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Investing in Lawsuits: Excludable Recoveries

By Robert W. Wood

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

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This article is the fourth and final in a series focusing on the taxation of litigation investing. Previous articles discussed the tax issues facing the investor, the attorney or law firm, and the plaintiff.[1] As in the most recent installment, this article focuses on plaintiffs who sell a portion of their legal claim.

However, this article exclusively focuses on plaintiffs entitled to receive a recovery that is excludable from income. This exclusion applies to amounts paid on account of personal physical injuries, personal physical sickness, or emotional distress arising from personal physical injuries or sickness.[2] In contrast to both the attorney and the investor, the plaintiff seeking financing for a claim must consider whether the exclusion will apply to the recovery.

Selling an Excludable Recovery

In general, the character of a lawsuit settlement is based on the claim's origin.[3] Damages received on account of personal physical injuries or physical sickness (or another of the categories identified in section 104(a)) may be excluded from income. There continues to be controversy regarding the scope of the section 104 exclusion, particularly in cases involving physical sickness, employment, and when observable bodily harm may be minimal.

Nevertheless, we will assume that the plaintiff's recovery if simply paid in full by the defendant would be tax free, either in whole or in part. The question is whether the litigation financing alters this result. When the underlying recovery represents excludable damages under section 104(a), may the plaintiff's receipt of money from an external investor also be excludable?

There appears to be no direct authority on the subject. To complicate matters, the payment from the investor can be characterized in several ways, and it is not always clear which is the best fit. Plainly, if the transaction is a loan, it is not income because the plaintiff has an obligation to return the money.[4]

When the case is resolved, the plaintiff receives his recovery and pays back the loan. Assuming the recovery qualifies for exclusion, there is no income to the plaintiff either at the time of the loan or at the time of the recovery. Instead of a loan, the injured plaintiff more commonly receives the money under a prepaid forward contract.

We do not know until later if the plaintiff will receive only this money on account of his physical injuries, or if he will also receive additional funds at the conclusion of the case. In either event, assuming the distribution is respected as a prepaid forward contract, the income recognition event (if any)

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[1]Robert W. Wood and Jonathan Van Loo, "Investors Who Fund Lawsuits: Form and Tax Treatment," *Tax Notes*, Dec. 16, 2013, p. 1239; Wood and Van Loo, "Litigation Funding: The Attorney's Perspective," *Tax Notes*, Jan. 27, 2014, p. 435.

[2]Section 104(a).

[3]*See 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).

[4]*Commissioner v. Tufts*, 461 U.S. 300, 307 (1983) ("When a taxpayer receives a loan, he incurs an obligation to repay that loan at some future date. Because of this obligation, the loan proceeds do not qualify as income to the taxpayer.").

should be deferred until the conclusion of the lawsuit. Then, tax decisions must be made.

Under a prepaid forward contract, should the tax treatment of the money from the investor depend on whether the lawsuit is successful? The answer should probably be no. If the plaintiff sustained physical injuries and 100 percent of the settlement proceeds would be paid on account of those injuries, the money from the investor should also be excluded.

This exclusion should apply regardless of whether the lawsuit is successful. Any settlement proceeds or litigation finance proceeds certainly seem to be paid on account of the injury claims, regardless of who advanced or paid the money.

Source of Funds for Excludable Recoveries

The fact that the money may come from an investor rather than from the defendant (or that some funds may come from each) seems unimportant. Insurance companies and various other parties often contribute to settlements. Perhaps more importantly, the IRS seems satisfied with the notion that the section 104 exclusion applies when the original tortfeasor somehow gets off scot-free and someone else ends up paying for the plaintiff's physical injury damages.

Thus, in one ruling, a highway worker was severely injured by a drunk driver who operated a tavern and drank on duty.[5] The plaintiff sued the tavern and its insurer, and the latter refused to settle. To stay collection, the tavern assigned its right against the insurer to the plaintiff.

When the plaintiff eventually recovered in a bad-faith claim against the insurer, the IRS ruled that the payment to the plaintiff was on account of the underlying physical injury. The plaintiff was merely trying to collect on his personal physical injury judgment. But for his personal physical injury claim and his rights as an assignee, the plaintiff would have received nothing from the insurer.

