



Volume 12 (2014) | ISSN 1932-1821 (print) 1932-1996 (online)
DOI 10.5195/taxreview.2014.31 | <http://taxreview.law.pitt.edu>

ARTICLES

THE TAX TREATMENT OF ALTERNATIVE LITIGATION FUNDING: SOME ANSWERS, BUT MOSTLY QUESTIONS

Alan B. Morrison and Randy Haight



This work is licensed under a Creative Commons Attribution-NonCommercial-No Derivative Works 3.0 United States License.



This journal is published by the [University Library System](#) of the [University of Pittsburgh](#) as part of its [D-Scribe Digital Publishing Program](#), and is cosponsored by the [University of Pittsburgh Press](#).

ARTICLES

THE TAX TREATMENT OF ALTERNATIVE LITIGATION FUNDING: SOME ANSWERS, BUT MOSTLY QUESTIONS

*Alan B. Morrison and Randy Haight**

BACKGROUND

In recent years, there has been a significant increase in a practice that has come to be known as “Alternative Litigation Funding” (ALF). In general, as the Fifth Circuit recognized in *In re Estate of Mixon v. United States*, the tax treatment of a particular transaction is dependent on the specific facts applicable to it.¹ This article is not intended to answer questions as to specific ALF transactions, but rather to set the framework in which such questions will be addressed as they arise. It may also assist the Internal Revenue Service in offering guidance as to how it views these transactions from the perspectives of both sets of parties. Nonetheless, even those modest goals cannot be achieved without some understanding as to the basics of ALF transactions, which are described in this background section.²

* Lerner Family Associate Dean for Public Interest & Public Service Law, and 2013 Graduate, George Washington University Law School. Mr. Morrison co-hosted a conference on Alternative Litigation Funding at the Law School in 2012 from which the idea for this article emerged, and he supervised the independent research of Mr. Haight that formed the basis of this article. The article has been reviewed by H. David Rosenbloom, a tax partner at Caplin & Drysdale, who agrees with its overall analytic approach, although not necessarily all of its specific conclusions or reasoning.

¹ 464 F.2d 394, 398 (5th Cir. 1972) (“As in most cases of this type, the facts here are both complicated and significant.”).

² Even though the facts are not the same in every transaction, there is sufficient similarity to be able to generalize about them. Where there may be variances that may have relevance for tax purposes, we have included that information. Under these circumstances, and because we do not think that most of the factual assertions are in doubt, we have chosen not to include citations for all of the factual

Broadly stated, ALF involves providing outside financial assistance to plaintiffs in litigation, other than from lawyers working on contingent fees, standard loans, and insurance companies. In theory, defendants could avail themselves of this practice, and in some cases, such as suits for declaratory judgments seeking to invalidate a patent, where there is a counterclaim for royalties from infringing usage—the labels plaintiff and defendant are of no significance. But for purposes of this article, we will focus on assistance to plaintiffs seeking money damages.

There are two basic categories of ALF—personal injury advances and those for large commercial cases. They operate in rather different ways, and their tax issues appear to be quite different, or at least subject to a different analysis. But there is one common feature that unites all ALF transactions: the outsider, whom we will call the “investor,” provides money (the “advance”) to the plaintiff, whom we will call the “recipient,” in connection with a lawsuit that has been or is about to be brought. The advance is made on a non-recourse basis, which means that the investor obtains the right to the repayment of the advance, plus an agreed upon additional amount described below, but only from the proceeds of the litigation. Thus, if the litigation fails, or produces less than the amount of the advance, the investor suffers a loss, and the recipient does not have to make up any difference.

ALF was initially used, and is still used today, in many personal injury cases, where the plaintiff has a lawyer who is working on a contingency fee basis and is paying for all litigation costs, which the lawyer expects to recover from a favorable judgment or settlement.³ The problem for the plaintiff is that she may need money for living expenses, such as food, housing, and transportation while the case is pending, but she has generally exhausted the usual lines of credit or at least those available at reasonable rates. Moreover, the ethics rules of most states prevent lawyers from advancing personal expenses during litigation, although they can advance the actual litigation costs.

statements in this background or elsewhere in this article. We have, however, included an Addendum that provides citations to the sources from which we obtained this information.

³ The origins of ALF in the United States date back to the 1990s when Perry Walton, a well-known Las Vegas entrepreneur, began loaning money—what he called “contingent obligations”—to plaintiffs in exchange for contractual rights to their legal claims. Richard B. Schmitt, *Staking Claims: A Las Vegas Lender Tests Odds in Court*, WALL ST. J., Sept. 15, 2000, at A1.

