TAX LAW ESSAY WINNERS

Excerpt: The Potential Implications of *Marinello* in § 7212(a) Prosecutions

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Introduction

This paper excerpt analyzes the *United States v. Marinello,* Supreme Court decision on whether a conviction under 26 U.S.C. § 7212(a)'s omnibus clause, for corruptly endeavoring to obstruct or impede the due administration of the tax laws requires proof that a defendant acted with knowledge of a pending Internal Revenue Service action. For a full version of the paper that won second place in the 2018 Donald C. Alexander Tax Law Writing Competition, please see the *Inside Basis* publication.

Part I: 26 U.S.C. § 7212(a)

A. § 7212(a)

Section 7212(a) of the Internal Revenue Code ("IRC" or "Code") consists primarily of two clauses.[1] The first clause prohibits corrupt or forcible endeavors to interfere with U.S. employees acting pursuant to Title 26.[2] The second clause, referred to as "the omnibus clause," prohibits corrupt or by threat of force, to obstruct or impede, or endeavors to obstruct or impede the due administration of the Code.[3] The omnibus clause is a catchall provision that criminalizes "any other way" of corruptly obstructing or impeding the "due administration" of the IRC. The omnibus clause is generally reserved for conduct occurring after a tax return has been filed, where the actions by the taxpayer or other person has impeded or obstructed the audit or investigation.[4]

B. Required Elements for Obstruction of Due Administration

The government must prove three elements beyond a reasonable doubt to prosecute a defendant with violating § 7212(a)'s omnibus clause: (1) in any way endeavored, (2) corruptly, and (3) to obstruct or impede the due administration of the IRC.[5]

1. Definition of Corruptly

The term "corruptly" is not defined in the Code.[6] In *United States v. Reeves,* the district court defined "corruptly" as meaning "with improper motive or bad or evil purpose."[7] In *United States v. Floyd,* the court held that the term "corruptly" in § 7212(a) means "acting with an intent to procure an unlawful benefit either for the actor or for some other person."[8]

2. Definition of Endeavor

Courts interpreting the term "endeavor" under § 7212(a) have looked to case law interpreting similar language in the obstruction of justice statutes such as 18 U.S.C. §§ 1503 and 1505.[9] The term "endeavor" as used in § 7212(a) is any effort to do or accomplish the evil purpose the section was intended to prevent.[10] According to the DOJ CTM, the means by which a defendant can "endeavor" to impede the due administration of the internal revenue laws is virtually unlimited.[11] In *United States v. Johnson,* the jury was instructed that "[a]n endeavor is any effort or any act or attempt to effectuate an arrangement or try to do something, the natural and probable consequence of which is to obstruct or impede the due administration of the Internal Revenue laws."[12]

3. To Obstruct or Impede the Due Administration of the Code

Section 7212(a) is aimed at prohibiting efforts to impede "the collection of one's taxes, the taxes of another, or the auditing of one's or another's tax records."[13] A violation of the omnibus clause can occur *whenever* a defendant intends to impede the administration of the tax laws.[14] A wide umbrella of activities fall under due administration of the internal revenue laws, including: "mailing out internal revenue forms; answering taxpayer's inquires; receiving, processing, recording and maintaining tax returns, payments and other taxpayers' submissions; as well as monitoring taxpayers' compliance with their obligations."[15] In *United States v. Sorenson,* the court held "to 'obstruct or impede' is to hinder or prevent from progress; to slow or stop progress; or to make accomplishment difficult and slow."[16]

C. The Legislative History of § 7212(a)

Section 7212(a) was enacted in 1954 to punish acts or threats of physical force directed at IRS employees in an attempt to obstruct or impede the employee's official acts.[17] Section 7212(a) was intended to outlaw corrupt solicitation of IRS employees engaged in an investigation or collection activity such as bribery or extortion acts.[18] In *United States v. Williams,* a case of first impression regarding interpretation of the omnibus clause, the government acknowledged that it had previously asserted that § 7212 applied only to situations involving force or threat of force.[19] There is nothing in the statute's legislative history that speaks to the view that the omnibus clause was intended to reach the whole gamut of acts which could be characterized as attempts to avoid the operation of the tax laws as a whole.[20]

The limited discussion of the § 7212(a)'s omnibus clause in both the House and Senate reports is extremely informative: if Congress

had wanted to enact an additional statute to be used routinely in prosecuting tax evasion or the submission of false statements, it would have explicitly stated such a far-reaching intention rather than through the use of the term "corruptly."[21]

Part II: Current Interpretation of § 7212(a) Omnibus Clause

Prior to the *Marinello* Supreme Court decision, there was a split among several circuit's interpretation the omnibus clause of § 7212(a).

