



Robert W. Wood

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Legal Funding Impacts Taxes, On Funding & Later Settlement

Lawyers and clients often need cash. There is also the element of risk. Lawyers and clients may want to lay off some of the risk of a case on someone else, and the litigation finance industry generally offers non-recourse money. Lawyers may seek funding, the clients alone may seek it, or each may get some, depending on how the deal is structured. But one of the most consistent questions is how taxes will be handled, and that depends on the documents. Financing documents vary materially, so one can't answer the tax questions without reviewing them. Fundamentally, is this a loan? Is it a sale of a portion of the claim, or of a portion of the fees?

These may sound like simple questions, but they can be difficult to answer. Notably, attorney fees can be taxed in surprising ways, especially under the new tax law. Thus, the client may have a tax impact even if the lawyer alone is getting funding. You can ask the litigation finance company about taxes, but they are generally not in the business of providing tax advice. The primary choice 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. A loan has the advantage of deferring any tax on the receipt of the initial funding.

However, there can be tax downsides later. Some litigation financing documents are written as sales. Sales are taxable, so the normal rule would be that the lawyer or client must pay tax when the sale is made on the up-front money. Getting money that will be immediately halved by taxes is very different from getting loan money that you can fully deploy without taxes. It can be nice to defer the tax problems until later. Running out some numbers

and timing under loan vs. sale scenarios can be helpful. But apart from sales and loans, some funders are willing to use an unusual structure called a prepaid forward contract. It is a sale, so you might assume you have to report the up-front money (the sale proceeds) immediately as income. However, this is a sale contract with an unclear final sales price, usually because the formula for payment depends heavily on the time when the case proceeds come in.



When you sign the documents and receive the money, you have entered a contract to sell a portion of your case (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, so it is called a forward contract. You are contracting to sell now, but the sale does not close until the case is resolved. For the contract to qualify, it must have certain required elements specified by the IRS. If you qualify, you generally should not have to report the up-front payment you receive from the litigation funder until the conclusion of the case. A loan arrangement is easiest to document, and some lawyers and clients prefer it. However, many litigation funders do not like loans.

Some documents are not even clear whether they are a loan or a sale. The prepaid forward contract has the advantage of no immediate tax on the upfront payment, just like a loan. However, good 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 or

offset it against your recovery. It pays to be careful and to run some examples on the numbers.

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