Investors Who Fund Lawsuits: Form and Tax Treatment

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In this article, Wood and Van Loo consider the basic tax issues of litigation funding arrangements, with a focus on the timing and character of income when outside investors acquire an interest in a lawsuit.

When plaintiffs in the United States are unable to fund litigation, contingent fees are the norm. That shifts the funding problem to the lawyers. Some law firms effectively fund their contingent fee cases with revenue generated by hourly fees. Some plaintiffs' firms maintain war chests generated from past recoveries to fund new contingent fee matters. Some firms borrow heavily.

It is no accident that litigation funding from outside investors is more common in countries that place restrictions on contingent fee arrangements. The prevalence of contingent fee arrangements in the United States explains why litigation funding from outside sources remains relatively rare here. But that is changing, and changing quickly.

Of course, injecting additional parties and documents into the mix raises tax concerns for outside investors and for the lawyers and plaintiffs. Surprisingly, there is a paucity of authority on the tax treatment of those arrangements. The tax questions they raise include debt-equity considerations, the character of investment returns, and, perhaps most sensitive of all, the timing of income.

This is the first of several articles considering the basic tax issues of those litigation funding arrangements. This first installment considers outside investors acquiring an investment in a lawsuit, focusing on the timing and character of income.[1]

Buyers/Lenders Versus Sellers/Borrowers

Buyers and sellers — or lenders and borrowers — in litigation funding transactions do not necessarily have the same goals. They may differ in how they wish to characterize the arrangement for tax purposes. As we will explore in a future article, the attorney or plaintiff undertaking that arrangement wants the money but hopes to defer recognizing any income until the lawsuit comes to a conclusion. It is notable that, lacking any realistic possibility of recognizing capital gain, the attorney may not be as concerned with the character of any income from the arrangement.

On the other hand, investors in the suit are less likely to be worried about timing issues, assuming the transaction is not treated as debt. Investors want the ability to offset gains and losses from their lawsuit investments. Also, they generally prefer capital over ordinary treatment.

Characterizing the funding arrangement as a loan is one method that allows the attorney or plaintiff to defer the recognition of income. However, treating the funding arrangement as a loan comes at the cost of requiring the investor to recognize all or nearly all gain as ordinary. Moreover, it may require the investor to accrue income before receiving cash. That usually makes a simple loan unacceptable to the investor.

Sale treatment may allow investors to recognize capital gain. The corollary is that the attorney or plaintiff receiving the funds from the investor would need to recognize gain at the outset. Thus,

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[1]This article focuses on commercial litigation financing, loosely defined as litigation with a minimum expected recovery of between $1 million and $10 million.

either a sale or loan classification is typically unfavorable to one of the parties.

One answer is to attempt to characterize the funding transaction as a prepaid forward contract, and that appears to be how this growing industry is going. Structuring the funding in that way may help to bridge the gap between the desired tax treatment for the attorney or plaintiff and the investors but it can be difficult to do in the eyes of the IRS. Some putative prepaid forward contracts used in litigation funding are probably vulnerable to challenge by the IRS.

Characterizing Investment in a Lawsuit

In a typical example of lawsuit funding, the financing party (Investor) provides cash to the attorney or plaintiff in exchange for a share of the attorney's contingent fee or the plaintiff's recovery (Contingent Note). Investor is frequently an investment fund specializing in litigation investing. The Contingent Note is nonrecourse, secured solely by Investor's right to a contingent fee or interest in the lawsuit.

If the plaintiff does not win or settle the case, Investor gets nothing and the attorney or plaintiff keeps the cash. If the lawsuit succeeds, Investor receives an amount determined according to the terms of the Contingent Note. It may be an annual rate of return, a multiple of the amount invested, a percentage of the amount recovered, or some combination.

Is the Contingent Note a loan to the plaintiff or attorney handling the case? Or, is it better classified as a sale of the plaintiff's recovery or a portion of that recovery? Or as a sale of the attorney's contingent fee or a portion of that contingent fee? The answer depends on the details.[2] Debt — the flip side of a loan — has traditionally been considered to be the return from the time value of money. A lender is primarily interested in earning interest and the return of principal should not depend on the success of the business.[3]

In contrast, equity — the flip side of a sale — relates to the return from the risks and rewards of ownership, control, business risk, and market fluctuations.[4] The Contingent Note certainly has elements of equity. It is nonrecourse, and therefore dependent on the outcome of the litigation. Of course, nonrecourse obligations can still qualify as debt. As in all litigation funding, the circumstances matter.

