What’s in a Name? The Role of Danielson in the Taxation of Credit Card Securitizations

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ABSTRACT

While the doctrine of substance over form has been a part of tax law for over seventy years, courts look disfavorably upon taxpayers who invoke the doctrine to argue against the forms of their own transactions under what is commonly referred to as the Danielson rule. Although the Danielson rule appears sound on its face, it holds less force when applied outside of its original context. In particular, the Danielson rule should not apply when the form given to a transaction is given for non-tax reasons, such as to achieve a particular accounting treatment. The taxation of credit card securitizations provides a particularly acute example of how the Danielson rule could lead taxing authorities to erroneously base the taxation of a transaction on its form for accounting purposes. In this article, I explain why the Danielson rule should not apply to credit card securitizations. First, I describe how credit card securitizations are structured and how they are treated under both the accounting and the tax rules. I then explain the origins and purposes of the Danielson rule, why it should not apply to credit card securitizations, and how it could adversely affect their taxation if applied. By expressly excluding from the scope of the Danielson rule those transactions where the difference between substance and form is rooted in the difference between the accounting and tax regimes, the government will clarify a currently muddled area of law and provide greater certainty to participants in credit card securitizations and similar transactions.
WHAT’S IN A NAME?: THE ROLE OF DANIELSON IN THE TAXATION OF CREDIT CARD SECURITIZATIONS

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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.”\(^1\) Although scholars are still 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 “sliced, diced and pureed individual debts to synthesize new assets.”\(^2\) 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.\(^3\) This

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\(^1\) Mark Gertler, New York University, quoted in Jon Hilsenrath, Serena Ng & Damian Paletta, Worst Crisis Since ’30s, With No End Yet in Sight, WALL ST. J., Sept. 18, 2008, at A1.

\(^2\) Paul Krugman, The Market Mystique, N.Y. TIMES, Mar. 27, 2009, at A29. See also Tom Petrunic, 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, JP Morgan Chase & Co.).

\(^3\) Krugman, supra note 2, at A29. See also Sheila Bair, chairman of the Federal Deposit Insurance Company (“[B]eing able to securitize debt… weakens underwriting discipline. Whether it’s credit cards or mortgages, this dynamic needs to be dealt with”), Travis Plunkett, legislative director for the Consumer Federation of America (“Securitization has increased the willingness of credit card companies to offer riskier loans”) (both quoted in Kathy Chu & Byron Acohido, Why Banks Are Squeezing Credit Card
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 often fraudulent) accounting practices.\footnote{Where Recent Scandals Stand, USA TODAY, Sept. 29, 2003, at 3B.}

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 they 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, like the use of special purpose vehicles, that came under fire post-Enron.\footnote{Vinod Kothari, Securitization: The Financial Instrument of the Future 9 (2006).} The current tax treatment of these credit card securitizations may be particularly vulnerable to criticism since the Internal Revenue Code (the “Code”) and Treasury Regulations do not specifically address the taxation of these vehicles, as they do with mortgage securitizations.\footnote{See I.R.C. § 860A - § 860G (2009) and related Treasury regulations for rules regarding Real Estate Mortgage Investment Conduits, which are used in mortgage securitizations.}

The silence by the taxing authorities is particularly glaring 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).\footnote{See infra Part III.} This discrepancy seems to violate what is commonly known 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.\(^8\) However, as can be seen upon a careful reading of the caselaw, when the Code discusses “form,” it means form as used for tax purposes and not form as used in other areas, such as accounting. 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 necessarily equate with form for accounting purposes, the Internal Revenue Service (the “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 rather than certificates. These new securitizations may avoid scrutiny by the Service even when they share more characteristics akin to equity than their older counterparts. In other words, by focusing solely on the name given to an instrument under *Danielson*, the Service may shift its focus away from the 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

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\(^8\) See *infra* Part IV for further discussion of the *Danielson* rule, which was first stated in the case *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967). The consequences of disavowing form are also addressed by the strong proof rule, also discussed in Part IV, which some courts have adopted as an alternative to the *Danielson* rule.
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 these two principles might be used by the Service to challenge the generally prevailing tax treatment of credit card securitizations. Part V describes how book-tax differences have been treated by the Code in other contexts and explains why credit card securitization should be treated similarly without being subject to Danielson and the strong proof rule. This part 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 V 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. 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]  

9 Kothari, supra note 5, at 633 (citing Powers Committee Report, February 1, 2002).
the purpose of financing.”10 In other words, if a company is owed money by multiple customers, securitization allows it to access the securities markets in order to get a loan secured by the aggregate value of these customer accounts.11

When receivables are used as part of a securitization, the money collected on these receivables is used to pay the investors directly.12 A securitization may therefore 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.13 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.14 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.15

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

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10 KOTHARI, supra note 5, at 5.
11 Id.
12 Id. at 8.
13 Id.
14 Id. at 8-9.
15 KOTHARI, supra note 5, at 97; JASON H.P. KRAVITT, ED., SECURITIZATION OF FINANCIAL ASSETS, § 1.01 (2d ed. 2008) (quoting J. ROSENTHAL AND J. OCAMPO, SECURITIZATION OF CREDIT: INSIDE THE NEW TECHNOLOGY OF FINANCE 3 (1988)).
Issuers generally prefer off-balance sheet financing because this allows them higher returns on their assets and equity without affecting their debt-equity ratios. 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.

Securitization has been around since 1970, when the Government National Mortgage Association first packaged its mortgages and sold them to investors. The first publicly issued securitization occurred in 1985, when Sperry Corporation issued $192.5 million of securities backed by computer lease receivables. Securitization thrived through the remainder of the twentieth century and the early part of the twenty-first; in 2002, the asset-backed security market held over six and one-half trillion 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.

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16 Kothari supra note 5, at 97; Kravitt, supra note 15, at § 1.01. The issuer may remove these receivables from its balance sheet because it no longer has a direct obligation to repay the debt. Peter Jeffrey, Articles and Comments: International Harmonization of Accounting Standards, and the Question of Off-Balance Sheet Treatment, 12 DUKE J. COMP. & INT’L L. 341 (2002).

17 Kothari, supra note 5, at 99.

18 Jeffrey, supra note 16, at 10. In addition to providing off-balance sheet financing and the opportunity to borrow money at lower rates, securitization also allows companies to attract investors who may otherwise be uninterested in the issuer’s securities. Kravitt, supra note 15, at § 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. Jeffrey, supra note 16, at 10.

19 Kothari, supra note 5, at 110.

20 Id. at 110.


22 Petruno, supra note 2, at C1.
Chicago, failed in part because they securitized high-risk loans that initially gave them high returns but eventually fizzled.\textsuperscript{23} More failures may be expected as banks face rising levels of defaults, bankruptcies and charge-offs (i.e., uncollectible expenses).\textsuperscript{24}

**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. 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.\textsuperscript{25} 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.\textsuperscript{26} Nonetheless, credit card securitizations became increasingly popular in the years preceding the economic downturn; 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.\textsuperscript{27}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{23} Id.
\item \textsuperscript{24} FRANK J. FABOZZI, HANDBOOK OF STRUCTURED FINANCIAL PRODUCTS 24 (1998).
\item \textsuperscript{25} KRAVITT, supra note 15, at § 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. THE ASSET SECURITIZATION HANDBOOK (Phillip L. Zweig, ed. 1989).
\item \textsuperscript{26} FABOZZI & KOTHARI, supra note 5, at 154.
\end{itemize}
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C. 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. The trust then issues debt instruments to investors entitled them to a return of their principal plus interest set at a predetermined rate. 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. 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. 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 fully repaid.

