South Carolina Law Review

Volume 72 | Issue 1 Article 4

Fall 2020

Tax Practice Gets a Mary Kay Makeover: The Tale of Peterson and the Danielson Rule

Joy Sabino Mullane
Villanova University Charles Widger School of Law

TAX PRACTICE GETS A MARY KAY MAKEOVER: THE TALE OF *PETERSON* AND THE *DANIELSON* RULE

Joy Sabino Mullane*

I. INTRODUCTION

Mary Kay is an iconic direct sales company, and many women aspire to gain the financial benefits derived from selling its cosmetics.[1] The Mary Kay makeover business currently generates nearly $4 billion in revenue per year, by way of approximately 3.5 million independent saleswomen.[2] Among that sales force, a small percentage generate enough revenue to qualify for some of the most prized perquisites that are available to those at the highest Mary Kay sales levels.[3] These benefits include not only the emblematic pink Cadillac but also other benefits such as the right to participate in programs that provide financial payments to the saleswoman once she ceases to sell

* Professor of Law and Faculty Director of the Graduate Tax Program, Villanova University Charles Widger School of Law. I wish to thank Les Book for inviting me to analyze the *Peterson* case for the blog Procedurally Taxing (www.procedurallytaxing.com) and reviewing my blog commentary. I also wish to express appreciation to PT blog-contributor, Keith Fogg, for his contribution to the title of this article. I am grateful to my colleagues who attended the summer workshop where I discussed this paper and provided helpful feedback. I am especially grateful to Teri Ravenell for reading countless drafts and her always-insightful comments.

1. *Mary Kay*, FORBES (Dec. 17, 2019), https://www.forbes.com/companies/marykay/#248cd2362bc9 [https://perma.cc/5XJY-P9FL].

2. *Id.*

3. *See* Peterson v. Comm'r, 827 F.3d 968, 970 (11th Cir. 2016).

Mary Kay cosmetics.[4] These latter benefits (the post-sales career payments) have recently been the subject of a significant tax dispute, reviving a longstanding controversy: what controls the tax consequences of a transaction—the transaction's form or its substance?[5]

The answer to this question depends, of course.[6] While tax literature and case law commonly assert that a transaction's substance controls over mere form or label, the reality is more nuanced.[7] Whether form or substance controls depends on which party is asserting one or the other, the context of the dispute, and the court before which the dispute is adjudicated.[8]

Often, the ability to successfully argue that the nature of a transaction—rather than contractual terms, labels, legal structure, or return characterization—should determine the tax consequences is limited to the government.[9] In this way, the substance-over-form doctrine is asymmetrical, with its benefits principally flowing to the government.

Sometimes, taxpayers succeed in asserting substance over form; although to do so, they often must meet a higher standard of proof.[10] In response, the

---

4. *See id.*; *Sell Mary Kay*, MARY KAY, https://www.marykay.com/en-us/sell-mary-kay [https://perma.cc/X34M-URGE].

5. Ray A. Knight & Lee G. Knight, *Substance over Form: The Cornerstone of Our Tax System or a Lethal Weapon in the IRS's Arsenal?*, 8 AKRON TAX J. 91, 92 (1991) ("[N]either the courts nor the IRS have provided a generally applicable answer to the question of whether substance should prevail over form or form should prevail over substance.").

6. This is the paradigmatic safe answer to almost any legal question.

7. *See, e.g.*, Gregory v. Helvering, 293 U.S. 465, 469–70 (1935); W. Md. Ry. Co. v. Comm'r, 33 F.2d 695, 698 (4th Cir. 1929); BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 4.3.6, Westlaw (database updated 2020); Kenneth L. Harris, *Should There Be a "Form Consistency" Requirement?* Danielson *Revisited*, 78 TAXES 88, 89 (2000) ("It is a fundamental principle of federal income taxation that the tax consequences of a transaction turn on the 'substance' and not the 'form' of the transaction."); Michael E. Baillif, *The Return Consistency Rule: A Proposal for Resolving the Substance-Form Debate*, 48 TAX LAW. 289, 289 (1995); J. Bruce Donaldson, *When Substance-over-Form Argument is Available to the Taxpayer*, 48 MARQ. L. REV. 41, 41 (1964) ("The gospel that the substance of a transaction, rather than mere form, controls the tax incidents is accepted by all.").

8. *See infra* Part II.

9. Donaldson, *supra* note 7, at 42 ("A considerable body of thought exists that the doctrine of substance is a sword available to the Commissioner, but that it may not be used as a shield by the taxpayer."); *see also* Higgins v. Smith, 308 U.S. 473, 477–78 (1940). For purposes of this Article, the "nature of a transaction" refers to a transaction's substance, while the "tax consequences" of the transaction refer to a transaction's form.

10. *See* Donaldson, *supra* note 7, at 45; Harris, *supra* note 7, at 89; Bartels v. Birmingham, 322 U.S. 126, 131–32 (1947); Throndson v. Comm'r, 457 F.2d 1022, 1024–25 (9th Cir. 1972); Comm'r v. Proctor Shop, 82 F.2d 792, 795 (9th Cir. 1936); Shaw v. Comm'r, 59 T.C. 375, 383–84, 387 (1972); *see also* Baillif, *supra* note 7, at 300 (noting that the "strong proof rule" allows a taxpayer to disavow form "if, and only if, she can establish by 'strong proof' the nature of the transaction's true substance which she claims differs from the form initially adopted" (quoting Coleman v. Comm'r, 87 T.C. 178, 204 (1986))). Under the *Weinert*

government will invariably invoke one of the rules that comprise the Non-Disavowal Doctrine.[11] These rules prohibit taxpayers from disavowing the form chosen for their transaction, even if the transaction would be taxed differently if the substance were assessed on its merits.[12] This embraces issues of "form" including contracts that specify how certain payments should be characterized or classified for tax purposes.[13]

One such non-disavowal rule is the so-called *Danielson* rule.[14] The *Danielson* rule binds parties to the form of their transaction regardless of the underlying substance, unless the taxpayer can show "proof which[,] in an action between the parties to the agreement[,] would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc." [15]

However, imagine entering into a transaction that gives one party—perhaps the party with significantly more negotiating power—the ability to unilaterally amend the contract at any time and in any manner post hoc. Further, assume the contract is subsequently amended in a way that, for the first time, explicitly characterizes the nature of the contract for tax purposes. Should the new amended form of the contract control the tax consequences, binding the non-amending party who had no opportunity to object to the amendment? Has the non-amending party forfeited all rights to make an argument on the merits because they agreed to the unilateral amendment clause *ex ante*? The Eleventh Circuit answered both questions affirmatively in a recent case of first impression, *Peterson v. Commissioner*.[16]

In this case, Christine Peterson, who rose to the highest sales levels of Mary Kay, elected to participate in two programs offered by Mary Kay that

---

standard—a little-used variation on the strong proof rule—taxpayers are most likely to be successful if they provide a non-tax justification asserting substance over form in a consistent manner. Est. of Weinert v. Comm'r, 294 F.2d 750, 755 (5th Cir. 1961).

