Taxing Litigation Finance

*Young Ran (Christine) Kim**

Abstract

The emerging litigation finance industry has the capacity to expand access to justice but also raises important legal and ethical questions. Although much has been said about the industry's potential to increase frivolous lawsuits and permit improper control over a claim by the funders, scholarly discussion on the proper tax treatment of the parties involved has fallen by the wayside.

The problem arises in classifying litigation finance contracts as either a nonrecourse loan, immediate sale, or variable prepaid forward contract, all of which discretely impact the timing and character of income. Unfortunately, courts have traditionally found it difficult to draw clear distinctions between these three categories for tax purposes, and the opaque industry combined with the complexity of the transaction enhances the confusion. The consequences are tax uncertainty and an opportunity for taxpayers to engage in aggressive tax planning by structuring transactions to obtain favorable tax treatment without altering their economic position.

This Article proposes a customized, multifactor analysis to identify the true nature of litigation finance transactions and impose proper tax treatment. The bedrock of the proposal is the concept of tax ownership, which in the litigation finance context can be streamlined into two key factors: economic risk and legal control of the claim. Emphasizing the legal control factor may address the agency problems inherent in litigation finance. As the industry develops, this Article calls on tax policymakers and regulators to reduce the current tax uncertainty by integrating this multifactor analysis when issuing future guidance and imposing disclosure obligations.

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INTRODUCTION

Burford Capital, a publicly traded litigation finance firm that invested $16.6 million to fund litigation against the government of Argentina, is currently poised to realize a 37,000% return on investment after the case resulted in a favorable $16 billion award.[1] With headlines

[1] Bob Van Voris & Emily Siegel, *Burford Eyes 37,000% Return in $16 Billion Argentina Award*, BLOOMBERG L. (Sept. 11, 2023, 4:37 PM), https://news.bloomberglaw.com/us-law-week/burford-eyes-37-000-return-in-16-billion-win-over-argentina [https://perma.cc/6K63-NKD5]; *see also* Jonathan Stempel, *Argentina Will Not Face $16.1 Billion YPF Judgment in US While It Appeals*, REUTERS (Nov. 21, 2023, 7:34 PM), https://www.reuters.com/legal/

showing astronomical returns and hundreds of billions of dollars spent on legal claims worldwide,[2] it is unsurprising that the topic of litigation finance has taken the legal community by storm.[3]

Third-party litigation financing is not a new concept. In the past, funding litigation for profit was largely prohibited under the common law doctrines of champerty, maintenance, and barratry.[4] However, a movement away from such doctrines began in the 1990s and spread to the United States following the 2008 financial crisis, paving the way for the growth of a billion-dollar industry.[5] A 2020 study found that third parties funded approximately thirteen percent of the dollar value of all United States lawsuits.[6]

Such a rapidly expanding market comes with various legal uncertainties. Perhaps the most highlighted issue is the agency problems that stem from the conflicting goals, risk profiles, and fiduciary duties of beneficiaries and funders.[7] Such conflicts profoundly impact the party's desire to settle or move forward with a case, raising concerns that funders might improperly influence the legal claim.[8]

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argentina-will-not-face-161-billion-ypf-judgment-us-while-it-appeals-2023-11-22/ [https://perma.cc/5YVX-DKDX] (reporting the suspension of the judgment while Argentina appeals the decision).

2 *See* Thomas Healey, Michael B. McDonald & Thea S. Haley, *Litigation Finance Investing: Alternative Investment Returns in the Presence of Information Asymmetry*, J. Alt. Invs., Spring 2022, at 110, 115–16 (identifying Burford Capital's growth in both revenue and geographic reach); *see also* Jarrett Lewis, *Third-Party Litigation Funding: A Boon or Bane to the Progress of Civil Justice?*, 33 Geo. J. Legal Ethics 687, 687–88 (2020) (discussing how the litigation finance industry moderates the high costs of litigation).

3 *See* Press Release, Burford Cap., Litigation Finance Growing Rapidly, New Burford Capital Research Shows (Oct. 17, 2018), https://investors.burfordcapital.com/news/news-details/2018/Litigation-finance-growing-rapidly-new-Burford-Capital-research-shows/ [https://perma.cc/4Z-CL-2P22] (showing that more than two-thirds of the legal community surveyed are aware of litigation finance's importance); *see also* Dan Packel, *Posner Casts Lot with Litigation Funding Underdog Legalist*, Am. Law. (June 20, 2019, 3:40 PM), https://www.law.com/americanlawyer/2019/06/20/posner-casts-lot-with-litigation-funding-underdog-legalist/ [https://perma.cc/B9KP-SRHY] (reporting that a retired Seventh Circuit judge started serving as an adviser to a start-up litigation finance firm).

4 U.S. Gov't Accountability Off., GAO-23-105210, Third-Party Litigation Financing: Market Characteristics, Data, and Trends 4 (2022); *A Brief History of Litigation Finance*, Practice, Sept.–Oct. 2019, https://clp.law.harvard.edu/knowledge-hub/magazine/issues/litigation-finance/a-brief-history-of-litigation-finance/ [https://perma.cc/D6RD-X2VU].

5 *See* Healey et al., *supra* note 2, at 110.

6 *Id.* at 117.

7 *See* Maya Steinitz, *Whose Claim Is This Anyway? Third-Party Litigation Funding*, 95 Minn. L. Rev. 1268, 1323–25 (2011) [hereinafter Steinitz, *Whose Claim*]; Maya Steinitz, *The Litigation Finance Contract*, 54 Wm. & Mary L. Rev. 455, 480 (2012) [hereinafter Steinitz, *Contract*].

8 Letter from Jerry Theodorou, Dir., Fin., Ins. & Trade, R St. Inst., to James Comer, Chairman, House Comm. on Oversight & Accountability, & Jamie Raskin, Ranking Member, House Comm. on Oversight & Accountability (Sept. 13, 2023), https://www.rstreet.org/outreach/statement-for-the-record-hearing-on-unsuitable-litigation-oversight-of-third-party-litigation-funding/ [https://perma.cc/S4HR-GZSS].

An understudied yet important issue is the taxation of litigation finance arrangements. In a typical litigation finance agreement, a funder provides cash to a beneficiary—e.g., a lawyer or a litigant—for a share of the contingent fee or litigation proceeds.[9] From a tax perspective, it is unclear whether the upfront payments received by the beneficiary are income, and thus, whether the beneficiary is liable to pay tax.[10] Furthermore, the funder's right to payment is nonrecourse when the case concludes.[11] The funder gets nothing if the beneficiary does not settle or win the case.[12] If the litigation succeeds, the funder receives returns based on formulas ranging from a fixed percentage of the proceeds to complex waterfalls.[13] It may be undisputed that the litigation proceeds divided between the beneficiary and the funder in a successful scenario should be taxed, but when and how it should be taxed is far from certain. It is also unclear how to deduct losses in an unsuccessful case.[14]

As such, litigation finance raises various tax questions regarding the timing and character of any gain or loss recognized from the transaction. The answers hinge on the nature of the agreement—namely, whether it qualifies as a loan, sale, or variable prepaid forward contract ("VPFC").[15] Consider an example. Ben is a plaintiff of a tort claim for $1 million in court. Ben thinks his chance of success is high, but he does not have enough money to proceed with the claim. To finance the litigation, Ben enters into a litigation finance agreement with a funder, L Capital, who immediately funds $30,000 of Ben's litigation costs. If Ben wins, settles, or, for whatever reason, earns money from the litigation, he pays L Capital 30% of the proceeds. Thus, L Capital will receive $300,000—a 900% return on investment—if Ben wins the entire $1 million in a successful lawsuit. In contrast, L Capital receives nothing if Ben loses the case.

In this example, three ways exist to classify the nature of the litigation finance agreement. The first method is to treat the contract as a nonrecourse loan, which imposes no personal liability on the borrower.[16] Instead, the debtor's obligation to repay is secured by collateral—the

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9 *See* Jeffrey James Grosholz, *In the Shadows: Third-Party Litigation Funding Agreements and the Effect Their Nondisclosure Has on Civil Trials*, 47 FLA. ST. U. L. REV. 481, 483 (2020); *see also* Victoria A. Shannon, *Harmonizing Third-Party Litigation Funding Regulation*, 36 CARDOZO L. REV. 861, 863 (2015) (noting that a funder usually receives a percentage of case proceeds as payment when the litigant is a plaintiff and usually receives predetermined periodic payments when the litigant is a defendant).

10 *See infra* Part II.

11 *See* Maya Steinitz & Abigail C. Field, *A Model Litigation Finance Contract*, 99 IOWA L. REV. 711, 713 (2014).

12 *See* Healey et al., *supra* note 2, at 111.

13 *See, e.g.*, *infra* Appendix Table 2 (providing examples of waterfall return structures).

14 *See infra* Section II.C.2.b.

15 *See infra* Table 1.

16 Daniel N. Shaviro, *Risk and Accrual: The Tax Treatment of Nonrecourse Debt*, 44 TAX L. REV. 401, 404 (1989).

value of the claim.[17] Although the $30,000 funding amount increases Ben's consumption power, it is not Ben's income for tax purposes because he has an obligation to repay that amount in the future. If Ben wins the case, he recognizes $1 million of income but can claim an interest deduction for $270,000—as $30,000 is considered payment of principal—and L Capital recognizes $270,000 of interest income subject to ordinary tax rates.[18]

The second way is to treat the contract as though Ben sold 30% of his interest in the claim to L Capital, resulting in surprisingly different tax consequences. Ben must report and pay taxes on $30,000 of income at the outset.[19] Worse, such income is likely to be ordinary, meaning Ben cannot enjoy preferential tax rates for capital gains.[20] If the case is successful, Ben cannot claim interest deductions. However, L Capital recognizes capital gains for the litigation proceeds and enjoys preferential tax rates.[21]

Finally, a more curious case is to treat the contract as a VPFC. Like a straightforward sale, Ben promises to sell a 30% interest in the claim to L Capital in exchange for $30,000 of immediate funds. The sale, however, takes the form of a forward contract, which postpones the execution of the sale until the litigation concludes sometime in the future.[22] Current tax rules consider forward contracts open transactions and allow taxpayers to defer any tax consequences until the contract is closed.[23] Therefore, Ben does not include the $30,000 of immediate funding as income upon receipt but rather upon resolution of the case. If the case is successful, Ben realizes $30,000 of income, and L Capital realizes $270,000 of capital gains after deducting its $30,000 of funding as the cost or basis of the investment.[24]

In all three cases, L Capital's and Ben's economic positions are almost identical, extending $30,000 of funds upfront and repaying 30% of the litigation proceeds if the litigation is successful. However, the tax consequences for each party are distinct. First, if the contract is a loan, the beneficiary does not pay tax until the receipt of litigation proceeds, if any, and may offset that income with interest payment deductions.[25] However, a loan is less forgiving to the funder because any interest

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17 *See id.*

18 *See infra* Section II.B. In addition, L Capital could be required to accrue income before receiving cash under the original issue discount rules. *See infra* Section II.B.

19 *See infra* Section II.C.1.

20 *See infra* Section II.C.2.a.

21 Whether L Capital claims capital losses for the initial funding amount of $30,000 is not clear. *See infra* Section II.C.2.a.

22 *See infra* Section II.D.1.

23 *See infra* Section II.D.1.

24 *See infra* Section II.D.

25 *See infra* Section II.B.

income it receives is subject to ordinary tax rates instead of preferential capital gains tax rates.[26] Hence, the funders may have a strong desire to avoid debt treatment for tax purposes. Second, if the contract is a sale, the funder may enjoy a preferential capital gains rate, but the beneficiary recognizes income for the initial funding amount at the outset.[27] Hence, the beneficiaries may desire to avoid a sale treatment for tax purposes. Third, if the contract is a VPFC, it may be a win-win for all parties involved because it provides the beneficiary with a deferral of income and the funder with a capital gain.[28] Thus, it is unsurprising that many litigation finance agreements are labeled VPFCs.[29] Nevertheless, whether the tax authority will respect the parties' intentions is unclear, as many derivatives transactions are notorious for altering the form of a transaction to obtain more favorable tax results while being economically equivalent to the original transaction.[30]

Unfortunately, there are many unanswered doctrinal questions for each of the three categories relating to when, how much, and whose income should be taxed for each party. Examples include the applicability of the original issue discount ("OID") rules[31] and I.R.C. § 1234.[32] Aside from a largely unhelpful 2015 memorandum,[33] the Internal Revenue Service ("IRS") has provided no clarity on the topic. Nevertheless, there are conflicting incentives between taxpayers who want to structure litigation financing in a tax-favorable way and tax authorities willing to recharacterize such transactions if substance departs from form. The result is a lack of clarity regarding the tax consequences for the parties involved and increased anxiety in the industry.

Moreover, whether to categorize a litigation finance agreement as a loan, sale, or VPFC for tax purposes posits a normative question. Such classification significantly impacts the tax consequences on both sides of the transaction, but unfortunately these agreements do not always fit cleanly into one box.[34] Courts have traditionally found it difficult to draw a clear line between these categories.[35] The only modern case to address this issue is *Novoselsky v. Commissioner*,[36] which held that a

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26 *See infra* Section II.B.

27 *See infra* Section II.C.

28 *See infra* Section II.D.

29 *See* Robert W. Wood & Jonathan Van Loo, *Investors Who Fund Lawsuits: Form and Tax Treatment*, 141 Tax Notes 1239, 1240 (2013).

30 *See generally* U.S. Gov't Accountability Off., GAO-11-750, Financial Derivatives: Disparate Tax Treatment and Information Gaps Create Uncertainty and Potential Abuse (2011) (offering an overview of tax uncertainties in derivatives transactions).

31 *See infra* Section II.B.2.a.

32 *See infra* Section II.C.2.b.

33 I.R.S. Gen. Couns. Mem. 20154701F (Nov. 20, 2015) [hereinafter 2015 Memorandum].

34 *See infra* Part II.

35 *See infra* Section III.A.

36 119 T.C.M. (CCH) 1474 (2020).

litigation finance transaction was not a loan but a sale primarily because the beneficiary had a "conditional obligation to repay."[37] This Article disagrees with the court's rationale.[38] Whether the beneficiary has an unconditional obligation to repay should not be a dispositive factor in determining whether a litigation finance agreement qualifies as a loan or sale because litigation finance, an area in which the repayment depends on the result of the litigation, is inherently nonrecourse. Nonrecourse debtors arguably lack the unconditional obligation to repay given that these debtors have no personal liability.[39] Nevertheless, current law treats nonrecourse loans as true debt,[40] meaning that the criteria of an unconditional obligation to repay is ineffective in distinguishing whether a transaction is a loan.[41] Instead, this Article proposes a novel test focusing on the key tenets of tax ownership.

This Article proposes that the best way to identify whether litigation finance transactions qualify as a loan, sale, or VPFC is to apply a customized, multifactor analysis centered around the concept of tax ownership.[42] Ownership for tax purposes is distinct from ownership under property or contract law, as it looks beyond mere form to the economic substance of the transaction to identify who must bear the tax burdens and reap the tax benefits with respect to property.[43] Tax ownership is essential in determining tax consequences of complex transactions, such as securities loans, sale and leasebacks, total return equity swaps, contingent payment debt instruments, forward and futures contracts, structured finance products, and so on.[44] Yet, despite its importance, the concept of tax ownership is notoriously convoluted.[45] Neither Congress nor the IRS has provided taxpayers with a clear formula for identifying tax ownership.[46] Rather, courts have been left to develop their own methods, resulting in a complex "patchwork of rules that appear to lack a unifying principle (or set of

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37 *Id.* at *16 (quoting Taylor v. Comm'r, 27 T.C. 361, 368 (1956)).

38 *See infra* Section III.A.

39 *See* Shaviro, *supra* note 16, at 404.

40 *See* Crane v. Comm'r, 331 U.S. 1, 11, 14 (1947).

41 *See infra* Section III.A.

42 *See infra* Section III.C.

43 *See* Michael J. Graetz & Anne L. Alstott, Federal Income Taxation: Principles and Policies 754 (9th ed. 2022) (discussing economic substance doctrine); David S. Miller, *Taxpayers' Ability to Avoid Tax Ownership: Current Law and Future Prospects*, 51 Tax Law. 279, 290 (1998) (demonstrating differences between economic ownership and tax ownership in the context of securities loans); Noël B. Cunningham & Deborah H. Schenk, *Taxation Without Realization: A "Revolutionary" Approach to Ownership*, 47 Tax L. Rev. 725, 725 (1992) (identifying how property ownership produces tax consequences); Daniel Shaviro, *Risk-Based Rules and the Taxation of Capital Income*, 50 Tax L. Rev. 643, 644–45 (1995).

44 *See* Miller, *supra* note 43, at 290–313, 330 (1998) (discussing tax ownership's impact on the listed various financial transactions).

45 Alex Raskolnikov, *Contextual Analysis of Tax Ownership*, 85 B.U. L. Rev. 431, 432 (2005).

46 *Id.*

principles)."[47] To be fair, any comprehensive answer to the question of tax ownership is not likely to be simple, as the complexity of modern transactions and the use of innovative financial instruments shun a one-size-fits-all solution.[48] This Article's goal is not to provide such a solution. Instead, it offers a more stylized approach in the narrow context of litigation finance.[49]

This Article asserts two critical factors in identifying tax ownership to determine the true nature of a litigation finance transaction. The first factor is whether the funder bears the economic risk for the transaction. This factor is the less dispositive of the two because the funder almost always bears this burden given the nonrecourse nature of litigation finance arrangements.[50] The second and more important factor is whether the funder has legal control. In litigation finance, legal control comes in two contexts: control over the litigation itself and the ability to freely transfer the rights and obligations with respect to litigation. A funder with legal control over the case strongly suggests that the transaction is an immediate sale, whereas the absence of such indicates that the transaction is either a loan or VPFC. This Article also entertains the idea of incorporating at least one ancillary factor in complex situations—namely, the form of repayment. Simply put, payment structures that reflect the time value of money would represent interest and may indicate a loan.

The application of the proposal is straightforward. If economic exposure and legal control lie with the funder, the transaction is an immediate sale for tax purposes. In contrast, if legal control remains with the beneficiary such that there is no transfer of tax ownership, the transaction will be either a loan or VPFC, depending on the taxpayer's intent. Although respecting the taxpayer's intent feels contrary to the substance over form doctrine,[51] this Article is comfortable taking this approach because when you prove that the beneficiary retains legal control, it is evident that legitimate tax ownership lies with the beneficiary. Because ownership can lie with the beneficiary under either a loan or VPFC, there is no departure from economic substance. If the intent is unclear, the form-of-repayment factor becomes relevant.

The virtue of this proposal is its simplicity and practicality. As alluded to above, the proposal has the potential to become more complex in situations in which ownership lies with the beneficiary, as both loans and VPFCs have this same characteristic. However, rather than complicating the task of classification by adding additional considerations,

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47 *Id.*

48 Cunningham & Schenk, *supra* note 43, at 726 & n.4.

49 *See infra* Section III.B.

50 *See* Healey et al., *supra* note 2, at 111.

51 *See* Graetz & Alstott, *supra* note 43, at 754.

the proposal chooses to respect the form of the transaction. Again, this choice is consistent with the substance over form doctrine, as substance matches both possible forms.[52] Moreover, it keeps the analysis uncomplicated by providing courts and practitioners with much-needed clarity without hindering market growth. Finally, matching tax ownership with the party that exercises control over the claim may resolve, or at least not exacerbate, the agency problems stemming from the fundamentally different objectives of the beneficiary and funder.[53]

This Article makes several contributions. First, it is the only scholarly article to highlight and address the tax uncertainty in the litigation finance industry brought on by the confusing case of *Novoselsky* and the lack of IRS guidance.[54] As the first of its kind, this Article empirically analyzes sample litigation finance contracts in the Appendix to draw a normative proposal with a minimum number of factors that reflect market reality and impose fair tax treatment.[55] The proposal's minimalistic design increases its practicality and avoids hamstringing growth in an industry with the potential to expand access to justice by making litigation more affordable. The hope is that this proposal will also offer insights to tax policymakers in issuing future instructions, such as Treasury Regulations or IRS Guidance.

Second, this Article demonstrates how tax policy can resolve agency problems in litigation finance and enhance transparency and procedural justice in litigation. The proposal emphasizes legal control of the claim in determining tax ownership of a litigation finance contract and urges regulators and courts to include the tax-related factors in the disclosure obligations.[56] This practical and interdisciplinary solution will likely resonate with a broader audience and may influence policymakers outside tax law.