A credit card securitization consists of two phases, a revolving period and an amortization period. 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).

28 JAMES PEASLEE & DAVID Z. NIRENBERG, THE FEDERAL INCOME TAXATION OF SEcuritization transactions 132 (2001). In most cases, this trust will be a “master 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. KOTHARI, supra note 5, at 387; KRAVITT, supra note 15, at § 4.03[C]. 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).

29 PEASLEE & NIRENBERG, supra note 28, at 38.

30 Jeffrey, supra note 16, at 15.

31 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. The issuer usually maintains the lowest class of instruments, which are not sold to investors. PEASLEE & NIRENBERG, supra note 28, at 38.

32 Id.

33 KRAVITT, supra note 15, at § 4.03[c]; PEASLEE & NIRENBERG, supra note 28, at 38.
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. Principal payments, on the other hand, are generally reinvested in new securitizations during the revolving period. In most instances, the trust will also 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. The revolving period is followed by an amortization period during which the trust uses the principal payments it receives from cardholders to return the investors’ principal in installments; 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.

In order to protect investors from losses and ensure they will be paid, the trust must generally 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.” 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

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34 Peaslee & Nirenberg, supra note 28, at 38.
35 Id.
36 Id.
37 Kravitt, supra note 15, at § 3.03[A]. 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 28, at 134-35.
38 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. However, excess spread generally only protects against expected losses; investors will generally want some protection against unexpected losses as well. Id. at 212.
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. 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. 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 subordinate, interests. 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.”

D. Treatment of Credit Card Securitizations under Accounting Rules

Although the credit card issuer will almost always 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. 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. A transferor usually meets these criteria by transferring the assets to a bankruptcy remote

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39 KOTHARI, supra note 5, at 212.
40 Id.
41 Id. These interests may be held by other investors or by the credit card issuer itself.
42 FABOZZI, supra note 24, at . In return, investors in subordinated classes receive a higher interest rate on their loan.
43 DAVID C. GARLOCK, FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS § 102.03 (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.
44 Id.
special purpose vehicle, such as the trust described in Section B.1, that is disregarded for tax purposes.\textsuperscript{45} Generally Accepted Accounting Principles ("GAAP") emphasize 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; by contrast, the Code looks to the benefits and burdens of ownership in determining whether a transaction constitutes a sale or a loan.\textsuperscript{46} 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.\textsuperscript{47}

E. \textit{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.\textsuperscript{48} The name given to these securities, while consistent with how they were treated for accounting purposes, conflicted with how they were treated for tax purposes.\textsuperscript{49} 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.\textsuperscript{50} In response, some credit card issuers restructured their

\begin{footnotes}
\item[45] \textit{Id.}
\item[46] PEASLEE \& NIRENBERG, supra note 28, at 167.
\item[47] GARLOCK, supra note 43, at § 102.03.
\item[49] \textit{See infra} Section II.C.
\item[50] Edward J. O’Connell and Katherine Bushueff, \textit{2003 Developments in Credit Card Securitization}, 20 S&P’S THE REVIEW OF BANKING AND FINANCIAL SERVICE 30L (February 2004); Edward J. O’Connell and
securitizations to begin issuing notes, using what is called a “note issuance trust.” The primary innovation of the note issuance trust is that it allows the issuance of separate classes of notes on an individual basis. 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. 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 had already committed many of their accounts to their existing trusts, which were structured to issue certificates rather than notes. Initially, only a few issuers, generally the largest banks, adopted this new structure due to the high costs

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52 KOThARI, supra note 5, at 14; CHARLES AUSTIN STone AND ANNE ZISSu, THE SECURITIZATION MARKETS HANDBOOK 25 (2005). 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. 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. Notes also present an advantage because they are eligible for benefit plans governed by the Employee Retirement Income Security Act (“ERISA”). 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. 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 15, at § 17.01[F][2][d].

53 KRAvITT, supra note 15, at § 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. 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. The trusts could then issue multiple series of notes backed by the collateral certificate.
associated with its implementation.\textsuperscript{54}

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 taxed as either a loan (i.e., debt) or a sale (i.e., equity). 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.\textsuperscript{55} 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.\textsuperscript{56}

Unlike securitizations of other types of assets, such as mortgages, the tax treatment of credit card securitizations has essentially been developed on an ad hoc basis and is therefore 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

\textsuperscript{54} Id. 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 since adopted the new structure. STONE AND ZISSU, supra note 52, at 75. 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. These new amendments take effect on January 1, 2010; it is still unclear what effect, if any, these new standards will have on credit card securitizations.

\textsuperscript{55} GARLOCK, supra note 43, at § 102.03.

\textsuperscript{56} Id. Recharacterization as debt may actually benefit investors, since they could be more favorably taxed on dividend income than on interest income. KRAVITT, supra note 15, at § 10.03.
purposes. Therefore, in order to determine which characteristics are important to a tax analysis of credit card securitizations, we must look at what characteristics have generally 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 rate of interest,” while equity is considered an investment in the venture itself, “taking the risk of loss, that [the investor] may enjoy the chance of profit.” While there is no definitive set of rules that 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.

Notice 94-47 lists the following factors as relevant to the debt-equity analysis:

57 The Treasury Department attempted to address the taxation of credit card securitizations in what were commonly referred to as “FASIT regulations” in 1996. The term FASIT refers to “Financial Asset Securitization Trust.” The FASIT rules were originally implemented by the Small Business Job Protection Act in 1996. P.L. 104-188, 104th Cong., 2d Sess. § 1621 (1996), adding §§ 860H-860L. The rules were enacted in part 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. However, the FASIT rules were generally viewed as being overly restrictive; moreover, the tax benefits they provided were often outweighed by the fact that they were subject to recognition of taxable gain on a contribution of assets. Finally, FASITs required a single ownership interest, whereas many credit card securitizations employed master trusts that had more than one sponsor/owner. These and other disadvantages prevented FASITs from ever gaining popularity among credit card issuers, and the FASIT rules were ultimately repealed by the American Jobs Creation Act of 2004. P.L. 108-357, § 835(a).

58 GARLOCK, supra note 43, at § 102.03.

59 PEASLEE & NIRENBERG, supra note 28, at 57. Although the Service did attempt to implement regulations governing the debt-equity distinction in 1980, these regulations were eventually withdrawn on the basis that they did not fully reflect the views of the Service or the Treasury Department. T.D. 7920.
(a) whether 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.\textsuperscript{60}

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.\textsuperscript{61} 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 instrument’s debt and equity features must be taken into account.”\textsuperscript{62}

\textsuperscript{60}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.

\textsuperscript{61}KRAVITT, supra note 15, at § 10.03[C].

\textsuperscript{62}I.R.S. Notice 94-47, 1994-1 C.B. 357.
One factor mentioned in Notice 94-47 is the issuer’s debt-equity ratio. 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 proprietor rather than a creditor.” 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. 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.” In other words, if those who owe money to the borrower default, any creditor whose loan to the borrower is severed by these debts will also suffer the default. 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 caselaw. Generally, sales of receivables are considered loans.

