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The Importance of Variable Prepaid Forward Contracts

To the Editor:

Lee A. Sheppard's articles are always interesting, and "Is Litigation Funding a Trade or Business?" (*Tax Notes Federal*, Mar. 23, 2020, p. 1876) is no exception. Sheppard raises a number of important issues about the tax treatment of these arrangements. We are writing to comment briefly on just one of them — her contention that litigation funding is not a variable prepaid forward contract (VPFC).

Sheppard argues that funders cannot transmute their share of a plaintiff's or attorney's ordinary income recovery into capital gain by running it through a VPFC. Her argument is best for lawyers, who are always earning a fee. But even if she is right in both cases, there is more to VPFCs than potential character conversion. Many sellers (plaintiff, lawyer, or both) do not expect a VPFC to alter the character of their recovery. They worry more about timing and getting taxed twice.

Nearly all sellers want to defer taxes on upfront money from funders if they can. Part of the appeal of a VPFC is to provide tax-free cash like a loan without sticking the funder with "interest" if there is a huge return. We often see transactions structured to comply with Rev. Rul. 2003-7, 2003-1 C.B. 363.

There, the IRS approved a VPFC that allowed a shareholder to extract tax-deferred cash from appreciated shares. A key point was that the number of shares to ultimately be delivered to the funder was subject to "significant" variation. Uncertainty in the property to be sold makes it hard to calculate gain or loss. Citing *Anschutz*, Sheppard rightly warns against complacency, but some plaintiffs who capitalize litigation expenses may have a plausible argument for open transaction treatment.

Sellers in litigation funding transactions also worry about being taxed on their gross recoveries. Taxpayers may receive Forms 1099 reporting millions of dollars of income actually paid to a funder. Even before the suspension of miscellaneous itemized deductions, the alternative minimum tax made sellers look for ways to report income on a net basis.

Here, too, the VPFC has a role to play. The transaction may be cast as a deferred sale, but some sellers view the remittance to the funder as a payment to terminate the seller's obligation under the funding contract. If section 1234A applies, the seller might report a capital gain or loss from the settlement of the VPFC, to be set off against capital loss or gain from the underlying recovery. This may provide sellers with an alternative to a problematic deduction, or having to argue that they received litigation proceeds (reported to them on a Form 1099) as their funder's nominee.

Sheppard may be correct that a VPFC should not change the tax character of a recovery to the lawyer, who is always a fee earner. Maybe she is even right that the tax character for a plaintiff often should not change either. But even if she is right about both, VPFCs remain valuable for plaintiffs and attorneys. As for Sheppard's many other tax arguments, she is right that there are some major tax issues for funders too, and we do not think the arguments are as clear-cut as Sheppard seems to suggest. Still, we leave those debates for another day. Thank you.

Best regards,

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Mar. 30, 2020

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