



## New Captive Guidance from U.S. Tax Court

By Jean Baxley and Catherine Moore

Many public and non-public entities use closely-held insurance companies, often referred to as captive insurance companies, to ensure the risks of their affiliates. These captives may or may not qualify as insurance companies for U.S. federal income tax purposes. Section 816(a), which is specifically cross-referenced in section 831(c), defines an “insurance company” as “any company more than half the business of which during the taxable year is the issuing of insurance or annuity contracts or reinsuring of risks underwritten by insurance companies.”<sup>1</sup> Moreover, to qualify as insurance for U.S. federal tax purposes, an arrangement must satisfy a number of judicially created tests. Among the non-exhaustive list of requirements are: (i) presence of insurance risk; (ii) the shifting of risk from the insured to the insurer; (iii) the distribution of risk by the insurer; and (iv) other considerations that are grouped together as “commonly accepted notions of insurance.” Corporations that satisfy these requirements are entitled to the special benefits afforded to a captive arrangement

(e.g., deductibility of premiums and “insurance company” treatment). Each arrangement’s specific facts and circumstances should be considered when evaluating qualification as an insurance company for tax purposes. Recently, in *Reserve Mechanical Corp. v. Commissioner*,<sup>2</sup> the U.S. Tax Court addressed insurance company qualification for a captive entity and concluded that the taxpayer’s arrangement did not constitute insurance for the reasons discussed below.<sup>3</sup>

### Factual Overview

#### *Reserve, the Captive*

The qualification of captives as insurance companies has been litigated for many years, most recently in *Reserve Mechanical*. Reserve Mechanical Corporation (f.k.a. Reserve Casualty Corp.) (“Reserve”) was organized in 2008 in Anguilla and had a section 953(d) election in place for 2008-2010, the tax years at issue. Reserve was wholly owned by Peak Casualty Holdings, LLC (“Peak”), an Idaho S corporation. Peak was owned by two U.S. persons who each had a 50 percent interest in the stock of

**SALES TAX NEXUS continued on page 2**

## Message from the Chair Shamik Trivedi

Dear Members of the Federal Bar Association Section on Taxation,

As we close the 2017-2018 year, I want to update you on the spectacular year the Section has had. This year has been one of the busiest yet, with the Section holding events across the country.



Outside of Washington, D.C., the Section has held events in Dallas, Atlanta, New York, Chicago, Miami, and Philadelphia. We are pleased to have a new Philadelphia chapter led by two well-known tax controversy practitioners, Matthew Lee of Fox Rothschild and Kevin Johnson of Baker Hostetler. The Philadelphia Chapter’s inaugural event featured Judge Mark Holmes of the U.S. Tax Court. The Section continues to grow its influence outside of Washington, and I urge our members and future members beyond the Beltway to get involved.

Here in Washington, the Section hosted its largest Tax Law Conference ever. The 42nd Annual Tax Law Conference was held on March 9 at the Ronald Reagan Building and

**CHAIR continued on page 4**

## IN THIS ISSUE

Section on Taxation Leadership .....	5
Excerpt: The Potential Implications of Marinello in § 7212(a) Prosecutions .....	6
Excerpt: The Trouble with Taxing Third-Party Litigation Funds .....	9

Peak and each of whom acted as a director for Reserve.

Peak was engaged in the business of distributing, servicing, repairing, and manufacturing equipment used for underground mining and construction. During the relevant years, Peak had between 13 and 17 employees. At all times during the relevant years Peak maintained third-party insurance coverage for general liability, workers' compensation, commercial property, inland marine, automobile, and international risk.

Peak's owners also equally co-owned 100 percent of the membership interests in two partnerships: RocQuest, LLC ("RocQuest") and ZW Enterprises, LLC ("ZW"). RocQuest held various real estate interests including the property it leased to Peak. ZW was organized to help finance a loan to a former employee. In exchange for the assistance, ZW owned 10 percent of the former employee's business.

### *Capstone*

The owners of Peak were introduced to Capstone, a "turnkey" services provider for captive administration and management. Capstone was formed by the managing partner of a law firm that provided legal services to Capstone clients.

Capstone provided a captive feasibility study to Peak that concluded "the viability of a small captive insurer... to address the insurance and risk management issues discussed herein is feasible, reasonable, and practical, and is the best alternative risk mechanism option for the proposed insured." The feasibility study was issued jointly with Willis HRH of Houston, an insurance broker and risk management consulting firm. Following the feasibility study, Reserve was incorporated on December 3, 2008. On December 10, 2008, Reserve received an initial capitalization of \$100,000.

From 2008-2010, Reserve issued direct written insurance policies including coverage for 11 to 13 different lines such as excess directors and officers liability, excess pollution, loss of major customer, excess cyber risk, and product recall. Peak, RocQuest, and ZW were the named insureds on each policy. All of the policies issued showed one premium price but did not allocate the amounts to be paid by each insured. The policies listed PoolRe Insurance Corp. ("PoolRe") as the stop loss insurer for the coverage. Additionally, each policy stated that it applied only after other (presumably commercial) coverages were exhausted.