11. *See* Emily Cauble, *Reforming the Non-Disavowal Doctrine*, 35 VA. TAX REV. 439, 441 (2016) ("Courts' resistance to taxpayers' attempts to assert that the substance of their transactions should prevail over form has been named the 'Non-Disavowal Doctrine.'").

12. *See id.* at 440–41.

13. *See* Baillif, *supra* note 7, at 294.

14. Comm'r v. Danielson, 378 F.2d 771, 775 (3d Cir. 1967) (establishing the *Danielson* rule).

15. *Id.* The *Danielson* rule was controversial when it was judicially accepted, and it received some immediate academic attention but has been largely ignored for the last twenty years. *See, e.g.*, Comment, *The* Danielson *Rule on the Tax Consequences of a Covenant Not to Compete*, 116 U. PA. L. REV. 517 (1968). There are some sound equitable and administrative justifications for the *Danielson* rule and other non-disavowal rules, such as preventing post-transactional tax planning by taxpayers and deterring whipsaw of the government, but the rule was expanded too far in *Peterson*. For further discussion of the *Peterson* decision, see *infra* Part III.

16. 827 F.3d 968 (11th Cir. 2016).

would provide her with payments once she ceased selling its cosmetics.[17] There was no upfront agreement as to allocations, labels, or characterizations of those payments, but each of the contract agreements contained a unilateral amendment clause allowing Mary Kay to "amend, modify or terminate" the agreements "at any time and in any manner."[18] Several years later, Mary Kay unilaterally amended the agreements to explicitly characterize the payments as deferred compensation.[19] This negatively affected Peterson's tax consequences, so she sought the tax court's determination that her payments under the contracts "constituted consideration for ending her Mary Kay businesses and her agreement not to compete with Mary Kay" rather than deferred compensation.[20] The Internal Revenue Service (IRS) opposed, advocating for the court to use the *Danielson* rule to bind Peterson to the contract terms and characterize the payments as deferred compensation regardless of the true nature of the payments.[21] Ultimately, the majority of an Eleventh Circuit panel concluded that the *Danielson* rule applied.[22]

No other court has applied the *Danielson* rule to bind a taxpayer to contract terms added post hoc via a unilateral modification.[23] In fact, over the last twenty years, there has been little academic discussion of the *Danielson* rule.[24] This Article considers the *Danielson* rule in light of *Peterson* and argues that it is an unjustifiable expansion of tax procedure and should not be followed in other circuits. Part II discusses the substance-over-form and non-disavowal doctrines generally, considering the *Danielson* rule in particular. Then, Part III examines the recent expansion of the *Danielson* rule in *Peterson*. Part IV considers the ramifications of this expansion, while Part V concludes that the *Danielson* rule, as well as other non-disavowal doctrines, should be appropriately constrained. At a minimum, this Article concludes that contracts of adhesion and changes due to unilateral amendment clauses should not bind a subordinate party for tax purposes.

---

17. *Id.* at 980.

18. *Id.* at 994 (Rosenbaum, J., concurring in part and dissenting in part); *id.* at 978 (majority opinion).

19. *Id.* at 981. The amendments made no substantive changes to the agreements. *Id.*

20. *Id.* at 983–84. On the other hand, as deferred compensation, the payments were deductible to Mary Kay and thus the characterization was beneficial to Mary Kay. *Id.* at 980.

21. *Id.* at 988.

22. *Id.* at 993.

23. *See* Michael S.J. Lozich, *The Continuing Application of the* Danielson *Rule:* Insilco Corp. v. United States, 49 TAX LAW. 769, 775–76 (1996); *see also infra* Section III.A.

24. The only serious consideration of the *Danielson* rule is found in a pre-*Peterson* article. *See* Baillif, *supra* note 7, at 306–10.

II. THE CLASSIC FOUNDATION

In tax law, there are two commonly accepted broad categories of doctrines that can be applied to assess the tax consequences of a transaction: the substance-over-form doctrine and, its opposite, the non-disavowal doctrine.[25] These doctrines cannot be defined in precise legal terms because both are truly an amalgamation of many other more targeted doctrines, all of which aim to focus the analysis either on the underlying substance of a transaction or on its form.[26] Nonetheless, instead of leading to robust and clearly delineated paths of analysis, the result of these doctrines is often confusion about whether any doctrine should apply and, if one does, about its precise legal elements. As one commentator described, "[a]ll too often the courts, based on a visceral reaction to the facts before them, arrive at a given holding which they proceed to support by spooning out liberal portions of substance soup or form fricassee."[27]

A. *The Substance-Over-Form Doctrine*

The substance-over-form doctrine has a long and rich history, beginning not long after the enactment of the first modern income tax.[28] The 1935 landmark case of *Gregory v. Helvering* is most often cited in reference to this doctrine.[29] In a holding favorable to the Commissioner, the Supreme Court determined that a taxpayer could be taxed according to the substance of a transaction where the substance varied from its legal form.[30]

In *Gregory*, a solely owned corporation sought to distribute to its shareholders certain appreciated shares in a nontaxable manner rather than as a taxable ordinary dividend.[31] To achieve this result, the corporation created a new subsidiary corporation to which it contributed the appreciated shares,

25. There are, of course, other analytical doctrines that can be used to assess the tax consequences of a transaction that does not fall neatly within the confines of either the substance-over-form doctrine or the non-disavowal doctrine, but these two capture the most commonly asserted doctrines. A full and complete analysis of all substance over form and non-disavowal doctrines is beyond the scope of this Article.

26. After *Gregory*, courts have developed several more specific substance-over-form doctrines, such as the business purpose doctrine, economic substance doctrine, step transaction doctrine, and sham transaction doctrine. *See generally* BITTKER & LOKKEN, *supra* note 7, ¶ 4.3. Variations of non-disavowal doctrines include not only the *Danielson* rule, but also the strong proof rule, the duty of consistency, and the *Weinert* standard. *See* Baillif, *supra* note 7, at 294.

27. Baillif, *supra* note 7, at 311.

28. *See, e.g.*, Weiss v. Stearn, 265 U.S. 242, 254 (1924).

29. 293 U.S. 465, 469–70 (1935) (articulating the substance-over-form doctrine and ancillary business purpose test).

30. *Id.* at 470.

