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The *Long* and Winding Road of Litigation Finance

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In this article, Wood discusses the tax issues facing investors, lawyers, and plaintiffs in litigation finance transactions. He notes a new and favorable case, *Long v. Commissioner*, decided by the Eleventh Circuit.

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In the United States and abroad, litigation finance is becoming common, bringing together lawyers, clients, and investors. Lawyers and clients hope to receive some of the proceeds before a case is resolved. Investors want to participate in the upside and risk of being a plaintiff, having a stake in the case.

The returns can be phenomenal, far better than even usurious interest. Yet there is risk because these are equity positions. For the plaintiff's lawyer, it is a chance to withdraw some of the money early to help cover costs or to operate the law firm. For the plaintiff, it is a chance to get money sooner and to lay off some of the risk.

Not surprisingly, defendants do not like litigation funding. It puts more money behind lawsuits and therefore can be seen as fomenting litigation. It can also inject another set of sophisticated parties into settlement dynamics.

Documents Matter

Getting money from investors can be documented in several distinct ways. The primary choice is between loan and sale, but from there it becomes substantially more nuanced. In a loan, the lawyer or client (or both) receives loan proceeds. Axiomatically, those proceeds are not taxable because the borrower must generally repay the loan.

Taking out a loan has the advantage of deferring taxes on the receipt of that loan money. But few investors like the loan model. One reason is regulatory requirements and statutory limitations on interest rates. Moreover, when the case resolves in a subsequent tax year, there can be a mismatch when it comes to taxes.

In fact, a taxpayer plaintiff may have to include the entire amount in income and claim what could be a very large, offsetting interest deduction. The deduction may be limited, which means the plaintiff may be paying tax on money he never sees. He may also be required to report the interest to his lender on a Form 1099.

Prepaid Forward

One of the most common structures to implement litigation funding is a prepaid forward contract. Despite its fancy name, it is basically a sale, but one that seems to be taxed at first like a loan. The prepaid forward contract may involve the plaintiff selling a piece of his claim or the lawyer selling a piece of the contingent fee.

It arguably offers the best tax result for the plaintiff and the lawyer. Because it is a sale, one might assume that the recipient of the money would have to report the sale proceeds as income. Nevertheless, this is a sale contract with an unclear final return.

When the seller signs the documents and receives the money, he has entered into a contract to sell a portion of the case (the client) or a portion of the contingent fee (the lawyer) when the lawsuit is resolved. That is why it is a forward contract. You are contracting to sell now, but the sale does not close until the case is resolved.

The result is that you generally should not have to report income until the conclusion of the case. That sounds similar to a loan, but it is actually better in many cases. Because a loan arrangement can be easiest to document, some lawyers and clients prefer it.

Still, most litigation funders do not like straight loans because of usury concerns or regulatory rules. The risk premium they charge might equate to 100 percent interest or more. Further, these loans are

generally nonrecourse, secured only by the proceeds from the claim. This can make the loan look more like equity.

For all those reasons, loans seem increasingly rare. Prepaid forward contracts are preferred by many lawsuit funding sources. They have the advantage of no immediate tax on the upfront payments, just like loans.

However, good documentation is critical. Under any structure, lawyers and clients face tax traps. A recent tax case illustrates how taxes can affect the plaintiff, sometimes in unexpected ways.

Long Hard Road

In *Long v. Commissioner*,[1] the Eleventh Circuit reversed (in part) a decision by the Tax Court. The appeals court sided with a Florida resident's argument that $5.75 million he received from the assignment of his position in a lawsuit represented a capital gain. Philip Long prevailed on his main argument and avoided ordinary income treatment.

But he did not win on his legal fees. The court rejected the deductions Long claimed for legal fees totaling more than $800,000. The case stemmed from a notice of deficiency the IRS served on Long in 2010.

It claimed he had taxable income of more than $4.1 million for 2006, not the $0 he reported on his return. The government said he had incurred a tax liability of more than $1.4 million. The Tax Court agreed with the IRS.

