Investing in Lawsuits: The Plight of the Plaintiff
By Robert W. Wood and Jonathan Van Loo


In this article, Wood and Van Loo focus on the tax issues facing plaintiffs who sell a portion of their legal claim.

This discussion is not intended as legal advice and cannot be relied on for any purpose without the services of a qualified professional.

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This article is the third in a series focusing on litigation investing. In previous articles, we discussed the tax issues facing the investor and the attorney or law firm. We will now focus on the tax issues facing plaintiffs who sell a portion of their legal claim.

As we discussed in previous articles, the investor is almost entirely focused on capital gain treatment. In contrast, the attorney’s primary concern is the timing of income. As a result, the interests of investors and law firms are not always aligned.

The plaintiff shares both of these concerns. Like the lawyer, the plaintiff receives cash at the outset of the transaction and therefore must determine the proper timing of income recognition. However, unlike the lawyer, the plaintiff is arguably selling an intangible property right rather than selling a right to ordinary services income.

Moreover, the plaintiff may be entitled to exclude the recovery from income if it is paid on account of personal physical injuries, personal physical sickness, or emotional distress arising from physical injuries or sickness. Although the plaintiff must consider whether that exclusion applies, in this article we focus only on recoveries that do not qualify for the exclusion. (We will address section 104 recoveries in the fourth installment of this series.)

However, the plaintiff may be entitled to exclude the recovery from income if it is paid on account of personal physical injuries, personal physical sickness, or emotional distress arising from physical injuries or sickness. Although the plaintiff must consider whether that exclusion applies, in this article we focus only on recoveries that do not qualify for the exclusion. (We will address section 104 recoveries in the fourth installment of this series.)

The plaintiff must also consider the possible double taxation of income. In light of the Supreme Court’s decision in Commissioner v. Banks,2 the plaintiff must be careful not to be treated as in receipt of the portion of the recovery that goes to the investor unless the plaintiff is confident of a full offsetting deduction. That is, a plaintiff who must include the amount payable to an investor in his gross income wants to be sure he can take a deduction above the line in the same year. A temporal mismatch or a miscellaneous itemized deduction can be extremely costly.

Before addressing the timing and double taxation issues, we first discuss the character of the plaintiff’s gain.

Character of Income
In general, the character of a lawsuit settlement is based on the origin of the claim.3 In the business context, if the recovery is compensation for damage to a capital asset, arises in the process of acquiring property, or concerns the disposition of property,

3See United States v. Gilmore, 372 U.S. 39 (1963); Raytheon Production Corp. v. Commissioner, 144 F.2d 110, 113 (1st Cir. 1943), cert. denied, 323 U.S. 779 (1944).
Character When Lawsuit Is Ordinary

The suggestion that gain on the sale of a plaintiff’s claim results in capital gain even if the claim itself is ordinary is hardly intuitive. For example, an employment-related lawsuit may have its origin in a claim for services rendered. A contract dispute may have its origin in lost business profits. Can a plaintiff realize capital gain from the sale of a piece of a legal claim even if a recovery on that claim would otherwise result in ordinary income?

Gain from the sale of an interest in a lawsuit might be compared to the sale of other types of property that produce ordinary income. Debt instruments, real estate, patents, and stock generate ordinary income in the form of interest, rents, royalties, and dividends. However, their sale generates capital gain or loss.

Of course, the plaintiff’s legal claim does not result in ordinary income in the same way as patents, bonds, or stock. The ordinary income produced in the form of interest, rent, royalties, and dividends generally represents compensation over time for the use of the underlying property. Interest is compensation for the time value of money, rent is compensation for the use of real estate, dividends are a return on invested capital, and so forth.

The plaintiff’s sale of a share of the proceeds from his lawsuit can also be viewed as analogous to the sale of a partnership interest. In both cases, the acquirer gains the right to a share of the underlying income. Gain from the sale of a partnership interest is capital except to the extent it is attributable to “hot assets” such as inventory and unrealized receivables.

If the lawsuit would result in ordinary income, should the lawsuit be viewed as analogous to a hot asset? In the hands of the lawyer or law firm, the legal claim certainly appears analogous to an unrealized receivable. Nonetheless, the analogy seems less appropriate for the plaintiff.