Enter the ALF investor, who is not subject to that restriction and is willing to make an advance, which in most ALF personal injury cases is less than \$10,000. In exchange, the investor obtains a promise to repay that advance from the proceeds of the litigation, plus a fee that is a percentage of the advance, generally calculated on a per-month or per-quarter basis. There is ordinarily no end-date for the transaction, and so the extent of the recovery will be known only when the case goes to judgment or is settled, which could be several years in the future. Once the recipient has the advance, there are no restrictions on what use may be made of it. Because lawyers in these cases operate on a contingent fee basis, none of the advance goes to the lawyer or to litigation expenses. Since the advance is non-recourse, which entails a higher risk of no recovery, or only a partial recovery, the rate charged is well above the rate that is lawful under the usury laws of most states. Usury laws generally apply to “loans,” and thus investors are very careful not to call the advances loans and to avoid having them treated as loans for any purpose, which would include under the Internal Revenue Code. That does not mean that the IRS will not consider the transaction a loan in some situations, but only that the investors will do their best to avoid having it called a loan, even by the IRS. This article will assume that the advances are not treated as loans for state law purposes, although some states have found their usury laws to apply to these non-recourse advances.⁴

To date, most ALF advances have been for claims for physical injuries, many involving automobile accidents and generally for claims of rather modest amounts. In principle, there is no reason why other personal injury claims, including quite substantial ones for medical malpractice or a product defect, could not be used to support ALF advances. The same is true for employment discrimination cases and a variety of consumer claims, although, as we will see, those may present different tax issues for the recipient.

One other significant aspect of ALF in personal injury claims is that the investors do not conduct extensive investigations before making the advance. In order to limit their overall risks, investors will be sure that the

⁴ Elizabeth C. Burch, *Financiers as Monitors in Aggregate Litigation*, 87 N.Y.U. L. REV. 1273, 1302 (2012).

plaintiff has a lawyer on the case and that the amount advanced is a relatively small percentage of the expected recovery. Their business model also involves a relatively high volume of cases, which essentially puts them in the business of making advances on a regular basis, rather like a bank that regularly makes car loans.

The other ALF category—major commercial cases—also makes advances on a non-recourse basis, but in all other respects is quite different. First, the amounts advanced are very large, often more than several million dollars. The cases generally involve complex commercial disputes, often between two or more corporations, and the claims may be based on contract, patents, antitrust, or other similar legal theories—although there is nothing magical about the nature of the claim and its relation to commercial ALF. The device could also be used when a government is the defendant.

Second, in contrast to the personal injury plaintiff who uses the money for everyday living expenses, the commercial ALF funds are used to fund the litigation exclusively. That includes paying the lawyers (and sometimes being involved in their selection), as well as funding for discovery, travel, expert witnesses, and anything else required in the litigation. Some money may be advanced at the outset and then at future times and/or based on future contingencies. Companies choose commercial ALF for any number of reasons, either alone or in combination. For example, the legal department's budget may not include expenses of a major affirmative litigation; the company may be risk averse on the cost side, but willing to sacrifice a substantial portion of its recovery in exchange; it would like to use its regular lawyers, but the lawyers do not do cases on a contingency fee basis; or the company has a current cash crunch that ALF funding can relieve.

Third, the investor engages in substantial due diligence, reportedly exceeding \$1 million in some cases, and often resulting in turning down the deal. Fourth, there is no usury problem because the recipients are corporations or the advance is above a modest size statutory exclusion, such as \$30,000. Fifth, the amount the ALF investor recovers is more likely to be based on a percentage of the total recovery for the recipient or a multiplier of the amount advanced, rather than a time-based percentage that looks like interest. Sixth, unlike for personal injury ALFs, where the investor has no

input into any decisions (except perhaps to discuss a settlement in which everyone will take a little less so that the case can be resolved), the investor can obtain rights through the investment contract to participate in the conduct and perhaps even control the litigation.⁵

There is one other point to note regarding commercial ALFs: unlike the personal injury ALFs, which are advertised and for which information about their general operation is reasonably well known and falls within a limited set of boundaries, commercial ALFs are not public. Thus, while their outlines and general approach are established, their details are not known. Moreover, whereas personal injury ALFs are standard form arrangements, with only the specific amount advanced and the rate charged being filled in, each commercial ALF contract is different. That is because the claims arise in a wide variety of factual and legal situations. In addition, the uncertainties tend to be larger, and the amounts advanced and the purposes of the advances are not the same from case to case. Because of these and other factors, the goals of the commercial ALF parties are tailored to the circumstances of each case, which means that potentially every contract is unique, or at least has some features not found in others. In particular, as discussed below, even after the amount of the advance has been set, there still remain questions as to whether it will go directly to the recipient, to the lawyers, or to a newly created entity of some kind, and the answer may affect the tax treatment of the transaction. Because of these variations and the lack of specific information about how a particular commercial ALF transaction has been structured, it is not possible to offer a universally applicable opinion on the tax treatment of these transactions.

Finally, there is one significant area of litigation in which there is no reported use of ALF: class actions. In theory, the advance could be made to the class members, but the only individuals who could sign up as recipients are the named class representatives and that cannot happen until there is class certification. Even with a certified class, if ALF were sought, the arrangement would almost certainly have to be subject to court approval, including divulging the terms of the arrangement to the defendants. The alternative would be for the advance to be made to the lawyers, but that too

⁵ To the extent that the investor obtains the right to control the lawyers, that may raise ethical issues, but those are outside the scope of this article.

would likely be subject to court approval and further limited by the prohibition against fee splitting with non-lawyers. Moreover, and perhaps most significantly, at present, lawyers who wish to represent plaintiffs in class actions seem to be able to find sufficient traditional funding, including full recourse loans from commercial lenders, so that ALF is not needed.

