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Taxing Litigation Finance: Plaintiff, Lawyer, and Funder Tax Goals

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In this article, Wood and Board survey tax issues in litigation funding transactions, considering plaintiffs, lawyers, funders, and fund investors.

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It is an understatement to say that litigation finance has blossomed over the last decade. At times it has been quite controversial, as perhaps contingent fees for lawyers were a few generations ago. But lawyers and clients often need cash, and as any funder will tell you, litigation finance serves a legitimate role in providing it. The costs of litigation are high, with modern litigation often being a good deal more expensive than it once was. Thus, the need for cash is often greater today than ever before.

The COVID-19 crisis has reportedly caused an uptick in the use of litigation funding. There is also the element of risk. Lawyers and clients may want to lay off some of the risk of a case onto someone else, rather than wait until the bitter end.[1] The end of litigation might be a big payday, but it also might be a big zero. In that sense, some hedging of the risk can be attractive to plaintiffs and their lawyers alike.

The litigation finance industry generally offers non-recourse money, which is one of its great allures.[2] Lawyers may seek funding, their clients alone may seek it, or each may get some, depending on how the deal is structured. Regardless, one of the most consistent questions from lawyers and clients is how taxes will be handled. Yet, as with so much else in the tax world, that depends on the documents.

Documentation Matters

Financing arrangements vary materially, so one cannot answer the tax questions without reviewing the funder's proposed documents. Even without documents, however, one can ask some basic questions that may make clients scratch their heads. Fundamentally, is this arrangement a loan with big interest payments and no personal recourse against the borrower? Or is it a sale of a portion of the claim, or of a portion of the legal fees?

If it is a sale, is it a currently taxable sale, or a forward sale that is taxed only later? The latter is a particularly quirky question with some huge tax

[1] *See generally* Robert W. Wood and Jonathan Van Loo, "Litigation Funding: The Attorney's Perspective," *Tax Notes*, Jan. 27, 2014, p. 435; Wood and Van Loo, "Investing in Lawsuits: The Plight of the Plaintiff," *Tax Notes*, May 5, 2014, p. 613.

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

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incentives. But, continuing through our menu of tax possibilities, might the financing arrangement be a partnership between funder and plaintiff?

Each of these possibilities may have plusses and minuses, but who will want what, and what are the documents likely to say? Is the litigation funder neutral in all of this? These may sound like simple questions, but they can be quite difficult to answer. And the answer may not be black or white, but rather shades of gray.

Multiple Tax Issues

The tax rules outside of litigation funding can play a part too. For example, attorney fees can be taxed in surprising ways, especially under the Tax Cuts and Jobs Act, which affects 2018 and subsequent tax years. Most plaintiffs assume that if they have a contingent fee lawyer, the worst tax result they will ever face is having their entire net recovery (after legal fees) taxed to them as ordinary income.

However, under established tax principles, the plaintiff in a contingent fee case will usually be treated as receiving 100 percent of the recovery, even if 40 percent or more is paid off the top to the plaintiff's attorney. The Supreme Court so ruled in *Banks*[3] in 2005. Most plaintiffs assume that they can just deduct the legal fees, which would make it a wash.

Surprisingly, though, beginning in 2018, plaintiffs in some cases can actually be taxed on 100 percent of their recoveries, with no deduction for their legal fees. This bizarre result is possible because some attorney fees are no longer deductible.[4] Not surprisingly, some plaintiffs are likely to find a way to argue that the fees in their case are not covered by the Supreme Court's decision because they are statutory or court awarded.[5]

Alternatively, some plaintiffs will claim they are allowed an above-the-line deduction, even if their case isn't classically an employment or civil rights suit of the sort described in section 62(a)(20).[6] In any event, the increased worry about the tax treatment of legal fees can complicate taxes on litigation funding, particularly because the client may have a tax effect even if the lawyer alone is getting funding.

Loan or Sale

Lawyers and clients can ask the litigation funder about taxes, but funders are generally not in the business of providing tax advice. To most plaintiffs, what is most important is that the money is non-recourse, and that any taxes will come later. That is, the plaintiff hopes not to have the upfront money from the litigation funder taxed when received. Why have the upfront money nearly halved by taxes if you can avoid it?

The primary structural choice in litigation funding is loan vs. sale, but from there it gets more complicated. With a loan, you receive loan proceeds, which are not taxable because you have to pay them back.[7] A loan has the advantage of deferring any tax on the receipt of the initial funding. A loan arrangement is the easiest to document, and some lawyers and clients prefer it.

However, there can be tax downsides later. Besides, funding documents written as loans seem to be increasingly rare. Many litigation financing documents are written as sales, although some funders shy away from using that term.[8] Sales are taxable, so the normal rule would be that the lawyer or client must pay tax in the year when the funder provides the upfront cash.