A. Circuit Splits

1. Sixth Circuit Interpretation

No circuit court prior to *United States v. Kassouf* had decided whether the omnibus clause of § 7212(a) requires a pending IRS proceeding or investigation of which the defendant was aware.[22]

In *Kassouf*, the defendant was charged with using partnership and controlled corporate transactions for his personal benefit and failing to maintain partnership books and records.[23] The district court concluded that the government did not show that the defendant had knowledge of a pending IRS investigation or investigation.[24] The Sixth Circuit affirmed, basing its conclusion on a comparison of the omnibus clause with 18 U.S.C. § 1503 and consulted case law interpreting § 1503 for guidance on how to construe the phrase, "the due administration of this title" under § 7212(a).[25] Specifically, the circuit looked to *United States v. Aguilar,* a decision addressing the scope of conduct covered by § 1503(a)'s broad prohibition on corrupt efforts to influence, obstruct, or impede the due administration of justice.[26]

Section 1503 has been uniformly interpreted as requiring a pending judicial proceeding.[27] In *Aguilar,* the Supreme Court limited the reach of the statute to pending proceedings which had a nexus between the act and the judicial proceeding such that "the act must have a relationship in time, causation, or logic with the judicial proceedings."[28] The Sixth Circuit believed if they imposed liability for conduct with less of a causal connection than what was rejected in *Aguilar,* they would be permitting the IRS to impose liability for conduct which was legal and occurred [well] before an IRS audit, or even tax return, was filed.[29]

2. Tenth, First, Fifth, and Ninth Circuit Interpretations

In contrast to the Sixth Circuit, the Tenth Circuit found 18 U.S.C. § 1503 "substantially different than [§] 7212(a)."[30] Since § 1503(a) requires a defendant to corruptly endeavor to influence, intimidate, or impede any juror, officer of the court, or magistrate judge in court-related duties, the statute inherently requires that the obstructive conduct take place during an ongoing proceeding.[31]

However, a defendant does not need to participate in an ongoing proceeding to "corruptly … endeavor to obstruct or impede the due administration of" the tax laws.[32] The Tenth Circuit found that there are many scenarios where the IRS duly administers the tax laws before initiating a proceeding, for example, when computing taxes owed.[33] A defendant who corruptly endeavors to obstruct or impede the administration of that computation opens themselves up to liability under § 7212(a).[34] Similarly, the First,[35] Fifth,[36] and Ninth[37] Circuits have found that a defendant need not have knowledge of a pending IRS investigation or proceeding before being held criminally liable under the omnibus clause.

B. The Second Circuit's Interpretation in *Marinello*

Marinello was prosecuted for violating the omnibus clause of § 7212(a) by failing to maintain corporate books and records and failing to furnish complete records for his accountant.[38] The court declined to construe § 7212(a) as narrowly as in *Kassouf,* holding that "[k]nowledge of a pending [IRS] investigation is not an essential element of the crime."[39]

The Second Circuit affirmed declining to follow the *Kassouf* standard on the grounds that the text of § 1503(a) is distinguishable from § 7212(a).[40] The circuit stated that § 1503(a)'s statutory language focuses on grand jury or judicial proceedings.[41] The circuit further held that § 7212(a) does not contain any such reference to specific IRS actions, investigations, or proceedings that would support analogizing it to § 1503(a).[42] The two statutes employ different phrases which suggest the statutes carry different meanings: "the due administration of *justice*," 18 U.S.C. § 1503(a) (emphasis added), and "the due administration of *this title*," 26 U.S.C. § 7212(a) (emphasis added).[43]

The Second Circuit denied an en banc review of Marinello's case.[44] Judge Jacobs strongly dissented stating that the broad interpretation and application of the statute could lead to allow any prosecutor to say "show me the man, and I'll find you the crime."[45] Judge Jacobs stated "[i]f Congress intended to dramatically expand the scope of the law in the way that the panel conceives, the legislative history gives no hint of that."[46]

C. Comparison of § 7212(a) to Other Criminal Tax Statutes

All of the primary tax crimes set forth in the IRC require that the defendant act with a specific mental state—that the acts be done "willfully."[47] Congress has not defined the term "willfulness" in the IRC.[48] The "Supreme Court has held that the term 'willfully' has the same meaning in the felony provisions of the IRC (e.g., §§ 7201 and 7206) as it does in the misdemeanor provisions (e.g., §§ 7203 and 7207)."[49] All of the other tax felony statutes require willfulness; § 7212(a) imposes no such requirement.[50]

D. Potential Violations of § 7212(a)

Potential violations of § 7212(a) may result from a lack of knowledge or a misunderstanding of its complexities.[51] Through the internal revenue administration system, the government interacts with "virtually the entire citizenry."[52] Every receipt collected by an individual for a charitable donation, every expense paid by a landlord for their rental property, and every bookkeeping entry made by an accountant could become potentially suspect to the scrutiny of the IRS.[53]

