

Forbes



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THE TAX LAWYER

June 17, 2026

How Litigation Funding Transactions Are Taxed



Litigation funding involves a funder handing over funds to a lawyer, a plaintiff, or both. The funder is making a bet on the eventual success of the litigation 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.

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.

Funding One Case or Many

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 series 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? Everyone has their own tax goals, the [plaintiff, lawyer, and funder](#). 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 financing, the loan proceeds are not income to the recipient. However, the tax treatment that both the funder and

the borrower 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.

Today, most litigation funding transactions have typically been documented with prepaid forward purchase agreements rather than via loan or sale agreements. The basic idea is [money now, taxes later](#). The forward contract is not a debt instrument and has no interest payments, it is impossible to tell how much the plaintiff or lawyer contracting with the funder will ultimately pay. Such forward contracts are often [used for stock transactions, and for legal funding](#).

Aren't Advances Taxable?

The tax authorities say that a taxpayer who receives an advance payment of the purchase price of property under a properly structured forward contract 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.

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

A forward contract 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.

When that happens, it 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 funding contract. In that way, the law firm is paying tax only on the funds it gets to keep from the case, not on the amount it owes the funder.

Portfolio Funding

In a portfolio funding, the law firm enters into a single contract requiring it to sell the funder a portion of its recoveries from *multiple* cases. The contract requires the law firm to make payments to the funder whenever a case is resolved as specified in the contract. In general, 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.

Conclusion

Litigation is expensive and involves uncertainty. And there are some [tax myths out there to beware of](#). 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 prepaid forward purchase agreements that are usually used in this context can achieve both goals. Funders like them because the lawyers and plaintiffs they deal with want and expect these agreements, and because of the tax advantages that funders and their investors can often achieve.