Getting money that will be immediately reduced by taxes is very different from getting loan proceeds that you can fully deploy without taxes. It can be nice to defer the tax problems until later. Running out some numbers and thinking about timing in the competing loan and sale scenarios can be helpful.

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

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

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

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

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

[8] 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. In recent years, there has been a tendency for funders to 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 is not a loan and does not create a partnership.

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Prepaid Forward Contracts

When the parties opt for a sale, funders will typically document their investment as a prepaid forward contract. Because the transaction is a sale, you might assume you have to report the upfront money (the sale proceeds) immediately as income. However, this is a sale contract that leaves open how much of the case proceeds the seller 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 proceeds actually come in.

When you sign a prepaid forward contract and receive the money, you have entered 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 resolved. The contract calls for a future sale, which makes it a "forward" contract. You are contracting to sell now, but the sale does not close until the case is resolved. In the meantime, your receipt of the funder's upfront cash is treated like a tax-free deposit.[9]

For the contract to qualify as a prepaid forward contract, it should have some elements specified 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 the funder's advance as income until the conclusion of the case. A prepaid forward contract has the advantage of providing cash with no immediate tax, just like a loan.

However, getting the right documentation is critical. Whatever structure is used, it is important for lawyers and clients to consider taxes. You do not want to receive taxable money, pay a litigation finance company a steep return, and find that you cannot deduct a big payment to the funder or somehow offset it against your recovery.

The economic terms of the deal affect the tax treatment too. Many kinds of fact patterns are possible in a litigation finance setting, and they all raise tax issues. For example, what if a plaintiff sells a share of his future recovery for a fixed sum, and the funder is entitled to receive 50 percent of all money the plaintiff receives by judgment or a 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 in excess of that? What if instead of some kind of sharing arrangement, the funder purchases 100 percent of the case proceeds? The parties may be thinking largely about the economics, but the tax treatment can also depend on these details.

The timing is also relevant. When the 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. In the latter case, it may largely be about enforcing the judgment.

To return to the most basic paradigm, what if all the money from the funder does not come at once? Does it matter if, in addition to the initial advance, the funder will fund expenses incurred as the litigation progresses? Conversely, if we go to the end of the case and assume a positive result, will it matter if the funder is not receiving a single payday, but is receiving its return in installments?

As these varied fact patterns suggest, there may be no one-size-fits-all tax treatment that applies in all these cases. Moreover, in assessing the tax consequences, some thought must be given to the role of the lawyer. Plaintiffs may be the most likely parties to seek funding, but sometimes lawyers do.

The plaintiff may or may not be participating. The lawyer may "sell" part of his interest in a particular case, or even in a portfolio of cases. All these variations raise tax issues.

For example, if the contract covers a portfolio of 10 cases, can the lawyer defer paying tax on any of them until the proceeds of the final case are received? If, instead, the results of each sale must be reported separately, how does the lawyer determine profit or loss if the contract has failed to allocate the funder's advance among the 10 cases? Plaintiffs and lawyers hungry for upfront cash may not work through all these issues until later but planning ahead is helpful.

What Litigation Funders Want

As if this were not confusing enough, what do funders want for their structure and tax

[9] *See* Wood, "Prepaid Forward Contracts Aren't All Bad," *Tax Notes*, Apr. 16, 2012, p. 365.

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treatment? They usually do not want loans, which generate interest income. They usually want to make a purchase. And if they can get it, the funders might especially like capital gain treatment.[10] That is helpful for U.S. investors who pay taxes, for non-U.S. investors, and even for U.S. tax-exempt investors.

For capital gain, one needs a capital asset, and a sale or exchange of that asset.[11] The capital gain question is a big tax subject in itself. Section 1221 of the tax code disqualifies some kinds of assets from capital gain treatment. On top of that, there are some payments that are ordinary income under the origin of the claim doctrine, the substitute for ordinary income doctrine, or the assignment of income doctrine.[12] These are all nonstatutory tax doctrines that the IRS can use to attack a claim of capital gain.

Capital gain requires a sale or exchange, not merely a disposition.[13] In theory, one could sell a litigation funding asset before a payout, but that does not appear to occur with any frequency. Instead, the underlying case is usually resolved, and the funder is simply paid its share of the proceeds. This can make it difficult for the funder to argue that it has sold or exchanged anything.

This is one reason that section 1234A of the tax code is frequently cited by funders. That tax provision can permit sale or exchange treatment even when there has not been a regular sale or exchange. Section 1234A says that:

> Gain or loss attributable to the cancellation, lapse, expiration, or other termination of . . . a right or obligation (other than a securities futures contract, as defined in section 1234B) with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer, or [a section 1256 contract] shall be treated as gain or loss from the sale of a capital asset.