Third, this Article updates tax ownership discourse in the context of litigation finance. The existing tests and proposals for identifying tax ownership are arguably comprehensive but lack simplicity and

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52 *See* Benenson v. Comm'r, 910 F.3d 690, 702 (2018) (explaining that the substance over form doctrine exists to restore the economic reality of transactions and is satisfied once a transaction meets this requirement).

53 *See infra* Section I.B.

54 There have been pieces discussing tax issues of litigation finance, but those are either student notes or practitioners' commentary. *See, e.g.*, John Gamino, *Taxing Nonrecourse Litigation Funding*, 12 ATA J. Legal Tax Rsch. 85, 86 (2014) (a practitioner's comment); Robert Daily, Betting on an Uncertain Future: The Tax Consequences of Large Third-Party Litigation Financing (Jan. 6, 2018) (unpublished manuscript), https://www.fedbar.org/wp-content/uploads/2019/12/FBA-Submission_1-6-18-1-pdf.pdf [https://perma.cc/CRP4-43WJ] (a student paper submitted to a Federal Bar Association writing competition); Sheri P. Adler, Note, *Alternative Litigation Finance and the Usury Challenge: A Multi-Factor Approach*, 34 Cardozo L. Rev. 329 (2012).

55 *See* discussion *infra* Appendix Table 2.

56 *See* discussion *infra* Sections I.B, III.C.

practicality. In *Frank Lyon Co. v. United States*,[57] the Supreme Court outlined twenty-six factors to determine tax ownership.[58] Although lower courts have attempted to simplify the test in *Frank Lyon*, these courts have only offered case-by-case decisions with slightly reduced number of factors, such as the thirteen-factor test in *Stinnett's Pontiac Service, Inc. v. Commissioner*[59] and the eight-factor test in *Grodt & McKay Realty, Inc. v. Commissioner*.[60] After an extensive review of tax ownership case law and literature, this Article distills the excessive number of factors in the context of litigation finance to two primary factors, economic exposure and legal control of the underlying asset, and one auxiliary factor, the format of repayment. In sum, this Article is confident in the proposal's ability to identify the true economic substance of litigation finance transactions while filling the practicality gap in the existing literature of tax ownership.

The remainder of this Article will proceed as follows. Part I introduces the rapidly increasing litigation finance market and emerging legal issues such as agency problems and tax uncertainty. Part II discusses the tax goals of the parties involved and provides a detailed analysis of their tax consequences depending on whether the transaction qualifies as a loan, sale, or VPFC. This Part also organizes many unresolved tax issues in litigation finance, aside from the classification problem, with the author's proposed interpretation or suggestion. Such issues involve advanced doctrinal tax questions that would be helpful for practitioners and market players. Part III introduces the concept of tax ownership and proposes a new standard based on tax ownership analysis that courts and taxpayers can use to determine the nature of litigation finance agreements. This Article concludes that the proposal may improve tax certainty of the emerging litigation finance industry and further help resolve agency problems between the funder and the beneficiary.

I. Primer of Litigation Finance

A. Growing Market

Litigation financing is the nonrecourse funding of litigation by a nonparty for a profit.[61] Broadly speaking, the two parties to the transaction are the beneficiary and the funder. The beneficiary is the person or entity connected to a legal claim, such as a plaintiff, contingent-fee

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57 435 U.S. 561 (1978).

58 *See id.* at 582–83.

59 730 F.2d 634, 638 (11th Cir. 1984).

60 77 T.C. 1221, 1237–38 (1981).

61 Gamino, *supra* note 54, at 86 ("[N]onrecourse litigation funding, also referred to as third-party litigation finance . . . is the business of advancing funds to plaintiffs in civil disputes in exchange for a formulaic share of any cash settlement or resulting judgment.").

lawyer, or law firm.[62] The funder is the nonparty to the litigation that lends money to the beneficiary in exchange for a percentage of the potential claim or legal fees.[63] Most funders are private firms specializing in litigation financing, but there are also a few funders that are either publicly traded companies or small firms with wealthy backers.[64]

The reasons for entering a litigation finance transaction are relatively straightforward. For the beneficiary, litigation financing can make it financially viable to pursue a claim or afford the representation the beneficiary wants.[65] It can also aid in resolving cash flow issues, diversifying the risk that accompanies litigation, and analyzing the strengths and weaknesses of a claim.[66]

From the funder's point of view, litigation financing offers considerably high rates of return. Data suggests that litigation financing boasts greater returns than more traditional investments.[67] Additionally, legal claims are not correlated with markets, nor are legal claims directly tied to changes in monetary policy or economic conditions.[68] Of course, the corollary to these benefits is a significant amount of risk for the funder. Given the nonrecourse nature of the agreement, a funder will lose all money invested in an unsuccessful claim.[69] Moreover, litigation is notoriously protracted and unpredictable, and funders likely lack complete information at the time of investing despite conducting due diligence.[70] Nevertheless, firms can mitigate this risk by taking steps such as grouping legal claims or having timed rounds of funding.[71]

The potential market for the litigation finance industry is substantial. In 2018, an estimated $400 billion was spent on legal claims worldwide, with the United States representing the lion's share.[72]

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62 Daily, *supra* note 54, at 2.

63 *See id.*; Gamino, *supra* note 54, at 86.

64 U.S. Gov't Accountability Off., *supra* note 4, at 6.

65 *See id*. at 18–19; Andrew A. Stulce & Jonathan D. Parente, *Demystifying the Litigation Funding Process*, Bloomberg L. (June 16, 2021, 4:00 AM), https://news.bloomberglaw.com/us-law-week/demystifying-the-litigation-funding-process [https://perma.cc/J4ES-VZWY].

66 U.S. Gov't Accountability Off., *supra* note 4, at 19.

67 *Id*. at 22 ("[I]n 2021, one commercial funder reported a 93 percent return on invested capital on concluded assets since inception in one of its portfolios. Another commercial funder reported a 91 percent return on invested capital on completed investments in two of its funds since 2017." (footnote omitted)).

68 *Id.* ("According to eight funders and two stakeholders we interviewed, [third-party litigation financing] has become an attractive market for investors because returns are uncorrelated to the price movements of other investments, such as stocks, bonds, and commodities.").

69 *Id.*

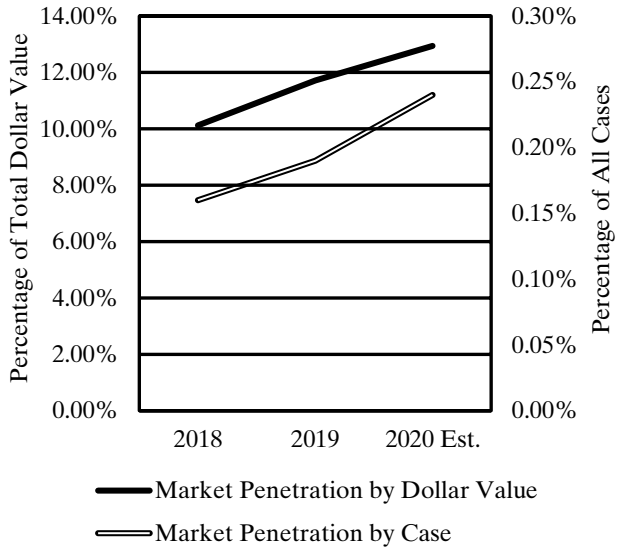
70 *Id.* at 22–23.

71 *See* Maya Steinitz, *How Much Is That Lawsuit in the Window? Pricing Legal Claims*, 66 Vand. L. Rev. 1889, 1900–02 (2013) (analyzing risk mitigation provisions in a litigation finance contract).

72 Healey et al., *supra* note 2, at 115.

Although exact numbers are hard to come by because of a lack of publicly available information,[73] current data suggests that third-party litigation financing remains a relatively small but growing industry. As shown in Figure 1 below, a 2020 study estimated that 12.94% of the dollar value of all United States lawsuits was funded by third parties, up from 11.71% in 2019 and 10.12% in 2018.[74] A 2022 market report identified forty-four active litigation funders in the United States with a combined $13.5 billion in assets under management and $3.2 billion in funds committed, up from $11.3 billion and $2.5 billion in 2020.[75] Participating funders also reported to the Government Accountability Office ("GAO") that from 2017 to 2021, the amount of funds they provided more than doubled, formal requests for funding agreements increased by 27%, and total new contracts increased by 19%.[76]

FIGURE 1. MARKET PENETRATION OF LITIGATION FINANCE



Most litigation finance agreements fall under one of two categories: consumer funding or commercial funding.[77] In a typical consumer funding agreement, an individual plaintiff or contingent-fee lawyer receives cash from a third-party funder in exchange for a fraction of any successful personal injury claim.[78] Generally, the funds provided are relatively

73 *See* U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 4, at 12, 15.

74 Healey et al., *supra* note 2, at 117.

75 WESTFLEET ADVISORS, THE WESTFLEET INSIDER: 2022 LITIGATION FINANCE MARKET REPORT 3 (2022), https://www.westfleetadvisors.com/wp-content/uploads/2023/02/WestfleetInsider-2022-Litigation-Finance-Market-Report.pdf [https://perma.cc/BK35-4F8M].

76 U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 4, at 11.

77 *Id.* at 5.

78 *See id.* at 13.

small, ranging from $1,000 to $25,000,[79] and are more commonly used to pay for living expenses rather than financing the actual litigation.[80] In a typical commercial funding agreement, a corporate plaintiff, contingent-fee lawyer, or law firm receives cash from a third-party funder in exchange for a percentage of any successful commercial claim, such as a breach of contract or a patent dispute.[81] Here, the typical amount funded is in the millions of dollars and is more commonly used to support the actual litigation.[82]

B. Legal Issues: Agency Problems and Tax Uncertainty

Traditionally, third-party litigation financing was viewed as disdainful, with Blackstone describing the practice as "an offence against public justice"[83] and those who fund litigation as "pests of civil society."[84] Although sentiments have shifted over the years, the legal community has yet to reach a consensus on the social and ethical merits of litigation financing.[85] Supporters often laud the practice's ability to expand access to justice by allowing "lawsuits to be decided on their merits, and not based on which party has deeper pockets or stronger appetite for protracted litigation."[86] Yet, opponents are quick to point out that funders take a significant portion of any "justice" realized and likely only seek out the strongest and most profitable suits rather than the down-and-out

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79 *See id.*; *see also* Healey et al., *supra* note 2, at 112 (providing that consumer funding amounts typically range from $2,500 to $25,000).

80 U.S. Gov't Accountability Off., *supra* note 4, at 12.

81 *See id.* at 8–9.

82 *Id.* at 8; Westfleet Advisors, *supra* note 75, at 2.

83 4 Henry John Stephen, New Commentaries on the Laws of England: Partly Founded on Blackstone 263 (London, Butterworth 1845), *reprinted in* Classics of English Legal History in the Modern Era (David S. Berkowitz & Samuel E. Thorne eds., 1979).

84 Paul T. Tetrault, *A Questionable Practice*, Ins. News Net (Nov. 16, 2010), https://insurancenewsnet.com/oarticle/A-Questionable-Practice-a-236400?utm_source=rss&utm_medium=rss&utm_campaign=A-Questionable-Practice-a-236400 [https://perma.cc/3J6P-KXM3].

85 *Compare* Lisa A. Rickard, Opinion, *This Is Casino Litigation, Where We All Lose*, N.Y. Times (May 27, 2016), https://www.nytimes.com/roomfordebate/2016/05/27/the-ethics-of-investing-in-anothers-lawsuit/this-is-casino-litigation-where-we-all-lose [https://perma.cc/2NTZ-633C] ("This practice is a cancerous growth on our civil justice system, turning our courts into profit centers, increasing the number of lawsuits in our already over-sued society, shifting control of lawsuit decisions toward funders rather than litigants, and reducing settlement dollars for truly deserving victims."), *with* Giugi Carminati, *Litigation Finance: A Modern Financial Tool for Corporate Counsel*, A.B.A. (Dec. 12, 2022), https://www.americanbar.org/groups/business_law/resources/business-law-today/2022-december/a-modern-financial-tool-for-corporate-counsel/ [https://perma.cc/8A5D-B35E] ("For CEOs and founders weighing the prospect of litigation, the ultimate question is no longer why they should be using litigation finance. The real question is: why not?").

86 Lawsuit Funding, LLC v. Lessoff, No. 650757/2012, 2013 WL 6409971, at *6 (N.Y. Sup. Ct. Dec. 4, 2013).

claims otherwise ignored.[87] Critics further argue that the practice will negatively impact the efficiency of the courts by leading to more frivolous lawsuits.[88] Litigants may also be discouraged from accepting realistic settlement offers, either because they will not make enough after paying the funder or because the cost of litigation is not an issue, resulting in prolonged lawsuits and inflated settlement awards.[89]

The industry also gives rise to various legal and ethical quandaries,[90] which includes, as this Article highlights, the agency problems caused by the potential for the funder to exert influence over a case.[91] Although many funders claim they exercise no control over the decision to settle or overall legal strategy,[92] it is easy to imagine how a litigant's goals and incentives might differ from those of a funder.[93] For starters, both parties likely have different appetites for risk, as an unsuccessful claim can be catastrophic to a litigant but merely part of an overall investment strategy to the funder.[94] A funder might even owe a fiduciary duty to its shareholders to push for more risky behavior.[95] Additionally, funders are repeat players in the legal arena, with an interest in how the rules of the game develop.[96] This might incentivize a funder to push for a trial if it could result in a profitable change in law, regardless of the claim's likelihood of success or a reasonable settlement offer.[97] Conflicts can also arise for more personal reasons, such as when billionaire Peter Thiel funded Hulk Hogan's suit against Gawker because Thiel had personal enmity toward Gawker.[98]

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87 Michael L. Zigelman & Kristina I. Duffy, *Considering Paths to Disclosure in Third Party Litigation Financing*, Reuters (Feb. 22, 2023, 7:29 PM), https://www.reuters.com/legal/legalindustry/considering-paths-disclosure-third-party-litigation-financing-2023-02-23/ [https://perma.cc/6R9D-VPFR].

88 *See* Tetrault, *supra* note 84; *see also* Rickard, *supra* note 85 ("Litigation funders claim they only invest in legitimate lawsuits, but the reality is they'll invest in many cases because virtually all settle. Therefore, they can take unmeritorious cases and spread the risk across a broad portfolio of litigation.").

89 Zigelman & Duffy, *supra* note 87.

90 For example, does disclosing information to a funder violate the attorney-client privilege? Are there situations where a funder essentially owns a law firm? *See* Theodorou, *supra* note 8.

91 *See id.*

92 *See* U.S. Gov't Accountability Off., *supra* note 4, at 10–11, 14. In contrast to these claims, Burford Capital recently objected and sought to block a settlement agreement it deemed insufficient in a recent case it funded. Timothy Lee, *Third-Party Litigation Financing Requires Greater Disclosure*, The Hill (Sept. 13, 2023, 8:15 AM), https://thehill.com/opinion/congress-blog/4201419-third-party-litigation-financing-requires-greater-disclosure/ [https://perma.cc/5AJ4-AFAF].

93 *See* Steinitz, *Whose Claim*, *supra* note 7, at 1318.

94 *See id.* at 1305.

95 *See id.* at 1319.

96 *See id.* at 1312.

97 *See id.*

98 Maya Steinitz, *Follow the Money? A Proposed Approach for Disclosure of Litigation Finance Agreements*, 53 U.C. Davis L. Rev. 1073, 1088 (2019).

On top of its ethical ambiguity, the litigation finance industry suffers from serious tax uncertainty. The IRS has remained silent on the topic of litigation financing, except for an unhelpful guidance memorandum released in 2015.[99] There is a recent Tax Court case, *Novoselsky v. Commissioner*, but the case is heavily criticized by both the industry and commentators.[100] Much of the uncertainty hinges on the categorization of the transaction as either a loan, sale, or VPFC, a distinction that profoundly impacts the tax consequences of the transaction. Each categorization presents complicated tax analysis and unresolved doctrinal issues discussed in Part II. But a more fundamental problem is how to decide whether a litigation finance contract is a loan, sale, or VPFC for tax purposes. In other words, even if a litigation finance contract refers to itself as a loan, it may not be treated as a loan but rather a sale for tax purposes under the substance over form doctrine in tax law.[101] This is exactly what happened in *Novoselsky*, in which the court held that the litigation contract at issue was not a loan for tax purposes although the title of the contract was a loan.[102] Part III further discusses such recast of the transaction for tax purposes, resulting problems, and the proposed solution.

State-level approaches to litigation financing have further contributed to taxpayer uncertainty. Some states—such as California, Louisiana, and Tennessee—have introduced or enacted consumer protection statutes outlaying detailed requirements for litigation finance agreements to be enforceable under state law.[103] Other states have left state courts as the primary regulator. Further, these courts take differing approaches in their litigation finance rulings. Some courts—such as those in Texas and Montana—do not characterize litigation finance agreements as loans when repayment is contingent upon the success of the litigation.[104] Other courts—such as those in Colorado and North Carolina—provide that the advance of funds pursuant to a litigation finance agreement is sufficient to characterize the transaction as a loan.[105] These jurisdictions that favor viewing litigation finance transactions as loans place less emphasis on conditional language within the

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99 *See* 2015 Memorandum, *supra* note 33.

100 *See infra* Section III.A; *see also* Robert W. Wood & Donald P. Board, *Do-It-Yourself Litigation Funding À La* Novoselsky, 168 Tax Notes Fed. 1665, 1669–70 (2020) (describing how to structure litigation finance agreements as loans in spite of *Novoselsky*).

101 *See* Graetz & Alstott, *supra* note 43, at 754.

102 *See infra* Section III.A.

103 *See* S. 581, 2023 Leg., Reg. Sess. (Cal. 2023); H.R. 336, 2024 Leg., Reg. Sess. (La. 2024); Tenn. Code Ann. §§ 47-16-101 to -110 (2024).

104 *See* Nyquist v. Nyquist, 841 P.2d 515, 518 (Mont. 1992); Anglo-Dutch Petrol. Int'l, Inc. v. Haskell, 193 S.W.3d 87, 101 (Tex. App. 2006).

105 *See* Oasis Legal Fin. Grp. v. Coffman, 361 P.3d 400, 410 (Colo. 2015); Cross v. Cap. Transaction Grp., Inc., 661 S.E.2d 778, 783 (N.C. Ct. App. 2008) (noting that the word "advance" in the context of funds means a loan).

agreement. In *Cross v. Capital Transaction Group*,[106] a North Carolina court specifically stated that "the character of a transaction" was not altered or changed despite the presence of conditional language.[107]

However, these rulings provide little clarity for taxpayers and litigants seeking to enter litigation finance agreements. Court rulings in both loan and sale jurisdictions employ a contract-centered legal analysis, often dealing primarily with usury and contract enforcement disputes.[108] These rulings lack fundamental elements of a tax law perspective. Tax law analysis distinguishes itself from other legal doctrines, such as contract law, by adopting the substance over form doctrine.[109] Sometimes, the intent of the parties entering a transaction is irrelevant, and instead, the analysis centers on the economic benefits and burdens transferred in the exchange.[110]

Definitive answers to the social, ethical, and legal questions surrounding this new and largely unregulated industry are hard to come by.[111] As such, disclosure obligations are at the forefront of the regulatory conversation.[112] Although some disclosure rules exist in the United States, their scope and substance vary. Federal law does not currently require the disclosure of litigation finance agreements, but not for lack of effort.[113] Various federal regulations and rules, however, may indirectly encapsulate litigation financing, such as the Federal Rules of Evidence and the federal securities laws.[114] Additionally, a minority of federal courts require litigants to divulge the identity of any third-party funders, with some of these courts also requiring the terms of the agreement.[115] At the state level, Wisconsin and West Virginia have passed laws requiring disclosure of third-party financing agreements.[116]

Although the efforts to impose disclosure obligations are commendable, there is room for improvement. So far, the predominant

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106 661 S.E.2d 778 (N.C. Ct. App. 2008).

107 *Id.* at 783.

108 *See Nyquist*, 841 P.2d at 518 (concluding that there was no usury issue in determining a litigation finance agreement was not a loan); *see also* Biven v. Charlie's Hobby Shop, 500 S.W.2d 597, 598–99 (Ky. Ct. App. 1973) (determining that the validity of a loan was dependent on the intent of the parties contracting to the loan agreement).

109 *See* GRAETZ & ALSTOTT, *supra* note 43, at 754.

110 *See id.*

111 *See* U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 4, at 12, 15; *A Brief History of Litigation Finance*, *supra* note 4.