Part III: *Marinello* Supreme Court Decision

The Supreme Court reversed the Second Circuit's judgment on March 21, 2018.[54] In light of the Court's decision in *Aguilar,* the Court found it appropriate to construe § 7212(a)'s omnibus clause more narrowly than the government proposes.[55] The 7-2 majority opinion concluded that the government must prove the following to support a omnibus conviction under § 7212(a): a "nexus" between the defendant's conduct and a particular administrative proceeding, such as an investigation, an audit, or other targeted administrative action, that the proceeding was pending at the time that the defendant engaged in the obstructive conduct or that the proceeding could be reasonably foreseeable.[56]

The majority took the view that "due administration of the tax code" does not cover routine administrative procedures that are near-universally applied to all taxpayers.[57] The clause as a whole refers to specific interference with targeted governmental tax-related proceedings, such as a particular investigation or audit.[58] The dissent felt that this limitation of the statute has no textual basis.[59] The plain meaning of the omnibus clause prohibits the due administration of the tax code in its entirety, not just particular IRS proceedings.[60] The words of "this title" cannot be read to mean "only some of this title."[61] "When Congress wanted to refer only to a particular subsection or paragraph, it said so."[62] According to the dissent, the phrase "due administration of this title" refers to the entire process of taxation, from gathering information to assessing tax liabilities to collecting and levying taxes, it is not only limited to specific provisions of the tax code.[63]

According to the majority, if the omnibus clause is interpreted broadly, perhaps "the provision could apply to a person who pays a babysitter $41 per week in cash without withholding taxes, leaves a large cash tip in a restaurant, fails to keep donation receipts from every charity to which [contributions are made], or fails to provide every record to an accountant."[64] If Congress had intended that outcome, it would have spoken with more clarity than it did in § 7212(a).[65] The dissent felt that whether the omnibus clause would cover the hypothetical scenarios listed in the majority opinion is debatable. [66] The dissent's position is that the majority in its efforts to exclude the hypothetical scenarios has constructed an opening in the omnibus clause large enough that even the worst offenders can escape liability.[67]

The IRC creates numerous misdemeanors.[68] If the Court were to interpret the omnibus clause as applying to all code administration, it would potentially transform "many, if not all," of these misdemeanor provisions into felonies, making the specific provisions redundant, or perhaps the subject matter of plea bargaining.[69] The dissent's view is that *Marinello's* preferred reading of § 7212(a) potentially overlaps with another provision of federal law that criminalizes the obstruction of the "due and proper administration of the law under which any pending proceeding is being had before any department or agency of the United States."[70]

If Marinello was somehow aware of the 2004 IRS investigation for tax evasion on the basis of an anonymous tip, he would then have been placed on alert of a pending IRS investigation or proceeding.[71]

Conclusion

The *Marinello* Supreme Court decision will be a game changer in future § 7212(a) omnibus clause prosecutions. Will the IRS initiate more proceedings so that the government can successfully bring § 7212(a) prosecutions? ⊙

Endnotes

[1]*See* 26 U.S.C. § 7212.
[2]*See id.*
[3]Marcia Coyle, *Jenner Lawyers Attack "Uber Tax Crime Law" in New High Court Term*, Nat'l L.J. (Aug. 11, 2017, 4:00 PM), https://www.law.com/nationallawjournal/sites/nationallawjournal/2017/08/11/jenner-lawyers-attack-uber-tax-crime-law-in-new-high-court-term/?slreturn=20180722232053.
[4]U.S. Dep't of Justice Tax Division, Directive No. 129 (2004), https://www.justice.gov/sites/default/files/tax/legacy/2014/08/05/ CTM%20 Chapter%203.pdf#Directive%20No.%20129.
[5]*United States v. Williams*, 644 F.2d 696, 699 (8th Cir. 1981), CTM § 17.04 (2012 ed.). *See* Mark E. Matthews & Scott A. Schumacher, Effectively Representing Client Before IRS, ch. 13.2.1 (6th ed. 2015).
[6]*See* 26 U.S.C. § 7701 (listing definitions).
[7]*United States v. Reeves*, 752 F.2d 995, 997 (5th Cir 1985).
[8]*United States v. Floyd,* 740 F.3d 22, 31 (1st Cir. 2014); *see* also CTM § 17.04[1].
[9]*See* Jennifer Gibbons, *Note: Proof of Tax Deficiency—The Silent Element in False Statements Charges?*, 50 Ariz. L. Rev. 337, 352 (2008).
[10]*United States v. Martin*, 747 F.2d 1404, 1409 (11th Cir. 1984) (citing *Osborn v. United States*, 385 U.S. 323, 333 (1966)).
[11]*See* CTM § 17.04[2].
[12]571 F. App'x 205, 209 (4th Cir. 2014).
[13]*Reeves*, 752 F.2d at 998; *United States v. Kuball*, 976 F.2d 529, 531 (9th Cir. 1992).
[14]*See* CTM § 17.04[3].
[15]*United States v. Bowman*, 173 F.3d 595, 600 (6th Cir. 1999).
[16]*United States v. Sorenson*, 801 F.3d 1217, 1229 (10th Cir. 2015).
[17]Robert S. Fink & Caroline Rule, *The Growing Epidemic of Section 7212(a) Prosecutions—Is Congress The Only Cure?*, 88 J. Tax'n 356 (1998).
[18]*See id.* at 357.
[19]*Williams*, 644 F.2d at 698, n. 12 (citing *United States v. Henderson*, 386 F.Supp. 1048, 1055-56 (S.D.N.Y. 1974)).
[20]*See id.*
[21]*See* Fink & Rule, *supra* note 17, at 357.
[22]*United States v. Kassouf*, 144 F.3d 952, 955 (6th Cir. 1998).
[23]*Id.* at 953.
[24]*See id.* at 954.
[25]*See id.* at 956-58.
[26]*United States v. Aguilar,* 515 U.S. 593, 598-600 (1995).
[27]*Kassouf*, 144 F.3d 952, 955 (6th Cir. 1998).
[28]*See id.* at 957 (quoting *United States v. Aguilar*, 515 U.S. 593, 599 (1995)).
[29]*See id.*
[30]*Sorensen*, 801 F.3d at 1232 (quoting *United States v. Wood*, 384 F. App'x 698, 703-04 (10th Cir. 2010)).
[31]*See id.*
[32]*See id.*
[33]*See id.* at 1232-33.
[34]*See id.*
[35]*Floyd,* 740 F.3d at 26 (finding the Kassouf Court's decision limited to its facts).
[36]*United States v. Westbrooks,* 858 F.3d 317, 323 (5th Cir. 2017) ("The breadth of § 7212(a)'s language shows that the omnibus clause was intended to prevent frustration of tax collection efforts, a purpose which would be thwarted by [the defendant's] narrow interpretation.").
[37]*United States v. Massey*, 419 F.3d 1008, 1010 (9th Cir. 2005) (finding defendant's threatening letters to the IRS sufficient to show that he hoped to benefit financially from the threats).
[38]*See* Brief for Petitioner at 6a-7a, *Marinello v. United States*, No. 16-1144, 2018 WL1402426 (Mar. 21, 2018).

