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When You Get Litigation Financing, When And How Is It Taxed?

Lawyers and plaintiffs often need cash, and litigation funding can provide it. It may come from a dedicated litigation funder or from a hedge or private equity firm. But perhaps the most classic feature is that litigation funders offer nonrecourse money. That way, if your case goes bust, the lawyer and plaintiff are not required to repay it. 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 most funders do not document it as a loan. Interest (on a debt) is ordinary income, and many fund investors hope for capital gain treatment on their investment. Many plaintiffs getting funding also don't like loans, as they may not be able to claim tax deductions for all the "interest" they pay. For most 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. After all, why have your upfront money nearly halved by taxes if you can avoid it?

All the parties, the plaintiff, lawyer, and funder all may have tax goals. But how do you reach the best 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.

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 ever 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.

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 until much later, such as at tax time or during an IRS audit. Ideally, though, getting tax advice before you sign is best.

Some funders will change their form of contract. 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 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.

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