Is Litigation Finance Tax Treatment in Jeopardy?

By Robert W. Wood and James L. Kresse

Lawsuits are expensive. From the time put in by the lawyers who frame, process, and ultimately try the case, to the out-of-pocket resources needed to properly research and prove the case, there is no denying that bringing (and defending) a lawsuit costs money. Companies and law firms alike now routinely note that the expenditures of managing a modern case are growing.

Consequently, in increasingly wide varieties of litigation, today’s lawyer for the plaintiff is likely to be compensated through a contingent fee. If the plaintiff wins, the lawyers are rewarded with a handsome piece of the recovery. If the plaintiff loses, the lawyers may walk away with nothing for their efforts.

Litigation finance is becoming an increasingly popular way to deal with the (also increasingly burdensome) expenses of litigation. In a typical litigation finance transaction, a third-party investor is given a piece of the potential recovery in exchange for capital. The returns can be handsome, far better than prevailing interest charges or even loans with some kind of equity feature. Even usurious interest rates may not compare. Yet there is risk, for these are equity positions.

Given these equity characteristics and the potential for huge returns, how should the gains be characterized for tax purposes? Is it a loan, perhaps a loan with equity features? Is it equity? Is it a partnership, or is it perhaps merely a contract right?

Form of Investment

One might begin to answer how to characterize the gains by asking another question: What do you want the funding to be? All too often, at least some of the participants are not asking this question. They clearly should. In fact, the funding company should ask for itself and for its investors. So should the plaintiff and the lawyers.

And the documents that you draft (or that you use off the shelf!) matter. Receiving money from investors can be documented in several distinct ways. The primary choice is between loan and sale, but from there it becomes substantially more nuanced.

In a loan, the lawyer or client (or both) receives loan proceeds. Axiomatically, the loan proceeds are not taxable as income because the borrower must generally pay them back. Taking out a loan has the advantage of deferring taxes on the receipt of that loan money.

But few investors like the loan model. Reasons for staying away from loans include regulatory requirements and statutory limitations on interest rates. Moreover, when the case resolves in a later tax year, there can be a surprising (and seemingly inequitable) mismatch when it comes to taxes.

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In fact, if the transaction is documented as a loan, the taxpayer plaintiff may have to include the entire amount in income and claim what could be a very large offsetting interest deduction. The deduction may be limited, which means the plaintiff can be paying tax on money he never sees.

Prepaid Forward

One of the most common structures to implement litigation funding is a prepaid forward contract. Despite its fancy name, it is basically a sale. A sale would seem to be taxed as such, with the
recipient of the money paying ordinary income or capital gain tax on the sale proceeds depending on the circumstances. Yet a prepaid forward sale seems to be taxed at first like a loan.

The prepaid forward contract may involve the plaintiff selling a piece of his claim. Alternatively, it may involve the lawyer selling a piece of the contingent fee. The lawyer (or law firm) is obviously a service provider, so one might assume the proceeds are in each case ordinary income for services. Even then, however, the lawyer may receive a material tax benefit by delaying tax on the fees.

From every angle, the prepaid forward arguably offers the best tax result for both the plaintiff and the lawyer. Because it is a sale, one might assume that the recipient of the money would have to report the sale proceeds as income. Nevertheless, this is a sale contract with an unclear final return.

When the seller signs the documents and receives the money, he has entered a contract to sell a portion of the case (the client) or a portion of the contingent fee (the lawyer) when the lawsuit is resolved. That is why it is a forward contract. You are contracting to sell now, but the sale does not close until the case is resolved.

The result is that you generally should not have to report income until the conclusion of the case. That sounds similar to a loan, but it is actually better in many cases. Because a loan arrangement can be easiest to document, some lawyers and clients prefer it.

Yet most litigation funders do not like straight loans because of usury concerns or regulatory rules. The risk premium the litigation funder charges might equate to a very high interest rate. Further, these loans are generally nonrecourse, secured only by the proceeds from the claim. This can make the loan look more like equity.