[39]*United States v. Marinello*, No. 12 Cr. 53S, 2015 BL 475209 at *4 (W.D.N.Y. June 26, 2015) (citing *United States v. Bowman*, 173 F.3d 595, 600 (6th Cir. 1999)).
[40]*United States v. Marinello*, 839 F.2d 209, 222 (2d Cir. 2016).
[41]*See id.* at 220 (citing *United States v. Wood*, 384 F. Appx. 698, 704 (10th Cir. 2010).
[42]*See id.*
[43]*See id.* at 221; *Kassouf*, 144 F.3d at 960 (Daughtrey, J. dissenting in part).
[44]*United States v. Marinello*, 855 F.3d 455 (2d Cir. 2017).
[45]*See id.* at 459.
[46]*See id.*
[47]Stanley S. Arkin et al., Business Crime: Criminal Liability of the Business Community, 27.02[1] n.1, (2017) (discussing stating §§ 7201-7207.)
[48]*See id.* at 27.02[1].
[49]*See id.* at 27.02[1] n.2; *see also* BNA U.S. Income Portfolios: Tax Crimes, at A-4.
[50]Cf. 26 U.S.C. §§ 7201 & 7206 with 7212(a).
[51]Kathryn Keneally & Michael J. Scarduzio, *Renewed Government Focus on Section 7212(a): What Does it Mean to Corruptly Endeavor to Impede the IRS?*, 35 Champion 36 (Sept./Oct. 2017).
[52]*See id.* at 37.
[53]*See id.* at 36.
[54]*Marinello v. United States*, No. 16-1144, 2018 WL1402426 at *8 (Mar. 21, 2018).
[55]*See id.* at *7.
[56]*See id.* at *7-8.
[57]*See id.* at *1.
[58]*See id.*
[59]*See id.* at *10.
[60]*See id.*
[61]*See id.* at *11.
[62]*See id.* (quoting *NRLB v. SW General Inc.*, 137 S.Ct. 929 (2017)).
[63]*See id.* at *12.
[64]*See id.* at *5.
[65]*See id.*
[66]*See id.* at *15.
[67]*See id.* at *16.
[68]*See id.* at *5 (discussing §§ 7203-7205).
[69]*See id.*
[70]*See id.* (discussing 18 U.S.C. § 1505).
[71]If Marinello prior to participating in his alleged conduct, knew that the IRS was investigating him, he could have been prosecuted under § 7212(a) under *Kassouf*. *See* Reply Brief for Petitioner at 7, *Marinello*, No. 16-1144, 2018 WL1402426 (Mar. 21, 2018).

The Trouble With Taxing Third-Party Litigation Funds

by Robert Daily

Introduction

Third-party litigation, also known as litigation finance, describes the "nonrecourse funding of litigation by a nonparty for a profit."[1] Under a typical agreement, a litigant or a contingent-fee lawyer receives cash from a third-party litigation fund in exchange for a percentage of the potential claim. The litigant uses the proceeds to either pay for living expenses or costs of litigation. The contingent-fee lawyer uses the proceeds to diversify risk and smooth out cash flow.