Debt?

Suppose a plaintiff wins a judgment against a creditworthy defendant. The last remaining contingency may be an appeal. At that point, the recovery may be all but a certainty. A security interest in that lawsuit may be just as safe as a loan secured by real estate. Indeed, because of Investor's security interest in the lawsuit, the nonrecourse obligation may be even safer than than an unsecured full recourse obligation of the plaintiff or the attorney.

Suppose the judgment entitles the attorney to a contingent fee of $1 million. Alternatively, suppose the plaintiff won a judgment that will yield a net award of $1 million after attorney fees. The plaintiff or attorney expects that the defendant would be willing to settle for an amount that would yield a net award or contingent fee of $800,000. Investor advances $400,000 at an 8 percent interest rate. That arrangement has several features that favor debt treatment.

Investor's return is based on the time value of money. Moreover, although the obligation is nonrecourse, the security appears to be very strong, making it reasonable for Investor to expect payment of interest and principal.[5] Indeed, the amount advanced is considerably less than the expected contingent fee or recovery even if the lawsuit settles for less than the judgment. Although the rate of interest may be high, it appears to be in line with other high-risk debt obligations.

That obligation would not have a fixed maturity. Although the absence of a fixed maturity date tends to favor equity, it is not necessarily determinative.[6] After all, even though the precise maturity date is contingent, there will generally be an objective basis for determining the maturity date. That date would

[2]*See* Notice 94-47, 1994-1 C.B. 357 (explaining that whether a financial instrument should be characterized as debt "depends on the terms of the instrument and all surrounding facts and circumstances").

[3]*See TIFD III-E Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006) ("We have noted that Congress appears to have intended that 'the significant factor' in differentiating between [debt and equity] be whether 'the funds were advanced with reasonable expectations of repayment regardless of the success of the venture or were placed at the risk of the business'"), citing *Gilbert v. Commissioner*, 308 F.2d 39, 47 (2d Cir. 1962); *accord Ellinger v. United States*, 470 F.3d 1325, 1335 (11th Cir. 2006).

[4]*See Saviano v. Commissioner*, 765 F.2d 643, 650 (7th Cir. 1985) (holding that a transaction was in substance a joint equity investment by two parties in a mining venture rather than a loan because, in part, the funds were placed at risk of the business venture).

[5]Rev. Rul. 68-54, 1968-1 C.B. 69 (holding that debentures were classified as debt despite subordination to general creditors, contingent interest payments, and lack of acceleration of maturity upon default in payment of interest because, in part, it was reasonable for holders to expect payment of interest and principal).

[6]*Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972) (instrument constituted debt despite absence of fixed maturity date).

be outside the control of Investor. In most cases, the date all appeals are exhausted and payment is received or the date a settlement is reached serves as the maturity date. On balance, the instrument appears to satisfy the essential standards for debt treatment.

Equity?

In contrast, a case that is in the early stages of development with only a complaint filed in court may be far more speculative and uncertain. In that situation, instead of requesting bridge financing, the attorney or plaintiff may be asking Investor to assume part or all of the risk of the outcome of the litigation. The terms of the financing arrangement are likely to provide clues whether debt or equity treatment is more appropriate.

Suppose the attorney estimates the potential contingent fee or the plaintiff estimates his net recovery to be in the range of $1 million to $4 million. Investor advances $250,000 to the attorney or plaintiff in exchange for a right to receive the greater of 30 percent of the fee or recovery, or $250,000 plus a 30 percent annual return, limited to the proceeds from the lawsuit. Although these terms may appear to be unfavorable to the attorney or plaintiff, they reflect reality. The outcome of the litigation remains highly uncertain and the obligation is nonrecourse.