For all of these reasons, loans seem increasingly rare. Prepaid forward contracts are preferred by many lawsuit-funding sources. They have the advantage of no immediate tax on the upfront payments, just like loans.

Characterizing the Recovery

In a typical lawsuit, the method for characterizing the plaintiff’s recovery is well settled. The plaintiff’s recovery is characterized according to the origin and nature of the claim. If the lawsuit relates to personal physical injuries, the recovery should generally be tax-free under the section 104 exclusion.

If the lawsuit relates to lost profits, the damages should represent ordinary income. If the lawsuit relates to damage to a capital asset, the recovery should usually be capital in nature. It may be capital gain, or perhaps even recovery of basis.

The tax rules governing litigation recoveries are not perfect. There can be nettlesome factual and legal questions about how a plaintiff’s recovery should be taxed, even without the added complication of litigation funding. Overall, however, the tax rules make sense.

On the attorney’s side, the recovery usually represents ordinary income for personal services. In that sense, attorneys may have the smallest tax incentives in the treatment of the financing. Characterizing (and applying tax rules to) the recovery of the investor is not as clear.

Should it be based on the origin of the claim? Perhaps, but the key question that the origin of the claim doctrine poses is: In lieu of what is the taxpayer receiving the income? In the case of the investor’s recovery, the income is from the investor’s ownership of an asset purchased from the attorney or the claimant. Could that asset be considered a capital asset giving rise to capital gain?

Capital Asset

A capital asset is defined by section 1221 as any property held by the taxpayer that is not specifically mentioned in section 1221. Most relevant here, a capital asset does not include inventory held by the taxpayer. The funding obligation is not likely to represent inventory or property held primarily for sale to customers within the meaning of section 1221(a)(1).

Indeed, an investor generally is not actively selling these types of obligations to customers. The investor probably has no customers and is not likely to be treated as a dealer in these types of obligations. Instead, once the funds are placed, the investor (or an investment fund managed by the investor) is likely to hold the obligation until maturity, much like an investment asset.

Assuming that the investor is not a dealer, the obligation appears to have the basic characteristics of a capital asset. There are several different formulations for evaluating what constitutes a capital asset. For example, in United States v. Maginnis, the U.S. Court of Appeals for the Ninth Circuit applied a two-factor test to determine if an asset is a capital asset: whether the taxpayer has made an investment in the asset and whether the asset appreciates in value over time.

1Even if the investor is not a dealer, the investor may be a trader. See Hart v. Commissioner, T.C. Memo. 1997-11, aff’d without published opinion, 135 F.3d 764 (3d Cir. 1997) (discussing the difference between dealers, traders, and investors and holding that the test for traders depends on the intent, nature of the income, and frequency and extent of trading activities).

2United States v. Maginnis, 356 F.3d 1179 (9th Cir. 2004).
Plainly, the investor advances cash. Moreover, the value of the obligation is likely to increase over time, as the litigation progresses. In that way, the obligation appears to satisfy both Maginnis factors.

Although the circumstances appear to favor classification as a capital asset, the Maginnis court stated that its two-factor test would not necessarily be appropriate in all cases. Other courts have applied different tests. For example, in Gladden v. Commissioner, the Tax Court articulated a six-factor test that is widely applied to determine whether contract rights represent a capital asset. Arguably, a litigation finance contract represents contract rights, making the Gladden test particularly relevant. The Gladden test considers the following factors: (i) how the contract rights originated; (ii) how the contract rights were acquired; (iii) whether the contract rights represented an equitable interest in property which itself constituted a capital asset; (iv) whether the transfer of contract rights merely substituted the source from which the taxpayer otherwise would have received ordinary income; (v) whether significant investment risks were associated with the contract rights and, if so, whether they were included in the transfer; and (vi) whether the contract rights primarily represented compensation for personal services.

Virtually all of those factors appear to favor treating a typical litigation finance contract as a capital asset. In a typical litigation finance contract, the investor will pay the claimant for a share of the investor’s recovery, thereby creating and acquiring the contract rights at issue. This exchange of value for rights is consistent with treating the litigation finance contract as a capital asset.

