SAVE 10%!
GO GREEN!
Recieve your newsletter by email to save time, money and paper!
Renew your subscription with the electronic version by April 30, 2016 and we will reduce the price by 10%
Call 800-248-3248 to renew and save!

The M&A Tax Report

March 2016 Volume 24, Number 8

The Monthly Review of Taxes, Trends & Techniques

EDITOR-IN-CHIEF

Robert W. Wood
Wood LLP
San Francisco

PRODUCTION EDITOR

Mina Chung
Wood LLP
San Francisco

ADVISORY BOARD

Michael R. Faber
Cooley LLP
New York

Jonathan R. Flora
Montgomery McCracken
Walker & Rhoads, LLP
Philadelphia

Stuart M. Finkelstein
Skadden, Arps, Slate,
Meagher & Flom LLP
New York

Steven R. Franklin
Gunderson Dettmer
Menlo Park

Lawrence B. Gibbs
Miller & Chevalier
Washington

Ivan Humphreys
Wilson Sonsini
Goodrich & Rosati
Palo Alto

Steven K. Matthias
Deloitte Tax
San Francisco

Mark J. Silverman
Steptoe & Johnson
Washington

Robert Willens
Robert Willens, LLC
New York

Financial Contracts and Section 1234A

By Robert W. Wood • Wood LLP and James L. Kresse • Wood LLP

In political campaigns, candidates constantly remind us that character matters. That is true in tax matters too, sometimes in more tangible ways. For individuals (and individuals investing through partnerships, limited liability companies and S corporations), capital gain means favorable tax rates.

On the other hand, capital losses are often less valuable than ordinary losses (for both individuals and corporations). The IRS not infrequently seems to regard gains as ordinary, losses as capital. Taxpayers are often inclined to view these norms in reverse.

Capital gain generally arises from the sale or exchange of a capital asset. Most dispositions of capital assets involve obvious and explicit sales, with valuable consideration passing hands. We are so accustomed to such transactions that it can be disorienting not to be able to identify precisely where, when and under what terms a sale occurs.

Disorienting or not, planning around the sale or exchange requirement can sometimes allow savvy taxpayers to improve their tax positions. For example, a taxpayer can dispose of an appreciated asset in a sale or exchange and recognize capital gain. However, abandonment of the same asset can sometimes lead to an ordinary loss.

The Great Equalizer: Section 1234A

The interplay between capital gain and capital loss has long plagued the IRS. Congress has also occasionally added its voice to the frequent classification debate. Concerned with taxpayers' ability to pick between a capital gain and an ordinary loss, Congress first enacted Section 1234A in 1981 to try to level the playing field.

Section 1234A was originally targeted at financial products that were actively traded. The original goal was hardly disguised. The IRS was worried, and Congress too became worried, that too many taxpayers were doing deals to trigger ordinary losses that really more fairly should only be allowed as capital losses.

Nevertheless, in 1997, Section 1234A was expanded to apply to all capital assets. Today, Section 1234A provides:

"Gain or loss attributable to the cancellation, lapse, expiration, or other termination of—

(1) a right or obligation (other than a securities futures contract, as defined in section 1234B) with respect to property which is (or

on acquisition would be) a capital asset in the hands of the taxpayer, or

(2) a section 1256 contract (as defined in section 1256) not described in paragraph (1) which is a capital asset in the hands of the taxpayer,

shall be treated as gain or loss from the sale of a capital asset. The preceding sentence shall not apply to the retirement of any debt instrument (whether or not through a trust or other participation agreement)."

Section 1234A is certainly not a one-way street. That is, despite its clear intention to turn some ordinary losses into capital losses, Section 1234A is reciprocal. It can clearly apply to generate a capital gain where one might not otherwise exist under the sale or exchange rules.

Litigation Finance

Litigation finance is one area in which taxpayers may be able to benefit from Section 1234A. Despite the arguably unique context of money being invested in the substantive claims of plaintiffs in lawsuits, litigation finance is not dissimilar from some other types of investments. The plaintiff and/or the plaintiffs' counsel need money to fuel the fight.

In a typical litigation finance contract, an investor provides capital to a plaintiff (or the attorney) in exchange for an interest in the recovery from the lawsuit. These transactions can take the form of a loan. However, it is far more common for the transaction to be structured as a sale of an interest in the lawsuit by the plaintiff (or attorney) to the investor.