Only one claim, for loss of a major customer, was made from 2008-2010. The claim was for \$164,820 and Reserve paid the total amount by way of two payments. Subsequently, Reserve issued another claims payment in the amount of \$175,000.

### *PoolRe*

PoolRe is an insurance company domiciled in the British Virgin Islands. PoolRe's operations were administered by Capstone. For each of the tax years in issue, Reserve

and PoolRe executed a joint underwriting stop loss endorsement that applied to all direct written policies that Reserve issued. Pursuant to these agreements, PoolRe agreed to serve as a joint underwriter and stop loss insurer for the direct written policies that Reserve issued. According to the stop loss agreement, Reserve was the lead insurer with respect to the policies and PoolRe assumed an amount of excess risk in exchange for 18.5-19.9 percent of the total combined premiums due from the insureds. During the years at issue, PoolRe also entered into similar endorsements for approximately 400 policies that between 51 and 56 Capstone clients issued, and that covered in the aggregate around 150 insureds.

From these various endorsements, PoolRe pooled the premiums that it was entitled to receive and executed reinsurance agreements designed to redistribute them to Capstone entities. Reserve and the other Capstone entities each executed with PoolRe a quota share reinsurance policy pursuant to which each entity agreed to assume coverage for a specified portion of the risks that PoolRe had assumed according to the stop loss endorsements. The quota share Reserve assumed was calculated so that Reserve was entitled to receive payments from PoolRe equal to the premiums that PoolRe was entitled to receive from Peak and the other insureds pursuant to the stop loss endorsement.

### *CreditRe*

For the relevant tax years, Reserve executed with PoolRe a credit insurance coinsurance contract, under which Reserve agreed to assume a small portion of risk that PoolRe had assumed from an unrelated company, Credit Reassurance Corporation, Ltd. ("CreditRe"). The coinsurance contracts stated that CreditRe ceded to PoolRe a pro rata share of the liability and premiums associated with its large pool of vehicle service contracts (these contracts originated with a large U.S. direct insurer). Under the coinsurance contract, Reserve reinsured between 0.9100-1.1576 percent of PoolRe's annual liability. PoolRe executed similar coinsurance contracts with other Capstone clients.

### *Tax Court Analysis and Takeaways*

#### *Risk Distribution*

The first issue addressed by the Tax Court was risk distribution. Based on the number of insureds and the total number of independent risk exposures, the Court concluded that the policies Reserve issued directly were insufficient to distribute risk. In reaching this conclusion, the Court referenced *Rent-A-Center*,<sup>4</sup> *Avrahami*,<sup>5</sup> and *Securitas*<sup>6</sup> but did not provide a bright line test for how many entities (i.e., legal entities) and/or how many independent risk exposure units (i.e., number of employees, vehicles, locations) would be sufficient to achieve risk distribution.

The Court then turned to the stop loss endorsements,

quota share reinsurance arrangement, and credit coinsurance contracts as they relate to risk distribution. Reserve stated that through these arrangements 30 percent of its gross premiums for each tax year was from insuring unrelated parties.<sup>7</sup> Citing *The Harper Group*, Reserve claimed that this percentage of third party premium income was sufficient to achieve risk distribution.<sup>8</sup> To determine if risk distribution was achieved, the Court first looked at whether PoolRe was a legitimate insurance company. As stated above, the quota share Reserve assumed was calculated so that Reserve was entitled to receive payments from PoolRe equal to the premiums that PoolRe was entitled to receive from Peak and the other insureds pursuant to the stop loss endorsement. The Court also noted: (i) Reserve did not have any losses related to the quota share arrangement; (ii) there was no evidence that these arrangements were priced on an arm's length standard; and (iii) there was no evidence that PoolRe was likely to ever suffer any economic loss pursuant to the stop loss arrangements. Taking the above into account, the Court found that: (i) at the end of each year Reserve's economic position had not changed; (ii) risk distribution was not achieved; (iii) Reserve was created solely to realize tax benefits; and (iv) the agreements with PoolRe were not bona fide insurance agreements. Finally, the Court held that the risk, if any was indeed transferred to Reserve from PoolRe, was de minimis (in fact, the Court hinted that there was a failure to produce evidence related to the underlying coinsurance agreements). Because risk distribution was not achieved, the Court concluded that the Reserve arrangement could not constitute insurance for U.S. federal tax purposes.

### Commonly Accepted Notions of Insurance

As a supplement to the first holding on risk distribution, the Court also found that the Reserve arrangement did not constitute insurance in the commonly accepted sense. To reach this ruling the court looked at the following factors: (i) organization, operation, and regulation; (ii) adequate capitalization; (iii) valid and binding policies; (iv) reasonableness of premiums; and (v) payment of claims.

