13 Tax Myths About Litigation Finance

by Robert W. Wood

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In this article, Wood dispels common misconceptions about the tax aspects of litigation funding transactions.

This discussion is not intended as legal advice.

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Lawyers and plaintiffs often need cash, and litigation finance serves a legitimate role in providing it. The litigation funding industry offers nonrecourse money, so if the case (or cases) goes bust, the lawyer and plaintiff are not required to pay back the funder's advance. Lawyers may seek funding, their clients alone may seek it, or each may participate in the financing, depending on how the deal is structured and what they want. There are many variations, with some deals focusing on a single case and others involving a series of cases, the latter often referred to as a portfolio.

There are also variations in the documents that funders use. Many people wonder about taxes, either when striking a deal or later, when they hover over their tax return with their preparer. Taxes play into just about everything, including litigation funding transactions. Litigation funding documents can differ in ways that are material to their tax treatment, so consider the tax impact before you sign and are committed. And don't get taken in by these common tax myths about such arrangements.

Myth 1. Loans are nonrecourse, so you don't have to repay them.

This isn't a myth exactly, since every deal I have seen calls for nonrecourse money — that is, no personal guarantee, etc. However, the "loans are nonrecourse" statement is still not entirely true. That is because few litigation finance transactions are structured as loans in the first place.

Many lawyers and plaintiffs think of these transactions as loans, and they are bound to be nonrecourse. But one cannot answer the tax treatment question without reviewing the funder's proposed documents. Is the funding structured as a loan with large interest payments, albeit a nonrecourse loan? Or is it set up as a sale of a portion of the claim or legal fees? If it is a sale, is it a currently taxable sale or a forward sale that is taxed only later?

Myth 2. Loans are not income, so loans are best.

It is true that if you receive loan proceeds, they are not income for tax purposes, since you need to pay back the loan or forfeit your collateral, whatever was securing the loan. But most funders do not want to make loans. They have their own tax reasons, and interest income is usually not what they want. If the fund is owned all or in part by non-U.S. persons, interest is subject to withholding tax. Even if the fund is owned by domestic investors, interest is ordinary income, and many investors hope for capital gain treatment on their investment instead.

Besides, plaintiffs who receive funding often don't like loans either. There are numerous limitations on deducting interest, so plaintiffs may be unable to claim tax deductions for all the

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interest they pay. Lawyers and law firms receiving funding usually have an easier time claiming interest tax deductions, but still, funding documents structured as loans are relatively rare.

Myth 3. The tax treatment of the case and legal fees is irrelevant.

Most people think of funding transactions as separate from how the eventual case recovery will be taxed. But if you are a plaintiff or a lawyer, you should think about the tax treatment of the case, too. The issue is easier for lawyers because they are earning legal fees that will always be ordinary income when they collect. But for plaintiffs, it is a different story.

Attorney fees can be taxed in surprising ways, especially under the Tax Cuts and Jobs Act rules for 2018 through 2025. Many plaintiffs assume that if they have a contingent fee lawyer, the worst tax result they will ever face is having their net recovery (after legal fees) taxed to them as ordinary income. However, for tax purposes, the plaintiff in a contingent fee case will be treated as receiving 100 percent of the recovery, even if 40 percent or more is separately paid to the plaintiff's attorney. The Supreme Court so ruled in *Banks* in 2005.[1]

Most plaintiffs assume they can deduct the legal fees, which would make it a wash. Surprisingly, though, for 2018 through 2025 tax years, plaintiffs in some cases can be taxed on 100 percent of their recovery, with no deduction for the 40 percent or more that is subtracted for legal fees.[2] There is much talk about what will happen in 2026 and whether individuals' abilities to claim miscellaneous itemized deductions will come back into the law.

In the meantime, some plaintiffs find a way to argue that their fees are not covered by the Supreme Court's decision — for example, because their fees are statutory or court awarded and therefore are not gross income to the plaintiff.[3] Many more plaintiffs claim they are allowed an above-the-line deduction, even if their case isn't a classical employment or civil rights suit entitled to that special treatment.[4] In any event, increased worries about the tax treatment of legal fees can complicate taxes on litigation funding.

Myth 4. Advance money is never taxable when received.