112 *See What You Need to Know About Third Party Litigation Funding*, U.S. CHAMBER INST. FOR LEGAL REFORM (June 7, 2024), https://instituteforlegalreform.com/what-you-need-to-know-about-third-party-litigation-funding/ [https://perma.cc/6V7D-M783]; Theodorou, *supra* note 8.

113 Steinitz, *supra* note 98, at 1076–78; U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 4, at 26–27.

114 *See* U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 4, at 23–24, 28; Zigelman & Duffy, *supra* note 87.

115 *See* U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 4, at 27–28.

116 *See id.* at 28–29.

purpose of disclosure obligations has understandably been procedural justice in litigation. This Article argues that in addition to this purpose, any disclosure requirements should also integrate key factors from a tax policy perspective. Section III.C discusses in more detail the policy reasons supporting this proposal.

II. Taxing Litigation Finance

As a tax matter, every litigation finance transaction falls under one of three categories: a (1) loan, (2) sale, or (3) VPFC. Each category offers different tax consequences for the parties, even if the economic positions of the parties might be similar or the same. Hence, parties may have incentives to structure a transaction in a tax-favorable way. This situation presents two doctrinal tax questions. The first question is how to analyze the tax consequences of a litigation finance transaction in each category. The second question is whether a litigation finance agreement is a loan, sale, or VPFC for tax purposes.

Aside from a largely unhelpful 2015 memorandum,[117] the IRS has remained silent on the topic of litigation financing. The result is a lack of clarity regarding the parties' tax consequences. The first question may be answered using the existing tax rules for loans, sales, and VPFCs. But much of the uncertainty hinges on the second question—the categorization of the transaction as either a loan, sale, or VPFC.

This Part aims to examine the first question, and Part III addresses the second question. One may think that the second question should precede the first question in order. However, sorting may not be easy unless one understands what tax consequences each category involves first. Hence, this Part identifies the primary tax objectives for each side of the transaction and provides a detailed analysis of the potential tax consequences to the beneficiary and the funder under each of the potential categories. Part III examines the second question of whether a particular litigation finance transaction is a loan, sale, or VPFC for tax purposes.

A. Overview of the Three Categories

The uncertain legal environment creates opportunities for tax planning as parties try to structure the transaction to maximize overall utility. From the perspective of the beneficiary, the goal is to defer inclusion of income until the end of litigation.[118] In contrast, the funder

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117 2015 Memorandum, *supra* note 33.

118 Recall that the beneficiary of a litigation finance agreement can be a litigant, contingent-fee lawyer, or law firm. Daily, *supra* note 54, at 2. Regardless, the primary tax objective remains the same.

typically cares little about the timing of the income as they only receive one lump sum payment upon the close of a successful claim. Instead, the funder's primary tax objective is to have the amount received be characterized as long-term capital gains to take advantage of the preferential tax rates.

The satisfaction of each party's primary tax objectives depends on the nature of the litigation finance transaction. These agreements typically fall under one of three scenarios. In the loan scenario, the funder lends money to the beneficiary in exchange for repayment of the principal amount plus interest via a percentage of the litigation claim.[119] The loan is nonrecourse, because the repayment happens only if the beneficiaries obtain gains from the claim.[120] The second category is a sale—or exchange[121]—whereby the funder immediately purchases a portion of the beneficiary's interest in a legal claim.[122] The final category is a VPFC, a subcategory of a sale.[123] The critical difference between an immediate sale and a VPFC is that in a VPFC, the funder's purchase is deferred until the end of litigation.[124]

Some also suggest a fourth category whereby a litigation finance transaction results in the deemed creation of a partnership,[125] an undesirable outcome for both sides of the transaction.[126] If this were the case, it would be as if the beneficiary and funder contribute to the partnership their respective rights to the legal claim and cash.[127] Characterizing the transaction as the formation of a partnership, however, gives rise to potential ethical violations related to sharing fees with nonlawyers.[128] From the point of view of the IRS, this untested characterization is equally unappealing. At worst, the IRS collects less income than under the immediate sale or loan scenario, and, at best, the IRS collects the

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119 *Infra* Section II.B.

120 *Infra* Section II.B.

121 The term "sale" may be understood as a term from the perspective of the seller. But a sale transaction involves something surrendered by the purchaser to the seller. Hence, the same transaction may be described as an "exchange" by considering the nature of quid pro quo of the sale transaction. Thus, the term "sale or exchange" is used as a term of art in tax law.

122 *See infra* Section II.C.

123 *See infra* Section II.D.

124 *See infra* Section II.D.

125 *See* Robert W. Wood & Jonathan Van Loo, *Litigation Funding: The Attorney's Perspective*, 142 Tax Notes 435, 435–36 (2014).

126 *See id.* Although the contribution would be tax-free, some or all funds distributed to the beneficiary are most likely immediately taxable as ordinary income under the disguised sale rules or as a distribution in excess of basis. *See id.* Any income to the funder resulting from a successful claim is likewise ordinary as it represents unrealized receivables, with any loss being capital. *See id.* at 436.

127 *See* Treas. Reg. § 1.704-1(d)(5) (1997) (illustrating how the IRS treats partnerships).

128 Wood & Van Loo, *supra* note 125, at 436.

exact same.[129] Given that the outcome is comparatively worse for the funder, beneficiary, and IRS, this Article does not devote an entire section to this potential fourth category.

Categorizing a litigation finance transaction as a VPFC is the best-case scenario because it provides the beneficiary with a deferral of income and the funder with a capital gain.[130] Failing that, a beneficiary clearly prefers a loan over an immediate sale as it allows the beneficiary to defer income.[131] The funder's preference is less certain, but under current law, it may opt for a loan over an immediate sale. Although the funder must recognize ordinary income in both scenarios, the funder recognizes relatively less from receiving interest payments.[132] Moreover, the funder can take advantage of the bad debt deduction if the claim is unsuccessful, but it is uncertain whether a funder can recognize any corresponding loss in the sale scenario.[133] Nevertheless, the resolution of various ambiguities in the law may shift the funder's preferences toward an immediate sale. For example, this Article believes that funders should be allowed a capital loss at the close of the case, regardless of the outcome. Moreover, if the OID rules apply, funders should recognize interest income before receipt in the loan scenario.[134]

The remainder of this Part provides a detailed analysis of the tax consequences to each party under all three categories. Although there are only two basic parties to the transaction—namely, the beneficiary and the funder—the analysis occasionally distinguishes between litigant beneficiaries and nonlitigant beneficiaries, such as contingent-fee lawyers and law firms. This Article assumes that any damages received by a litigant are taxable and not subject to any exclusions. It also refers to a hypothetical litigation finance transaction to illustrate the application of these rules under each category. The details of this hypothetical transaction are as follows: A funder lends $1 million in Year One to a beneficiary in exchange for 30% of whatever the beneficiary receives from a successful legal claim. In Year Two, the beneficiary receives $10 million because of successful litigation, $3 million of which is paid to the funder per their agreement. Alternatively, the beneficiary and funder get $0 in Year Two if the litigation is unsuccessful. For the reader's convenience, Table 1 below offers a summary of the analysis using the numbers provided in the hypothetical.

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129 *See id.* at 435–36 (discussing the IRS's use of the disguised sale rule to recharacterize a distribution to a partner as a sale).

130 *See infra* Section II.D.1.

131 *See infra* Section II.B.1.

132 *See infra* Sections II.B.1, II.C.1.

133 *See infra* Section II.C.2.b.

134 *See infra* Section II.B.2.a.

TABLE 1: SUMMARY OF THE TAX CONSEQUENCES OF A HYPOTHETICAL LITIGATION FINANCE TRANSACTION

Category	Litigation Result	Beneficiary		Funder	
		Year 1	Year 2	Year 1	Year 2
Loan[135]	*Successful*	No tax consequences	$10 million in ordinary income, or in capital gains if individual litigant's award is for damages to capital assets; and $2 million interest payment deduction	No tax consequences	$2 million in ordinary interest income
	Unsuccessful	No tax consequences	$1 million in cancellation of debt income	No tax consequences	$1 million in bad debt loss
Sale[136]	*Successful*	$1 million in ordinary income per substitute for ordinary income doctrine	$7 million in ordinary income, or in capital gains if individual litigant's award is for damages to capital assets	Acquire capital asset with basis of $1 million	$3 million in ordinary income; and $1 million in capital loss per I.R.C. § 1234A
	Unsuccessful	$1 million in ordinary income per substitute for ordinary income doctrine	No tax consequences	Acquire capital asset with basis of $1 million	$1 million in capital loss per I.R.C. § 1234A
VPFC[137]	*Successful*	No tax consequences	$1 million in ordinary income; and $7 million in ordinary income, or in capital gains if individual litigant's award is for damages to capital assets	Acquire capital asset with basis of $1 million	$2 million in capital gains
	Unsuccessful	No tax consequences	$1 million in ordinary income	Acquire capital asset with basis of $1 million	$1 million in capital loss per I.R.C. § 1234A

135 *See infra* Section II.B.1.

136 *See infra* Section II.C.

137 *See infra* Section II.D.1.

B. Loan

In the loan scenario, the funder lends money to the beneficiary in exchange for repayment of the principal amount plus interest, collected as a percentage of the litigation claim. Beneficiaries may be partial to categorizing litigation finance transactions as loans because it accomplishes the goal of deferring recognition of income and may allow them to offset that income with interest payment deductions.[138] However, a loan is less than satisfactory to the funder. Although it allows the funder to recognize a loss in the event of unsuccessful litigation, any interest income it receives is subject to ordinary tax rates as opposed to preferential capital gains tax rates.[139] The funders may even have to include that taxable income annually under the OID rules.[140]

1. Tax Consequences

The tax consequences to the beneficiary are relatively straightforward. Regardless of the case's outcome, a beneficiary does not include any income upon receiving funds under current tax law—that is, a borrower does not include loan amounts in their gross income because the borrower has an obligation to repay that amount.[141] But generally, the beneficiary is taxed on any amount received from a successful settlement of a claim per usual.[142] In contrast, if the beneficiary's legal claim is unsuccessful, a beneficiary must include cancelation of debt income upon the close of the case, which is treated as ordinary income.[143]

A beneficiary may be either a lawyer or an individual litigant.[144] In a successful case, a fee-contingent lawyer or law firm includes ordinary income for their legal services at the close of the case but can likely deduct any amount paid to the funder that equates to interest payments.[145] Similarly, a litigant includes income from the award of any taxable damages,[146]

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138 *See* Comm'r v. Tufts, 461 U.S. 300, 307 (1983); I.R.C. § 163(a).

139 *See* I.R.C. § 1272(a)(1).

140 *See* discussion *infra* Section II.B.2.a.

141 *See, e.g.*, *Tufts*, 461 U.S. at 307 ("When a taxpayer receives a loan, he incurs an obligation to repay that loan at some future date. Because of this obligation, the loan proceeds do not qualify as income to the taxpayer."); Graetz & Alstott, *supra* note 43, at 171 ("A borrower does not realize income upon receipt of a loan, regardless of how the loan proceeds are used.").

142 This Part proceeds on the assumption that the beneficiary cannot apply the settlement toward recovery of capital or other excludable income. *See generally* Raytheon Prod. Corp. v. Comm'r, 144 F.2d 110 (1st Cir. 1944) (discussing recovery of capital at issue in a settlement claim).

143 *See* I.R.C. § 61(a)(11).

144 Daily, *supra* note 54, at 2.

145 *See* I.R.C. §§ 61(a)(1), 163(a).

146 *See* Lee Gay, *Sorting the Tax Consequences of Settlements and Judgments*, Tax Adviser (July 1, 2021), https://www.thetaxadviser.com/issues/2021/jul/tax-consequences-settlements-judgments.html [https://perma.cc/S2WB-ZQ4T].

subject to relevant deductions.[147] The character of the income from damages would be ordinary income in most cases, but it can be capital gains depending on the origin of the claim.[148] Courts apply an "origin of the claim" test to determine the character of payments received under a judgment or settlement.[149] Under this test, "[d]amages generally are taxable as ordinary income if the payment relates to a claim for lost profits, but they may be characterized as capital gain (to the extent the damages exceed basis) if the underlying claim is for damage to a capital asset."[150]

Like the beneficiary, a funder has no tax consequences from transferring the funds to the beneficiary, regardless of the success of the claim.[151] However, the funder includes income upon the receipt of any interest payments due to successful litigation.[152] There is some uncertainty as to whether the OID rules requiring annual recognition of income would apply in this context.[153] If so, the funder would recognize the interest annually across the loan term.[154] If the litigation ends up failing, the funder may offset income for the year with a bad debt loss.[155]

As an illustration of each party's tax consequences, consider the hypothetical transaction outlined above but assume that it qualifies as a valid loan. Thus, the funder loans the beneficiary $1 million in Year One. In Year Two, the beneficiary receives $10 million because of successful litigation. The beneficiary pockets $7 million and pays the funder the $1 million principal amount of the loan plus $2 million of interest.

The situation looks pretty good from the perspective of the beneficiary. In Year One, the beneficiary does not include any income upon receipt of the $1 million loan. In Year Two, a nonlitigant beneficiary—like a lawyer—receives $10 million of ordinary income but can likely offset that amount by the $2 million interest payment made to the funder, netting $8 million in ordinary income for the year. If the beneficiary is a

147 *See id.*; Alan B. Morrison & Randy Haight, *The Tax Treatment of Alternative Litigation Funding: Some Answers, But Mostly Questions*, 12 PITT. TAX REV. 1, 8 (2014); I.R.C. § 104(a)(2).

148 *See* Raytheon Prod. Corp. v. Comm'r, 144 F.2d 110, 113 (1st Cir. 1944); *see also* Gay, *supra* note 146 (identifying that damages from legal proceeds can be ordinary income or capital gains depending on the nature of the claim).

149 *See, e.g.*, Keller St. Dev. Co. v. Comm'r, 688 F.2d 675, 678, 681–82 (9th Cir. 1982) (identifying and applying the "origin of the claim" test in characterizing the damage payment); *see also* United States v. Gilmore, 372 U.S. 39, 49–50 (1963) (establishing the origin of the claim test in the context of deductibility of legal expenses); ROBERT W. WOOD, PORTFOLIO 522: TAX ASPECTS OF SETTLEMENTS AND JUDGMENTS 17–18 (4th ed. n.d.) ("The origin of the claim test plays a crucial role in determining the tax treatment of payments received or made under a judgment or settlement.").

150 Gay, *supra* note 146.

151 The funder realizes no income from extending a loan to beneficiary. *See* Treas. Reg. § 1.61-1(a) (1960).

152 *See* I.R.C. § 61(a)(4).

153 *See* discussion *infra* Section II.B.2.a.

154 *See id.*

155 *See* I.R.C. § 166.

litigant, the beneficiary also receives $10 million of income in Year Two, but the character of that income depends on the underlying nature of the claim. On the other hand, if the litigation was ultimately unsuccessful, the beneficiary still has no tax consequences in Year One but would include $1 million of cancellation of debt income in Year Two.

The funder is not nearly as well off. In Year One, the funder has no tax consequences resulting from the $1 million loan to the beneficiary. In Year Two, the funder receives $2 million of interest income from the successful result of a claim. If the litigation is unsuccessful, the funder still has no tax consequence in Year One but can realize a $1 million loss for bad debt in Year Two. As discussed below, if the OID rules apply, the funder would recognize interest income in Year One with an adjustment made in Year Two for any over or under payment.

2. Peripheral Issues

a. Original Issue Discount Rules

In practice, most funders strive to avoid labeling agreements as a debt instrument to not run afoul of existing state champerty and usury laws.[156] Although it is unclear how the growing trend of relaxing these common law doctrines impacts the industry,[157] there is at least one documented case in which the party has attempted to label the transaction as a loan.[158] Still, the loan category is not without its complexities, not the least of which is whether the OID rules apply in the litigation finance context. The answer to this question has profound implications for the funder, as it requires them to annually recognize interest income prior to the actual receipt.[159]

The OID rules come into play whenever certain debt instruments are issued for less than their redemption price upon maturity.[160] If applicable, an amount equal to the difference between the "stated redemption price at maturity" and "the issue price" is treated as a

156 Alison Frankel, *CFPB Signals Regulation of Litigation Funding Industry*, REUTERS (Feb. 8, 2017, 6:49 PM), https://www.reuters.com/article/us-otc-litfunding/cfpb-signals-regulation-of-litigation-funding-industry-idUSKBN15N2W1 [https://perma.cc/SST7-SVNL] ("[Funders] could demand payback rates that would be considered usurious if the cash advances were loans—but funders carefully structure their contracts with plaintiffs so the advances are technically not loans.").

157 *See* Healey et al., *supra* note 2, at 114.

158 Novoselsky v. Comm'r, 119 T.C.M. (CCH) 1474, at *3 (2020).

159 *See* I.R.C. § 1272(a)(1).

160 *See id.* § 1271(a)(2); *Guide to Original Issue Discount (OID) Instruments*, IRS (Jan. 2025), https://www.irs.gov/publications/p1212#en_US_202301_publink1000206277 [https://perma.cc/ZSR5-Z7EP].

form of interest amortizable over the loan period.[161] Litigation finance transactions seem to be the type of situation in which the OID rules should apply, as the funder issues debt to the beneficiary for less than the redemption price at maturity and receives zero interest payments throughout the loan period.[162] However, an issue arises in how to calculate the OID amount because litigation finance transactions lack a fixed maturity date.[163] A solution may be to utilize an assumed maturity date whereby "the amount of OID that accrued based on an assumed maturity date was simply equal to the amount of interest payable at any given time under the terms of the instrument."[164] Given the difficulty in calculating the OID amount and the lack of IRS guidance on this specific issue, this Article assumes that the OID rules do not apply.

b. Obligation to Repay

The loan category also raises the age-old dilemma of identifying whether a transaction qualifies as debt or equity. Courts traditionally apply a multifactor test on a case-by-case basis.[165] However, the factors and their application vary from court to court.[166] Some of the critical factors include the existence of formal documents, the name and label of those documents, whether there is a fixed maturity date to pay a certain amount, and if there is an obligation to repay.[167] It is unclear exactly how the line between debt and equity should be drawn in the context of litigation finance. The current trend places significant weight on whether the beneficiary has an obligation to repay, as discussed in *Novoselsky*.[168]

In *Novoselsky*, an attorney entered into multiple litigation finance transactions as the beneficiary.[169] Although the exact terms of each transaction differed, all of them were labeled as nonrecourse loans

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161 *See* I.R.C. §§ 1272(a)(1), 1273(a)(1); Robert W. Wood & Jonathan Van Loo, *Investing in Lawsuits*, M&A Tax Rep., Nov. 2013, at 3–4, https://woodllp.com/Publications/Articles/pdf/Investing.pdf [https://perma.cc/R29B-J86J]; *Original Issue Discount (OID)*, Wall St. Prep (Mar. 24, 2024), https://www.wallstreetprep.com/knowledge/original-issue-discount-oid/ [https://perma.cc/MX8F-XGQ5].

162 Wood & Van Loo, *supra* note 161, at 3.

163 *See id.* at 4.

164 *Id.*

165 *See, e.g.*, PepsiCo P.R., Inc. v. Comm'r, 104 T.C.M. (CCH) 322, 335–45 (2012) (applying a multifactor test to determine whether a transaction qualifies as debt or equity); *see also* Jeff Borghino, *Debt vs. Equity in the Tax Court*, Tax Adviser (Feb. 1, 2013), https://www.thetaxadviser.com/issues/2013/feb/clinic-story-01.html [https://perma.cc/894G-YZFC] ("While there is a lack of guidance from the IRS on determining whether an instrument constitutes debt or equity, there are many cases that have established a list of factors that assist taxpayers in making such a determination.").

166 *See PepsiCo*, 104 T.C.M. (CCH) at 335.

167 *See id.*

168 *See* Novoselsky v. Comm'r, 119 T.C.M. (CCH) 1474, at *14–16 (2020).

169 *Id.* at *3–4.

secured by the attorney's legal fees.[170] The IRS disagreed with this categorization, arguing that the litigation finance transactions were a sale.[171] The court held in favor of the IRS, reasoning that the transaction was not a loan mainly because the attorney's obligation to repay was contingent.[172] Additionally, the court cited the lack of any formal promissory note or schedule of repayment as indicative of an equity interest but disregarded the attorney's actual ability to repay.[173]

Although this Article believes the court came to the correct conclusion, it disagrees with the court's reasoning. More specifically, it disagrees with the court's heavy reliance on whether the beneficiary has an obligation to repay the loans. Rather, the court should have primarily relied on the concept of tax ownership—namely, the extent of each party's legal control over the claim and the economic risk of loss concerning the transaction. Part III provides a more detailed analysis of *Novoselsky* and fleshes out this proposal further.