That scenario appears to have more equity than debt features. The rate of return depends far more on the amount actually recovered than the time value of money. Investor seems to be acquiring an interest in the litigation. The contingent element tends to outweigh the note aspect.

Of course, some financing arrangements represent a hybrid that includes both equity and debt characteristics. The amount the plaintiff or attorney owes Investor may increase over time but at a rate far higher than is normal for debt. In those situations, the expected yield of the financing arrangement may provide information on the nature of the financing arrangement.[7]

Treatment as Debt

If the arrangement qualifies as debt, it is not clear if the arrangement would be subject to the original issue discount rules. Interest would not be payable annually, suggesting that it should be treated as having OID. However, under section 1273(a)(1), the amount of OID is defined as the difference between the stated redemption price at maturity and the issue price.

As noted, the instrument would have an uncertain maturity date. Therefore, it does not seem possible to determine the amount of OID. Nevertheless, it should be possible to determine the amount of OID based on an assumed maturity date.

What if the OID that accrued based on an assumed maturity date was equal to the amount of interest payable at any given time under the terms of the Contingent Note? For example, the interest may be compounded annually. In that case, the absence of a definite maturity date may have little significance.

That is, the terms of the Contingent Note may provide for an accrual of interest that matches the OID based on an assumed maturity date. Therefore, it may be reasonable to treat the Contingent Note as subject to the OID rules even in the absence of a definite maturity date. In that situation, Investor would accrue OID annually.[8]

Investor may be loath to agree to an arrangement that requires it to accrue OID before any cash is received. Moreover, while OID accruals are ordinary, Investor's resulting loss may be capital if the lawsuit fails to yield any payment. In other words, Investor may be unable to use losses to offset gains.

Sale Treatment

Treating the funding transaction as a sale appears to be preferable to Investor. In classifying the transaction as either a sale or a loan, courts have traditionally asked whether Investor has assumed the benefits and burdens of the transaction, focusing mostly on economic exposure.[9] Unfortunately, to figure that out involves a multifactor test that can be vague and difficult to apply. Furthermore, economic exposure is not always the determinative factor.

In many litigation financing arrangements, several factors — including economic exposure — appear to favor sale treatment. The intention of both parties is to make Investor assume the risk for the outcome of the litigation. Because the plaintiff or

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[7]*See* New York State Bar Association Tax Section, "Taxation of Distressed Debt," Report No. 1248 (2011) (recommending that debt should be classified as "distressed" based on a yield test).

[8]Of course, if Investor is a foreign lender, it may not be required to include OID in income under its local tax law. Moreover, the interest may qualify for the portfolio interest exemption under section 871(h) even though it is nonrecourse because nonrecourse debt generally qualifies under section 871(h)(4)(C)(ii).

[9]*See, e.g.*, *Dettmers v. Commissioner*, 430 F.2d 1019, 1023 (6th Cir. 1970) (explaining that "ownership of real property is acquired either upon the delivery of the deed or upon the transfer of the benefits and burdens of ownership of the property, whichever occurs first"); *Grodt & McKay Realty Inc. v. Commissioner*, 77 T.C. 1221, 1237 (1981) ("the key to deciding whether [the transactions] are sales is to determine whether the benefits and burdens of ownership have passed from" the seller to the buyer).

attorney's obligation to Investor is effectively nonrecourse, the plaintiff or attorney has effectively transferred the risk of loss as well as the potential for gain to Investor.[10] Courts have determined that that type of nonrecourse financing favors sale treatment.[11]

In litigation funding transactions, the property being transferred is unique and specifically identified: the attorney's right to a contingent fee or plaintiff's recovery in a particular case. Thus, the attorney or plaintiff cannot substitute other property in the transfer, another factor that favors sale treatment.[12] Further, transfers of claims to litigation are recognized under state law and the IRS appears to accept this.[13] Therefore, Investor's advance may indeed be treated as a sale because too many of the benefits and burdens have passed to it.

From Investor's perspective, sale treatment does not require the accrual of income before the receipt of cash. Additionally, as explained in greater detail below, it offers the possibility of capital gain treatment. However, the tax consequences to the seller (the plaintiff or attorney) may not be as beneficial.