*Organization, operation, and regulation.* The court found that apart from satisfying the formalities of organization and compliance with legal requirements Reserve was not operated as an insurance company. The court noted that Reserve had no employees, its directors knew nothing about its operations and policies, it had no activities in Anguilla, and that management was handled entirely by Capstone. Moreover, there was no evidence of due diligence related to the policies Reserve issued and Capstone's feasibility study was not complete when Reserve issued the direct policies for 2008 and 2009. Additionally, the Tax Court found there was no evidence that Reserve evaluated the risks assumed before executing the quota share policies. The Court seemed to impose

a "due diligence" standard wherein purported captive insurance companies must demonstrate that they behave like insurers would with respect to underwriting and pricing products for unrelated parties.

*Adequate Capitalization.* The Court held that Reserve was sufficiently capitalized as it met the minimum capitalization requirements of its domicile, Anguilla.

*Valid and Binding Policies.* The Court held that Reserve's direct written policies contained terms to make them valid and binding insurance. The Court also noted that these were "cookie cutter" policies that in many instances were not reasonably suited to the needs of the insureds. Accordingly, this factor was determined to be neutral.

*Reasonableness of Premiums.* For this factor, the Court noted that Reserve's directors always approved the premium amounts recommended by Capstone. Though evidence was produced that indicated the methodology for determining premium amounts, the Court noted that there were a number of factors indicating that the premiums were not reasonable in relation to the risk of loss. For 2007, Peak paid insurance expenses of \$95,828. For 2008, Peak and two affiliates that had no active business operations paid premiums of \$412,089 in addition to the premiums Peak paid for third-party commercial insurance. The Court also noted that seven of the 2008 policies had retroactive dates. In summary, the Court found that the facts did not reflect that Peak had a genuine need for acquiring additional insurance during the relevant tax years and accordingly, the premiums were determined not to be reasonable.

*Payment of Claims.* The Court held that this factor slightly favored Reserve but that evidence relating to payment of claims was not overwhelming.

In summary, Reserve Mechanical provides some additional considerations for taxpayers concerned with meeting the risk distribution and commonly accepted notions of insurance standards for captive qualification. Ultimately, it is likely that the IRS will continue to challenge the validity of captive arrangements and the Tax Court will continue to apply the same judicial tests as were applied in Reserve Mechanical. As mentioned above, however, each captive arrangement is to be evaluated taking into account the relevant facts and circumstances.

**Disclaimer: The article does not constitute tax, legal, or other advice from Deloitte Tax LLP, which assumes no responsibility with respect to assessing or advising the reader as to tax, legal, or other consequences arising from the reader's particular situation.**

Jean Baxley is a managing director in the Washington National Tax office of Deloitte Tax LLP and may be reached at [jebaxley@deloitte.com](mailto:jebaxley@deloitte.com).

Catherine Moore is a manager in the Washington National Tax office of Deloitte Tax LLP and may be reached at [catmoore@deloitte.com](mailto:catmoore@deloitte.com).

**Endnotes:**

<sup>1</sup>Section 831(c), which refers to section 816(a), was added by The Pension Funding Act of 2004 (29 U.S.C. 1001) to incorporate pertinent section 816 definitions to specifically apply the definition of an insurance company to property and casualty insurance companies, including captive insurers.

<sup>2</sup>*Reserve Mechanical, f.k.a. Reserve Casualty Corporation v. Commissioner*, T.C. Memo 2018-86 (June 18, 2018),

<sup>3</sup>See also *Rent-A-Center, Inc. v. Commissioner*, 142 T.C. 1 (2014); *Securitas Holdings, Inc. v. Commissioner*, T.C. Memo 2014-255; and *Avrahami v. Commissioner*, 149 T.C. 7 (2017).

<sup>4</sup>*Rent-A-Center, Inc. v. Commissioner*, 142 T.C. 1 (2014).

<sup>5</sup>*Avrahami v. Commissioner*, 149 T.C. 7 (2017).

<sup>6</sup>*Securitas Holdings, Inc. v. Commissioner*, T.C. Memo 2014-255.

<sup>7</sup>We note the Tax Court previously invalidated a pooling arrangement in *Avrahami*. The IRS has long disfavored such arrangements and taken the position such arrangements do not successfully achieve risk distribution.

<sup>8</sup>*The Harper Group v. Commissioner*, 96 T.C. 45, *aff'd*, 979 F.2d 1341 (9th Cir. 1992).

**CHAIR continued from page 1**

drew more than 600 attendees who heard from dozens of officials from the IRS, Treasury Department, Department of Justice, and Congress. As the tax bar grapples with the implementation of the Tax Cuts and Jobs Act, events like the Tax Law Conference, as well as the Insurance Tax Seminar, will be critical education opportunities. My personal thanks to Andrew Strelka of Latham & Watkins and Drita Tonuzi of the IRS Office of Chief Counsel for their efforts to organize the Tax Law Conference.