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63 PEASLEE & NIRENBERG, supra note 28, at 103.
64 Id.
65 Id.
66 Id.
for tax purposes unless the investor “benefits in a capacity other than as a lender.”67 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.68

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.69 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.”70 According to the court, “a disposition involves the relinquishment of the substantial incidents of ownership of the obligations.”71 In support of its conclusion, the court noted that

[t]he 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

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67 KRAVITT, supra note 15, at § 10.03.
68 Id.
71 Id. at 1057.
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.72

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.”73

Similarly, in U.S. Surgical Steel v. Commissioner, a pledge of installment obligations was held to be a loan because, “while the bank 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.”74 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 “[t]here 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.”75 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

72 Id.
73 Id.
74 54 T.C. 1215, 1229 (1970).
75 Id. at 1228.
sale of collateral.” 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.

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:

the 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 benefits of the obligations being paid (by being relieved of its obligations to either repurchase or have its holdback debited) and suffers the loss if they are not paid.”

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76 Id. at 1229 (emphasis in original).

77 Id. at 1229-30. The court also noted the following restrictions, which in its words “are wholly inconsistent with the view that the transaction was not a loan by the bank to the petitioner…:

The 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 the 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.

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.\textsuperscript{79} 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.\textsuperscript{80}

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

\textsuperscript{79} Id.

\textsuperscript{80} 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

[i]f 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 could still be a sale despite protection against loss.

\textit{Id.}
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 the merchant’s operations.\(^\text{81}\)

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 yet publicly addressed the taxation of credit card securitizations in a case, ruling or memorandum.\(^\text{82}\) 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 200130009. The factors considered relevant in these memoranda may help us determine how the Service should view credit card securitizations.

\(^{81}\text{Id. Although the Service has not withdrawn the positions it took in prior revenue rulings finding that the transfer of receivables constituted a sale when the merchant no longer had an unconditional risk of loss, subsequent General Counsel Memoranda confirm the Service’s adoption of the “incidents of ownership” approach. Rev. Rul. 65-185, 1965-2 C.B. 153; Rev. Rul. 54-43, 1954-1 C.B. 119; KRAVITT, supra note 15, at \S 10.03[C].}\)

\(^{82}\text{In a case against Transamerica Corporation, the IRS challenged the debt characterization of certificates issued as part of a mortgage securitization. However, the IRS conceded prior to trial the transaction would be treated as a secured borrowing. PEASLEE & NIRENBERG, supra note 28, at 132 n.177. In Field Service Advice 200136010, the Internal Revenue Service indicated that a particular credit card securitization would be treated as debt for tax purposes in a memorandum addressing the separate issue of whether expenses related to the transaction should be capitalized. Id.}\)
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. In this memorandum, the Service examined the issue of whether a transfer of automobile loans from a subsidiary to two trusts constituted sales or secured financings. 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.

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. The taxpayer then formed a bankruptcy-remote grantor trust to hold these receivables. This trust issued two classes of certificates representing a fractional, undivided interest in the trust and its assets (i.e., the pool of receivables). Credit support was provided to investors by the fact that, from their perspective, the trust was heavily overcollateralized. In addition, the certificates held by the subsidiary were subordinate to the certificates held by investors, and each securitization was further supported by a

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83 “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 (2009). Unless otherwise established by regulation, a technical advice memorandum “may not be used or cited as precedent.” I.R.C. § 6110(k)(3) (2009).
85 Id.
86 Id.
87 Id.
88 Id. The higher class of certificates was sold to investors, while the taxpayer’s subsidiary retained the lower class of certificates.
89 Id.
reserve account. 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.

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.” 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:

- whether the transaction was treated as a sale,
- whether the obligors on the notes (the transferor’s customers) were notified of the transfer of the notes,
- which party serviced the notes,
- whether payments to the transferee corresponded to collections on the notes,
- whether the transferee imposed restrictions on the operations of the transferor that are consistent with a lender-borrower relationship,
- which party had the power of disposition,
- which party bore the risk of loss, and
- which party had the potential for gain.

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90 Id.
91 Id.
92 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)).
93 Id. (internal citations omitted).
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.\(^{94}\) 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.”\(^{95}\) 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.”\(^{96}\) 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] because then the Taxpayer would have retained the risk of loss and opportunity for gain.”\(^{97}\) 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.\(^{98}\)

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.\(^{99}\)

With respect to the risk of loss, the Service noted that the taxpayer had experienced only

\(^{94}\) Id.

\(^{95}\) Id.

\(^{96}\) Id.

\(^{97}\) Id.

\(^{98}\) Id.

\(^{99}\) 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 securitizations do change along with short-term interest rates, since they are based on the Treasury yield curve. 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. As a result, the Service shifted its focus to an examination of who bore the risk of loss in the transactions at issue. Id.
minimal losses on its auto loans prior to the securitization. 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. 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.” The Service then concluded that “[t]his level of security indicates that [investors] did not bear the risk of loss from defaults or prepayments as they would had they bought the underlying loans.”

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.” 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].” However, the Service found that “[t]his sort of

100 Id.
101 Id.
102 Id.
103 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. 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.” 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.
104 Id.
105 Id.
catastrophic risk [] is more theoretical than real.” 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.107

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

the sponsor retained a clean-up call it could use when the outstanding principal balance of the mortgages in the pool dropped to 10 percent of their original balance;

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;

the sponsor, as servicer, had to pay the trustee’s fees and mortgage insurance premiums out of its servicing fee;

the sponsor retained the right to make advances to the [mortgage-backed securities] holders should the mortgagors pay late or default; and

106 Id.

107 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. 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. 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.” 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. 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.” 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.
the sponsor retained the right to guarantee principal and interest payments on the mortgages, either itself or through a third party.\footnote{108}{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.\footnote{109}{Id.} 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.”\footnote{110}{Id. (citing Thor Power Tool Co. v. Comm’r, 439 U.S. 522 (1979)).} 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.”\footnote{111}{Id.}

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.\footnote{112}{Id.} Instead, the Service declared this point “moot,” stating that “[t]he Taxpayer merely agrees with how the Commissioner has recharacterized the transactions.”\footnote{113}{Id.} 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.”

Some commentators have interpreted this to mean “that the IRS will permit other taxpayers to use the analysis of TAM 98-39-001 to reach a similar result on similar facts, but that it does not represent a general relaxation of the IRS’s long-standing reluctance to allow taxpayers to disregard their own form.” Furthermore, 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. 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.

In Field Service Advice 200130009, the Service examined a trust established by a bank holding a pool of loans secured by second mortgages. 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. Contrary to the bank’s argument, the Service found that the notes constituted ownership interests in the trust.

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114 Id.
115 KRAVITT, supra note 15, at § 10.03[C].
118 FSA 200130009. 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 and/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) (2009).
119 Field Service Advice 200130009.
rather than secured debt supported by the mortgages.\textsuperscript{120} 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, they 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.”\textsuperscript{121}

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

The risk of loss for an auto loan securitization depends on the rates of both default and prepayment, and Field Service Advice 200130009 indicates that a securitization that

\textsuperscript{120} Id.

\textsuperscript{121} The Service also concluded in the Field Service Advice that the form of the transaction constituted a sale, “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.” 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.” Despite the fact that the Field Service Advice 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. 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.
takes into account the risk presented by only one of these rates may be recharacterized as a sale.\textsuperscript{122} 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.”\textsuperscript{123}

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

When viewed alongside prior cases and rulings, credit card securitizations should be treated as issuances of debt rather than equity. Credit card securitizations fall into the traditional definition of debt because they represent “an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed rate of interest” rather than an investment in which the investor takes on both the risk of loss and the potential for profit.\textsuperscript{124} 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.\textsuperscript{125} 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.\textsuperscript{126}

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

\textsuperscript{122} Field Service Advice 200130009.