Quite literally, the plaintiff was receiving money from the insurer only because the plaintiff was injured. Thus, the Service concluded that the section 104 exclusion applied. This ruling suggests that the IRS takes an appropriately flexible view of section 104 recoveries, at least regarding the source of funds.

The critical requirements are that the plaintiff must have suffered personal physical injuries and that the payment must be traceable to those injuries. Beyond those basics, the reason the payer is making the payment to the plaintiff seems not to have significant bearing on the plaintiff's exclusion. That is, it did not seem to matter that the insurer was paying the plaintiff because the insurer was liable for a bad-faith claim rather than compensating for the plaintiff's injuries. Instead, what seems to matter more is whether the recipient of the payment can trace the payment to personal physical injuries.

Analogy to Malpractice Recoveries

The other persuasive analogue is legal malpractice recoveries, an area curiously devoid of authority. By definition, every legal malpractice claim must be based on an underlying claim, cause of action, or transaction. If not for the underlying matter, the plaintiff would not need the attorney's services in the first place. A 2007 article posed this hypothetical[6]:

Paula Plaintiff is injured in a car accident and retains Alan Ambulance-Chaser to sue the driver and his insurer. Paula should recover $400,000 in damages for personal physical injuries. However, Alan fails to introduce critical evidence, misses the statute of limitations, or commits some other grievous error. Alan's error was the only reason Paula failed to recover.

As a result, Paula files a legal malpractice action against Alan and settles for the amount she would have received had Alan not erred. Instead of receiving $400,000 from the defendant for personal physical injuries, she receives $400,000 from Alan or his insurer. Should Paula include the recovery in income because it stems from a malpractice claim rather than a personal physical injury claim?

The answer is certainly no. Although Paula's complaint against Alan alleges malpractice, the malpractice is solely regarding her failure to recover for her personal physical injuries. One should look through the malpractice claim to determine the proper tax treatment. The $400,000 payment makes Paula whole. It is not punitive against the negligent attorney. It is compensation Paula should and would have received from the driver on account of her personal physical injuries except for the negligence of her lawyer.

In the same way, the assignment of all or part of an injured plaintiff's claim in a litigation financing transaction should not spoil the tax-free character of monies that would be excludable under section 104 except for the litigation financing. It bears noting, however, that in many cases only a portion of the damages paid are excludable. Even in unequivocal personal physical injury cases, punitive damages and interest are taxable. Moreover, claims of a

[5] LTR 200903073.

[6] Wood, "Tax Treatment of Legal Malpractice Recoveries," *Tax Notes*, Feb. 12, 2007, p. 665.

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mixed nature, involving physical injuries and property damage, are common.

So too are claims for emotional distress and physical injuries in which not all damages can be excluded. For example, in many sexual harassment and assault cases, some of the damages are likely to be wages or non-wage income reported on Form 1099 even if some of the proceeds are clearly excludable. In the so-called bruise ruling,[7] the Service ruled that in a sexual harassment case, all emotional distress damages after the ''first pain incident'' were tax free.[8] Those before it were not.

Attorney Fees

The often unanticipated tax impact of legal fees should be noted. Legal fees can obscure the tax picture, especially for allocated recoveries in which not all amounts are excludable from tax. If a plaintiff will receive damages that are 50 percent tax free and 50 percent taxable, the gross recovery must first be considered.

Presumptively, the plaintiff must include in income 50 percent of his gross recovery and deduct 50 percent of his attorneys' fees. Depending on the type of claim, the fees may only qualify for a miscellaneous itemized deduction. It is hard enough for plaintiffs, their attorneys, and their tax advisers to recognize and address those issues when resolving cases.

When litigation financing is added to the mix, the primary objective may simply be liquidity. Spotting the tax issues then and later can be even more difficult. All of this suggests that a litigation financing transaction for the plaintiff in a 100 percent physical injury case should not adversely affect the tax-free character of the recovery.

This seems true regardless of when the plaintiff receives money on the claim, and regardless of from whom it is received. Assuming there is no interest being paid and no punitive damages, the award should be traceable to the plaintiff's personal physical injuries. However, cases in which there are mixed claims are unlikely to be so simple.