Nonetheless, the Eleventh Circuit was persuaded by Long's argument. He claimed that the $5.75 million he received from assigning his position as plaintiff in a lawsuit over a Florida real estate development was capital gain. The appeals court found that the Tax Court had misidentified the property Long sold.

He did not receive payment for the actual land where he planned to develop a luxury high-rise condominium. In fact, that sale would have been impossible. The record showed that Long never owned the property.

Rather, what he sold was his right to purchase the land. According to the Eleventh Circuit, that contractual right was a "distinct contractual right that may be a capital asset."[2] Whether it was held in the ordinary course of business or for investment was also relevant.

The Eleventh Circuit found that there was no evidence that Long entered into the agreement with the intent to assign his contractual rights to someone else in the ordinary course of business. Further, the court found that there was no evidence that Long obtained the Florida court judgment for the purpose of assigning his position as plaintiff to a third party in the ordinary course of his business.

Indeed, the record showed that Long *always* intended to develop the real estate project himself. The appeals court rejected the IRS's argument that Long's proceeds were a lump sum substitute for his future ordinary income. The profit Long received from selling the right to attempt to finish the project, which was far from complete, could not be equated to what he would have received had he built it himself.

On other points in Long's case, however, the Eleventh Circuit affirmed the Tax Court's judgment. It found that Long had not met his burden of proving that $600,000 he paid out of the $5.75 million to resolve a business agreement with another entity was deductible. The appeals court agreed it was a loan repayment.

Similarly, the Eleventh Circuit held that Long did not provide sufficient evidence of more than $238,000 in legal fees he also claimed should be deductible. The only evidence he provided was a letter from his attorneys. No bills or checks were submitted, and the appeals court found the letter from the lawyer to be hearsay.

Character of Income

Long contains lessons about character in these transactions. In general, the character of a lawsuit settlement is based on the origin of the claim.[3] If a recovery represents compensation for damage to a capital asset, arises in the process of acquiring property, or concerns the disposition of property, the recovery should represent a return of basis and capital gain.[4]

Should the character of an amount received by a plaintiff from an investor be based on the character of the underlying lawsuit? Strangely enough, there appears to be no authority directly on point. When the underlying recovery would be capital, any gain from the investor should presumably also be capital.

But can a plaintiff realize capital gain from the sale of a portion of a legal claim to an investor even if that claim would otherwise result in ordinary income? Gain from the sale of an interest in a lawsuit might be compared with the sale of other

[1]772 F.3d 670 (11th Cir. 2014), *rev'g in part and aff'g in part* T.C. Memo. 2013-233.

[2]772 F.3d at 676.

[3]*See United States v. Gilmore*, 372 U.S. 39 (1963); *Raytheon Production Corp. v. Commissioner*, 144 F.2d 110, 113 (1st Cir. 1943).

[4]*Dye v. United States*, 121 F.3d 1399, 1404 (10th Cir. 1997), citing *Woodward v. Commissioner*, 397 U.S. 572, 577 (1969); Rev. Rul. 81-152, 1981-1 C.B. 433 (recovery constituted a return of capital); Rev. Rul. 81-277, 1981-2 C.B. 14 (same).

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types of property that produce ordinary income. Debt instruments, real estate, patents, and stock generate ordinary income in the form of interest, rents, royalties, and dividends.

However, their sale generates capital gain or loss. The plaintiff's sale of a share of the proceeds from a lawsuit seems analogous to the sale of a partnership interest. In both cases, the acquirer gains the right to a share of the underlying income.

Gain from the sale of a partnership interest is capital except to the extent it is attributable to hot assets such as inventory and unrealized receivables.[5] If the lawsuit would result in ordinary income, should the lawsuit be viewed as analogous to a hot asset such as an unrealized receivable? The plaintiff is unlikely to be in the business of selling legal claims.

This point came up in *Long*, and Long effectively defeated the IRS. As in his case, in many cases it is likely that the legal claim should not represent inventory or a receivable. Moreover, the legal claim is probably also sufficiently uncertain and contingent that the plaintiff is willing to sell a portion of his interest.