Unfortunately, litigation finance defies an easy tax characterization. To make matters worse, the Internal Revenue Service (IRS) has not issued any substantive guidance to help taxpayers categorize the transaction.[2] The lone IRS publication is a highly redacted and unhelpful memorandum issued in 2015.[3] Scholars have started, but have been unable, to solve the tax characterization puzzle.[4]

Adding insult to injury, the largest litigation funds are pushing the limits on how they categorize the transaction. Most funds label these contracts as "variable prepaid forward contracts" as a way to pay tax at the preferential capital gains rate.[5] This categorization stretches the logical limitations of a favorable revenue ruling issued in 2003.[6] Without this categorization, the tax consequences of investing in litigation finance would be far worse.[7]

On one hand, this categorization allows investors to choose investments in a tax indifferent way; the tax consequences of investing in a litigation fund would be the same as investing in a publicly traded stock. On the other hand, the tax lawyers setting up these agreements are aggressively shaping the future of variable prepaid forward contracts. This article argues that under current law, the third-party litigation finance funds cannot support their position.

Litigation Finance Basics

Overview

Litigation finance typically comes in two varieties: small funding for personal injury cases and large funding for corporate litigation.[8] The first type of funding usually involves a funder advancing money, typically less than $30,000,[9] to a litigant or contingent-fee lawyer in exchange for part of the rights to future judgment or settlement.[10]

On the other hand, this paper will focus on funding for "complex commercial disputes," which often exceed "several million dollars."[11] The funding does not go directly to the plaintiff; rather, it goes to fund the complex litigation.[12] One of the most prominent litigation funds states that it "provides strategic capital to the business community … [for] expensive, complex, high-risk commercial legal disputes … [which] is similar to other funding mechanisms available to businesses, including bank financing and other forms of financing that might be collateralized."[13]

These contracts are hard to generalize. While a smaller litigation fund may use an almost identical contract to fund plaintiff's lawsuits, a large litigation fund likely will not use the same agreement for more

than one party.[14] And almost all contracts "contain strict confidentiality provisions" that make disclosure illegal.[15] Moreover, most courts do not require parties to tell opposing counsel or the court about the third-party financing.[16]

Therium Agreement

This article analyzes a recently disclosed contract to explain the typical funding and recovery provisions in a large third-party litigation finance contract. The contract was disclosed in *Gbarabe v. Chevron*, a lawsuit concerning a "2012 explosion of a natural gas rig" owned by Chevron Corporation "off the coast of Nigeria."[17] The plaintiffs had trouble funding the risky lawsuit and were running out of cash in the lengthy discovery phase.[18] Therium, a large British-based litigation fund, stepped in and invested $1.7 million into the case in exchange for a piece of the claim. But the court denied the plaintiffs' motion for class-certification, effectively ending the lawsuit and causing Therium to lose its investment.[19]

Funding

Although there is a trend for litigation funds to invest in a portfolio of a contingent-fee lawyer's lawsuits, most litigation finance funds invest in a single lawsuit. The earlier the stage of the litigation, the riskier it is to invest. But with more risk comes more reward. Litigation finance funders will require a substantial amount of upside if they invest in a litigation claim that has not settled and is still going through discovery.

In the Therium contract, the contingent-fee lawyers primarily used the funding for discovery disputes and to finance trips back and forth from Nigeria.[20] The contingent-fee lawyers also received $15,000 a month because they had to "give up a great deal of work to concentrate on the" case.[21] But the funding was not without significant risk. The agreement contained a nonrecourse provision, meaning that Therium would not be able to recover its cost of litigation from the plaintiffs or lawyers if the lawsuit was unsuccessful.[22]

Recovery

Because this investment was particularly risky, Therium required a high success fee as a prerequisite of investing. The agreement states that Therium would have received "6x … the total committed funds, plus 2 percent of all proceeds."[23] In less risky lawsuits, litigation finance funds usually ask for a recovery of four times the funds it invests in the litigation.[24]

If the litigation was successful, Therium would first recover its investment and would then split the success fee with the plaintiffs and the contingent-fee lawyers.[25] It is unclear, based on a reading of the agreement, whether Therium would get the six times committed funds before splitting the rest of the proceeds from the arrangement. Most contracts created by U.S. funds have a more explicit ordering schedule.[26] Some litigation finance contracts create a "security interest" in the claim, giving investors a right to the litigation proceeds in front of creditors.[27]

If the litigation were incredibly successful (for example, a recovery of $100 million), the vast majority of the funds would have gone to the plaintiffs and contingent-fee lawyers (over $86.4 million). In contrast, if the litigation was moderately successful (for example, a recovery of $10 million), all of the funds may have gone to the funder. This high hurdle creates an incentive for the plaintiffs to stay in the litigation for as long as possible.[28] In this case, the break-even point, whereby the plaintiffs would likely not settle for anything less, would be $13.6 million.