Funders may take the position that the payments they receive are to terminate their rights to a share of the proceeds under the litigation funding contract. Assuming that the seller's right to the proceeds (or perhaps the proceeds themselves) would be a capital asset in the funder's hands, section 1234A may treat gain realized upon the funder's receipt of a termination payment as if it were gain from a sale or exchange. The limited guidance from the IRS suggests that it may take a dim view of this argument,[14] but the question will probably have to be decided by the courts.

Non-U.S. Investors

Litigation funders have other tax issues to worry about, too. For example, is the income or gain they will eventually collect effectively connected with the conduct of a U.S. trade or business? "Effectively connected" is a term of art, and effectively connected income is usually a bad thing that a funder wants to avoid. Non-U.S. persons optimally want access to U.S. investment opportunities, but without having to pay U.S. taxes if they make money.

ECI, FDAP, and Capital Gains

If the funder has ECI, its non-U.S. investors, who typically participate as limited partners, 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.[15] That is usually the last thing non-U.S. investors want. So one key question in all this is: Does litigation funding rise to the level of a U.S. trade or business, like some lending operations?

Or is it more like equity investing, which can usually be conducted from a safe distance offshore?[16] It is rarely possible to discuss these

[10] *See* Wood and Kresse, *supra* note 2.

[11] Section 1222.

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

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

[14] *See* FAA 20154701F, released Nov. 20, 2015 (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 2.

[15] *See* section 871(b) (nonresident alien individuals); section 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).

[16] Even non-U.S. persons who actively trade stocks, securities, or commodities in the United States can avoid having a U.S. trade or business if they trade through a resident broker, commission agent, custodian, or other independent agent, and abstain from having an office in the United States that directs or effects the trades. *See* section 864(b)(2)(A)(i), (B)(i), and (C).

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points without digging into the facts of the particular investment, what the funder actually does in the United States, and more. In general, though, the jury is still out on the status of these arrangements as producing the unpleasant ECI.

Even if the non-U.S. investor is able to steer clear of the ECI taint, this does not mean there can never be any U.S. tax. Even nonbusiness income can be taxed by the United States if it is "fixed or determinable annual and periodical income."[17] (In tax jargon, this is abbreviated as "FDAP," and invariably pronounced "fuh-DAP.")

Non-U.S. investors who receive FDAP do not have to file U.S. tax returns, which suits them just fine. But any amounts paid to them are subject to U.S. withholding tax. That can smart, particularly because the statutory rate is a relatively steep 30 percent. Fortunately, tax treaties frequently reduce the withholding rate to a more civilized 5 or 10 percent.

A non-U.S. investor's capital gains, on the other hand, are typically neither ECI nor FDAP.[18] They are simply ignored for U.S. tax purposes. It doesn't get much better than that. Not surprisingly, non-U.S. investors are interested in section 1234A, which may allow them to treat their litigation funding profits as tax-free capital gain.

In that sense, the "can I get capital gain" question is likely to be far more urgent when there are non-U.S. investors. A U.S. investor in a litigation finance funder might love to pay 23.8 percent on his profit (the top capital gain rate plus the 3.8 percent net investment income tax) rather than 37 percent. But the stakes for non-U.S. investors are even higher.

Tax-Exempt Investors

Tax-exempt organizations may want to invest in litigation, too. It is true that they generally do not pay federal income taxes. However, there is an important exception for income earned from an unrelated trade or business.[19] In general, this means a business that does not relate to an organization's tax-exempt mission. This unrelated business taxable income (UBTI) is taxable at the corporate rate, and most organizations try to avoid it.

As in the case of non-U.S. investors, tax-exempt organizations should consider whether litigation funding may itself be treated as a trade or business. If it is, those investors will hope that their profits can be treated as capital gain, which is generally not treated as UBTI under section 512(b)(4). Here, too, investors may want to consider a reporting position based on section 1234A.

Conclusion

Litigation funding is clearly not going away, and if anything, seems likely to continue to grow. Many plaintiffs and their lawyers are used to considering it, and many partake. Some are so anxious to get the money that they may not consider the tax issues before they sign. Some do, and they may have either an easy or difficult time working out with their funder who should get what.

Plaintiffs nearly always want to delay taxes until later. And that usually means either a loan or a prepaid forward contract. Some funders are willing to change their basic forms of contract a little, and some may change them a lot. Some funders are willing to change their documents more extensively if they really want the particular investment.

Of course, the funders must also deal with their investors, whether domestic, foreign, or tax exempt. That can make for a complex web of tax issues that should be considered, often from multiple points of view. ■

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[17] *See* sections 871(a)(1) (nonresident alien individuals) and 881(a) (corporations).

[18] Under section 865(a), income from a nonresident's sale of personal property is generally treated as income from sources outside the United States.

[19] *See* section 512.

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