The fourth, fifth, and sixth factors also seem to support treating a litigation finance contract as a capital asset. Before acquiring the rights created by a litigation finance contract, the investor had no rights to the plaintiff’s recovery. Therefore, it cannot be said that the investor’s recovery is a substitute for ordinary income.

Regarding the fifth factor, the investor will generally receive nothing if the litigation fails to result in a recovery. Depending on the status of the litigation at the time of the investment, the risk can often be substantial. This again favors capital treatment. Finally, the investor generally does not per-

form personal services as part of a litigation finance contract. Thus, the sixth factor also favors capital treatment.

The third factor may or may not favor capital treatment, depending on from whom the investor purchases his interest. An interest in a lawyer’s contingent fee is ordinary income to the attorney, and therefore the underlying asset generally would not be a capital asset. However, when a plaintiff sells the right to a portion of the recovery, it can be considered the sale of a capital asset to the investor.

In that case, the underlying asset could be considered a capital asset. Regardless of the party from whom the investor purchases an interest, both the Maginnis and Gladden tests seem met. Indeed, they provide strong support for the conclusion that the investor’s interest acquired in a typical litigation finance contract should be considered a capital asset.

Sale or Exchange Requirement

An often-overlooked requirement of recognizing capital gain is a triggering event. It is not merely the nature of the asset that matters. Optimally, the income should be realized from the sale or exchange of a capital asset. If of course, the sale or exchange requirement is usually satisfied by the sale of a capital asset to a third party.

In some cases, a sale or exchange is not necessary to reach capital gain treatment. This is especially true in the case of a litigation recovery when the damages relate to an underlying capital asset. For example, in Electroenergy Corp. v. Commissioner, the Tax Court held that the taxpayer’s recovery for trademark infringement represented damage to a capital asset, resulting in capital gain.

The IRS may reach the same result on its own. Thus, in Rev. Rul. 81-152, the IRS concluded that amounts recovered by a homeowners association from a builder for defects in construction were a nontaxable reduction in basis. The IRS reached a similar conclusion in FSA 200228005, holding that a taxpayer’s recovery for diminished land value was a nontaxable reduction in basis.

The field service advice came to this conclusion without discussing the sale or exchange requirement. It is debatable whether the nature of the

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5See Long v. Commissioner, 772 F.3d 670 (11th Cir. 2014), rev’g in part and aff’g in part T.C. Memo. 2013-233.
7See Electroenergy Corp. v. Commissioner, 48 T.C. 465, 474 (1967), acq., 1968-2 C.B. 3 (1968) (stating that despite no sale or exchange of goodwill, the award was a tax-free recovery of

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litigation should affect the character of the investor’s recovery. Arguably, the investor’s interest is an independent contract right that is itself a capital asset.

In some cases the Internal Revenue Code provides for capital gain or loss resulting from a transaction in which a capital asset is eliminated — even when there is no obvious sale or exchange. For example, in the context of a redemption of securities, there is section 302. It provides that the transaction will be considered a sale or exchange of those securities (generally giving rise to capital gain).

Similarly, section 165(g) provides that the abandonment of worthless securities gives rise to a capital loss. Both of these examples appear to be based on an understanding that redemption or abandonment terminates the taxpayer’s interest in the capital asset. A termination, one might assume, should be afforded a tax treatment similar to a sale or exchange.

In many respects, an investor in litigation can be analogized to a shareholder of a corporation. By purchasing a piece of an ongoing lawsuit, the investor will generally have at least a largely if not entirely passive role in managing the litigation. There may be ongoing updates the lawyer or plaintiff must provide, but even that may be kept to a minimum. And decision-making and tactics are almost never within the funder or investor’s province.

However, the funder will have a priority interest in any recovery from the litigation. In this sense, any payment received by the investor could be considered a redemption of the investor’s interest in the litigation. Another relevant example is the retirement of a debt instrument.

Under section 1271(a)(1), “amounts received by the holder on a retirement of any debt instrument shall be considered as amounts received in exchange therefor.” Thus, a taxpayer will generally recognize a capital gain if he receives more than his basis when a bond is retired. The bondholder has a capital loss if the bond is retired for less than its basis.