If the advance by Investor is treated as a sale, the attorney or plaintiff would likely be required to recognize taxable income at the time of the advance. In comparison to debt treatment, therefore, the attorney or plaintiff may not be able to defer the recognition of income until the lawsuit was resolved. Nevertheless, the attorney or plaintiff may be able to defer income if the transaction is treated as a prepaid forward contract, as we will discuss at greater length in a future article.

While Investor may care little about whether the transaction is treated as a present sale or a forward contract, it may be quite important to the attorney or plaintiff. In any case, the facts and terms of the funding documents should control the loan versus sale question.

Character of Income: Property Requirement

Investor's taxable income should be equal to the difference between its amount realized and adjusted basis. Investor's basis in the Contingent Note is equal to the amount of the advance plus any expenses it has capitalized and, in the case of a debt instrument, any OID it has accrued. If the Contingent Note were treated as debt, and Investor held it to maturity, the entire amount of any gain would likely be characterized as interest income or OID.

However, in the case of a sale transaction, the character of the gain depends on whether the Contingent Note is a capital asset within the meaning of section 1221(a). The first requirement to qualify as a capital asset is that the Contingent Note must be classified as property within the meaning of section 1221(a). The Contingent Note is analogous to various types of property.

Because the Contingent Note represents a claim to a future amount of cash depending on future events, it bears an analogy to several financial instruments such as a forward contract note treated as equity for tax purposes, a partnership interest, or even a notional principal contract.[14] These instruments generally qualify as property. Yet the rights of Investor also appear to represent simple contract rights. Not all contract rights qualify as capital assets.

In *Gladden v. Commissioner*, the Tax Court applied a multifactor test in determining whether contract rights qualified as capital assets.[15] The court considered how the rights originated and were acquired, whether the rights represented a right to underlying property or income that itself is ordinary or capital, whether there were significant investment risks, and whether the rights represented compensation for services.

[10]*See* GCM 39584 (Dec. 3, 1986) (focusing on risk of loss and opportunity for gain as most important factors in determining if transfer of installment obligations should be treated as pledge or sale of installment obligations).

[11]*Sollberger v. Commissioner*, 691 F.3d 1119, 1124 (9th Cir. 2012) (''nonrecourse financing, which is sometimes viewed as an 'indicator of a sham transaction,' placed [the taxpayer] more in the position of a seller than a debtor'').

[12]*See*, *e.g.*, Rev. Rul. 74-227, 1974-1 C.B. 119 (explaining that the sale of commodities are not treated as closed until the commodities are specifically identified and title has passed, even if the seller no longer has any economic exposure to them).

[13]*See*, *e.g.*, LTR 200107019 (accepting as a taxpayer representation that the transfer of a judgment to a charitable trust would be effective under state law).

[14]The Contingent Note should not be treated as a notional principal contract because the Contingent Note does not provide for payments at ''specified intervals'' but instead only provides for a single payment. *See* reg. section 1.446-3(c)(1)(i). Still, a litigation funding arrangement that refers to a portfolio of contingent lawsuits rather than a single lawsuit may yield *more* than one payment. In that case, it may qualify as a financial instrument that provides for ''two or more payments'' at specified intervals under prop. reg. section 1.446-3(c)(1)(i). Even in that case, however, the reference to the amount of a recovery or contingent fee in a lawsuit is not likely to qualify as ''objective financial information'' and thus apparently does not qualify as an NPC. *See* reg. section 1.446-3(c)(4)(ii). Nevertheless, it may be relevant to consider whether a payment made to an investor under such a litigation funding arrangement qualifies as a ''termination payment'' within the meaning of reg. section 1.446-3(h)(1). After all, under prop. reg. section 1.1234A-1(b), any payments under an NPC *other than* a termination payment constitute ordinary income or expense.

[15]*See Gladden*, 112 T.C. 209 (1999), *rev'd on a different issue*, 262 F.3d 851 (9th Cir. 2001) (holding that water rights granted under Colorado state law qualified as capital assets).

The Contingent Note appears to satisfy most of the *Gladden* factors. There are substantial investment risks, the rights originated through an investment of cash, and the rights represent consideration for an advance of cash rather than compensation for services. However, Investor may be considered to have an interest in property rights that would themselves produce ordinary income in the hands of the attorney or plaintiff.