C. Sale

The second category is a sale—or exchange—whereby the funder immediately purchases a portion of the beneficiary's interest in a legal claim in exchange for the funding amount. Most likely, neither the beneficiary nor the funder wants the transaction to fall under the immediate sale category. The beneficiary should include taxable income upon receipt of the funds no matter the case's outcome,[174] the character of which is most likely to be ordinary under the substitute for ordinary income doctrine.[175] The available authority also suggests that despite a legal claim being a capital asset, the funder should include ordinary income upon a successful settlement.[176] Depending on the interpretation of the law, the funder may also recognize a capital loss under

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170 *See id.* at *4; Mark Leeds & Matthew Stevens, *Litigation Finance: A New Asset Class*, Mayer Brown 9 (Jan. 10, 2023), https://www.mayerbrown.com/-/media/files/perspectives-events/events/2023/01/012023-nysscpa-litigation-finance--mark-leeds.pdf [https://perma.cc/BNF2-LYDF].

171 *See Novoselsky*, 119 T.C.M. (CCH) at *9–11; Mark Leeds & Stephanie Wood, *Litigation Finance Update: US Tax Court Refutes Loan Treatment for Upfront Litigation Support Payments in* Novoselsky v. Commissioner, Mayer Brown 1 (June 2, 2020), https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2020/06/litigation-finance-update-us-tax-court-refutes-loan-treatment-for-upfront-litigation-support-payments-in-novoselsky-v-commissioner.pdf [https://perma.cc/ELY6-BBKL].

172 *See Novoselsky*, 119 T.C.M. (CCH) at *15–24; Leeds & Wood, *supra* note 171, at 1–2.

173 *See Novoselsky*, 119 T.C.M. (CCH) at *21.

174 *See* I.R.C. § 61(a)(3).

175 *See* Philip G. Cohen, *The* Long *(*v. Commissioner*) and Short of the Substitute for Ordinary Income Doctrine*, 13 Pitt. Tax Rev. 151, 153 (2016).

176 *See* 2015 Memorandum, *supra* note 33, at 1.

I.R.C. § 1234A at the end of the case, be it successful or otherwise.[177] To simplify the discussion, Section II.C.1 below provides a detailed analysis of the likely tax consequences to both parties and only highlights the various uncertainties relating to the character and amount of income recognized by each party. Section II.C.2 further elaborates on those uncertainties.

1. Tax Consequences

A beneficiary immediately includes income from the sale of their legal claim or contractual right to payment attached to a claim.[178] This Article believes that the character of that income should be ordinary under the substitute for ordinary income doctrine.[179] Additionally, a beneficiary includes any income resulting from the successful resolution of a claim.[180] To be specific, a nonlitigant beneficiary—like a lawyer for example—has ordinary income from the receipt of any contingency fees not assigned to the funder,[181] and litigants could have ordinary income or capital gain from the receipt of any taxable damages.[182] In a losing scenario, the beneficiary still recognizes gain upon receipt of the funds but has no additional tax consequences in the year of the loss.

The analysis for the funder is less straightforward. Current law supports the notion that a legal claim in the hands of a funder qualifies as a capital asset.[183] Therefore, the funder's initial purchase of the legal claim almost certainly results in the funder holding a capital asset with a basis equal to the price paid, regardless of the outcome of the case.[184] However, available guidance from the IRS strongly suggests that the funder recognizes ordinary income, not capital gains, upon receipt of any successful settlement award.[185] As discussed in more detail in Section II.C.2.b, the crux of the issue is a lack of a sale or disposition at the time of receipt. Additionally, this Article argues that the funder should always recognize a capital loss upon termination of the legal claim under I.R.C. § 1234A. Again, the details of this argument are outlined below in Section II.C.2.b.

To demonstrate how these rules apply, consider the hypothetical transaction but assume that it qualifies as an immediate sale. The funder

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177 *See* I.R.C. § 1234A.

178 *See id.* § 61(a)(3).

179 *See* Cohen, *supra* note 175, at 153.

180 *See, e.g.*, Raytheon Prod. Corp. v. Comm'r, 144 F.2d 110, 113 (1st Cir. 1944).

181 *See* I.R.C. § 61(a)(1).

182 *See Raytheon*, 144 F.2d at 113.

183 *See* I.R.C. § 1221(a); *see also* 2015 Memorandum, *supra* note 33, at 6–7 (assuming a funder's right to proceeds from a legal claim qualifies as a capital asset).

184 *See* I.R.C. § 1012(a).

185 *See* 2015 Memorandum, *supra* note 33, at 8.

purchases a 30% interest from the beneficiary in the outcome of a legal claim for $1 million in Year One. In Year Two, the litigation results in a favorable $10 million award, of which $7 million goes to the beneficiary and $3 million goes to the funder.

Under this scenario, the beneficiary realizes and recognizes $1 million of ordinary income—under the substitute for ordinary income doctrine—upon the sale and receipt of the funds in Year One. If the litigation is successful, the beneficiary receives another $7 million of income in Year Two, the character of which is likely ordinary unless the beneficiary is a litigant with an underlying claim for damages to a capital asset. In a loss scenario, the beneficiary still realizes the $1 million of ordinary income in Year One but has no tax consequences in Year Two.

The funder acquires a capital asset in Year One that has a basis of $1 million. In Year Two, the funder receives $3 million of ordinary income, or 30% of the $10 million award. The funder also realizes a $1 million capital loss from the termination of the legal claim under I.R.C. § 1234A. Alternatively, an unsuccessful litigation still results in acquiring a capital asset with a basis of $1 million in Year One, but the funder only realizes a $1 million capital loss from the termination of the claim in Year Two.

2. Areas of Uncertainty

There are two areas of uncertainty regarding the tax consequences of an immediate sale. The first is how to characterize the initial funds received by the beneficiary.[186] This Article believes that the funds amount to ordinary income under the substitute for ordinary income doctrine. The second issue pertains to the amount and character of any gain or loss recognized by the funder and potential application of I.R.C. § 1234A.[187] Consistent with the IRS and court interpretations, this Article argues that any income to the funder would be ordinary because it does not stem from the sale of the legal claim. However, contrary to current interpretations of the law, this Article argues that I.R.C. § 1234A should allow the funder to recognize a capital loss upon termination of the litigation.

a. Beneficiary: The Character of Initial Funding Income and the Substitute for Ordinary Income Doctrine

The beneficiary realizes and recognizes income upon receipt of the funds in an immediate sale.[188] In usual cases of selling assets like stock, the seller would realize capital gains rather than ordinary income.[189]

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186 *See infra* Section II.C.2.a.

187 *See infra* Section II.C.2.b.

188 *See* I.R.C. § 61(a)(3).

189 *See id.* §§ 1221(a)(1), 1222.

That may not be the case here. The substitute for ordinary income doctrine characterizes a present payment for future income as ordinary income—rather than a capital gain—if that future payment would have been otherwise characterized as ordinary income when received in due time.[190] In making this decision, courts look to "the type and nature of the underlying right or property assigned or transferred."[191] The "type and nature" of the right or property transferred by a litigation finance agreement varies based on whether the beneficiary is a litigant.

The Tax Court has identified six factors to determine if the sale of a contractual right results in a capital gain or loss.[192] The majority of these factors weigh in favor of the nonlitigant beneficiary recognizing ordinary income, because the contractual rights stem from the lawyer's relationship with a client and represent compensation for personal services rather than an equitable interest in property that qualifies as a capital asset.[193] The only point against this characterization is that the funder takes on the significant risk that the litigation will ultimately be unsuccessful.[194] As discussed below, it also satisfies a more general test for applying the substitute for ordinary income doctrine. One practitioner also finds support for it not being a capital asset under the accounts and notes receivable section to capital assets.[195] However this conclusion is reached, it seems relatively uncontroversial to say that a nonlitigant beneficiary recognizes ordinary income.

In contrast, consider a litigant who exchanges a portion of a potential damages award for an upfront cash payment. Although there is some authority to support the notion that a legal claim is a capital asset in the hands of the beneficiary,[196] this Article concludes that the sale of a legal claim should still result in ordinary income under the substitute

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190 *See* Cohen, *supra* note 175, at 153; *see also* James A. Beavers, *Assignment of Rights in Lawsuit Results in Capital Gain*, Tax Adviser (Feb. 1, 2015), https://www.thetaxadviser.com/issues/2015/feb/tax-trends-02-feb-2015/ [https://perma.cc/3ZK8-KEGT] (analyzing the Eleventh Circuit's application of the substitute for ordinary income doctrine in *Long v. Commissioner*).

191 Long v. Comm'r, 772 F.3d 670, 677 (11th Cir. 2014) (quoting United States v. Woolsey, 326 F.2d 287, 291 (5th Cir. 1963)).

192 Foy v. Comm'r, 84 T.C. 50, 70 (1985) ("(1) How the contract rights originated; (2) How the contract rights were acquired; (3) Whether the contract rights represented an equitable interest in property which itself constituted a capital asset; (4) Whether the transfer of contract rights merely substituted the source from which the taxpayer otherwise would have received ordinary income; (5) Whether significant investment risks were associated with the contract rights and, if so, whether they were included in the transfer; and (6) Whether the contract rights primarily represented compensation for personal services.").

193 *See id.*

194 *See id.*

195 *See* Wood & Van Loo, *supra* note 161, at 5.

196 *See* Cohen, *supra* note 175, at 195. The IRS adopted the assumption that legal claims are capital assets in the hands of funders in a guidance memorandum regarding litigation financing. *See* 2015 Memorandum, *supra* note 33, at 7.

for ordinary income doctrine. Although the application of this doctrine varies, the three-step rubric outlined in *Lattera v. Commissioner*[197] provides a helpful framework to aid this analysis.[198]

Per *Lattera*, courts first consider whether the rights sold bear a "family resemblance" to traditional capital assets (e.g., stocks, bonds, and options) or ordinary income (e.g., rental income and interest income).[199] Lacking family resemblance, the court then asks if the taxpayer sold their entire interest in the underlying asset (i.e., a vertical carveout) or only some (i.e., a horizontal carveout).[200] A horizontal carveout results in ordinary income, whereas a vertical carveout requires the court to determine if the taxpayer sold the right to *earn income* or instead sold the right to *already-earned income*; the former results in capital gain and the latter results in ordinary income.[201] In making that final distinction, courts consider whether the buyer can realize economic appreciation from the acquired right to earnings.[202]

The recent case of *Long v. Commissioner*[203] is an example of when the substitute for ordinary income doctrine should not apply in the context of legal claims. In *Long*, the taxpayer won a judgment allowing him to enforce an option to buy real estate to build condos plus other damages.[204] While the case was on appeal, the taxpayer sold the rights of the lawsuit for $5.75 million.[205] The court examined the legal right to the option to purchase real estate that was sold.[206] The court held that the taxpayer had capital gains because the option "represented the potential to earn income in the future based on the owner's actions in using it, not entitlement to the income *merely by owning the property*."[207]

Applying the *Lattera* framework to nonlitigant beneficiaries strongly suggests that the substitute for ordinary income doctrine should apply. Under the family resemblance test, the funds received by fee-contingent lawyers and law firms amount to a present payment in lieu of future service fees, which resembles ordinary income type

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197 437 F.3d 399 (3d Cir. 2006).

198 *See id.* at 406–08; *see also* Cohen, *supra* note 175, at 182 ("*Lattera*'s framework for determining the application of the doctrine, while neither infallible nor immune to criticism, appears conceptually sound and should serve as a means for analyzing future cases. The methodology in *Lattera* is certainly, as Professor Timothy R. Koski observed, 'a step in the right direction.'" (footnotes omitted)).

199 *Lattera*, 437 F.3d at 406.

200 *Id.*; Cohen, *supra* note 175, at 161.

201 *Lattera*, 437 F.3d at 407; Cohen, *supra* note 175, at 180.

202 Cohen, *supra* note 175, at 190.

203 772 F.3d 670 (11th Cir. 2014).

204 *See id.* at 672–73, 675.

205 *Id.* at 673.

206 *See id.* at 677; *see also* Leeds & Wood, *supra* note 171, at 3 (discussing the court's conclusion that the legal right was an option to buy real estate rather than the real estate itself).

207 *Long*, 772 F.3d at 677.

items.[208] Even if the court proceeds past or does not apply the family resemblance test, a nonlitigant's transfer amounts to a horizontal carveout, as the beneficiary only transfers a portion of the right to future service fees. Further, the Tax Court's six-factor capital-asset test suggests that these funds are ordinary income.[209] The funds the beneficiary receives represent the present value of future earned income rather than an appreciable interest in property.[210]

The analysis is less straightforward in the context of litigants. A legal claim as a standalone asset does not bear significant resemblance to the per se capital or ordinary assets and thus would fail the family resemblance test. On the other hand, the funds received by a litigant equate to a present payment in lieu of future damages, the character of which depends on the nature of the underlying claim.[211] *Long* appears to further flesh out the application of the substitute for ordinary income doctrine to the sale of a legal claim by looking to the nature of the underlying option to purchase real estate, rather than the legal claim as a standalone asset.[212] Thus, the family resemblance test may be satisfied if applied to an underlying claim that represents a per se capital asset or ordinary income.

Even assuming that the court proceeds past or does not apply the family resemblance test, a litigant's transfer of rights amounts to a horizontal carveout, as the beneficiary only sells a portion of the claim to the funder.[213] That factor alone suggests it would result in ordinary income, as the funds the litigant receives represent the present value of what the litigant would be entitled to in the future—i.e., earned income.[214]

This Article assumes that the character of income a beneficiary receives under a sale scenario is ordinary per the substitute for ordinary income doctrine. Yet, it also acknowledges that this result is far from certain. Given the various factors that courts consider and potentially conflicting case law and IRS guidance, reasonable minds can differ on the conclusion.[215] Thus, this Article urges the IRS to provide more guidance on this issue.

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208 *See* Lattera v. Comm'r, 437 F.3d 399, 409–10 (3d Cir. 2006).

209 *See supra* text accompanying notes 191–96.

210 *See* Cohen, *supra* note 175, at 190.

211 *See supra* notes 190–92 and accompanying text.

212 *See* Leeds & Wood, *supra* note 171, at 3 ("The appeals court agreed that the character of the income should be determined by looking through the litigation claim. In the view of the appeals court, however, the underlying claim related to an option to purchase the real estate, not the real estate itself. The court concluded that the option was a capital asset in the hands of the taxpayer.").

213 *See supra* text accompanying notes 200–01.

214 *See* Cohen, *supra* note 175, at 190.

215 For example, the Tax Court might place a lot of weight on the fact that the nonlitigant beneficiary's sale of contract rights included the transfer of a significant amount of risk and conclude that it is a capital asset. *See supra* note 192 (discussing the six-factor test in *Foy*).

b. Funder: Application of I.R.C. § 1234A

Current guidance from the IRS makes it clear that any income to the funder is characterized as ordinary, regardless of whether the legal claim qualifies as a capital asset.[216] It also strongly suggests that the favorable recharacterization provisions under I.R.C. § 1234A are unlikely to apply to that income.[217] Although this Article understands this somewhat unintuitive outcome, the Article argues that I.R.C. § 1234A should apply to allow the funder to recapture their basis in the extinguished legal claim by recognizing a capital loss.

Capital gains only arise from the sale of a capital asset.[218] Thus, for a funder to recognize anything other than ordinary income, the legal claim must qualify as a "capital asset."[219] Also, any income must result from the "sale" of that asset.[220] The first requirement is likely satisfied, but the second is not.

As to the first requirement that a legal claim be a capital asset, two exceptions potentially disqualify a legal claim from this characterization. First is the inventory exception, exempting any property held by a taxpayer primarily for sale to customers in the ordinary course of a trade or business.[221] Second is the exception for any accounts receivables acquired in the ordinary course of a trade or business.[222] Here, neither of the two relevant exceptions is likely to apply. The inventory exception falls short because all indicators suggest that litigation finance firms invest in legal claims, rather than sell them.[223] Moreover, the receivables exception is equally unlikely given the IRS's position that unless substantial services were performed, "'receivables' in the hands of an originating lender" are capital assets.[224]

The IRS does not oppose the characterization of legal claims as capital assets. In the 2015 memorandum addressing the character of income from the sale of an interest in the proceeds of a legal claim, the IRS assumed that such an interest qualifies as a capital asset.[225] Various courts have made the same assumption, albeit from the perspective of the litigant.[226] Further strength can be found by comparing litigation

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216 *See* 2015 Memorandum, *supra* note 33, at 7–8.

217 *See id.* at 7.

218 *See* I.R.C. §§ 1221–1222.

219 *See id.* § 1222.

220 *See id.*

221 *Id.* § 1221(a)(1).

222 *Id.* § 1221(a)(4).

223 *See* Austin Rucker, *Pay to Play or Get Rich Quick: A Look at Litigation Finance in the United States*, 7 Bus., Entrepreneurship & Tax L. Rev. 332, 333 (2024).

224 Gamino, *supra* note 54, at 98.

225 2015 Memorandum, *supra* note 33, at 6.

226 Cohen, *supra* note 175, at 195 ("[T]he Tax Court in *Hudson v. Commissioner* recognized that a court 'judgment . . . was property and a capital asset.' Another case not cited by the Eleventh

finance with the similar industry of venture capital, wherein investments are characterized as capital assets.[227]

However, the second requirement—a sale—is difficult to satisfy because any income the funder receives is not the result of selling that claim. In the 2015 memorandum, the IRS concluded that the taxpayer's "mere receipt" of their share of the successful claim did not constitute a capital gain because there was no sale or disposition of property under I.R.C. § 1001 resulting in ordinary income to the taxpayer.[228] The IRS's conclusion makes sense, as any sale or exchange of the claim only occurs in Year One at the time of funding, and there is no such sale or exchange in Year Two.

The IRS's reasoning is perhaps best understood by analogizing the transaction with the sale and purchase of stock and receipt of dividends. Stock is a capital asset for an investor.[229] When an investor sells stock, the investor realizes a capital gain.[230] In contrast, the mere receipt of dividends with respect to that stock would be ordinary income and does not give rise to capital gain.[231] Similarly, a funder purchases a legal claim—i.e., a share of stock—that qualifies as a capital asset.[232] However, any income the funder receives from a successful case is not from selling that claim but rather the funder's inherent rights as a possessor—i.e., the dividends from stock.

Savvy readers may quickly point out the negative implications of the IRS's position—that is, not only will funders have to recognize ordinary income, but funders will also go from having a basis in a capital asset one second to nothing the next. Litigation finance firms would be unhappy with this result. Unfortunately, funders face an uphill battle in achieving a better outcome under the current state of the law.

At first glance, I.R.C. § 1234A looks like the perfect solution to the funder's disappearing basis dilemma. The statute provides that any

> [g]ain or loss attributable to the cancellation, lapse, expiration, or other termination of . . . a right or obligation . . . with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer . . . shall be treated as gain or loss from the sale of a capital asset.[233]

Circuit, *Nahey v. Commissioner*, concluded that a lawsuit was a capital asset, but like *Hudson*, denied the taxpayer capital gain treatment because there was no assignment of the property." (footnotes omitted) (quoting Hudson v. Comm'r, 20 T.C. 734, 736 (1953))).

227 Daily, *supra* note 54, at 18.

228 2015 Memorandum, *supra* note 33, at 7.

229 I.R.C. § 1221(a)(1).

230 *See id.* §§ 1221(a)(1), 1222.

231 *Id.* § 61(a)(7).

232 *See id.* § 1221(a).

233 *Id.* § 1234A.

However, the 2015 memorandum disregards I.R.C. § 1234A entirely, stating that it was "predicated on the existence of 'gain' or 'loss' . . . [and] in order to have a 'gain or loss' there must be a sale or other disposition of property."[234]

The only other relevant authority on this statute is the Fifth Circuit case *Pilgrim's Pride Corp. v. Commissioner*[235] dealing with the application of I.R.C. § 1234A to a taxpayer's abandonment of securities qualifying as a capital asset.[236] Contrary to the Tax Court's initial opinion, the Fifth Circuit held that, under the plain language of the statute, I.R.C. § 1234A did not apply to the termination of the capital asset itself, but rather the rights or obligations with respect to capital assets.[237] Applying the same logic to litigation finance transactions again results in I.R.C. § 1234A not applying, as it is the legal claim itself that terminates, not an attached right or obligation with respect to the claim.

The seeming inapplicability of I.R.C. § 1234A under current law paints a bleak lose-lose picture for funders, begging the question of whether this is the correct result. This Article answers that it is not, arguing that the logical and fairer interpretation of the law would allow funders to recognize a capital loss equal to their basis in the legal claim—i.e., the initial funding amount—under I.R.C. § 1234A to recover basis.

