of transferring receivables.<sup>110</sup> In this memorandum, the

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<sup>107</sup> *Id.* Although the Service has not withdrawn the positions it took in prior revenue rulings finding that the transfer of receivables constituted a sale when the merchant no longer had an unconditional risk of loss, subsequent General Counsel Memoranda confirm the Service's adoption of the "incidents of ownership" approach. *See* Rev. Rul. 65-185, 1965-2 C.B. 153; Rev. Rul. 54-43, 1954-1 C.B. 119; KRAVITT, *supra* note 18, § 10.03[C][3][d].

<sup>108</sup> *See* PEASLEE & NIRENBERG, *supra* note 12, at 103. In a case against Transamerica Corporation, the IRS challenged the debt characterization of certificates issued as part of a mortgage securitization. *See id.* at 132 n.177. However, the IRS conceded prior to trial the transaction would be treated as a secured borrowing. *Id.* at 131-32. In Field Service Advice 200136010, the Internal Revenue Service indicated that a particular credit card securitization would be treated as debt for tax purposes in a memorandum addressing the separate issue of whether expenses related to the transaction should be capitalized. *See generally* I.R.S. Field Serv. Adv. 200136010 (Sept. 7, 2001).

<sup>109</sup> *See generally* I.R.S. Field Serv. Adv. Mem. 200130009 (July 27, 2001); I.R.S. Tech. Adv. Mem. 98-39-001 (Sept. 25, 1998).

<sup>110</sup> *See generally* I.R.S. Tech. Adv. Mem. 98-39-001 (May 29, 1998).

A technical advice memorandum is "a written statement issued by the National Office [of Chief Counsel] to, and adopted by, a district director in connection with the examination of a taxpayer's return or consideration of a taxpayer's claim for refund or credit. A technical advice memorandum generally recites the relevant facts, sets forth the applicable law, and states a legal conclusion."

Treas. Reg. § 301.6110-2(f) (2009). Unless otherwise established by regulation, a technical

Service examined the issue of whether a transfer of automobile loans from a subsidiary to two trusts constituted sales or secured financings.<sup>111</sup> The taxpayer, an automobile seller, had securitized two sets of auto loans and reported both of these securitizations as sales on its federal income tax returns and financial statements, and the Service received an inquiry regarding the correctness of this reporting.<sup>112</sup>

The two securitizations at issue were substantially similar: in both, the taxpayer formed a wholly owned subsidiary to which it transferred a pool of receivables.<sup>113</sup> The taxpayer then formed a bankruptcy-remote grantor trust to hold these receivables.<sup>114</sup> This trust issued two classes of certificates representing a fractional, undivided interest in the trust and its assets (i.e., the pool of receivables).<sup>115</sup> Credit support was provided to investors by the fact that, from their perspective, the trust was heavily overcollateralized.<sup>116</sup> In addition, the certificates held by the subsidiary were subordinate to the certificates held by investors, and each securitization was supported further by a reserve account.<sup>117</sup> Finally, the taxpayer's subsidiary agreed to repurchase loans that did not meet several criteria within a limited period at the beginning of the securitization.<sup>118</sup>

In analyzing this transfer, the Service first noted that “[a] transaction is a sale if the benefits and burdens of ownership have passed to the purported purchaser.”<sup>119</sup> The court then noted the following factors that have been deemed to be relevant when determining whether the benefits and burdens of ownership have passed on a debt instrument:

- (1) whether the transaction was treated as a sale;
- (2) whether the obligors on the notes (the transferor's customers) were notified of the transfer of the notes;

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advice memorandum “may not be used or cited as precedent.” I.R.C. § 6110(k)(3) (2006).

<sup>111</sup> I.R.S. Tech. Adv. Mem. 98-39-001 (Sept. 25, 1998).

<sup>112</sup> *Id.*

<sup>113</sup> *Id.*

<sup>114</sup> *Id.*

<sup>115</sup> *Id.* The higher class of certificates was sold to investors, while the taxpayer's subsidiary retained the lower class of certificates. *Id.*

<sup>116</sup> *See id.*

<sup>117</sup> *Id.*

<sup>118</sup> *Id.*

<sup>119</sup> *Id.* (citing *Highland Farms, Inc. v. Comm'r*, 106 T.C. 237, 253 (1996); *Grodt & McKay Realty, Inc. v. Comm'r*, 77 T.C. 1221, 1237 (1981)).



- (3) which party serviced the notes;
- (4) whether payments to the transferee corresponded to collections on the notes;
- (5) whether the transferee imposed restrictions on the operations of the transferor that are consistent with a lender-borrower relationship;
- (6) which party had the power of disposition;
- (7) which party bore the risk of loss; and
- (8) which party had the potential for gain.<sup>120</sup>

The Service further noted that no single factor was determinative and that the importance of each factor depended on the facts and circumstances of each case.<sup>121</sup> It also noted that, in the case of a high-quality auto-loan securitization like the one at issue, “the economics dictate that only the last two factors have real significance, and only to the extent they are economically realistic.”<sup>122</sup> In other words, a sale has taken place if investors “assumed Taxpayer’s risk of loss and opportunity for profit inherent in the Trusts and their underlying loans, within economically realistic limits.”<sup>123</sup> On the other hand, “[a] secured financing has taken place if the cash flows due the [investors] do not depend to any real degree on the performance of the underlying debt instruments . . . because then the Taxpayer would have retained the risk of loss and opportunity for gain.”<sup>124</sup> In this particular scenario, the Service determined that the taxpayer retained the risk of loss and opportunity for gain and, as a result, the transaction was a secured financing rather than a sale.<sup>125</sup>

In reaching this conclusion, the Service noted the features that made auto loans different from the mortgages that underlie mortgage-backed securities and determined that, for auto loan securitizations, the relevant inquiry was who bore the risk of loss.<sup>126</sup> With respect to the risk of loss, the

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<sup>120</sup> *Id.* (citations omitted).

<sup>121</sup> *Id.*

<sup>122</sup> *Id.*

<sup>123</sup> *Id.*

<sup>124</sup> *Id.*

<sup>125</sup> *Id.*

<sup>126</sup> *See id.* In particular, although the rates of prepayment on auto loans, unlike the rates of prepayment on mortgages, do not change when interest rates change, the pricing of auto loan

Service noted that the taxpayer had experienced only minimal losses on its auto loans prior to the securitization.<sup>127</sup> This low rate of loss, coupled with the amount invested in the reserve account and the taxpayer's interest in the subordinated certificates and the residual balance in the trust, indicated that the investors bore little risk of loss on their investment.<sup>128</sup> In particular, the Service noted that, given the terms of the reserve account, "[d]efault and prepayment rates would have to increase dramatically above historical levels before the [reserve account] would be insufficient to cover any shortfall."<sup>129</sup> The Service then concluded that "[t]his level of security indicates that the [investors] did not bear the risk of loss from defaults or prepayments as they would had they bought the underlying loans."<sup>130</sup>

The Service acknowledged that "extreme economic conditions could result in much higher than expected losses on the loans in the Trusts, in turn causing a severe shortfall in cash flows."<sup>131</sup> It further noted that "[i]f the resulting losses were great enough, the combination of the [reserve account], the subordination feature of the [subordinated] certificates, and the residual cash flows might not be sufficient to cover the payments due the [investors]."<sup>132</sup> However, the Service found that "[t]his sort of

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securitizations do change along with short-term interest rates, since they are based on the Treasury yield curve. *Id.* Although the owner of the underlying auto loans could hypothetically benefit from a change in prepayment rates, both of the securitizations at issue had maturity periods that were too short for either the taxpayer or the investor to gain from a lower than expected rate of prepayment. *Id.* As a result, the Service shifted its focus to an examination of who bore the risk of loss in the transactions at issue. *Id.*

<sup>127</sup> *Id.*

<sup>128</sup> *See id.*

<sup>129</sup> *Id.*

<sup>130</sup> *Id.* The Service also considered the fact that the auto loans were transferred to the trusts without recourse and the fact that the taxpayer was required to repurchase non-conforming loans during the first two months of the transaction, but ultimately concluded that these factors also indicated the securitizations were financings (i.e., borrowings) rather than sales. *Id.* In particular, with respect to the repurchase provision, the Service noted that the events that would require repurchase of an auto loan generally occur during the early stages of the loan and noted that, as a result, "this particular risk of loss is economically realistic only during the initial stages of a securitization." *Id.* Because repurchase provisions were in place for these early stages, "by the time the two Trusts were formed and the . . . certificates sold to the investors, the loans in the two Trusts did not have an economically significant risk of loss of this sort that could be passed to the [investors]." *Id.*

<sup>131</sup> *Id.*

<sup>132</sup> *Id.*

catastrophic risk . . . is more theoretical than real.”<sup>133</sup> As a result, the Service concluded that this factor of passing on only “catastrophic” risk, while holding on to historic risk, was consistent with a secured financing.<sup>134</sup>

Finally, the Service rejected several additional factors raised as potential reasons why the auto loan securitizations should be treated as sales:

- (1) the sponsor retained a clean-up call it could use when the outstanding principal balance of the mortgages in the pool dropped to ten percent of their original balance;
- (2) the sponsor retained prepayment penalties, late payment charges, and assumption fees (i.e., ancillary income) from the pooled mortgages as part of its servicing fees;
- (3) the sponsor, as servicer, had to pay the trustee’s fees and mortgage insurance premiums out of its servicing fee;
- (4) the sponsor retained the right to make advances to the [mortgage-backed securities] holders should the mortgagors pay late or default; and
- (5) the sponsor retained the right to guarantee principal and interest payments on the mortgages, either itself or through a third party.<sup>135</sup>

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<sup>133</sup> *Id.*

<sup>134</sup> *See id.* In reaching its conclusion, the Service distinguished two earlier revenue rulings, Revenue Ruling 70-544 and Revenue Ruling 70-545, which held that two mortgage securitizations should be treated as sales rather than financings. *Id.* Although the servicer in Revenue Ruling 70-544, like the taxpayer in the instant situation, could (but was not required to) cover deficiencies or late payments until the mortgage was corrected or foreclosed, the investors in the mortgage securitization, unlike the investors in the auto loan securitization, had to look to the cash flows on the underlying mortgages after that date. *Id.* In Revenue Ruling 70-545, on the other hand, the issued securities had “the full guarantee of GNMA to the certificate holders as to payment of interest and principal . . . the full faith and credit of the United States [was] pledged to the payment of all amounts required by the certificates.” *Id.* (citing Rev. Rul. 70-545, 1970-2 C.B. 8). Because investors in this securitization looked to the United States rather than the taxpayer for payment, the taxpayer was relieved of the credit risk on the underlying mortgages. *Id.* The Service found that neither of these rulings “attempted any economic analysis of whether the benefits and burdens of ownership had passed from the sponsor to the certificate holders.” *Id.* The Service further noted that neither of the transactions discussed in the rulings were as overcollateralized or contained as much subordination as the auto loan securitization. *Id.*

<sup>135</sup> *Id.* The field argued that these features were similar to features found in mortgage-backed securities that had been recharacterized as sales. *See id.*

The Service noted that many of these features were common in securitizations and therefore had no bearing on whether the transactions constituted sales or financings.<sup>136</sup> The Service also rejected the contention that GAAP pronouncements characterizing securitizations as sales were relevant, noting that “GAAP . . . cannot affect federal income tax rules unless specifically made controlling.”<sup>137</sup> Even though investors suffered more losses from prepayments than the taxpayer suffered as a result of defaults, the Service found this sort of comparison to be “suspect” and further found that “hindsight analysis cannot affect whether the securitization is a sale or a secured financing . . . . This issue is determined at the outset of the transaction.”<sup>138</sup>

Although the taxpayer in Technical Advice Memorandum 98-39-001 apparently was allowed to disregard the form of its transaction by treating the certificates it issued as loans for tax purposes, the memorandum did not directly address this issue.<sup>139</sup> Instead, the Service declared this point “moot,” stating that “[t]he Taxpayer merely agrees with how the Commissioner has recharacterized the transactions.”<sup>140</sup> The Service further stated, “[n]o opinion is expressed whether the Taxpayer would be bound by the form of its transactions if it were the first to assert that its transactions were secured financings.”<sup>141</sup> However, the Service reached the opposite conclusion in Technical Advice Memorandum 98-40-001, which agreed with a taxpayer’s characterization of a transfer of subprime auto loans as a sale rather than a financing.<sup>142</sup> That transfer did not occur as part of a traditional securitization, involved subprime rather than high-quality assets, and was structured as a sale of notes rather than a transfer to a grantor trust. Nonetheless, some authorities have had difficulty reconciling the conclusion of this memorandum with that reached in Technical Advice Memorandum 98-39-001.<sup>143</sup>

In Field Service Advice Memorandum 200130009, the Service examined a trust established by a bank holding a pool of loans secured by

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<sup>136</sup> *See id.*

<sup>137</sup> *Id.* (citing *Thor Power Tool Co. v. Comm’r*, 439 U.S. 522 (1979)).

<sup>138</sup> *Id.*

<sup>139</sup> *See id.*

<sup>140</sup> *Id.*

<sup>141</sup> *Id.*

<sup>142</sup> *See* I.R.S. Tech. Adv. Mem. 98-40-001 (Oct. 2, 1998).

<sup>143</sup> *See, e.g.,* KRAVITT, *supra* note 18, § 10.03[D][3] n.272.

second mortgages.<sup>144</sup> The trust issued four classes of notes, all of which were supported by an additional, subordinate class of notes and two classes of trust instruments held by the bank itself.<sup>145</sup> Contrary to the bank's argument, the Service found that the notes constituted ownership interests in the trust rather than secured debt supported by the mortgages.<sup>146</sup> Although the Service acknowledged that the bank, as holder of the most junior classes of notes, retained most of the credit risk associated with the notes, it noted that "mortgage loans carry not only credit risk but also prepayment risk" and that, because the payments on the loans determined the payments on the notes, the "[b]ank has transferred a large part of the prepayment risk associated with the mortgage loans."<sup>147</sup>

By looking at Technical Advice Memorandum 98-39-001 and Field Service Advice Memorandum 200130009 together, we can identify which factors are particularly relevant in determining whether a credit card securitization constitutes a loan or a sale.<sup>148</sup> Most of the factors listed in

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<sup>144</sup>I.R.S. Field Serv. Adv. Mem. 200130009 (July 27, 2001). Field Service Advice Memoranda, like Technical Advice Memoranda, are taxpayer-specific rulings furnished by the IRS National Office in response to requests made by taxpayers or Service officials. Unless otherwise established by regulation, Field Service Advice memoranda "may not be used or cited as precedent." I.R.C. § 6110(k)(3) (West 2009).