Variable Prepaid Forward Contract

These third-party litigation finance contracts likely create a "sale" for tax purposes.[29] This means that continent-fee lawyers recognize income immediately upon funding and, if the litigation is successful, funders recognize income and pay tax at the higher ordinary income tax rates when they receive money from the claim.

But neither party likes this result: contingent-fee lawyers want to defer income recognition and funders want to pay tax at the preferential capital gains rates, which could cut the funders' tax bill by half. In an attempt to counteract these negative tax consequences, funders label the claims as variable prepaid forward contracts.[30]

In a standard forward contract, two parties agree to a contract "for the purchase and sale of property for a specified price on a future date."[31] In contrast, in a variable prepaid forward contract, one party typically "prepays" their obligation so that only one party would make a payment or delivery on the settlement date.[32] Because the parties keep the transaction "open," this characterization pushes the sale from when the parties fund the contract to when the parties recover on the litigation claim.[33]

This categorization is ideal for both the funder and the contingent-fee lawyer. First, the contingent-fee lawyer need not recognize income when the parties enter into the contract—the lawyer recognizes income when the litigation is over, which could take years. Second, the litigation fund would pay tax at the preferential capital gain rate, significantly decreasing the funder's tax liability.[34] The only downside is that if the litigation is unsuccessful, the funder would have a capital loss rather than an ordinary loss, which could prevent the funder from using all of the loss.[35]

Litigation finance funds point to two things to support the variable prepaid forward contract characterization: Revenue Ruling 2003-7 and the open transaction doctrine.

Revenue Ruling 2003-7

In Revenue Ruling 2003-7, the IRS held that there was no sale when a shareholder received a "fixed amount of cash" and "simultaneously enter[ed] into an agreement to deliver on a future date a number of shares on common stock that varies significantly depending on the value of the shares on the delivery date."[36] The holding is dependent on three conditions: (1) the shareholder must pledge enough shares at the time of funding, (2) the shareholder must have an unrestricted legal right to substitute the shares for cash, and (3) the shareholder cannot be "economically compelled to deliver the pleaded shares."[37]

The Tenth Circuit, in *Anschutz Co. v. Commissioner of Internal Revenue*, declined to follow Revenue Ruling 2003-7 when a taxpayer simultaneously entered into a variable prepaid forward contract, sold public company shares to a bank, and borrowed back the shares from the bank.[38] The court found that there was a sale because the parties had effectively shifted the majority of the risk and the rewards of owning the public stock from the taxpayer to the bank.[39]

Whether the litigation finance argument is successful may depend on how a judge defines the transaction. The successful claim could

be viewed as a "right to recovery." As long as the taxpayer can "settle" the claim by delivering cash, the claim would satisfy the requirements of Revenue Ruling 2003-7.[40] The litigation fund may also argue that *Anschutz* is not applicable because "ownership" of the claim did not shift to the fund.[41]

Nevertheless, the IRS may argue that the parties shifted risk and rewards of the litigation like the taxpayer in *Anschutz*. Most contracts are nonrecourse, do not provide for a minimum recovery, and ensure that the funder has significantly more of the upside and downside than the contract described in Revenue Ruling 2003-7.[42] If the taxpayer in *Anschutz* was unable to argue that the Revenue Ruling applied, the funder will likely also be unsuccessful.

Furthermore, the litigation finance claim is a fundamentally different type of asset. The market for litigation finance claims is almost illiquid, while the publicly traded stock in Revenue Ruling 2003-7 is likely extremely liquid. Therefore, the "right to recovery" in litigation finance is probably just a shorthand for cash. Thus, the funder likely fails prong 3 of Revenue Ruling 2003-7 because the contingent-fee lawyer *would* be economically compelled to deliver the cash from the successful litigation.

Open Transaction Doctrine

A recent Tax Court case, *Estate of McKelvey v. Commissioner of Internal Revenue*, said that Revenue Ruling 2003-7 was published pursuant to the "open transaction doctrine" as a "rule of fairness."[43] While the Tax Court's holding is not significant to litigation finance, the court's rationale in applying the open transaction doctrine to variable prepaid forward contracts is very helpful to litigation finance funders.

The doctrine, which the Supreme Court adopted in *Burnet v. Logan*, "applies in deferred payment cases with so much uncertainty that it is impossible to determine whether any profit will be realized, because income is contingent upon unknown factors."[44] Part of the uncertainty in *Burnet* was that the Court did not know whether the payments constituted taxable gain or recovery of basis.[45] Some courts interpret this to mean that *Burnet* only applies when the adjusted basis is unknown and does not apply to cases where the amount realized is unknown.[46]

This open transaction doctrine categorization has three significant roadblocks for litigation funds. First, courts rarely apply the open transaction doctrine today. The Ninth Circuit even stated that the open transaction doctrine now applies only in "rare and extraordinary cases" because "statutes, regulations and the courts have severely limited the use of the" doctrine since *Burnet*.[47]

Second, Revenue Ruling 2003-7 did not mention the open transaction doctrine in the rationale. It seems like the Tax Court read the doctrine into the revenue ruling without the IRS explicitly saying so. The problem with this rationale is that the IRS undoubtedly knew about this doctrine when it drafted the revenue ruling and likely left out any cite to *Burnet* on purpose.