The plaintiff is not likely to be in the business of selling legal claims. Thus, the legal claim should not represent inventory or a receivable. Moreover, the legal claim is sufficiently uncertain that the plaintiff is willing to sell a portion of his interest. The sale will take place at a price that represents a discount to the expected recovery to factor in the investor’s risk. Therefore, there appear to be enough differences that the gain may be viewed as capital, even when compared with a partnership interest.

Several courts have explained in dicta that if a plaintiff sells a claim or a chose in action, the character of the gain generally will be capital even if a direct payment on the claim would otherwise be ordinary. For example, in Nahey v. Commissioner, the taxpayer acquired a claim in a leveraged acquisition of a business. The acquirer stepped into the shoes of the plaintiff as a result of the acquisition. Six years later, the case settled for $6 million, and the acquirer claimed the settlement amount was capital gain even though it would have been ordinary income to the original business owner.

In ruling against the taxpayer, the court acknowledged that the claim represented a capital asset. Judge Richard Posner explained that he assumed for the sake of argument that any income from a sale of the claim by the taxpayer would represent

4Section 741 (defining gain from the sale of a partnership interest as capital, except to the extent provided in section 751, relating to inventory and unrealized receivables).

5See Osenbach v. Commissioner, 198 F.2d 233, 236-237 (4th Cir. 1952) (“it is quite clear that ordinarily . . . when a taxpayer makes a gain from the sale or exchange of a claim or chose in action, this is taxable as a capital gain; while if the gain results from the collection of the claim or chose in action, this is taxable as ordinary income”); Commissioner v. Golonsky, 200 F.2d 72, 74 (3d Cir. 1952) (a chose in action is intangible property that could be sold), acq. 1956-2 C.B. 6; Benedum v. Granger, 180 F.2d 564 (3d Cir. 1950) (disposition of a chose in action “clearly constitutes an exchange of capital assets”); Jeffrey v. United States, 261 B.R. 396, 401 (Bankr. W.D. Pa. 2001) (“for federal tax purposes, the right to assert a tort claim is a chose in action, constituting intangible personal property”); Appalachian Elec. Power Co. v. United States, 141 Ct. Cl. 367, 370 (Ct. Cl. 1958) (identifying an “intangible such as a chose in action” as a capital asset that if sold or exchanged could receive “receive capital assets treatment for tax purposes”).

3See Freda v. Commissioner, 656 F.3d 570 (7th Cir. 2011) (proceeds from settlement of trade secret misappropriation claim constituted ordinary income); Rev. Rul. 74-251, 1974-1 C.B. 234 (settlement payment from investment adviser of a regulated investment company represented ordinary income).
capital gain.9 However, the taxpayer received the settlement amount directly, resulting in ordinary income.

A plaintiff’s legal claim can be viewed as a kind of intangible property right that is analogous to various types of capital assets. This seems to be exactly the kind of theory that courts had in mind when they explained in dicta that income from the sale of a legal claim should be treated as capital gain.

Substitute for Ordinary Income

It is also important to consider the potential application of the judicially created “substitute for ordinary income” doctrine. This doctrine has treated gain from the sale of rights to income as ordinary in some circumstances.10 Typically, the doctrine applies when a taxpayer sells a right to a fixed share of income to be received in the future.11 The amount received generally represents the present value of a relatively certain payment to be received in the future.12 The case law has recognized that the degree of investment risk is important.13

In sales of a portion of a legal claim, the amount to be received in the future is usually speculative and highly contingent. Further, the time when the proceeds (if any) will be received is also unknown. In these circumstances, it does not appear appropriate to apply the substitute for ordinary income doctrine. After all, the plaintiff may receive nothing, in which case the payment from the investor should not be treated as a substitute for anything.

Timing of Income for Plaintiffs

In a previous article,14 we noted that documenting the investment as a prepaid forward contract addresses many of the concerns of both investors and law firms. Treating an investment in a lawsuit as a prepaid forward means it is an open transaction that does not close until the lawsuit is resolved. We concluded that if a law firm capitalizes its expenses for the underlying lawsuit, open transaction treatment is arguably appropriate for the law firm.