\textsuperscript{124} GARLOCK, supra note 43, at § 1.01[B] (citing Estate of Mixon v. United States, 464 F.2d 394 (5th Cir. 1972); Laidlaw Transp. Inc. v. Comm’r, 75 T.C.M. (CCH) 2598 (1998); I.R.S. Notice 94-47, 1994-1 C.B. 357)); KRAVITT, supra note 15, at § 10.03[C].

\textsuperscript{125} KRAVITT, supra note 15, at § 10.03.

\textsuperscript{126} PEASLEE & NIRENBERG, supra note 28, at 134.
increase dramatically before the reserve account and other forms of credit support would be insufficient to cover shortfalls. 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. In other words, investors in the securitization will be paid regardless of when (or if) payments are made on the receivables. 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. 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.

Credit card securitizations share other factors with the transactions that were characterized as debt in other cases and rulings. For example, cardholders are rarely if ever aware that the receivables on their accounts have been securitized, since investors can only look to the securitization vehicle for payment; this factor was cited as supporting characterization as debt in *U.S. Surgical Steel*, Technical Advice Memorandum 98-39-001 and General Counsel Memorandum 34,602. In addition, the issuer often acts as servicer on the accounts and is subject to restrictions similar to those found in *U.S. Surgical Steel*, 54 T.C. at 1229-30; I.R.S. Tech. Adv. Mem. 98-39-001 (May 29, 1998); I.R.S. Gen. Couns. Mem.34,602 (Nov. 17, 1971).

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128 KOTHARI, *supra* note 5, at 212.
129 Id.
130 FABOZZI, *supra* note 24, at 156.
Surgical Steel to be “wholly inconsistent” with sale characterization.\textsuperscript{133} 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.\textsuperscript{134}

The instruments issued as part of a securitization are nonrecourse, which means that investors cannot look to the issuer for payment; while this is normally indicative of a sale, this presumption may be overcome by other facts and circumstances.\textsuperscript{135} 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.\textsuperscript{136} 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.”\textsuperscript{137}

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.\textsuperscript{138} While credit card securitizations share some characteristics with the transaction at issue in Field Service Advice 200130009, which also found that a sale rather than a loan had taken place, a Field Service Advice is not considered binding

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\textsuperscript{133} \textit{U.S. Surgical Steel}, 54 T.C. at 1230.
\textsuperscript{134} \textit{Kravitt}, supra note 15, at § 10.03[C].
\textsuperscript{137} Id.
\end{flushleft}
precedent, and this particular Field Service Advice does not appear to have been followed by the Service when analyzing transfers of receivables.\textsuperscript{139}

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.\textsuperscript{140} 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.”\textsuperscript{141} 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 are generally labeled certificates, suggesting a sale, although some later securitizations have issued instruments labeled notes, indicating a loan.\textsuperscript{142} 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 should ultimately be of little, if any, relevance.\textsuperscript{143}

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. Of course, none of this is to say that all credit card securitization should be automatically taxed as debt. For example, if a credit card issuer

\textsuperscript{139} GARLOCK, \textit{supra} note 43, at § 102.03.

\textsuperscript{140} I.R.S. Notice 94-47, 1994-1 C.B. 357.

\textsuperscript{141} \textit{Id}.

\textsuperscript{142} \textit{Id}.

\textsuperscript{143} \textit{Id}. 
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 indeed be characterized as equity rather than debt. However, the typical credit card securitization described above should possess almost all the characteristics listed as being consistent with debt and should therefore be treated as such for tax purposes.

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. The Service may pay closer attention to these transactions as some issuers begin to default on their credit card securitizations. 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. 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.

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

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144 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.

145 KOTHARI, supra note 5, at 633 (citing Powers Committee Report, February 1, 2002).
own transaction. This rule, as well as a variant referred to as the strong proof rule, are described in detail in the following section.

IV. DANIELSON \textsuperscript{146} 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 the construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc.”\textsuperscript{147} 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.\textsuperscript{148} 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. Finally, this section explains how the two rules may affect the taxation of credit card securitizations.

A. Substance over Form

For almost seventy years, taxing authorities have adhered to the principle that “the

\textsuperscript{146} Danielson v. Commissioner, 378 F.2d 771 (3d Cir. 1967).
\textsuperscript{147} Id. at 775.
\textsuperscript{148} Ullman v. Comm’r, 264 F.2 305 (2d Cir. 1959).
incident of taxation depends on the substance rather than the form of the transaction.” 149

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.” 150

Under this doctrine, often referred to as “substance-over-form,” authorities may
recharacterize a transaction to comply with its true substance when such substance is
contrary to its outward form. 151 Recharacterization is warranted when the taxpayer
realizes nothing of substance beyond a tax benefit, and there is no substance or purpose
aside from the taxpayer’s desire to receive such benefit. 152 Recharacterization may be
further justified when, in addition to a lack of business purpose, there is no reasonable
possibility of turning a profit from the transaction. 153

Although the substance over form doctrine provides the Service with a strong
weapon to use against taxpayers, this weapon is not invincible. 154 Even though the
Service is authorized, and arguably even “duty-bound,” “to disregard transactions which
are designed to manipulate the Tax Code so as to create artificial tax deductions,” it may

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150 Higgins v. Smith, 308 U.S. 473 (1940). See also Saviano v. Comm’r, 765 F.2d 643 (7th Cir. 1985) (“The Commissioner and the courts are empowered, are in fact duty-bound, to look behind the contrived forms of transactions to their economic substance and to apply the tax laws accordingly”); Rev. Rul. 2000-12.

151 U.S. v. Ingalls, 399 F.2d 143 (5th Cir. 1968).


153 Rice’s Toyota World v. Comm’r, 752 F.2d 89 (4th Cir. 1985).

not disregard those transactions “which result in actual, non-tax related changes in economic position.”  

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.  

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. 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. In these cases, both the taxing authorities and the courts have generally abandoned their previous commitment to the principle that substance trumps form. The court’s 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.  

**B. Commissioner v. Danielson**

In Danielson, an investment corporation purchased the common stock of

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156 UPS of America v. Comm’r, 254 F.3d 1014 (11th Cir. 2001).
158 Johnson, supra note 149, at 1326.
159 Comm’r v. State-Adams Corp., 283 F.2d 395, 398-99 (2d Cir. 1960); Johnson, supra note 149, at 1326.
shareholders in an unrelated company.\textsuperscript{161} 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. 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.\textsuperscript{162} 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.\textsuperscript{163} 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 and the corporation and therefore had no value.\textsuperscript{164} 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 (although, by remanding the case, the court left open the possibility that the taxpayers could still present sufficient evidence to uphold their

\textsuperscript{161} Id. at 773.

\textsuperscript{162} Id. Under rules that were in place prior to 1993, payments attributable to a covenant not to compete, like the one at issue in \textit{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. An issue arose because the seller, who did not want to recognize the covenant as ordinary income, would sometimes 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.” Ullman v. Comm’r, 264 F.2d 305, 308 (2d Cir. 1959). Lacking outside signifiers, the court relied on the parties to come up with an equitable allocation: “[t]he 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.”

\textsuperscript{163} \textit{Danielson}, 378 F.2d at 773-74.

\textsuperscript{164} Id. at 774.
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. 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.” Second, such attacks on the form of a transaction “would nullify the reasonably predictable tax consequences of the agreement to the other party thereto.” 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. 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 unwilling to bargain for tax savings that may never materialize.

