

Litigation funding increasingly popular, but what about taxes?

By Robert W. Wood

If you are a lawyer with a contingent fee practice, no matter how successful you are, you can probably use some cash. In fact, if you are developing a reputation and getting new or more complex cases, you may be especially cash poor. You need to invest to keep numerous balls in the air.

One answer is to contact one of the many new entrants to the expanding field of lawsuit funding. You might get money for yourself, since you know some of your cases are eventually going to pay off handsomely. In lieu of (or in addition to) getting money for yourself, you may resort to litigation funding to help your clients get money.

Either way, you should be thinking about taxes. Is this a loan? Is it a sale of a portion of the claim (or of a portion of your fees)?

These may sound like simple questions, but you might be surprised how difficult they can be to answer. Documentation varies, so read your documents carefully. You will want to make sure to avoid the worst-case scenario: being taxed on the funding in the year of receipt while not being able to deduct or exclude the amount you pay to your funding source when the lawsuit settles.

Get some tax advice, and if the client is getting money, suggest that your client do so. Even if only your client is getting money, you will have to sign documents, too. Make sure you know if it is a loan or a sale and how it's taxed.

You can ask the litigation funding source, but they may not want to tell you anything. They are generally not in the business of providing tax advice. Besides, many such lawsuit investors are not based in the U.S.

Even the funding sources that are domestic may have differing tax interests than you and your client. Nontax issues such as securities laws, usury or regulatory concerns (such as fee-sharing with nonlawyers) can play a part, too. For all of those reasons, the tax issues can be murky.

Getting money from a pending legal claim or for contingent attorney fees can be documented in several ways. The primary dichotomy is loan versus sale, but from there it gets more complicated. In a loan, you receive loan proceeds which are not taxable because you have to pay them back.

Structuring as a loan has the advantage of deferring any tax on the receipt of the funding. But you have to include the entire amount of your contingent fee in income and claim a very large offsetting interest deduction. You may also be required to report the interest to your "lender" on a Form 1099. Finally, some amounts can be treated as interest for tax purposes.

The funding source may be required to accrue income and you may be required to accrue interest expense under the "original issue discount" rules. This can add reporting complexity.

For example, say you borrow \$1 million on your one-third contingent fee share of a lawsuit, and three years later, the case is resolved. Let's say you owe \$2 million to the funding source and you received a \$3 million contingent fee. You keep \$1 million, repay the original \$1 million, and if the documents are done properly, should be able to deduct the \$1 million of "interest." That should leave you with \$3 million of taxable income and a \$1 million interest expense deduction.

In contrast to structuring as a loan, one of the most common structures is what tax lawyers call a prepaid forward contract. That's a

fancy name, but it is basically a sale, not a loan. It arguably offers the best tax result for the plaintiff or the lawyer.

Because it's a sale, you might assume you have to report the sale proceeds as income. However, this is a sale contract with an unclear final return for the funding source. When you sign the documents and receive the money, you have entered into a contract to sell a portion of your case (if you are the client) or a portion of your contingent fee (if you are the lawyer) when the lawsuit is resolved.

That's why it's called "forward." You are contracting to sell now, but the sale does not close until the case is resolved. Assuming it works as a prepaid forward contract, you generally should not have to report income until the conclusion of the case, when it is clear how much you and your funding source will receive.

Although the up-front money you receive isn't a loan, it isn't taxed until later. For clients, this works well assuming it is properly documented. That is key, since the Internal Revenue Service could argue the up-front money should be income because the client may have little or no cost basis in the claim.

For lawyers, there is an additional risk the IRS could argue that the sale represents an anticipatory assignment of income. That means there's a risk all your contingent fees are income, even the amount paid to the funding source. However, that tax risk can usually be mitigated and shouldn't cause problems.

Since a loan arrangement can be easiest to document, some lawyers and clients prefer it. Yet most litigation funders don't like straight loans because of usury or regulatory rules. The risk premium they charge can look like 100 percent interest or more.

As if all this was not complex enough, some litigation funding arrangements may even qualify as derivative contracts, also called notional principal contracts. They call for one or more fixed payments from the funding source, and one or more contingent payments from you depending on the outcome of the case. These are not common, but if you have one, you'll need accounting or tax help.

What is the best choice? A loan is easiest but seems increasingly rare. The "interest" seems too high. Moreover, these "loans" are generally nonrecourse, secured only by the proceeds (if any) from the claim. This can make the "loan" look more like equity for the funding source. The prepaid forward contract seems to be the vehicle of choice for many lawsuit funding sources. It has the advantage of no immediate tax on the upfront payment, just like a loan. However, you might expect the IRS to argue in some cases that the receipt of the funding should result in income. For that reason, good documentation is critical.

Whatever structure is chosen, it is vitally important for lawyers or clients receiving litigation funding to make sure they can either exclude or claim a full tax deduction for the investment return element paid to the litigation funding source when the case is concluded. You certainly don't want to receive taxable legal fees or settlement amounts, have to pay your litigation funding source a steep return and find you can't deduct it. Although in most cases this issue isn't a problem, it may be a risk and merits being careful in every deal.



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