THE TAX FRAMEWORK

There are tax implications for both sides of the ALF transaction, and while the issues may be similar, the differences between personal injury and commercial ALF are sufficiently significant so that a separate analysis is required for each type. Our analysis also considers the investor and the recipient separately. Moreover, we will assume that the advance and any repayment (or non-repayment) do not occur in the same tax year so that the tax treatment of each element of the transaction retains significance to taxpayers on both sides of the transaction.

There are two sides to every ALF transaction, and indeed to every event in the overall transaction. That means that each advance, each repayment, and any final non-payment (or partial payment) must be considered for tax purposes from the perspective of both the investor and the recipient. For the recipient, the first question will be, whether the advance is “income” that must be reported, or whether it is something else. If it is income, is it ordinary income, or can it be treated as the proceeds from the sale or exchange of a capital asset? And, if it is income, is there an exclusion that makes the receipt non-taxable?

From the investor’s side, the question is whether the payment is an expense that can be deducted immediately, or perhaps at a future date. Is the payment treated like a loan and hence not deductible because there is an expectation of repayment? Is the advance properly treated as the purchase of an asset, and if so, is the asset a capital one (making it eligible for capital gains [or loss] treatment), or is the asset one used regularly in the investor’s business (like inventory) whose subsequent sale (repayment) at a gain, produces ordinary income?

Two other preliminary points should be noted. The investor and the recipient may not always want to view the transaction the same way, so that a favorable tax treatment for one may produce an unfavorable result for the other. It may be that, to some extent, either by proper drafting and/or by choosing one method of providing the advance rather than another (or creating a new entity as part of the process), the tax treatment for the two

parties may push in one direction rather than another. This is more likely to happen for the large commercial ALFs, in part because the participants are more likely to have sophisticated tax counsel who will be involved in the structuring of the transaction, in contrast to the personal injury ALFs that operate on a standard form basis. But regardless of what the parties attempt to do, the IRS is not bound by their characterization. Second, there is much that is not known about the large commercial ALFs, and so there may be factors in at least some of those transactions that may have significant effects on their tax treatment, and for which this article cannot account.

Because of the substantial differences between the two kinds of ALFs, we discuss them separately, beginning with the personal injury ALFs. This discussion pertains only to the Federal Income Tax in Title 26 of the U.S. Code and not to any other kind of tax or to income taxes imposed at the state or local level. It also assumes that all parties are U.S. taxpayers; if there were foreign taxpayers, the issues would be even more complicated.

PERSONAL INJURY ALFS

The Recipients

The first question is whether the plaintiff who obtains an advance from an ALF investor must treat the amount received as income under the Code, which broadly defines income as follows: “Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items.”⁶ For those taxpayers using the accrual method of accounting, “income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.”⁷ A recipient of an ALF advance has an absolute right to retain the advance and to use it for any purpose, which suggests that the advance is income under *James v. United States*.⁸ Indeed, it is the freedom to spend

⁶ I.R.C. § 61(a).

⁷ Treas. Reg. § 1.451-1(a).

⁸ 366 U.S. 213, 219 (1961) (treating embezzled funds as income, in part because of taxpayer’s ability to use money without restriction); *N. Am. Oil Consol. v. Burnet*, 286 U.S. 417, 424 (1932).

the money for personal needs that is the reason that these plaintiffs seek ALF advances. Moreover, ALF advances are unlike the advances (deposits) in *Commissioner v. Indianapolis Power & Light Co.*, which the Court found not to be taxable when received because the customer could cancel the contract with the utility and have the advance returned.⁹ However, once an ALF advance is made, the investor can never get its money back except from the proceeds of the litigation. Accordingly, the recipient has arguably received taxable income on receipt of the advance.¹⁰

However, under § 104(a)(2) there is an exclusion from the definition of income for “the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness.” The key words for ALF purposes are “on account of personal physical injuries” because they do not limit the exclusion to the amounts paid by the tortfeasor or its insurance company. Given the fact that the investor will recover the advance, plus its fees, only from amounts received “on account of personal physical injuries,” the exception seems to be satisfied. Moreover, since the amount received from the investor is, in economic reality, an advance of money that the recipient expects to receive later from a non-taxable personal injury claim, treating the advance as an exclusion from income does not undermine the purpose of the exclusion.

However, in some ALF cases, the plaintiff loses at trial or settles for an amount that does not provide enough money to fully repay the advance, plus the agreed upon fee. If the ALF transactions were treated like a loan, and some portion were forgiven, or became uncollectible, that portion would be treated as income. That is because § 61(a)(12) specifically includes as taxable income “[i]ncome from discharge of indebtedness,” and, unless the recipient were insolvent or in bankruptcy, none of the exclusions in § 108 would apply. If the advance were treated as a loan, it would not be income when received because of the obligation to repay.¹¹ But when that

⁹ 493 U.S. 207 (1990).

¹⁰ See *Comm’r v. Banks*, 543 U.S. 426, 429 (2005) (requiring employment discrimination plaintiff to treat as income the full amount of the recovery despite the plaintiff’s legal obligation to pay a percentage of it to his contingency fee counsel). However, the harshness of this result as applied to discrimination cases has been remedied prospectively by Congress. *Id.* at 433.