<sup>145</sup>See I.R.S. Field Serv. Adv. Mem. 200130009 (July 27, 2001).

<sup>146</sup>See *id.*

<sup>147</sup>*Id.* The Service also concluded in the Field Service Advice Memorandum that the form of the transaction constituted a sale:

This appears to be based on a failure to understand the distinction between the transfer of the mortgage loans to the trust, which unquestionably was in form a sale (as is necessary to achieve sale treatment for financial accounting purposes) and the transactions between the trust and the investors in the notes, which were in form borrowings by the trust.

GARLOCK, *supra* note 52, at 1056 (citations omitted). The Service then concluded that "the sale from the Bank to the trust should have no effect for tax purposes because the Bank owns the trust and transactions between a taxpayer and its wholly owned trust (or other noncorporate entity) are disregarded for tax purposes." *Id.* Despite the fact that the Field Service Advice Memorandum represents the Service's current stance, "[t]he marketplace and IRS examining agents have virtually ignored FSA 200130009," perhaps because the National Office reportedly reversed its position shortly after release of the Field Service Advice Memorandum. *Id.* According to Garlock, "[a]lthough the IRS did not signal that reversal in a published document [i.e., did not revoke or revise], the lack of subsequent follow-up (e.g., a TAM, a docketed case, or similar examinations of other securitizations) is telling." *Id.* at 1056-57.

<sup>148</sup>See generally I.R.S. Field Serv. Adv. Mem. 200130009 (July 27, 2001); I.R.S. Tech. Adv. Mem. 98-39-001 (Sept. 25, 1998).

Technical Advice Memorandum 98-39-001, such as whether the accountholders were notified of the transfer and whether payments corresponded with collections, could also apply to credit card securitizations.<sup>149</sup> Presumably, however, the most important factor in determining whether a loan or a sale has taken place is the same for auto loan securitizations and credit card securitizations, namely which party bears the risk of loss and has the potential for gain.<sup>150</sup>

The risk of loss for an auto loan securitization depends on the rates of both default and prepayment, and Field Service Advice Memorandum 200130009 indicates that a securitization that takes into account the risk presented by only one of these rates may be recharacterized as a sale.<sup>151</sup> However, Technical Advice Memorandum 98-39-001 recognizes that a securitization may be treated as a loan for tax purposes even if it does not protect against the “catastrophic” risk posed by “extreme economic consequences.”<sup>152</sup>

#### *D. Tax Treatment of Credit Card Securitizations*

When viewed alongside prior cases and rulings, credit card securitizations clearly should be treated as issuances of debt rather than equity.<sup>153</sup> Credit card securitizations fall into the traditional definition of

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<sup>149</sup> See I.R.S. Tech. Adv. Mem. 98-39-001 (Sept. 25, 1998).

<sup>150</sup> See *id.*; KOTHARI, *supra* note 5, at 387.

<sup>151</sup> See I.R.S. Field Serv. Adv. Mem. 200130009 (July 27, 2001).

<sup>152</sup> See I.R.S. Tech. Adv. Mem. 98-39-001 (Sept. 25, 1998).

<sup>153</sup> See PEASLEE & NIRENBERG, *supra* note 12, at 136. Peaslee and Nirenberg base their conclusion on several primary factors:

- (1) the economic resemblance of the trust certificates to traditional debt (fixed principal amount, fixed interest rate or fixed spread over a common interest rate index, and the low risk of nonpayment), (2) the concentration of entrepreneurial risk or rewards in the sponsor (credit risk retained by the sponsor through subordination of excess spread, retention of balance of excess spread which can change significantly over time reflecting market conditions, risk of fluctuations in receivables balances absorbed by the sponsor through expanding and contracting the sponsor's interest, and costs of servicing born by sponsor), (3) the retention of control over the receivables by the sponsor (including the right to change the economic terms of the receivables and in some cases to remove them from the pool), and (4) the intention of the parties to treat the certificates as debt.

*Id.* They note that debt classification may become doubtful if some of the subordinated classes of certificates do not receive a high enough credit rating. *Id.*

debt because they represent “an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest” rather than an investment in which the investor takes on both the risk of loss and the potential for profit.<sup>154</sup> Most importantly when analyzing a transfer of receivables, the issuer retains the risk of loss and potential for gain, also referred to as the benefits and burdens of ownership, in a credit card securitization.<sup>155</sup> The terms of the securitization and the credit enhancement accompanying the deal ensure that the investor will be paid the amount specified, as well as interest set at a predetermined rate, based on a schedule set at the time the deal is made.<sup>156</sup>

Like the auto loan securitization at stake in Technical Advice Memorandum 98-39-001, default and prepayment rates in a typical credit card securitization would have to increase dramatically before the reserve account and other forms of credit support would be insufficient to cover shortfalls.<sup>157</sup> In addition, the fact that the issuer retains a residual interest in the trust ensures that it, rather than investors, stands to lose should the receivables provide a less than expected rate of return.<sup>158</sup> In other words, investors in the securitization will be paid regardless of when (or if) payments are made on the receivables.<sup>159</sup> Conversely, because the investor’s return on his investment in the securitization is limited to a predetermined interest rate, any amounts collected in excess of that amount are returned to the issuer.<sup>160</sup> Finally, the parties to a credit card securitization clearly intend to treat the instrument as debt for tax purposes, as the bank and the investors agree to treat them as such in the documents related to the transaction.<sup>161</sup>

Credit card securitizations share other factors with the transactions that were characterized as debt in other cases and rulings.<sup>162</sup> For example, cardholders rarely, if ever, are aware that the receivables on their accounts

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<sup>154</sup> GARLOCK, *supra* note 52, at 1015 (citing *Gilbert v. Comm’r*, 248 F.2d 399, 402 (2d Cir. 1957)); *see also* KRAVITT, *supra* note 18, § 10.03[C][1].

<sup>155</sup> *See* KRAVITT, *supra* note 18, § 10.03[D][5][a].

<sup>156</sup> *See* PEASLEE & NIRENBERG, *supra* note 12, at 134.

<sup>157</sup> *See* I.R.S. Tech. Adv. Mem. 98-39-001 (Sept. 25, 1998).

<sup>158</sup> *See* KOTHARI, *supra* note 5, at 390.

<sup>159</sup> *See id.*

<sup>160</sup> *See* Schorin, *supra* note 38, at 156.

<sup>161</sup> PEASLEE & NIRENBERG, *supra* note 12, at 135.

<sup>162</sup> *See* *United Surgical Steel Co. v. Comm’r*, 54 T.C. 1215, 1229–30 (1970); I.R.S. Tech. Adv. Mem. 98-39-001 (Sept. 25, 1998); I.R.S. Gen. Couns. Mem. 34,602 (Sept. 9, 1971).

have been securitized, since investors can only look to the securitization vehicle for payment. This factor was cited as supporting characterization as debt in *United Surgical Steel*, Technical Advice Memorandum 98-39-001 and General Counsel Memorandum 34,602.<sup>163</sup> In addition, the issuer often acts as servicer on the accounts and is subject to restrictions similar to those found in *United Surgical Steel* to be “wholly inconsistent” with sale characterization.<sup>164</sup> Payments on the receivables do not match payments made to investors, further suggesting that the investor has not received an interest in the receivables themselves.<sup>165</sup>

The instruments issued as part of a securitization are nonrecourse, which means that investors cannot look to the issuer for payment. While this normally is indicative of a sale, this presumption may be overcome by other facts and circumstances.<sup>166</sup> And even though credit card securitizations, like the auto loan securitization described in Technical Advice Memorandum 98-39-001, may be exposed to “catastrophic risk” that occurs during “extreme economic conditions,” the Service considered such catastrophic risk to be “more theoretical than real” and therefore consistent with debt.<sup>167</sup> Technical Advice Memorandum 98-39-001, unlike Notice 94-47, also found accounting treatment of the transaction irrelevant when determining the tax treatment of a securitization, noting that “GAAP . . . cannot affect federal income tax rules unless specifically made controlling.”<sup>168</sup>

Credit card securitizations are easily distinguishable from the transaction at issue in Technical Advice Memorandum 98-40-001, since the transferor in that case sought sale treatment.<sup>169</sup> While credit card securitizations share some characteristics with the transaction at issue in Field Service Advice Memorandum 200130009, which also found that a sale rather than a loan had taken place, a Field Service Advice Memorandum is not considered binding precedent, and the Service does not appear to have followed this particular Field Service Advice Memorandum

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<sup>163</sup> See *United Surgical Steel*, 54 T.C. at 1229–30 (1970); I.R.S. Tech. Adv. Mem. 98-39-001 (Sept. 25, 1998); I.R.S. Gen. Couns. Mem. 34,602 (Sept. 9, 1971).

<sup>164</sup> See *United Surgical Steel*, 54 T.C. at 1230.

<sup>165</sup> See KRAVITT, *supra* note 18, § 4.03[C].

<sup>166</sup> See I.R.S. Notice 94-47, 1994-1 C.B. 357, 357; I.R.S. Tech. Adv. Mem. 98-39-001 (Sept. 25, 1998).

<sup>167</sup> I.R.S. Tech. Adv. Mem. 98-39-001 (Sept. 25, 1998).

<sup>168</sup> *Id.*

<sup>169</sup> See I.R.S. Tech. Adv. Mem. 98-40-001 (Oct. 2, 1998).



when analyzing transfers of receivables.<sup>170</sup>

The greatest threat to the taxation of credit card securitizations as debt may come from Notice 94-47, although upon closer inspection many of the factors listed in the Notice are of limited usefulness in evaluating these transactions.<sup>171</sup> Although Notice 94-47 lists thin capitalization as a relevant factor in determining whether an instrument constitutes debt or equity, the Notice acknowledges that the situation may become more complicated when the issuer is a special purpose vehicle and notes that the transaction may still be considered a loan if “the risks of the pool are concentrated in one class through subordination.”<sup>172</sup> Notice 94-47 also lists the label given to the instrument by the parties as a relevant factor. As discussed further below, the instruments issued in a credit card securitization generally are labeled certificates, suggesting a sale, although some later securitizations have issued instruments labeled notes, indicating a loan.<sup>173</sup> Finally, Notice 94-47 also considers whether the instruments issued as part of the transaction are treated as debt or equity for non-tax purposes, although, as discussed below, this factor ultimately should be of little, if any, relevance.<sup>174</sup>

In sum, an analysis of all the features relevant to a debt-equity analysis reveals that a credit card securitization, at least in its typical form, should be treated as debt rather than equity for tax purposes.<sup>175</sup> Of course, none of this is to say that all credit card securitization should be taxed automatically as debt.<sup>176</sup> For example, if a credit card issuer transfers only a minimal amount of receivables to the securitization trust (i.e., does not provide much overcollateralization), the trust may be thinly capitalized, which suggests that the transaction should be characterized as equity rather than debt.<sup>177</sup> However, the typical credit card securitization described above should possess almost all the characteristics listed as being consistent with debt and

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<sup>170</sup> See GARLOCK, *supra* note 52, at 1056–57.

<sup>171</sup> See I.R.S. Notice 94-47, 1994-1 C.B. 357, 357.

<sup>172</sup> PEASLEE & NIRENBERG, *supra* note 12, at 108.

<sup>173</sup> I.R.S. Notice 94-47, 1994-1 C.B. 357, 357; *see infra* Part V.C.

<sup>174</sup> I.R.S. Notice 94-47, 1994-1 C.B. 357, 357.

<sup>175</sup> See I.R.S. Notice 94-47, 1994-1 C.B. 357, 357; PEASLEE & NIRENBERG, *supra* note 12, at 136.

<sup>176</sup> See I.R.S. Notice 94-47, 1994-1 C.B. 357, 357; PEASLEE & NIRENBERG, *supra* note 12, at 136.

<sup>177</sup> See I.R.S. Notice 94-47, 1994-1 C.B. 357, 357; PEASLEE & NIRENBERG, *supra* note 12, at 136.

therefore should be treated as such for tax purposes.<sup>178</sup>

Despite the similarities between credit card securitizations and other transactions that have been treated as debt for tax purposes, the danger remains that the Service may challenge their characterization as debt and argue that they should be taxed as equity instead.<sup>179</sup> The Service may pay closer attention to these transactions as some issuers begin to default on their credit card securitizations.<sup>180</sup> Moreover, credit card securitizations utilize special purpose vehicles to hold their receivables; the use of special purpose vehicles has come under particular scrutiny ever since their infamous role in the demise of Enron.<sup>181</sup> Thus, even as securitizations in general have been criticized in light of the recent economic crisis, credit card securitizations have become particularly vulnerable to attack from the Service.<sup>182</sup>

Should the Service choose to challenge the treatment of credit card securitizations as debt for tax purposes, they may turn to what has come to be known as “the *Danielson* Rule,” which places strong limitations on a taxpayer’s ability to challenge the form of its own transaction.<sup>183</sup> This rule, as well as a variant referred to as the strong proof rule, are described in detail in the following section.<sup>184</sup>

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<sup>178</sup> See I.R.S. Notice 94-47, 1994-1 C.B. 357, 357; PEASLEE & NIRENBERG, *supra* note 12, at 136.

<sup>179</sup> PEASLEE & NIRENBERG, *supra* note 12, at 131.

<sup>180</sup> In 2002, NextBank was required to close its credit card accounts and, as a result, holders of its lower rated notes did not receive interest and lost about half the principal on their investments; some of these bondholders later filed suit against the Federal Deposit Insurance Company. *Bank of New York Granted Judgment on Pleadings as to FDIC’s Counterclaims in Interpleader Action*, N.Y. L.J., April 11, 2008, at 35. Also in 2002, two credit card securitizations issued by Spiegel Corporation were subject to an early amortization due to the declaration of a payout event. Mark Adelson, *2Q02 Sees Substantial Developments in Credit Card ABS*, ASSET SECURITIZATION REP., July 22, 2002, at 6, 7. Although the declaration was later rescinded, allowing Spiegel Corporation to avoid early amortization for the two transactions, the company filed for Chapter 11 Bankruptcy protection the following year. *Will Spiegel Survive Chapter 11?*, MULTICHANNEL MERCHANT, Apr. 15, 2003, at 5. More recently, on May 11, 2009, Advanta Corporation announced that it would unwind its credit card securitization vehicle and stop lending to account holders, leading to concerns about the future of card-backed securities. Harry Terris, *Will Advanta Plan Spook Market for Card Paper?*, AM. BANKER, May 13, 2009, at 1.

<sup>181</sup> See KOTHARI, *supra* note 5, at 633.

<sup>182</sup> See *id.* at 113.

<sup>183</sup> See *Comm’r v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967).

<sup>184</sup> See *infra* Part IV.A–E.