31. *Id.* at 467.

and only a few days later, the new subsidiary corporation was dissolved and liquidated.[32] The appreciated shares were then distributed to the shareholder in a transaction that technically qualified as a nontaxable reorganization.[33] As a result, when the taxpayer subsequently sold the appreciated shares, her overall tax consequences were significantly less than if she had received the appreciated shares as an ordinary dividend.[34]

The IRS assessed a tax deficiency on the basis that the reorganization was not a true reorganization within the meaning of the Internal Revenue Code (the Code).[35] The taxpayer argued "that since every element required by the [nontaxable reorganization provision] is to be found in what was done, a statutory reorganization was effected; and that the motive of the taxpayer thereby to escape payment of a tax will not alter the result or make unlawful what the statute allows."[36] In its seminal statement, the Court acknowledged "[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."[37] However, the Court also went on to note that "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended."[38] The Court then held:

> Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose[—]a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner . . . .
>
> In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of [the Code], was in fact an elaborate and devious form of conveyance masquerading as a

32. *Id.*

33. *Id.* at 468.

34. *Id.* at 467. As an ordinary dividend, the proceeds would be subject to two levels of tax: first at the corporate level and again at the individual level.

35. *Id.*

36. *Id.* at 468–69.

37. *Id.* at 469 (first citing United States v. Isham, 84 U.S. (17 Wall.) 496, 506 (1873); then citing Superior Oil Co. v. Mississippi, 280 U.S. 390, 395–96 (1930); and then citing Jones v. Helvering, 71 F.2d 214, 217 (D.C. 1934)).

38. *Id.*

> corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction[,] upon its face[,] lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.[39]

Like the Court in *Gregory*, most academic discussions regarding substance over form occur in the income tax area, particularly in the business context. However, the doctrine applies equally to other areas of tax law. For example, the substance-over-form doctrine is commonly used to resolve wealth transfer tax disputes where taxpayers enter into transactions that, in form, are structured to avoid the estate tax but are, in substance, captured by one of its provisions.[40]

In *Estate of Maxwell*, the Second Circuit addressed whether a transaction should be treated as a sale followed by a leaseback, which would not be subject to estate tax consequences, or as a gratuitous transfer with a retained life estate, which would be subject to estate tax consequences.[41] The decedent, Lydia Maxwell, unquestionably structured the transaction as a sale-leaseback.[42] The decedent conveyed her house to her son and daughter-in-law (the "Maxwells") in exchange for a promissory note.[43] In essence, the decedent was acting in a capacity similar to that of a bank receiving a promissory note for funds borrowed to purchase a home. The decedent then entered into another agreement, leasing the property back from the Maxwells so she could continue living in the home.[44] On paper, this transaction appeared to be a sale of the home, followed by a leaseback of the home.[45] The resulting tax consequences of such a transaction would typically be limited to the income tax system and not generally within the scope of the estate tax.[46]

Nonetheless, external facts suggested the nature of the transaction was a retained life estate, which falls within the scope of the estate tax.[47] When individuals die, their assets are included in their gross estate and taxed

39. *Id.* at 469–70.

40. *See generally* Jay A. Soled, *Use of Judicial Doctrines in Resolving Transfer Tax Controversies*, 42 B.C. L. REV. 587 (2001) (concluding that judicial doctrines should serve a limited role in resolving tax controversies in which taxpayers plan their estates).

41. Est. of Maxwell v. Comm'r, 3 F.3d 591, 594 (2d Cir. 1993).

42. *See id.* at 594.

43. *Id.* at 592.

44. *Id.*

45. *See id.* at 592–93.

46. Typical federal income tax considerations would include whether decedent had any gain on the sale of the home, whether she had any interest income, and whether the Maxwells had any lease income or related deductions. *See id.*

47. *See* I.R.C. § 2036(a)(1).

pursuant to the estate tax.[48] Under the retained life estate rule, taxpayers cannot avoid the estate tax by giving away a remainder interest in their property (e.g., a home) and simultaneously retaining a life estate interest. When taxpayers die holding a life estate, their interest in the property is not subject to the estate tax because they do not own the property, and, therefore, cannot transfer any right therein to their heirs or beneficiaries—rather, their interest in the property expires at death.[49] However, similar to fee owners, taxpayers owning a life estate can live in their home and enjoy their property, and upon death, the property goes to a remainderman in a manner similar to a beneficiary receiving a home via will.[50] Thus, retained life estates are viewed as akin to will substitutes and any such property is subject to estate tax.[51]

In *Maxwell*, the decedent did not retain a life estate expressly; she sold her home.[52] However, the Tax Court considered that the decedent was eighty-two and had been diagnosed with cancer when she conveyed the home to the Maxwells and contemporaneously executed a leaseback.[53] Considering these facts together, the Tax Court concluded that the decedent transferred the home with, at a minimum, an implied understanding she would be able to continue to reside in the home until death.[54] In this way, she had, in substance, retained a life estate in the home.

The Tax Court also concluded that the home sale was a sham because the decedent regularly forgave the principal payments due under the note[55] and her lease payments were structured to match the interest payments that the Maxwells owed under the note.[56] Ultimately, the court found that the combined effect was to ensure that, according to the terms of the promissory note, the Maxwells would "at no time [be] called upon to pay any of the principal" such that the effect of the rental payments was to "cancel out the interest payments" and the effect of the will provision was to forgive any

---

48. *See id.* § 2031 (defining gross estate); *id.* § 2033 (including in decedents' gross estate property that they own, to the extent of any interest they may have).

49. The estate tax is an excise tax on the transfer of property; thus, the tax does not attach without an actual or constructive transfer. *See id.* § 2001.

50. *See generally* Note, *Understanding the Measuring Life in the Rule Against Perpetuities*, 1974 WASH. U. L.Q. 265 (examining how to measure life estates in property law).