Although there is no authority directly supporting this argument, a narrow reading of the 2015 memorandum would not preclude it. The sole focus of that memorandum was the character of income received by the funder, not any loss resulting from the termination of the capital asset itself.[238] The only potential clash with this Article's position lies in the IRS's conclusion that I.R.C. § 1234A is predicated upon a sale.[239] Thus, if the holding and rationale therein is limited to the character of income to the funder, there is no such conflict with also allowing the funder to recognize a capital loss under I.R.C. § 1234A. Indeed, one could reasonably assume that this is what the IRS meant in the first place given that "§ 1234A is premised on the fact that there is no sale or exchange and treats a 'cancellation, lapse, or other termination' as such for certain transactions."[240]

This Article's stance directly conflicts with the Fifth Circuit's interpretation that I.R.C. § 1234A only applies to the termination of the rights and obligations with respect to capital assets and not the assets

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234 2015 Memorandum, *supra* note 33, at 7.

235 779 F.3d 311 (5th Cir. 2015).

236 *Id.* at 312.

237 *Id.* at 315, 318.

238 *See* 2015 Memorandum, *supra* note 33, at 1.

239 *See id.* at 7 ("[I]n order to have a 'gain or loss' there must be a sale or other disposition of property.").

240 Leeds & Wood, *supra* note 171, at 4.

themselves.[241] Instead, this Article prefers the Tax Court's initial interpretation that the "rights with respect to property" logically "includes the rights inherent in the ownership of the property."[242] Not only will this result in a fairer outcome, as funders will still have to recognize the full amount of ordinary income but be able to recover basis, but it is also more in line with congressional intent. The Tax Court in *Pilgrim's Pride* came to the same conclusion after considering "the committee's example of the redemption of a bond which, like a share of stock, is intangible property—a bundle of contractual rights."[243] The Tax Court also cited the committee's criticism of taxing "similar economic transactions differently" as allowing taxpayers to make an "election to sell the property right if the resulting transaction results in a gain or extinguish the property right if the resulting transaction results in a loss."[244]

This Article's position that I.R.C. § 1234A applies to rights inherent in the property is also consistent with the overarching tax policy of permitting basis recovery in these situations. In addition to I.R.C. § 1234A, various code provisions allow taxpayers to recover basis in certain types of capital assets that either cease to exist or lose all value. For example, I.R.C. § 165(g) allows shareholders to recognize a loss if stock becomes completely worthless.[245] The casualty loss provision under I.R.C. § 165(c) provides property owners with similar relief if their property is destroyed or rendered worthless.[246] There is not a good reason under these rationales why litigation finance should be treated any differently.

D. Variable Prepaid Forward Contract

The definition of a VPFC or forward is less intuitive than a loan or immediate sale. Perhaps the simplest way to think of a VPFC is as an open sale that begins on the date of funding and ends upon settlement of the legal claim.[247] The benefits of this characterization are twofold. First, the beneficiary defers recognition of income until the maturity of the claim.[248] Second, it allows the funder to recognize capital

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241 *See Pilgrim's Pride*, 779 F.3d at 315.

242 Pilgrim's Pride Corp. v. Comm'r, 141 T.C. 533, 543 (2013), *rev'd*, 779 F.3d 311.

243 *Id.* at 547 (citing First Nat'l Bank of Bos. v. Maine, 284 U.S. 312, 327–28 (1932)).

244 *Id.* at 548.

245 *See* I.R.C. § 165(g).

246 *See id.* § 165(c).

247 *Cf.* Estate of McKelvey v. Comm'r, 906 F.3d 26, 27–28 (2d Cir. 2018) (explaining that in a VPFC, the buyer pays the seller a fixed sum of money, and the seller at a later date delivers a variable amount of stock to the buyer—an amount which is determined by the price of the stock at a contractually predetermined future date).

248 *See id.* at 33, 39; Rev. Rul. 2003-7, 2003-1 C.B. 363, 363 (holding that when a taxpayer receives cash in exchange for the future obligation to deliver a variable amount of stock, that taxpayer does not sell stock under I.R.C. § 1001 or I.R.C. § 1259).

gains if the litigation is successful by avoiding the issues that arise in the immediate sale setting.[249] However, whether the IRS would respect this categorization in the context of litigation finance is unknown. The answer inevitably hinges on whether the open transaction doctrine is applicable and how the parties structure the agreement.[250]

The remainder of this Section first outlines the tax consequences for both sides of the transaction in more detail. Given the complexity of derivatives contracts, the Section then discusses the nature, tax consequences, and scholarship of traditional forward contracts, prepaid forward contracts, and VPFCs, and whether the IRS would respect litigation finance agreements labeled as VPFCs.

1. Tax Consequences

The critical difference between an immediate sale and a VPFC is that in a VPFC, the funder's purchase is deferred until the end of litigation.[251] A VPFC is ideal for the beneficiary as it defers the usual tax consequences of an immediate sale until the conclusion of the case.[252] Like the immediate sale scenario, the character of that income should be ordinary under the substitute for ordinary income doctrine.[253] If the claim is successful, the beneficiary should also recognize their portion of the litigation proceeds per usual.[254] Depending on the nature of the beneficiary and claim, the character of that additional income may be ordinary or capital.[255]

A VPFC is also the best-case scenario for the funder as it allows the funder to recognize a capital gain. Upon settlement of the case, the transaction closes, and the funder should recognize a capital gain or loss.[256] If successful, the funder has a capital gain equal to their portion of the award net the amount funded. If unsuccessful, the funder recognizes a capital loss equal to the amount funded.[257]

To demonstrate, recall our hypothetical transaction but assume that it qualifies as a valid VPFC. Under this scenario, the funder and the beneficiary enter a VPFC in Year One, whereby the funder prepays

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249 *See* I.R.C. §§ 1221(a), 1222; *see also* Robert W. Wood, *Prepaid Forward Contracts: What's All the Fuss?*, M&A Tax Rep., Feb. 2012, at 6, https://www.woodllp.com/Publications/Articles/pdf/Prepaid.pdf [https://perma.cc/WG2N-BCLC] (stating that for tax purposes, forward contracts are typically treated similarly to the forward contract's underlying asset).

250 *See, e.g.*, Rev. Rul. 2003-7, 2003-1 C.B. 363.

251 *See McKelvey*, 906 F.3d at 27–28.

252 *See id.* at 33, 39.

253 For application of the doctrine, see *supra* Section II.C.2.a.

254 *See* Raytheon Prod. Corp. v. Comm'r, 144 F.2d 110, 113 (1st Cir. 1944); I.R.C. § 61(a)(1).

255 *See Raytheon*, 144 F.2d at 113.

256 *See* I.R.C. §§ 1221(a), 1222; Wood, *supra* note 249, at 6.

257 This Article takes the position that I.R.C. § 1234A allows funders to recapture their basis in litigation finance transactions. *See supra* Section II.C.2.b.

$1 million for the future delivery of 30% of any litigation proceeds, thus opening the transaction. In Year Two, the litigation results in a favorable $10 million award, of which $7 million goes directly to the beneficiary. The remaining $3 million goes to the funder to close the transaction.

From the beneficiary's perspective, there are no tax consequences in Year One upon receiving the $1 million lump-sum payment. However, the beneficiary must recognize $1 million in Year Two when the transaction closes. The character of that income would be ordinary under the substitute for ordinary income doctrine. The beneficiary also recognizes their $7 million share of the award, the character of which may be ordinary or capital depending on the beneficiary and nature of the claim. If the claim were unsuccessful, the beneficiary would still have no tax consequences in Year One but would recognize $1 million of ordinary income in Year Two.

Likewise, the funder has no tax consequences in Year One. In Year Two, the transaction closes, resulting in the funder recognizing a $3 million capital gain and a $1 million capital loss, netting a capital gain of $2 million. If unsuccessful, the funder still has no tax consequences in Year One but only recognizes the $1 million capital loss in Year Two.

Categorizing the transaction as a VPFC is a win-win for all parties involved. Thus, it is not surprising that many litigation finance agreements are labeled VPFCs rather than loans or immediate sales.[258] Nevertheless, whether the IRS will allow such agreements to benefit from the open transaction doctrine is unclear. Even if so, parties will likely have to structure their agreements carefully to obtain these favorable results.

2. Areas of Uncertainty

Given the complexity of derivatives contracts and uncertainty regarding the tax treatment of VPFCs in the context of litigation finance, a brief digression into the nature, tax consequences, and scholarship of traditional forward contracts, prepaid forward contracts, and VPFCs is prudent. At its core, a VPFC is a permutation of a prepaid forward contract, which is itself a variation of the traditional forward contract. Although the tax treatment for each can be the same, there is a question of whether it should be. Moreover, whether that same tax treatment extends to VPFCs in the litigation finance setting is unknown.

A traditional forward contract entitles the buyer to purchase an asset for a fixed price at a future time.[259] Buyers typically enter into

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258 Wood & Van Loo, *supra* note 29, at 1240.

259 David F. Levy, *Towards Equal Tax Treatment of Economically Equivalent Financial Instruments: Proposals for Taxing Prepaid Forward Contracts, Equity Swaps, and Certain Contingent Debt Instruments*, 3 FLA. TAX REV. 471, 478 (1997).

these contracts as a way to mitigate the risk of price changes.[260] As such, the parties can agree to settle their respective contractual obligations either upon delivery of the asset (i.e., physical settlement) or payment of cash (i.e., cash settlement).[261] Regardless, neither party recognizes any gain or loss from the transaction until the contract is "settled, assigned, or terminated."[262] Moreover, so long as the forward contract is a capital asset in the hands of the taxpayer, any gain or loss resulting from the sale, termination, or settlement of that position is capital in nature.[263]

A prepaid forward contract is similar, except that the buyer pays for future delivery of the asset with a "lump sum payment of a lesser amount of money" at the time of execution.[264] Thus, the fundamental differences between a traditional forward contract and prepaid forward contract are price and timing. Current tax law ignores this distinction, treating the prepayment as merely "a deposit to support the [buyer's] obligations under the contract" per the open transaction doctrine.[265] The result is that a prepaid forward contract has the same tax treatment as its traditional counterpart.

There has been some talk of adjusting the tax consequences of prepaid forward contracts to better align with the economic reality of the situation.[266] As a whole, a prepaid forward contract would be the economic equivalent of the parties entering into a traditional forward contract plus a loan from the buyer to the seller that is ultimately paid off upon physical or cash settlement.[267] From this perspective, the difference between the amount of the loan—i.e., the prepayment—and the value of the eventual cash or physical settlement is the equivalent of interest income to the buyer and should be taxed as ordinary income.[268]

To better align the economic reality and tax treatment of prepaid forward contracts, the IRS issued a notice seeking comments about the proper timing and character of income recognized under a prepaid forward contract.[269] Although the details differ, the various suggestions amount to implementing some form of imputation regime similar to the regulations regarding contingent debt, such as the OID rules discussed

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260 *Id.*; SAM CHEN & PAUL J. KUNKEL, PORTFOLIO 188: TAXATION OF EQUITY DERIVATIVES § I.B (2d ed. n.d.).

261 CHEN & KUNKEL, *supra* note 260, at § I.B.2.a.

262 *Id.*

263 *Id.*; I.R.C. § 1234A; *see* Prop. Treas. Reg. § 1.1234A-1, 69 Fed. Reg. 8886, 8891, 8898 (Feb. 26, 2004).

264 Levy, *supra* note 259, at 481.

265 Steven M. Rosenthal & Liz R. Dyor, *Prepaid Forward Contracts and Equity Collars: Tax Traps and Opportunities*, J. TAX'N FIN. PRODS., Winter 2001, at 35, 36; *see* David A. Weisbach, *Tax Responses to Financial Contract Innovation*, 50 TAX L. REV. 491, 498 (1995).

266 *See* CHEN & KUNKEL, *supra* note 260, § I.B.2.b.

267 *See* Levy, *supra* note 259, at 483.

268 *Id.* at 517.

269 I.R.S. Notice 2008-2, 2008-2 I.R.B. 252; CHEN & KUNKEL, *supra* note 260, at § I.B.2.b.

in Section II.B.2.a.[270] Under this regime, the buyer recognizes imputed interest income each year based on their assumed return on the initial loan amount.[271] If the eventual settlement price is unknown, the interest is calculated based on a "comparable yield" or market borrowing rate, with an adjustment mechanism upon cash or physical settlement.[272] The remainder of the transaction is taxed as a traditional forward contract.[273] Additional solutions include adopting the contingent debt regulations or implementing a mark-to-market system.[274] Unfortunately, these and other solutions designed to bring the tax treatment of derivatives in line with economically equivalent transactions likely require "a comprehensive overhaul of our current tax system,"[275] which may "increase the complexity of the system, distort economic behavior and create possibilities for electivity and/or abuse."[276] Thus, it is uncertain whether such changes would take place.

VPFCs are an alteration of the prepaid forward contract that provide taxpayers with appreciated equity positions "an opportunity to monetize their position without paying tax."[277] In essence, a buyer makes a payment upon execution of the contract for the future delivery of an asset held by the seller, the exact amount of which varies based on a predetermined formula.[278] VPFCs differ from prepaid forwards in three crucial respects: (1) the seller holds a pre-existing position in the underlying asset; (2) the exact amount of the underlying asset is uncertain; and (3) the buyer typically receives the right to a "fixed interest coupon payment from the selling party with respect to the money it has deposited to secure its obligation under the forward contract."[279]

It is possible for a properly structured VPFC to have the same tax consequences as the traditional and prepaid forward contracts—that is, the transaction would be treated as open such that any gain or loss is not recognized until delivery of the underlying asset or upon cash settlement.[280] Any gain or loss would be capital in nature so long as the

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270 *See, e.g.*, DAVID M. SCHIZER, N.Y. STATE BAR ASS'N, TIMING AND CHARACTER RULES FOR PREPAID FORWARDS AND OPTIONS 2–3 (2001); MICHAEL FARBER & ARI WEINSTEIN, N.Y. STATE BAR ASS'N, REPORT ON PREPAID FORWARD CONTRACTS 4, 6 (2008); Levy, *supra* note 259, at 517–19.

271 SCHIZER, *supra* note 270, at 4–5; Levy, *supra* note 259, at 517–19; FARBER & WEINSTEIN, *supra* note 270, at 6.

272 *See, e.g.*, FARBER & WEINSTEIN, *supra* note 270, at 9–10; Levy, *supra* note 259, at 517–19; SCHIZER, *supra* note 270, at 4–5.

273 *See* SCHIZER, *supra* note 270, at 18–19.

274 FARBER & WEINSTEIN, *supra* note 270, at 12.

275 Levy, *supra* note 259, at 514.

276 FARBER & WEINSTEIN, *supra* note 270, at 7.

277 CHEN & KUNKEL, *supra* note 260, § I.G.1.

278 *Id.*

279 *Id.*

280 *See* Rosenthal & Dyor, *supra* note 265, at 37–38 ("In a typical variable share prepaid forward contract, the taxpayer does not know which shares of stock, if any, will be delivered to close

VPFC is a capital asset in the hands of the taxpayer. However, whether the IRS would allow this favorable treatment in the context of litigation finance depends on whether the open transaction doctrine is applicable, and if so, how the parties structure the agreement.

The favorable treatment currently afforded prepaid forward contracts is centered on the open transaction doctrine, which is a "rule of fairness"[281] initially adopted in *Burnet v. Logan*[282] for "cases with so much uncertainty that it is impossible to determine whether any profit will be realized, because income is contingent upon unknown factors."[283] Although no existing authority applies this doctrine to a VPFC in a litigation finance setting, IRS Revenue Ruling 2003-7 applied it in the context of a VPFC for stock.[284] In the ruling, an individual shareholder received an upfront cash payment in exchange for an obligation three years later to deliver a variable amount of stock, determined via a preset formula.[285] The ruling concludes that the shareholder does not have to recognize income upon receipt of the upfront payment because (1) the shareholder has "an unrestricted legal right to substitute cash or other shares for the pledged shares," (2) the shareholder was not "economically compelled to deliver the pledged shares," and (3) the shareholder maintained voting and dividend rights throughout the three years.[286]

The Tax Court recently discussed the open transaction treatment presented in Revenue Ruling 2003-7 in the 2017 case of *Estate of McKelvey v. Commissioner*.[287] In *McKelvey*, an investment bank paid the plaintiff $50 million in exchange for the plaintiff's future delivery of a variable amount of stock, determined via a preset formula.[288] Although the ultimate holding is irrelevant, the court's rationale explains that VPFCs

> are afforded "open" transaction treatment because either the amount realized or the adjusted basis needed for a section 1001 calculation is not known until contract maturity. In these

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the transaction. Thus, until the shares actually are transferred, the transaction is treated as open."); CHEN & KUNKEL, *supra* note 260, § I.G.1.c ("A VPFC (when properly structured) is not generally treated as a current sale of the underlying stock . . . .").

281 Estate of McKelvey v. Comm'r, 148 T.C. 312, 326 (2017) (quoting Dennis v. Comm'r, 473 F.2d 274, 285 (5th Cir. 1973)), *rev'd*, 906 F.3d 26 (2d Cir. 2018). The reasons for reversal do not implicate the issues discussed in this Article. *See McKelvey*, 906 F.3d at 34–35 (2d Cir. 2018) (holding that the Tax Court incorrectly determined that the taxpayer's restructuring and refinancing of a VPFC was not an exchange).

282 283 U.S. 404 (1931).

283 Bernice Patton Testamentary Tr. v. United States, No. 96-37T, 2001 WL 429809, at *3 (Fed. Cl. Mar. 20, 2001) (citing *Burnet*, 283 U.S. at 413).

284 *See* Rev. Rul. 2003-7, 2003-1 C.B. 363.

285 *Id.* at 363.

286 *Id.* at 364–65; *see also* CHEN & KUNKEL, *supra* note 260, § I.B.2.b (analyzing the conclusion of Revenue Ruling 2003-7).

287 148 T.C. 312 (2017), *rev'd*, 906 F.3d 26.

288 *Id.* at 313.

> instances the component that is known is held in suspense and gain or loss is not realized until the missing component is determined and the transaction is properly closed.[289]

At first glance, the available authority looks like a homerun for taxpayers. Nevertheless, the good news for taxpayers is tempered because the IRS's position in the Revenue Ruling 2003-7 is guaranteed only under identical facts and circumstances.[290] What is more, the IRS is loath to apply the open transaction doctrine except under very "rare and extraordinary" circumstances.[291] Courts are of a similar disposition, typically opting to obtain fair results by using the best estimate of the asset's fair market value rather than postpone the sale.[292] Some courts have even limited the holding in *Burnet* to require that both the amount realized and the basis be unknown, the latter of which is not an issue in the litigation finance context.[293] Finally, the discrepancy between the IRS and courts' tax treatment and the economic reality of prepaid forward contracts leaves open the possibility of bifurcation.

Assuming the IRS and courts are willing to apply the open transaction doctrine to litigation finance agreements, not every agreement labeled as a VPFC qualifies for favorable treatment. Thus, perhaps the true value of Revenue Ruling 2003-7 is that it provides taxpayers with guidelines on how to structure a VPFC to maintain the open nature of the transaction. Applying these guidelines to litigation financing would suggest, for example, that the beneficiary (1) should have "an unrestricted legal right to substitute cash or other [property] for the pledged [litigation proceeds]" upon settlement of the case,[294] (2) is not "economically compelled to deliver the pledged [litigation proceeds],"[295] and (3) retains the rights and benefits of the claim throughout the litigation.[296] Yet even this guidance is limited in practical value. For starters, funders may be unwilling to enter into an agreement that allows for the substitution of other property at the close of the case.[297] Moreover, there

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289 *Id.* at 326 (citation omitted).

290 *See* Internal Revenue Serv., LMSB-04-1207-077, All Industries — Variable Prepaid Forward Contracts Incorporating Share Lending Arrangements (2008) ("Rev. Rul. 2003-7 generally will not serve as substantial authority for the VPFC transactions described herein, subject to additional administrative guidance."); *see also* Chen & Kunkel, *supra* note 260, § I.G.1.e (noting the IRS's aggressive position in categorizing VPFC transactions "notwithstanding Rev. Rul. 2003-7").

291 Wood & Van Loo, *supra* note 125, at 439 n.28.

292 *See, e.g.*, Bernice Patton Testamentary Tr. v. United States, No. 96-37T, 2001 WL 429809, at *5 (Fed. Cl. Mar. 20, 2001).

293 *See* Daily, *supra* note 54, at 30.