To most plaintiffs, what is most important is that the money is nonrecourse and that any taxes they may have to pay will come later. That is, the plaintiff hopes not to have the advance money from the litigation funder taxed when received. Why have the upfront money nearly halved by taxes if you can avoid it? But how do you reach that result?

The primary structural choice in litigation funding is between a loan and a sale. With a loan, you receive loan proceeds, which are not taxable because you need to pay the money back.[5] A loan is easier to document and frequently more familiar, so some lawyers and clients prefer it. However, there can be tax downsides to loans.

Many financing documents are written as sales, although some funders shy away from using that term.[6] Most regular sales are taxable, so the normal rule would be that the lawyer or client must pay tax in the year in which the funder provides the upfront cash. Of course, lawyers and plaintiffs prefer deferring the tax problems until later. Moreover, funders, plaintiffs, and lawyers have reason to be wary of any transaction that suggests the funder is purchasing a *current* interest in the underlying claim, since this can raise nontax issues.

Myth 5. Every sale contract is currently taxable.

When the parties opt for a sale, they typically document the funder's investment as a prepaid forward contract. Because the transaction is a sale, you might assume you have to report the upfront money immediately as income. However, this is

[1] *Commissioner v. Banks*, 543 U.S. 426, 430 (2005).

[2] *See* section 67(g) (disallowing all miscellaneous itemized deductions through 2025).

[3] *See* Robert W. Wood, "Lemon Law Plaintiffs Face Tax Lemon on Legal Fees," *Tax Notes Federal*, Jan. 13, 2020, p. 265.

[4] *See* Wood, "Civil Rights Fee Deduction Cuts Tax on Settlements," *Tax Notes Federal*, Mar. 2, 2020, p. 1481.

[5] *Commissioner v. Tufts*, 461 U.S. 300, 307 (1983).

[6] Most funders go out of their way to disclaim any sort of control of the plaintiff's case or any ownership interest in the plaintiff's underlying claims. Instead, they insist that they are purchasing no more than a share of the future *proceeds* of the litigation. Some funders avoid using the terms "purchase" and "sale" to describe how they have acquired even that watered-down interest. In some cases, the funder's documents do not characterize the transaction beyond stating that it is *not* a loan and does *not* create a partnership.

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an unusual type of sale contract that leaves open how much of the case proceeds the plaintiff or lawyer will have to deliver to the funder. The amount is uncertain because the formula for the seller's payment generally depends on facts that will not be known until the case is resolved.

When you sign a prepaid forward contract and receive money, you have entered into a contract to sell a portion of your recovery (if you are the client) or a portion of your contingent fee (if you are the lawyer) when the lawsuit is eventually resolved. The contract calls for a *future* sale, so it is called a forward contract. You are contracting to sell now, but the sale doesn't close until the case is resolved. In the meantime, the funder's upfront cash is treated like a tax-free deposit.[7]

Myth 6. To qualify as a prepaid forward contract, just use the right label.

Mere labeling is not enough. For a contract to qualify as a prepaid forward contract, it should have certain elements required by the IRS. The details are listed in Rev. Rul. 2003-7, 2003-1 C.B. 363. If you qualify, you generally should not have to report as income the upfront payment you receive from the litigation funder until the conclusion of the case. If the case is a success and you end up paying the funder more than the funder paid you, you would report the funding transaction as a *loss*.

However, if you want your transaction to be taxed on a deferred basis, good documentation is critical. Whatever structure is used, it is important to consider taxes. You don't want to receive taxable money, pay the funder a steep return, and then find that you can't deduct a big payment to the funder or somehow offset it against your recovery.

The economic terms affect the tax treatment too. For example, what if a plaintiff sells a share of his future recovery for a fixed sum of money and the funder is entitled to receive 50 percent of all money the plaintiff receives by judgment or settlement? Would it matter if instead of receiving 50 percent of all the proceeds, the funder is entitled to all its money back first and then 30 percent of anything exceeding that? What if instead of some kind of sharing arrangement, the funder purchases 100 percent of the case proceeds?

Those terms influence the tax treatment. Timing is also relevant. When funding is provided, the defendant may already have been found liable. The funding may come while the case is on appeal or even if the judgment is final but there are payment delays. In the latter case, the funding may largely be about enforcing a judgment, and these facts may influence the tax treatment.

Myth 7. You don't need to worry about how law firms distribute advance money to partners.