IV. *DANIELSON* AND THE STRONG PROOF RULE

The *Danielson* rule places limits on the tax precept that substance prevails over form by requiring a taxpayer who wishes to challenge the tax consequences of his characterization of an agreement to present “proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc.”<sup>185</sup> An alternative to the *Danielson* rule, called the strong proof rule, also limits a taxpayer’s ability to challenge the tax consequences of its transaction, although it merely requires “strong proof” that the taxpayer’s characterization is in fact the correct one.<sup>186</sup> This section first explains the principle of substance over form and then describes both the *Danielson* rule and the strong proof rule in more detail, including their history and the policies underlying the rules.<sup>187</sup> Finally, this section explains how the two rules may affect the taxation of credit card securitizations.<sup>188</sup>

A. *Substance over Form*

For almost seventy years, taxing authorities have adhered to the principle that “the incident of taxation depends on the substance of the transaction.”<sup>189</sup> In other words, “[t]he Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute.”<sup>190</sup>

Under this doctrine, often referred to as substance-over-form, authorities may recharacterize a transaction to comply with its true substance when

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<sup>185</sup> *Id.* at 775.

<sup>186</sup> *Ullman v. Comm’r*, 264 F.2d 305, 308 (2d Cir. 1959).

<sup>187</sup> See *infra* Part IV.A–E.

<sup>188</sup> See *infra* Part IV.E.

<sup>189</sup> *Comm’r v. Court Holding Co.*, 324 U.S. 331, 334 (1945); Christian A. Johnson, *The Danielson Rule: An Anodyne for the Pain of Reasoning*, 89 COLUM. L. REV. 1320, 1326 (1989) (citing *Gregory v. Helvering*, 293 U.S. 465 (1935); Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859, 863 (1982) (book review)).

<sup>190</sup> *Higgins v. Smith*, 308 U.S. 473, 477 (1940); see also *Saviano v. Comm’r*, 765 F.2d 643, 654 (7th Cir. 1985) (“The Commissioner and the courts are empowered, and in fact duty-bound, to look beyond the contrived forms of transactions to their economic substance and to apply the tax laws accordingly”); Rev. Rul. 2000-12, 2000-1 C.B. 744, 745.

such substance is contrary to its outward form.<sup>191</sup> Recharacterization is warranted when the taxpayer realizes nothing of substance beyond a tax benefit and has no substance or purpose aside from his desire to receive such benefit.<sup>192</sup> Recharacterization may be further justified when, in addition to a lack of business purpose, no reasonable possibility of turning a profit from the transaction exists.<sup>193</sup>

Although the substance over form doctrine provides the Service with a strong weapon to use against taxpayers, this weapon is not invincible.<sup>194</sup> Even though the Service is authorized, and arguably even duty-bound,<sup>195</sup> “to disregard transactions which are designed to manipulate the Tax Code so as to create artificial tax deductions,” it may not disregard those transactions “which result in actual, non-tax related changes in economic position.”<sup>196</sup> Furthermore, a choice made between two equally valid forms for tax reasons does not necessarily violate the principle of substance over form and therefore must be respected.<sup>197</sup>

Usually, when a transaction is recharacterized due to a difference between substance and form, the transaction will be taxed differently than the taxpayer originally desired.<sup>198</sup> Occasionally, however, the taxpayer rather than the Service may attempt to argue both that a transaction’s substance differs from its form and that the transaction should be taxed on its substance rather than its form.<sup>199</sup> In these cases, both the taxing authorities and the courts generally have abandoned their previous

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<sup>191</sup> See *United States v. Ingalls*, 399 F.2d 143, 145 (5th Cir. 1968).

<sup>192</sup> See *Knetsch v. United States*, 364 U.S. 361, 366 (1960); see also *ACM P’ship v. Comm’r*, 157 F.3d 231, 249 n.33 (3d Cir. 1998) (discussing contingent installment sales).

<sup>193</sup> See *Rice’s Toyota World, Inc. v. Comm’r*, 752 F.2d 89, 94 (4th Cir. 1985).

<sup>194</sup> See, e.g., *Frank Lyon Co. v. Comm’r*, 435 U.S. 561, 583–84 (1978) (“[W]here, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties . . .”).

<sup>195</sup> See *Comm’r v. State-Adams Corp.*, 283 F.2d 395, 398–99 (2d Cir. 1960) (“[T]he Commissioner, to prevent unfair tax avoidance, has greater freedom and responsibility to disregard the [form of a transaction] than a taxpayer . . .”).

<sup>196</sup> *N. Ind. Pub. Serv. Co. v. Comm’r*, 115 F.3d 506, 512 (7th Cir. 1997).

<sup>197</sup> See *United Parcel Serv. of Am., Inc. v. Comm’r*, 254 F.3d 1014, 1019 (11th Cir. 2001).

<sup>198</sup> See *Laidlaw Transp. Inc. v. Comm’r*, 75 T.C.M. (CCH) 2598, 2624 (1998); Johnson, *supra* note 189, at 1326 (citing Bittker, *Pervasive Judicial Doctrines in the Construction of the Internal Revenue Code*, 21 HOW. L.J. 693, 703–13 (1978)).

<sup>199</sup> Johnson, *supra* note 189, at 1326.

commitment to the principle that substance trumps form.<sup>200</sup> The courts' reluctance to adopt substance over form at the taxpayer's behest was outlined in the case *Commissioner v. Danielson*, which held that a taxpayer cannot disavow the form of its transaction by stating that the form of the transaction differs from its substance unless he can show the transaction itself is illegitimate.<sup>201</sup>

### B. Commissioner v. Danielson

In *Danielson*, an investment corporation purchased the common stock of shareholders in an unrelated company.<sup>202</sup> As part of the sale, each shareholder signed a covenant not to compete with the new company, and the purchase agreement allocated a value of \$152 per share to that covenant.<sup>203</sup> Although the buying corporation deducted this amount from its income on its tax return, the selling shareholders did not allocate any amount of the purchase price to the covenant, instead reporting the entire purchase price as a capital asset resulting from the sale of the shares.<sup>204</sup> The Commissioner challenged the shareholders' characterization of the purchase price and recharacterized that portion of the purchase price that had been allocated in the agreement to the covenant.<sup>205</sup> The Tax Court agreed with the shareholders, finding that they had produced strong proof that the covenants were not the result of a realistic bargain between the shareholders

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<sup>200</sup> See *State-Adams Corp.*, 283 F.2d at 398–99; Johnson, *supra* note 189, at 1326.

<sup>201</sup> See *Comm'r v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967).

<sup>202</sup> See *id.* at 773.

<sup>203</sup> See *id.*

<sup>204</sup> See *id.* Under rules that were in place prior to 1993, payments attributable to a covenant not to compete, like the one at issue in *Danielson*, were ordinary income to the seller, but could be amortized by the buyer. Conversely, if the amount paid for the covenant was attributed to goodwill instead, then it was capital gain to the seller and could not be amortized by the buyer. See *Ullman v. Comm'r*, 264 F.2d 305, 307–08 (2d Cir. 1959). An issue arose because the seller, who did not want to recognize the covenant as ordinary income, sometimes would argue that the amount received should be attributed entirely to the purchase price of the company and that the price originally assigned to the covenant was “simply a fictitious allocation designed to benefit the tax position of the buyer.” See *id.* at 308. Lacking outside signifiers, the court relied on the parties to come up with an equitable allocation: “The tax avoidance desires of the buyer and seller [when dealing with a covenant not to compete] are ordinarily antithetical, forcing them, in most cases, to agree upon a treatment which reflects the parties’ true intent with reference to the covenants, and the true value of them in money.” See *id.*

<sup>205</sup> See *Danielson*, 378 F.2d at 773–74.

and the corporation and therefore had no value.<sup>206</sup> However, the Third Circuit vacated and remanded the Tax Court's decision, finding that the shareholders had failed to present evidence indicating that the allocation was not the result of a conscious agreement between the parties<sup>207</sup> (although, by remanding the case, the court left open the possibility that the taxpayers could still present sufficient evidence to uphold their characterization).<sup>208</sup>

The court in *Danielson* cited various reasons why a taxpayer should face a heavier burden than the Commissioner when arguing that the substance of a transaction does not follow its form.<sup>209</sup> First, if a party is allowed to negate the consequences of its own agreement, that party has arguably been unjustly enriched. Such a result could promote litigation by encouraging parties "to an admittedly valid agreement to use the tax laws to obtain relief from an unfavorable agreement."<sup>210</sup> Second, such attacks on the form of a transaction "would nullify the reasonably predictable tax consequences of the agreement to the other party thereto."<sup>211</sup> In other words, the Service, upon losing the revenue it expected to receive from one side of the transaction, could attempt to recover that loss from the other side.<sup>212</sup> Because the other party would be forced to defend the agreement and, if unsuccessful, would lose a tax advantage that it had bargained for as part of the transaction, future transactions could be endangered by parties

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<sup>206</sup> See *id.* at 774.

<sup>207</sup> See *id.* at 778–79.

<sup>208</sup> See *id.* at 777.

<sup>209</sup> See *id.* at 775.

<sup>210</sup> *Id.* See also *N. Am. Rayon Corp. v. Comm'r*, 12 F.3d 583, 587–88 (6th Cir. 1993) ("Not only does the *Danielson* rule provide certainty to the Commissioner, it also provides a higher level of certainty to the taxpayer by maintaining 'the reasonably predictable tax consequences' of agreements. . . . The *Danielson* rule [increases] the predictability of tax results by preventing one party to an agreement from unilaterally reforming the agreement for tax purposes"); *Spector v. Comm'r*, 641 F.2d 376, 385 (5th Cir. Unit A Apr. 1981) ("[T]o the extent that the Tax Court's approach rewards a taxpayer's intentional misrepresentation to the Commissioner of the true nature of a transaction, it is not desirable from a policy standpoint."); *Ill. Power Co. v. Comm'r*, 87 T.C. 1417, 1431–32 (1986) (applying the strong proof rule to prevent taxpayers from changing form because doing so "would . . . create uncertainty in that taxpayers at their whim could choose to respect or not respect transactions depending on which approach would most favor their position at trial.").

<sup>211</sup> *Danielson*, 378 F.2d at 775.

<sup>212</sup> See *id.*

unwilling to bargain for tax savings that may never materialize.<sup>213</sup>

In order to demonstrate that a transaction's form is illegitimate under *Danielson*, the taxpayer must provide "evidence of such extreme character as to invalidate the agreement itself and thus render it unenforceable."<sup>214</sup> In order to clear this hurdle, the taxpayer must demonstrate more than the fact "that the explicit allocation had no independent basis in fact or arguable relationship with business reality."<sup>215</sup> Furthermore, a taxpayer may only argue that substance differs from form if "tax reporting and other actions have shown an honest and consistent respect for" the substance of the transaction and may not simply claim that "the parties to the transaction did not follow all of the formalities that might be considered probative . . . ."<sup>216</sup>

### C. Strong Proof Rule

Although the Third,<sup>217</sup> Fifth,<sup>218</sup> Eleventh,<sup>219</sup> and Federal Circuits,<sup>220</sup> have adopted *Danielson*, some courts have criticized *Danielson* on the basis that

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<sup>213</sup>*Id.* See also *Schatten v. Comm'r*, 746 F.2d 319, 322 (6th Cir. 1984) ("If parties in Mr. Schatten's position cannot depend upon [the agreement] but instead learn that they face potentially dramatic increases in their federal income tax liabilities . . . then such agreements will not be entered into.").

<sup>214</sup>*Schmitz v. Comm'r*, 51 T.C. 306, 317 (1968). See also *N. Am. Rayon*, 12 F.3d at 589 (finding that lack of negotiation alone was insufficient to show contract was unenforceable).

<sup>215</sup>*Sullivan v. United States*, 618 F.2d 1001, 1006 (3d Cir. 1980) (quoting *Danielson*, 378 F.2d at 777).

<sup>216</sup>*Taiyo Haw. Co. v. Comm'r*, 108 T.C. 590, 602 (1997). In *Spector v. Commissioner*, for example, the taxpayer argued that he had sold his interest in a partnership, while the government argued that, based on the partnership agreement, the taxpayer in fact had liquidated his interest. *Spector v. Comm'r*, 641 F.2d 376, 379–80 (5th Cir. Unit A Apr. 1981). The court agreed with the government, noting that "a taxpayer, having voluntarily and at arm's length bargained for a particular form of transaction, with complete foreknowledge of the tax consequences flowing therefrom, and having represented to the Commissioner that the chosen form reflected the true nature of the transaction," should not be allowed "to disavow that form as a sham designed for the sole purpose of misleading the Commissioner, and, having already received substantial nontax benefits therefrom, adopt one with more favorable present tax consequences." *Id.* at 384. Peaslee and Nirnberg note that such honest and consistent reporting, at least by taxpayers, is encouraged by § 385(c) of the Code, which generally binds parties to a transaction to the issuer's characterization of the transaction. PEASLEE & NIRENBERG, *supra* note 12, at 141.

<sup>217</sup>See *Danielson*, 378 F.2d at 775.

<sup>218</sup>See *Insilco Corp. v. United States*, 53 F.3d 95, 97–98 (5th Cir. 1995) (discussing the purchase of stock).

<sup>219</sup>See *Bradley v. United States*, 730 F.2d 718, 720 (11th Cir. 1984).

<sup>220</sup>See *Stokely-Van Camp, Inc. v. United States*, 974 F.2d 1319, 1325 (Fed. Cir. 1992).

to adopt it “would be to endorse a formalistic policy akin to caveat emptor by announcing that [courts] will no longer permit the showing of strong proof to realign the lopsided tax consequences produced by an agreement having no rational basis with economic or business reality.”<sup>221</sup> In response, these courts have adopted what has come to be known as the “strong proof” rule instead.<sup>222</sup> The debate over whether to adopt *Danielson* or the strong proof rule has been characterized as a debate between the need for “an efficient and orderly administration of the tax laws and the need to ensure flexibility and fairness in individual cases.”<sup>223</sup>

Under the strong proof rule, once taxpayers have agreed to a particular tax treatment for a transaction, “strong proof must be adduced by them in order to overcome that declaration.”<sup>224</sup> Under this rule, the taxpayer must provide strong proof not only that the parties intended for the transaction’s substance to prevail over its form but also that this substance is consistent with the economic reality of the transaction.<sup>225</sup> The strong proof rule, like the *Danielson* rule, is grounded in the idea that the taxpayer, unlike the

<sup>221</sup> *Schmitz v. Comm’r*, 51 T.C. 306, 316 (1968).