¹¹ *Tufts*, 461 U.S. 300, 307 (1983); *James*, 366 U.S. at 219.

obligation is removed (in whole or in part), the borrower has received an economic benefit, which at the time of removal becomes income to the borrower. The fact that the transaction was a non-recourse advance, with no fixed obligation to repay it, might mean that the discharge of indebtedness rule would not apply, although the IRS takes the position that the non-recourse nature of the obligation is irrelevant, at least in some circumstances.¹² Moreover, in the case of personal injury ALF recipients, even if the IRS were to treat the removal of the obligation in a non-recourse advance as income, the exclusion in § 104(a)(2) would arguably override the discharge of indebtedness rule on the theory that the advance, when it was made, was “on account of personal physical injuries” and that the recipient should not be in a worse tax position because she lost her personal injury claim than if she had won it.

To date, almost all individual ALF advances have been for automobile personal injury cases, but there is no reason why plaintiffs with other types of claims will not seek to take advantage of ALF. It is not clear, however, that the economics and relative risks in other areas will support ALF or may not require higher fees before an investor will provide an advance. One area where ALF would be useful to plaintiffs is in employment disputes, especially when the individual is out of work. There is no exclusion from income for amounts paid in employment disputes—nor should there be because the principal losses are of wages that are ordinary taxable income. In that case, an advance would probably be income to the recipient-employee at that time because there is no fixed obligation to repay and the “taxpayer exercises complete dominion over the income in question.”¹³ In the alternative, if the advance is not taxable on receipt (because it is treated like a loan), but is not repaid because, for example, the plaintiff loses at trial, that loss would create income to the recipient. Thus, outside the personal injury context, the issue is not whether the advance is taxable income—it surely is—but whether it must be recognized on receipt or,

¹² See Rev. Rul. 91-31, 1991-20 I.R.B. 1 (income realized by reduction of under-secured non-recourse debt where holder of debt not the seller of property).

¹³ *Banks*, 543 U.S. at 434.

because the advance is treated like a loan, only when the transaction with the investor is finalized.¹⁴

Other kinds of cases would follow a similar method of analysis. The initial inquiry would be to ascertain the tax treatment of the proceeds of a lawsuit absent an advance, and then apply the same tax treatment to the advance as would be proper for the proceeds.¹⁵ A landlord who sued for back rent and received an advance would treat that as rental income. A suit by a homeowner against a contractor for damages caused by faulty repairs would have no taxable income because the money received would be either a return of amounts previously paid or a substitute for the harm caused to the property by the faulty work. In all of these examples, we have assumed that the plaintiff is a cash basis taxpayer because that is how almost all but the wealthiest individuals report their incomes and expenses. That assumption does not hold for either side in the commercial ALF transaction and may not apply to investors in personal injury ALFs, as we now discuss.

The Investors

It appears that most investors providing personal injury advances are corporations that are in the ALF business on a regular basis. Their business plan is to make a large volume of small to modest size advances, hoping that most of them will be repaid in full, plus the agreed upon fee, in a relatively short time horizon, although in most cases not in the same tax year in which the advance was made. They probably file their tax returns on an accrual basis, although it is not clear that the analysis would be different if they were cash basis taxpayers.

¹⁴ If for any reason the advance was treated like a loan, and hence not includible in income on receipt, and the investor did not recoup its investment because the recipient lost the case, the analysis in *Crane v. Comm'r*, 331 U.S.1 (1947), would apply in determining the amount of the recipient's gain. In a personal injury case, the exclusion in 104 would still apply, but, under *Crane*, the fact that the advance was non-recourse would not affect the gain realized. That conclusion is supported by I.R.S., PUB. NO. 4681, CANCELED DEBTS, FORECLOSURES, REPOSSESSIONS, AND ABANDONMENTS (FOR INDIVIDUALS) 4 (2013), which provides an example of a foreclosure on a home with a non-recourse loan in which the owner lost money, but nonetheless had a gain.

¹⁵ See *United States v. Gilmore*, 372 U.S. 39, 49 (1963) (looking to the "origin and character of the claim" to determine tax treatment).

In order to ascertain the tax effects of the advances and repayments to investors in personal injury ALF cases, it may be useful to describe their business model in terms of other traditional businesses. The most useful characterization may be that ALF investors are in the business of selling money—making advances—for which they are paid in the future, with the repayment equal to the advance plus the agreed upon fee. One way to think about the advance would be to treat it as a loan, which, for a bank, would not create a deductible expense because repayment is expected. But personal injury ALF investors seek to avoid the loan characterization at all costs in order to steer clear of the usury laws. Because investors insist that advances are not loans, they might seek to deduct those advances in full in the year made. That would arguably be proper on the theory that the money has been paid out, the recipient can use it fully and freely, and the advance may never be repaid since there is no absolute repayment obligation. For some investors, that would be highly advantageous because it would create large current deductions that would offset current income.¹⁶

Under a third alternative, the investors could treat the advance as a “sale” of the funds, but with the final price, and hence any gain or loss, to be determined later. Under that approach, the advance would not be reflected on the investor’s tax returns until it was either repaid, plus the agreed upon charges or fees, or became uncollectible because the plaintiff lost her claim. This alternative would be most aligned with the accrual accounting, and it would result in the same tax treatment as if each advance were treated as a loan. Because the gain (or loss) would occur only on repayment, months or years later, it would provide less favorable tax treatment for most investor-taxpayers than treating the advances as immediate deductions, thereby saving on current taxes even if they would have to be paid later.¹⁷ However, in the absence of a ruling from the IRS, it is not possible to determine which method or perhaps methods would be permitted. The only certainty is that the investors would have to maintain the same method from year to year.

