Litigation Funding: The Attorney's Perspective

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In this article, Wood and Van Loo consider the basic tax issues of litigation funding arrangements from the attorney's perspective.

In a previous article,[1] we discussed some of the basic tax considerations investors face in lawsuits. We concluded that debt treatment tends to be unfavorable to an investor because income is ordinary and the investor may even be required to accrue phantom income. Outside the debt context, we observed, the investor tends to be indifferent as to whether the arrangement is a prepaid forward contract or an equity-like interest followed by a redemption.

In both scenarios, the investor realizes gain or loss only at the conclusion of the lawsuit. It may matter little whether the initial financing transaction is treated as open (for a prepaid forward contract) or closed (for an acquisition of an equity interest or interest in a financial contract). In contrast, timing is arguably the attorney's main concern, and in some cases, it may be the only concern.

Deemed Partnership

As we discussed previously, in a typical litigation financing transaction, an outside investor provides cash to a lawyer or law firm in exchange for a portion of the firm's contingent fee. The investor's obligation is generally nonrecourse, secured solely by the firm's right to a contingent fee. The investor may be entitled to a multiple of the amount advanced to the law firm, a percentage of the contingent fee, an amount that increases over time (typically at a rate far higher than is customary for debt), or some combination of those elements.

One possible characterization of the litigation financing transaction is a deemed partnership between the investor and the law firm. However, partnership characterization does not appear to be favorable to either party. Under a partnership theory, the investor apparently would be treated as contributing cash to a deemed partnership. The law firm would be treated as contributing its right to a contingent fee.

The law firm likely would have little basis in its partnership interest, which should be equal only to its basis in its contingent fee.[2] This deemed partnership would then distribute the cash to the law firm. This transfer of property by a partner, followed by a distribution by the partnership, may be treated as a disguised sale under section 707.

Under the disguised sale rules, a distribution to a partner made within two years of the contribution of property by that partner is presumed to be a sale.[3] To avoid sale treatment, the facts and circumstances should clearly establish the transfer was not a sale. In this case, the distribution of cash by the

[1]Robert W. Wood and Jonathan Van Loo, "Investors Who Fund Lawsuits: Form and Tax Treatment," *Tax Notes*, Dec. 16, 2013, p. 1239.

[2]*See Scott v. Commissioner*, T.C. Memo. 1997-507, at 16-17 (holding that a lawyer only had basis in accounts receivable contributed to a partnership to the extent they were previously included in the lawyer's income). However, as discussed in greater detail below, the law firm may have incurred nondeductible expenses in relation to the lawsuit. Those nondeductible expenses apparently should be capitalized and treated as basis.

[3]Reg. section 1.707-3(c)(1).

deemed partnership immediately following the contribution of the law firm's contingent fee would almost surely be treated as a sale of the contingent fee.

Recently, the IRS achieved two highly publicized and controversial victories applying the disguised sale rules. In one case, the IRS lost in the Tax Court but won on appeal to the Fourth Circuit, which held that investment funds should be treated as selling Virginia state historic rehabilitation tax credits.[4] In the other case, the Tax Court held that a leveraged partnership transaction resulted in a disguised sale of business assets that were contributed by one of the partners.[5]

In the litigation financing scenario, the distribution of cash does not seem to depend on the entrepreneurial risks of the deemed partnership. The amount of cash contributed depends merely on the terms of the agreement between the law firm and investor rather than on the business profits or financial results of the deemed partnership.[6] Nonetheless, one might argue that the law firm should be treated as a partner to the extent it still retains a right to the income of the partnership.

That is, a genuine chance that the law firm could receive a financial reward from a large contingent fee might provide an argument against the application of the disguised sale rules. Still, given the IRS's recent track record in applying the disguised sale rules, it does not seem to be a stretch to view them as applicable in this context.

Even if the disguised sale rules did not apply, the distribution might nevertheless result in ordinary income. As discussed above, the law firm partnership would likely have little basis in its partnership interest, equal only to its basis in its contingent fee. A distribution that exceeds basis is normally treated as capital gain.[7]

However, under section 741, a distribution attributable to unrealized receivables is ordinary.[8] The determination of whether a distribution is attributable to unrealized receivables is generally made at the partnership level.[9] It is unclear how to determine the proper character of the contingent fee at the level of the deemed partnership in this context.