165 Id. at 777.
166 Id. at 775.
167 Id. See also N. Am. Rayon Corp. v. Comm’r, 12 F.3d 583, 587 (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”); Coleman v. Comm’r, 87 T.C. 178 (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 chose to respect or not respect transactions depending on which approach would most favor their position at trial”); Spector v. Comm’r, 641 F.2d 376, 385 (5th Cir. 1981) (“to the extent that the Tax Court’s approach rewards a taxpayer’s misrepresentation to the Commissioner of the true nature of a transaction, it is not desirable from a policy standpoint”).
168 Danielson, 378 F.2d at 775.
169 Id.
170 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”).
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.” 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.” 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.”

C. **Strong Proof Rule**

Although Danielson has been adopted by the Third, Fifth, Eleventh and Federal Circuits, some courts have criticized Danielson on the basis that to adopt it

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


173 Taiyo Hawaii Co. v. Comm'r, 108 T.C. 590 (1997). In Spector, 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 had in fact liquidated his interest. The court agreed with the government, noting that “a taxpayer, having voluntarily and at arms’ 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.” 641 F.2d at 383.

174 Danielson, 378 F.2d at 771.

175 Insilco Corp. v. U.S., 53 F.3d 95 (5th Cir. 1995) (purchase of stock).

176 Bradley v. United States, 730 F.2d 718 (11th Cir. 1984).

177 See, e.g., Danielson, 378 F.2d at 771 (Third Circuit); Spector, 641 F.2d at 386 (Fifth Circuit); Schatten v. Comm'r, 746 F.2d 319, 321-22 (6th Cir. 1984); Bradley, 730 F.2d at 720 (Eleventh Circuit); Forward Comm. Corp. v. U.S., 608 F.2d 485 (Cl. Ct. 1979) (applying Danielson to the Court of Claims, a precursor to the Federal Circuit); Stokely-Van Camp, Inc. v. U.S., 974 F.2d 1319 (Fed. Cir. 1992).
“would be to endorse a formalistic policy akin to caveat emptor by announcing that this Court 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.”\textsuperscript{178} In response, these courts have adopted what has come to be known as the “strong proof” rule instead.\textsuperscript{179} The debate over whether to adopt \textit{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”\textsuperscript{180}

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.”\textsuperscript{181} 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

\begin{footnotesize}
\textsuperscript{178} Schmitz v. Comm’r, 51 T.C. 306 (1968).

\textsuperscript{179} The Tax Court has generally followed the strong proof rule. See, e.g., Pac. Gamble Robinson v. Comm’r, T.C. Memo 1987-533 (citing Ullman v. Comm’r, 264 F.2d 305, 308 (2d Cir. 1959)); G C Servs. Corp. v. Comm’r, 73 T.C. 406 (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 (1978) (rejecting taxpayer’s attempt to recharacterize transaction as a sale despite the fact that it was not in form a sale); Mittleman v. Comm’r, 56 T.C. 171 (1971) (rejecting taxpayer’s attempt to recharacterize gain resulting from liquidated damages); Lucas v. Comm’r, 58 T.C. 1022 (1972) (denying taxpayer’s claim that purchase agreement included covenant not to compete); Schmitz, 51 T.C. at 306 (citing \textit{Ullman}, 264 F.2d at 308); Schulz v. Comm’r, 294 F.2d 52 (9th Cir. 1961). However, under what has been termed “the \textit{Golsen} rule,” the Tax court is required to follow the rules of the circuit where an appeal would lie. Golsen v. Commissioner, 54 T.C. 742, 757 (1970). However, in some cases the Tax Court may decline to apply the \textit{Danielson} rule even when required to under the \textit{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).

\textsuperscript{180} Spector, 641 F.2d at 384 (“in contrast to the Tax Court’s application of the ‘strong proof’ rule in the present case, the prior decisions of the 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 thereunder”).

\textsuperscript{181} \textit{Ullman}, 264 F.2d at 308. See also Utley v. Comm’r, 906 F.2d 1033 (5th Cir. 1990); \textit{Coleman}, 87 T.C. at 178; Ill. Power Co. v. Comm’r, 87 T.C. 1417 (1986).
\end{footnotesize}
this substance is consistent with the economic reality of the transaction. The strong proof rule, like the Danielson rule, is grounded in the idea that the taxpayer, unlike the 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.

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 economic value.” 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. 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.”

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

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183 Spector, 641 F.2d at 386. See also Levinson v. Comm’r, 45 T.C. 380 (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”); Estate of Rogers v. Comm’r, 29 T.C.M. (CCH) 869 (1970) (“[t]he 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”).
184 Spector, 641 F.2d at 383. See also O’Callaghan v. Comm’r, T.C. Memo 1984-214 (“The focus of our inquiry is on whether the allocation possesses economic reality and whether petitioner in fact agreed to it”).
185 Spector, 641 F.2d at 385; Johnson, supra note 149, at 1323.
186 Estate of Rogers, 29 T.C.M. (CCH) 869; Johnson, supra note 149, at 1324.
While the tax court has stated that strong proof consists of proof “beyond a mere preponderance of the evidence,” 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.” 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 showing required for the reformation of a contract.”

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. 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. 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.

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

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189 *Muskat*, 554 F.3d at 191.
190 *Id.* at 191.
191 Levine v. Comm’r, 324 F.2d 298 (3d Cir. 1963) (citing Ullman v. Comm’r, 264 F.2 305, 308 (2d Cir. 1959)).
192 Faris v. Comm’r, T.C. Memo 1988-465 (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”).
193 *Id.* at 191.
rather than its form. The taxpayer may even be able to disavow the form of his transaction despite not showing an “honest and consistent respect” for the substance of the transaction in his tax reporting. Nonetheless, the strong proof rule requires more than a simple showing of what would be fair or equitable. Instead, the taxpayer must show that the parties in fact agreed on a different figure at the time they entered into the agreement. 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.

Although jurisdictions may argue over whether Danielson or the strong proof rule should be applied, often the result is the same, since the taxpayer is generally unable to clear either the high bar of proving fraud or duress under Danielson or the slightly lower

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194 See, e.g., Schmitz v. Comm’r, 51 T.C. 306 (1968) (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).

195 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. 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. 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 was attacking the form of the transaction, but we see no reason why we should make a distinction on this point.” 51 T.C. at 317. See also Sonnleitner v. Comm’r, 598 F.2d 464, 467 n.9 (5th Cir. 1979) (“[t]he Danielson rule imposes a heavier burden upon taxpayers challenging agreements than does the Ullman rule”).


197 For example, the court 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. Estate of Rogers v. Comm’r, 29 T.C.M. (CCH) 869 (1970).

198 Muskat v. U.S., 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)).
bar of providing “strong proof” that substance differs from form. At least one court
has noted that

the 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.

Under either test, the taxpayer essentially rejects the form altogether and asks the
government to look to the transaction’s substance instead, something the  government is
loath to do other than on its own terms.

D. Policies underlying Danielson and the Strong Proof Rule

The Danielson rule and strong proof rule are based on the notion that “the
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

199 See, e.g., U.S. v. Fletcher, No. 07-10043, 2008 WL 162758 (N.D. Ill. 2008); Thomas v. Comm’r, T.C. Memo 2002-108 (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) (“regardless of the standard applied [petitioner] has failed to carry its burden”); Dodson v. Comm’r, 52 T.C. 544 (1969) (holding against taxpayer under the strong proof rule, but noting “that under the more stringent Danielson rule’… the result would be the same”).