<sup>222</sup> The Tax Court has generally followed the strong proof rule. See, e.g., *Pac. Gamble Robinson & Affiliated Cos. v. Comm’r*, 54 T.C.M. (CCH) 915, 921 (1987) (citing *Ullman v. Comm’r*, 264 F.2d 305, 308 (2d Cir. 1959)); *G C Servs. Corp. v. Comm’r*, 73 T.C. 406, 415 (1979) (rejecting taxpayer’s attempt to show that form of settlement allocation did not conform to its substance); *Penn-Dixie Steel Corp. v. Comm’r*, 69 T.C. 837, 841 (1978) (rejecting taxpayer’s attempt to recharacterize transaction as a sale despite the fact that it was not in form a sale); *Lucas v. Comm’r*, 58 T.C. 1022, 1038 (1972) (denying taxpayer’s claim that purchase agreement included covenant not to compete); *Schmitz*, 51 T.C. at 316 (citing *Ullman*, 264 F.2d at 308); *Mittleman v. Comm’r*, 56 T.C. 171, 175 (1971) (rejecting taxpayer’s attempt to recharacterize gain resulting from liquidated damages). See also *Schulz v. Comm’r*, 294 F.2d 52, 55 (9th Cir. 1961). However, under what has been termed the *Golsen* rule, the Tax Court is required to follow the rules of the circuit where an appeal would lie. See *Golsen v. Comm’r*, 54 T.C. 742, 757 (1970). However, in some cases the Tax Court may decline to apply the *Danielson* rule even when required under the *Golsen* rule, where the policy considerations underlying the rule are inapplicable. See, e.g., *Strick Corp. v. United States*, 714 F.2d 1194, 1206 (3d Cir. 1983); *Comdisco, Inc. v. United States*, 736 F.2d 569, 578 (7th Cir. 1985).

<sup>223</sup> See *Spector v. Comm’r*, 641 F.2d 376, 384, 386 (5th Cir. Unit A Apr. 1981) (“[I]n contrast to the Tax Court’s application of the ‘strong proof’ rule in the present case, the prior decisions of this Court reveal a concern for the type of equitable considerations that traditionally have been invoked when determining whether a party to a transaction may, in fairness, be held to its obligations arising thereunder.”).

<sup>224</sup> *Ullman*, 264 F.2d at 308. See also *Utley v. Comm’r*, 906 F.2d 1033, 1038–39 (5th Cir. 1990); *Coleman v. Comm’r*, 87 T.C. 178, 202 (1986); *Ill. Power Co. v. Comm’r*, 87 T.C. 1417, 1434 (1986).

<sup>225</sup> *Major v. Comm’r*, 76 T.C. 239, 247 (1981).



Commissioner, was free to choose the form of the agreement and therefore should be held to a higher standard when he attempts to challenge the form that he chose.<sup>226</sup>

Unlike the *Danielson* rule, which requires the taxpayer to show that the agreement itself is invalid, the strong proof rule focuses on “whether the [transaction] bears ‘economic reality’ to the circumstances surrounding the transaction, i.e., whether the allocation . . . bears some relationship to its actual value.”<sup>227</sup> Courts applying the strong proof rule, like those that apply the *Danielson* rule, are in part concerned with the danger of parties “whipsawing” the Commissioner by taking inconsistent tax positions.<sup>228</sup> They are also concerned with the possibility of a taxpayer who disavows the form of a transaction achieving “a unilateral reformation of the contract and a present tax advantage.”<sup>229</sup>

Courts have often struggled with the definition of “strong proof” and appear reluctant to strictly define the term, preferring instead to apply the rule on a case by case basis.<sup>230</sup> While the Tax Court has stated that strong proof consists of proof “beyond a mere preponderance of the evidence,”<sup>231</sup> the First Circuit has defined strong proof as something closer to “the ‘clear and convincing’ evidence required to reform a written contract on the ground of mutual mistake.”<sup>232</sup> Under this standard, the party seeking to disavow form “must show a meeting of minds different from that professed in the written instrument—a showing that bears a family resemblance to the

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<sup>226</sup> See *Spector*, 641 F.2d at 386. See also *Estate of Rogers v. Comm’r*, 29 T.C.M. (CCH) 869, 873 (1970) (“The Commissioner must be permitted to go beyond mere form to substance in order to protect the revenue; but taxpayers have the opportunity at the outset to choose the most advantageous arrangement.”); *Levinson v. Comm’r*, 45 T.C. 380, 389 (1966) (“While neither the Commissioner nor the courts are bound by the form in which the parties clothe the transaction, where the dispute is between the parties to the agreement themselves, and it is apparent that the provision for the [transaction] was agreed upon by both parties with a full understanding of the implications thereof, the courts are reluctant to go beyond the terms of the agreement.”(citations omitted)).

<sup>227</sup> *Spector*, 641 F.2d at 383. See also *O’Callaghan v. Comm’r*, 47 T.C.M. (CCH) 1661, 1665 (1984) (“The focus of our inquiry is on whether the allocation possesses economic reality and whether petitioner in fact agreed to it.”).

<sup>228</sup> See, e.g., *Spector*, 641 F.2d at 385; *Johnson*, *supra* note 189, at 1323.

<sup>229</sup> *Estate of Rogers*, 29 T.C.M. (CCH) 869, 873 (1970); *Johnson*, *supra* note 189, at 1324.

<sup>230</sup> See *Muskat v. United States*, 554 F.3d 183, 191 (1st Cir. 2009) (“The phrase ‘strong proof’ is not self-elucidating.”).

<sup>231</sup> *Major v. Comm’r*, 76 T.C. 239, 247 (1981).

<sup>232</sup> *Muskat*, 554 F.3d at 191.

showing required for the reformation of a contract.”<sup>233</sup>

Some courts applying the strong proof rule have found that a taxpayer has not provided strong proof that the substance of a transaction differs from its form when the intent of the parties, as evidenced by the agreement, supports the original form of the transaction.<sup>234</sup> However, a court applying the strong proof rule may be more inclined to look not only at the facts and circumstances surrounding the transaction but also the relative sophistication of the parties involved.<sup>235</sup> Although the sources of “strong proof” may vary from case to case, the court may be particularly interested in the negotiations leading up to the written agreement.<sup>236</sup>

Taxpayers facing the strong proof rule rather than the *Danielson* rule may be more successful in arguing that a transaction should be taxed based on its substance rather than its form.<sup>237</sup> The taxpayer even may be able to disavow the form of his transaction despite not showing an “honest and consistent respect for the substance of the transaction”<sup>238</sup> in his tax reporting.<sup>239</sup> Nonetheless, the strong proof rule requires more than a simple

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<sup>233</sup> *Id.* at 191.

<sup>234</sup> *See, e.g.,* *Levine v. Comm’r*, 324 F.2d 298, 300–02 (3d Cir. 1963) (citing *Ullman v. Comm’r*, 264 F.2d 305, 307–08 (2d Cir. 1959)).

<sup>235</sup> *Faris v. Comm’r*, 56 T.C.M. (CCH) 319, 327 (1988), *rev’d*, 937 F.2d 616 (10th Cir. 1991) (unpublished table decision) (finding that taxpayers met the strong proof standard while noting “we attribute [taxpayers’] modus operandi to the informal rural environment and lack of legal assistance in these matters”).

<sup>236</sup> *See Muskut*, 554 F.3d at 191.

<sup>237</sup> *See, e.g.,* *Schmitz v. Comm’r*, 51 T.C. 306, 319–21 (1968), *aff’d sub nom. Thronson v. Comm’r*, 457 F.2d 1022 (9th Cir. 1972) (finding that a partnership dissolution agreement should not have allocated a portion of the payment made to the exiting partner to disavow the form of the transaction as it was laid out in the dissolution agreement).

<sup>238</sup> *See Comdisco Inc. v. United States*, 756 F.2d 569, 578 (7th Cir. 1985); *infra* note 269 and accompanying text.

<sup>239</sup> *See, e.g., Schmitz*, 51 T.C. at 319–21. The court in *Schmitz* found the following elements constituted strong proof: the fact that the exiting partner was in his late fifties (and therefore unlikely to move into the area covered by the covenant in order to compete with the partnership), the exiting partner’s lack of knowledge regarding the existence of the covenant, and the fact that the agreement did not assign any value at all to goodwill, instead assigning all excess value to the covenant. *Id.* at 319–21. In addition, the court found it “highly unlikely that reasonable men who are genuinely concerned with their economic future would bargain for an agreement allocating all of the excess (over the physical assets) of the purchase price to a covenant with no time limit expressly stated.” *Id.* at 321. Arguably, the court in *Schmitz* did not apply even the less stringent strong proof rule, since it favorably cited various cases applying the substance-over-form doctrine and had this to say about them: “We recognize that in many of the above cases the Commissioner

showing of what would be fair or equitable.<sup>240</sup> Instead, the taxpayer must show that the parties in fact agreed on a different figure at the time they entered into the agreement.<sup>241</sup> Moreover, even if a party can show that a written allocation lacked economic reality, the court may be unable to find that the parties intended another allocation instead.<sup>242</sup>

Although jurisdictions may argue over whether *Danielson* or the strong proof rule should be applied, often the result is the same, since the taxpayer generally is unable to clear either the high bar of proving fraud or duress under *Danielson* or the slightly lower bar of providing “strong proof” that substance differs from form.<sup>243</sup> At least one court has noted the likelihood of the same result:

[T]he difference between ‘strong proof’ and proof of ‘unenforceability’ [under *Danielson*] may not be great. What constitutes ‘strong proof’ has not been defined by the courts which have used the phrase. But we perceive the import of the decisions is that the ‘strong proof’ called for would be tantamount to proof that a subterfuge was committed during the negotiations.<sup>244</sup>

Under either test, the taxpayer essentially rejects the form altogether and asks the government to look to the transaction’s substance instead,

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was attacking the form of the transaction, but we see no reason why we should make a distinction on this point.” See *id.* at 315–17. See also *Sonnleitner v. Comm’r*, 598 F.2d 464, 467 n.9 (5th Cir. 1979) (“The *Danielson* rule imposes a heavier burden upon taxpayers challenging agreements than does the *Ullman* rule.”).

<sup>240</sup> See *Leslie S. Ray Ins. Agency, Inc. v. United States*, 463 F.2d 210, 212 (1st Cir. 1972).

<sup>241</sup> For example, the court in *Sonnleitner* found that the taxpayer had not presented strong proof that a covenant not to compete had no value when the buyer “had genuine business reasons for negotiating” such a covenant in light of the seller’s business. *Sonnleitner*, 598 F.2d at 468.

<sup>242</sup> See *Muskat v. United States*, 554 F.3d 183, 192 (1st Cir. 2009) (citing *Harvey Radio Labs., Inc. v. Comm’r*, 470 F.2d 118, 119–20 (1st Cir. 1972)).

<sup>243</sup> See, e.g., *United States v. Fletcher*, No. 06-C-6056, 2008 WL 162758, at \*12–13 (N.D. Ill. Jan. 15, 2008); *Thomas v. Comm’r*, 83 T.C.M. (CCH) 1576, 1583–84 (2002), *aff’d*, 67 F. App’x 582 (11th Cir. 2003) (unpublished table decision) (upholding a purchase price allocation as stated in an agreement and noting “the result is the same under the law in both circuits” applying the *Danielson* rule and those applying the strong proof rule); *Major v. Comm’r*, 76 T.C. 239, 249 (1981) (“[R]egardless of the standard applied [petitioner] has failed to carry its burden.”); *Dodson v. Comm’r*, 52 T.C. 544, 549 (1969) (holding against taxpayer under the strong proof rule, but noting “that under the more stringent ‘*Danielson* rule’ . . . the result would be the same.”).

<sup>244</sup> *Estate of Rogers v. Commissioner*, 29 T.C.M. (CCH) 869, 872–73 (1970), *aff’d*, 445 F.2d 1020 (2d Cir. 1971).

something the government is loath to do other than on its own terms.<sup>245</sup>

#### *D. Policies Underlying Danielson and the Strong Proof Rule*

The *Danielson* rule and strong proof rule are based on the notion that “[t]he circumstances which permit the Internal Revenue Service to look to the substance rather than the form of a transaction in order to seek payment of taxes which would otherwise be due but for the form, does not require the mutuality that [the taxpayer] contends.”<sup>246</sup> In other words, even though the government should be able to claim that the form of a transaction cannot be used to avoid or postpone taxes that are in fact due, “[t]he taxpayer does not have the like right to contend that the form that it has chosen should be ignored so that avoidance or postponement of the tax can be accomplished.”<sup>247</sup>

The Service may be concerned especially with a taxpayer’s potential to disavow the form of a transaction where, as with a covenant not to compete, revenue derived from one side of the transaction may be offset by a deduction provided to the other side of the transaction.<sup>248</sup> However, both

<sup>245</sup> See *id.*; Johnson, *supra* note 189, at 1326; *supra* notes 214–226 and accompanying text.

<sup>246</sup> See *Strick Corp. v. United States*, 714 F.2d 1194, 1206 (3d Cir. 1983).

<sup>247</sup> See *id.*. See also *Harvey Radio Labs., Inc. v. Comm’r*, 470 F.2d 118, 120 (1st Cir. 1972) (“It does not seem unfair that [the Commissioner] should be less strictly bound to its bona fides than are the parties themselves.”).

<sup>248</sup> See, e.g., *Commissioner v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967); *Proulx v. United States*, 40 A.F.T.R.2d (RIA) 77-6168, 77-6171 (Ct. Cl. 1977). See also *Kreider v. Comm’r*, 762 F.2d 580, 587 (7th Cir. 1985) (applying strong proof rule to covenant not to compete); *Leslie S. Ray Ins. Agency, Inc. v. United States*, 463 F.2d 210, 212 (1st Cir. 1972); *Ullman v. Comm’r*, 264 F.2d 305, 308 (2d Cir. 1959). *Danielson* and the strong proof rule were considered especially important when dealing with covenants not to compete:

These rule are necessitated by a general desire to instill a degree of predictability into this area of law [and] guard against a flood of frivolous litigation in cases where one party seeks to obtain a judicial alteration of a contract, freely and knowingly entered into, despite the fact that the other party thereto . . . is willing to accept the terms of the contract as written.

*Major v. Comm’r*, 76 T.C. 239, 247–48 (1981).

Under Section 197 of the Internal Revenue Code, enacted in 1993, both goodwill and covenants not to compete are amortizable over a fifteen-year period, thereby rendering moot the distinction drawn in *Danielson* between a covenant not to compete and goodwill for most transactions. See I.R.C. § 197 (2006). Nonetheless, *Danielson* still has been invoked with respect to the general allocations made in a purchase agreement. See, e.g., *Becker v. Comm’r*, 92 T.C.M. (CCH) 481, 489 (2006) (upholding purchase agreement that allocated entire purchase price to stock and none

the *Danielson* and strong proof rules have been expanded since to other contexts in which a taxpayer attempts to argue that the substance of a transaction differs from its form.<sup>249</sup> For example, the strong proof rule has been applied to leasing transactions when both the lessor and lessee have attempted to receive tax benefits from the transaction<sup>250</sup> and to other

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to covenant not to compete).