In June, the Section held its one-of-a-kind Insurance Tax Seminar, chaired by Lori Jones of Scribner, Hall and Thompson, and Alexis MacIvor of the IRS Office of Chief Counsel. This two-day event continues to be the premier insurance tax event in the country, and featured numerous public sector speakers from the IRS, Department of Labor, and Treasury. I want to convey my personal thanks to Lori Jones for her years and years of service to the Insurance Tax Seminar. Lori will be stepping down as the chair at the end of this year, but we have great leadership in place to continue on.

Throughout the year, the Section has hosted numerous happy hours, networking events, and panel discussions benefiting students and young lawyers. Most recently, the Section hosted a Careers in Tax Law panel at Alston & Bird that featured a broad array of practitioners, including speakers from the Tax Court, Department of Justice, IRS, and private practice. More than 50 young lawyers attended this great event. My thanks to Sophia Siddiqui of the Department of Justice for her efforts in organizing the

panel, and to Ryan Kelly of Alston & Bird for hosting.

The Section also submitted letters of support to the Senate Finance Committee this year for Chuck Rettig, nominee for Commissioner of Internal Revenue, and Michael Desmond, nominee for Chief Counsel of the IRS. Both Chuck and Mike have been familiar faces at the Tax Law Conference, and the Section was proud to lend its support for their nominations.

Finally, in July, the Section held its annual elections. My deep appreciation to all those who volunteered their time this year, and to those who will do so next year. The Section is in good hands with Anne Gordon of PwC, who will begin her term as Chair on October 1, 2018. Anne has a great Executive Committee behind her, which will include chair-elect Marissa Rensen of the IRS Office of Chief Counsel, Robert Russell of alliantgroup, and David Lappin of the U.S. Tax Court. I am confident this group will take the Section to new heights in 2019.

I want to thank you all for your support over the past year, and especially to my Executive Committee: Anne as our chair-elect, our Treasurer, Nick Gard, and our Secretary, Brandon King. The three of you have made my job easy. It has been my privilege to serve as the Chair of the Section, and follow in the footsteps of so many talented practitioners. ☘

Best regards,  
Shamik Trivedi  
Chair, Section on Taxation (2017-2018)

## SECTION ON TAXATION LEADERSHIP

**CHAIR**

Shamik Trivedi  
Grant Thornton LLP

**IMMEDIATE PAST CHAIR**

Christine S. Hooks

**CHAIR-ELECT**

Anne R. Gordon  
Pricewaterhouse Coopers LLP

**TREASURER**

Nick Gard  
Williams, Parker Harrison Dietz  
& Getzen

**SECRETARY**

Brandon King  
Baker & McKenzie

**MEMBERSHIP CO-CHAIRS**

Laura Pisarello  
U.S. Tax Court

Neville Jiang  
Deloitte

David Lappin  
U.S. Tax Court

**2018 TAX LAW  
CONFERENCE CHAIR**

Private Sector:  
Andy Strelka  
Latham & Watkins LLP

Public Sector:  
Drita Tonuzi  
Deputy Chief Counsel  
(Operations), I.R.S.

**2018 TAX LAW  
CONFERENCE VICE-CHAIR**

Brandon King  
Baker & McKenzie

Robert Russell  
Alliantgroup

Kandyce Korotky  
Covington & Burling LLP

Alan Williams  
I.R.S.

**WOMEN IN TAX LAW CO-  
CHAIRS**

Lisandra Ortiz  
Miller & Chevalier Chartered

Carina Federico  
Steptoe & Johnson LLP

Teresa Abney  
Crowell & Moring LLP

**2018 INSURANCE TAX  
SEMINAR CO-CHAIRS**

Lori J. Jones  
Scribner, Hall & Thompson, LLP

**PUBLICATION EDITORS**

Catherine Moore  
Deloitte

Daniel Strickland  
Eversheds Sutherland LLP

**YOUNG TAX LAWYER CO-  
CHAIRS**

Elizabeth Kanyer  
Department of Justice

Annie Wurtzebach  
DLA Piper

Maria Critelli  
Mayer Brown LLP

**CHAIR, EVENTS BEYOND  
THE BELTWAY**

Ryan J. Kelly  
Alston & Bird LLP

**DIGITAL MEDIA CHAIR**

Derek Berry  
Schulte Roth & Zabel

**TAX WRITING  
COMPETITION CO-CHAIRS**

Derek Berry  
Schulte Roth & Zabel

David Berke  
Skadden, Arps, Slate, Meagher &  
Flom LLP

**FBA TAX ATLANTA CHAIRS**

Charles E. Hodges, II  
Jones Day

**FBA TAX BOSTON CHAIRS**

Gabby Hirz  
Ropes & Gray LLP

Ryan Montgomery  
Morgan, Lewis & Bockius

**FBA TAX CHICAGO CHAIR**

Jonathan Welbel  
Baker McKenzie

Jason Anderson  
Grant Thornton LLP

Lauren May  
I.R.S.