51. I.R.C. § 2036.

52. Estate of Maxwell v. Comm'r, 3 F.3d 591, 592 (2d Cir. 1993).

53. Estate of Maxwell v. Comm'r, 98 T.C. 594, 602 (1992), *aff'd*, 3 F.3d 591 (2d Cir. 1993).

54. *Id.*

55. The court also considered that two days after the home sale, the decedent included a provision in her will forgiving any unpaid balance the Maxwells owed under the note. *Id.*

56. *Maxwell*, 3 F.3d at 592 ("Not only did the rent functionally cancel out the interest payments made by the Maxwells, but the Maxwells were at no time called upon to pay any of the principal.").

unpaid balance.[57] Thus, in substance, the transaction was not a sale followed by a leaseback, but rather was the gift of a remainder interest in the home to the Maxwells.[58] The Tax Court summarized its holding as follows:

> On this record, bearing in mind [the estate's] burden of proof, we hold that, notwithstanding its form, the substance of the transaction calls for the conclusion that decedent made a transfer to her son and daughter-in-law with the understanding, at least implied, that she would continue to reside in her home until her death, that the transfer was not a bona fide sale for an adequate and full consideration in money or money's worth, and that *the lease represented nothing more than an attempt to add color to the characterization of the transaction as a bona fide sale*.[59]

These cases typify the substance-over-form doctrine—cases in which the IRS asserts that the form of a transaction should be disregarded and that the court should assess the underlying substance to determine tax consequences. The principal rationale for this doctrine is that the taxpayer chose the form of the transaction. As such, the IRS should be able to assert that "the form does not comport with the substance" of the transaction.[60] Generally, commentators agree with this logic.[61] However, can taxpayers, having chosen the form of the transaction they wanted to undertake, later disavow that chosen form and assert a substantive argument? The answer is sometimes yes.[62]

Prior to 1967, taxpayers were more successful in arguing substance-over-form.[63] In modern times, taxpayers who are successful in asserting that the substance of a transaction should determine its tax consequences largely fall

---

57. *Id.*

58. *See id.* at 597 n.6 (distinguishing the Maxwells' situation from a Tax Court decision that held a similar transaction constituted "a gift of a remainder interest" (quoting Deal v. Comm'r, 29 T.C. 730, 736 (1958))). The Maxwells were obligated to pay, and did pay, certain expenses associated with the property such as property taxes and insurance, but this was not enough to overcome the gift nature of the transaction. *See id.* at 592.

59. *Maxwell*, 98 T.C. at 601 (emphasis added).

60. Donaldson, *supra* note 7, at 42; *see also* Harris, *supra* note 7, at 89 ("[T]here is . . . a fundamental notion that where the taxpayer, and not the government controls the facts, the taxpayer should be restricted in its ability to assert that the substance and not the form controls for tax purposes.").

61. *See, e.g.*, BITTKER & LOKKEN, *supra* note 7, ¶ 4.3.3; Baillif, *supra* note 7, at 298–99.

62. *See, e.g.*, Donaldson, *supra* note 7, at 42 ("It is the purpose and task of this article to demonstrate that the substance-over-form argument is available to the taxpayer in an expanding number of situations and with increasing and encouraging success."); Harris, *supra* note 7, at 89 (stating that a taxpayer may prevail on a substance over form argument depending on the threshold rule applied by the court).

63. *See generally* Harris, *supra* note 7, at 90–93 (describing pre-*Danielson* case law applying the substance-over-form doctrine).

into one of two categories: (1) they have a valid non-tax reason for why the particular form should be chosen, even if the substance of the transaction should be viewed differently,[64] and (2) they have honestly and consistently reported the transaction on tax returns according to the substance of the transaction.[65] Additionally, if taxpayers can show "strong proof" either that the form or agreement had "no basis in fact" and thus should not bind the taxpayer[66] or that the form or agreement is unenforceable due to "mistake, undue influence, fraud, duress, etc.[,]" they may be successful in rebutting the non-disavowal doctrine.[67] Despite some wins, taxpayers often lose these arguments and are held to their chosen form.[68]

B. *The Non-Disavowal Doctrine and the* Danielson *Rule*

As its name suggests, under the non-disavowal doctrine, taxpayers are prevented from disavowing the form of a chosen transaction by arguing that the underlying substance of the transaction should control instead. The principal rationale is "that where the taxpayer, and not the government controls the facts, the taxpayer should be restricted in its ability to assert that the substance and not the form controls for tax purposes . . . ."[69] From the government's perspective, the non-disavowal and substance-over-form doctrines work together to allow the government (since it was not a party to the original transaction) to tax the transaction in whatever manner it deems best—form or substance.

To bolster this asymmetrical leverage, the government long argued for a strict taxpayer non-disavowal principle.[70] This argument was rejected until it found success with the Third Circuit in *Danielson v. Commissioner*.[71]

In *Danielson*, the stockholders of Butler County Loan Co. (Seller) decided to sell the company to the Thrift Investment Corp. (Buyer) for $374 per share.[72] Buyer was responsible for drafting the sales agreement, and it allocated $222 of the share price to the stock purchase and $152 of the share

64. *See, e.g.*, Comm'r v. Proctor Shop, 82 F.2d 792, 793 (9th Cir. 1936). *See generally* Cauble, *supra* note 11, at 450 (noting that taxpayers who provide a non-tax justification for the transactional form selected are more likely to succeed at trial).

65. Harris, *supra* note 7, at 101 ("In a distinct line of cases . . . , the rule has developed that a taxpayer is entitled to assert that the substance and not form of a transaction controls for tax purposes so long as the taxpayer has honestly and consistently reported the substance of the transaction."). This scenario is called "return consistency."

66. *Id.* at 92.

67. Comm'r v. Danielson, 378 F.2d 771, 775 (3d Cir. 1967); *see infra* Section II.B.

68. *See infra* Section II.B.

69. Harris, *supra* note 7, at 89.

70. *Id.* at 90.

71. *Danielson*, 378 F.2d at 778.

72. *Id.* at 772–73.

price to the cost of the covenants not to compete.[73] This allocation provided Buyer with favorable tax benefits.[74]

When Seller noticed the allocation, "[it] questioned the unexpected and large amounts allocated to the covenants not to compete."[75] Buyer responded that the allocations were to its tax advantage, but did not specify the result on the amounts allocated to the covenants not to compete: more favorable capital gains treatment for Buyer and taxable ordinary income for Seller (taxed at a higher rate than capital gains).[76] Seller did not challenge or negotiate the allocation.[77] Rather, "[a]t the conclusion of a brief discussion of the allocation, [Seller's attorney] advised [Seller] to sign the documents."[78] After the sale, Seller reported all profits as capital gains without regard to the sales agreement allocations.[79] In response, the Commissioner asserted that Seller should have reported the portion allocated to the covenant not to compete as ordinary income.[80]

The Tax Court subsequently considered whether the terms of the sales agreement contract should be controlling for tax purposes, even if the parties did not meaningfully negotiate or bargain for those terms.[81] The government "vigorously urge[d]" the court to "adopt a 'new rule' of law concerning the treatment of such written covenants . . . prevent[ing] either [the] contracting party thereto or the respondent from subsequently attacking the stated consideration in such agreements unless fraud, duress, or undue influence existed at the time they were signed."[82] This argument was unsuccessful before the Tax Court but effective before the Third Circuit on appeal.[83]

At the trial level, the Tax Court concluded the taxpayers provided "strong proof" that the allocations in the purchase agreement had no "arguable relationship with business reality" and no "independent basis in fact."[84] Buyer determined the purchase price allocations in a manner that suited its purposes and without more substantial support such as a reliable valuation, negotiation, or tax plan.[85] The Tax Court concluded that, based on those facts, Seller should not be bound by the purchase agreement even though it was aware of