Exclusion When Lawsuit Fails

In a prepaid forward transaction, the plaintiff receives money now. Yet we wait to judge its tax impact until the other shoe finally drops. If gain from the investment is excludable, the investment never needs to be reported.[9]

[7]LTR 200041022.

[8]Discussed in Wood, ''Cut or Bruise Can Yield Tax-Free Damages,'' *Tax Notes*, July 1, 2013, p. 79.

[9]*See, e.g.*, LTR 200925039 (holding that damages were excludable under section 104 and therefore were not required to be reported under section 6041 on Form 1099).

In that case, the plaintiff does not face a timing question. Nonetheless, despite the considerations discussed above, in an area of tax law that is as indeterminate as those facing the new industry of litigation investing, questions remain. Consider the following hypothetical.

As above, Paula Plaintiff is injured in a car accident and suffers personal physical injuries. She receives $1 million from an outside investor for a share of her claim under the terms of a prepaid forward contract. Several years later, although the defendant is solvent, the lawsuit fails to result in a recovery. After paying her lawyer his fee of $400,000, Paula walks away with the net amount of $600,000.

In the tavern ruling discussed above, the tavern defendant assigned a claim against the insurer to the plaintiff to settle the tavern's liability. In contrast, in this hypothetical, the defendant was not liable to the plaintiff. This seems to threaten to break the chain connecting the investor's payment with the plaintiff's personal physical injuries. Can the payment from the investor still be traced to Paula's personal physical injuries?

It can be argued that, even in this case, the exclusion should still apply. But the IRS could assert that Paula should be treated as recognizing income because the lawsuit failed. The IRS may further contend that the litigation financing transaction was an independent transaction, one that represented a sale of a capital asset — a portion of Paula's claim.

Leaving aside the timing questions, it could conceivably be regarded as a sale of an intangible asset. Ultimately, the outcome may depend on the facts and claims in the underlying lawsuit. For example, if the defendant successfully asserts a defense based on assumption of the risk, Paula may nevertheless possess substantial evidence of personal physical injuries.

And as is so often true in cases examining section 104 claims, the IRS and the courts may focus overwhelmingly on the bona fide nature of the physical injuries or physical sickness. That is, the plaintiff may be able to establish that a recovery would have been excludable. So gain from the litigation finance transaction must also be excludable. A plaintiff may have a compelling case that whenever and however the money was paid, it was on account of his personal physical injuries.

Conclusion

As noted in the third installment of this series, the plaintiff faces more complex and challenging tax issues than the investor or the attorney in litigation investing. However, plaintiffs who have claims that qualify for tax-free treatment under section 104(a) are in a far better position than plaintiffs with taxable recoveries. In the litigation

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investing context, there are good reasons to believe that to the extent plaintiffs may exclude a recovery, they should equally be able to exclude any cash they receive from investors.

Nevertheless, in the absence of any direct authority or convincing analogies, much may depend on the strength of the plaintiff's claim to a tax-free recovery. The plaintiff would hope that the amount received from investors can be viewed as received on account of the plaintiff's personal physical injury. Despite the lingo of prepaid forward contracts or sales of intangible property, it is hopefully not an independent taxable transaction.

In fact, the plaintiff with an excludable recovery may be haunted by the same arguments that a plaintiff with a taxable claim may vigorously assert. That is, the plaintiff who would be claiming ordinary gain may argue that the litigation investment should be considered an independent transaction. The IRS may similarly argue in favor of independence.

The IRS could conceivably claim that the litigation investor is not paying on behalf of or in lieu of the defendant. Therefore, if the case ultimately fails, it could be asserted that the cash from the investor should not be excludable. This is a strained analysis but hardly an impossible one.

On a practical level, even if the proceeds from a sale of a section 104 claim are tax exempt for the plaintiff, as seems likely, mixed claims will be messy. Given the uncertainty surrounding the tax treatment of these transactions, getting the documentation right is crucial. Unfortunately, plaintiffs involved in those matters may not be well prepared to appreciate the tax considerations and the high stakes involved.

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