The investor’s return upon settlement of the underlying litigation is similar to the retirement of a debt instrument. Generally, in both cases, the creditor-investor provides cash, with the expectation of repayment in cash. Upon repayment, the asset held by the investor ceases to exist. Under the principles of section 1271(a), this extinguishment is considered a sale or exchange, giving rise to capital gain.

Section 1234A

Section 1234A provides for capital gain (or loss) treatment on the cancellation, lapse, expiration, or other termination of a right or obligation regarding property that is (or on acquisition would be) a capital asset in the hands of the taxpayer. This code section was originally enacted in 1981, primarily to deal with financial products. However, section 1234A was expanded to apply to all capital assets in 1997.

The section was also designed primarily to prevent taxpayers from claiming ordinary loss treatment. In that sense, its statutory capital treatment for some contracts is really more about making their tax treatment less favorable, not more so. Of course, the provision is not restricted to losses. It applies to gains and losses alike.

The House report to the Tax Relief Act of 1997 states that section 1234A was amended to apply to: (i) “interests in real property” (for example, “amounts received to release a lessee from a requirement that the premises be restored upon termination of the lease”); and (ii) “non-actively traded personal property” (for example, “the forfeiture of a down payment under a contract to purchase stock”). The legislative history further indicates that the change was motivated in part because lawmakers believed that the law in effect at the time (1) taxed similar economic transactions differently; and (2) lacked certainty.

After the 1997 amendment, section 1234A is clearly not limited to financial instruments. Other than its exception for section 1234B securities future contracts, section 1234A expressly refers to all rights or obligations regarding property that would constitute a capital asset in the hands of the taxpayer. As discussed above, a litigation finance investment appears to qualify as a capital asset.

Does the settlement of litigation and the payment to an investor result in the termination of rights or obligations from an underlying capital asset? It certainly seems to. After all, a litigation finance agreement creates a continuing contractual relationship between the plaintiff (or the attorney) and the investor. This relationship terminates only when the plaintiff makes the affirmative decision to settle (or, less frequently, the case ends with a judgment that results in payment from the defendant). Moreover,
in some cases the investor has a continuing obligation to fund expenses, which ends only with resolution of the underlying litigation.

Narrow View of Section 1234A

Since the expansion of section 1234A in 1997, there has been little definitive guidance regarding the scope or application of the section. The existing IRS guidance has generally advocated for a narrow scope of section 1234A without much discussion. For example, in TAM 200427025, the IRS concluded that a payment received by a utility company for termination of a long-term power purchase agreement was ordinary income under the extinguishment doctrine. The IRS stated in a footnote that section 1234A did not apply to the transaction with no further explanation or discussion.

In LTR 200823012, the IRS ruled that termination fees that a company received from an abandoned merger represented ordinary income. The IRS applied the origin of the claim doctrine and concluded that the fee was a substitute for lost profits. The IRS again stated that section 1234A did not apply to the transaction without further explanation.

In Rev. Rul. 2009-13, the IRS addressed the tax consequences of the sale and settlement of life insurance policies. In the revenue ruling, the IRS appears to concede that an interest in a life insurance policy is a capital asset. To this end, the agency concluded that the sale of such an interest to a third party should generate capital gain.

However, the IRS concluded that settlement proceeds from the life insurance policy for the cash surrender value represented ordinary income (to the extent the amount recovered exceeds cost). Regarding section 1234A, the ruling states simply that “Section 1234A . . . does not change this result.” In this guidance, the IRS has essentially avoided section 1234A altogether.

The IRS has continued to advance principles existing before the 1997 expansion of section 1234A, such as the extinguishment doctrine. This approach appears to ignore some of the very reasons Congress amended section 1234A in 1997. Under the principles of the extinguishment doctrine, a taxpayer could abandon a capital asset and recognize an ordinary loss.

On the other hand, a savvy taxpayer could pick and choose. If the taxpayer’s position in the capital asset had appreciated, he could execute a sale or exchange and recognize a capital gain. This mismatch, or indeed manipulation, between gain and loss mechanics appears to be what Congress was attempting to remedy when it amended section 1234A.