The sale will take place at a price that represents a discount to the expected recovery, to factor in the investor's risk. Therefore, there appear to be enough differences that even if it is viewed as analogous to a partnership interest, the gain may be capital. Several courts have explained in dicta that if a plaintiff sells a claim or a chose in action, the character of the gain will generally be capital even if a direct payment on the claim would otherwise be ordinary.[6]

For example, in *Nahey v. Commissioner*,[7] the taxpayer acquired a claim in the leveraged acquisition of a business. The acquirer stepped into the shoes of the plaintiff as a result of the business acquisition. Six years later, the case settled for $6 million, and the acquirer claimed the settlement amount was capital gain even though it would have been ordinary to the original business owner.

In holding against the taxpayer, the court acknowledged the claim represented a capital asset. Judge Richard A. Posner explained that he assumed for the sake of argument that any income from a *sale* of the claim by the taxpayer would represent capital gain. However, the taxpayer received the settlement amount directly, resulting in ordinary income.

A plaintiff's legal claim can be viewed as a kind of intangible property right that is analogous to various types of capital assets. This seems to be exactly the kind of theory that courts had in mind when they explained in dicta that income from the sale of a legal claim should be treated as capital gain.

Substitute for Ordinary Income?

It is also important to consider the potential application of the judicially created substitute for ordinary income doctrine.[8] Once again, this point was raised by the IRS in *Long*, but the appeals court sided with the taxpayer. This doctrine has treated gain from the sale of specific rights to income as ordinary.

The substitute for ordinary income doctrine applies in some circumstances to deny capital gain treatment when rights to ordinary income are sold. Typically, this doctrine applies when a taxpayer sells a right to a fixed share of income to be received in the future. The amount received generally represents the present value of a relatively certain payment to be received in the future.

The case law has recognized that the degree of investment risk is important.[9] It is not uncommon for one to say with conviction that the amount to be received is speculative and highly contingent. Moreover, the time when the proceeds (if any) will be received may also be unknown. It does not appear appropriate to apply the substitute for ordinary income doctrine if the plaintiff may receive nothing.

Timing of Income

Treating litigation financing as a prepaid forward contract means it is an open transaction that does not close until the lawsuit is resolved. The plaintiff will retain significant economic exposure to the underlying lawsuit even if the potential risks and rewards are mitigated by the investor's advance. Further, the plaintiff will also generally retain substantial or even exclusive control over the lawsuit.

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[5]Section 741.

[6]*See Osenbach v. Commissioner*, 198 F.2d 235, 236-237 (4th Cir. 1952) (''it is quite clear that ordinarily . . . when a taxpayer makes a gain from the sale or exchange of a claim or chose in action, this is taxable as a capital gain; while if the gain results from the collection of the claim or chose in action, this is taxable as ordinary income''); *Commissioner v. Golonsky*, 200 F.2d 72, 74 (3d Cir. 1952) (a chose in action is intangible property that could be sold), *acq.* 1956-2 C.B. 6; *Benedum v. Granger*, 180 F.2d 564 (3d Cir. 1950) (disposition of a chose in action ''clearly constitutes an exchange of capital assets''); *Jeffrey v. United States*, 261 B.R. 396, 401 (Bankr. W.D. Pa. 2001) (''for federal tax purposes, the right to assert a tort claim is a chose in action, constituting intangible personal property''); *Appalachian Elec. Power Co. v. United States*, 141 Ct. Cl. 367, 370 (1958) (identifying an ''intangible such as a chose in action'' as a capital asset that if sold or exchanged could receive ''receive capital assets treatment for tax purposes'').

[7]196 F.3d 866 (7th Cir. 1999).

[8]*See Commissioner v. P.G. Lake Inc.*, 356 U.S. 260 (1958); and *Holt v. Commissioner*, 303 F.2d 687 (9th Cir. 1962).

[9]*See Gladden v. Commissioner*, 112 T.C. 209, 220 (1999).