From the law firm's perspective, the distribution is attributable to an unrealized receivable.[10] After all, an unrealized contingent fee seems to be the quintessential unrealized receivable. Yet at the level of the deemed partnership, the characterization of the distribution is far from clear.

The right to a share of the contingent fee is surely not attributable to any services performed by that deemed partnership. Instead, it is attributable to the law firm's services. Further, the plaintiff did not sign a contract with that deemed partnership but instead with the law firm. The attorneys working for the plaintiff are arguably working on behalf of the law firm, not the deemed partnership.

Under section 724(a), when a partner contributes property that is an unrealized receivable in the hands of the partner, any gain or loss recognized by the partnership from the property is ordinary. This suggests that the law firm should not be able to convert any gain from the contingent fee from ordinary income into capital gain. Moreover, there are the partnership antiabuse regulations to consider in reg. section 1.701-2.

In short, regardless of whether the disguised sale rules apply, ordinary income treatment seems to be all but a certainty. It appears equally clear that the law firm should recognize income at the time of the distribution. Thus, partnership treatment seems undesirable for the law firm.

The investor would also generally prefer to avoid partnership status. This is because when the contingent fee is actually earned, the partnership should have ordinary income under section 724(a) that should be allocated to the law firm and the investor, respectively. Not only is partnership treatment undesirable for tax purposes, but it also raises the ethical question whether the firm is improperly sharing fees with a non-lawyer.[11] Partnership treatment therefore appears to be undesirable all around.

Can the investor and the law firm elect out of subchapter K under section 761? Certain participants in the joint acquisition, sale, or exchange of

[4] *Virginia Historic Tax Credit Fund 2001 v. Commissioner*, 639 F.3d 129 (4th Cir. 2011).

[5] *Canal Corp. v. Commissioner*, 135 T.C. 199 (2010).

[6] *See* reg. section 1.707-3(b)(1) (explaining factors favoring a disguised sale).

[7] Under section 731, a distribution in excess of basis is treated as a sale or exchange of a partnership interest. Under section 741, gain on the sale or exchange of a partnership interest is generally treated as capital.

[8] Section 741 provides an exception to the extent provided under section 751. Section 751 provides for ordinary treatment for unrealized receivables of the partnership.

[9] *See* reg. section 301.6501(o)-3(c)(4).

[10] *See Scott*, T.C. Memo. 1997-507.

[11] This issue has been addressed by various state bar associations. Some have issued opinions sanctioning this practice, but others have raised questions about its propriety. *See* American Bar Association Commission on Ethics 20/20, "Informational Report to the House of Delegates," Feb. 2012, at 29 (white paper discussing various aspects of litigation financing and noting the inconsistent stance on whether litigation financing may violate the prohibition against fee sharing with non-lawyers).

investment property may elect out of partnership treatment under section 761.[12]

To qualify, the participants must own the investment property as co-owners, have the right to separately dispose of their property shares, and must not actively conduct a business.[13] A litigation funding arrangement may not qualify to make the election because the investor may not own the law firm's contingent fee as a co-owner, nor is the law firm likely to have the right to dispose of its remaining share of that contingent fee.

Although far from assured, a prophylactic election out of subchapter K presumably cannot hurt. More generally, there appear to be various reasons that deemed partnership treatment is unlikely. First, as discussed above, the partnership rules themselves seem to apply to treat the basic transaction as a disguised sale that takes place outside the partnership context.

That is, insofar as it exchanges part of its right to a contingent fee for a distribution of cash, the law firm is treated as engaging in a transaction with the deemed partnership outside its role as a partner. This recharacterization of the basic litigation financing transaction as something outside the partnership context seems to reinforce the fact that partnership treatment is inappropriate. Outside the tax arena, it may violate ethical rules.

It is interesting to observe that the disguised sale rules may actually help the investor and law firm argue against any deemed partnership. For example, assume the IRS contends that the litigation financing arrangement should be treated as a deemed partnership and that the transaction therefore should be characterized at the partnership level. In that scenario, the investor and law firm should be able to point to the disguised sale rules to argue that the transaction is not appropriately treated as a partnership.

Character of Income

A lawsuit investor outside a partnership (as discussed in our previous article) will often hope to have a capital gain on the investment. The plaintiff may have a tax-free recovery, ordinary income, basis recovery, or capital gain depending on the origin and nature of the claim and the plaintiff's damages. We will discuss the plaintiff's perspective in litigation funding in an upcoming article.