Character of Recovery

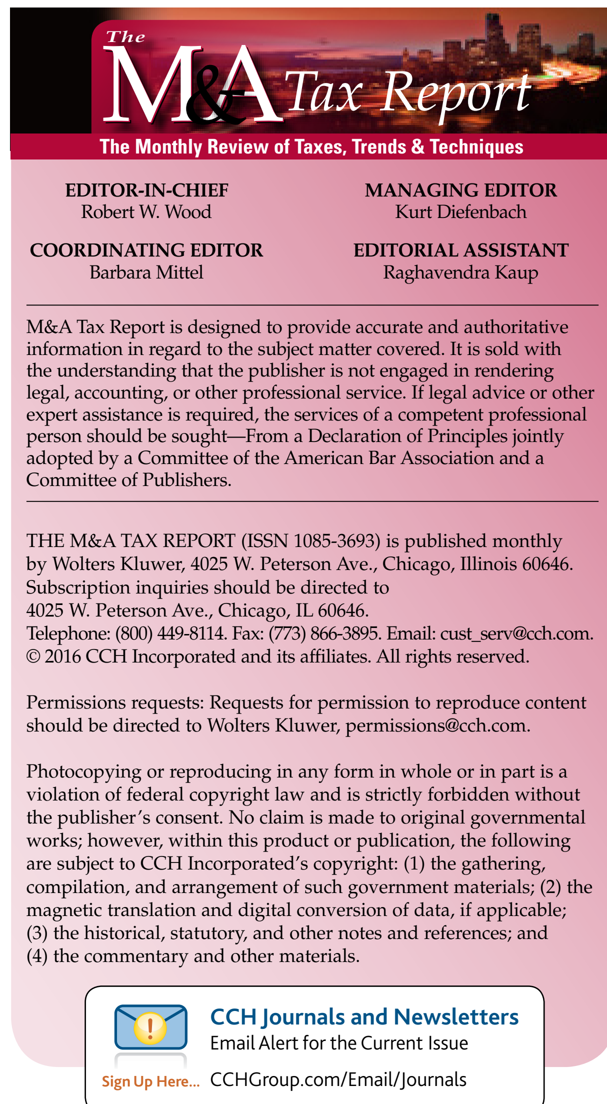
In a typical lawsuit, the methodology for characterizing the plaintiff's recovery is well settled. The plaintiff's recovery is characterized according to the origin and nature of the claim. If the lawsuit relates to physical injuries, the recovery (at least of compensatory damages, but not of interest or punitive damages) 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. Just as litigation often does not involve only one claim and only one type of damage, the tax treatment can involve an array of differing results. There can also be nettlesome factual and legal questions about how a plaintiff's recovery should be taxed, even without the added complication of litigation funding.

On the whole, however, the tax rules make sense. On the attorney's side, the recovery almost always 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 the origin of the claim doctrine poses is, *in lieu of* what is the taxpayer receiving the income?


The M&A Tax Report
The Monthly Review of Taxes, Trends & Techniques

EDITOR-IN-CHIEF
Robert W. Wood

MANAGING EDITOR
Kurt Diefenbach

COORDINATING EDITOR
Barbara Mittel

EDITORIAL ASSISTANT
Raghavendra Kaup

M&A Tax Report is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought—From a Declaration of Principles jointly adopted by a Committee of the American Bar Association and a Committee of Publishers.

THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by Wolters Kluwer, 4025 W. Peterson Ave., Chicago, Illinois 60646. Subscription inquiries should be directed to 4025 W. Peterson Ave., Chicago, IL 60646. Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com.
© 2016 CCH Incorporated and its affiliates. All rights reserved.

Permissions requests: Requests for permission to reproduce content should be directed to Wolters Kluwer, permissions@cch.com.

Photocopying or reproducing in any form in whole or in part is a violation of federal copyright law and is strictly forbidden without the publisher's consent. No claim is made to original governmental works; however, within this product or publication, the following are subject to CCH Incorporated's copyright: (1) the gathering, compilation, and arrangement of such government materials; (2) the magnetic translation and digital conversion of data, if applicable; (3) the historical, statutory, and other notes and references; and (4) the commentary and other materials.

CCH Journals and Newsletters
Email Alert for the Current Issue
Sign Up Here... CCHGroup.com/Email/Journals

In the case of the investor's recovery, the income is coming from the investor's ownership of an asset purchased from the attorney or the plaintiff. Could this 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 various formulations for parsing capital asset status, and several of them seem helpful here. For example, in *J.M. Maginnis* [CA-9, 2004-1 USTC ¶50,149, 356 F3d 1179], 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.

Because the investor advances cash, and because the value of the obligation is likely to increase over time as the litigation progresses, the obligation appears to satisfy both *Maginnis* factors. Although the circumstances may appear to favor classification as a capital asset on a given set of facts, the *Maginnis* court stated that its two-factor test would not necessarily be appropriate in all cases. Other courts have applied different tests.

Other Capital Asset Tests

For example, in *W.T.Gladden* [112 TC 209, Dec. 53,337 (1999), *rev'd. on a different issue* CA-9, 2001-2 USTC ¶50,597, 262 F3d 851], 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.