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Thus, assuming there is substantial uncertainty over the plaintiff's net income and the plaintiff capitalizes all deductible expenses, the plaintiff is arguably justified in treating the investment as an open transaction. Axiomatically, the assignment of income doctrine applies when taxpayers attempt to assign income that has accrued but not yet been realized. Under this judicial doctrine, the taxpayer is treated as earning this unrealized income despite any attempt to sell or give it away.

The Supreme Court explained in a frequently cited 1930 opinion that if the income has sufficiently ripened on the tree, it is too late to transfer and the income will be assigned to the assignor.[10] Ten years later, in *Helvering v. Horst*,[11] the taxpayer detached interest coupons from a bond and gave them to his son. The Supreme Court held that although the taxpayer had not yet realized the income from the coupons, the income had still accrued to him.

Therefore, the case seemed to stand for the proposition that a cash basis taxpayer cannot assign income that has already accrued but has not yet been realized. In *Commissioner v. Banks*,[12] the Supreme Court held that the anticipatory assignment of income doctrine applies to contingent fee arrangements. The Court explained that in a contingent fee matter, the plaintiff enjoys dominion and control over an income-generating asset.

The Court stated that the plaintiff obtains the benefit of legal services by diverting payment from the cause of action to the attorneys. According to the Court, this is just like the taxpayer who attempted to divert interest income by gifting the interest coupons in *Horst*. In at least one important respect, however, the comparison to *Horst* is strained.

In *Banks*, the plaintiff had not yet accrued any income. Nevertheless, the Court held that it made no difference that the plaintiff's legal claim was contingent in amount and that he might receive nothing. After *Banks*, a plaintiff is generally considered to be required to include the entire recovery in income, including the amount he is required to pay his attorney under a contingent fee agreement.

Assignments of Income

Could the IRS make the same anticipatory assignment of income argument in the context of litigation financing? The income-generating asset in *Long* is the plaintiff's cause of action, which is the same as in *Banks*. But fortunately, there seems to be a more liberal standard for assigning legal claims to parties other than an attorney working for a contingent fee.

The critical question is usually how far the litigation has advanced. For example, in *Doyle v. Commissioner*,[13] the taxpayer assigned a portion of his claim after the trial court denied an application for a new trial and the Supreme Court had denied *certiorari*. The Fourth Circuit explained that the litigation had progressed too far because the outcome was essentially assured.

In the court's view, the fruit in *Doyle* had ripened too much. Nonetheless, in another case, the transfer occurred after the district court had rendered a judgment but while the case was on appeal. In *Cold Metal Process Co. v. Commissioner*,[14] the Sixth Circuit determined that the matter represented a continuing controversy.

This dividing line appears to be accepted by the IRS. For example, the IRS has ruled that transfers of litigation claims are valid if the case is on appeal and there therefore remains a genuine uncertainty regarding the outcome.[15] As long as the litigation continues to be subject to appeal and a genuine contingency exists, the anticipatory assignment of income doctrine should not apply.[16]

This suggests that the assignment of income doctrine should generally not apply to litigation investments. When a plaintiff enters into a litigation finance transaction, the underlying lawsuit may result in a recovery. Alternatively, the lawsuit may fail without resulting in any payment.

The plaintiff may recognize income at the time of the advance or treat it as an open transaction that triggers income only at the resolution of the lawsuit (as in a prepaid forward contract). This suggests four possible scenarios: (1) closed transaction and successful lawsuit; (2) closed transaction and unsuccessful lawsuit; (3) open transaction and successful lawsuit; or (4) open transaction and unsuccessful lawsuit. It is worth considering whether the character of the plaintiff's income may be different in any of the four situations.

When the plaintiff treats the litigation investment as a closed transaction, the plaintiff receives cash from the investor in exchange for a right to a portion of the proceeds from the plaintiff's claim. The claim is arguably an intangible property right that is a capital asset in the hands of the plaintiff.

[10]*See Lucas v. Earl*, 281 U.S. 111 (1930).
[11]311 U.S. 112 (1940).
[12]543 U.S. 426 (2005).