¹⁶ This article takes no position on whether these advances are debt instruments, or if so, how they should be treated under the regulations applicable to contingent payment debt instruments. Treas. Reg. § 1.1275-4.

¹⁷ See JAMES J. FREELAND, FUNDAMENTALS OF FEDERAL INCOME TAXATION 588 (15th ed. 2009) (discussing the time value of money).

At some point, the advance will either be repaid or written off, in whole or in part, although from a tax perspective nothing turns on which occurs. If the advance plus the fee were recovered, that amount would be taxed as ordinary income since these investors are in the business of selling money, and the receipts are in the ordinary course of business. Assuming that they had not previously deducted the advance, they could subtract the amount of the advance at that time as, in effect, the cost of the sale of the money advanced. If the proceeds did not equal the advance, there would be a loss on that transaction, which would be combined with the other transactions, as well as overhead and other expenses and income in that year, to determine taxable income. The fact that the anticipated fee was not recovered would have no effect on taxable income because there was no “cost” for it and hence nothing to offset.

The final question is whether there is a possibility that the transaction could receive capital gains treatment because the advance is a capital asset under I.R.C. § 1221, assuming that the advance meets the holding period requirements in § 1222. Regardless of whether the advance is considered a loan or a sale of money for tax purposes, the first exception in the definition in § 1221 would seem to preclude capital asset treatment because it applies to:

- (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

That conclusion is reinforced by the broad construction given the term “inventory” in *Corn Products Refining Co. v. Commissioner*,¹⁸ as interpreted in *Arkansas Best Corp. v. Commissioner*.¹⁹ Thus, for ALF investors in personal injury transactions, ordinary income treatment for their profits and losses is compelled.

¹⁸ 350 U.S. 46 (1955).

¹⁹ 485 U.S. 212, 222 (1988).

COMMERCIAL ALF TRANSACTIONS

In the personal injury ALF situation, there is no likely tension between the parties on how the transaction should be treated for tax purposes. Neither one has a reason to seek a tax benefit for that party by structuring the transaction or by taking a position that would, if accepted by the IRS, produce a less favorable tax treatment for the other. As explained below, the possibility of some tension, not unusual in commercial transactions, is more likely in the commercial ALF situation. Moreover, there are more structural options for these transactions, with some producing more favorable tax consequences for one party or the other. At the very least, the choice of the form of the transaction may become the subject of bargaining because one party seeks to obtain a tax or other advantage not directly related to the price charged for the advance.

It is impossible to know the tax goals of all commercial ALF transactions, but it seems a reasonable assumption that the investor would very much want to structure the deal in a way that produced a gain that was taxable at capital gains rates. If Chapter C of Title 26 governs the corporation, it is not eligible for favorable capital gains treatment and its losses are capital losses.²⁰ For this reason, it is likely that the “investor” will be organized as a partnership or a subchapter S corporation so that the income is taxable only for the individuals whose money funds the investor.²¹ That would probably mean that losses would be capital, not ordinary losses, but since most investors expect to make a profit, they have to be willing to accept that consequence as well. For these purposes, we assume that the requisite holding periods have been satisfied, although in the real world that may affect how a particular deal is done. It is less clear what the recipients—which are probably all corporations—would like, and/or what is even possible for them to expect from a tax perspective. Because the investors have the most at stake on the tax side, this discussion will begin with them and ask whether it is possible for them to make their

²⁰ See I.R.C. §§ 1(h), 1201(a); see also § 1211(a) (capital losses are only allowed to the extent of capital gains).

²¹ See I.R.C. §§ 1361(b)(3)(A)(i)–(iii), 1363(a)–(b) (stating business profits of an S corporation are taxed only once, at the shareholder level, rather than receiving double-taxation at both the corporate and shareholder levels, thereby providing preferential capital gains [or loss] treatment); I.R.C. § 701.

profit a capital gain, and if so how that might happen and with what impact on the recipient.

Simple Direct Investments

Before embarking on the quest for capital gains, it may be useful to examine how the tax aspects of a commercial ALF transaction might look if both the investor and the recipient company were willing to have any gains treated as ordinary income. In that case, the transaction would be seen like the typical personal injury ALF transaction, as the sale of money for a profit, on a non-recourse basis. Thus, money would be advanced, either all at once or in segments, and the recipient could use it for litigation expenses including hiring attorneys. In that situation, it would be treated like a loan from the investor's perspective, but one that presents no usury problems because of the large amounts involved, and because the money is advanced to a corporation. However, the investor could not obtain an immediate deduction for the litigation expenses for which the money was being used, but the recipient could, assuming that the use to which the money was put is an otherwise deductible expense, as the costs of litigation generally are for a business and did not have to be capitalized.