73. *Id.* at 773.
74. *Id.*
75. Danielson v. Comm'r, 44 T.C. 549, 555 (1965), *rev'd*, *Danielson*, 378 F.2d at 779.
76. *Id.*
77. *Id.*
78. *Id.*
79. *Id.*
80. *Id.*
81. *Id.* at 557.
82. *Id.* at 555; *see also* Harris, *supra* note 7, at 93.
83. *Danielson*, 44 T.C. at 555 ("We are unwilling to abdicate our judicial responsibility of examining the substance of a transaction. We are not bound by its form.").
84. *Id.* at 556.
85. *Danielson*, 44 T.C. at 557.

the terms and executed the purchase agreement documents despite this awareness.[86]

The Third Circuit disagreed and articulated what is now referred to as the *Danielson* rule:

> [Parties] can challenge the tax consequences of [their] agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc.[87]

The *Danielson* rule is a more stringent non-disavowal rule. When it applies, it binds parties to the form of their transaction regardless of the underlying substance, unless the taxpayer can show admissible proof to "alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc."[88] Application of the rule is limited by the need for an "agreement" between the parties. Thus, for the rule to apply, there must be a contract that is binding and unambiguous between the parties.[89]

In *Danielson*, the Third Circuit justified the new rule with equitable and administrative concerns. Of the former, the court noted that failing to bind a party to its initial characterization "would be in effect to grant, at the instance of a party, a unilateral reformation of the contract with a resulting unjust enrichment . . . nullify[ing] the reasonably predictable tax consequences of the agreement to the other party thereto."[90] Of the latter, the court noted that the rule would avoid the government's need to take action against both parties to a contract—even if only one party raised an issue—lest the government risk not being able to collect all the taxes properly due (i.e., the potential "whipsaw" scenario).[91]

86. *Id.* at 558.

87. Comm'r v. Danielson, 378 F.2d 771, 775 (3d Cir. 1967).

88. Peterson v. Comm'r, 827 F.3d 968, 987 (11th Cir. 2016) (internal quotation marks omitted) (quoting Plante v. Comm'r, 168 F.3d 1279, 1280–81 (11th Cir. 1999)).

89. N. Am. Rayon Corp. v. Comm'r, 12 F.3d 583, 589 (6th Cir. 1993); Throndson v. Comm'r, 457 F.2d 1022, 1025 (9th Cir. 1972) (holding the *Danielson* rule did not apply when the covenant not to compete in dispute was invalid).

90. *Danielson*, 378 F.2d at 775.

91. *Rayon*, 12 F.3d at 587. The whipsaw scenario occurs when "the Commissioner [is] required to litigate against both parties to the agreement in order to protect tax revenues." *Id.* (first citing Schatten v. United States, 746 F.2d 319, 322 (6th Cir. 1984) (per curiam); and then citing *Danielson*, 378 F.2d at 775). The *Danielson* rule serves to prevent the whipsaw problem "[b]y allowing the Commissioner to hold taxpayers to the terms of their agreement." *Id.* (citing Spector v. Comm'r, 641 F.2d 376, 385 (5th Cir. 1981)).

Danielson's strict standard was controversial. Its rule has been adopted by some jurisdictions (almost half),[92] rejected by others,[93] and in some cases has yet to be commented on at all.[94] In the latter situation, the courts generally apply the "strong proof" rule.[95] Recently, a divided panel in the Eleventh Circuit revived the debate surrounding the role and scope of the *Danielson* rule.[96] In *Peterson v. Commissioner*, the court—facing an issue of first impression—utilized the rule in a factual setting departing from the typical application of *Danielson* and significantly expanded its scope.[97]

III. A MARY KAY MAKEOVER

A. *An Overview of* Peterson v. Commissioner

Peterson is an interesting case from both a substantive and procedural perspective. The principal substantive issue was the tax characterization of certain payments.[98] Procedurally, the majority decided the case by first relying on the *Danielson* rule in a factual setting that departs from the typical *Danielson* scenario and then nonetheless proceeding to a consideration of the underlying substantive issues.[99]

In *Peterson*, the taxpayer (Peterson) was an independent contractor associated with Mary Kay.[100] Peterson irrevocably elected to participate in two programs offered by Mary Kay that would make payments once she ceased selling Mary Kay cosmetics.[101] There was no upfront agreement as to allocations, labels, or characterizations of those payments.[102] Each of the contract agreements, however, contained a unilateral amendment clause.[103]

92. The *Danielson* rule has been adopted by the Fifth, Sixth, Eleventh, and Federal Circuits and has been positively considered by the Second and Fourth Circuits but not officially adopted. *See, e.g.*, United States v. Bergbauer, 602 F.3d 569, 577 n.10 (4th Cir. 2010); Michael Baillif, *When (and Where) Does the* Danielson *Rule Limit Taxpayers Arguing 'Substance over Form'?*, 82 J. TAX'N 362, 363–64 (1995).

93. The rule has been rejected by the First, Seventh, and Ninth Circuits. *See* Baillif, *supra* note 92, at 364–65.

94. The Eighth and Tenth Circuits have yet to comment on the rule. *See id.* at 365.

95. Grace Soyon Lee, *What's in A Name?: The Role of* Danielson *in the Taxation of Credit Card Securitizations*, 62 BAYLOR L. REV. 110, 148–49 (2010).

96. *See* Peterson v. Comm'r, 827 F.3d 968, 987 (11th Cir. 2016); Comm'r v. Danielson, 378 F.2d at 775 (3d Cir. 1967).

97. *See Peterson*, 827 F.3d at 987; *see also* United States v. Fort, 638 F.3d 1334, 1337–38 (11th Cir. 2011) (explaining the circumstance in which the *Danielson* rule should apply).

98. *Peterson*, 827 F.3d at 989.

99. *Id.* at 988 n.30.

100. *Id.* at 980.

101. *Id.* at 980–81.

102. *Id.* at 996 (Rosenbaum, J., dissenting in part and concurring in the judgment in part).