In contrast to the investor and plaintiff, the attorney is selling a right to fee income that would otherwise be ordinary. The law firm is in the trade or business of generating income, such as contingent fees, from providing legal services. This has several implications for the tax treatment of the sale of the contingent fee.

First, the attorney's claim to a contingent fee appears to qualify as "accounts or notes receivable acquired in the ordinary course of trade or business for services rendered," which is excluded as a capital asset under section 1221(a)(4). The law firm obviously acquires its right to a contingent fee in exchange for legal services. It is less clear if the law firm's contingent fee qualifies as a receivable, given that the claim is entirely contingent on the outcome of the lawsuit.

Despite this uncertainty over the scope of section 1221(a)(4), the better answer seems to be that the attorney's gain should be treated as ordinary. From a common-sense perspective, the gain on the sale of the claim appears to bear a close similarity to ordinary services income.

Even if section 1221(a)(4) does not apply, the transaction seems ripe for the application of the judge-made substitute for ordinary income doctrine.[14] This doctrine has been applied in a wide variety of settings involving proceeds from the sale of service-related contracts.[15] In this scenario, the payment seems to be a substitute for the contingent fee that represents ordinary services income. Therefore, it too should be ordinary, even outside the deemed partnership context.

Timing of Law Firm's Income and Deductions

Given the absence of any realistic possibility of obtaining capital gain treatment, timing represents the principal, if not the only, issue for the law firm. If the arrangement is treated as a loan, the law firm can defer recognizing any gross income until the case is resolved. Instead, the firm merely receives the gross proceeds from a loan.

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[12]Reg. section 1.761-2(a)(2).

[13]*Id.*

[14]*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).

[15]*Foote v. Commissioner*, 81 T.C. 930 (1983) (payment to professor for agreement to resign position represented substitute for future ordinary income rather than consideration for payment in exchange for tenure, a capital asset); *Flower v. Commissioner*, 61 T.C. 140 (1973) (termination of sales contract treated as ordinary income substituted for ordinary commission income rather than as attributable to personal goodwill); *Clark v. Commissioner*, T.C. Memo. 1994-278 (payment received for termination of agency contract with insurance company represented ordinary income).

The firm may even be able to deduct interest expenses before recognizing any income if the arrangement is treated as having original issue discount. However, the deduction for OID may not generate a significant tax benefit to the law firm because it would be incurred before the contingent fee is realized. If the firm lacks any other income, it may be unable to use the deduction. Moreover, the investor is likely to strongly oppose any arrangement that requires it to include OID as ordinary income before the outcome of the lawsuit is known.

If the financing is not treated as debt because it is too speculative and uncertain, should the law firm be required to recognize income at the time it receives cash from the investor? In this context, it is instructive to consider the law firm's ability to deduct expenses related to the contingent lawsuit. The timing of deductions by contingent fee attorneys continues to be controversial.

The Tax Court has long held that in most contingent fee cases, expenses are not currently deductible.[16] The type of contingency fee arrangement matters far more than the probability of success.[17] In *Boccardo v. Commissioner*, the Ninth Circuit held that some contingent fee attorneys could currently deduct costs, but only if the attorney had a gross fee contract.[18]

Many contingent fee contracts require the client to entirely or partially bear the costs of the litigation. That is, the costs of litigation either come entirely out of the client's share of the recovery or they are shared pro rata. Those costs are generally not currently deductible.

Instead, in a successful settlement or recovery, the attorney excludes the amount of the costs when he is reimbursed. Otherwise, the attorney can only deduct the costs when the lawsuit is lost or dropped. In those cases, the courts have reasoned that the expenses merely constitute a loan from the attorney to the client.[19] Although one recent case considers the probability of success of the lawsuit to be relevant, it appears that even cases with less than a 50 percent probability of success will still be treated as loans.[20]

In contrast to those cases, in a gross fee contract, the attorney receives a set percentage of any gross recovery regardless of the expenses of the lawsuit. Attorneys are arguably entitled to deduct costs when working under gross fee contracts.[21] In *Boccardo*, the taxpayer successfully argued that with a gross fee contract, the lawyer is never reimbursed for expenses. Instead, the lawyer is entitled to the same gross fee regardless of expenses. Nevertheless, in response to *Boccardo*, the IRS issued a field service advice memorandum stating that it would follow *Boccardo* only in the Ninth Circuit.[22]