Pilgrim’s Pride

In recent litigation, the IRS found itself arguing for a much broader application of section 1234A. The case arose when a taxpayer attempted to take an ordinary loss under section 165 (as the law existed at that time) arising from the abandonment of worthless securities. The IRS contended that the abandonment of the securities represented the termination of all of the taxpayer’s rights regarding the securities.

The IRS said that made the loss capital under section 1234A. The Tax Court agreed, siding with the IRS. The court concluded that section 1234A applied to make the abandonment of securities a capital loss.

In its analysis, the Tax Court determined that section 1234A was intended to apply to property rights inherent in intangible property as well as to ancillary or derivative contract rights. In reaching this conclusion, the court noted that Congress was critical of how existing law allowed taxpayers to elect their tax treatment by either selling property (and recognizing capital gain) or holding on to property (and recognizing ordinary losses).

The Tax Court believed that the stated goal of remedying this mismatch supported a broad reading of section 1234A. However, the Fifth Circuit reversed the court’s decision. In holding for the taxpayer, the Fifth Circuit took a far narrower view of section 1234A.

Specifically, the appeals court concluded that section 1234A applies only to derivative and contractual rights, not to rights inherent in a capital asset. In reaching this conclusion, the court rejected the IRS’s argument that section 1234A should be read consistently with Supreme Court cases in which the phrase “with respect to property” was used to refer to inherent rights. Notably, the Fifth Circuit also appeared to be influenced by some of the IRS’s own inconsistencies.

For example, the taxpayer argued that if section 1234A was to be read expansively, the IRS should have amended Rev. Rul. 93-80, which concludes

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that losses from an abandoned partnership interest are ordinary. The Tax Court accepted the IRS’s argument that the 1997 amendment of section 1234A superseded the result in the revenue ruling. However, the Fifth Circuit concluded that the IRS’s failure to amend the revenue ruling was an indication that the agency itself believed section 1234A should be read narrowly.

Pilgrim’s Pride provides as many questions as it does answers. Arguably, the Fifth Circuit’s decision is consistent with prior IRS guidance regarding a narrow scope of section 1234A. But the decision is contrary to the IRS position in the case and overturns the Tax Court decision.

Significantly, the IRS and the Tax Court are bound by the Fifth Circuit’s decision only as it concerns taxpayers residing in the Fifth Circuit (that is, Louisiana, Mississippi, and Texas). Therefore, it is possible that when presented with another case regarding the scope of section 1234A, the Tax Court could again rule that the provision applies broadly to inherent rights.

**New IRS Guidance, More Questions**

Not surprisingly, not many authorities are directly addressing the tax consequences of a litigation finance investment. Taxpayers are therefore forced to analogize these assets, rights, and instruments to other assets, rights and instruments addressed more explicitly by the tax code. When the IRS issues relevant guidance, it is worth taking note, even if the advice is nonprecedential. Crumbs, after all, are better than nothing.

In heavily redacted field attorney advice recently released to the public, the IRS concluded that gain realized by the investor upon settlement of the litigation was ordinary income. The reason? Because there had been no sale or exchange of a capital asset under section 1001. In addressing section 1234A, FAA 20154701F concludes simply that the proceeds are not realized from the disposition of property. Unfortunately, the heavily redacted nature of the advice makes it difficult to compare the contract language seems notable. It could be an indication that the field attorney advice should be read narrowly, applying only to the specific facts of the contract at issue in the advice. Nonetheless, investors can take important lessons from the advice regarding future litigation finance transactions.

Before critiquing the myopic focus on a sale or exchange, it is important to say what is good, explicit, and true in the field attorney advice. The asset is a capital asset, the IRS says. It is worth saying again. The contract is a capital asset. Many plaintiffs in litigation, and many litigation finance investors, should take notice, for that is quite positive.