The plaintiff is not likely to be subject to the same constraints as the law firm on deducting attorney fees and other litigation expenses. In many cases, the plaintiff is hiring the law firm on a contingent fee basis and therefore may have few, if any, expenses. Even if the plaintiff does incur expenses, they should be deductible as they are incurred or paid rather than capitalized.

To the extent the plaintiff does not capitalize expenses, one of the main justifications for open transaction treatment appears to be missing. Whatever the outcome of the lawsuit, the plaintiff is sure to receive as gross income at least the amount advanced by the investor. Moreover, the plaintiff is free to deduct expenses as they are incurred. However, open transaction treatment may still be viable.

For example, the investor’s advance may be intended to be used in whole or in part to cover the cost of deductible expenses incurred in the lawsuit. The plaintiff will typically retain significant economic exposure to the underlying lawsuit even if the potential risks and rewards are mitigated by the investor’s advance. Furthermore, the plaintiff will also generally retain substantial or even exclusive control over the lawsuit. Thus, assuming there is substantial uncertainty over the plaintiff’s net income and the plaintiff capitalizes all deductible expenses, the plaintiff is arguably justified in treating the investment as an open transaction.

Double Taxation?

The “anticipatory assignment of income” doctrine applies when taxpayers attempt to assign income that has accrued but has not yet been realized. Under this judicial doctrine, the taxpayer is treated as earning the unrealized income despite any attempt to sell or give it away. As the Supreme Court explained in one frequently cited opinion

196 F.3d at 868.

10 See Commissioner v. P.G. Lake Inc., 356 U.S. 260, 265 (1958) (holding that amounts received for an assignment of rights under oil and gas leases represented ordinary income rather than capital gain because the “consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income”); Holt v. Commissioner, 303 F.2d 687 (9th Cir. 1962) (holding that a lump sum payment received in consideration for future royalty income was ordinary income and not capital gains).


12 See United States v. Midland-Ross Corp., 381 U.S. 54 (1965) (gain from the sale of promissory notes attributed to the accrual of original issue discount was ordinary rather than capital).

13 See Gladden v. Commissioner, 112 T.C. 209, 220 (1999) (explaining that the degree of investment risk is a critical factor to consider in determining if the substitute for ordinary income doctrine should apply), rev’d on a different issue, 262 F.3d 851 (9th Cir. 2001).

from 1930,15 if the income has sufficiently ripened on the tree, it is too late to transfer, and the income will be assigned to the assignor.

Ten years later, in Helvering v. Horst,16 the taxpayer detached interest coupons from a bond and gave the coupons to his son. The Supreme Court held that although the cash-basis taxpayer had not yet realized the income from the coupons, the income had nevertheless accrued to him and therefore could not be assigned.

In Commissioner v. Banks,17 the Supreme Court held that the anticipatory assignment of income doctrine applies to contingent fee arrangements. The Court explained that in a contingent fee matter, the plaintiff enjoys dominion and control over an “income-generating asset.”18 It also stated that the plaintiff obtains the benefit of legal services by diverting payment from the cause of action to the attorneys. According to the Court, this is comparable to the taxpayer who attempted to divert interest income by gifting the interest coupons in Horst.

In at least one important respect, the comparison to Horst is strained. In Banks, the plaintiff had not yet accrued any income. Nonetheless, the Court held that it made no difference that the plaintiff’s legal claim was contingent in amount and that he might receive nothing. After Banks, a plaintiff is generally considered to be required to include the entire recovery in income, including the amount he is required to pay his attorney under a contingent fee agreement.19

Could the IRS make the same anticipatory assignment of income argument in the context of a litigation investment transaction? The income-generating asset is the plaintiff’s cause of action, just like in Banks. Thus, could the IRS argue that the plaintiff is diverting payment from the cause of action to the investor?