Third, the basis uncertainty that existed in *Burnet* does not exist in litigation finance claims. The contingent-fee lawyer would have a basis close to zero, while the litigation fund would have a basis equal to the funding amount. There is no dispute about what is taxable: everything that the contingent-fee lawyer receives and everything in excess of the funder's basis will be income. It is unclear why the *character* of the gain should change when the *amount* of gain is unknown.

Conclusion

This article has highlighted some of the uncertainty in categorizing litigation finance contracts for tax purposes. Although far from certain, this article argues that litigation finance funds cannot support their variable prepaid forward categorization based on either Revenue Ruling 2003-7 or the open transaction doctrine. It is quite possible that this is the wrong normative answer and may lead to an unnecessary slowing in litigation finance investment. But this is for Congress and the IRS to decide, not the tax lawyers setting up these agreements. ⊙

Endnotes

[1]John Gamino, *Taxing Nonrecourse Litigation Funding*, 12 ATA J. of Legal Tax Res. 85, 86 (2014).

[2]*See id.* (noting the IRS's "lack of administrative guidance" for litigation finance "in the face of elemental federal income tax issues" like "characterization and timing").

[3]I.R.S. Tech. Adv. Mem. 20154701F (Nov. 20, 2015).

[4]*See e.g.,* Robert W. Wood & Jonathan Van Loo, *Investors Who Fund Lawsuits: Form and Tax Treatment*, 2013 Tax Notes Today 141-1239 (Dec. 16, 2013); Robert W. Wood & Jonathan Van Loo, *Litigation Funding: The Attorney's Perspective*, 142 Tax Notes Today 435 (Jan. 27, 2014); Alan B. Morrison & Randy Haight, *The Tax Treatment of Alternative Litigation Funding: Some Answers, But Mostly Questions,* 12 Pitt. Tax Rev. 1 (2014); Gamino, *supra* note 1.

[5]*See* Wood & Van Loo, *Investors*, *supra* note 4, at 1240.

[6]*See infra* note 35.

[7]*See infra* note 30.

[8]Morrison & Haight, *supra* note 4, at 2.

[9]Gamino, *supra* note 1, at 88.

[10]Morrison & Haight, *supra* note 4, at 2.

[11]*Id.* at 4.

[12]*Id.*

[13]Gamino, *supra* note 1, at 91 n. 14.

[14]*See* Morrison & Haight, *supra* note 4, at 5 ("[W]hereas personal injury [litigation finance has] standard form arranges, with only the specific amount advanced and the rate charged being filled in, commercial [litigation finance] is different.").

[15]Gamino, *supra* note 1, at 92.

[16]*See* Ben Hancock, *How Jones Day Unmasked a Litigation Funding Deal and Won*, Am. Law. (Oct. 29, 2017), https://www.law.com/americanlawyer/sites/americanlawyer/2017/10/29/how-jones-day-unmasked-a-litigation-funding-deal-and-won.

[17]*Id.*

[18]*Id.*

[19]*Id.*

[20]*See* Hancock, *supra* note 16; Amended and Restated Litigation Funding Agreement at 70, *Gbarabe v. Chevron Co.,* Case 3:14-cv-00173-SI (No. 186-4) (N.D. Ca. Sep. 16, 2016) [hereinafter Therium Contract].

[21]*Id.*

[22]Therium Contract, *supra* note 20, at 76.

[23]*Id.* at 70.

[24]*See e.g.,* Gamino, *supra* note 1, at 89 (noting the Transcapital Financial Corp. funding in *In re Transcapital Fin. Corp.*, 433 B.R.

900 (Bankr. S.D. Fla. 2010) was "4 times the amount invested plus 1 percent of the … claims") (internal citations omitted).

[25]Therium Contract, *supra* note 20, at 75.

[26]*See, e.g.,* Brief of Appellants at 88, *Cash Funding Network L.P. v. Anglo-Dutch Petroleum Int'l Inc.*, No. 01-05-00960-CV (Tex. App. Jan. 22, 2007), 2007 WL 929514.

[27]*Id.*

[28]*See* Hancock, *supra* note 16 ("That math naturally incentivizes lawyers to keep pushing for a higher recovery—especially if there's no downside risk of having to pay the funder back if the case collapses.").