Given how speculative these nonrecourse ''loans'' from a law firm to a plaintiff can be, it seems incongruous for the Tax Court to uniformly treat them as debt for tax purposes even when the probability of recovery is exceedingly low. Surely in a different context, a nonrecourse instrument that has a greater than 50 percent chance of default would have difficulty qualifying as debt.[23] Moreover, although the Tax Court may treat the expenses as a loan from the lawyer to the plaintiff, apparently there is no requirement for the client to recognize income on the below-interest loan for these advances.

Imputed interest under section 7872 does not seem to apply because it was intended for loans from service recipients to service providers.[24] In the traditional scenario, the service provider implicitly benefits from a below-market interest loan. In this case, however, the service provider (the lawyer) is also the lender. It is the service recipient (that is, the plaintiff) who receives any implicit benefit from this deemed loan.

This fictional loan may be analogized to the reverse of the open transaction doctrine as much as to a zero-interest loan. Under that doctrine, a taxpayer is not required to recognize income when the outcome of a transaction is so uncertain and contingent that the amount of income in the future cannot reasonably be determined in the present.[25] In this context, the government is arguing that the law firm's ''expense'' cannot be deducted until it is

[16]*See Canelo v. Commissioner*, 53 T.C. 217 (1969), *aff'd*, 447 F.2d 484 (9th Cir. 1971).

[17]*See* Wood, ''Another Tax Case Limits Lawyer Costs Deduction,'' *Tax Notes*, Feb. 25, 2013, p. 997.

[18]56 F.3d 1016 (9th Cir. 1995).

[19]*Burnett v. Commissioner*, 356 F.2d 755, 759-760 (5th Cir. 1966).

[20]*Humphrey, Farrington & McClain PC v. Commissioner*, T.C. Memo. 2013-23, at *19 (explaining that a law firm had a ''significant possibility'' that the contingent fee expenses would be reimbursed even for categories of contingent fee cases that had a probability of success that was less than 50 percent). However, in *Burnett*, the Fifth Circuit noted that the law firm was very successful in recovering advanced expenses, only writing off less than $5,000 out of a total of approximately $290,000 advanced during a five-year period. 356 F.2d at 760.

[21]*See* Gregg D. Polsky and R. Kader Crawford, ''Must Contingent Fee Lawyers Capitalize Litigation Costs?'' *Tax Notes*, Oct. 21, 2013, p. 295 (arguing that under the *INDOPCO* regulations, litigations costs are currently deductible for gross fee contracts but not under other arrangements).

[22]1997 FSA 442.

[23]*See, e.g.*, *Affiliated Research Inc. v. United States*, 351 F.2d 646, 648 (Ct. Cl. 1965) (holding that equity characterization is suggested if the advances depend on the success of the recipient).

[24]*See* Polsky and Crawford, *supra* note 21, at 296.

[25]*Burnett v. Logan*, 283 U.S. 404 (1931).

reasonably certain that the law firm will never recover the expense from its client.

When a contingent fee law firm receives litigation funding, should it treat that advance from the outside investor as an interest-free loan? After all, although the advance may not qualify as debt for federal income tax purposes, the firm has an obligation to repay the investor from the proceeds of any contingent fee. Just as the law firm must delay its deduction of any expenses related to the lawsuit, should it also defer recognizing any income from the advance?

The answer may depend on the details. If the funding arrangement requires the law firm to use the proceeds of the advance exclusively to fund lawsuit expenses, open transaction treatment would seem appropriate. It does not seem abusive to allow the firm to defer recognizing income when the advance is being used only to fund expenses.

This seems particularly true when the law firm is not permitted to currently deduct expenses. If the firm defers the deduction of expenses until the lawsuit is concluded, open transaction treatment seems justified. Indeed, if the lawsuit is unsuccessful, the lawyer may have no income because the expenses may equal or exceed the amount of the advance.

However, if the lawyer currently deducts all lawsuit expenses and there is no restriction on the use of the advance to fund expenses, open transaction treatment seems more aggressive. In this scenario, it seems more appropriate to treat the gross amount of the funding as gross income upon receipt. Lawsuit expenses can simply be deducted as they are incurred.