Fortunately for plaintiffs, there seems to be a different and more liberal standard for assigning legal claims to parties other than an attorney working for a contingent fee. The critical question is usually how far advanced the litigation has progressed. For example, in Doyle v. Commissioner,20 the taxpayer assigned a portion of his claim to his wife and children after the trial court had already denied an application for a new trial and the Supreme Court had denied a writ of certiorari. The Fourth Circuit explained that the litigation had progressed too far because the outcome was essentially assured. The fruit had ripened too far.

However, in another case, the transfer occurred after the district court had rendered a judgment, but while the case was still on appeal.21 The Sixth Circuit determined that the matter was a continuing controversy, and the income was not certain or earned at the time of the assignment. This dividing line appears to be accepted by the IRS.

For example, the IRS has ruled that transfers of litigation claims are valid if the case is on appeal, and so there remains a genuine uncertainty about the outcome.22 As long as the litigation continues to be subject to appeal and a genuine contingency exists, the anticipatory assignment of income doctrine should not apply.23 Assuming this more liberal standard applies, the anticipatory assignment of income doctrine should generally not apply to litigation investments.

After all, plaintiffs are not likely to seek financing if all appeals have truly been exhausted.24 Nevertheless, this doctrine has the potential to be a trap for the unwary if the litigation has progressed so far that there are no true contingencies remaining.

Additional Character Concerns

When the plaintiff enters into a litigation finance transaction, the underlying lawsuit may result in a recovery. Alternatively, the lawsuit may fail without resulting in any payment. The plaintiff can either recognize income at the time of the advance or treat it as an open transaction that triggers income only at the resolution of the lawsuit (as in a prepaid forward contract).

This seems to suggest a menu of four possible scenarios: closed transaction — successful lawsuit; closed transaction — unsuccessful lawsuit; open transaction — successful lawsuit; or open transaction — unsuccessful lawsuit. It is worth considering

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16311 U.S. 112 (1940).
18Id. at 427.
19The Banks court declined to address several alternative theories for excluding a recovery from a plaintiff’s income, such as the use of a partnership under subchapter K, the treatment of attorney fees as a capital expense, and attorney fees granted under fee-shifting statutes. Id. at 437-439.
20147 F.2d 769 (4th Cir. 1945).

21Cold Metal Process Co. v. Commissioner, 247 F.2d 864 (6th Cir. 1957).
22LTR 200107019 (“anticipatory assignment of income principles require the transferee to include the proceeds of the claim in gross income where recovery on the transferred claim is certain at the time of transfer, but not where recovery on such claim is doubtful or contingent at the time of transfer”).
23See LTR 201232024 (transfer of claim to charity was valid while judgment was on appeal).
24However, one function of litigation investing is for outside investors and parties to provide “after the event” insurance for legal risks created after lawsuits have been filed or for litigants that have won judgments but whose cases are on appeal. See Jonathan T. Molot, “A Market in Litigation Risk,” 76 Univ. of Chi. L. Rev. 367 (2009).
whether the character of the plaintiff’s income from a litigation investment may be different in any of these four situations.

When the plaintiff treats the litigation investment as a closed transaction, he receives cash from the investor in exchange for a right to a portion of the proceeds from the plaintiff’s claim. The claim is arguably an intangible property right that is a capital asset in the hands of the plaintiff. This should be true even if the claim would otherwise result in ordinary income. Thus, the plaintiff may be justified in treating the transaction as resulting in capital gain.

In a closed transaction, the plaintiff reports income from the litigation investment in the year that he entered the transaction. Assuming the plaintiff reports the income as capital gain, the character of the plaintiff’s gain does not appear to be affected by whether the underlying lawsuit is successful. If the lawsuit is unsuccessful, neither the plaintiff nor the investor will receive any award.

However, the plaintiff should experience no tax consequences on the conclusion of the failed lawsuit. If the lawsuit is successful, the proceeds are divided between the plaintiff and the investor. Assuming that the anticipatory assignment of income doctrine does not apply, the plaintiff should be able to exclude the amount that the investor receives. The plaintiff’s share of the recovery should be characterized based on the origin of the claim.