103. *Id.*

This clause allowed Mary Kay to "amend, modify or terminate" the agreements "at any time and in any manner."[104] Mary Kay subsequently exercised its rights to unilaterally amend the agreements in a manner that, for the first time, explicitly characterized the nature of the payments as deferred compensation—the amendments made no substantive changes.[105]

Peterson disputed the deferred compensation characterization and its resulting tax consequences (payments subject to self-employment tax).[106] Instead, Peterson averred that the payments were either made in consideration for ending her association with Mary Kay or her agreement not to compete, neither of which were subject to self-employment tax.[107] The Commissioner asserted a tax deficiency for self-employment tax among other things, and Peterson found herself in Tax Court.[108] Ultimately, a majority of an Eleventh Circuit panel concluded that the *Danielson* rule applied to bind Peterson to the characterization provided by the amended agreements, while the dissent objected to the rule's use in the context of a post hoc unilateral modification.[109]

The facts of *Peterson* depart from the paradigmatic *Danielson*-rule fact pattern. The typical scenario to which the *Danielson* rule applies involves parties that agreed to structure a transaction in a particular form followed by one of the parties subsequently challenging the tax characterization of that form based on the underlying substance of the transaction. For example, assume someone sells a business and the contract allocates a larger portion of the proceeds to a non-compete agreement (ordinary income to the seller) and a smaller portion of the proceeds to a sale of capital assets (capital gains to the seller). If the seller subsequently disputes the allocation in order to lower the amount of taxes owed and claims that the true nature of the transaction (i.e., its economic substance) was predominantly a sale of capital assets, the *Danielson* rule would step in to prevent the disavowal of the agreed upon contract allocation.[110]

No other court has applied the *Danielson* rule outside of that context until *Peterson*. This case not only significantly expands the scope of the *Danielson*

104. *Id.* at 978 (majority opinion).
105. *Id.* at 981.
106. *Id.* at 989.
107. *Id.*
108. *Id.* at 983.
109. *Id.* at 993; *id.* at 994 (Rosenbaum, J., dissenting in part and concurring in the judgment in part).
110. The *Danielson* rule has been utilized in situations beyond this archetypal case including "divorce settlements, liquidation of partnership interests, asset sale agreements, stock purchase and repurchase agreements, stock redemptions, employment contracts, dealer commission agreements, compromise settlements and releases, sale of real property, assignments of leases, and leases." Lozich, *supra* note 23, at 772 (1996).

rule but also signals the judiciary's modern views of consent and contracts of adhesion more generally.

B. A Closer Look at Peterson

This Section takes a closer look at *Peterson*—the facts, the majority holding, and the dissent. In *Peterson*, the Eleventh Circuit significantly expanded the reach of the *Danielson* rule based on a distinctive set of facts. Peterson was an independent contractor for Mary Kay, who rose to the highest level of the Mary Kay sales network and became an extremely successful National Sales Director (NSD).[111] Mary Kay offers NSDs the opportunity to participate in two different programs that provide certain monetary benefits to the NSD once she is no longer actively associated with Mary Kay: the Family Security Program and the Great Futures Program.[112] These programs provide benefits similar to retirement plans and are unique in the direct sales industry—providing financial benefits to non-employee, independent contractors after they are no longer associated with Mary Kay.[113]

Under the Family Security Program, payment amounts are based on a formula, calculated by averaging the three highest years of domestic sales commissions from the NSD's last five years of active association with Mary Kay.[114] Payments pursuant to the Great Futures Program are collected from commissions on current sales made by the former NSD's foreign sales teams.[115] In other words, while Family Security Program payments are determined with reference to past sales activity, Great Futures Program payments are determined with reference to ongoing sales activity after the NSD is no longer associated with Mary Kay. In exchange for receiving payments under the programs, the NSD agrees to sever her NSD agreement with Mary Kay at either age fifty-five or sixty-five and agrees to certain non-compete covenants.[116] Nothing in the program agreements characterized the nature of the program payments prior to 2008.[117]

In October 2004, Congress enacted a new Code section: § 409A.[118] In brief, § 409A governs the taxation of nonqualified deferred compensation

111. *Peterson*, 827 F.3d at 980.
112. *Id.* at 974, 976. The Family Security program was established in 1991, and the Great Futures Program was established in 2005. *Id.*
113. *Id.* at 993.
114. *Id.* at 974.
115. *Id.* at 977.
116. *Id.*
117. *Id.* at 996 (Rosenbaum, J., dissenting in part and concurring in the judgment in part).
118. *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 885(a), 118 Stat. 1418, 1634–39 (codified as amended at I.R.C. § 409A); Joy Sabino Mullane, *Incidence and Accidents: Regulation of Executive Compensation Through the Tax Code*, 13 LEWIS & CLARK L. REV. 485, 526–31 (2009) (discussing the history and function of § 409A).

plans. It provides that participants failing to satisfy § 409A's requirements are immediately subject to current taxation, plus interest, on all compensation deferred under the plan to the extent the compensation is not subject to a substantial risk of forfeiture or has not been previously included in gross income.[119] Section 409A also imposes an additional twenty percent tax on any non-complying compensation included in the participant's income for the taxable year.[120]

Section 409A was so complicated that, although enacted in 2004, it did not go into effect until 2009.[121] In anticipation of its effectiveness, the agreements for both the Family Security Program and the Great Futures Program were modified in 2008 pursuant to a unilateral amendment clause that allowed Mary Kay to make any change to the agreements at any time.[122] The amendments provided that the programs were intended to be nonqualified deferred compensation arrangements in compliance with § 409A.[123] Mary Kay claimed it always viewed the plan's payments as deferred compensation (deductible by Mary Kay) and undertook the amendments to protect participating NSDs from the consequences of not complying with § 409A.[124]

Peterson participated in both of the programs offered by Mary Kay, and thus began receiving payments pursuant to the programs once she ceased her involvement with Mary Kay in 2009.[125] The tax characterization of these payments was the principal issue of the case—whether they were deferred compensation payments subject to self-employment tax or some other type of payment not subject to self-employment tax. While the Commissioner argued the payments were deferred compensation, Peterson argued the payments were consideration for "ending her Mary Kay businesses and her agreement not to compete with Mary Kay post-retirement." [126]

119. *See* I.R.C. § 409A(a)(1) (including all deferred compensation under the plan unless it is "subject to substantial risk of forfeiture and not previously included in gross income"); *id.* § 409A(a)(1)(B)(ii) (defining the interest rate as one percentage point above the underpayment rate).

120. *Id.* § 409A(a)(1)(B)(i)(II); *see also id.* § 4999(a) ("There is hereby imposed on any person who receives an excess parachute payment a tax equal to 20 percent of the amount of such payment.").

121. *See* I.R.S. Notice 2007-86, 2007-2 C.B. 990; I.R.S. Notice 2007-78, 2007-2 C.B. 780. The IRS repeatedly issued transition relief delaying the date on which nonqualified deferred compensation plans had to comply with § 409A. *See also* I.R.S. Notice 2007-86, 2007-2 C.B. 990; I.R.S. Notice 2007-41, 2007-1 C.B. 1287.

122. *Peterson*, 827 F.3d at 979.

123. *Id.*

124. *Id.* at 979–80.