The next issue is whether the recipient would have to take the advances into income at the time of receipt. If the advance were a full recourse loan, it would not be income. But under ALF, because the recipient has no obligation to repay the non-recourse advance from its assets other than the lawsuit, it may well have to include the advance as income when received. Because the advance is an anticipatory payment on a claim that is still in litigation that would, if successful, result in the realization of income, the receipt of an advance should be treated the same way. Thus, coupling the receipt of the advance with the incurring of deductible litigation expenses seems the proper way to treat these advances for tax purposes by the recipient.

When the case is over, the amount paid to the investor, minus the amount advanced, would be the profit (or loss), taxable as ordinary income to the investor, with the remainder payable to the recipient company as the net proceeds from its claim. Because the recipient is a business and the amount paid to the investor is business-related, there is no question that all those costs and payments are proper reductions in the recipient's income, unlike the potential problem that an employee might have in a suit against the employer noted above. If for any reason the recipient did not include the

advance(s) as income when received, they would have to be included when the case was concluded. As either proceeds of litigation, or an advance on such proceeds, the character of that income to the recipient would remain unchanged, which would be ordinary income—unless, for example, the lawsuit was over the price to be paid for the sale of a capital asset, in which case the proceeds might be treated as a capital gain and not ordinary income.

Seeking Immediate Deductions for the Investor

Another possible approach might enable the investor to obtain immediate deductions for the amounts used for attorneys' fees and other litigation expenses. The parties would agree that the investor itself would pay all such expenses (or an agreed amount for agreed purposes, up to a ceiling). The investor would then seek to deduct those expenses when paid as those of the enterprise in which the investor and the recipient are engaged. Under that approach a deduction for the investor would arguably be proper because the money has been expended and there is no absolute right to repayment, which can come only from the proceeds of the litigation. The agreement could provide that only the investor can claim the deductions for the litigation expenses.

That approach has some risk for both recipient and investor. For example, the deductions for the investor could be denied on the basis that they were not the expenses of the investor, but of someone else (the recipient) and that the IRS is not bound by any contrary agreement.²² And if the recipient did not take the deductions because of the agreement, and the IRS denied them to the investor, it might be too late for the recipient to claim them, resulting in the worst of results for both. There is also the possibility that the advance (even in the form of payment of expenses to third parties by the investor) would be treated as income to the recipient, perhaps even with no deduction for the expenses that were paid by the investor. Or, somewhat more likely, the attempt to obtain the deductions would be denied on the ground that the advances were either a loan (despite the non-recourse nature) or a capital investment that is subtracted from the

²² See *Welch v. Helvering*, 290 U.S. 111 (1933).

eventual proceeds to determine the proper amount of the taxable gain. But having tried to deduct the expenses on the front end would make it harder to convince the IRS on the back end that the gain was based on a sale or disposition of a capital asset, rather than ordinary income from a business in which the investor and the recipient were both involved.

*Seeking Capital Gains Treatment*²³

The previous alternatives present some uncertainties, and they do not have the potential upside to the investor of having its profit treated as a long-term capital gain. One way for the investor to obtain capital gains treatment is to purchase newly issued stock from the recipient company in exchange for the agreed upon advance(s). However, that approach has two problems for the investor: first, the investor's fate is tied to the entirety of the recipient's business, while the investor is interested only in the lawsuit on which it has done due diligence. In addition, a buyer for the stock would have to be found when the investor wanted to sell, and that may not be feasible, especially if the recipient company's stock is not publicly traded.

An alternative might be to form a new corporation into which the claim that is the basis of the litigation is transferred by the recipient, and the funds to litigate the case are provided by the investor, under an agreed upon formula. If the claim were, for example, one for patent infringement, the patent could be assigned to the new corporation, which would then be the plaintiff in the litigation, perhaps licensing the patent back to the donor-recipient for limited uses. Or if there were a contract claim in dispute, the remaining rights under the contract might (depending on the contract) be assignable to the new corporation. However, if the claim were based in whole or in part on the antitrust laws, the concept of the transfer of those rights does not seem to fit into that model, not to mention the potential for legal problems in the litigation resulting from that transfer. Such transfers by the recipient may also cause problems with its ongoing business, which might include having a board and officers who would manage the new corporation that owned the claim (on an arm's-length basis), with the recipient and the investor, now co-shareholders. Depending on the nature of

²³ Whether capital gains treatment can be obtained under §§ 1221 and 1222 by creation of a partnership, subject to the requirements of I.R.C. §§ 701-709, is beyond the scope of this article.

the claim and its relation to the ongoing business of the recipient, such transfers may appear too artificial, with no reason for the transfer other than the hope of obtaining favorable tax treatment, and as such might be vulnerable under § 269(a) if the IRS concludes that “the principal purpose . . . is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy.”

Another approach is for the commercial ALF investor to buy a portion of the claim from the recipient in the same way that the investor could purchase a portion of other assets, such as real estate, an ongoing business, a loan, or a business’s accounts receivable, again with no recourse to the recipient’s general assets. The Supreme Court has recognized that in litigation “the income-generating asset is the cause of action that derives from the plaintiff’s legal injury.”²⁴ And in many cases it has held that a claim for money damages is a species of property that is protected by the Due Process Clause.²⁵ Thus, it is unlikely that as a matter of state law there would be any problem with the purchase itself. From a state law perspective, the purchase does not appear to differ significantly from a loan that is purchased from a third party and that is secured only by a claim that a debtor holds, especially if the debtor has no other assets. Under this approach, when the case is resolved, the investor would be able to treat the difference between the purchase price of the asset investment, and what the asset is worth at that time as a capital gain.