Applying Capital Formulations

Virtually all of these 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 plaintiff for a share of the plaintiff'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. Prior to 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.

With regard to the fourth 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 usually does not perform personal services as part of a litigation finance contract. Therefore, the sixth factor also favors capital treatment. The third factor may or may not favor capital treatment depending on from whom the investor purchases their interest.

An interest in a lawyer's contingent fee is ordinary income to the attorney, and therefore the underlying asset would generally not be a capital asset. However, when a plaintiff sells

the right to their recovery, such sale can be considered the sale of a capital asset to the investor. [*See P.D. Long*, CA-11, 2014-2 USTC ¶50,510, 772 F3d 670 , *rev'g in part and aff'g in part* 106 TCM 409, Dec. 59,660(M), TC Memo. 2013-233.] In that case, the underlying asset could be considered a capital asset.

Still, regardless of from whom the investor purchases their interest, both the *Maginnis* test and the *Gladden* test 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

The next hurdle to capital gain treatment is the sale or exchange requirement in Section 1222. Assuming the investor holds their interest until the litigation is resolved successfully, there is clearly income. However, it is less clear if this income arises from a sale or exchange.

Here, the law is enigmatic. In fact, the law suggests that a sale or exchange is not always *absolutely* necessary. This is especially true in the case of litigation recovery where the damages relate to an underlying capital asset.

For example, in *Electroenergy Corp.* [54 TCM 359, Dec. 44,159(M), TC Memo. 1987-437], the Tax Court held that the taxpayer's recovery for trademark infringement represented damage to a capital asset, resulting in capital gain. The IRS itself has sometimes come to the same conclusion on its own. Thus, in Rev. Rul. 81-152 [1981-1 CB 433], the IRS concluded that amounts recovered by a homeowners association from a builder for defects in construction was a nontaxable reduction in basis.

The IRS reached a similar conclusion in FSA 200228005 (Mar. 29, 2002). There, the IRS stated that a taxpayer's recovery for diminished land value was a nontaxable reduction in basis. The FSA came to this conclusion without discussing the sale or exchange requirement.

It is debatable whether the nature of the litigation should impact the character of the investor's recovery. Arguably, the investor's interest is an independent contract right that is itself a capital asset. In certain cases, the Internal Revenue Code provides for capital gain or loss resulting from a transaction in which a capital asset is eliminated—even where 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 such 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 an entirely (or at least a largely) passive role in managing the litigation. There may be ongoing information 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 (almost inevitably) 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 bond holder 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 1271(a), this extinguishment is considered a sale or exchange, giving rise to capital gain.

Terminating Rights and Obligations?

While Sections 302, 165(g) and 1271(a) make the case for an investor's capital gain by analogy, could Section 1234A make the case

more directly? 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 only terminates 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 only ends 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. One of the first cases discussing Section 1234A is *J. Freda* [98 TCM 120 Dec. 57,913(M) TC Memo. 2009-191]. In that case, C&F Packing Co. filed suit against Pizza Hut and its suppliers for infringement of a trade secret. A jury trial eventually resulted in a verdict in favor of C&F for $10,939,391 for unjust enrichment.

The parties ultimately settled, with Pizza Hut agreeing to pay $15.3 million jointly to C&F and its lawyers. C&F reported only the net (after legal fees) as long-term capital gain. It denominated the payment on its Schedule D as a "trade secret sale," passing through the long-term capital gain to shareholders pro rata. Predictably, the IRS argued it was all ordinary income.

In defense, one of the arguments advanced by C&F was that Section 1234A applied to the settlement because the agreement terminated its contract rights in the trade secret. However, the Tax Court rejected the argument, holding that under an origin of the claim analysis, the settlement related to lost profits, lost opportunities and other damages.

Like the Tax Court in *J. Freda*, the existing IRS guidance has generally advocated for a narrow scope of Section 1234A. In so doing, the IRS has provided little meaningful discussion. For example, in TAM 200427025 (Dec. 03, 2004), the IRS concluded that a payment received by a utility company for termination of a long-term power purchase agreement was ordinary income.

The IRS relied on the extinguishment doctrine. Maddeningly, the IRS stated in a footnote that Section 1234A did not apply to the transaction with no further explanation or discussion. The IRS has done the same in other contexts.

In LTR 200823012 (June 8, 2008), the IRS ruled that termination fees that a company received as a result of 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 [IRB 1029, 2009-21, 1029], 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 IRS 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). With regard to Section 1234A, the ruling states simply that, "Section 1234A … does not change this result." In this guidance, the IRS has avoided Section 1234A altogether.

Extinguishment?

At the same time, the IRS has continued to advance principles existing before the 1997 expansion of 1234A. The most important, and arguably least appropriate in this context, is the extinguishment doctrine. After all, the IRS's approach appears to ignore some of the very reasons Congress amended Section 1234A in 1997.