294 Rev. Rul. 2003-7, 2003-1 C.B. 363, 365.

295 *Id.*

296 *See id.* at 364.

297 *See* Chen & Kunkel, *supra* note 260, § I.G.1.d.

is currently no concrete understanding of what qualifies as "economic compulsion," nor whether the potential ethical issues of the litigation finance industry give rise to such.[298] Finally, the retention of rights and control implicates the notion of tax ownership, a notoriously convoluted concept that Part III discusses in more depth.

III. Classifying Litigation Finance

Based on the analysis of the potential tax consequences to the beneficiary and the funder under the three potential categories of litigation finance contracts discussed in Part II, this Part examines the second question: whether a particular litigation finance arrangement is a loan, sale, or VPFC for tax purposes.

Unfortunately, these agreements do not aways fit cleanly into any one box. The only modern case to directly address this issue is *Novoselsky*, which held that a litigation financing transaction was not a loan but a sale primarily because the beneficiary had a conditional obligation to pay.[299] This Article disagrees with the Tax Court's rationale. Instead, this Part proposes a novel test that focuses on the key tenets of tax ownership—namely, the economic risk and legal control. Given the historic difficulty of identifying tax ownership, it overviews tax ownership jurisprudence and scholarship and then provides a new proposal for classifying litigation finance.

A. A Critique of Novoselsky

The only available case on how to characterize litigation finance transactions is *Novoselsky*. Mr. Novoselsky, a class action attorney, entered into various "litigation support agreements with at least nine individuals or entities," receiving a total of $410,000 in 2009 and $1 million in 2011.[300] The exact labels of each agreement differ; some were explicitly described as nonrecourse loans whereas others considered the amount funded as a credit or a retainer fee.[301] The method of repayment also varied between an annual interest rate, a percentage of the proceeds of litigation, or a lump sum payment of a specified amount of cash.[302] Consistent across all the agreements, however, was that Mr. Novoselsky had no obligation to repay the funds advanced unless the relevant litigation was successful.[303] Mr. Novoselsky treated the amount received as loans and did not include the amounts funded in

298 *See* Rev. Rul. 2003-7, 2003-1 C.B. 363, 364.

299 Novoselsky v. Comm'r, 119 T.C.M. (CCH) 1474, at *26–28 (2020).

300 *Id.* at *4, *9.

301 *Id.* at *4–9.

302 *Id.*

303 *Id.* at *8.

gross receipts on his 2009 or 2011 tax returns.[304] The IRS disagreed with this position, issuing a notice of deficiency for the amounts funded.[305]

The issue confronted by the Tax Court was whether the amount Mr. Novoselsky received constituted gross income.[306] The court began its analysis by concluding that the traditional rules governing contingent debt also "appl[y] to payment obligations conditioned on the outcome of litigation."[307] In other words, the money Mr. Novoselsky received would only be respected as a loan, and thus not included in gross income, if there was an "unconditional obligation . . . to pay . . . a definite sum of money."[308] To support this position, the Tax Court cited two cases dealing with litigation financing related issues: *Bercaw v. Commissioner*[309] and *Estate of Paine v. Commissioner*.[310] In *Bercaw*, the Fourth Circuit held that a taxpayer's advance of funds to a guardian to pay for litigation was not a debt because the guardian only had to pay back the principal amount if the litigation was successful.[311] Similarly, in *Estate of Paine*, the Tax Court held that a taxpayer's weekly payments to family members did not constitute a loan because the family members only had to pay back the money if they "realized, through judgment or settlement or otherwise, proceeds from the prosecution of . . . [a specified] lawsuit."[312] Applying the same principles to *Novoselsky*, the court held that the litigation support agreements were not loans because Mr. Novoselsky only had to repay the funders if the litigation was successful, and thus the funding had to be included in gross income.[313]

The Tax Court also reasoned that it would come to the same conclusion under a more traditional multifactor approach. Under this approach, the court determines whether "there [was] a genuine intention to create a debt, with a reasonable expectation of repayment" by considering a variety of factors.[314] In addition to the unconditional obligation to pay, the court looks at "such factors as the existence vel non of a debt instrument; provisions for security, interest, and a fixed

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304 *Id.* at *9.

305 *Id.* at *10–11.

306 *Id.* at *2–3.

307 *Id.* at *17.

308 *Id.* at *18 (first alteration in original) (quoting United States v. Henderson, 375 F.2d 36, 39 (5th Cir. 1967)).

309 165 F.2d 521 (4th Cir. 1948).

310 22 T.C.M. (CCH) 1383 (1963); *Novoselsky*, 119 T.C.M. (CCH) at *17 (2020).

311 *Novoselsky*, 119 T.C.M. (CCH) at *17.

312 *Id.* (alterations in original) (quoting Estate of Paine v. Comm'r, 22 T.C.M. (CCH) 1383, 1389 (1963)).

313 *Id.* at *17–18.

314 *Id.* at *21 (alteration in original) (quoting Litton Bus. Sys., Inc. v. Comm'r, 61 T.C. 367, 377 (1973)).

repayment schedule; the taxpayer's ability to repay the loan; and whether loan repayments were in fact made."[315]

Applying these factors, the court concluded that Mr. Novoselsky's litigation support agreements fell short of being loans.[316] The court first pointed out that Mr. Novoselsky did not execute a formal promissory note, as he failed to establish a fixed schedule for repayment, provide any collateral or security, or receive any principal or interest payments.[317] However, the fact that Mr. Novoselsky's "repayment was contingent on the uncertain outcome of litigation" remained the most important factor to the court.[318] Because the funds were not "advanced with reasonable expectations of repayment regardless of the success of the venture," the court reasoned that the parties did not treat the transaction as a bona fide loan.[319] The court further cited *Frierdich v. Commissioner*[320] to justify its conclusion. In *Frierdich*, an attorney's $100,000 promissory note subject to 8% interest was not a loan from a client but rather an advancement for future services, because the note explicitly linked repayment to the attorney's completion of services.[321] Comparing the two cases, the Tax Court stated that the facts of *Novoselsky* were even stronger then the *Frierdich* case, as Mr. Novoselsky's repayment was contingent on the litigation succeeding.[322]

The Tax Court's application of the contingent debt analysis and multifactor loan test is understandable given the relatively new emergence of litigation finance transactions and Mr. Novoselsky's position that the litigation support agreements were loans. Nevertheless, as the first case to directly address the characterization and tax consequences of litigation finance transactions, the court had the opportunity to provide taxpayers with additional guidance and highlight various areas of uncertainty requiring further clarification from the IRS, as *Novoselsky* involved various types of litigation finance agreements. Unfortunately, the court chose to lump together the agreements into one analysis and failed to highlight the true complexity of these arrangements.

This Article's primary criticism is the court's heavy reliance on whether Mr. Novoselsky had an unconditional obligation to repay the funds received. Even when purporting to apply a "multi-factor" test, the court based its conclusion almost entirely on the fact that repayment

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315 *Id.* at *22–23.

316 *Id.* at *24.

317 *Id.* at *21.

318 *Id.*

319 *Id.* at *21–22 (quoting Ill. Tool Works Inc. v. Comm'r, 116 T.C.M. (CCH) 124, at *47 (2018)).

320 925 F.2d 180 (7th Cir. 1991).

321 *Id.* at 181–82, 186.

322 *See Novoselsky*, 119 T.C.M. (CCH) at *24.

was only required if litigation was successful.[323] By the court's logic, a litigation finance agreement will never qualify as a loan, regardless of a "genuine intention to create a debt[] with a reasonable expectation of repayment," the execution of a formal promissory note, or the provision of collateral or security.[324] The unconditional obligation to repay cannot be a dispositive factor given that it is possible to have a loan where the debtor lacks an unconditional obligation to pay. It is for these reasons that "no single factor is controlling" in these multifactor tests, which are at best "a source of helpful guidance."[325]

Additionally, nothing in the court's holding or rationale provides any insight into the true nature of the litigation finance transaction. By only concluding that the agreements were not loans, the court left the question of the transaction's true nature and tax consequences open to interpretation. Did Mr. Novoselsky's income stem from a payment for future services, the immediate sale of his contractual right to legal service fees, or a prepayment for delivery of forthcoming litigation proceeds? As Part II makes clear, answers to these and similar questions significantly impact the tax consequences to both beneficiaries and funders.

The purpose of this Section is not to criticize the Tax Court's analysis in *Novoselsky* harshly. As alluded to above, this Article empathizes with the court's position and understands its logic. Rather, this Article's intent is to highlight the need for a more well-rounded approach to analyze litigation finance transactions. Courts should adopt a multifactor approach structured around the two fundamental aspects of tax ownership, legal control and economic risk, as well as the ancillary factor of the repayment structure. Section III.B provides an overview of tax ownership, and Section III.C provides an in-depth analysis of this Article's proposal and methods of implementation.

B. Tax Ownership Revisited

Tax ownership plays an essential role in determining tax consequences. For example, owners respected under tax law may recognize income produced by property and take advantage of related tax benefits such as depreciation and amortization.[326] Moreover, it is the transfer of ownership in property that triggers realization of any gain or loss.[327] Yet, despite its importance, the concept of tax ownership is notoriously

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323 *See id.* at *18, *24.

324 *See id.* at *21 (quoting Litton Bus. Sys., Inc. v. Comm'r, 61 T.C. 367, 377 (1973)).

325 *Id.* at *20 (first quoting Busch v. Comm'r, 728 F.2d 945, 948 (7th Cir. 1984); and then quoting MoneyGram Int'l, Inc. v. Comm'r, 153 T.C. 185, 216 (2019)).

326 *See* Miller, *supra* note 43, at 285–87; Cunningham & Schenk, *supra* note 43, at 725; Shaviro, *supra* note 43, at 643–45.

327 Cunningham & Schenk, *supra* note 43, at 725.

convoluted.[328] Neither Congress nor the IRS has provided taxpayers with a clear formula for identifying tax ownership.[329] Rather, courts have been left to develop their own methods, resulting in a complex "patchwork of rules that appear to lack a unifying principle (or set of principles)."[330] To be fair, any comprehensive answer to the question of tax ownership is not likely to be simple, as the complexity of modern transactions and use of innovative financial instruments shun a one-size-fits-all solution.[331] The goal of this Article is to offer a more stylized approach in the narrow context of litigation finance that focuses on broad themes of economic risk and legal control. To provide more context for its proposal, the remainder of this Section offers an overview of the traditional tax ownership analysis and related scholarship.

1. Economic Risk

Case law makes it clear that ownership is not dependent on possession or title alone, but rather on the economic reality of the situation.[332] Courts apply variations of a multifactor test to identify the true nature of a transaction.[333] Although the exact considerations vary, courts rely heavily on the broad themes of economic exposure and legal control.[334] The controversial case *Frank Lyon Co. v. United States* demonstrates the heavy reliance on economic risk to determine ownership.[335] In *Frank Lyon*, the Worthen Bank & Trust Company ("Worthen") set out to construct a building and entered into a series of agreements with the Frank Lyon Company ("Lyon") to obtain funding.[336] The agreements provided that Lyon would simultaneously purchase the building and lease it back to Worthen as it was being constructed.[337] During the construction period, Worthen retained the benefits and burdens of ownership, but Lyon held nontransferable legal title.[338] At specific times, Worthen also had the option to either extend the lease period or repurchase the

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328 Raskolnikov, *supra* note 45, at 432.

329 *See id.*

330 *Id.*

331 *See* Cunningham & Schenk, *supra* note 43, at 725 n.1.

332 *See* Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978) ("[T]he Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed.").

333 *See generally* Raskolnikov, *supra* note 45 (discussing the different factors courts use to identify tax ownership under certain circumstances).

334 *See, e.g.*, *Frank Lyon*, 435 U.S. at 576–81; Helvering v. Clifford, 309 U.S. 331, 335–37 (1940).

335 *See Frank Lyon*, 435 U.S. at 576–81; *see also* Bernard Wolfman, *The Supreme Court in the* Lyon*'s Den: A Failure of Judicial Process*, 66 Cornell L. Rev. 1075, 1090–99 (1981) (reflecting on the problems with and aftermath of the Court's opinion in *Frank Lyon*).

336 *Frank Lyon*, 435 U.S. at 565–68.

337 *Id.* at 565.

338 *Id.* at 566–67.

building by paying off the mortgage and repaying Lyon's investment with interest.[339] Importantly, Worthen was not obligated to pay any rent until the building was completed, and Lyon was primarily liable for the third-party loans.[340]

Upon completion of the building, Worthen took rental deductions for the payments required under the lease, while Lyon recognized ordinary rental income and deducted both the interest payments on the mortgage and depreciation on the building.[341] The IRS recharacterized the transaction, finding that Worthen was the true owner.[342] The Supreme Court disagreed with the IRS in a seven-to-two decision, reasoning that Lyon was the true owner because it bore the "real and substantial risk" of being liable for the attached mortgage notes and not recouping its initial investment if Worthen decided to not exercise its repurchase or lease extension options.[343] The Court then proceeded to lay out twenty-six factors in support of its position.[344]

The Supreme Court's decision in *Frank Lyon* has been heavily criticized as creating a tax shelter for taxpayers and confusing the tax ownership analysis.[345] Nevertheless, *Frank Lyon* remains good law, and the spirit of the test—namely, the importance of economic risk and loss—remains a way to identify the economic substance of a transaction.[346]

2. Legal Control

Although the risk-based approach adopted in *Frank Lyon* has its merits, risk alone is not always indicative of true economic ownership.[347] Case law suggests that the next most important factor of ownership

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339 *Id.*

340 *Id.* at 566, 568.

341 *Id.* at 568.

342 *Id.*

343 *Id.* at 576–77.

344 *Id.* at 582–83.

345 *See* Wolfman, *supra* note 335, at 1099–100 ("The elucidation of principle in tax cases should not depend on irrelevant or legalistic distinctions. A Supreme Court opinion ought not become the basis for tax lawyers to make a laughingstock of the Court as they now do when quite routinely they add unnecessary third parties to financing transactions in order to qualify for the shelter of *Frank Lyon*."); Charles I. Kingson, *The Confusion over Tax Ownership*, 93 TAX NOTES 409, 410 (2001) (criticizing *Frank Lyon* as "nobody knows what it means").

346 *See, e.g.*, John Hancock Life Ins. (U.S.A.) v. Comm'r, 141 T.C. 1, 56–58 (2013); Exelon Corp. v. Comm'r, 147 T.C. 230, 289–90 (2016), *aff'd*, 906 F.3d 513 (7th Cir. 2018); Aderholt Specialty Co. v. Comm'r, 50 T.C.M. (CCH) 1101, 1108 (1985).

347 *See* Shaviro, *supra* note 43, at 643–45 (criticizing the use of risk-based rules in the tax system more broadly as well as for derivatives); Edward D. Kleinbard, *Risky and Riskless Positions in Securities*, 71 TAXES 783, 785 (1993) ("[I]t is possible to be a riskless owner of securities for realization purposes. If riskiness were a *sine qua non* of ownership in the first instance, no capital gain holding period would begin (or continue) during a period that an investor had immunized itself from market risk, because the investor would not be treated as owning the immunized asset at all.").

is control over the underlying property. The Supreme Court took this approach in *Helvering v. Clifford*.[348] In *Clifford*, a husband created a five-year trust made up of securities for the exclusive benefit of his wife.[349] During that time, he was to maintain absolute discretion over the distribution of any investment proceeds and management of the underlying securities.[350] The Court held that the husband was the true owner of the underlying securities because his control "was in all essential respects the same after the trust was created, as before."[351] Also, since the beneficiary was his wife, the husband was assured that the trust would not substantially change his economic position.[352] Although preempted,[353] the Court's holding in *Clifford* has been used to support the notion that a "derivative holder with investment control is the tax owner of the underlying assets."[354]

Clifford illustrates what is perhaps the most recognizable element of control: the ability to manage the underlying assets. However, the right to freely transfer the underlying asset is also a strong indicator. For example, in Revenue Ruling 82-144, an investor purchased municipal bonds at fair market value along with nontransferable put options to sell the bonds back to the original seller.[355] The IRS concluded that the investor owned the bonds because he "h[eld] the obligations for [his] own benefit and was free to dispose of the obligations at any time."[356] Similarly, in *Richardson v. Shaw*,[357] the Court held that a stockholder owned a publicly traded security despite the fact that possession and legal title belonged to the broker.[358] The Court reasoned that as a matter of law, the broker could not transfer the securities to anyone but the stockholder.[359] *Shaw* also demonstrates the importance of identifying the specific asset in determining the timing of both control and economic exposure. In the context of forward and futures contracts, the underlying asset and timing are especially relevant, as the general law on tax ownership provides that a "holder of a forward or futures contract to purchase property, who does not hold and cannot acquire title of

348 309 U.S. 331 (1940).

349 *Id.* at 332.

350 *Id.* at 332–33.

351 *Id.* at 335.

352 *Id.* at 335–36.

353 *See* I.R.C. § 671 ("No items of a trust shall be included in computing the taxable income and credits of the grantor . . . solely on the grounds of his dominion and control over the trust . . . .").

354 Miller, *supra* note 43, at 324.

355 *See* Rev. Rul. 82-144, 1982-2 C.B. 34, 34.

356 *Id.* at 35.

357 209 U.S. 365 (1908).

358 *See id.* at 380.

359 *Id.* at 379–80.

or possess or control the property, is not generally treated as the owner of the property for federal income tax purposes prior to settlement."[360]

In some circumstances, control even overrides economic exposure.[361] In *Provost v. United States*,[362] the Court addressed the issue of whether a broker's loan of stock transfers ownership to the borrower.[363] Despite acknowledging that the lender retained economic exposure, the Court held that it was a transfer of ownership because the borrower retained control.[364]

3. Distilling into Two Main Factors

This Article believes that the core attributes of ownership are economic exposure and legal control of the underlying asset. Some may view this two-main-factor interpretation of the law as an oversimplification. Indeed, various scholars have tackled the challenge of identifying an underlying logic to the cases dealing with tax ownership.[365] Perhaps the most thorough is Alex Raskolnikov's work.

Raskolnikov performs an extensive analysis of existing law and offers a comprehensive framework for analyzing tax ownership based on the fungibility of the underlying asset in one of two factual scenarios that he labels as the "whether" and "when" cases.[366] The former arises if the question is whether ownership transferred at all, whereas the latter deals with the question of timing.[367] The result is four potential categories and tests for determining ownership: (1) "nonfungible whether," (2) "fungible whether," (3) "nonfungible when," and (4) "fungible when" cases.[368]

The "whether" scenarios deal with the question of whether the taxpayer sold an asset. "Nonfungible whether" cases often arise in the

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360 Miller, *supra* note 43, at 305; *see also* Lucas v. N. Tex. Lumber Co., 281 U.S. 11, 13–14 (1930) (holding that for tax purposes, a landowner retained title and right of possession to land despite an open option contract to purchase such land and the holder's intent to exercise that option); Modesto Dry Yard, Inc. v. Comm'r, 14 T.C. 374, 386 (1950) ("Under a contract to sell unascertained or future goods by description, title thereof does not pass to the purchaser until goods of that description in a deliverable state are unconditionally appropriated . . . .").

361 Raskolnikov, *supra* note 45, at 482 ("[C]ontrol overrides economic exposure . . . .").

362 269 U.S. 443 (1926).

363 *Id.* at 450.

364 *Id.* at 454–56; *see also* Raskolnikov, *supra* note 45, at 481–82 ("[A] borrower does become a tax owner of a borrowed stock because . . . the stock borrower's control is complete.").

365 *See generally* Kleinbard, *supra* note 347 (explaining the criteria and general principles for determining the tax ownership of publicly traded securities); Reid Thompson & David Weisbach, *Attributes of Ownership*, 67 Tax L. Rev. 249 (2014) (proposing a tax ownership rule for fungible securities that focuses on assigning tax attributes).