The character of a lawsuit recovery is generally determined by reference to the ''origin of the claim.''[16] What if the character of the lawsuit recovery is ordinary income to the attorney or plaintiff? At first blush, that seems to support ordinary rather than capital treatment. Nevertheless, it is not clear that the character of Investor's income should be determined by the character of the lawsuit recovery to the attorney or plaintiff.

For example, suppose Investor acquires an interest in a lawsuit from a plaintiff who would be entitled to exclude his recovery from income as attributable to personal physical injury under section 104. Should Investor be entitled to exclude its gain from income? Surely not.

In litigation funding, the character of the recovery in the hands of the attorney or plaintiff should not necessarily control the character of Investor's income. It may have no more bearing than the character of securities in the hands of a dealer bears on the character of securities in the hands of an investor. Thus, on balance, a Contingent Note in litigation funding appears to qualify as property in the hands of Investor based on the *Gladden* factors.

In *United States v. Maginnis*, the Ninth Circuit applied a two-factor test to determine if a lottery winner's rights qualified as a capital asset: whether the taxpayer made an investment in the asset and whether the asset appreciated in value over time.[17] In the case of litigation funding, because Investor advances cash, and because the value of the Contingent Note is likely to increase over time as the litigation progresses, the Contingent Note appears to satisfy both *Maginnis* factors. In the context of litigation funding, it appears reasonably clear that the Contingent Note would pass the first hurdle — being classified as property — for capital asset characterization.

Character of Income: Dealer Status

Even if the Contingent Note qualifies as property, it will not qualify as a capital asset if it is excluded from capital treatment under one of the eight categories specified in section 1221(a). Under section 1221(a)(1), the Contingent Note will not qualify as a capital asset if it represents inventory or property held primarily for sale to customers. If the Contingent Note is viewed as analogous to a security or other financial instrument, the relevant question is whether Investor is a dealer.[18]

In general, taxpayers must act as middlemen or merchants to be treated as dealers. As the Tax Court explained in *Kemon v. Commissioner*, the words ''to customers'' were added to the predecessor of section 1221(a)(1) on the theory that taxpayers who sell securities on exchanges have no customers.[19] Engaging in frequent trading transactions on the open market is not sufficient to be accorded dealer status.

Instead, to qualify as a dealer, a taxpayer must acquire securities with the intention of profiting from a markup in price that represents compensation as a middleman or merchant. In contrast to dealers, traders do not perform any services as a source of supply of securities.[20] Rather, they seek to gain income from a short-term increase in price or an opportunity to buy at a favorable price.[21] Even if a taxpayer is engaged in an active trade or business as a trader in securities, those securities still remain capital assets if the taxpayer lacks customers.[22]

Regarding investing in lawsuits, Investor is generally investing for its own account rather than seeking to sell the Contingent Note. Investor is likely to hold the Contingent Note until maturity. Indeed, Investor may not enter into any sales transactions of Contingent Notes whatsoever. Given the focus on the customer requirement, as long as Investor does not engage in frequent or regular sales, the Contingent Note should not be excluded from being a capital asset under section 1221(a)(1).

Character of Income: Receivable

Another pitfall for capital gain treatment is that the Contingent Note could be viewed as a receivable acquired by Investor for services. Under section 1221(a)(4), accounts and receivables ''acquired in the ordinary course of trade or business for

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[16]*See Raytheon Production Corp. v. Commissioner*, 144 F.2d 110, 113 (1st Cir. 1943), *cert. denied*, 323 U.S. 779 (1944).

[17]*See Maginnis*, 356 F.3d 1179 (9th Cir. 2004).

[18]*See Kemon v. Commissioner*, 16 T.C. 1026 (1951) (explaining that dealers hold securities as ordinary assets in inventory).

[19]*Id.* at 1032.

[20]*See, e.g.*, *Marrin v. Commissioner*, 147 F.3d 147, 151-152 (2d Cir. 1998) (explaining that the taxpayer was not a dealer because he sold securities on the open market to persons he did not know and therefore did not have customers).

[21]*Id.* at 1033.