125. *Id.* at 981.

126. *Id.* at 989.

The Tax Court agreed with the Commissioner and concluded the program payments were deferred compensation; therefore, Peterson was liable for self-employment tax.[127] On appeal, the majority similarly concluded in holding:

> On the facts of this case and controlling law, we hold the percentage commissions received by Peterson, a retired NSD, under the Mary Kay Family Program and Futures Program are subject to self-employment tax[] because they are classified specifically as deferred compensation, derived from her prior association with Mary Kay.[128]

What is not entirely clear in *Peterson* is whether the language "classified specifically as deferred compensation, derived from her prior association with Mary Kay[,]" is referring to a conclusion reached by application of the *Danielson* rule or by substantive legal analysis. This lack of clarity stems from the opinion's initial focus on and use of the *Danielson* rule, followed by a consideration of the underlying substantive issues. Essentially, in a less direct fashion, the Eleventh Circuit found that not only were the payments deferred compensation pursuant to the *Danielson* rule, but even if the rule were not applicable, the payments would still be considered deferred compensation. This is the complete opposite of the Tax Court's approach, which first focused on the substantive deferred compensation issue before giving a nod to the *Danielson* rule.[129] The dissent, on the other hand, opposed the application of the *Danielson* rule on the unique facts of *Peterson* and also disagreed on the merits with the characterization of the payments as deferred compensation.[130]

All tax professionals agree, however, that for self-employment tax to be due, the taxpayer's income must be "derived . . . from any trade or business carried on by [the taxpayer]."[131] The specific substantive question in *Peterson* was whether the program payments were "derived" from the taxpayer's Mary Kay business—i.e., deferred compensation or other income captured by self-employment tax—or were instead paid to acquire Peterson's Mary Kay business and secure a non-compete agreement.[132]

After providing a lengthy factual background, the majority quickly delved into its summary *Danielson* analysis. The majority first noted that the 2008 amendments to the Mary Kay programs labeled payments under the programs

127. *Id.* at 984.

128. *Id.* at 993. The majority consisted of Judge Fay with Judge Middlebrooks sitting by designation.

129. *Id.* at 989; *id.* at 993 (Rosenbaum, J., dissenting in part and concurring in the judgment in part).

130. *Id.* at 996. (Rosenbaum, J., dissenting in part and concurring in part).

131. I.R.C. § 1402(a).

132. *Peterson*, 827 F.3d at 989.

as "deferred compensation."[133] As such, the majority then concluded that, pursuant to the *Danielson* rule, contract terms control the treatment of program payments.[134] The majority was unconcerned with the post hoc unilateral nature of the amendments, indicating that Peterson's initial assent to the agreements at the time of contract formation "permitting Mary Kay to amend [the programs] prospectively" meant that she "consented to the 2008 Amendments . . . expressly characteriz[ing] the Family Program and Futures Program payments as 'deferred compensation' under a nonqualified compensation plan pursuant to § 409A of the Internal Revenue Code . . . . "[135] Thus, "the *Danielson* rule [is applicable and] requires . . . Peterson[] [be] bound by the characterization of her 2009 Mary Kay, post-retirement Program payments as deferred compensation, making them subject to self-employment tax."[136]

The dissent was troubled, however, by the fact that Peterson never explicitly agreed to the characterization of the payments as deferred compensation. After examining the history and purpose of the *Danielson* rule, the dissent concluded the majority's expansion of the rule was unwarranted and unadvisable:

> [T]he agreements Peterson executed to enter Mary Kay's programs empowered Mary Kay to make unilateral amendments to the Programs. Years after Peterson and Mary Kay entered into the agreements, Mary Kay invoked that power to unilaterally characterize payments made under the Programs as "deferred compensation." The *Danielson* rule has never been applied on facts like these. Nor should it be.[137]

The first justification for the *Danielson* rule is preventing "a party from unjustly enriching itself by unilaterally altering the intended tax consequences of a transaction after consummation."[138] However, in the *Peterson* context, applying the *Danielson* rule "stands th[is] . . . [justification] on its head."[139] This should be readily apparent because Peterson "made no attempt to alter the express terms of the transaction that she and Mary Kay agreed to at formation; she merely [sought] review and enforcement of the terms of the Programs themselves."[140] Indeed, "[o]nly Mary Kay . . . arguably attempted

133. *Id.* at 987.
134. *Id.* at 989.
135. *Id.* at 987.
136. *Id.* at 989.
137. *Id.* at 994 (Rosenbaum, J., dissenting in part and concurring in the judgment in part).
138. *Id.* at 997.
140. *Id.* at 998.
141. *Id.*

to alter the tax consequences flowing from the substantive terms of the Programs to which the parties agreed."[141] As the dissent noted:

> In these circumstances, applying the *Danielson* rule does not *prevent* a unilateral, post-consummation contract reformation. Instead, the Majority's application of the rule *insulates* Mary Kay's unilateral, *ex post facto* characterization of the Program payments from meaningful review. As a result, today's decision encourages parties to risk litigation by attempting unilateral, post-consummation contract reformations to avoid the tax consequences of their transactions. Another result of today's decision is that parties will be less certain about the tax consequences of a transaction where the agreement contains a unilateral amendment provision—whichever party has the power to amend the agreement will be able to alter those consequences by simply re-characterizing the transaction after consummation.[142]

Regarding the second justification, the dissent thoroughly analyzed the role of the *Danielson* rule in preventing whipsaw litigation. It began by reminding the majority that the intent of the *Danielson* rule was never to "entirely eliminate the need for the Commissioner to *ever* pursue litigation against both parties to an agreement . . . ."[143] This was readily apparent in the language of the rule itself, which contains an exception in the form of a carve-out in situations "where a taxpayer . . . 'adduc[es] proof which in an action between the parties to the agreement would be admissible to alter [the Commissioner's] construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc.'"[144]

The dissent acknowledged that the *Danielson* rule serves a valuable, pro-government, and protective function:

> [The] rule eliminates the need for the Commissioner to pursue litigation against both parties in a very particular set of cases. Where a taxpayer initially agrees to an *express* contractual characterization or form and later attempts to re-characterize the term or form, the *Danielson* rule acts as a prophylactic to prevent the IRS from having

142. *Id.*
142. *Id.*
143. *Id.* at 999.
144. *Id.* (alterations in original) (quoting Comm'r v. Danielson, 378 F.2d 771, 775 (3d Cir. 1967)).