**FBA TAX DALLAS CHAIRS**

Laura Gavioli  
McDermott Will & Emery

Kristina Novak  
McDermott Will & Emery

**FBA TAX MIAMI CHAIR**

Scott A. Knott  
The Ferraro Law Firm

**FBA TAX NEW YORK  
CHAIRS**

S. Starling Marshall  
Covington & Burling LLP

Sarah Sheldon  
Metlife

Michael Sardar  
Kostelanetz & Fink LLP

**FBA TAX PHILADELPHIA  
CHAIR**

Matthew Lee  
Fox Rothschild LLP

Kevin Johnson  
Baker Hostetler

**FBA TAX ST. LOUIS CHAIR**

Mark C. Milton  
MCM Law LLC

**FBA TAX SAN DIEGO CHAIR**

Kathleen A. Agbayani  
Baker McKenzie

**FBA TAX SAN FRANCISCO  
CHAIRS**

Mumi Hemrajani  
DLA Piper

Brandon Boyle  
Grant Thornton LLP

**TAX PRACTICE &  
PROCEDURE ROUNDTABLE  
CO-CHAIRS**

Matthew Cooper  
EY

Larry Mack  
KPMG

**CAREERS IN TAX LAW  
PANEL**

Drew Cummings  
Morgan, Lewis & Bockius

Sophia Siddiqui  
U.S. Department of Justice

**COMMUNITY OUTREACH**

Marissa Rensen  
I.R.S. Office of Chief Counsel

**QUARTERLY PANELS/  
WEBINARS**

Blaine Saito  
Department of Justice Tax  
Division

Andrew Brewster  
Deloitte



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

by Michael A. Benison, CPA; J.D. Candidate, 2019, Fordham University School of Law; M.S., Taxation, 2011, B.S.; Accounting, Dec. 2009, University at Albany.

### 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.<sup>1</sup> The first clause prohibits corrupt or forcible endeavors to interfere with U.S. employees acting pursuant to Title 26.<sup>2</sup> 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.<sup>3</sup> The omnibus clause is a catch-all 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.<sup>4</sup>

#### 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.<sup>5</sup>

##### 1. Definition of Corruptly

The term "corruptly" is not defined in the Code.<sup>6</sup> In *United States v. Reeves*, the district court defined "corruptly" as meaning "with improper motive or bad or evil purpose."<sup>7</sup> 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."<sup>8</sup>

##### 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.<sup>9</sup> The term

"endeavor" as used in § 7212(a) is any effort to do or accomplish the evil purpose the section was intended to prevent.<sup>10</sup> 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.<sup>11</sup> 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."<sup>12</sup>

##### 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."<sup>13</sup> A violation of the omnibus clause can occur *whenever* a defendant intends to impede the administration of the tax laws.<sup>14</sup> 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."<sup>15</sup> 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."<sup>16</sup>

...

##### D. 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.<sup>17</sup> 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.<sup>18</sup> 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.<sup>19</sup> 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.<sup>20</sup>

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”<sup>21</sup>.

## 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.<sup>22</sup>

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.<sup>23</sup> The district court concluded that the government did not show that the defendant had knowledge of a pending IRS investigation or investigation.<sup>24</sup> 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).<sup>25</sup> 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.<sup>26</sup> Section 1503 has been uniformly interpreted as requiring a pending judicial proceeding.<sup>27</sup> 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.”<sup>28</sup> 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.<sup>29</sup>

#### 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).”<sup>30</sup> 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.<sup>31</sup> 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.<sup>32</sup> 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.<sup>33</sup> A defendant who corruptly endeavors to obstruct or impede the administration of that computation opens themselves up to liability under § 7212(a).<sup>34</sup> Similarly, the First,<sup>35</sup> Fifth,<sup>36</sup> and Ninth<sup>37</sup> 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.<sup>38</sup> 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.<sup>39</sup>

The Second Circuit affirmed declining to follow the *Kassouf* standard on the grounds that the text of § 1503(a) is distinguishable from § 7212(a).<sup>40</sup> The circuit stated that § 1503(a)'s statutory language focuses on grand jury or judicial proceedings.<sup>41</sup> 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).<sup>42</sup> 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).<sup>43</sup>

The Second Circuit denied an en banc review of *Marinello*'s case.<sup>44</sup> 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.”<sup>45</sup> 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.”<sup>46</sup>

### B. 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.”<sup>47</sup> Congress has not defined the term “willfulness” in the IRC.<sup>48</sup> 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).”<sup>49</sup> All of the other tax felony statutes require willfulness; § 7212(a) imposes no such requirement.<sup>50</sup>