[13]147 F.2d 769 (4th Cir. 1945).
[14]247 F.2d 864 (6th Cir. 1957).
[15]LTR 200107019.
[16]*See* LTR 201232024 (transfer of claim to charity was valid while judgment was on appeal).

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Indeed, this should be so even if the claim would otherwise result in ordinary income.

Thus, the plaintiff may well be justified in treating the transaction as resulting in capital gain.

In a closed transaction, the plaintiff reports income from the litigation investment in the year of entering the transaction. Assuming the plaintiff reports the income as capital gain, the character of the plaintiff's gain does not appear to be affected by whether the underlying lawsuit is successful.

If the lawsuit is unsuccessful, neither the plaintiff nor the investor will receive any cash. However, the plaintiff should experience no tax consequences on the conclusion of the failed lawsuit. If the lawsuit is successful, the proceeds are divided between the plaintiff and the investor.

If the assignment of income doctrine does not apply, the plaintiff should be able to exclude the amount that goes to the investor. The plaintiff's share should be characterized based on the origin of the claim. If the recovery is ordinary, that should not affect the character of the earlier investment transaction that was reported as capital gain.

The investment was arguably an independent transaction between the plaintiff and a third-party investor. By contrast, the recovery comes from the defendant and expressly relates to the plaintiff's legal claim. An ordinary recovery should not taint the character of the plaintiff's gain from the litigation investment.

Open Transaction and Unsuccessful Suit

In an open transaction such as a prepaid forward contract, the plaintiff recognizes income only when the lawsuit concludes. If the lawsuit is unsuccessful, the plaintiff should recognize income in the amount of the original advance, less the basis (if any) he has in the lawsuit, such as capitalized expenses. Therefore, just as in a closed transaction, any gain should arguably be capital.

This should be the case even if the underlying lawsuit was ordinary. Yet the substitute for ordinary income doctrine may apply, particularly if the lawsuit was relatively certain to succeed at the time of the investment. In that case, gain should be ordinary even if gain is triggered only at a later time.

Open Transaction and Successful Suit

If the lawsuit is successful, the proceeds are divided between the investor and the plaintiff. At the same time, the plaintiff also recognizes income from the investment. If the lawsuit recovery is ordinary, can the plaintiff still treat gain from the investment as capital?

For example, suppose that the plaintiff receives $100 from the investor. In exchange, the investor will receive 50 percent of the net proceeds from the lawsuit after attorney fees are paid and the investor's money is returned. Assume the lawsuit is successful and results in a recovery of $500.

Of this amount, $200 goes to the attorney, and the investor receives a return of its original $100 investment. The plaintiff and investor then evenly divide the remaining net proceeds of $200. As a result, the attorney receives a fee of $200, the investor receives $200, and the plaintiff receives $100 from the $500 recovery.

Assume that the recovery is ordinary based on the origin of the claim. Because the lawsuit is ordinary, the plaintiff should have $100 of ordinary income. Nonetheless, the plaintiff claims that the $100 from the investor should be treated as capital gain.

Under *Banks*, the plaintiff is treated as receiving the attorney fees. The IRS may argue the plaintiff should similarly be treated as receiving the amount that is due to the investor. The IRS may seek to apply a variant of the anticipatory assignment of income doctrine and argue that the investor's advance to the plaintiff was simply a loan.

If so, the return of $100 to the investor would be a nondeductible return of loan principal. But the plaintiff should be eligible to deduct the remaining payment of $100 to the investor, along with the payment of $200 in attorney fees. If the plaintiff is a corporation and the legal claim is related to its business, it should be able to deduct the payment to the investor as an ordinary and necessary business expense.

If the plaintiff is an individual and the claim is unrelated to his trade or business, he may be entitled to only a miscellaneous itemized deduction under section 212. Section 212 permits a deduction for items related to activities entered into for profit. It covers items such as investment adviser fees and, in some cases, attorney fees.