Actually, this can be a huge issue. Even if you have a good position (under, say, a prepaid forward contract) that the law firm does not have income when it receives the advance, what if it pays the money out to its partners? If the "partners" are actually employees for tax purposes, the distribution will be treated as wages, which are currently taxable to the employees.

What if the firm distributes funding proceeds to partners who qualify as partners for tax purposes? Distributions to partners are taxable, unless the partners have enough basis in their partnership interests to absorb the distribution. Notably, though, if the firm receives the funding without having to report it as current income, the funding *will not* increase the partners' respective bases in their interests.

Depending on the facts, a partner that receives a large distribution from the funding could face tax on the distribution to the extent it exceeds the partner's basis in their partnership interest. Same for lawyers who are shareholders of S corporations. So a second analysis is usually needed if the plan is to distribute money to partners (or shareholders) without triggering current tax to them.

Some firms try to avoid this result by forgoing distributions to partners and instead making them loans. This must be done with care, however, especially if the firm is considering making loans in amounts that reflect the recipients' respective equity interests. You don't want the IRS to be able to successfully argue that the loans are disguised distributions that should be taxed.

[7] *See* Wood, "Prepaid Forward Contracts Aren't All Bad," *Tax Notes*, Apr. 16, 2012, p. 36.

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Myth 8. If a case fails and the advance is not repaid, no tax is due.

Most people know that the price tag for failing to treat an advance as income when received is that the advance *will* be taken into account later, whenever it is clear that the funder will not receive any further payments and will not recover its advance. This is the same rule as with a loan: If the loan is forgiven, the unpaid balance is taxed as income to the borrower (unless one of the few exceptions applies). The funder may or may not send out a Form 1099, but either way, it is still income.

Myth 9. Lawyers can't defer taxes because all their fees are ordinary income.

Lawyers are service providers, so all fees they receive are ordinary income and generally subject to self-employment taxes, too. However, in my opinion it is still possible for lawyers to enter a prepaid forward contract with a funder and to defer taxes on the advance money in the same way plaintiffs can.

Myth 10. You get the same tax deferral with portfolio funding.

Plaintiffs may be the most likely parties to seek funding, but many lawyers do too, and the plaintiff may not even be participating. The lawyer may "sell" part of their interest in a particular case or in a portfolio of cases. If the contract covers 10 cases, can the lawyer defer paying tax on *any* of them until the proceeds of all 10 cases are received?

No. Under the existing authorities,[8] sales of a collection of assets must be reported and taxed separately. So the IRS should clearly object if the lawyer argues (based on cross-collateralization or other factors) that there was nothing to report until the 10 cases were settled. Instead, the results of each sale should be reported separately because the contract covers 10 cases. Ideally, the funder and lawyer agree on case values upfront. In any event, funders informally generally do this as part of their underwriting, so those figures are useful benchmarks.

How do lawyers determine profit or loss if the contract has failed to allocate the upfront cash among the 10 cases? Also, what is the tax result if case 1 or case 3 tank and the funder would not get that portion of its advance money back? Lawyers hungry for upfront cash may not work through these issues until later. It is difficult to arrive at values after the fact, so ideally, you should agree at the time the funding contract is signed.

Myth 11. No one wants to report advance funds as current income.

A classic tenet of tax planning is to defer income and accelerate expenses. That suggests that no one who gets funding and has a choice would want to declare income that could be deferred. However, even this rule has exceptions.

A contract may be a defensible prepaid forward contract, but some law firms still decide to report advance money from a funder as income now, even if they could arguably defer it. Sometimes it is because their CPAs are uncomfortable with the prepaid forward tax analysis. Sometimes the law firm is more calculating, watching income and expenses and trying to match them.

For example, suppose a lawyer spent $5 million on advertising this year and has little income but also received $5 million in funding. The lawyer may want to declare the $5 million as income, even if she could defer it. Matching income and expenses may make sense. Would the IRS ever complain that the lawyer reported income too early? It is technically possible but seems unlikely.

Myth 12. You don't need to consider the funder's taxes.

Funders worry about their own taxes, but it still pays for plaintiffs and lawyers to know what funders are up against. Funders usually do not want loans, which generate interest income. They usually want to make a purchase, and if they can get it, funders like capital gain treatment.[9] That is best for U.S. investors, non-U.S. investors, and tax-exempt investors.