> to pursue the taxpayer's counterparty out of a concern that a court will agree with the taxpayer's *ex post facto* re-characterization.[145]

Nevertheless, the dissent emphasized the limits of the *Danielson* rule by recognizing it does not apply in cases where "the taxpayer does not seek to avoid an express contractual term or form."[146] Rather, in those cases, the Commissioner must litigate the issue of tax deficiency "on the merits," identifying inconsistencies between the parties' arguments and assessing tax deficiencies amongst several individuals on the same issue.[147] In the dissent's words: "the Commissioner must go ahead and pursue whipsaw litigation . . . to protect the public . . . from any whipsaw effect in cases '[with] an accepted legal basis' for asserting a single tax deficiency against multiple parties."[148]

Finally, the dissent concluded by identifying the critical facts that distinguished Peterson's situation from the typical *Danielson* scenario:

> Here, Peterson never expressly agreed to a characterization of the Program payments as "deferred compensation" in the *Danielson* sense. Instead, as the Commissioner implicitly acknowledges, there is a reasonable legal basis to conclude that Program payments are either (1) deferred compensation, in which case Peterson is liable for the tax deficiency; or (2) payments for a covenant not to compete, in which case Mary Kay would be responsible for incorrectly deducting the payments on its tax returns. In these circumstances, I would hold that the Commissioner may not rely on the *Danielson* rule in lieu of pursuing actual whipsaw litigation to resolve a genuine dispute about whether Peterson or Mary Kay is responsible for the tax deficiency at issue. The Majority's contrary conclusion, in my opinion, does not vindicate the rule's prophylactic purpose of preventing *unnecessary* whipsaw litigation; it prevents necessary whipsaw litigation.[149]

After their *Danielson* rule discussions, both opinions considered the tax characterization issue on its merits. This aspect of the case is also interesting, as once again there was some disagreement among the panel as to whether the payments were of a nature that would subject them to self-employment tax. The narrow substantive issue was whether the post-retirement payments were

---

145. *Id.*; *see also* Patterson v. Comm'r, 810 F.2d 562, 572 (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.").

146. *Peterson*, 827 F.3d at 999.

147. *Id.*

148. *Id.* (quoting Gerardo v. Comm'r, 552 F.2d 549, 555 (3d Cir. 1977)).

149. *Id.* at 999–1000.

"derived" from Peterson's Mary Kay business. Consideration of this issue in the context of the direct sales industry is also unique and worthwhile, but beyond the scope of this Article. Nonetheless, the upshot is that the majority concluded the program payments were deferred compensation, while the dissent disagreed. First, the dissent concluded that the Family Security Program payments were still subject to self-employment tax because the payment amount was directly tied to and derived from the quality of Peterson's prior Mary Kay labor.[150] Then, the dissent further held that the Great Futures Program payments were not subject to self-employment tax because those payment amounts were "entirely dependent on the quality of other, non-retired Mary Kay laborers."[151]

IV. WAS THE MAKEOVER A HIT OR MISS?

The Eleventh Circuit did not need to rely on the *Danielson* rule, and in so doing, it significantly expanded the rule's reach. The court could have reached its conclusion based solely on a substantive analysis. Further, the majority insinuated that if Mary Kay had not labeled the program payments as deferred compensation, the government could decide the tax consequences of the payments by analyzing their substance to determine whether § 409A applied.[152] In fact, absent Mary Kay's subsequent characterization, the government would need to independently determine the nature of the payments.[153] Of course, because Mary Kay did indeed exercise its unilateral amendment power to label the payments as deferred compensation, the government asserted Peterson was estopped from challenging that label based on a substantive examination of the payments. This highlights the lopsided nature of the *Danielson* rule combined with the substance-over-form doctrine—both of which are one-way streets favoring the government.[154]

There are two primary justifications for the *Danielson* rule. The first is that it enforces the original expectations of the parties, preventing one party from attempting a unilateral, post-consummation reform of the contract. Second, it prevents whipsaw situations. In *Peterson*, while whipsaw prevention was preserved, the court allowed one party to subsequently and

150. *Id.* at 1007.
151. *Id.* at 1007–08.
152. *See id.* at 990, 991 (majority opinion).
153. *See id.* at 1001 (Rosenbaum, J., dissenting in part and concurring in the judgment in part).
154. Professor Emily Cauble suggests one explanation for this lopsided nature is evidentiary consideration. However, she also asserts this explanation is a flawed justification for three reasons. Cauble, *supra* note 11, at 458–60.

unilaterally reform the contract.[155] This is contrary to the first justification. Moreover, as the dissent noted, sometimes whipsaw litigation is necessary and beneficial rather than something to be universally avoided.[156]

It makes—or at least it should make—little difference that the mechanism for post-consummation reformation was pursuant to an antecedent granting of consent. Such consent is not meaningful and certainly not powerful enough to automatically bind parties for tax purposes to any and all post hoc reformations. As commentators note:

> The common thread which unites [a] group [of cases where taxpayers successfully assert substance over form] is the factor that the form of the transaction was either not wanted or not controlled by the taxpayer. Thus, the rationalization that taxpayers cannot be heard to complain of the consequences of their choice loses much of its force.[157]

The *Peterson* fact pattern is exactly the type of scenario described—the taxpayer does not actively choose the form of the transaction, and thus should not be bound to it.

On a practical level, *Peterson* significantly expands the scope of the *Danielson* rule and its long-term ramifications are not entirely clear yet. Certainly, parties should exercise caution in dealing with contracts that contain a unilateral amendment clause. Even though sometimes considered illusory, parties should contemplate savings clauses.[158] However, the foregoing considerations are pointless in the context of contracts of adhesion like the one in *Peterson*.

V. CONCLUSION

The Eleventh Circuit should have declined to reach a result relying on the *Danielson* rule based on the fact pattern of *Peterson*, and other circuits should decline as well.

Combining contracts of adhesion with both unilateral amendment clauses and the *Danielson* rule elevates form to untouchable levels—providing the IRS with the strict standard it always sought. Elements of "mistake, undue

---

155. *Peterson*, 827 F.3d at 994 (Rosenbaum, J., dissenting in part and concurring in the judgment in part).

156. *See supra* Part III.A.

157. Donaldson, *supra* note 7, at 48.

158. Although it was not discussed, an implicit assumption in the opinions is that there was no savings clause that would have allowed Peterson to object or otherwise terminate the agreement in the face of an unsatisfactory unilateral amendment.

influence, fraud, duress, etc."[159] simply are not relevant in these contexts. There is no justification sound enough to allow for application of the *Danielson* rule in a post hoc unilateral amendment for which one party cannot meaningfully consent. The *Danielson* rule, as well as other non-disavowal doctrines, should be appropriately constrained. At a bare minimum, contracts of adhesion and changes due to unilateral amendment clauses should not bind a subordinate party for tax purposes.

159. Comm'r v. Danielson, 378 F.2d 771, 775 (3d Cir. 1967).