If the recovery is ordinary income, that should not affect the character of the earlier investment transaction that was reported as resulting in capital gain. The investment was arguably an independent transaction at arm’s length between the plaintiff and a third-party investor. By contrast, the recovery money comes from the defendant and expressly relates to the plaintiff’s legal claim. An ordinary recovery should not affect the character of the plaintiff’s gain from the litigation investment.

Open Transaction andUnsuccessful Suit

In an open transaction such as a prepaid forward contract, the plaintiff recognizes income only when the lawsuit concludes. If the lawsuit is unsuccessful, the plaintiff should recognize income in the amount of the original advance, less the basis (if any) the plaintiff has in the lawsuit, such as capitalized expenses. Therefore, just as in a closed transaction, any gain should arguably be capital gain.

This should be so even if the underlying lawsuit would have produced ordinary income. Of course, the substitute for ordinary income doctrine may apply, particularly if the lawsuit was relatively certain to succeed at the time of the investment. In that case, gain should be ordinary even if gain is only triggered at a later time.

Open Transaction and Successful Suit

If the lawsuit is successful, the proceeds are divided between the investor and plaintiff. At the same time, the plaintiff also recognizes income from the investment. If the lawsuit recovery is ordinary income, can the plaintiff nevertheless treat gain from the investment as capital?

For example, suppose the plaintiff receives $100 from the investor. In exchange, the investor will receive 50 percent of the net proceeds from the lawsuit after attorney fees are paid and the investor’s money is returned. Assume the lawsuit is successful and results in a recovery of $500.

Of this amount, $200 goes to the attorney, and the investor receives a return of its original $100 investment. The plaintiff and investor then evenly divide the remaining net proceeds of $200. As a result, the attorney receives $200, the investor receives $100, and the plaintiff receives $100 from the $500 recovery.

Assume the recovery is ordinary income based on the origin of the claim. The plaintiff should have $100 of ordinary income. However, the plaintiff contends the $100 from the investor should be treated as capital gain.

Under Banks, the plaintiff is treated as receiving the attorney fees. The IRS may argue that the plaintiff should similarly be treated as receiving the amount that is due to the investor. The IRS may seek to apply a variant of the anticipatory assignment of income doctrine and argue that the investor’s advance to the plaintiff was simply a loan.

This would presumably be similar to the “loan” that a law firm is deemed to make to its client when the firm pays expenses related to a contingent fee lawsuit. Under this theory, the plaintiff would be treated as receiving the entire $500 recovery. The amount paid to the investor would not be deductible. Instead, it would only be deductible.

The return of $100 to the investor would be a non-deductible return of loan principal. However, the plaintiff should be eligible to deduct the remaining payment of $100 to the investor, along with the payment of $200 in attorney fees. If the plaintiff is a corporation and the legal claim is related to its business, it should be able to deduct the payment to the investor as an ordinary and necessary business expense.

If the plaintiff is an individual, and the claim is not related to his trade or business, he may only be entitled to a miscellaneous itemized deduction under section 212, which permits a deduction for items related to activities entered into for profit. It covers...

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items such as investment adviser fees and, in some cases, attorney fees. Yet a section 212 deduction is a miscellaneous itemized deduction that is a preference item for purposes of the alternative minimum tax.\textsuperscript{26} A plaintiff in this situation would face a very serious AMT problem. The entire $500 recovery would be treated as income, resulting in tax of $140 (28 percent of $500) even though the plaintiff receives a net amount of $200 ($100 from the investor plus his share of $100 from the recovery).

In fact, the plaintiff would have been better off if the lawsuit had failed. In that case, the plaintiff would have paid capital gains tax of approximately 20 percent on the investor’s advance of $100. This would generate an after-tax amount of approximately $80, compared with only $60 in the successful lawsuit scenario.

When the plaintiff treats the litigation investment as an open transaction, such as a prepaid forward contract, it may well increase the risk that the IRS will argue that the litigation finance investment was a loan. The plaintiff may object that the legal claim was merely speculative and contingent at the time of the litigation investment transaction, claiming that the investor should not be treated as lending money to the plaintiff in such a risky and uncertain matter. Although in hindsight the lawsuit may appear more certain and secure, at the time of the investment it may have been very uncertain.\textsuperscript{27}

Despite these arguments, the IRS may say the plaintiff should not be permitted to have his cake and eat it too. The Service could argue that if the plaintiff treats the litigation finance investment as an open transaction, and the lawsuit is successful, the plaintiff’s entire return comes from the proceeds of the lawsuit and although the plaintiff is paying the investor from those proceeds, the entire amount is income to the plaintiff.