Yet a section 212 deduction is a miscellaneous itemized deduction that is a preference item for purposes of the alternative minimum tax. This plaintiff would face a serious AMT problem. The entire $500 recovery would be treated as income, resulting in tax of $140 (28 percent of $500) even though the plaintiff receives a net amount of only $200 ($100 from the investor plus his share of $100 from the recovery).

In fact, the plaintiff would have been better off if the lawsuit had failed. In that case, the plaintiff would have paid capital gain tax of approximately 20 percent on the investor's advance of $100. This would have generated an after-tax amount of approximately $80, compared with only $60 in the successful lawsuit scenario.

Beware of Loan Arguments

When the plaintiff treats the litigation investment as an open transaction, such as a prepaid forward

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contract, it may well increase the risk that the IRS would argue that the litigation finance investment was a loan. The plaintiff may object on grounds that the legal claim was merely speculative and contingent at the time of the litigation investment transaction. The investor should not be treated as lending money to the plaintiff in such a risky and uncertain matter.

In hindsight, the lawsuit may appear more certain and secure. Still, at the time of the investment, it may have been very uncertain. As noted in *Plantation Patterns Inc. v. Commissioner*,[17] the transaction must be judged when the deal was consummated.

Despite those arguments, the IRS may contend that if the plaintiff treats the litigation finance investment as an open transaction and the lawsuit is successful, the plaintiff's entire return comes from the proceeds of the lawsuit. The plaintiff is paying the investor from the proceeds of the lawsuit, but the proceeds are entirely income to the plaintiff. How serious is the risk that the IRS would seek to characterize the lawsuit finance transaction as a loan?

Clearly, the documents will matter and should inform this issue. Assuming proper documentation, the loan theory seems to ignore the basic terms of the transaction. After all, the plaintiff's obligation is nonrecourse, meaning that the investor gets paid only if the lawsuit is successful.

The investor does not have a right to get its money back from the plaintiff. Instead, the investor is arguably better viewed as having a right to a share of the lawsuit recovery. However, courts have consistently held that the expenses of a contingent fee attorney should be regarded as a loan to the plaintiff even though the plaintiff bears no liability for those expenses if the lawsuit is unsuccessful.[18]

Plaintiffs should not ignore the risk that if they seek to treat the litigation finance transaction as a prepaid forward contract, they may increase the risk that it would instead be treated as a loan if the lawsuit is successful. In that case, the investor's advance may be ordinary. Further, the plaintiff could run into a considerable AMT problem, particularly if the plaintiff is an individual.

[17]462 F.2d 712, 723 (5th Cir. 1972).

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

Conclusion

The tax issues facing investors, lawyers, and plaintiffs in litigation finance transactions are varied, yet the plaintiff faces the most challenging problems. For the investor, a lawsuit is unusual, but its basic form seems analogous to other investments that generate capital gain. There is an acquisition of an intangible property right, followed by the redemption or liquidation of that property right in exchange for cash.

Thus, the investor often has a strong basis for claiming capital gain treatment. For the law firm, ordinary treatment seems inevitable, with the main concern being timing. The critical requirement seems to be consistency: The law firm should also capitalize all expenses related to the lawsuit.

The plaintiff must consider *both* timing *and* character issues. Plaintiffs already face difficult tax concerns in resolving litigation, and litigation finance transactions add to the complexity. It may be possible for the plaintiff to treat the litigation investment as a prepaid forward contract and recognize capital gain.

Nevertheless, if the plaintiff treats the litigation investment as a prepaid forward contract and the lawsuit is successful, it may heighten the risk that the IRS would regard the litigation investment as a loan. In that case, the character of the investment may be ordinary rather than capital. Moreover, individual plaintiffs may face significant limitations on deducting the payment to the investor. This problem is exacerbated when they must also deduct payments to their attorneys.

All of this suggests that plaintiffs entering into a litigation finance transaction should consider taxes. It is particularly important for plaintiffs to carefully analyze the various combinations and possibilities their case might achieve. Evaluating the range of possibilities in the future, documenting the transaction consistently, and understanding the risks are critical for plaintiffs who want to achieve their desired tax treatment.

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