### C. Potential Violations of Section 7212(a)

Potential violations of § 7212(a) may result from a lack of knowledge or a misunderstanding of its complexities.<sup>51</sup> Through the internal revenue administration system, the government interacts with “virtually the entire citizenry.”<sup>52</sup> 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.<sup>53</sup>

## Part III: *Marinello* Supreme Court Decision

The Supreme Court reversed the Second Circuit's judgment on March 21, 2018.<sup>54</sup> 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.<sup>55</sup> The 7-2 majority opinion concluded that the government must prove the following to support an 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.<sup>56</sup>

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.<sup>57</sup> The clause as a whole refers to specific interference with targeted governmental tax-related proceedings, such as a particular investigation or audit.<sup>58</sup> The dissent felt that this limitation of the statute has no textual basis.<sup>59</sup> The plain meaning of the omnibus clause prohibits the due administration of the tax code in its entirety, not just particular IRS proceedings.<sup>60</sup> The words of “this title” cannot be read to mean “only some of this title.”<sup>61</sup> “When Congress wanted to refer only to a particular subsection or paragraph, it said so.”<sup>62</sup> 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.<sup>63</sup>

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.”<sup>64</sup> If Congress had intended that outcome, it would have spoken with more clarity than it did in § 7212(a).<sup>65</sup> The dissent felt that whether the omnibus clause would cover the hypothetical scenarios listed in the majority opinion is debatable.<sup>66</sup> 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.<sup>67</sup>

The IRC creates numerous misdemeanors.<sup>68</sup> 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.<sup>69</sup> 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.”<sup>70</sup>

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.<sup>71</sup>

## 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

<sup>1</sup>See 26 U.S.C. § 7212.

<sup>2</sup>See *id.*

<sup>3</sup>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>.

<sup>4</sup>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.

<sup>5</sup>*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).

<sup>6</sup>See 26 U.S.C. § 7701 (listing definitions).

<sup>7</sup>*United States v. Reeves*, 752 F.2d 995, 997 (5th Cir. 1985).

<sup>8</sup>*United States v. Floyd*, 740 F.3d 22, 31 (1st Cir. 2014); see also CTM § 17.04[1].

<sup>9</sup>See Jennifer Gibbons, *Note: Proof of Tax Deficiency—The Silent Element in False Statements Charges?*, 50 ARIZ. L. REV. 337, 352 (2008).

<sup>10</sup>*United States v. Martin*, 747 F.2d 1404, 1409 (11th Cir. 1984) (citing *Osborn v. United States*, 385 U.S. 323, 333 (1966)).

<sup>11</sup>See CTM § 17.04[2].

<sup>12</sup>571 F. App’x 205, 209 (4th Cir. 2014).

<sup>13</sup>*Reeves*, 752 F.2d at 998; *United States v. Kuball*, 976 F.2d 529, 531 (9th Cir. 1992).

<sup>14</sup>See CTM § 17.04[3].

<sup>15</sup>*United States v. Bowman*, 173 F.3d 595, 600 (6th Cir. 1999).

<sup>16</sup>*United States v. Sorenson*, 801 F.3d 1217, 1229 (10th Cir. 2015).

<sup>17</sup>Robert S. Fink & Caroline Rule, *The Growing Epidemic of Section 7212(a) Prosecutions—Is Congress The Only Cure?*, 88 J. TAX’N 356 (1998).

<sup>18</sup>See *id.* at 357.

<sup>19</sup>*Williams*, 644 F.2d at 698, n. 12 (citing *United States v. Henderson*, 386 F.Supp. 1048, 1055-56 (S.D.N.Y. 1974)).

<sup>20</sup>See *id.*

<sup>21</sup>See Fink & Rule, *supra* note 17, at 357.

<sup>22</sup>*United States v. Kassouf*, 144 F.3d 952, 955 (6th Cir. 1998).

<sup>23</sup>*Id.* at 953.

<sup>24</sup>See *id.* at 954.

<sup>25</sup>See *id.* at 956-58.

<sup>26</sup>*United States v. Aguilar*, 515 U.S. 593, 598-600 (1995).

<sup>27</sup>*Kassouf*, 144 F.3d 952, 955 (6th Cir. 1998).

<sup>28</sup>See *id.* at 957 (quoting *United States v. Aguilar*, 515 U.S. 593, 599 (1995)).

<sup>29</sup>See *id.*

<sup>30</sup>*Sorenson*, 801 F.3d at 1232 (quoting *United States v. Wood*, 384 F. App’x 698, 703-04 (10th Cir. 2010)).

<sup>31</sup>See *id.*

<sup>32</sup>See *id.*

<sup>33</sup>See *id.* at 1232-33.