How serious is the risk that the IRS would seek to characterize the lawsuit finance transaction as a loan? Clearly, the documents will matter and should inform this issue. Yet assuming proper documentation, the loan theory seems to ignore the basic terms of the transaction. After all, the plaintiff’s obligation is nonrecourse, meaning that the investor gets paid only if the lawsuit is successful.

The investor does not have a right to get its money back from the plaintiff. Instead, the investor is better viewed as having a right to a share of the lawsuit recovery. Nonetheless, courts have consistently held that a contingent fee attorney’s expenses should be regarded as a loan to the plaintiff even though the plaintiff bears no liability for those expenses if the lawsuit is unsuccessful.\textsuperscript{28}

Plaintiffs should not ignore the risk that if they seek to treat the litigation finance transaction as a prepaid forward contract, they may increase the risk that it will instead be treated as a loan if the lawsuit is successful. In that case, the investor’s advance may be ordinary income. Furthermore, the plaintiff could run into a serious AMT problem, particularly if the plaintiff is an individual.

Conclusion

In previous articles, we examined the tax issues facing investors and lawyers in litigation finance transactions. The plaintiff, however, appears to face the most complex and challenging tax issues in these settings. For the investor, a lawsuit is an unusual form of investment without any established parallels or analogies.

Nonetheless, the basic form of the transaction seems analogous to that of other investments generating capital gain. There is an acquisition of an intangible property right, followed by the redemption or liquidation of that property right in exchange for cash. Thus, the investor seems to have a strong basis for claiming capital gain treatment while it does not appear to have any serious timing concerns.

For the law firm, ordinary income treatment seems inevitable. Therefore, the law firm or attorney is mainly concerned with timing. Assuming proper documentation, it appears reasonable for a law firm to treat a litigation investment transaction as a prepaid forward contract. The critical requirement seems to be consistency: The law firm should also capitalize all expenses related to the lawsuit.

The plaintiff must consider both timing and character issues, and the underlying lawsuit looms large. Plaintiffs already face difficult tax issues in resolving litigation, and litigation finance transactions add to the complexity. Plaintiffs in commercial disputes may be well equipped to address these issues. Many individual and unsophisticated plaintiffs may not be.

Moreover, there appears to be a trade-off. That is, it may be possible for the plaintiff to treat the litigation investment as a prepaid forward contract and to recognize capital gain. However, what if the plaintiff treats the litigation investment as a prepaid forward contract, and the lawsuit is successful? This

\textsuperscript{26}Section 67(b).

\textsuperscript{27}Plantation Patterns Inc. v. Commissioner, 462 F.2d 712, 723 (5th Cir. 1972) (“the transaction must be judged on the conditions that existed when the deal was consummated, and not on conditions as they developed with the passage of time”).

\textsuperscript{28}Canelo v. Commissioner, 53 T.C. 217 (1969), aff’d, 447 F.2d 484 (9th Cir. 1971).
would seem to heighten the risk that the IRS will regard the litigation investment as simply a loan. In that case, the character of the investment may be ordinary rather than capital. Also, individual plaintiffs may face serious limitations on deducting the payment to the investor. This problem is exacerbated when they must also deduct payments to their attorneys.

All of this suggests that plaintiffs entering into a litigation finance transaction should consider taxes. It is particularly important for plaintiffs to carefully consider the various possibilities that may arise under their case. In reality, of course, unsophisticated plaintiffs embarking on such a transaction may have little bargaining power under the documents. Even if they did, they might not get adequate tax advice regarding the effect of any changes to the documents. The plaintiff may simply be trying to generate some immediate cash. Nevertheless, evaluating the range of possibilities in the future, documenting the transaction consistently, and understanding the risks are all critical for plaintiffs who want to receive favorable tax treatment.

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