200 Estate of Rogers, 29 T.C.M. (CCH) 869.

201 Id.
be due but for the form, does not require the mutuality that [the taxpayer] contends.”

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.”

The Service may be especially concerned 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. However, both the Danielson and strong proof rules have since been expanded to other contexts in which a taxpayer attempts to argue that the substance of a transaction differs from its form. For example, the strong proof rule has been applied

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202 Strick Corp. v. United States, 714 F.2d 1194, 1206 (3d Cir. 1983).

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

204 See, e.g., Proulx v. U.S., 40 AFTR 2d 77-6168 (Cl. Ct. 1977); Commissioner v. Danielson, 378 F.2d 771. See also Kreider v. Comm’r, 762 F.2d 580 (7th Cir. 1985) (applying strong proof rule to covenant not to compete); Leslie S. Ray Ins. Agency, Inc. v. U.S., 463 F.2d 210 (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 because they “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 (and the respondent as a stakeholder) is willing to accept the terms of the contract as written.” Major v. Comm’r, 76 T.C. 239, 248 (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. Nonetheless, Danielson has still been invoked with respect to the general allocations made in a purchase agreement. See, e.g., Becker v. Comm’r, T.C. Memo 2006-264 (upholding purchase agreement that allocated entire purchase price to stock and none to covenant not to compete).

205 Johnson, supra note 149, at 1324. See also Sullivan v. U.S., 618 F.2d 1001 (3d Cir. 1980); Dakan v. U.S., 492 F.2d 1192 (11th Cir. 1974); Estate of Durkin v. Comm’r, 99 T.C. 561 (1992); U.S. v. Fletcher, No. 07-10043, 2008 WL 162758 (N.D. Ill. 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); Coleman v. Comm’r, 87 T.C. 178, 202 (1986) (“it 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. Commissioner, T.C. Memo 1986-353 (applying strong proof rule to trust agreement).
to leasing transactions when both the lessor and lessee have attempted to receive tax benefits from the transaction\footnote{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. If, on the other hand, the lessee actually receives ownership of the property, then the lessor may no longer depreciate its interest in the property, and the lessee may no longer deduct rental payments. 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), and the parties may 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. Coleman put an end to this practice by stating “[t]he 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 petitioners to disavow that form in order to obtain the benefits of U.S. tax laws.” 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.” In support of its ruling, the court stated “there is nothing in [prior cases] which compels us to ignore the form of a transaction 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.” Coleman, 87 T.C. at 203.} and to other 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.\footnote{Strick, 714 F.2d at 1206; Sullivan, 618 F.2d at 1001.} 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.\footnote{Sullivan, 618 F.2d at 1007. (“the 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”).}

Danielson and the strong proof rule may be particular necessary in situations where legislative policy supports giving the parties flexibility in structuring the tax consequences of their transactions.\footnote{Spector v. Comm’r, 641 F.2d 376, 385 (5th Cir. 1981). Cf. Johnson, supra note 149, at 1324 (indicating that some courts have rejected Danielson because of contrary legislative intent).} 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.”\footnote{Spector, 641 F.2d at 379.}
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.’” Permitting taxpayers to attack form in this way “would nullify the reasonably predictable tax consequences” of agreements. 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.”

In addition to gamesmanship, the Service may be concerned with being whipsawed, a condition described above as one which 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. 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.” Such freedom “encourag[es] parties unjustifiably to risk litigation after consummation of a transaction in order to avoid the tax consequences of their agreements.” Arguably, without the availability of the *Danielson* and strong proof rules, the only way the Service could protect itself against

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211 *Sullivan*, 618 F.2d at 1004.
212 Id. (quoting *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967)).
213 Id.
214 *Spector*, 641 F.2d at 379; Johnson, *supra* note 149, at 1323.
215 Id.
216 Id.
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...” 217 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.” 218 Another reason for the Danielson and strong proof rules was stated by the court in Spector, which noted that

to 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. 219

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 predictability, reducing administrative burdens and whipsaws) must be present. 220 Others have concluded that one particular

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217 Spector, 641 F.2d at 385.
218 Sullivan, 618 F.2d at 1004.
219 Spector, 641 F.2d at 385.
220 Plante v. Comm’r, 168 F.3d 1279 (11th Cir. 1999); U.S. v. Daum, 968 F. Supp. 1037 (W.D. Pa. 1997) (preventing taxpayer from recharacterizing sale proceeds as settlement proceeds); Hosp. Corp. v. Comm’r, T.C. Memo 1996-559 (citing Comdisco, 736 F.2d at 578); 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); Freeport Transport, Inc. v. Commissioner, 63 TC 107, 116 (1974); Johnson, supra note 149, at 1324.
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.\footnote{221} 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.\footnote{222} Finally, some courts have suggested that *Danielson* and the strong proof rule do not apply when one of the parties is tax-exempt.\footnote{223}

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 in substance a clear expression of Congressional intent.”\footnote{224} For example, in *Comdisco*, 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 was thus initially denied the credit by the district court.\footnote{225}

\footnote{221} *Schmitz v. Commissioner* 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.” 51 T.C. 306 (1968). This argument loses force when one considers the fact that *Danielson* itself involved a taxing authority on the other side. Furthermore, *Schmitz* was decided in a jurisdiction that followed the strong proof rule, so any statements regarding *Danielson* are essentially dicta.

\footnote{222} *Patterson v. Comm’r*, 810 F.2d 562 (6th Cir. 1987) (“The *Danielson* rule can only be meaningfully applied in those cases where a specific amount has been mutually allocated to the covenant as expressed in the contract…”).

\footnote{223} *Estate of Rogers v. Comm’r*, 29 T.C.M. (CCH) 869 n.1 (1970). Courts may also 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*, 294 F.2d at 55 (taxpayer “was apparently unaware that the tax benefits which he was willing to confer upon the [other party] would be a tax detriment to him”), or when the form changes in light of later, more accurate information. *Amerada Hess Corp. v. Comm’r*, 517 F.2d 75 (3d Cir. 1975) (allowing taxpayer to use value of stock on closing date rather than value of stock on date of initial agreement).

\footnote{224} *Comdisco Inc. v. United States*, 756 F.2d 569 (7th Cir. 1985).

\footnote{225} *Id.*
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.” 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.

The court further noted that

[...]

In allowing the taxpayer to disavow, the court said, “[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.”

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226 Id. at 577.
227 Id. at 578.
228 Id.
229 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. 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. The Service’s silence on this issue presents particular problems for the issuers of credit card securitizations because, if Danielson does apply, then credit card issuers could be placed in the difficult position of having to argue against the validity of their own carefully negotiated transactions.

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 the construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc." In the case of a credit card securitization, the parties to the securitization, in order to receive the desired tax treatment specified in the transaction documents, would have to show that the agreement they reached is itself unenforceable. 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

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230 Kravitt, supra note 15, at § 10.03(C)[2][a] (“a risk remains that the IRS may attempt to hold a taxpayer to the chosen form”) (citing Stein v. Director of Internal Revenue, 135 F. Supp. 356 (E.D.N.Y. 1955); Gatlin v. Comm’r, 34 B.T.A. 50 (1936)).