Of course, the other shoe falls with the reason the IRS says ordinary income treatment nevertheless applies. The conclusion that “section 1234A does not apply” could signal a return to a narrow reading of the scope of section 1234A espoused by the IRS in prior guidance. What’s interesting is that the IRS was again rather tight-lipped regarding the reasons for its conclusion. For example, the guidance does not mention Pilgrim’s Pride in concluding that section 1234A does not apply.

That appears to be a rather big omission. And it at least leaves open the possibility that the IRS might again argue for a broad interpretation of section 1234A similar to the position advanced in Pilgrim’s Pride. On the other hand, perhaps it means little!

Notably, the analysis in FAA 20154701F relies heavily on the language in the particular litigation finance contract under consideration. The field attorney advice states that the terms of the agreement strongly suggest that the parties did not view the payments received by the investor as a disposition of property. Unfortunately, investors can take important lessons from the advice regarding future litigation finance transactions.

**Documents Matter**

It is no secret that the intent of the parties in executing a transaction is often key to determining the tax consequences of the transaction. For example, while not determinative, intent is a key factor to determining whether an instrument is debt or equity for tax purposes. In this case, a litigation finance contract can potentially be written in a way that emphasizes key aspects of section 1234A without materially affecting the economics of the transaction.

A typical litigation finance contract involves the purchase and sale of a capital asset. In addition, the agreement generally governs rights and obligations between the parties that will exist until the litigation

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24 Pilgrim’s Pride, 141 T.C. 533, 550.
25 Pilgrim’s Pride, 779 F.3d 311, 317.
26 FAA 20154701F (released to the public on Nov. 20, 2015).
27 PepsiCo Puerto Rico Inc. v. Commissioner, T.C. Memo. 2012-269 (holding for taxpayer that instruments treated as debt in the Netherlands were equity for U.S. federal income tax purposes). But see Hewlett-Packard Co. v. Commissioner, T.C. Memo. 2012-135 (holding that an instrument that took the form of equity was recharacterized as debt in a case involving foreign tax credit planning).
is resolved. The plaintiff generally maintains control of the underlying litigation and must use his best efforts to successfully resolve the litigation. An investor may have a continuing obligation to fund litigation expenses as they arise or at the request of the plaintiff.

To emphasize the importance of section 1234A: The contract can be drafted to highlight that these rights and obligations terminate upon settlement of the litigation and payment to the investor. Arguably, the payment to the investor of their investment return relates to the termination of their rights and obligations under the litigation finance agreement.

Sale or Exchange Canard?

Another possible solution to the sale or exchange requirement is to provide an investor with an option to sell his interest in the litigation when it is sufficiently clear (but not certain) what will be recovered. Existing authorities suggest that the IRS will respect such sales. For example, as discussed above, the IRS concluded that the sale or exchange of a life insurance contract to a third party resulted in capital gain.

The IRS reached this result even though termination of the contract for the cash surrender value resulted in ordinary income. In the case of a true sale, of course, capital gain should result regardless of the application of section 1234A. However, even if the option terminated without exercise, the agreement could be worded to make it explicit that the payment to the investor is a result of the termination of the option.

Conceivably, such a termination was within the range of contract rights that Congress contemplated when it enacted section 1234A and when it remodeled its scope in 1997.

Conclusion

Section 1234A has existed in relative obscurity since its enactment and even since its amendment. Plainly, the language of section 1234A suggests the potential for broad application. Yet it is undeniable that the IRS and courts have been rather inconsistent in their application of section 1234A.

Section 1234A has interesting potential in the context of litigation finance agreements. They are a growing presence in a variety of types of litigation and, like litigation itself, can touch many businesses. Some observers even think these funding devices are beginning to influence litigation trends and exposures.

The IRS has caused a ripple in some circles by issuing FAA 20154701F, which is of course non-precedential. At the least, it has cast some doubt on the application of section 1234A in this context. On the other hand, with the field attorney advice’s focus on explicit contract language, savvy financiers may make lemonade from any lemons the advice provides.

After all, the field attorney advice assumes the litigation finance contract is a capital asset. If the IRS wants to see a sale or exchange, it may not be difficult to structure one. In that sense, investors considering litigation finance might now feel they can better position themselves for capital gain treatment.