<sup>249</sup> See William S. Blatt, *Lost on a One-Way Street: The Taxpayer's Ability to Disavow Form*, 70 OR. L. REV. 381, 434 (1991); Johnson, *supra* note 189, at 1324. See also Sullivan v. United States, 618 F.2d 1001, 1007 (3d Cir. 1980); Dakan v. United States, 492 F.2d 1192, 1199 (Ct. Cl. 1974); United States v. Fletcher, No. 06-C-6056, 2008 WL 162758, at \*9–12 (N.D. Ill. Jan. 15, 2008) (denying partner's claim that her receipt of stock should be disregarded under either the *Danielson* rule or the strong proof rule because the underlying agreement was entered into under duress and undue influence); Estate of Durkin v. Comm'r, 99 T.C. 561, 574 (1992); Coleman v. Comm'r, 87 T.C. 178, 202 (1986), *aff'd*, 833 F.2d 303 (3d Cir. 1987) (unpublished table decision) ("[I]t is clear that the 'strong proof' rule followed by this Court and the more restrictive rule of *Danielson*, apply beyond the confines of allocating payments to a covenant not to compete."); Boseker v. Comm'r, 52 T.C.M. (CCH) 70, 74 (1986) (applying strong proof rule to trust agreement).

<sup>250</sup> If the lessor remains the owner of the property, he may depreciate his interest in the property, while the lessee may deduct the payments made to the lessor as rent. See I.R.C. §§ 162(a)(3), 167(a) (2006). If, on the other hand, the lessee actually receives ownership of the property, such as through a sale or a transfer of the property, then the lessor may no longer depreciate its interest in the property, and the lessee may no longer deduct rental payments. See *id.* § 162(a)(3) (allowing deductions for rental payments only when the taxpayer "has not taken or is not taking title or in which he has no equity"); Coleman, 87 T.C. at 208 (allowing only the owner of the property to depreciate his interest in the property). In some cases, ownership may be difficult to determine because one party may retain some features related to ownership (like a residual interest in the property), while the other party retains the others (like title to the property). See Frank Lyon Co. v. United States, 435 U.S. 561, 572–73, 581–83 (1978). The parties may try to exploit this ambiguity by claiming that a transaction is a lease in one jurisdiction in order to obtain certain foreign tax benefits while later claiming that a transaction is a financing for U.S. tax purposes in order to obtain tax benefits here. See, e.g., Coleman, 87 T.C. at 200–208. Coleman put an end to this practice:

The fact that the purpose underlying the form of the transactions . . . was to take advantage of U.K. rather than U.S. tax laws does not, in our opinion, provide a sufficient foundation for permitting [taxpayers] to disavow that form in order to obtain the benefits of U.S. tax laws.

See Coleman, 87 T.C. at 202–03.

Furthermore, the court noted that limitations on a taxpayer's right to disavow were particularly relevant "where . . . the form of the transaction was adopted . . . in order to achieve a bona fide, permissible tax purpose." *Id.* at 202. The Court explained its ruling:

[T]here is nothing in [prior cases] which compels us to ignore the form of a transaction

situations in which a taxpayer tries to “claim that it is entitled to all of the benefits but not the normal tax detriments that flow” from a transaction.<sup>251</sup> However, *Danielson* and the strong proof rule are not limited to situations in which tax considerations were a factor in the formation of the agreement.<sup>252</sup>

*Danielson* and the strong proof rule may be necessary particularly in situations where legislative policy supports giving the parties flexibility in structuring the tax consequences of their transactions.<sup>253</sup> In such cases, *Danielson* and the strong proof rule may protect taxpayers from each other: “[t]o allow one taxpayer to later challenge the form of the agreement necessarily would endanger and perhaps ultimately defeat the reasonable expectations of the other party, who has proceeded taxwise under the parties’ contract and agreement, as to the tax consequences flowing therefrom.”<sup>254</sup> In other words, “allowing a party unilaterally to vary his agreement for tax purposes, absent evidence that would negate it in an action between the parties, ‘would be in effect to grant at the instance of a party, a unilateral reformation of the contract with a resulting unjust enrichment.’”<sup>255</sup> Permitting taxpayers to attack form in this way “would nullify the reasonably predictable tax consequences” of agreements.<sup>256</sup> Furthermore, “[b]y allowing the government to adopt as conclusive a result agreed to by the parties, *Danielson* provided a more efficient system that also greatly reduced the possibility of litigation . . . aimed at revising the parties’ bargained agreement.”<sup>257</sup>

In addition to gamesmanship, the Service may be concerned with being

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structured to obtain tax benefits in one jurisdiction and to restructure the transaction, at the insistence of the taxpayer, in order to confer tax benefits in another jurisdiction—in short, to enable the taxpayer to play both ends against the middle.

*Id.* at 202–03.

<sup>251</sup> See *Strick*, 714 F.2d at 1206; *Sullivan*, 618 F.2d at 1004.

<sup>252</sup> *Sullivan*, 618 F.2d at 1007 (“[T]he *Danielson* rule appears on its face to apply generally and without limitation to cases in which a party attempts to challenge the tax consequences of his own agreement.”).

<sup>253</sup> See *Spector v. Comm’r*, 641 F.2d 376, 385 (5th Cir. Unit A Apr. 1981). Cf. *Johnson*, *supra* note 189, at 1324 (indicating that some courts have rejected *Danielson* because of contrary legislative intent).

<sup>254</sup> *Spector*, 641 F.2d at 385.

<sup>255</sup> *Sullivan*, 618 F.2d at 1004.

<sup>256</sup> *Id.* (quoting *Comm’r v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967)).

<sup>257</sup> *Id.*

whipsawed, a condition described above as one that occurs when the Service is forced to litigate against both parties to a transaction in order to protect its revenue, with the possible result that the Service loses revenue that logically should have been paid by one of the parties.<sup>258</sup> Prior to *Danielson*, “[s]ince parties to . . . transactions were free to advocate mutually conflicting tax characterizations of their agreement, the Commissioner was frequently compelled to assess inconsistent deficiencies against parties to the same transaction in order to protect total tax revenue.”<sup>259</sup> Such freedom “encourage[d] parties unjustifiably to risk litigation after consummation of a transaction in order to avoid the tax consequences of their agreements.”<sup>260</sup> Arguably, without the availability of the *Danielson* and strong proof rules, the only way the Service could protect itself against losing revenue from both sides when the potential for a whipsaw existed was “by issuing protective notices of deficiency in virtually every case . . . and then proceeding against all of the parties to the transaction . . . .”<sup>261</sup> By preventing parties from changing their positions, *Danielson* and the strong proof rule “alleviate problems for the Commissioner in the collection of taxes and in the administration of tax laws.”<sup>262</sup> Another reason for the *Danielson* and strong proof rules was stated by the court in *Spector*:

[T]o the extent that the Tax Court’s approach rewards a taxpayer’s intentional misrepresentation to the Commissioner of the true nature of the transaction, it is not desirable from a policy standpoint. Inasmuch as our federal system of income taxation relies heavily upon individual taxpayers to report their income in an accurate and forthright manner, little, if anything, is to be gained by a rule that encourages just the opposite.<sup>263</sup>

Some courts have held that, in order for *Danielson* or the strong proof rule to apply, at least one of the policy rationales underlying those doctrines (e.g., avoiding unilateral reformation of contracts, encouraging

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<sup>258</sup> See *Sullivan*, 618 F.2d at 1004; *Spector*, 641 F.2d at 385; Johnson, *supra* note 189, at 1323.

<sup>259</sup> *Sullivan*, 618 F.2d at 1004.

<sup>260</sup> *Spector*, 641 F.2d at 385.

<sup>261</sup> See *id.*

<sup>262</sup> See *Sullivan*, 618 F.2d at 1004.

<sup>263</sup> *Spector*, 641 F.2d at 385.

predictability, reducing administrative burdens and whipsaws) must be present.<sup>264</sup> Others have concluded that one particular feature, a whipsaw, is essential and that, as a result, neither *Danielson* nor the strong proof rule apply when both parties are before the court.<sup>265</sup> Some courts have attempted to limit the reach of these two doctrines by arguing that they do not apply when the form of the transaction is expected to vary over time, as when the value of a company's stock fluctuates prior to the closing of the agreement.<sup>266</sup> Finally, some courts have suggested that *Danielson* and the strong proof rule do not apply when one of the parties is tax-exempt.<sup>267</sup>

In some cases, courts have held that a taxpayer should be allowed to disavow the form of its transaction when the taxpayer's actions show "an honest and consistent respect for the substance of a transaction" and "meet

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<sup>264</sup> See *Plante v. Comm'r*, 168 F.3d 1279, 1281–82 (11th Cir. 1999); *N. Am. Rayon Corp. v. Comm'r*, 12 F.3d 583, 588 (6th Cir. 1993); *Harvey Radio Labs, Inc. v. Comm'r*, 470 F.2d 118, 120 (1st Cir. 1972) (noting that whipsaw is not necessary for application of strong proof rule); *United States v. Daum*, 968 F. Supp. 1037, 1047–48 (W.D. Pa. 1997) (preventing taxpayer from recharacterizing sale proceeds as settlement proceeds); *Hosp. Corp. of Am. v. Comm'r*, 72 T.C.M. (CCH) 1581, 1592 (1996) (citing *Comdisco, Inc. v. United States*, 756 F.2d 569, 578 (7th Cir. 1985)); *Freeport Transp., Inc. v. Comm'r*, 63 T.C. 107, 115–16 (1974); *Johnson*, *supra* note 189, at 1324. See also *PEASLEE & NIRENBERG*, *supra* note 12, at 138 (suggesting *Danielson* and the strong proof rule should not apply to credit card securitizations because the parties to the securitization have taken consistent tax positions).

<sup>265</sup> See, e.g., *Schmitz v. Comm'r*, 51 T.C. 306, 317 (1968), *aff'd sub nom. Thronson v. Comm'r*, 457 F.2d 1022 (9th Cir. 1972). *Schmitz* takes this argument one step further by suggesting that *Danielson* does not apply when one of the parties is the taxing authority, since "[t]he Commissioner will not have changed his position one iota in reliance on [the transaction's] terms." See *id.* This argument loses force when one considers the fact that *Danielson* itself involved a taxing authority on the other side. See *Comm'r v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967). Furthermore, *Schmitz* was decided in a jurisdiction that followed the strong proof rule, so any statements regarding *Danielson* are essentially dicta. *Schmitz*, 51 T.C. at 316.

<sup>266</sup> *Patterson v. Comm'r*, 810 F.2d 562, 572 (6th Cir. 1987) ("The *Danielson* rule can only be applied meaningfully in those cases where a specific amount has been allocated mutually to the covenant as expressed in the contract.").

<sup>267</sup> *Rochester Dev. Corp. v. Comm'r*, 36 T.C.M. (CCH) 1213, 1217 n.1 (1977). Courts also may allow a taxpayer to disavow the form of a transaction when the taxpayer demonstrates that he or she was unaware of the tax consequences of adopting a particular form. *Schulz v. Comm'r*, 294 F.2d 52, 55 (9th Cir. 1961) (allowing taxpayer to disavow the form of the transaction because he "was apparently unaware that the tax benefits which he was willing to confer upon the [other party] would be a tax detriment to him"). Additionally, when the form changes in light of later, more accurate information the court may allow a taxpayer to disavow. *Amerada Hess Corp. v. Comm'r*, 517 F.2d 75, 87 (3d Cir. 1975) (allowing taxpayer to use value of stock on closing date rather than value of stock on date of initial agreement).



in substance a clear expression of Congressional intent.”<sup>268</sup> For example, in *Comdisco, Inc. v. United States*, the taxpayer entered into a series of transactions in which it was ostensibly the assignee of a lease rather than a lessee. In order to receive the benefits of an investment tax credit provision, the taxpayer was required to be a lessee and thus initially was denied the credit by the district court.<sup>269</sup> The Seventh Circuit reversed and allowed the taxpayer to take the credit, noting that doing so “effectuates both Congressional policies of stimulating capital investment and granting the credit to the party without whom the investment could not have occurred.”<sup>270</sup> In rejecting the government’s attempt to invoke *Danielson*, the court noted that a whipsaw would be impossible because the credit could only be transferred pursuant to an express assignment.<sup>271</sup>

The court further noted that the taxpayer has a right to assert the substance of the transaction:

Resort to substance is not a right reserved for the Commissioner’s exclusive benefit, to use or not to use—depending on the amount of the tax to be realized. The taxpayer too has a right to assert the priority of substance—at least in a case where his tax reporting and actions show an honest and consistent respect for the substance of a transaction.<sup>272</sup>

The court allowed the taxpayer to disavow:

A taxpayer whose transactions meet in substance a clear expression of Congressional intent, as it does here, for inclusion in a tax benefit should not invariably be at the mercy of governmental whim to decide which route to take, dependent, often it seems, on which way revenue will be produced.<sup>273</sup>

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<sup>268</sup> *Comdisco, Inc. v. United States*, 756 F.2d 569, 578 (7th Cir. 1985).

<sup>269</sup> *Id.* at 573–74.

<sup>270</sup> *Id.* at 577, 579.

<sup>271</sup> *Id.* at 578.

<sup>272</sup> *Id.*

<sup>273</sup> *Id.*

*E. Application of Danielson and the Strong Proof Rule to Credit Card Securitizations*

As noted above, the government's stance with respect to the taxation of securitizations in general, and of credit card securitizations in particular, remains unclear.<sup>274</sup> The Service has remained silent on the question of whether *Danielson* or the strong proof rule could apply to these transactions, even when they have been asked the question specifically.<sup>275</sup> The Service's silence on this issue presents particular problems for the issuers of credit card securitizations because, if *Danielson* does apply, credit card issuers could be placed in the difficult position of having to argue against the validity of their own carefully negotiated transactions.<sup>276</sup>

*Danielson* holds that a taxpayer may not disavow the form of its agreement without presenting "proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc."<sup>277</sup> In the case of a credit card securitization, the parties to the securitization, to receive the desired tax treatment specified in the transaction documents, would have to show that the agreement they reached is itself unenforceable.<sup>278</sup> Doing so would place the parties in the almost impossible situation of arguing against the validity of the agreement while still holding themselves (and the other side) responsible for the remaining terms of the agreement.<sup>279</sup> For the credit card issuer, this would mean either upholding the agreement and losing the tax benefits of the securitization, or retaining the tax benefits and risking litigation by investors who might try

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<sup>274</sup> See KRAVITT, *supra* note 18, § 10.03[C][2][a] ("[A] risk remains that the IRS may attempt to hold a taxpayer to the chosen form." (citing *Stein v. Dir.*, 135 F. Supp. 356, 357 (E.D.N.Y. 1955))). See also *Gatlin v. Comm'r*, 34 B.T.A. 50, 56–57 (1936); *supra* Part III.C.