[22]*See King v. Commissioner*, 89 T.C. 445, 459 (1987) (holding that the taxpayer was in the trade or business of trading securities, but that the securities were capital assets because he did not have customers or perform services analogous to a merchant).

services rendered'' are excluded from capital asset treatment. Although that may seem strained, the possibility remains.

In one case, the Tax Court viewed a savings and loan bank as acquiring a mortgage in exchange for services.[23] *Burbank Liquidating* was decided before the enactment of section 582(c) in 1969, which generally mandates ordinary treatment for gains and losses on the sale or exchange of notes, loans, and other debt instruments by banks and other financial institutions. Still, the case remains relevant to taxpayers that fall outside the scope of section 582(c).[24]

It seems counterintuitive to view a bank as acquiring a note in exchange for services. Interestingly, the government apparently agreed and issued proposed regulations in 2006 that would have significantly narrowed the scope of section 1221(a)(4).[25] The government did not consider it appropriate to treat a mortgage as acquired by a financial institution in exchange for services. Despite that, the government later retracted those proposed regulations.[26]

It is possible that the IRS might view Investor as engaged in the trade or business of providing financing to lawyers and plaintiffs to fund lawsuits. It is conceivable that the Contingent Note might be viewed, by analogy to *Burbank Liquidating*, as acquired by Investor in exchange for services. However, there are several differences between the Contingent Note and the mortgage in *Burbank Liquidating*.

The Contingent Note is likely to be a highly unique and privately negotiated transaction in contrast to a conventional residential mortgage. The attorney or plaintiff is not likely to have many alternative sources of funding in such a specialized market. At the same time, Investor is likely to have a relatively limited source of potential lawsuits in which it may invest. Moreover, in the case of litigation funding, we are assuming the Contingent Note is treated as an equitable interest in the underlying lawsuit and recovery rather than as debt.

The exclusion in section 1221(a)(4) seems intended to apply to receivables that originate regarding some independent underlying service or property rather than cash. Indeed, the government appears concerned with the too broad application of section 1221(a)(4) as applied to loans. In light of those differences, it seems that Investor should not be viewed as acquiring the Contingent Note in exchange for services.

Character of Income: Sale or Exchange

To qualify as capital gain, it is necessary to satisfy the sale or exchange requirement.[27] In some cases, courts have held that a legal settlement does not constitute a sale or exchange because the settlement merely extinguishes the claimant's legal claim.[28] Under the extinguishment doctrine, to qualify for capital gain treatment, a taxpayer must possess and convey a property right apart from his claim in the lawsuit.[29]

Courts have questioned whether there is a true distinction between the sale or exchange of a contractual right versus the extinguishment of a right or legal claim.[30] Further, a sale or exchange does not appear to always be necessary for capital gain treatment.[31] Nevertheless, even if the extinguishment doctrine applied, Investor should arguably satisfy the independent property right requirement.

After all, Investor is giving up its contractual, albeit contingent, right under the Contingent Note in exchange for cash. The payment to Investor might also be viewed as a ''retirement'' of the Contingent Note. That type of retirement bears an analogy to the retirement of a debt instrument, which is accorded sale or exchange treatment under section 1271(a)(1).

Character of Income: Imputed Interest

Assuming Investor is treated as receiving capital gain, may a portion of its income be treated as imputed interest? It seems unlikely. In an economic sense, Investor pays cash at the outset and receives cash at a later date. It is certainly possible to view Investor's return as attributable, in part, to the time

[23]*Burbank Liquidating Corp. v. Commissioner*, 39 T.C. 999 (1963), *modified on other grounds*, 335 F.2d 125 (9th Cir. 1964), *acq.*, 1965-1 C.B. 5.

[24]*See* Rev. Rul. 80-57, 1980-1 C.B. 157 (holding that a real estate investment trust recognized ordinary income on the disposition of a note incurred in the course of its ordinary trade or business).

[25]Prop. reg. section 1.1221-1.

[26]Announcement 2008-41, 2008-1 C.B. 943.