There are several potential barriers to achieving that goal. First, the investor must establish that buying and selling claims is not its regular business, like personal injury ALF investors, in which case it would be treated like inventory²⁶ or as “accounts or notes receivable acquired in the ordinary course of trade or business for services rendered.”²⁷ Second, in most cases where there is a capital gain, there is a “sale” of an asset, but that is not how investors usually collect on ALF transactions. On the other

²⁴ *Comm’r v. Banks*, 543 U.S. 426, 435 (2005).

²⁵ *See, e.g., Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 811–12 (1985).

²⁶ *See supra* note 14.

²⁷ I.R.C. § 1221(a)(4).

hand, redemption by the recipient, which this would be, may be enough because § 1222 provides for capital gains treatment for capital assets (as defined in § 1221) when there is an “exchange” as well as a sale. If the investor sold its rights to a third party the date before the recipient collected its judgment, that would qualify for capital gains treatment assuming the other requirements were met. Therefore, it should not matter for capital gains purposes whether the recipient or a third party gave the investor the money.

Another problem for the investor is that the IRS may contend that the transaction is in effect a loan, with a high rate of interest to reflect the risk of non-payment, and thus is not a capital asset. In that connection, the IRS might contend that, even though the agreement calls for the recipient to pay the investor a certain percentage of the recovery rather than a fee stated as a percentage of the advance and/or tied to the time until repayment, that is of no consequence. If that position were sustained, the investor would receive interest income that would be taxable at ordinary rates.²⁸

If the investor contends that it is a partial owner of the claim, the IRS may inquire into whether the investor acted like an owner, which would (or might) include substantial involvement in the management of the asset, here the litigation to realize on the claim.²⁹ This ownership aspect is likely to be of greater significance if the investor’s share of the recovery is substantial—perhaps a third or more—on the theory that a real owner would want some measure of participation in the key decisions regarding the lawsuit. Those might include deciding the law firm to be retained, supervising the firm’s conduct of the litigation and reviewing its bills, participating in key decisions, and having a formal role in settlement discussions. A related consideration may be whether the investor or the recipient pays the lawyers and other costs of litigation. If the investor wishes to have the transaction treated like a purchase of the claim as a capital asset, it is more likely to achieve that goal if the purchase price is paid to the recipient (or an entity created to manage the litigation), either at the start, or perhaps on agreed upon conditions in the future. Once the

²⁸ See also *supra* note 16 as to the possible applicability of the regulations on contingent payment debt instruments.

²⁹ *But see Banks*, 490 U.S. at 436–37 (rejecting the argument that the lawyer and client were co-owners of the claim; instead they were in an agent-principal relationship).

money is paid to the recipient, even if it is limited by contract in how it can be used, the recipient will pay the bills and obtain the tax deductions, but that should make the transaction more sustainable as a purchase than if the investor paid the bills, especially where the recipient claimed the deductions for those payments.

One risk is that the investments will be treated as being made in “property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business,”³⁰ and thereby become ineligible for capital gains treatment. A possible way around that would be for the investor to set up a separate corporation for each lawsuit. That approach may also be advisable where different investors have different views about the strengths and weaknesses of different claims, or where the time horizons for the case may influence whether an investor wishes to invest in a particular claim. The investors would supply the corporation’s capital, and it would be used to invest in a single claim. When the case was resolved, the corporation would be liquidated, and the investors would seek capital gains treatment for their investments.³¹

There is one feature of commercial ALF investing on which we have not focused to this point, but which raises particular issues if a separate corporation were used for each investment. Unlike personal injury ALF investing, where the amounts are small and the business model assumes a large number of essentially identical transactions (with the only variables being the amount advanced and the “price” charged), commercial ALF investors turn down the vast majority of requests, and they spend large amounts—sometimes in excess of \$1 million—on due diligence investigating all aspects of a claim that is being considered for an investment. There are also other costs, such as raising money to be invested, as well as general overhead not related to specific claims. Those expenses could probably be treated as investment costs and added to the purchase price, but that would mean that they were not deductible when incurred, like the advance paid to the recipient. In addition, in the model of

³⁰ I.R.C. § 1221(a)(1).

³¹ With a small number of investors, the corporation would qualify under subchapter S, and so there would be no tax at the corporate level and the only income would be from the proceeds of the claim.

a single corporation for a single investment, the investor would be more likely to want to be sure that those costs are able to be deducted by someone, at some time, as business expenses, or be added to the basis of the investment (the advance). In either case, there would be difficulties in determining to which purchases (advances) those expenses should be attributed. The problem is especially knotty for the costs of investigations that did not result in an investment, from both a tax perspective and in terms of treating all individual investors fairly.