231 See, e.g. Tech. Adv. Memo 98-39-001 (“[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”).

232 Danielson, 378 F.2d at 775.

233 See N. Am. Rayon Corp. v. Comm’r, 12 F.3d 583, 589 (6th Cir. 1993) (focus under Danielson is on whether contract is enforceable).
side) responsible for the remaining terms of the agreement.\footnote{Id.} 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 to take advantage of the fact that the issuer has argued that its own contract is unenforceable.\footnote{\textit{Danielson}, 378 F.2d at 775.} Moreover, it is unlikely that the parties would 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.\footnote{Id.}

Taxpayers would face similar problems under the strong proof rule. Although they would not have to show that the argument itself is invalid, they would have to provide strong proof that the substance of the transaction is a loan rather than a sale.\footnote{Ullman v. Comm’r, 264 F.2d at 305 (2d Cir. 1959).} Courts and authorities have thus far failed to provide an exact definition of strong proof, and many have noted that the result under either \textit{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.\footnote{\textit{See}, e.g., U.S. v. Fletcher, No. 07-10043, 2008 WL 162758 (N.D. Ill. 2008); Thomas v. Comm’r, T.C. Memo 2002-108 (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 \textit{Danielson} rule and those applying the strong proof rule); Major v. Comm’r, 76 T.C. 239, 249 (1981) (“regardless of the standard applied [petitioner] has failed to carry its burden”); Dodson v. Comm’r, 52 T.C. 544 (1969) (holding against taxpayer under the strong proof rule, but noting “that under the more stringent \textit{‘Danielson rule’… the result would be the same”}).} Even if the taxpayer expected to ultimately prevail, the specter of a challenge under this rule could make the transaction less desirable to investors.\footnote{KOTHARI, supra note 5, at 23.}

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 is essentially asking taxpayers to disclaim provisions that were carefully drafted for non-tax reasons.\textsuperscript{240} 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.\textsuperscript{241} Finally, discrepancies in the taxation of credit card securitizations under Danielson versus the strong proof rule could lead to forum shopping or other undesirable results.\textsuperscript{242}

\textbf{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, the treatment of credit card securitizations as debt for tax purposes is supported by many factors.\textsuperscript{243} When analyzing these transactions, the Service should rely on typical debt-equity analysis without resorting to the Danielson and strong proof rules. Those credit card securitization 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.\textsuperscript{244} 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.

\textsuperscript{240} Id.
\textsuperscript{241} Schmitz v. Comm’r, 51 T.C. 306 (1968).
\textsuperscript{242} Id.
\textsuperscript{243} See supra Part III.D.
\textsuperscript{244} See supra Part III.D.
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. 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.

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 long resisted attempts to bring the two into alignment. 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,”\(^{245}\) 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.”\(^{246}\) Some specific concerns raised by the AICPA,


\(^{246}\) *Id.*
which still carry weight today, were that conformity rules would be applied unequally and could deter innovation in accounting principles.\textsuperscript{247}

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.”\textsuperscript{248} 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.\textsuperscript{249}

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.\textsuperscript{250}

Although some commentators have argued for a more comprehensive requirement of book-tax conformity,\textsuperscript{251} 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

\begin{footnotesize}
\begin{enumerate}
\item Id. at 41.
\item Id. at 129.
\item Id. at 153 n.289.
\item Id.
\end{enumerate}
\end{footnotesize}
have to follow accounting treatment in all cases.\textsuperscript{252} Similarly, Professor Schon 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.”\textsuperscript{253}

We may start to see greater arguments for book-tax conformity in the wake of financial accounting scandals, like Enron.\textsuperscript{254} In particular,

the 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.\textsuperscript{255}

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

[w]ith the constantly increasing complexity of business transactions and financial products, and the proliferation of enormously detailed provisions

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\textsuperscript{253} Schon, \textit{supra} note 251, at 111.
\textsuperscript{254} Luppino, \textit{supra} note 245, at 43.
\textsuperscript{255} Id. at 130.
\end{flushleft}
of the IRS 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.”

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.” 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. 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.

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

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256 *Id.* at 179 (citing Thor Power Tool Co. v. Comm'r, 439 U.S. 522 (1979)).

257 *Id.* at 189.

258 *Id.*

259 *Id.*
address these situations. Furthermore, the recent trend towards greater disclosure of book-tax differences allows 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. 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, would be akin to swatting a fly with a sledgehammer.

The Treasury Department and the Service have already 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. Danielson and the strong proof rule would only provide 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 reflects income.”

There may be instances where a discrepancy between the accounting treatment and tax treatment of a transaction is indicative of the fact that one of the two treatments is incorrect. The government has clearly identified some of these situations and addressed them, for example, in the reportable transaction regulations. The remaining situations are too complex to be addressed by a rigid rule mandating conformity, since the varying

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260 Keinan, supra note 252, at 680.
261 Luppino, supra note 245, at 189.
262 Id.
263 Id.
goals of the accounting and tax rules may sometimes require different treatment. 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.

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 suggest that form for accounting purposes should not be equated with form for tax purposes. 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, continues to leave the landscape unclear and potentially dangerous for those who wish to enter into credit card securitizations.

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 do not apply when the form on the taxpayer’s tax return complies with its substance, regardless of what form is used elsewhere. 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.\(^\text{264}\) In *Campbell*, the taxpayers sold their company to the Unitec Corporation in exchange for stock and notes of the corporation, as well as cash.\(^\text{265}\)

\(^{264}\) 661 F.2d 209 (Ct. Cl. 1981).

\(^{265}\) *Id.*
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. The Commissioner challenged this amended return, citing Danielson. 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.”

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.” 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. 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 here.”

As a result, the question of whether a difference in

\[266\] Id.
\[267\] Id.
\[268\] Id. at 217.
\[269\] Id.
\[270\] Id.
\[271\] Id. In addition, the court said, “the 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.” 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 had in fact been disavowed. The court in Campbell ultimately “split the baby,” rejecting both the taxpayer’s and the Commissioner’s proposed values for the stock and notes and calculating these values itself.
form for accounting purposes and form for tax purposes constitutes a difference between substance and form remains unresolved, even after *Campbell*.272

Similarly, the court in *Illinois Power* accepted a taxpayer’s reporting despite its difference from accounting treatment when the taxpayer showed “an honest and consistent respect for what [the taxpayer] considers to be the substance of the [agreement].”273 This case involved a sale-leaseback that was consistently 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.274 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.”275 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.”276 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.”277 Nonetheless, the court concluded that the taxpayer was still required to produce “at a minimum, ‘strong proof’ that the other elements of the

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272 *Id.*
274 *Id.*
275 *Id.*
276 *Id.*
277 *Id.* at 1433 n.12.
benefits and burdens of ownership” warranted the taxpayer’s desired treatment, suggesting that it did in fact view the difference as one between form and substance.\textsuperscript{278}

The court then found that the taxpayer had indeed presented strong proof of the benefits and burdens of ownership when the sale was made “for the purpose of financing” and the taxpayer claimed an interest expense deduction on its tax return.\textsuperscript{279} 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.\textsuperscript{280} According to the court,

\begin{quote}
[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 \textit{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.\textsuperscript{281}
\end{quote}

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\textsuperscript{278} \textit{Id.} at 1434.
\textsuperscript{279} \textit{Id.} at 1432. 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…” \textit{Id.}
\textsuperscript{280} \textit{Id.} at 1433.
\textsuperscript{281} \textit{Id.}
\end{flushleft}
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.\textsuperscript{282}

In \textit{Durkin}, 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.\textsuperscript{283} In doing so, the court compared the taxpayer’s situation unfavorably to one in which a taxpayer had both structured the transaction as a redemption and reported it as such on his income tax return.\textsuperscript{284} 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.”\textsuperscript{285} However, the court refused to respect actions that were nothing more than a unilateral attempt to recharacterize the transaction after it had been challenged.\textsuperscript{286} To do so “would unjustly enrich petitioners to permit them to belatedly change the deal made after well-informed negotiations.”\textsuperscript{287} While \textit{Durkin} comes closer than \textit{Campbell} or \textit{Illinois Power

\textsuperscript{282} See \textit{KRAVITZ, supra} note 15, at § 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 the labels used in the transaction. While the taxpayer has the better argument in claiming that economic substance should prevail, an element of uncertainty exists until courts clearly define when a taxpayer may contest the form chosen”).