366 Raskolnikov, *supra* note 45, at 434.

367 *See id.*

368 *Id.*

context of sale-leaseback transactions.[369] In these cases, the test focuses primarily on who bears the economic benefits and burdens of the property.[370] In contrast, the test for "fungible whether" cases places less weight on economic exposure in favor of identifying who has control over the asset.[371] "Fungible whether" cases frequently deal with the sale and repurchase of securities.[372]

If there was a transfer of ownership, the "when" cases deal with the timing of that transfer. The classic example of a "nonfungible when" case is the sale of an office building.[373] Although the authorities purport to use a multifactor test to identify when ownership transfers, Raskolnikov argues that courts primarily focus on the point of no return.[374] In other words, "the sale takes place when neither the buyer nor the seller can [unilaterally] back away from the deal."[375] On the other hand, the test for "fungible when" cases states that transfer of ownership does not occur "until the specific [assets] are identified, usually by delivery to the buyer."[376]

Raskolnikov provides a thorough review of the available authorities on tax ownership and identifies the common themes throughout. Indeed, his work was instrumental in helping conceptualize and form this Article's proposal. For example, the "whether" and "when" analyses in the context of litigation finance are closely intertwined, as the "whether" analysis deals with the distinction between a sale or loan and the "when" analysis separates an immediate sale from a VPFC. Nevertheless, this Article declines to adopt his approach in the context of litigation finance for two reasons. This departure is not meant to criticize Raskolnikov's work, but rather to recite and expand upon the limitations that he acknowledges.[377]

First, despite his efforts to the contrary, Raskolnikov's proposal fails to provide the simplicity that this area of law so dearly needs. Raskolnikov's framework merely organizes the factors that courts have been using for years.[378] Although the organization of this large body of law is certainly helpful to conceptualize the nature of tax ownership and identify relevant authorities, it fails to provide practitioners with any additional certainty, as the complex and fact-intensive inquiries

369 *See id.* at 473.
370 *See id.* at 476.
371 *See id.* at 488.
372 *See id.* at 435.
373 *Id.*
374 *Id.*
375 *Id.*
376 *Id.*
377 *See id.* at 516.
378 *See id.* at 433.

performed by the courts remain unchanged.[379] Absent very similar facts to the cases discussed in this Article, practitioners are still largely in the dark. Moreover, placing a specific transaction in one of the four categories is no easy task.[380]

Second, the two tests that would be relevant in the context of litigation finance transactions fall apart in the face of litigation finance agreements. Given the distinct nature of a legal claim, litigation finance transactions most likely qualify as nonfungible.[381] Therefore, under Raskolnikov's "nonfungible whether" test, a sale occurs if the funder bears the economic benefits and burdens. As discussed in more detail below, this test will always result in a litigation finance transaction being treated as a sale because the funder almost always has economic exposure. However, placing excessive weight on economic exposure runs the risk of ignoring the true substance of the transaction, as it is possible to have a loan under which the lender retains economic exposure—e.g., nonrecourse loans. As commenters have pointed out, the risk-based approach in the context of derivatives contracts and the like is largely ineffective due to the ability of taxpayers to manipulate the situation in their favor.[382]

Alternatively, if it is clear that there is a transfer of ownership, Raskolnikov's "nonfungible when" test provides that the transfer of ownership occurs at the point when neither the beneficiary nor funder can unilaterally back out of the deal.[383] Unfortunately, this test is also largely unhelpful. Assuming the beneficiary retains the ability to control settlement of the case, the nonrecourse nature of the funding permits the beneficiary to essentially "back out" at any time. This test will always result in treating litigation finance transactions as a VPFC because ownership will never transfer until the close of litigation.[384] Again, placing excessive weight on the ability to back out of the transaction disregards economic reality because the ability to back out is also a feature of nonrecourse loans. Moreover, it forecloses the possibility of the transaction being treated as an immediate sale in favor of what is essentially a bright-line rule, opening the door for extensive tax planning.

This Article's view is that the core attributes of tax ownership are economic exposure and legal control over the underlying asset. Although current law typically opts for either a risk-based or control-based approach,[385] the complex nature of modern financial

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379 *See supra* notes 344–46 and accompanying text.

380 *See* Raskolnikov, *supra* note 45, at 512–14.

381 *See id.* at 436–37; Richardson v. Shaw, 209 U.S. 365, 378–79 (1908).

382 *See, e.g.*, Kleinbard, *supra* note 347, at 783, 785; Miller, *supra* note 43, at 327.

383 *See* Raskolnikov, *supra* note 45, at 458.

384 *See supra* note 360 and accompanying text.

385 *See supra* notes 346, 355–60 and accompanying text.

instruments—such as litigation finance contracts—necessitates the consideration of both. David Miller's work provides further support for this position.[386] Miller suggests that taxpayers wanting to avoid the negative consequences that come with ownership in the context of forward contracts should not exercise any control over the asset or receive any income from the asset.[387] Thus, rather than adopting one of the existing multifactor tests, this Article proposes a new, more stylized approach in the context of litigation finance centered around these core concepts. This proposal is not dismissing the use of a multifactor test, but rather offering a clearer guideline on the relevant factors to litigation financing. Section III.C will lay out the proposal in more detail.

C. A Proposal Based on Tax Ownership

This Article proposes that the best way to identify whether litigation finance transactions qualify as a loan, sale, or VPFC is to apply a customized, multifactor analysis centered around the concept of tax ownership. In the context of litigation finance, there are two key factors to consider. The first is whether the funder bears the economic risk with respect to the transaction.[388] The second and more important factor is whether the funder has legal control. In the context of litigation finance, legal control comes in two flavors: control over the litigation itself[389] and the ability to freely transfer the rights and obligations with respect to litigation.[390] This proposal also entertains the idea of incorporating at least one ancillary factor in complex situations: the form of repayment. Put simply, repayment structures that reflect the time value of money would represent interest and may indicate a loan.

1. Economic Risk

The first factor of the proposal is economic risk. The underlying logic is that any party who bears the benefits and burdens with respect to property must be the true owner.[391] In the context of litigation finance, the economic risk factor looks to whether the beneficiary or the funder is entitled to any profits attributable to the legal claim or subject to the risk of loss if the claim is unsuccessful. Typically, the transaction

386 *See* Miller, *supra* note 43, at 285.

387 *See id.* at 327.

388 As discussed in more detail below, this burden will almost always be borne by the funder given the nonrecourse nature of litigation finance arrangements.

389 *See* Helvering v. Clifford, 309 U.S. 331, 335 (1940) ("[T]he retention of control . . . by respondent all lead irresistibly to the conclusion that respondent continued to be the owner . . . .").

390 *See* Kleinbard, *supra* note 347, at 799 (noting that an investor owned bonds because they were "free to dispose of the obligations at any time" (quoting Rev. Rul. 82-144, 1982-2 C.B. 34, 35)).

391 *See supra* Section III.B.1.

resembles a loan if the relevant risks remain with the beneficiary and a sale if the relevant risks are transferred to the funder.[392]

It is apparent that the economic risk in traditional litigation finance transactions almost always lies with the funder, as demonstrated in the sample litigation finance contracts in the Appendix.[393] First, any profit stemming from the underlying legal claim goes to the funder upon successful resolution of litigation.[394] However, the right to profit inquiry is largely unhelpful because, unlike stock or rental property, the legal claim does not provide any ongoing profits to the true owner. The more relevant factor would be the risk of loss. Still, the nonrecourse nature of these transactions means that the funder bears the risk of loss.[395] Although the beneficiary has a degree of risk with respect to the litigation itself, only the funder will lose money from the transaction if the case fails.

If the analysis solely relied on economic risk, it would result in treating all litigation finance transactions as sales for tax purposes. Such an outcome contradicts with the treatment of nonrecourse debt under current law. A nonrecourse loan imposes no personal liability on the debtor. Rather, the risk of nonpayment or a drop in the collateral's value falls on the lender.[396] The exact same risk allocation occurs in the context of litigation finance, in which the funder loses its investment if the litigation is unsuccessful. Nevertheless, the law respects nonrecourse loans as true debt.[397] This true-debt approach supports this Article's position that the unconditional-obligation-to-pay requirement applied in *Novoselsky* should not be dispositive, as the economic reality of nonrecourse loans is that the debtor has no personal obligation to pay. Thus, although economic risk is an important factor to consider, it does not fit perfectly within the context of litigation finance transactions because the law respects nonrecourse loans as true debt.

The true-debt approach was initially adopted by the court in *Crane v. Commissioner*.[398] The taxpayer in *Crane* inherited a building from her late husband.[399] The building was subject to an existing mortgage that the taxpayer had no personal obligation to repay—i.e., nonrecourse debt.[400] The question before the Court was whether the taxpayer had

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392 *See supra* notes 336–44 and accompanying text.

393 *See infra* text accompanying note 456 (granting the funder profit following successful litigation, recoupment of investment if net litigation proceeds are too low, and no recovery if the claim fails).

394 *See infra* text accompanying note 473.

395 *Cf.* Shaviro, *supra* note 16, at 427 (explaining that the lender or funder bears the risk in a nonrecourse mortgage arrangement).

396 *See id.*

397 *See* Crane v. Comm'r, 331 U.S. 1, 11, 14 (1947).

398 331 U.S. 1 (1947).

399 *Id.* at 3.

400 *Id.* at 3–4.

to include the amount of nonrecourse debt in calculating her gain or loss from the sale of the building.[401] Despite the lack of any personal liability, the Court held that the taxpayer should include the amount of nonrecourse debt in calculating her cost basis and amount realized.[402] Citing administrative simplicity, the Court wanted to avoid the "tremendous accounting burden on both the Commissioner and the taxpayer" of calculating annually shifting basis for the purpose of depreciation deductions.[403]

Unsurprisingly, the *Crane* ruling created a market for tax shelters utilizing nonrecourse debt.[404] The Ninth Circuit largely shut this market down in the *Estate of Franklin v. Commissioner*,[405] when it held that basis excludes nonrecourse debt if the debt greatly exceeds the fair market value of property securing such debt.[406] Moreover, the Court in *Commissioner v. Tufts*[407] clarified that the entire amount of nonrecourse debt attached to property must be included in the amount realized upon disposition of property.[408] Congress also stepped in by imposing various at-risk rules on nonrecourse debt.[409] Although these efforts largely succeeded in curbing the tax shelters, the true-debt approach to nonrecourse debt survived.[410]

Looking back at the historical treatment of nonrecourse debt, some tax commentators are skeptical of the true-debt approach. Linda Sugin argues that the true-debt approach is "unworkable" because it fails to "reflect economic reality or correctly measure income," leads to "bizarre and unpredictable consequences" and opens up opportunities for abuse.[411] Believing that the true-debt approach should be abandoned, Sugin proposes "redefining nonrecourse debt as an investment by the lender in the securing property, rather than as part of the borrower's current cost of the property."[412] Daniel Shaviro also criticizes the rules

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401 *Id.* at 4–5.

402 *Id.* at 11, 14.

403 *Id.* at 10; *see also* Linda Sugin, *Nonrecourse Debt Revisited, Restructured and Redefined*, 51 TAX L. REV. 115, 119 (1995) ("One of the Court's primary concerns in reaching its conclusion . . . was administrative.").

404 Shaviro, *supra* note 16, at 425.

405 544 F.2d 1045 (9th Cir. 1976).

406 *Id.* at 1048–49; *see also* Shaviro, *supra* note 16, at 425 (discussing *Estate of Franklin* as a way to limit the scope of *Crane* and the tax shelters that followed).

407 461 U.S. 300 (1983).

408 *Id.* at 307, 310; *see also* Shaviro, *supra* note 16, at 425 (discussing *Tufts* as a way to limit the scope of *Crane* and the tax shelters that followed).

409 Shaviro, *supra* note 16, at 425–26 (discussing congressional efforts to combat tax shelters facilitated by nonrecourse debt).

410 *See Tufts*, 461 U.S. at 307 ("[W]e read *Crane* to have approved the Commissioner's decision to treat a nonrecourse mortgage in this context as a true loan.").

411 Sugin, *supra* note 403, at 115.

412 *Id.* at 117.

stemming from *Crane* as erratic, complex, and overly harsh given the nontax benefits of nonrecourse loans and argues for more favorable rules compared to the current regime.[413] Unlike Sugin, however, Shaviro does not advocate throwing out the true-debt approach entirely.[414] Citing the "political or administrative impossibility" of changing the entire tax system, Shaviro asserts that any attempt to limit the true-debt treatment of nonrecourse loans would impose a "set of penalties for risk aversion," essentially charging a toll to achieve a desired tax outcome and ignoring the valid nontax reasons for engaging in nonrecourse transactions.[415] Regardless, the true-debt approach lives on and is unlikely to change. Despite empathizing with Sugin's criticism that such treatment fails to recognize economic reality, this Article ultimately agrees with Shaviro that "it often is better to do nothing than to pursue first best objectives by second best means."[416]

2. Legal Control

The second factor of the proposal is legal control. Unlike economic risk, the analysis for legal control is likely to produce more than one result and, thus, is particularly relevant in the context of litigation finance. Control comes in two flavors: (1) control over the contractual right to receive the proceeds of successful litigation and (2) control over the legal claim itself. As illustrated in the sample contracts in the Appendix, the former is easier to identify but not a perfect indicator of ownership, whereas the latter is largely dispositive but far harder to substantiate.[417] Evidence of one or both elements is strong evidence of ownership.

Control over the right to receive litigation proceeds is the first class in the analysis. A hallmark of this type of control is free transferability.[418] The proposed test then asks whether the funder can sell or otherwise transfer the right to receive proceeds from a successful settlement. If so, the ownership likely transferred to the funder. Identifying control via transferability is beneficial for two reasons. First, the right to transfer is relatively easy to identify based on contractual terms and the law governing contracts.[419] Second, and more importantly, the analysis of litigation finance contracts in the Appendix discovered substantial variations in the funder's rights to transfer, with some allowing free

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413 *See* Shaviro, *supra* note 16, at 444–45.

414 *See id.* at 444.

415 *Id.* at 444–45.

416 *Id.* at 444.

417 *See, e.g.*, *infra* text accompanying notes 466–68.

418 *See supra* notes 355–59 and accompanying text.

419 *See, e.g.*, Helvering v. Clifford, 309 U.S. 331, 332–33, 335 (1940).

transferability[420] and others requiring permission from the beneficiary.[421] Given the available information and this disparity in empirical evidence, this Article believes that free transferability highly indicates the presence of legal control and ownership. The one caveat is that like economic risk, free transferability is not a perfect indicator because some loans allow lenders to assign their rights to third parties.[422]

The second class of the legal control test is control over the legal claim itself. Here, the test asks whether the funder can make legal decisions that are typically reserved only for the beneficiary, such as the decision to settle or move forward with a case. This Article argues that when a funder has the ability to control the course of litigation, it indisputably proves that ownership of the claim belongs with the funder. Unfortunately, the application of this test may be challenging for two reasons. First, it may be difficult to identify how much control is sufficient to constitute ownership. The ability to accept or reject settlement offers is obviously enough, but the funder's ability to influence legal strategy presents a harder question. Also, given the unequal bargaining positions of beneficiaries and funders, a funder with the right to provide "advice" could effectively assert control over the litigation. Second, it may be difficult to prove sufficient legal control given the lack of regulation and overall secrecy surrounding the litigation finance industry. Some funders voluntarily reported to GAO that they had no authority to make litigation decisions.[423] Even if these assertions were true, there is evidence to suggest that these funders are in the minority. The Institute for Legal Reform sent a letter to the Administrative Office of the United States Courts stating that "we are not aware of any actual agreements that do not contain provisions affording funders some degree of control or influence over the litigation they are financing."[424] Indeed, there are reports that Burford Capital, one of the larger publicly traded litigation finance firms, recently objected and sought to block a settlement agreement it deemed insufficient in a case it funded.[425] Despite these challenges,

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420 *See, e.g.*, discussion *infra* note 468.

421 *See, e.g.*, discussion *infra* note 464.

422 *See generally* Dahnken v. Wells Fargo Bank, 705 Fed. Appx. 508 (9th Cir. 2017) (discussing the assignment and securitization of mortgages).

423 U.S. Gov't Accountability Off., *supra* note 4, at 10–11, 14.

424 Inst. for Legal Reform, Comment Letter on Proposed Federal Rule of Civil Procedure 26(a)(1)(A)(v), at 3–4 (May 8, 2023), https://www.uscourts.gov/sites/default/files/23-cv-m_suggestion_from_35_organizations_-_rule_26_0.pdf [https://perma.cc/W3ZV-3AJE]; *see also* Lee, *supra* note 92 (discussing the rise of third-party litigation finance and the influence that funders can have over the litigation they fund).

425 Lee, *supra* note 92 ("[W]hen [the beneficiary] tried to settle its claims with the meat producers without needlessly protracting the costly litigation, Burford objected and sought to block settlements that it considered insufficient.").

the effort of identifying who controls the legal claim is worthwhile because it provides such dispositive evidence of ownership.

Further, the act of connecting control over the legal claim with tax ownership serves the valuable purpose of correcting the various agency problems that arise in litigation financing.[426] As discussed in Section I.B, litigation financing gives rise to agency problems that stem from the fundamentally different aims of the beneficiary and the funder.[427] For example, funders have much higher risk appetites than typical beneficiaries because funders are repeat players in litigation and opt to diversify risk by taking on more claims, whereas beneficiaries only occasionally go to court.[428] For similar reasons, it may be profitable for funders to pursue litigation in hopes of changing or shaping the law, whereas a beneficiary may be more concerned with the immediate claim.[429] Funders also primarily care about the monetary aspects of litigation.[430] In contrast, the nonmonetary aspects of litigation such as obtaining "justice" or avoiding bad press may be significant to beneficiaries.[431] Finally, a funder has a fiduciary duty to maximize profit for its shareholders or investors, but an attorney owes a duty to their client.[432] These conflicting incentives have a profound impact on each party's decisions in a case.[433]

Tax law can help reduce these agency problems by matching tax ownership with the party that controls the claim. When a funder controls a claim, the funder owns the claim for tax purposes. This tax ownership, as demonstrated below, warrants treating the litigation finance agreement as a sale.[434] Given that a sale, relative to a loan or VPFC, imposes the worst tax consequences onto a funder and a beneficiary,[435] both the funder and beneficiary will want to avoid this treatment. This desire to avoid a sale disincentivizes the funder from controlling the claim and incentivizes the beneficiary to control the claim. This Article, however, acknowledges that funder control can sometimes benefit litigation because the funder often has much greater litigation experience.[436]

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426 *See supra* notes 91–97 and accompanying text.

427 At the heart of these differences is the differing incentives of a repeat player versus a one-shot player. Repeat players like funders engage in many similar litigations and thus have lower stakes in any one case. One-shot players like beneficiaries only occasionally go to court and thus have much higher stakes in any one claim. *See* Steinitz, *Whose Claim*, *supra* note 7, at 1303–04.

428 *See id.* at 1305.

429 *See id.* at 1312.

430 *Id.* at 1321.

431 *See id.*

432 *Id.* at 1319.

433 *See id.* at 1323.

434 *See infra* Section III.C.4.

435 *See supra* Table 1.

436 *See* Marc Galanter, *Why the "Haves" Come out Ahead: Speculations on the Limits of Legal Change*, 9 Law & Soc'y Rev. 95, 98, 103 (1974).

Nevertheless, this does not resolve the agency problems.[437] Tax ownership thus provides a simple, logical solution that could mitigate these agency issues.

3. Additional Factor: Form of Repayment

The proposal also entertains the idea of incorporating at least one ancillary factor in complex situations: the format of repayment. Put simply, payment structures that reflect the time value of money may be indicative of a loan generating interest income.

Interest is "compensation for the use or forbearance of money"[438] and represents the time value of money. The time value of money states that a dollar now is worth more than a dollar later owing to the effect of interest.[439] Hence, interest rates are a key quantitative representation of the time value of money, and interest is considered equivalent to the time value of money.[440] If the repayment scheme in a litigation finance contract is calculated based on a formula that reflects the time value of money, that would be strong evidence for classifying the contract as a loan.

As illustrated in the Appendix, there are various arrangements for how the proceeds from a successful suit are distributed. For some agreements, the funder gets a fixed percentage of the litigation proceeds.[441] This kind of distribution is more like an investment return and would not be characterized as interest. Another form of distribution provides the funder a certain multiple of its funding amount for a specific period that has elapsed since the original funding date. These distributions are more like interest.

4. Application

The application of this proposal is straightforward. First, if economic exposure and legal control lie with the funder, the transaction will be treated as an immediate sale for tax purposes. Second, if ownership remains with the beneficiary, the transaction will be treated as either a loan or VPFC based on the taxpayer's intent. In the rare case in which the intent is unclear, the format of repayment becomes relevant. Figure 2 visualizes application of the proposal.

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437 *See* Steinitz, *Contract*, *supra* note 7, at 488, 496–515.

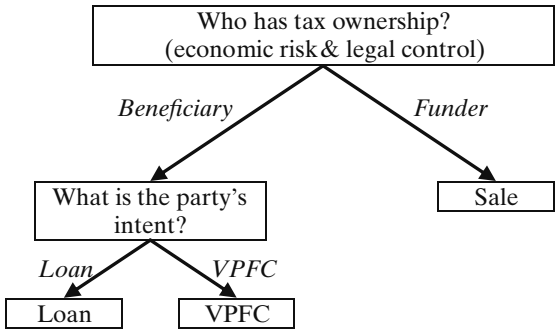
438 Deputy v. du Pont, 308 U.S. 488, 498 (1940).