How the extinguishment doctrine could apply in this context is not hard to imagine. 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 [*Pilgrim's Pride*, 141 TC 533, Dec. 59,715 (2013)]. 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 with respect to 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. Plus, the court said the provision clearly applied to ancillary or derivative contract rights. In reaching this conclusion, the Tax Court noted that Congress was critical of the way in which existing law allowed taxpayers to *elect* their tax treatment.

The court recognized that taxpayers could simply sell property and recognize capital gain, or could hold on to the property and recognize an ordinary loss. The Tax Court believed that the stated goal of remedying this mismatch supported a broad reading of Section 1234A.

Fifth Circuit Reversal

However, the Tax Court decision was reversed by the Fifth Circuit Court of Appeals [*Pilgrim's Pride Corp.*, CA-5, 2015-1 USTC ¶50,211, 779 F3d 311]. 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 in *Pilgrim's Pride* argued that if Section 1234A was to be read expansively, the IRS should have amended Rev. Rul. 93-80 [1993-2 CB 239]. That ruling concludes 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.

Nonetheless, the Fifth Circuit concluded that the IRS's failure to amend the Revenue Ruling was an indication that the IRS *itself* believed Section 1234A should be read narrowly. In large part, it seems, the IRS was hoist by its own petard. In any event, *Pilgrim's Pride* raises as many questions as it provides answers.

Arguably, the Fifth Circuit's decision is consistent with prior IRS guidance regarding a narrow scope of Section 1234A. However, the decision is contrary to the IRS's position in the case and overturns the Tax Court decision. Notably, the IRS and the Tax Court are only bound by the Fifth Circuit's decision with respect to taxpayers residing in the Fifth Circuit.

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

Litigation finance in the United States is a relatively recent phenomenon. Not surprisingly, there are not many authorities 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. And that, at least arguably, is what the litigation finance industry and its advisers have received in a recently released IRS missive.

In a heavily redacted Field Attorney Advice [FAA 20154701F (Dec. 2, 2015)] 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, the FAA concludes simply that the proceeds are not realized from the disposition of rights, and therefore Section 1234A does not apply. Before critiquing the myopic focus on a sale or exchange, it is important to say what is good and explicit and true in the FAA. The asset is a capital asset, says the IRS.

It is worth saying this again. *The contract is a capital asset,* according to the IRS. Many plaintiffs in litigation, and many litigation finance investors, should take notice, for that is quite a positive and declarative statement. It has consequences too, even if the IRS does not explain it and merely moves on.

Of course, the other shoe falls with the reason the IRS says ordinary income treatment nevertheless applies. The "Section 1234A does not apply" conclusion could signal a return to a narrow reading of the scope of 1234A espoused by the IRS in prior guidance. Interestingly, 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 FAA notes 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, the heavily redacted nature of the FAA makes it difficult to compare the contract under review with the terms of a typical litigation finance transaction. However, the importance placed on the specific contract language seems noteworthy. It could be an indication that FAA 20154701F should be read narrowly, applying only to the specific facts of the contract at issue in the FAA.

Nonetheless, investors can take important lessons from the FAA with respect to future litigation finance transactions.

Documentation Matters

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, although it is 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 impacting 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 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 could presumably be drafted to highlight the fact 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 at a time 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 in Rev. Rul. 2003-13 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.

Arguably, 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. Even since its amendment in 1997, this code section can be regarded as a bit of a sleeper. 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 at least a ripple in some circles by issuing an admittedly nonprecedential FAA. At the least, it has cast some doubt on the application of Section 1234A in this context. On the other hand, with FAA 20154701F focusing on explicit contract language, savvy financiers may be able to make lemonade from any lemons the FAA provides.

After all, the FAA *assumes* that the litigation finance contract under consideration is a capital asset. That seems reasonable and should hopefully give some backhanded assurances to many investors embarking on such investments. If the IRS wants to see a sale or exchange, is that so bad?

It may not be difficult to structure one, if it turns out that the IRS wants to stick on this seeming technical requirement. In that sense, investors considering litigation finance may now feel they can better position themselves for capital gain treatment.

Article Submission Policy

THE M&A TAX REPORT welcomes the submission of unsolicited articles. Submissions should be 2,000 words or less and use textual citations, rather than footnotes. All submissions should be made via email attachment in either Microsoft Word or WordPerfect format to Robert W. Wood, Editor-in-Chief, at *wood@woodLLP.com.* THE M&A TAX REPORT reserves the right to accept, reject, or edit any submitted materials.

TO SUBSCRIBE TO THE M&A TAX REPORT CALL 1-800-638-8437.

4025 W. Peterson Ave.
Chicago, IL 60646

PRESORTED
FIRST-CLASS MAIL
U.S. POSTAGE
PAID
CCH