<sup>275</sup> See, e.g., I.R.S. Tech. Adv. Mem. 98-39-001 (Sept. 25, 1998) ("No opinion is expressed whether the Taxpayer would be bound by the form of its transactions if it were the first to assert that its transactions were secured financings.").

<sup>276</sup> See *Comm'r v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967); I.R.S. Tech. Adv. Mem. 98-39-001 (Sept. 25, 1998).

<sup>277</sup> *Danielson*, 378 F.2d at 775.

<sup>278</sup> See *N. Am. Rayon Corp. v. Comm'r*, 12 F.3d 583, 589 (6th Cir. 1993) (stating that the focus under *Danielson* is on whether contract is enforceable). Arguably, this would be the case even though the transaction meets the characteristics of debt listed in Notice 94-47 and other authorities, since the very act of classifying the certificates as debt would constitute a disavowal of form. See I.R.S. Notice 94-47, 1994-1 C.B. 357; *supra* Part III.D.

<sup>279</sup> See *supra* notes 274–76 and accompanying text.

to take advantage of the fact that the issuer has argued that its own contract is unenforceable.<sup>280</sup> Moreover, the parties likely would not be able to show that the agreement, generally reached after complex negotiations between sophisticated parties, should be invalidated on the grounds of duress, undue influence, or for similar reasons.<sup>281</sup>

Taxpayers would face similar problems under the strong proof rule.<sup>282</sup> Although they would not have to show that the agreement itself is invalid, they would have to provide strong proof that the substance of the transaction is a loan rather than a sale.<sup>283</sup> Courts and authorities thus far have failed to provide an exact definition of strong proof, and many have noted that the result under either *Danielson* or the strong proof rule is often the same. As a result, application of this rule to credit card securitizations would leave taxpayers with a sense of uncertainty over whether their desired tax treatment would be respected.<sup>284</sup> Even if the taxpayer expected to prevail ultimately, the specter of a challenge under this rule could make the transaction less desirable to investors.<sup>285</sup> Furthermore, to the extent that the strong proof rule requires the taxpayer to argue against the use of the term “certificate” in its transaction documents, the rule essentially is asking taxpayers to disclaim provisions that carefully were drafted for non-tax reasons.<sup>286</sup> The strong proof rule, like *Danielson*, was intended to “realign the lopsided tax consequences produced by an agreement having no rational basis with economic or business reality”; to apply it to book-tax differences would be to violate the spirit of the rule.<sup>287</sup> Finally, discrepancies in the taxation of credit card securitizations under *Danielson* versus the strong

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<sup>280</sup> See *Danielson*, 378 F.2d at 775; *supra* Part III.

<sup>281</sup> See *Danielson*, 378 F.2d at 775; *supra* Part II.B.1.

<sup>282</sup> See *Ullman v. Comm’r*, 264 F.2d 305, 308 (2d Cir. 1959).

<sup>283</sup> See *id.*; *supra* Part III.A–B.

<sup>284</sup> See, e.g., *United States v. Fletcher*, No. 06-C-6056, 2008 WL 162758, at \*13 (N.D. Ill. Jan. 15, 2008); *Thomas v. Comm’r*, 83 T.C.M. (CCH) 1576, 1583–84 (2002), *aff’d*, 67 F. App’x 582 (11th Cir. 2003) (unpublished table decision) (upholding a purchase price allocation as stated in an agreement and noting that “the result is the same under the law in both circuits” whether they apply the *Danielson* rule or the strong proof rule); *Major v. Comm’r*, 76 T.C. 239, 249 (1981) (“[R]egardless of the standard applied [petitioner] has failed to carry its burden.”); *Dodson v. Comm’r*, 52 T.C. 544, 559 (1969) (holding against taxpayer under the strong proof rule, but noting “that under the more stringent ‘*Danielson* rule’ . . . the result would be the same.”).

<sup>285</sup> See *Ullman*, 264 F.2d at 308; KOTHARI, *supra* note 5, at 23.

<sup>286</sup> See *Ullman*, 264 F.2d at 308; KOTHARI, *supra* note 5, at 23; *supra* Part IV.C.

<sup>287</sup> *Schmitz v. Comm’r*, 51 T.C. 306, 316 (1968), *aff’d sub nom. Throndson v. Comm’r*, 457 F.2d 1022 (9th Cir. 1972).

proof rule could lead to forum shopping or other undesirable results.<sup>288</sup>

V. THE SERVICE SHOULD ACKNOWLEDGE THAT THE DISCREPANCY BETWEEN ACCOUNTING AND TAX TREATMENT SHOULD NOT LEAD TO THE CHARACTERIZATION OF CREDIT CARD SECURITIZATION AS EQUITY FOR TAX PURPOSES UNDER EITHER *DANIELSON* OR THE STRONG PROOF RULE

As noted above, many factors support the treatment of credit card securitizations as debt for tax purposes.<sup>289</sup> When analyzing these transactions, the Service should rely on typical debt-equity analysis without resorting to the *Danielson* and strong proof rules.<sup>290</sup> Those credit card securitizations that deviate from the characteristics that make them look like debt (e.g., a fixed interest rate, high levels of credit enhancement, retention of the residual interest by the credit card company) can and should be recharacterized without reliance upon either *Danielson* or the strong proof rule.<sup>291</sup> These rules have no place in the analysis of credit card securitizations, as evidenced by the fact that the tax code and GAAP have goals that often overlap but also frequently diverge.<sup>292</sup> Even though some cases and commentators have suggested that *Danielson* and the strong proof rule should not apply to certain book-tax differences, none has stated the real reason these rules do not apply, which is that “form” under the accounting rules is not the same as “form” under the tax rules.<sup>293</sup> Finally, while some commentators have suggested that these rules may not apply to credit card securitizations because the form of these transactions is ambiguous, those commentators miss the larger point, which is that form is limited to what the taxpayer reports to the taxing authorities.<sup>294</sup>

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<sup>288</sup> See *id.*; *supra* notes 210–15

<sup>289</sup> See *supra* Part III.D.

<sup>290</sup> See *supra* Part III.D.

<sup>291</sup> See *supra* Part III.D.

<sup>292</sup> See *supra* Parts II.B.2, III.C.

<sup>293</sup> See *infra* Part V.B.

<sup>294</sup> See *supra* Part IV.E.

A. *Courts and Authorities Have Long Recognized that Form for Accounting Purposes May Differ from Form for Tax Purposes Because the Accounting Rules Have Different Goals than the Tax Rules.*

Due to the differences between accounting requirements and tax requirements, authorities in both the tax world and the accounting world have resisted attempts to bring the two into alignment.<sup>295</sup> For example, when the Treasury Department proposed conditioning the use of GAAP treatment for tax purposes on the actual use of GAAP in a company's financial statements, the AICPA responded that "[a] policy of complete conformity is . . . not in the public interest,"<sup>296</sup> although it acknowledged that "a policy which expresses a presumption that tax accounting methods should conform to financial accounting methods is desirable if it recognizes the existence of factors . . . which may operate to overcome that presumption."<sup>297</sup> Some specific concerns raised by the AICPA, which still carry weight today, were that conformity rules would be applied unequally and could deter innovation in accounting principles.<sup>298</sup>

An additional concern was "that the integrity of GAAP would be compromised if it became advantageous to shape financial reporting to facilitate the securing of desired tax results."<sup>299</sup> In other words, the AICPA was concerned that accountants would be pressured into preparing financial statements that would yield higher tax results, even if the statements did not serve their fundamental purpose of presenting an accurate picture of the financial condition of the company for the benefit of creditors and shareholders.<sup>300</sup> This argument is basically the reverse of the one made by proponents of book-tax conformity, who argue that allowing book and tax treatment to diverge gives companies freedom to characterize transactions in the most favorable light for tax purposes without regard to the consequences for financial accounting purposes.<sup>301</sup>

Although some commentators have argued for a more comprehensive

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<sup>295</sup> See Anthony J. Luppino, *Stopping the Enron End-Runs and Other Trick Plays: The Book-Tax Accounting Conformity Defense*, 2003 COLUM. BUS. L. REV. 35, 120–37.

<sup>296</sup> See *id.* at 124–25.

<sup>297</sup> *Id.* at 125.

<sup>298</sup> See *id.* at 126.

<sup>299</sup> *Id.* at 129.

<sup>300</sup> *Id.* at 150–51, 153 n.289.

<sup>301</sup> See *id.*

requirement of book-tax conformity,<sup>302</sup> most agree that complete conformity between “book” treatment and “tax” treatment is unrealistic. Keinan notes that, although limited book-tax conformity exists in the United States, “a general book-tax conformity regime for corporate tax is not feasible,” citing various cases concluding that tax treatment does not have to follow accounting treatment in all cases.<sup>303</sup> Similarly, Professor Schön states that “[t]here is a longstanding and prevalent opinion in many countries that the different goals of taxation and accounting render it impossible to rest the assessment of a person’s taxable income on the results of financial accounting.”<sup>304</sup>

We may start to see greater arguments for book-tax conformity in the wake of financial accounting scandals, like Enron:<sup>305</sup>

[T]he enhanced pressure to ‘manage earnings’ and cosmetically improve the appearance of balance sheets implicated in the Enron and other recent audit failures, coupled with the continuing desire to avoid taxes reflected in the recent proliferation of corporate tax shelters, strongly suggest a need to reassess the value of book-tax comparisons and, where appropriate, to impose conformity requirements as defenses against abuse from both a tax and securities regulation perspective.<sup>306</sup>

However, the very complexity that led to various accounting scandals also weighs against blanket restrictions against book-tax differences:

With the constantly increasing complexity of business

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<sup>302</sup> See, e.g., Mitchell L. Engler, *Corporate Tax Shelters and Narrowing the Book/ Tax “GAAP,”* 2001 COLUM. BUS. L. REV. 539, 559–70 (proposing conformity requirements for “unwelcome” tax shelters but not “intended” tax incentives like accelerated depreciation); Luppino, *supra* note 295, at 189–90 (proposing book-tax conformity for “fundamental” questions like ownership of property and debt-equity distinctions but not for timing differences and tax subsidies); Wolfgang Schön, *The Odd Couple: A Common Future for Financial and Tax Accounting?*, 58 TAX L. REV. 111, 121, 146–48 (2005) (citing George K. Yin, *Getting Serious About Corporate Tax Shelters: Taking a Lesson From History*, 54 SMU L. REV. 209, 224 (2001) (arguing more comprehensive book-tax conformity would prevent cherry-picking by corporate managers)).

<sup>303</sup> Yoram Keinan, *Book Tax Conformity for Financial Instruments*, 6 FLA. TAX REV. 676, 679–80 (2004).

<sup>304</sup> Schön, *supra* note 302, at 111.

<sup>305</sup> See Luppino, *supra* note 295, at 43.

<sup>306</sup> *Id.* at 130.

transactions and financial products, and the proliferation of enormously detailed provisions of the I.R.C. enacted for a variety of reasons (which often have little to do with traditional notions of the measurement of 'book' income), the rationale for rejecting a blanket conformity requirement enunciated by the Supreme Court in *Thor Power* over three decades ago is perhaps even stronger now than it was then.<sup>307</sup>

Professor Luppino argues for book-tax conformity in areas where financial accounting and tax accounting share a common purpose, such as on "fundamental" questions like "who really owns this property" and "who owes this debt."<sup>308</sup> However, this distinction between these "fundamental" issues and presumably "non-fundamental" issues, like timing and tax subsidies, is unclear, and Professor Luppino fails to explain what would make an issue a fundamental one that would justify a regulatory requirement of conformity between book and tax.<sup>309</sup> Moreover, Professor Luppino's requirement of book-tax conformity in areas like "who owes this debt" suggests that, contrary to current practice, he would require conformity between tax and accounting treatment in the area of credit card securitizations.<sup>310</sup>

Congress and the Treasury Department have identified particular areas in which a lack of conformity between book and tax could be a sign of abuse, and they have implemented regulations, like the reportable transactions regulations, to identify and address these situations.<sup>311</sup> Furthermore, greater disclosure of book-tax differences would allow the government to ferret out those transactions that are truly abusive without using lack of conformity itself to serve as the basis for attacking a taxpayer's treatment of a transaction.<sup>312</sup> An attempt to require greater conformity across the board, either through regulations or through the use of judicial doctrines like *Danielson* and the strong proof rule,<sup>313</sup> would be akin to swatting a fly with a sledgehammer.

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<sup>307</sup> *Id.* at 179 (citing *Thor Power Tool Co. v. Comm'r*, 439 U.S. 522 (1979)).

<sup>308</sup> *Id.* at 189.

<sup>309</sup> *See id.*

<sup>310</sup> *See id.*; *supra* Part II.B.2, III.D.

<sup>311</sup> *See* Keinan, *supra* note 303, at 680.

<sup>312</sup> *See* Luppino, *supra* note 295, at 183–90.

<sup>313</sup> *See* Keinan, *supra* note 303, at 680; *supra* Part IV.A–C.

The Treasury Department and the Service already have been criticized for taking a one way street approach to book-tax differences, claiming a taxpayer's accounting methods "clearly reflect income" as required under Section 446 of the Code, when doing so will lead to greater tax revenue, but rejecting the argument when doing so would result in less revenue.<sup>314</sup> *Danielson* and the strong proof rule would only provide the Treasury and the Service with greater leverage to claim that a taxpayer whose tax return legitimately diverges from its accounting treatment has not chosen a method that "clearly reflect[s] income."<sup>315</sup>

Instances may exist where a discrepancy between the accounting treatment and tax treatment of a transaction indicates that one of the two treatments is incorrect. The government clearly has identified some of these situations and addressed them, for example, in the reportable transaction regulations.<sup>316</sup> The remaining situations are too complex to be addressed by a rigid rule mandating conformity, since the varying goals of the accounting and tax rules may sometimes require different treatment.<sup>317</sup> Those transactions that are in fact incorrect can be identified by analyzing the factors listed in Notice 94-47 rather than by resorting to a blanket conformity requirement, which is just as likely to sweep in legitimate transactions as illegitimate ones.<sup>318</sup>

*B. Cases and Commentary Discussing Danielson and the Strong Proof Rule, Although Suggesting that These Rules May Not Apply to Book-Tax Differences, Do Not Go Far Enough in Establishing the Scope of their Application.*

Some cases and commentators suggest that form for accounting purposes should not be equated with form for tax purposes.<sup>319</sup> However, inconsistency among courts, as well as a reluctance to explicitly state that *Danielson* and the strong proof rule do not apply to these situations,

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<sup>314</sup> See I.R.C. § 446(b) (2006); Luppino, *supra* note 295, at 131.