Prepaid Forward

In a variation on open transaction treatment, an increasingly common possibility is treating a litigation funding arrangement as a prepaid forward contract.[26] In a prepaid forward contract, the buyer pays the seller now for a sale that takes place in the future. There is no sale for tax purposes at the time the initial money changes hands.

In a prepaid forward, the transaction only closes at some future date, at which time there may (or may not) be an additional payment. This transaction seems to come closest to achieving the desired tax treatment for both the investor and law firm. The investor may be entitled to capital gain treatment. The law firm defers income until the settlement and does not have to worry about a mismatch between the timing of deductions and income.

In Rev. Rul. 2003-7,[27] the IRS ruled that a variable prepaid forward contract would be treated as an open transaction rather than a current sale. The ruling considered a seller of stock that agreed to deliver a variable number of shares depending on the future stock price. The seller posted the maximum number of shares that it could be obligated to deliver. But the seller had the right to settle the transaction with cash or to substitute other shares.

Although the rationale for the ruling is not clearly stated, the uncertainty of the transaction is at its heart. This uncertainty means that the transaction bears a closer similarity to an option transaction than a sale. There was uncertainty over how many shares and which shares would be delivered. As such, the prepaid forward was simply too indeterminate to treat as a sale.

In litigation funding, what uncertainty could merit open transaction treatment? Because the obligation of the law firm is entirely nonrecourse, it will never have to pay anything to the investor unless it receives at least as much in a contingent fee. In addition, it will never receive more from the investor than the amount advanced.

Thus, whatever the outcome of the lawsuit, the law firm is sure to receive at least the entire amount advanced by the investor as gross income. Yet significant contingencies remain. Most obviously, it is unclear if the lawsuit will result in payment of a contingent fee. Further, the amount of the law firm's net income from the lawsuit is unknown.

The law firm may incur significant expenses in the lawsuit after receiving the advance and may be required to capitalize those expenses. Also, the law firm will generally stand to realize substantial gain if the lawsuit is successful. In this sense, the law firm continues to have an equity-like interest in the lawsuit.

All these factors support treating the financing transaction as open. Of course, the IRS typically strongly disfavors open transaction treatment and argues that it is available only in limited circumstances.[28] This suggests that the law firm may be challenged in treating the litigation financing arrangement as a prepaid forward. Nonetheless, the requirement to capitalize expenses related to contingent fee matters seems to provide an opportunity for taxpayers to argue in favor of prepaid forward contract treatment. In any case, under a prepaid

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[26]For a review of prepaid forward contracts, see Wood, "Prepaid Forward Contracts Aren't All Bad," *Tax Notes*, Apr. 16, 2012, p. 365.

[27]2003-1 C.B. 363.

[28]*See* LTR 9034002 (explaining that open transaction treatment is reserved for rare and extraordinary circumstances and citing the legislative history to the installment sale rules).

forward, when the lawsuit pays out, the law firm would exclude from the firm's income all amounts payable to the investor and include the amount initially paid by the investor.

Conclusion

In contrast to the investor, the main issue facing the law firm in litigation financing is the timing of income. In that sense, the interests of the law firm receiving the financing and the investor are not perfectly aligned. Unlike the investor, the law firm may benefit from treating litigation financing as a loan because income recognition is deferred.

However, the investor is unlikely to welcome loan treatment because that treatment could require the accrual of income before receiving any cash. It also appears to eliminate the possibility of capital gain treatment. Moreover, in many cases, the financing transaction may be so speculative that it may not qualify as debt for federal income tax purposes.

Open transaction treatment, treating the litigation financing transaction as a prepaid forward, seems to bridge the gap between the law firm and investor. Furthermore, this type of open transaction treatment may be appropriate given the general requirement for law firms to defer the deduction of expenses in contingent fee matters. Nevertheless, structuring the financing transaction to qualify as a prepaid forward may be difficult, and challenges from the IRS should be expected.

It is critical that the parties consider consistency of treatment both by the law firm and investor. The parties should also be consistent in timing income recognition and deducting expenses. As such, the burden of drafting the documents and explaining to whom, when, and how taxes will apply can be significant.

In the next (and last) article in this series, we will examine litigation funding from the plaintiff's perspective.