<sup>34</sup>See *id.*

<sup>35</sup>*Floyd*, 740 F.3d at 26 (finding the *Kassouf* Court’s decision limited to its facts).

<sup>36</sup>*United States v. Westbrook*, 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.”).

<sup>37</sup>*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).

<sup>38</sup>See Brief for Petitioner at 6a-7a, *Marinello v. United States*, No. 16-1144, 2018 WL1402426 (Mar. 21, 2018).

<sup>39</sup>*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)).

<sup>40</sup>*United States v. Marinello*, 839 F.2d 209, 222 (2nd Cir. 2016).

<sup>41</sup>*See id.* at 220 (citing *United States v. Wood*, 384 F. Appx. 698, 704 (10th Cir. 2010)).

<sup>42</sup>*See id.*

<sup>43</sup>*See id.* at 221; *Kassouf*, 144 F.3d at 960 (Daughtrey, J. dissenting in part).

<sup>44</sup>*United States v. Marinello*, 855 F.3d 455 (2d Cir. 2017).

<sup>45</sup>*See id.* at 459.

<sup>46</sup>*See id.*

<sup>47</sup>STANLEY S. ARKIN ET AL., BUSINESS CRIME: CRIMINAL LIABILITY OF THE BUSINESS COMMUNITY, 27.02[1] n.1, (2017) (discussing stating §§ 7201-7207.)

<sup>48</sup>*See id.* at 27.02[1].

<sup>49</sup>*See id.* at 27.02[1] n.2; *see also* BNA U.S. Income Portfolios: Tax Crimes, at A-4.

<sup>50</sup>Cf. 26 U.S.C. §§ 7201 and 7206 with 7212(a).

<sup>51</sup>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).

<sup>52</sup>*See id.* at 37.

<sup>53</sup>*See id.* at 36.

<sup>54</sup>*Marinello v. United States*, No. 16-1144, 2018 WL1402426 at \*8 (Mar. 21, 2018).

<sup>55</sup>*See id.* at \*7.

<sup>56</sup>*See id.* at \*7-8.

<sup>57</sup>*See id.* at \*1.

<sup>58</sup>*See id.*

<sup>59</sup>*See id.* at \*10.

<sup>60</sup>*See id.*

<sup>61</sup>*See id.* at \*11.

<sup>62</sup>*See id.* (quoting *NRLB v. SW General Inc.*, 137 S.Ct. 929 (2017)).

<sup>63</sup>*See id.* at \*12.

<sup>64</sup>*See id.* at \*5.

<sup>65</sup>*See id.*

<sup>66</sup>*See id.* at \*15.

<sup>67</sup>*See id.* at \*16.

<sup>68</sup>*See id.* at \*5 (discussing §§ 7203-7205).

<sup>69</sup>*See id.*

<sup>70</sup>*See id.* (discussing 18 U.S.C. § 1505).

<sup>71</sup>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 non-party for a profit.”<sup>1</sup> 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.<sup>2</sup> The lone IRS publication is a highly redacted and unhelpful memorandum issued in 2015.<sup>3</sup> Scholars have started, but have been unable, to solve the tax characterization puzzle.<sup>4</sup>

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.<sup>5</sup> This categorization stretches the logical limitations of a favorable revenue ruling issued in 2003.<sup>6</sup> Without this categorization, the tax consequences of investing in litigation finance would be far worse.<sup>7</sup>

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.<sup>8</sup> The first type of funding usually involves a funder advancing money, typically less than \$30,000,<sup>9</sup> to a litigant or contingent-fee lawyer in exchange for part of the rights to future judgment or settlement.<sup>10</sup>

On the other hand, this paper will focus on funding for “complex commercial disputes,” which often exceed “several million dollars.”<sup>11</sup> The funding does not go directly to the plaintiff; rather, it goes to fund the complex litigation.<sup>12</sup> 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.”<sup>13</sup>

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.<sup>14</sup> And almost all contracts “contain strict confidential-

ity provisions” that make disclosure illegal.<sup>15</sup> Moreover, most courts do not require parties to tell opposing counsel or the court about the third-party financing.<sup>16</sup>

### 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.”<sup>17</sup> The plaintiffs had trouble funding the risky lawsuit and were running out of cash in the lengthy discovery phase.<sup>18</sup> 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.<sup>19</sup>

### 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.<sup>20</sup> 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.<sup>21</sup> But the funding was not without significant risk. The agreement contained a non-recourse provision, meaning that Therium would not be able to recover its cost of litigation from the plaintiffs or lawyers if the lawsuit was unsuccessful.<sup>22</sup>

### 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.”<sup>23</sup> In less risky lawsuits, litigation finance funds usually ask for a recovery of four times the funds it invests in the litigation.<sup>24</sup>

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.<sup>25</sup> 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.<sup>26</sup> Some litigation finance contracts create a “security interest” in the claim, giving investors a right to the litigation proceeds in front of creditors.<sup>27</sup>