<sup>315</sup> See I.R.C. § 446(b); Luppino, *supra* note 295; *supra* Part IV.

<sup>316</sup> See Keinan, *supra* note 303, at 680.

<sup>317</sup> See Luppino, *supra* note 295, at 183–90; *supra* notes 295–316.

<sup>318</sup> See I.R.S. Notice 94-47, 1994-1 C.B. 357; *supra* notes 295–312.

<sup>319</sup> See, e.g., David P. Hariton, *Distinguishing Between Equity and Debt in the New Financial Environment*, 49 TAX L. REV. 499, 521 (1994) ("Such irrelevancies as what holders, bankers, the press, regulators, rating agencies or accountants call an investment sometimes may correlate with whether the investment is equity or debt for tax purposes, but it need not.").



continues to leave the landscape unclear and potentially dangerous for those who wish to enter into credit card securitizations.<sup>320</sup>

Several cases suggest that when courts use the term form, they are referring to form as it appears on the taxpayer's tax return, not form as it appears in other contexts of the transaction. However, none of these cases explicitly state that *Danielson* or the strong proof rule does not apply when the form on the taxpayer's tax return complies with its substance, regardless of what form is used elsewhere.<sup>321</sup> For example, *Campbell v. United States* illustrates that the court will acknowledge that the tax rules may treat a transaction differently than the accounting rules, even when such differences result in a net loss to the government.<sup>322</sup> In *Campbell*, the taxpayers sold their company to the Unitec Corporation in exchange for stock and notes of the corporation, as well as cash.<sup>323</sup> Unitec's value declined precipitously after the sale, and the taxpayers amended their tax returns as a result, adjusting the value of the stock and notes to zero.<sup>324</sup> The Commissioner challenged this amended return, citing *Danielson*.<sup>325</sup> The court rejected this argument, noting that "it was entirely proper for Unitec," which was an accrual basis taxpayer, "to have reported the full face value of the notes," while the taxpayers, who were cash basis taxpayers, "to have reported only the notes' fair market value."<sup>326</sup>

In rejecting the government's argument, the court stated that the difference in valuation "has nothing to do with incompatible characterizations of the same transaction. Both positions here may logically succeed for they are reflections of different accounting requirements."<sup>327</sup> Such reasoning suggests the court believed a difference between form for accounting purposes and form for tax purposes was not a difference between substance and form.<sup>328</sup> However, the court then undermined this reasoning by relying on the old saw used in earlier cases that "the concern expressed in *Danielson*—that the government not be whipsawed by factually opposing views arising out of a single transaction—is not present

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<sup>320</sup> See *supra* Part IV.E.

<sup>321</sup> See *supra* Part IV.A–D.

<sup>322</sup> See 661 F.2d 209, 217–18 (Ct. Cl. 1981).

<sup>323</sup> *Id.* at 211–12.

<sup>324</sup> *Id.* at 213.

<sup>325</sup> See *id.* at 216.

<sup>326</sup> *Id.* at 217.

<sup>327</sup> *Id.*

<sup>328</sup> See *id.*

here.”<sup>329</sup> As a result, the question of whether a difference in form for accounting purposes and form for tax purposes constitutes a difference between substance and form remains unresolved, even after *Campbell*.<sup>330</sup>

Similarly, the court in *Illinois Power Co. v. Commissioner* accepted a taxpayer’s reporting despite its difference from accounting treatment when the taxpayer showed “an honest and consistent respect for what [the taxpayer] consider[ed] to be the substance of the [agreement].”<sup>331</sup> This case involved a sale-leaseback that consistently was treated as a financing for tax purposes, and the ultimate issue, as in credit card securitizations, revolved around whether the taxpayer could treat the transaction as a loan.<sup>332</sup> The taxpayer’s “intentions were made clear at the time the agreements were entered into and have continued to be manifested in a similar manner.”<sup>333</sup> Because the discrepancy between tax and accounting treatment in such a case was apparent, the taxpayer “is not bound to the labels affixed to the transaction, but instead may argue that the economic substance of the arrangement is controlling for Federal tax purposes.”<sup>334</sup> The court further acknowledged in a footnote “that the tax characterization of a transaction for financial accounting purposes, on the one hand, and tax return purposes on the other, need not necessarily be the same.”<sup>335</sup> Nonetheless, the court concluded that the taxpayer was still required to produce “at a minimum, ‘strong proof’ that the other elements of the burdens and benefits of ownership” warranted the taxpayer’s desired treatment, suggesting that it did in fact view the difference as one between form and substance.<sup>336</sup>

The court then found that the taxpayer indeed had presented strong proof of the benefits and burdens of ownership when the sale was made “for

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<sup>329</sup> *See id.* In addition, the court said, “[T]he greater problem the court has with the government’s position is the absence of any credible evidence to support the claimed agreement between the parties.” *Id.* In other words, even though the court suggested that *Danielson* should not apply to differences in accounting treatment, it seemed to rest its conclusion on the fact that the agreement itself was not clear enough for the court to conclude that it in fact had been disavowed. *See id.* The court in *Campbell* ultimately split the baby so to speak, rejecting both the taxpayers’ and the Commissioner’s proposed values for the stock and notes and calculating these values itself. *See id.* at 217–18, 221–25.

<sup>330</sup> *See id.* at 217.

<sup>331</sup> 87 T.C. 1417, 1433–35, 1442 (1986).

<sup>332</sup> *See id.* at 1432–33; *supra* Part III.D.

<sup>333</sup> *Id.* at 1433.

<sup>334</sup> *Id.*

<sup>335</sup> *Id.* at 1432 n.12.

<sup>336</sup> *See id.* at 1434.

the purpose of financing” and the taxpayer claimed an interest expense deduction on its tax return.<sup>337</sup> Although the court could have taken this “honest and consistent” tax treatment to mean that there was in fact no discrepancy between substance and form for tax purposes, the court instead found that the company “retains the full incidents and burdens of ownership regardless of the fact that mere legal title is now held by” a separate company.<sup>338</sup>

[T]he combination of these facts persuade us that petitioner’s tax reporting actions have shown an honest and consistent respect for what it considers to be the substance of the [transaction]. Its intentions were made clear at the time the agreements were entered into and have continued to be manifested in a similar manner. Thus, under *Comdisco*, petitioner is not bound to the labels affixed to the transaction, but instead may argue that the economic substance of the arrangement is controlling for Federal tax purposes.<sup>339</sup>

Ultimately, even though the court acknowledged that the taxpayer’s desired tax treatment was correct, it did so by applying the “strong proof” standard, thereby setting a higher bar than necessary for taxpayers whose accounting treatment differs from their tax treatment.<sup>340</sup>

In *Estate of Durkin v. Commissioner*, the court prevented the taxpayer from recharacterizing its transaction as a redemption because the proposed form differed, not only from what appeared on the transaction documents, but also from what appeared on the tax returns.<sup>341</sup> In doing so, the court distinguished the taxpayer’s situation from one in which a taxpayer had structured the transaction as a redemption and reported it as such on his

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<sup>337</sup> *Id.* at 1432, 1435. The taxpayer also noted on its tax return that it “entered into a sale and leaseback transaction with Illinois Power Fuel Company to effect a financing arrangement . . . .” *Id.* at 1433.

<sup>338</sup> *Id.* at 1433.

<sup>339</sup> *Id.*

<sup>340</sup> *See id.* at 1434–35, 1442; KRAVITT, *supra* note 18, § 10.03[D][3] (“The fact that the IRS chose to litigate this issue indicated the IRS could decide to treat a transaction as a sale or loan based solely on labels used in the transaction. While the taxpayer has the better argument in claiming that the economic substance should prevail, an element of uncertainty exists until courts clearly define when a taxpayer may contest the form chosen.”).

<sup>341</sup> *See* 99 T.C. 561, 567–77 (1992).

income tax return.<sup>342</sup> So long as the structure of the transaction matched the tax return, the court indicated that “the transaction may be taxed in the form chosen by the taxpayer.”<sup>343</sup> However, the court refused to respect actions that were nothing more than a unilateral attempt to recharacterize the transaction after it had been challenged.<sup>344</sup> To do so “would unjustly enrich petitioners [by] permit[ting] them to belatedly change the deal made after well-informed negotiations . . . .”<sup>345</sup> While *Durkin* comes closer than *Campbell* or *Illinois Power* to acknowledging the limits of form for tax purposes, it never explicitly states that form for tax purposes is fundamentally different from form for accounting purposes.<sup>346</sup>

Courts also have acknowledged that the form adopted for tax purposes may change prior to the filing of the tax return.<sup>347</sup> For example, in *Amerada Hess Corp. v. United States*, the taxpayer agreed to sell farm equipment to a corporation in exchange for some of the corporation’s stock. The agreement for the purchase placed an initial value to the stock based on its closing price on the date the sale initially was proposed.<sup>348</sup> On its return, the taxpayer valued the stock at its value on the stock exchange as of the closing date of the sale rather than the value as stated in the agreement. The Commissioner argued that this valuation was an improper attempt by the taxpayer to disavow the form of its transaction.<sup>349</sup> Although the Tax Court agreed with the Commissioner,<sup>350</sup> the Third Circuit reversed, finding that “[w]here . . . the property to be valued consists of securities traded on a stock exchange, the general rule is that the average exchange price quoted on the valuation date furnishes the most accurate, as well as the most readily ascertainable, measure of fair market value.”<sup>351</sup>

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<sup>342</sup> See *id.* at 568–69.

<sup>343</sup> See *id.* at 570.

<sup>344</sup> See *id.* at 571–77.

<sup>345</sup> *Id.* at 575. See also *Bradley v. United States*, 730 F.2d 718, 720–21 (11th Cir. 1984) (disallowing the taxpayer’s disavowal of form on amended tax return); *Norwest v. Comm’r*, 111 T.C. 105, 145–46 (1998) (“[W]hen a taxpayer seeks to disavow its own tax return treatment of a transaction by asserting the priority of a substance only after the Commissioner raises questions with respect thereto, this Court need not entertain the taxpayer’s assertion of the priority of substance.”).

<sup>346</sup> See *Estate of Durkin*, 99 T.C. at 567–77.

<sup>347</sup> See, e.g., *Amerada Hess Corp. v. Comm’r*, 517 F.2d 75, 83–84 (3d Cir. 1975).

<sup>348</sup> See *id.* at 77–78.

<sup>349</sup> See *id.* at 81–82.

<sup>350</sup> See *id.* at 82.

<sup>351</sup> *Id.* at 83, 89–90.

The court distinguished the situation from other disavowal cases, noting that those generally involved valuations of items, like a covenant not to compete, in which no established market existed.<sup>352</sup> The court noted that the existence of an outside valuation eliminated one of the primary reasons behind *Danielson*, namely preventing parties from unilaterally reforming a contract to their benefit.<sup>353</sup> Finding that such reformation had not taken place, the court found it unnecessary to apply *Danielson* or the strong proof rule.<sup>354</sup> While cases like *Durkin* and *Amerada Hess* suggest form for tax purposes may differ from form for accounting purposes, no case has made this distinction explicit.<sup>355</sup> Furthermore, even those cases that allow a particular tax treatment despite such discrepancies, like *Campbell* and *Illinois Power*, do so on other grounds without acknowledging the fact that such differing treatments not only can, but sometimes should, coexist peacefully.<sup>356</sup>

Most commentators seem to agree that *Danielson* and the strong proof rule should not be applied to credit card securitizations, although their reasons vary.<sup>357</sup> For example, Peaslee and Nirenberg argue that *Danielson* should not apply because the specific policy rationales addressed in that case, “namely the desire to avoid upsetting bargained-for tax consequences and whipsawing the government,” are not present in a credit card securitization.<sup>358</sup> They also argue that *Danielson* should not apply “because the relative weight given to form and substance is different in the tax world than in” regulatory capital and accounting areas, although they do not elaborate on these differences.<sup>359</sup> Furthermore, because “the parties are not seeking any tax advantage compared with a conventional borrowing . . . the government has no reason to adopt a hostile stance in analyzing” the transaction.<sup>360</sup> However, they fail to recognize the larger point, which is

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<sup>352</sup> See *id.* at 85.

<sup>353</sup> See *id.* at 85–86.

<sup>354</sup> See *id.* at 86.

<sup>355</sup> See, e.g., *id.* at 83–86; *Estate of Durkin v. Comm’r*, 99 T.C. 561, 567–77 (1992).

<sup>356</sup> See, e.g., *Campbell v. United States*, 662 F.2d 209, 217 (Ct. Cl. 1981); *Ill. Power Co. v. Comm’r*, 87 T.C. 1417, 1433, 1442 (1986).

<sup>357</sup> See, e.g., PEASLEE & NIRENBERG, *supra* note 12, at 138–39.

<sup>358</sup> *Id.*

<sup>359</sup> *Id.* at 141.

<sup>360</sup> *Id.* at 141–42; see also KRAVITT, *supra* note 18, § 10.03[C][2][a] (“In receivables transactions, practitioners generally conclude that the overall economics of the transaction prevail over the labels used. The fact that in most transactions the parties agree in writing to treat the

that a difference between treatment for accounting purposes and treatment for tax purposes is not a difference between substance and form.<sup>361</sup>

Professor Johnson argues that *Danielson* should be limited:

The *Danielson* Rule should be applied only to situations in which legislative intent is unclear; analysis of an applicable tax statute and the legislative intent behind it often will be dispositive as to whether Congress intended the taxpayer to have the privilege of recharacterizing the form of his agreement for tax purposes.<sup>362</sup>

In his view, “automatic application of the *Danielson* Rule in new contexts may become a total substitute for statutory analysis, replacing judicial reasoning with an arbitrary rule of thumb.”<sup>363</sup> With respect to the debt-equity distinction, for example, he argues, “If both parties are willing to treat the transaction consistently for tax purposes,” even if that consistent treatment differs from their treatment for accounting or regulatory purposes, “none of the rationales advanced in *Danielson* is applicable.”<sup>364</sup> He also points out that “[c]ourts have been willing to allow . . . issuers to treat certain securities . . . as equity for book or regulatory [sic] purposes and as debt for tax purposes” and that “[p]reventing a taxpayer from recharacterizing the security by applying the *Danielson* Rule could deprive taxpayers of interest or dividends-received deductions that Congress intended the taxpayer to enjoy.”<sup>365</sup>

While Professor Johnson correctly argues for limitations on *Danielson*,

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transaction as a sale or a loan or instruments as debt or equity minimizes the risk that the IRS will be disadvantaged by the parties taking inconsistent positions.”).