For capital gain, you need a capital asset and a sale or exchange.[10] Section 1221 disqualifies some

[8] *See, e.g.*, *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945).

[9] *See* Wood and James L. Kresse, "Is Litigation Finance Tax Treatment in Jeopardy?" *Tax Notes*, Mar. 7, 2016, p. 1193.

[10] Section 1222; *Helvering v. William Flaccus Oak Leather Co.*, 313 U.S. 247, 249 (1941).

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assets from capital gain treatment. Plus, some payments are ordinary income under various tax principles, including the origin of the claim doctrine, the substitute for ordinary income doctrine, and the assignment of income doctrine.[11] Section 1234A is frequently cited by funders because it can permit sale or exchange treatment even when there has not been a regular sale or exchange. The IRS could argue this point,[12] but so far it appears not to be bothered by such positions.

Myth 13. It doesn't matter whether the funder is U.S. or foreign.

Money is money, so in a sense, it does not matter who is sending it. But the tax issues with non-U.S. funders can be touchy. Non-U.S. persons optimally want access to U.S. capital markets without having to pay U.S. taxes if they make money. Is the income or gain they eventually collect effectively connected with the conduct of a U.S. trade or business? Effectively connected income is a term of art and is usually something funders want to avoid.

If the funder has ECI, its non-U.S. investors may be required to file U.S. tax returns and pay tax on their shares of that income (net of applicable deductions) at the same rates as U.S residents.[13] That is the last thing non-U.S. investors want. In that sense, the "can I get capital gain" question can be more pressing if the fund is overseas or if it has non-U.S. investors. Plainly, a U.S. investor in a litigation finance funder prefers paying 23.8 percent on profit (the top capital gain rate plus the 3.8 percent net investment income tax) rather than 37 percent. But the stakes for foreign investors — not paying U.S. tax versus paying U.S. tax and filing returns — are bigger.

How does this affect plaintiffs and lawyers? A non-U.S. funder may demand a commitment that the plaintiff or lawyers will not withhold U.S. taxes when they send money to a foreign funder. But the U.S. plaintiff or lawyers may risk the wrath of the IRS if they don't withhold U.S. taxes, and the taxes and penalties can be large. Some non-U.S. funders include a provision in their documents that if you do withhold U.S. taxes, you must "gross up" the funder's return to make up for it. Litigation funding money can be expensive, and a gross-up provision can make it even more so.

Conclusion

Litigation funding has experienced explosive growth over the last 15 years, and many plaintiffs and lawyers participate. Some are so anxious to get the money that they may not consider taxes before they sign. Thinking about it only later, such as at tax time or during an IRS audit, is hardly optimal.

Plaintiffs generally want to delay taxes until later, and that usually means a loan or a prepaid forward contract. Some funders will change their basic form of contract a little, and some may change it a lot. Some are willing to change their documents more extensively if they really want the particular investment. Sometimes, the funder may adopt a kind of neutral strategy, not calling their arrangement a loan but not calling it a prepaid forward contract, either.

In those cases, whichever side of the table you are on, it is important to have some seasoned and realistic tax advice about exactly what you are getting and how it may need to be tweaked. Litigation funding transactions should be supported by a formal tax opinion. Tax opinions protect against penalties, but they have numerous other benefits, too.[14]

The tax dollars at stake can be substantial, even if only timing considerations are at play. What's more, many accountants need assurances that they can treat a case in a certain way. You don't want to find out about that a few days before your tax return must be filed. Far from one size fits all, funding transactions can involve a complex web of tax issues that should be considered, often from multiple points of view. ■

[11] *See, e.g.*, *Commissioner v. P.G. Lake Inc.*, 356 U.S. 260, 261-262, 265-267 (1958) (substitute for ordinary income).

[12] *See* FAA 20154701F (contending that a funder's profit when it received case proceeds was not gain for purposes of section 1234A because there had been no "sale or disposition" described in section 1001). *See* Wood and Kresse, *supra* note 9.

[13] *See* sections 871(b) (nonresident alien individuals) and 882(b) (corporations). A non-U.S. person investing in a partnership that conducts a U.S. trade or business is treated as engaged in that U.S. trade or business. Section 875(1).

[14] *See* Wood, "Debunking 10 Myths About Tax Opinions," *Tax Notes*, Aug. 17, 2015, p. 789.

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