PERSPECTIVE

Los Angeles | Daily Journal

AUGUST 3, 2026

How is Litigation Funding for Lawyers Taxed?

By Robert W. Wood

Litigation funding involves someone (a dedicated litigation funder, a hedge or private equity fund, or a private party) handing over funds to a lawyer, a plaintiff, or both. In a sense, the funder is making a bet on the eventual success of the litigation. The money is almost invariably offered on a nonrecourse basis, so if the litigation is a bust, the plaintiff or lawyer does not owe the funder anything.

In the early days of litigation funding, plaintiffs were the usual recipients of these funds. They still can be today, either alone or in concert with their lawyer. In the latter case, both plaintiff and lawyer might obtain funding together. However, in recent years, lawyers and law firms, including some very large firms that you might not think of as typical plaintiff lawyers, have emerged as some of the biggest consumers of litigation funding.

The funder may be betting on a single case from which the lawyer anticipates a healthy contingent fee. Alternatively, the funder may be investing in a whole bevy of cases that the law firm has underway. They may all be similar or related cases, or they could be unrelated cases. The funder gets additional spreading of its risk in these so-called portfolio funding transactions.

Loan, Sale, or Prepaid Forward Sale

How are these transactions taxed? To answer, one first should look at the documents. You cannot assess how a transaction will be taxed without seeing them. Some transactions, albeit a minority, are documented as nonrecourse loans. The funder loans money, and the lawyer must repay it plus a healthy amount of interest if the case is successful.

If the documents support treating the arrangement as a loan for tax purposes, the loan proceeds are not income to the lawyer. However, the tax treatment that both the funder and the lawyer receive from a loan is generally disadvantageous. This is one major reason that few transactions are documented as loans. A transaction could be documented as a current purchase and sale of an interest in the case, but that too is uncommon, because of the poor tax treatment to one or both sides.

Instead, for at least the last fifteen years, litigation funding transactions have typically been documented with prepaid forward purchase agreements (PFPAs) rather than via loan or sale agreements. The PFPA is not a debt instrument and has no interest payments, and given its terms, it is impossible to tell how much the plaintiff or lawyer contracting with the funder will ultimately pay. This is one reason that the litigation funding industry uses PFPAs, which are a form of variable prepaid forward contract.

The tax authorities say that a taxpayer who receives an advance payment of the purchase price of property under a properly structured PFPA is not taxable on receipt of the advance payment. Instead, the transaction is held open until the contract is settled. The IRS approved this treatment in Revenue Ruling 2003-7. It is consistent with the fundamental principle that gross income includes gains derived from dealings in property, not gross sale proceeds. See Section 61(a)(3) of the tax code.

In a litigation funding contract involving a law firm, the litigation funder makes one or more cash advances to the law firm. The advances are in exchange for the law firm's promise to sell the funder a variable portion of the attorney fees and costs that the law firm hopes to receive under its contingent fee agreement with its client.

Single-Case Funding

The PFPA may relate to the law firm's representation of a single client in a single case. The law firm agrees to sell the funder a variable portion of whatever tangible or intangible property it recovers from its representation of a client in that single case. The law firm's right to payment does not accrue until the case is resolved, whether by settlement or by a non-appealable final judgment.

Once the law firm's payment right accrues, two things happen. First, the law firm should report its recovery as compensation in accordance with its method of accounting. The basic tax principle that compensation income is taxed when earned is unaffected by whether the law firm has made a side bet with a funder.

Second, the accrual of the law firm's payment right entitles the funder to a portion of the recovery under the PFPA. When the law firm settles its obligation, the PFPA provides that the law firm's payment *terminates* the parties' rights and obligations under the contract. When the PFPA is terminated, the law firm calculates and reports its gain or loss under the contract.

This is generally equal to the difference between the advances the law firm received and the sum of the law firm's payments to the funder; and the law firm's basis in the PFPA. Section 1234A of the tax code requires taxpayers to report capital gain or loss from certain terminations of sale contracts. However, because the property that is the subject of the sale is the law firm's right to *fees*, the law firm's gain or loss is ordinary gain or loss under the substitute-for-ordinary-income doctrine. See, e.g., *United States v. Midland–Ross Corp*., 381 U.S. 54 (1965).

Hence, the resolution of the case should result in the law firm reporting ordinary compensation income equal to the gross amount of its recovery, and ordinary gain or loss from the termination of the PFPA. In that way, the law firm is paying tax only on the funds that it gets to keep from the case, not on the amount it owes the funder.

Portfolio Funding

In a portfolio funding transaction, the law firm enters into a single PFPA requiring it to sell the funder a portion of its recoveries from *multiple* cases. The PFPA requires the law firm to make payments to the funder whenever a case is resolved as specified in the contract. A taxpayer who sells a collection of assets should generally treat the transaction as a collection of separate sales, rather than as the sale of a single asset. See, e.g., *Williams v. McGowan*, 152 F.2d 570 (2nd Cir. 1945).

Applying this principle to portfolio funding, the law firm should generally report the results of settling its obligations with respect to any particular case in the year that case is resolved. To calculate the law firm's gain or loss, an appropriate portion of the funder's advances should be allocated to the case in question as the amount realized in that sale.

Novoselsky Case

This tax case does not apply in this context, but its notoriety makes it worth a few paragraphs. *Novoselsky*, TC Memo. 2020-68, was a 2020 Tax Court case that caused some people to worry that it could apply to commercial litigation funding. The case involved a lawyer's do-it-yourself loans from interested parties that have no bearing on commercial litigation funding.

Mr. Novoselsky tried to borrow money on a non-recourse basis using self-drafted "litigation support agreements." His agreements were so poorly written that the Tax Court correctly held that they failed to create debt for tax purposes, so he had to report the payments he received in his income. Novoselsky even argued that the payments should be classified as nontaxable gifts or amounts he received in trust.

Not surprisingly, the Tax Court sided with the IRS. The case has no application to properly drafted litigation funding documents. The case did not discuss prepaid forward contracts.

Conclusion

Litigation is expensive and involves uncertainty. For clients and lawyers, litigation funding can help to reduce risk, albeit with a cost of funding that is usually commensurate with the degree of risk the funder is taking on. From a tax viewpoint, most recipients of funds want to delay the event of taxation, and to be sure that when they pay taxes, they are paying taxes on their net recoveries, not on any of the money that is being paid to the funder.

Properly structured, the unique prepaid forward purchase agreements that are usually used in this context can achieve both goals. Funders like them too because the lawyers and plaintiffs they deal with want and expect these agreements, and because of the tax advantages that the funders and their investors can often achieve.

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