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The Ever-Expanding 'Danielson' Rule?

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A recent decision of the Court of Appeals for the 11th Circuit (*Peterson v. Commissioner*, 117 AFTR 2d 2016-1815) involved a surprising application of the *Danielson* rule.

Commissioner v. Danielson (378 F.2d 771 (3d Cir. 1967)), the case that gave rise to the *Danielson* rule, involved the sale of all of the stock of a company to a purchaser under documents that, at the purchaser's insistence, included a noncompetition covenant from the selling stockholders and an allocation of the overall purchase price between the shares of stock and the noncompetition covenant. The allocation, if respected, would permit the purchaser to amortize the amount allocable to the covenant, but require the selling stockholders to report ordinary income in the same amount.

The selling stockholders disregarded that allocation in reporting the entire consideration as proceeds from the sale of capital assets. That position was challenged by the government. The Court of Appeals for the Third Circuit concluded that, notwithstanding circumstances suggesting that the parties' agreed-upon allocation to the covenant exceeded its true value, the sellers should be held to the agreed-upon allocation absent "strong proof" of the type that would be admissible in litigation between the parties to cause the agreed-upon allocation to be held unenforceable, such as on the basis of mistake, fraud, or undue influence.

The *Danielson* rule has since been applied in numerous other cases (including cases cited in *Peterson*), with some variation as to, for example, the strength of the evidence said to be needed to overcome an agreed-upon allocation of consideration or characterization of the underlying transaction for tax purposes.

Peterson, however, involved an unusual application of this rule. Christine Peterson ("Peterson") had worked for many years as an independent contractor of Mary Kay, Inc. ("Mary Kay"), a manufacturer and seller of cosmetics. From 1991 onward she was a "National Sales Director" (or "NSD") of Mary Kay and, as such, her compensation was based on commissions from certain sales networks she helped develop.

As an NSD, she was eligible to participate and did participate in two Mary Kay programs, documented by agreements signed by Peterson, which would provide her with payments after she reached a mandatory retirement age. Under one program relating to her domestic sales network (the "Family Program"), she would receive payments over a 15-year period based on her commissions from her sales units during the five-year period before she retired. Under the other program ("Futures Program"), she would receive payments over a 12-year period based on a percentage of sales of foreign sales units in periods after she retired.

Under both programs, Peterson was required to discontinue her Mary Kay business in the relevant markets and to agree not to engage in certain promotional, recruiting and other activities or transactions with people involved in the sale of Mary Kay products.

Internal Revenue Code ("IRC") section 1401 imposes a tax on "self-employment income" such as, generally, income earned by an independent contractor. The sole issue before the Court of Appeals was whether payments received by Peterson under the programs in 2009, after her retirement from Mary Kay on January 1 of that year, were subject to the self-employment tax ("SE tax").

The Tax Court had previously concluded, in a brief memorandum decision (TC Memo 2013-271), that the program payments were subject to SE tax because Peterson had carried on a trade or business and because the payments were derived from that business, citing the circumstances that the payments were computed by reference to the number of years in which she worked in the business of selling Mary Kay products and the commission income from that business before and after her retirement.

The Court of Appeals decision notes that Peterson had argued that the

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program payments were either consideration for the sale of the business that she had developed or for the non-competition covenants that were applicable to her after retirement by reason of her participation in the programs.

In rejecting these arguments, the Court of Appeals emphasized an amendment to the programs that was made unilaterally by Mary Kay in 2008, under a provision in both programs permitting the Mary Kay Board of Directors to "amend, modify or terminate" either program "at any time and in any manner." The amendments were characterized in contemporaneous communications by Mary Kay with the NSDs as non-substantive clarifications to make clear that the programs complied with IRC section 409A (as added to the Internal Revenue Code in 2004), and stated that each program was intended "to be a non-qualified deferred compensation arrangement" and "to meet the requirements of Section 409A of the Code and shall be construed and interpreted in accordance with such intent." The amendments also stated that Mary Kay did not make any representation or guarantee regarding the tax treatment of either program.

Because the 2008 amendments were authorized by provisions of agreements Peterson had previously accepted, and characterized the programs as providing for compensation, the court concluded that the *Danielson* rule required that Peterson be bound by this characterization of the programs as deferred compensation, which in turn caused the payments to be subject to SE tax.

One Circuit Judge concurred in part and dissented in part. The thrust of his dissent was that the *Danielson* rule should not be applied here. The dissent characterizes the *Danielson* rule as applicable in situations where parties to a transaction expressly agree to a characterization of a transaction in a particular form, or intentionally structure a transaction in a particular form for tax purposes, and as intended to prevent any party from unduly enriching itself by claiming a unilateral alteration of the agreed-upon consequences after the consummation of the transaction.

The dissenting opinion asserted that Mary Kay's later characterization of the program in the 2008 amendments as deferred compensation should not be binding on Peterson under the *Danielson* rule because the amendments were unilateral and made after the agreements were entered into and after Peterson had performed services. The dissent went on to conclude that other circumstances indicated that payments under the Family Program (which were based on pre-retirement commissions), but not payments under the Futures Program (which were based on the post-retirement performance of non-U.S. sales units which Peterson had been involved), were derived from Peterson's past business and therefore subject to SE tax.

The ultimate result in *Peterson* is almost certainly less surprising than how the Court of Appeals reached that conclusion. Regardless of the merits of the court's analysis, *Peterson* suggests at least two points for business executives and their advisors to keep in mind.

One point (for which *Peterson* is not the sole support—see, e.g., *Brinkley v. Commissioner*, 808 F.3d 657 (5th Cir. 2015)) is that a provision in an agreement that might otherwise be ignored as Section 409A "boilerplate" may ultimately be given weight by the IRS or a court in characterizing a payment arrangement as compensatory in nature. Another is to be wary, in drafting a provision that may permit amendment of an agreement after its execution by fewer than all parties, of the possibility that a later amendment by one party may have significant consequences, intentionally or otherwise, in respect of another party's tax treatment.