\textsuperscript{284} Id. at 568.

\textsuperscript{285} Id. at 570.

\textsuperscript{286} Id.

\textsuperscript{287} Id. at 575. See also Norwest \textit{v. Comm’r}, 111 T.C. 105, 145 (1998) (“when 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”); Bradley (disavowal made on amended tax return).
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.

Courts have also acknowledged that the “form” adopted for tax purposes may change prior to the filing of the tax return.\textsuperscript{288} For example, in \textit{Amerada Hess}, 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 was initially proposed.\textsuperscript{289} 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.\textsuperscript{290} Although the Tax Court agreed with the Commissioner, 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.”\textsuperscript{291}

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.\textsuperscript{292} The court noted that the existence of an outside valuation eliminated one of the primary reasons behind \textit{Danielson}, namely preventing parties from

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\textsuperscript{288} Amerada Hess Corp. v. Comm’r, 517 F.2d 75 (3d Cir. 1975).
\textsuperscript{289} \textit{Id.}
\textsuperscript{290} \textit{Id.}
\textsuperscript{291} \textit{Id.} at 83.
\textsuperscript{292} \textit{Id.} at 85.
\end{flushright}
unilaterally reforming a contract to their benefit.\textsuperscript{293} Finding that such reformation had not taken place, the court found it unnecessary to apply \textit{Danielson} or the strong proof rule.\textsuperscript{294} While cases like \textit{Durkin} and \textit{Amerada Hess} suggest form for tax purposes may differ from form for accounting purposes, no case has made this distinction explicit. Furthermore, even those cases that allow a particular tax treatment despite such discrepancies, like \textit{Campbell} and \textit{Illinois Power}, do so on other grounds without acknowledging the fact that such differing treatments not only can but sometimes should peacefully coexist.

Most commentators seem to agree that \textit{Danielson} and the strong proof rule should not be applied to credit card securitizations, although their reasons vary. For example, Peaslee and Nirenberg argue that \textit{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.\textsuperscript{295} They also argue that \textit{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.\textsuperscript{296} 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.\textsuperscript{297} However, they fail to recognize the larger point, which is

\begin{align*}
\textsuperscript{293} & \textit{Id.} \text{ at 86.} \\
\textsuperscript{294} & \textit{Id.} \\
\textsuperscript{295} & \textsc{Peaslee} \text{ & Nirenberg, supra} \text{ note 28, at 138.} \\
\textsuperscript{296} & \textit{Id.} \\
\textsuperscript{297} & \textit{Id. See also Kravitt, supra} \text{ note 15, at § 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}}
\end{align*}
that a difference between treatment for accounting purposes and treatment for tax purposes is not a difference between substance and form.\textsuperscript{298}

Professor Johnson argues that “[t]he 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.”\textsuperscript{299} 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.”\textsuperscript{300} With respect to the debt-equity distinction, for example, he argues, “[i]f 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.”\textsuperscript{301} He also points out that “[c]ourts have been willing to allow [] issuers to treat certain securities… as equity for book or regulatory purposes and as debt for tax purposes” and that “[p]reventing a taxpayer from recharacterizing the security by applying the Danielson Rule could deprive the taxpayers of interest or dividends-received deductions that Congress intended the taxpayer to enjoy.”\textsuperscript{302}

\textsuperscript{298} Peaslee and Nirenberg 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. \textit{See infra} Section V.C.

\textsuperscript{299} Johnson, \textit{supra} note 149, at 1320-21.

\textsuperscript{300} \textit{Id.} at 1330.

\textsuperscript{301} \textit{Id.} at 1341.

\textsuperscript{302} \textit{Id.}
While Professor Johnson correctly argues for limitations on Danielson, 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. 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 has specifically authorized such treatment; his analysis does not cover transactions like credit card securitizations that have not been specifically addressed by the legislature. 303 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.

In sum, neither the Service, the courts, or other scholarly authorities have clearly established 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. 304 In other words, according to these

303 Id.

304 KRAVITT, supra note 15, at § 10.03[d][4]. Peaslee and Nirenberg also 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 28, at 138 (citing Estate of Rogers v. Comm’r, 29 T.C.M. (CCH) 869 (1970)). They argue that “[t]he terms of the trust
commentators, the use of the term “certificate” alongside other terms that are consistent with debt treatment creates an issue of interpretation rather than disavowal. 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 there is ambiguity as to the true substance of the transaction. Other cases have found that Danielson would not exclude extrinsic evidence the taxpayer wished to bring in to support his tax characterization. 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.

In Smith, an ambiguity arose because the purchase agreement at issue contained two different prices, only one of which could be correct. 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 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 (1990)).

305 See, e.g., Jorgl v. Comm’r, T.C. Memo 2000-10 (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 (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).

306 See, e.g., Sharewell, Inc. v. Comm’r, T.C. Memo 1999-413 (taxpayer allowed to bring in evidence indicating purchase price inadvertently excluded covenant not to compete); Patterson v. Comm’r, 810 F.2d 562, 572 (6th Cir. 1987) (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”); Elrod v. Comm’r, 87 T.C. 1046 (1986) (“neither the Danielson rule nor the strong proof rule are applicable to exclude parol evidence offered with respect to an ambiguous document”).
ambiguity, as in the instant case, we think the Danielson rule is inapplicable.”\(^{307}\) It noted that ambiguity also served as an exception under the strong proof rule: “Where ‘Neither 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.”\(^{308}\)

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.\(^{309}\) 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. To hold otherwise would, as noted above, require the credit card company to argue against an interpretation that had been carefully drafted 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.\(^{310}\) The landscape changed, however, with the


\(^{308}\) Id. at 714. (quoting Peterson Matching Tool, Inc. v. Comm’r, 79 T.C. 72, 82 (1982); citing Kreider v. Comm’r, 762 F.2d 580 (7th Cir. 1985)).

\(^{309}\) Id.

inception of note issuance trusts in 2003.\textsuperscript{311} As noted above, only a select number of credit card companies, particularly larger ones, have switched to note issuance trusts.

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 \textit{Danielson} or the strong proof rule to these transactions.\textsuperscript{312} Such a selective attack would be unfair, particularly because it would harm those credit card companies which did not have the resources or did not engage in enough securitizations to make a switch to the new note structure.\textsuperscript{313} Moreover, because notes under this new structure, unlike certificates under the old structure, may be de-linked, credit card issuers are in fact able 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.\textsuperscript{314}


\textsuperscript{314} Edward J. O’Connell and Katherine Bushueff, \textit{2003 Developments in Credit Card Securitization}, 20 S&P’S \textit{THE REVIEW OF BANKING AND FINANCIAL SERVICE} 30L (February 2004); Edward J. O’Connell and Katherine Bushueff, \textit{Developments in Credit Card Securitization}, 19 S&P’S \textit{REV. OF BANKING AND FIN. SERVICE}, 26A (January 2003). See \textit{supra} Section 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, \textit{supra} note 28, at 485.
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.