There is a related inquiry that might bear on whether some commercial ALF transactions can produce capital gains treatment for the investor. Because the payment of interest by a corporation is deductible from its income, whereas the payment of dividends is not, the IRS seeks in some cases to establish that what the taxpayer characterizes as a loan is in reality a capital investment.³² In the ALF situation, the IRS might argue that the advances are loans and not capital investments because the only payment is at the end, and because the taxpayer-recipient will likely be indifferent to the treatment, provided that it is able to avoid counting as income the amount that it pays to the investor as its share of the proceeds. As *Mixon* makes clear, the debt versus equity dispute is complicated and fact-dependent, and seems to arise most often when the investment is made by a substantial stockholder and/or officer of the corporation, which is not the case here. The inquiry arises in different contexts than the usual ordinary income versus capital gains setting, but it cannot be ruled out in this area, which has no set guidelines to date.

The ultimate question in the quest of ALF investors for capital gains treatment may depend on the answer to the question whether there is any way to transform ordinary income into capital gains in this situation. As noted above, the recipient must report the proceeds of the litigation as ordinary income, except perhaps where the dispute relates to the sale of what was originally a capital asset. As *Commissioner v. Gillette Motor Transport, Inc.*,³³ makes clear, the proceeds of a claim retain the character of the income on which the claim was based for purposes of determining capital gains treatment. In that case, a claim for temporary taking for lost

³² See, e.g., *In re Estate of Mixon v. United States*, 464 F.2d.394, 397 (5th Cir. 1972).

³³ 364 U.S. 130 (1960).

rental income retained its ordinary income status. Accordingly, there is no basis for the recipient to gain more favorable treatment for its part in the claim resolution just because there was an ALF investment than if it had litigated the claim on its own. For these reasons, the most basic objection to providing capital gains treatment for the investor is that there is no reason why the character of the income arising from a successful claim should vary as between the recipient and the investor. Put another way, how can the making of an advance, and collecting on that in the future, transform ordinary income into capital gains, other than by some form of alchemy?

That argument has some intuitive appeal, but it cannot be taken too far. For example, an inventor can license his invention and be paid royalties that produce ordinary income. Or he can transfer it to a corporation that will develop it, and in exchange receive stock in the company. If the principal asset of the company is the patent, including royalties that it will receive from licensing it, that would not prevent the inventor from obtaining capital gains treatment on the sale of stock in the company. Indeed, the value of many assets and even ongoing businesses is their ability to produce ordinary income, yet their stock can be bought and sold to produce capital gains in many situations. The question here is whether an ALF investment is more like those latter transactions, or more like an assignment of income (here proceeds from a litigation) in which the income retains the same status in the hands of the investor as it does for the recipient. On these questions, investors seeking capital gains treatment for their ALF profits may encounter real problems because of the definition of capital asset when held by a business, in particular, the observation by the Supreme Court that section “1221 ‘property’ does not include claims or rights to ordinary income.”³⁴

FINAL OBSERVATIONS

Regrettably, there are no clear answers to many of the questions presented. Part of that is because some ALF transactions have significant differences from other seemingly similar ALF transactions, and it is unclear whether the differences will be found to be more significant than their

³⁴ *Arkansas Best Corp. v. Comm’r*, 485 U.S. 212, 217 n.5 (1988).

similarities. Another reason for the uncertainty, especially for commercial ALF transactions, is that the precise structures of these deals are generally not public and, as far as we can determine, they do not follow a single model. Indeed, we are largely surmising the tax treatment that the investors and recipients are seeking. And as far as we have been able to determine, the IRS has not weighed in with its views on the tax treatment of either kind of ALF transaction. Our hope is that this article will start a further discussion of these issues that are, or should be, of significant concern to ALF investors and, at least in the commercial area, to ALF recipients.

Our final thought is hardly a novel one in the tax field. The time to think about taxes is before the contract is signed and the transaction's structure is locked in place. In this context, that should mean that both investors and recipients need to think through their tax, as well as business objectives to assure compatibility with both. In all likelihood, how a transaction is structured, both in terms of formal entities created and which party will have which duties and obligations as the litigation proceeds, may affect the tax treatment of the various aspects of the transaction. But focusing solely on taxes may result in less financial protection to one party or the other in the operational aspect of the investment, and perhaps even less or no profit for the investor. And because the tax goals of the two parties may present conflicts, not only in which party takes which tax positions, but in how the transaction is to be structured, the tax issues need to be addressed early on and then revisited as the deal moves forward toward an agreement.

ADDENDUM

1. *Alternative Litigation Funding Conference: A Roundtable Discussion Among Experts*, GEORGE WASHINGTON UNIVERSITY LAW SCHOOL (May 2, 2012), <http://www.law.gwu.edu/News/20112012events/Pages/AlternativeLitigation.aspx> (includes video, conference summary, and submissions of participants).

2. Am. Bar Assoc. Comm'n on Ethics 20/20, *Informational Report to the House of Delegates*, A.B.A. (Feb. 2012), http://www.americanbar.org/content/dam/aba/administrative/ethics_2020/20111212_ethics_20_20_alf_white_paper_final_hod_informational_report.authcheckdam.pdf.

3. Steven Garber, *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns*, RAND INST. FOR CIV. JUST. (2010), http://www.rand.org/content/dam/rand/pubs/occasional_papers/2010/RAND_OP306.pdf.

4. U.S. Chamber Institute for Legal Reform, *Lawsuit Lending*, <http://www.instituteforlegalreform.com/issues/lawsuit-lending>.

5. BURFORD CAPITAL, <http://www.burfordcapital.com/> (website for one of the leading commercial investors).