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.<sup>28</sup> In this case, the breakeven 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.<sup>29</sup> This means that contingent-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.<sup>30</sup>

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.”<sup>31</sup> 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.<sup>32</sup> 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.<sup>33</sup>

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.<sup>34</sup> 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.<sup>35</sup>

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.”<sup>36</sup> The holding is dependent on three conditions: one, the shareholder must pledge enough shares at the time of funding; two, the shareholder must have an unrestricted legal right to substitute the shares for cash; and three, the shareholder cannot be “economically compelled to deliver the pledged shares.”<sup>37</sup>

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.<sup>38</sup> 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.<sup>39</sup>

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.<sup>40</sup> The litigation fund may also argue that *Anschutz* is not applicable because “ownership” of the claim did not shift to the fund.<sup>41</sup>

Nevertheless, the IRS may argue that the parties shifted risk and rewards of the litigation like the taxpayer in *Anschutz*. Most contracts are non-recourse, 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.<sup>42</sup> 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.”<sup>43</sup> 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.”<sup>44</sup> Part of the uncertainty in *Burnet* was that the Court did not know whether the payments constituted taxable gain or recovery of basis.<sup>45</sup> 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.<sup>46</sup>

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*.<sup>47</sup>

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: every-

thing 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

<sup>1</sup>John Gamino, *Taxing Nonrecourse Litigation Funding*, 12 ATA J. OF LEGAL TAX RES. 85, 86 (2014).

<sup>2</sup>*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”).

<sup>3</sup>I.R.S. Tech. Adv. Mem. 20154701F (Nov. 20, 2015).

<sup>4</sup>*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.

<sup>5</sup>*See* Wood & Van Loo, *Investors*, *supra* note 4, at 1240.

<sup>6</sup>*See infra* note 35.

<sup>7</sup>*See infra* note 30.

<sup>8</sup>Morrison & Haight, *supra* note 4, at 2.

<sup>9</sup>Gamino, *supra* note 1, at 88.

<sup>10</sup>Morrison & Haight, *supra* note 4, at 2.

<sup>11</sup>*Id.* at 4.

<sup>12</sup>*Id.*

<sup>13</sup>Gamino, *supra* note 1, at 91 n. 14.

<sup>14</sup>*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.”).

<sup>15</sup>Gamino, *supra* note 1, at 92.

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

<sup>17</sup>*Id.*

<sup>18</sup>*Id.*

<sup>19</sup>*Id.*

<sup>20</sup>*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], <https://www.law.com/americanlawyer/sites/>

americanlawyer/2017/10/29/how-jones-day-unmasked-a-litigation-funding-deal-and-won/.

<sup>21</sup>*Id.*

<sup>22</sup>Therium Contract, *supra* note 20, at 76.

<sup>23</sup>*Id.* at 70.

<sup>24</sup>*See e.g.*, Gamino, *supra* note 1, at 89 (noting the Transcapital Financial Corporation funding in *In re Transcapital Financial 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).

<sup>25</sup>Therium Contract, *supra* note 20, at 75.

<sup>26</sup>*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.

<sup>27</sup>*Id.*

<sup>28</sup>*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.”).

<sup>29</sup>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, Federal Bar Association Section on Taxation (forthcoming 2018), <http://www.fedbar.org/Image-Library/Sections-and-Divisions/Tax/Robert-Daily-Paper.aspx>.

<sup>30</sup>*See supra* note 5.

<sup>31</sup>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).

<sup>32</sup>*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).

<sup>33</sup>*See generally* Rosenthal & Dyor, *supra* note 31.

<sup>34</sup>*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).

<sup>35</sup>I.R.C. § 165(c).

<sup>36</sup>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.

<sup>37</sup>Rev. Rul. 2003-7, 2003-1 C.B. 363.

<sup>38</sup>664 F.3d 330 (10th Cir. 2011).

<sup>39</sup>*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.”).

<sup>40</sup>*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”).

<sup>41</sup>*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.”).

<sup>42</sup>*See supra* part II.

<sup>43</sup>148 T.C. No. 13.

<sup>44</sup>*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)).

<sup>45</sup>*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.”).

<sup>46</sup>*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”).

<sup>47</sup>*See id.* at \*12; *see also* Treas. Reg. §1.1001-1(g)(2)(ii).

# Inside Basis

Federal Bar Association  
Section on Taxation  
1220 North Fillmore Street, Suite 444  
Arlington, VA 22201

*Inside Basis is published semiannually by the Section on Taxation of the Federal Bar Association, 1220 North Fillmore Street, Suite 444, Arlington, VA 22201, ISSN No. 1069-1553. © 2018 Federal Bar Association. All rights reserved. The views expressed herein are not necessarily those of the Federal Bar Association or the Section on Taxation. Managing Editor: Zebley Foster.*