<sup>361</sup> Peaslee and Nirenberg make several additional arguments as well that have been suggested by other authorities. For example, they note that some authorities seem to distinguish between purchase price allocations, the original purview of *Danielson*, and debt-equity issues by ignoring *Danielson* altogether, although they suggest that these authorities to some extent are relying on the consistent reporting test that often accompanies the strong proof rule. See PEASLEE & NIRENBERG, *supra* note 12, at 140 (citing I.R.S. Tech. Adv. Mem. 97-48-005 (Aug. 19, 1997)). They also suggest that a taxpayer may try to argue that neither *Danielson* nor the strong proof rule apply due to the ambiguity surrounding the transaction but, as discussed below, this argument is a weak one, and it is difficult to predict how it would be received by a court. See *id.* at 139–40.; *infra* Section V.C.

<sup>362</sup> Johnson, *supra* note 189, at 1320–21.

<sup>363</sup> *Id.* at 1330.

<sup>364</sup> *Id.* at 1341.

<sup>365</sup> *Id.* at 1341–42.

his argument is grounded largely in policy; i.e., he argues that *Danielson* should not apply only when its use does not conform with legislative goals.<sup>366</sup> Although he notes that some securities may be treated as equity for accounting purposes and debt for tax purposes, he limits his analysis to those situations in which Congress specifically has authorized such treatment; his analysis does not cover transactions like credit card securitizations that have not been addressed by the legislature specifically.<sup>367</sup> Clarifying the definition of form to exclude form for accounting purposes would reach a broader range of transactions and would avoid the case by case analysis that Professor Johnson's approach would require.<sup>368</sup>

In sum, neither the Service, the courts, nor other scholarly authorities have established clearly that the definition of form under *Danielson*, and the strong proof rule does not depend on the name used for accounting purposes, leaving the taxation of credit card securitizations in flux.

*C. Danielson and the Strong Proof Rule Cannot Be Discounted on the Basis of Ambiguity*

As discussed above, the instruments issued as part of a credit card securitization are called certificates (suggesting equity), but are treated as debt for tax purposes; some commentators have argued that this constitutes an ambiguity that precludes application of *Danielson* or the strong proof rule.<sup>369</sup> In other words, according to these commentators, the use of the term "certificate" alongside other terms that are consistent with debt

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<sup>366</sup> *Id.* at 1320–21.

<sup>367</sup> *See id.* at 1320–21, 1330, 1341–42.

<sup>368</sup> *See id.* at 1320–21, 1338–44; *infra* Part V.C.

<sup>369</sup> For example, Peaslee and Nirenberg suggest that an ambiguity argument may help credit card securitizations because "[c]ourts have generally not applied the *Danielson* rule where the terms of a transaction are ambiguous." PEASLEE & NIRENBERG, *supra* note 12, at 138 (citing *Estate of Rogers v. Comm'r*, 29 T.C.M. (CCH) 869 (1970)). They explain this ambiguity:

[T]he terms of the trust agreement should be considered ambiguous given the agreement of the parties to treat the certificates as debt and the economic and legal terms of the instruments that are consistent with debt treatment. Even in cases where the terms of the transaction are not ambiguous, courts have declined to apply either the *Danielson* or the strong proof rule where the conclusion has been reached that the overarching arrangement is ambiguous.

*Id.* (citing *Coulter Elecs., Inc. v. Comm'r*, 59 T.C.M. (CCH) 350, 364 (1990)).

treatment creates an issue of interpretation rather than disavowal.<sup>370</sup> Although this approach may appear tempting, it fails to take into account the true issue, which is that form for accounting purposes has no real bearing on form for tax purposes.

Some courts have determined that *Danielson* does not apply when the true substance of the transaction is ambiguous.<sup>371</sup> Other cases have found that *Danielson* would not exclude extrinsic evidence the taxpayer wished to bring in to support his tax characterization.<sup>372</sup> Under either rule, ambiguity clearly applies only when each party, by arguing for acceptance of its own interpretation of an ambiguous term, is also arguing for rejection of all other interpretations.<sup>373</sup>

In *Smith*, an ambiguity arose because the purchase agreement at issue contained two different prices, only one of which could be correct.<sup>374</sup> The court in *Smith* noted that “[i]n order to hold contracting parties to their written agreement, the *Danielson* rule impliedly requires an unambiguous agreement. Where an agreement is permeated with ambiguity, as in the instant case, we think the *Danielson* rule is inapplicable.”<sup>375</sup> It noted that

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<sup>370</sup> See *id.*

<sup>371</sup> See, e.g., *Jorgl v. Comm’r*, 79 T.C.M. (CCH) 1318, 1323 (2000) (holding *Danielson* did not apply to covenant not to compete when contract was ambiguous regarding allocation of purchase price). Courts applying the strong proof rule have made similar ambiguity arguments. See, e.g., *Coulter Elecs., Inc. v. Comm’r*, 59 T.C.M. (CCH) 350, 364 (1990) (finding ambiguity where agreement included terms indicating both a sale and a financing); *Smith v. Comm’r*, 82 T.C. 705, 714 (1984) (finding ambiguity where purchase price in original agreement differed from purchase price in addendum); see also PEASLEE & NIRENBERG, *supra* note 12, at 138 (arguing “[t]he terms of the trust arrangement should be considered ambiguous, given the agreement of the parties to treat the certificates as debt and the economic and legal terms of the instruments that are consistent with debt treatment”). Peaslee & Nirenberg argue that, “[e]ven in cases where the terms of the transaction are not ambiguous, courts have declined to apply either the *Danielson* or the strong proof rule where the conclusion has been reached that the overarching arrangement is ambiguous.” *Id.* at 139 (citing *Coulter Elecs.*, 59 T.C.M. (CCH) at 364).

<sup>372</sup> See, e.g., *Patterson v. Comm’r*, 810 F.2d 562, 572 (6th Cir. 1987) (holding *Danielson* does not apply when “the parties are not seeking to vary the terms of the contract but to have the court construe terms which are obviously ambiguous”); *Sharewell, Inc. v. Comm’r*, 78 T.C.M. (CCH) 1190, 1194 (1999) (allowing taxpayer to bring in evidence indicating purchase price inadvertently excluded covenant not to compete); *Elrod v. Comm’r*, 87 T.C. 1046, 1066 (1986) (“[N]either the *Danielson* rule nor the strong proof rule are applicable to exclude parole evidence offered with respect to an ambiguous document.”).

<sup>373</sup> See *supra* notes 345–346 and accompanying text

<sup>374</sup> *Smith v. Comm’r*, 82 T.C. 705, 712 (1984).

<sup>375</sup> *Id.* at 705, 713–14.



ambiguity also served as an exception under the strong proof rule: “Where ‘[n]either party seeks to vary the terms of the contract [and] . . . both merely attempt to construe an obviously ambiguous term of the contract in a light more favorable to their respective causes,’ the strong proof doctrine is inappropriate.”<sup>376</sup>

The language in *Smith* makes clear that ambiguity applies only when differing interpretations of the same document are “irreconcilable,” usually because of a mistake in drafting, and only one interpretation can prevail.<sup>377</sup> In a credit card securitization, however, the taxpayer is not arguing against the use of the term “certificate” and its interpretation as a sale, but is rather arguing that this interpretation should be limited to the accounting context. As noted above, to hold otherwise would require the credit card company to argue against an interpretation that had been drafted carefully and agreed to by the parties.

*D. Application of Danielson and the Strong Proof Rule to Credit Card Securitizations Could Lead to Unequal Treatment*

While the threat of *Danielson* and the strong proof rule has existed since the inception of credit card securitizations in 1986, until recently the threat was the same for all issuers of credit card securitizations.<sup>378</sup> The landscape changed, however, with the inception of note issuance trusts in 2003.<sup>379</sup> As noted above, only a select number of credit card companies, particularly larger ones, have switched to note issuance trusts.<sup>380</sup>

Should the Service decide to challenge the taxation of certain credit card securitizations on the basis that they constitute equity rather than debt, it may be tempted to attack securitizations that use the older certificate structure because it can apply *Danielson* or the strong proof rule to these transactions.<sup>381</sup> Such a selective attack would be unfair, particularly because it would harm those credit card companies that did not have the resources or did not engage in enough securitizations to make a switch to the new note structure.<sup>382</sup> Moreover, because notes under this new

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<sup>376</sup> *Id.* at 714 (quoting *Peterson Matching Tool, Inc. v. Comm’r*, 79 T.C. 72, 82 (1982)).

<sup>377</sup> *See id.*

<sup>378</sup> O’Connell, *supra* note 24.

<sup>379</sup> *Id.* at 2.

<sup>380</sup> *Id.*

<sup>381</sup> *Id.*

<sup>382</sup> *Id.*

structure, unlike certificates under the old structure, may be de-linked, credit card issuers are to issue notes under the new structure that have a lower rating than certificates that were issued, and continue to be issued, under prior structures. By focusing only on certificate-based structures, the Service would be drawing its attention away from transactions that are not only riskier, but that also draw upon a broader base of investors.<sup>383</sup>

## VI. CONCLUSION

In order to clarify the tax treatment of credit card securitizations and other transactions that employ book-tax differences, the Service needs to confirm that book-tax differences do not constitute differences between substance and form for purposes of the *Danielson* and strong proof rules. Prior cases have declined to apply these rules to book-tax differences in certain contexts, although their reasons for doing so vary, leaving the landscape of debt-equity analysis cluttered and confused. By leaving open the possibility that *Danielson* and the strong proof rule may be applied to book-tax differences, the Service creates uncertainty for taxpayers who continue to issue certificates as part of credit card securitizations and leaves open the possibility that, should the Service decide to recharacterize certain credit card securitizations, it will attack those securitizations that look the most like debt.

## VII. POSTSCRIPT

In June, 2009, the Financial Accounting Standards Board issued “Statement of Financial Accounting Standards No. 166: Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140” (FAS 166). FAS 166, which takes effect at the beginning of a bank’s first fiscal year after November 15, 2009, removes the concept of a qualifying

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<sup>383</sup>*Id.* See *supra* Part II.E. Delinking refers to the issuance of multiple tranches of notes from different classes at different times. The issuance of delinked notes is allowed so long as sufficient collateral is available to support each tranche. Faulkner, *supra* note 34, at 485. While the increased use of note issuance trusts, along with recent changes to the financial accounting standards, discussed *supra*, could arguably make the risk posed by *Danielson* and the strong proof rule obsolete for future credit card securitizations, they remain a threat for those credit card securitizations that were completed in the recent past and for which statute of limitations has not yet passed. Moreover, the problems associated with current misreading of *Danielson* and the strong proof rule should be addressed because they potentially affect transactions other than credit card securitizations.

special-purpose entity (QSPE) from FAS 140.<sup>384</sup> Credit card securitizations generally utilize QSPE's when transferring credit card receivables in order to comply with the control requirement for sale treatment under FAS 140.<sup>385</sup> Under FAS 166, they no longer can treat the transfer of these receivables as a sale that removes the receivables from the issuer's balance sheets.<sup>386</sup> In addition, FAS 166 no longer allows a securitizer to recognize gain or loss on a partial transfer of assets. Transfers that do not satisfy the conditions to be accounted for as sales in their entirety will be treated as secured borrowings.<sup>387</sup> Still unclear is whether credit card issuers will be able to modify their securitizations in a way that accommodates these revised standards while continuing to provide benefits to the issuers and to investors, although anecdotal evidence suggests that banks already have begun to reduce their credit card securitization activity.<sup>388</sup>

Once FAS 166 becomes effective, credit card issuers may be forced to characterize their securitizations as borrowings under the accounting rules; this would eliminate the current discrepancy that exists between how these transactions are treated under the accounting rules (as sales) and how they

<sup>384</sup> ACCOUNTING FOR TRANSFERS OF FIN. ASSETS: AN AMENDMENT OF FASB STATEMENT NO. 140, Statement of Fin. Accounting Standards No. 1, § 7C (Fin. Accounting Standards Bd. 2009).

<sup>385</sup> See *supra* Section II.B.2.

<sup>386</sup> Statement of Fin. Accounting Standards No. 1, §§ 7C, 9.

<sup>387</sup> Statement of Fin. Accounting Standards No. 1, § 11–11A; ACCOUNTING FOR TRANSFERS AND SERVICING OF FIN. ASSETS AND EXTINGUISHMENTS OF LIABS., Statement of Fin. Accounting Standards No. 166, § 78 (Fin. Accounting Standards Bd. 2000) (indicating that “[g]ain or loss recognition for revolving period receivables sold to a securitization trust is limited to receivables that exist and have been sold”).

<sup>388</sup> Credit card issuers have already begun to calculate the impact FAS 166 will have on their financial statements. For example, Citigroup Inc. reported that it expects to bring almost \$160 billion of assets, over half of which stem from credit card securitizations, back onto their balance sheet once FAS 166 goes into effect. Citigroup, Inc., Quarterly Report (Form 10-Q), at 84 (Aug. 7, 2009). Similarly, JP Morgan Chase & Co. estimated that it might have to bring as much as \$130 billion of assets onto its balance sheet. JP Morgan Chase & Co., Quarterly Report (Form 10-Q), at 91 (Aug. 10, 2009). Bringing these assets back onto the balance sheet may affect not only the apparent health of these issuers as reflected in their financial statements, but also the amount of regulatory capital the issuers are required to provide in order to comply with frameworks of various regulatory agencies. A pending rule change by the Federal Deposit Insurance Company also has decreased the appeal of credit card securitizations to banks by allowing a deposit insurer to seize securitized card receivables in the event of receivership. *Exodus Begins as Accounting Threats Grow*, ASSET-BACKED ALERT (Sept. 18, 2009), <http://securitization.net/article.asp?id=1&aid=9237>.

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are treated under the tax rules (as debt). However, FAS 166 should not be seen as a solution to the issues raised by *Danielson* and the strong proof rule, since, as this Article demonstrates, the characterization of credit card securitizations as sales for accounting purposes never was in conflict with their characterization as debt for tax purposes in the first place.

The same dilemma faced by issuers of credit card securitizations prior to the issuance of FAS 166—i.e., having to choose between either disavowing their own carefully structured transactions or losing their desired tax treatment—arises whenever a taxpayer seeks a legitimate tax treatment that varies from its equally legitimate accounting treatment. A clear statement from the Service that the *Danielson* and strong proof rules do not apply to book-tax differences will clear away much of the confusion that is apparent in the currently muddled interpretations of these two rules.