439 GRAETZ & ALSTOTT, *supra* note 43, at 767.

440 *See, e.g.*, Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 YALE L.J. 506, 507 (1986); Lawrence Lokken, *The Time Value of Money Rules*, 42 TAX L. REV. 1, 11 (1986).

441 *See infra* notes 453–57, 456, 483, 508, 514 and accompanying text.

FIGURE 2. FLOW CHART FOR CLASSIFYING LITIGATION FINANCE CONTRACTS FOR TAX PURPOSES



The simplicity of this proposal is by design. The proposal may become more complex when ownership lies with the beneficiary, as both loans and VPFCs have that same characteristic. Rather than complicating the classification by adding additional considerations, the proposal opts to merely respect the form of the transaction. Because ownership rightfully lies with the beneficiary under either a loan or VPFC scenario, this treatment aligns with economic reality. In other words, substance matches both possible forms. As Section III.B demonstrated, the existing tests and proposals for identifying ownership are comprehensive but lack practicality.[442] By merely respecting the taxpayer's stated intent, the proposal further fills the practicality gap in the context of litigation finance and simultaneously aligns with the transaction's substance. Finally, the acceptance of form can be justified from a policy perspective. The recent emergence of the litigation finance industry has the potential to expand access to justice by making litigation more affordable.[443] The proposal's minimalistic approach thus reduces the risk of unintentionally hamstringing the positive externalities of the market's growth.

In the Appendix, this Article applies the proposal to publicly available litigation finance transactions.[444] This analysis demonstrates the proposal's ability to accurately discern the character of litigation finance transactions as either sales or loans. Although this analysis fails to include a VPFC-type transaction, practitioners can nevertheless successfully apply this analysis themselves. Discerning between loans and VPFCs requires less demonstration, given that this step of the proposal examines the stated intents of the funder and beneficiary.

This Article acknowledges the challenges of implementation brought on by the current state of the law. Thus, in addition to the

442 *See supra* Section III.B.

443 *See* U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 4, at 18–19.

444 *See infra* Appendix.

proposal, this Article expressly calls on the tax authorities to issue additional regulations and rulings to provide taxpayers with guidance in this area. In so doing, this Article strongly recommends incorporating the key factors and uncertainties addressed in Parts II and III.

This Article also stands with those calling on courts and regulatory bodies to impose more uniform obligations of disclosure on the litigation finance industry. However, the Article goes one step further and encourages courts and regulators to impose disclosure obligations not just pursuant to social justice but also pursuant to the factors relevant to tax policy. In so doing, tax policy may contribute to solve agency problems associated with litigation financing, which would be another excellent way to use taxation for regulatory purposes to address externalities in the market.[445]

Conclusion

Litigation finance is a billion-dollar industry that can potentially expand access to the justice system by combatting increasing litigation costs. However, this relatively new and largely unregulated industry also raises ethical challenges and legal uncertainties. Scholars and practitioners alike opine that third-party litigation financing may further reduce the efficiency of the court system by increasing the number of frivolous lawsuits and giving rise to agency issues that allow for improper influence over the underlying legal claim. However, lesser attention has been given to the substantive legal implications of the practice, such as the proper tax consequences to the beneficiary and the funder. This Article aims to fill that gap and encourage further guidance from the tax authority and regulators.

From a tax perspective, the most significant ambiguity surrounding litigation finance transactions is the timing and character of any gain or loss recognized by the relevant parties. Such uncertainty stems from the inability to easily classify these transactions as a loan, sale, or VPFC, all of which have profoundly different tax consequences. Unfortunately, there is little guidance on where to draw the line. The lack of clear lines combined with the shadowy nature of the industry creates opportunities for taxpayers to structure their transactions to obtain the best tax outcomes without altering their economic positions.

This Article proposes that the best way to identify the true nature of litigation finance transactions and impose proper tax treatment is to apply a customized, multifactor analysis centered around the concept of tax ownership. Although identifying tax ownership has traditionally

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445 *See, e.g.*, Reuven S. Avi-Yonah, *Taxation as Regulation: Carbon Tax, Health Care Tax, Bank Tax and Other Regulatory Taxes*, Acct., Econ., & L. 2–3 (Jan. 31, 2011), https://www.degruyter.com/document/doi/10.2202/2152-2820.1008 [https://perma.cc/L6VR-ZDGG].

been difficult, this Article's proposal simplifies the analysis to two key factors: the economic risk of loss and legal control.

The proposal may identify the true nature of litigation finance transactions and impose proper tax treatment on the parties involved. In addition, by attaching ownership to legal control over the claim, the proposal may prevent, or at least not exacerbate, the agency issues inherent in the industry. The simplicity of this approach promotes tax certainty in a new and emerging market without hindering growth.

Appendix: Analysis of Sample Litigation Finance Contracts

This Article collected publicly available litigation finance contracts to analyze their tax consequences. When determining whether an agreement is a sale, loan, or VPFC, this Article looks at the tax ownership of the funding agreement through two criteria. The first criterion is who has the economic benefits and risks of a funding agreement. Generally, the funder does. The second criterion is the control or free transferability of the asset. Under this criterion, the Article looks to see who controls the contractual right to the claim; if the funder can transfer the right freely, the agreement is likely a sale, and if not, then it is a loan. Further, the Article looks at who controls the underlying asset—the litigation itself. If the funder controls the litigation, the agreement looks more like a sale. If the beneficiary still controls the litigation, the agreement looks more like a loan, because ownership of the claim has not been fully transferred to the funder. Unfortunately, the Article did not find any publicly available litigation finance contracts that resembled a VPFC. Table 2 below summarizes the key provisions of the sample contracts.

This Article concludes that control of the litigation has considerable influence in determining loan or sale characterization because the control provisions in the sample contracts provided herein are in line with the parties' intent to treat their agreement as a sale or loan. An example is the BioCardia funding agreement,[446] in which the beneficiary had the ultimate right to settle the claim[447] and neither the funder nor beneficiary could assign without consent of the other party—which shows lack of free transferability.[448] However, there are funding agreements in which determination of loan or sale through the two factors can be more complicated. Some agreements will give the funder free transferability of the asset, allowing the funder to assign its rights freely without the consent of the beneficiary. But in these same agreements, the beneficiary simultaneously retains full control. Although the free transferability may imply a sale characterization, the control aspect is in tension with that characterization because the funder lacks ultimate control of the underlying asset—a characteristic more in line with a loan. In these agreements, there are other provisions that can help with the loan or sale determination. The DiaMedica agreement[449] is a helpful example where the agreement allows the funder to assign freely

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446 Litigation Funding Agreement Between BioCardia, Inc. & BSLF, LLC (Apr. 9, 2020) [hereinafter BioCardia Agreement], https://www.sec.gov/Archives/edgar/data/925741/000143774920007637/ex_181285.htm [https://perma.cc/3RWY-89HG].

447 *Id.* at 3.

448 *Id.* at 9.

449 Litigation Funding Agreement Between LEGALIST FUND II, L.P. & DiaMedica Therapeutics Inc. (Dec. 27, 2019) [hereinafter DiaMedica Agreement], https://www.sec.gov/Archives/edgar/data/1401040/000143774920000102/ex_168050.htm [https://perma.cc/3XG9-KZEW].

without consent[450] but the beneficiary still retains full control of the suit.[451] The agreement has another provision that implies that both parties consider the claim proceeds as collateral and that the funder is the first creditor.[452] This provision coupled with the control provision brings the agreement more in line with the loan characterization.

There are various arrangements for how the litigation proceeds from a successful suit are distributed. For some agreements, the funder gets a fixed percentage of the entire litigation proceeds. This kind of distribution is more like an investment return and would not be characterized as interest. Examples of that type of agreement include the UMB Bank,[453] Strikeforce,[454] Dominion Minerals,[455] Overland Storage,[456] and Treca agreements.[457] Another form of distribution is one in which the funder gets a certain multiple of its funding amount for a specific period that has elapsed since the original funding date. These distributions feel more like interest. Examples of this type of arrangement include the AmBase,[458] DiaMedica,[459] and Prism Technologies[460] agreements.

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450 *Id.* at 11.

451 *Id.* at 7.

452 *Id.* at 9.

453 Press Release, Sanofi, Sanofi Announces Settlement Agreement Related to Contingent Value Rights (CVRs) Litigation (Oct. 31, 2019), https://www.sec.gov/Archives/edgar/data/1121404/000114036119019468/ex99_1.htm [https://perma.cc/3ADD-6ETP].

454 Strikeforce Techs., Inc., Annual Report (Form 10-K) item 8, at F-13 (Dec. 31, 2019), https://www.sec.gov/Archives/edgar/data/1285543/000147793220002343/sfor_10k.htm [https://perma.cc/5NRE-HRS4].

455 Litigation Funding Agreement Between Therium Fin. AG IC & Dominion Mins. Corp. 3 (2015) [hereinafter Dominion Minerals Agreement], https://www.sec.gov/Archives/edgar/data/1402747/000151116417000078/f105.htm [https://perma.cc/GA2K-EMQE]; *see also* Dominion Mins. Corp., Amendment No. 1 to Form 10 (Form 10-12G/A) 13 (Feb. 14, 2017), https://www.sec.gov/Archives/edgar/data/1402747/000151116417000078/form10.htm [https://perma.cc/4HYL-RWNU] (providing that this agreement was entered on June 18, 2015).

456 Special Situations Fund III QP, L.P. v. Overland Storage, Inc., No. 651557/2014, 2017 WL 4517773, at *1–2 (N.Y. Sup. Ct. Sept. 27, 2017); *see also* Sphere 3D Corp., Annual Report (Form 10-K) app. at F-34 (Dec. 31, 2018), https://www.sec.gov/Archives/edgar/data/1591956/000159195619000008/a10-ksphere12312018.htm [https://perma.cc/44EJ-SHGP] (discussing the litigation funding agreement between the parties and the subsequent litigation between the parties relating to the funding agreement).

457 Funding Agreement Between Treca Fin. Sols. & Claimants, sched. 1, at 3 (Nov. 29, 2011) [hereinafter Treca Agreement], https://disputefinancinglibrary.org/?r=3441 [https://perma.cc/Z2VL-RFSC].

458 Letter from AmBase Corp. to Richard A. Bianco (Sept. 26, 2017) [hereinafter AmBase Agreement], https://www.sec.gov/Archives/edgar/data/20639/000002063917000034/litfundagree.htm [https://perma.cc/8T37-ASDF].

459 DiaMedica Agreement, *supra* note 449.

460 Litigation Funding Agreement Between Bentham Cap. LLC & Prism Techs. LLC, 22 (Dec. 15. 2016) [hereinafter Prism Agreement], https://www.sec.gov/Archives/edgar/data/1077370/000143774917013467/ex10-10.htm [https://perma.cc/J8MA-PLU6].

TABLE 2: SUMMARY OF KEY PROVISIONS

Beneficiary / Funder	Type Proposed by the Author	Who Controls the Litigation	Who Can Assign the Claim	How Are Litigation Proceeds Distributed
Claimants / Treca Financial Solutions[461]	Loan, as the agreement grants funder a security interest in litigation proceeds[462]	Beneficiary controls and directs a trust that holds all litigation rights and proceeds therefrom[463]	Neither party can assign without consent of the other party[464]	When litigation proceeds exceed $1 billion, funder receives 5.545% of all proceeds When litigation proceeds are less than $1 billion, funder receives 98.25% of all proceeds but only to the extent necessary to recoup its investment When litigation proceeds are less than $2.5 million, funder receives nothing[465]
AmBase Corp. / Richard A. Bianco[466]	Loan, as litigation proceeds are used to fully reimburse the funder on a first-priority basis[467]	Unspecified	Beneficiary cannot assign without funder's consent Funder may freely assign[468]	Funder is first repaid in full for all amounts funded If litigation proceeds are received within 36 months, funder receives 30% of the excess If litigation proceeds are received outside of 36 months, funder receives 45% of excess[469]

461 Treca Agreement, *supra* note 457, at 2.

462 *See id.* at 12–13.

463 *See id.* at 10.

464 *See id.* at 26.

465 *See id.* sched. 1, at 3–4.

466 AmBase Agreement, *supra* note 458.

467 *Id.*

468 *Id.*

469 *Id.*

Beneficiary / Funder	Type Proposed by the Author	Who Controls the Litigation	Who Can Assign the Claim	How Are Litigation Proceeds Distributed
BioCardia, Inc. / BSLF, LLC[470]	More likely a loan, as beneficiary retains right to settle claim, the agreement grants funder first lien to all litigation proceeds as collateral, and neither party can transfer without the other's consent[471]	Beneficiary retains right to accept or decline settlement[472]	Neither party can assign without consent of the other party	Funder is first repaid in full for all amounts funded Of the remainder, funder gets the greater of (1) 50% of the remaining litigation proceeds up to three times the actual funding or (2) 30% of the remaining litigation proceeds[473]
DiaMedica Therapautics Inc. / LEGALIST FUND II, L.P.[474]	Both sale and loan aspects Sale, as agreement imposes no assignment restrictions on funder Loan, as beneficiary retains control of litigation[475] Loan, as section 6.10 implies that litigation proceeds are funder's collateral[476]	Beneficiary must update funder Beneficiary retains control of litigation[477]	Beneficiary cannot assign without funder's consent[478] No explicit limitation on funder's ability to assign	Funder is first repaid in full for all amounts funded If repayment occurs within 9 months, the greater of $1 million or 20% of the litigation proceeds If repayment occurs outside of 9 months, the greater of $2 million or 20% of litigation proceeds[479]

470 BioCardia Agreement, *supra* note 446.

471 *Id.* at 3, 7, 9.

472 *Id.* at 3.

473 *Id.* at 15.

474 DiaMedica Agreement, *supra* note 449.

475 *See id.* at 7.

476 *See id.* at 9.

477 *See id.* at 7–8.

478 *See id.* at 11.

479 *See id.* at 2.

Beneficiary / Funder	Type Proposed by the Author	Who Controls the Litigation	Who Can Assign the Claim	How Are Litigation Proceeds Distributed
Dominion Minerals Corp. / Therium Finance AG IC[480]	More likely a loan, as section 6.3 suggests that a loan was intended, and beneficiary retains control However, funder can assign freely (but this Article places greater emphasis on control of litigation)[481]	Nothing in agreement entitles funder to interfere with or control litigation	Funder can assign with notice Beneficiary cannot assign[482]	Funder receives 2.5 times the total amount funded plus a contingency fee ranging between 2% and 35% of litigation proceeds depending on the total amount funded and litigation proceeds awarded[483]
RareGen, LLC / PBM RG Holdings, LLC[484]	More likely a sale, as funder has right to control litigation, and beneficiary forfeits any right in litigation proceeds[485]	Funder has right to control litigation[486]	Neither party can assign without consent of the other party[487]	Funder receives all litigation proceeds less the amount owed to the senior lender[488]
Client / Atlas Legal Funding[489]	Loan, as beneficiary remains in control and funder's repayment is structured as accrued interest	Beneficiary retains control of litigation, with agreement explicitly stating that funder has no right to control litigation[490]	Funder may freely assign with notice[491]	Funder receives the amount funded plus accrued interest[492]

480 Dominion Minerals Agreement, *supra* note 455.

481 *See id*. at 8–9.

482 *See id.* at 16.

483 *See id.* at 3, 6, 19.

484 Litigation Funding and Indemnification Agreement Between PBM RG Holdings, LLC and RareGen, LLC (Nov. 17, 2020), https://www.sec.gov/Archives/edgar/data/1819576/000110465920126838/tm2035325d12_ex10-1.htm [https://perma.cc/AVC5-3XXM].

485 *See id.* at 2, 6, 9.

486 *See id.* at 8.

487 *See id.* at 16.

488 *See id.* at 2–3, 6–7.

489 Funding Agreement Between Atlas Legal Funding II, L.P. and Client (Feb. 12, 2016), https://disputefinancinglibrary.org/?r=4041 [https://perma.cc/NTT9-E3AN].

490 *See id.* at 4.

491 *See id.* at 7.

492 *See id.* at 3.

Beneficiary / Funder	Type Proposed by the Author	Who Controls the Litigation	Who Can Assign the Claim	How Are Litigation Proceeds Distributed
Novelstem International Corp. / Omni Bridgeway (Fund 4) Invt. 3 L.P.[493]	Unclear, given the lack of any information regarding control and assignability	Unspecified	Unspecified	Funder receives the amount funded plus a multiple of such in the case of a successful claim[494]
PARTS iD, Inc. / Pravati Investment Fund VI LP[495]	More likely a loan, as agreement provides funder a security interest in litigation proceeds[496] However, agreement explicitly states that it is not a loan[497]	Beneficiary retains control of litigation, with agreement explicitly stating that funder has no right to control litigation[498]	Neither party can assign without consent of the other party[499]	Funder is first repaid in full for all amounts funded If repayment occurs within 15 months, funder additionally receives 2.3 times the amount funded If repayment occurs between 15 and 24 months, funder additionally receives 2.7 times the amount funded If repayment occurs outside of 24 months, funder additionally receives 3.5 times the amount funded[500]

493 Novelstem Int'l Corp., Quarterly Report (Form 10-Q) 11 (June 30, 2023), https://www.sec.gov/Archives/edgar/data/912544/000149315223028259/form10-q.htm [https://perma.cc/PM4U-KVLY].

494 *Id.*

495 Litigation Funding Agreement Between Pravati Inv. Fund VI LP and PARTS iD, Inc. (Sept. 29, 2023), https://www.sec.gov/Archives/edgar/data/1698113/000101376223002237/ea186124ex10-1_partsid.htm [https://perma.cc/6CSN-87VR].

496 *See id.* at 2, 12.

497 *See id.* at 27.

498 *See id.* at 12.

499 *See id.* at 24.

500 *See id*. at 7.

Beneficiary / Funder	Type Proposed by the Author	Who Controls the Litigation	Who Can Assign the Claim	How Are Litigation Proceeds Distributed
Prism Technologies LLC / Bentham Capital LLC[501]	Loan, as agreement provides funder a security interest in litigation proceeds, not only from the present litigation but also from related litigation[502]	Beneficiary retained sole right to settle the litigation[503]	Neither party can assign without consent of the other party[504]	If litigation proceeds are received within 18 months, funder receives 2.5 times the funding amount If litigation proceeds are received outside of 18 months, funder receives 3 times the funding amount If the present litigation fails to fully repay the funding amount, funder is entitled to litigation proceeds received in related litigation[505]
UMB Bank, N.A. as trustee for contingent value rights holders / certain contingent value rights holders[506]	Unclear, as beneficiary is the trustee of funders and funders are also parties to the litigation[507]	Unspecified	Unspecified	Funders receive the greater of (1) half the contingent legal fees plus the funding amount or (2) between 20% and 27% of the gross litigation proceeds, which was estimated to total $107 million[508]

501 Prism Agreement, *supra* note 460.

502 *See id.* at 10, 18, 22.

503 *See id.* at 3.

504 *See id.* at 14.

505 *See id.* at 2, 22.

506 Sanofi, *supra* note 453.

507 *Id.*

508 *Id.*

Beneficiary / Funder	Type Proposed by the Author	Who Controls the Litigation	Who Can Assign the Claim	How Are Litigation Proceeds Distributed
Overland Storage, Inc. / Special Situations Fund III QP, L.P.[509]	Sale, as beneficiary sold funders an interest in certain patent infringement claims[510]	Beneficiary retained sole right to settle the litigation[511]	Unspecified	Funders receive 20% of litigation proceeds However, if beneficiary enters into a merger transaction prior to conclusion of the litigation, funders receive a payment of $6 million[512]
Strikeforce Technologies, Inc. / Therium Inc. & VGL Capital, LLC[513]	Unclear, given the lack of any information regarding control and assignability	Unspecified	Unspecified	From the litigation proceeds, funders receive full repayment, then 10% of additional proceeds up to $7.5 million, and then 2.5% of any proceeds remaining[514]

509 Sphere 3D Corp., *supra* note 456, at 19–20.

510 Special Situations Fund III QP, L.P. v. Overland Storage, Inc., No. 651557/2014, 2017 WL 4517773, at *1 (N.Y. Sup. Ct. Sept. 27, 2017).

511 *Id.* at *14.

512 *Id.* at *1–2.

513 Strikeforce Techs., Inc., *supra* note 454, item 8, at F-13.

514 *Id.*