[27]*Alderson v. United States*, 686 F.3d 791 (9th Cir. 2012) (the taxpayer's whistleblower recovery represented ordinary income in part because sale or exchange requirement for capital gain was not satisfied); Rev. Rul. 74-251, 1974-1 C.B. 234 (settlement payment from investment adviser of a regulated investment company represented ordinary income rather than proceeds from sale or exchange of intangible property right).

[28]*Eckersley v. Commissioner*, T.C. Memo. 2007-282 , *aff'd*, No. 08-70934 (9th Cir. 2009).

[29]*See Turzillo v. Commissioner*, 346 F.2d 884 (6th Cir. 1965) (sale or exchange satisfied when the taxpayer gave up claim to stock option in exchange for settlement).

[30]*Commissioner v. Ferrer*, 304 F.2d 125, 131 (2d Cir. 1962).

[31]*See Inco Electroenergy Corp. v. Commissioner*, T.C. Memo. 1987-437 (proceeds from trademark infringement action were for damages to a capital asset without determining whether the taxpayer consummated a sale or exchange); Rev. Rul. 81-152, 1981-1 C.B. 433; Rev. Rul. 81-277, 1981-2 C.B. 14.

value of money and therefore as including an imputed interest component.

However, the standard imputed interest provisions simply do not seem to apply. Section 7872 provides for imputed interest on loans, but it should not apply as long as the Contingent Note does not qualify as debt. There is imputed interest under section 483 that applies to some contracts for the sale or exchange of property. Nevertheless, the imputed interest charge applies only to deferred payments of the sales price.

In the case of litigation funding, at the outset of the transaction, Investor acquires an equitable interest in the lawsuit in exchange for cash. At the conclusion, Investor redeems its interest in the lawsuit in exchange for cash. There does not appear to be any deferred payment of a sales price that would be subject to section 483. Even if the transaction is treated as a prepaid forward contract, Investor should not be required to include any imputed interest.[32]

Conclusion

Litigation funding — characterized as either a loan or sale — for either the plaintiff or attorney can be accomplished using different kinds of documents. If it is a sale, the type and timing is variable. The documents will be significant and yet that is a feature of the transaction that the parties may be inclined to ignore.

Getting the economic terms worked out and the money placed is important. For example, charging a very high annual rate of return can work against Investor's interests if the amount increases so much that the attorney or plaintiff ceases to have any incentive to work on the case. Of course, the tax considerations deserve careful attention as well. No party should consider them for the first time when preparing tax returns the year following the funding event. Furthermore, given that those transactions tend not to be standardized, there may be considerable room to negotiate the desired tax treatment and provide for consistent treatment by both parties.

It is arguably bad for everyone if the documents do not address the transaction's tax implications and if the parties take inconsistent positions on its form. Sale treatment has many attractive features for Investor, including that Investor will likely receive capital gain treatment.

Moreover, Investor should not be required to accrue any income before receiving cash, as it would if the transaction were treated as a loan. However, the attorney or plaintiff may be required to recognize income upon the funding event rather than deferring income as could occur with a loan. Loan treatment also appears to eliminate the possibility of capital gain treatment for any income from the transaction.

Treating the transaction as a prepaid forward contract seems to bridge the gap between the attorney or plaintiff, on one hand, and Investor, on the other. The attorney or plaintiff defers the recognition of income. Investor is not required to accrue income before receiving cash and still has the potential to receive capital gain treatment on the income from the transaction. Additionally, Investor is not required to include any imputed interest under a prepaid forward contract.

Nevertheless, structuring the financing transaction to qualify as a prepaid forward contract may be challenging. Even that uncertainty hits the parties differently. The stakes of that uncertainty may not be high for Investor. After all, if the IRS were to challenge a prepaid forward contract it would likely argue in favor of a current sale on the date of the funding.

In short, a range of structural and tax treatments may be viable. Plainly, not every transaction merits the same treatment. Therefore, the burden of drafting the documents and explaining to whom, when, and how taxes will apply can be significant.

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[32]*See* Rev. Rul. 2003-7, 2003-1 C.B. 363 (open transaction treatment for variable prepaid forward contract); Notice 2008-2, 2008-1 C.B. 252 (IRS requests comments on the proper tax treatment of prepaid forward contracts).