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# Navigating Litigation Funding Requires a Thorough and Careful Tax Strategy

**By Robert W. Wood**

Lawyers and plaintiffs often need cash, and litigation finance serves a legitimate role in providing it. Litigation funders offer nonrecourse money, so if the case (or cases) go bust, the lawyer and plaintiff are not required to repay the funder's advance. Lawyers may seek funding, their clients may seek it, or each may participate. Some deals focus on a single case and some involve a portfolio of cases.

Many people wonder about taxes when striking a deal or later when they are hovering over their tax returns. You may think of these as nonrecourse loans, but very few litigation finance transactions are structured as loans. Most funders do not want interest income. Interest is ordinary income, and many fund investors hope for capital gain treatment on their investment. Many plaintiffs getting funding don't like loans either, as they may not be able to claim tax deductions for all the "interest" they pay.

For plaintiffs and lawyers, what is most important is that the money is nonrecourse, and that any taxes they may have to pay will come later. That is, 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 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. But as loans have tax downsides, many financing documents are written as sales. Most sales are taxable, so the normal tax rule would be that the lawyer or client must pay tax when the funder provides upfront cash. Therefore, many funders use a prepaid forward contract.

This is an unusual sale contract that leaves open how much of the case proceeds the plaintiff or lawyer must deliver to the funder as the case or cases resolve. 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 a contract to sell a portion of your recovery (if you are the client) or a portion of your contingent fees (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 does not close until the case is resolved. In the meantime, the funder's upfront cash is treated like a tax-free deposit. For a contract to qualify as a prepaid forward contract, it should have certain elements specified by the IRS. The details are listed in Revenue Ruling 2003-7, 2003-1 C.B. 363.

If you qualify, you generally should not have to report the upfront payment as income. If the case is a success and you end up paying the funder more than the funder paid you, you report the funding transaction as a *loss*. 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 do not want to receive taxable money, pay the funder a steep return, and find that you cannot deduct a big payment to the funder.

Even if you have a good position that your *law firm* does not have income on an advance, what if your firm then pays the money out to its partners? That is a second tax issue to address. If the "partners" are actually employees for tax purposes, the distribution will be treated as wages, which are currently taxable to the employees (even if the advance was not currently taxable to the firm).

What if your law 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. But notably, if the law firm receives the funding without having to report it as current income, the funding *will not* increase the partners' respective bases in their interests.

Therefore, a partner who receives a large distribution from the funding could face tax on the distribution if it exceeds the partner's basis in his or her partnership interest. The same problem can arise for lawyers who are shareholders of S corporations. In short, a *second* analysis may be needed if the plan is to distribute money to partners (or shareholders) without triggering current tax to them.

There is no one size fits all solution. But some law firms in this situation will forgo distributions to partners, and instead have the law firm make *loans* to the partners. This must be done with care, and the loans need to be documented, bear interest, and hopefully not be in exact proportion to the partner's interests in the firm. You don't want the IRS to be able to successfully argue that the loans are disguised distributions that should be taxed.

Most people know that the price tag for failing to treat an advance as income when you receive it is that the advance will be taxed later, if it becomes 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.

Many lawyers seek funding, and the plaintiff may not be participating. If the contract covers ten cases, can the lawyer defer paying tax on *any* of them until the proceeds of the tenth case are eventually received? The tax law is not 100% clear, but under the existing authorities, sales of a collection of assets should probably be reported and taxed separately. The results of each sale should be reported separately. Ideally, the funder and lawyer will agree on case values up front. Funders generally do this as part of their underwriting, and those figures are useful benchmarks.

How do lawyers determine profit or loss if the contract has failed to allocate the upfront cash among ten cases? If the first case to be resolved generates no proceeds, it may be tempting to lowball the allocation to that case in order to reduce the amount of ordinary gain that the lawyer must report that year. However, that is the sort of after-the-fact tax,

do-it-yourself deferral that has traditionally drawn the IRS's ire, so be careful.

There may be no bullet-proof solution, but it might help if the lawyer adopts a set of valuations when the funder's advance is made, and then sticks to it through thick and thin. It is difficult to arrive at values unilaterally and after the fact. As a result, agreeing on case values with the funder at the time the contract is signed is best.

Litigation funding has experienced explosive growth over the last fifteen 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 taxes 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 extensively if they really want the particular investment. Sometimes, the funder may adopt a kind of neutral strategy, not calling their arrangement a loan, and yet not calling it a prepaid forward contract either.

Whichever side of the table you are on, it is important to get some tax advice about what you are getting and how it may need to be tweaked. Then, when the smoke clears, litigation funding transactions should be supported by a formal tax opinion. Tax opinions protect against penalties, but they have numerous other benefits too. The tax dollars at stake, even if only timing considerations are at play, can be quite material.

What's more, many accountants need assurances that they can treat litigation funding money 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 mix of tax issues that should be considered, often from multiple points of view.

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