[29]For a full discussion of this categorization, see Robert Daily, *Betting on an Uncertain Future: The Tax Consequences of Large Third-Party Litigation Financing*, Inside Basis, FBA Section on Taxation (forthcoming 2018), http://www.fedbar.org/Image-Library/Sections-and-Divisions/Tax/Robert-Daily-Paper-.aspx.

[30]*See supra* note 5.

[31]Steven M. Rosenthal & Liz R. Dyor, *Prepaid Forward Contracts and Equity Collars: Tax Traps and Opportunities*, 2 Tax'n Fin. Prod. 35, 35 (Winter 2000).

[32]*See generally Estate of McKelvey v. Comm'r*, 148 T.C. No. 13, at *12-13 (2017), *appeal docketed*, No. 17-2552 (2d Cir. Aug. 16 2017).

[33]*See generally* Rosenthal & Dyor, *supra* note 31.

[34]*See* Wood & Van Loo, *Litigation Funding, supra* note 4, at 439 (noting that the funder qualifies for long-term capital gains treatment because the funder gets a holding period that is "tacked" to the date of the original investment).

[35]I.R.C. § 165(c).

[36]Rev. Rul. 2003-7, 2003-1 C.B. 363. *See also* David H. Shapiro, *Taxation of Equity Derivatives,* 188 Tax Mgmt. (BNA) U.S. Income, at III-C.

[37]Rev. Rul. 2003-7, 2003-1 C.B. 363.

[38]664 F.3d 330 (10th Cir. 2011).

[39]*Id.* ("[T]he transactions at issue in this case … are different from … Revenue Ruling 2003-7…. The result of these related transactions was that DLJ obtained possession, and most of the incidents of ownership, of TAC's pledged shares. TAC, in turn, obtained cash payments and an elimination of any risk of loss in the pledged stock's value at the end of the term of the transactions.").

[40]*See* Robert W. Wood, *Prepaid Forward Contracts Are not All Bad*, 135 Tax Notes Today 365, 367 (Apr. 16, 2012) (defining the funding in terms of delivering a "portion of a claim" not the "rights to recovery").

[41]*Id.* at 368 ("[Variable Prepaid Forward Contracts] that stick closely to the pattern set out in Rev. Rul. 2003-7 and that do not involve a transfer or loan of the underlying property to the counterparty, should still be on solid ground.").

[42]*See supra* part II.

[43]148 T.C. No. 13.

[44]*Patton v. United States,* No. 96-37T, 2001 U.S. Claims LEXIS 60, at *9 (Fed. Cl. Mar. 20, 2001) (citing *Burnet v. Logan,* 283 U.S. 404, 413 (1931)).

[45]*See id.* (citing *Burnet,* 283 U.S. at 413-14) ("[T]he taxpayer first applies any payments received to his or her basis. Once they have recovered their basis, they report any additional payments as income.").

[46]*See Tribune Pub. Co. v. United States,* 836 F.2d 1176, 1180 (9th Cir. 1988) (holding that a taxpayer cannot apply the open transaction simply because the amount of profit was unknown "because we read *Burnet* to apply only if there is uncertainty as to whether the taxpayer will realize a profit from the transaction at issue").

[47]*See id.* at *12; *see also* Treas. Reg. § 1.1001-1(g)(2)(ii).

Alternative Dispute Resolution *continued from page 10*

Everywhere, Stacking the Deck of Justice, N.Y. Times (Oct. 31, 2015)), https://www.nytimes.com/2015/11/01/business/dealbook/arbitration-everywhere-stacking-the-deck-of-justice.html; *and* Jessica Silver-Greenberg & Michael Corkery, *In Arbitration, a "Privatization of the Justice System,"* N.Y. Times (Nov. 1, 2015), https://www.nytimes.com/2015/11/02/business/dealbook/in-arbitration-a-privatization-of-the-justice-system.html. It has been anecdotally reported that parties often refuse to, or minimally participate in, court-ordered mediations.

[5]The lawyer third-party neutral should also visit the ABA ADR Ethics Resources page for examples of ethical dilemmas. *ADR Ethics Resources*, A.B.A., https://www.americanbar.org/groups/dispute_resolution/resources/Ethics.html (last visited Sept. 21, 2018).

[6]*See Arbitrator Ethics Guidelines*, JAMS, https://www.jamsadr.com/arbitrators-ethics (last visited Sept. 21, 2018); *and* Am. Arb. Ass'n & A.B.A., Code of Ethics for Arbitrators in Commercial Disputes (Mar. 1, 2004), https://www.adr.org/sites/default/files/document_repository/Commercial_Code_of_Ethics_for_Arbitrators_2010_10_14.pdf.

[7]*See* Am. Arb. Ass'n et al., Model Standards of Conduct for Mediators (Sept. 2005), https://www.americanbar.org/content/dam/aba/migrated/2011_build/dispute_resolution/model_standards_conduct_april2007.authcheckdam.pdf.

[8]9 U.S.C. §§ 1-10 (1925).

[9]CPR Model Rule r. 4.5.1: Diligence and Competence.