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THE TAX LAWYER

Litigation Funders And Lawyers Face 40.8% Tax In One, Big, Beautiful Bill

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The litigation funding industry—and many lawyers and law firms—are worried about a provision inserted in the pending tax bill. Senator Thom Tillis (R-N.C.) introduced the Tackling Predatory Litigation Funding Act in the Senate, you can read the text [here](#). A companion bill was introduced in the House by Kevin Hern (R-Okla.). The litigation funding tax was not in the House-passed One, Big, Beautiful Bill Act, but the Senate's reconciliation bill includes it.

Its ostensible goal as described by [Tillis when he introduced it](#) is to prevent foreign influence in the U.S. court system and stem frivolous lawsuits.

Some [insurers and trade groups](#) support it, you can see a list [here](#). Investors (both foreign and domestic) often help fund lawsuits, and the U.S. is full of lawsuits. But given the elephant gun approach of the proposed new tax, domestic funders are equally worried, as are lawyers and law firms. Lawsuits on contingency are the norm, so the plaintiff pays nothing, no legal fees and no costs, until the case settles.

Meantime, litigation is expensive, with experts, court reporters, travel, consultants, and lawyer time. Law firms must pay their staff, rent and other expenses, and keep funding case costs until they win. Bank loans may be possible, but many banks won't lend big dollars, especially not on a non-recourse basis. Litigation funders make nonrecourse bets on cases or on a law firm's case portfolio. If the case pays off, the funders do well. If the case craters, the funders collect nothing.

How do [taxes fit in, and when and how is it](#) taxed? Funding deals can be loans, purchases, or prepaid forward purchases, a kind of hybrid [you can read about here](#). Loans sound simplest, but most funders don't like them because the "interest" may be huge, and it is all taxed as ordinary income. Domestic and foreign funders, as well as domestic funders with foreign investors, usually feel the same way.

After all, capital gain taxed at lower rates is better than interest for everyone. Foreign funds, and domestic funds with foreign investors, especially dislike interest, since it is taxed by the U.S., even if they have no other U.S. income. Foreign funds with just capital gain income don't even have to file U.S. tax

returns. Apart from litigation funding, they like buying U.S. stocks for the same reason, as selling stock produces capital gain income.

Although this tax rule for non-U.S. persons is long-standing U.S. tax policy, supporters of the Tillis bill claim that it is closing a loophole that unfairly subsidizes foreign investment in litigation funding. However, rather than just targeting non-U.S. funders and non-U.S. investors, it adds a new, big special tax that also applies to U.S. funders and their U.S. investors. It's an excise tax, not an income tax.

40.8% Excise Tax

The bill imposes a steep 40.8% excise tax on “qualified litigation proceeds” received by “covered parties” under a “litigation financing agreement.”

Qualified litigation proceeds include all realized gains, net income or other profits derived from any litigation financing agreement. So, it would be more accurate to describe the new tax as a tax on qualified litigation *income*.

Broad ‘Covered Parties’

Pretty much everyone, any kind of person or entity, whether U.S. or foreign, is subject to the tax. It doesn't matter how the deal is set up or what kinds of entities are involved. Flow-through entities like partnerships and S corporations pay 40.8% tax, too—at the entity level—even though they are ordinarily supposed to receive flow-through tax treatment. The tax applies to all litigation financing agreements and virtually any agreement creating an interest in the outcome of litigation. Plus, the law allows the Treasury Department to expand this definition as needed.

No Offsets, No Relief

Unlike typical taxable income, you can't offset this tax with losses of any kind. Qualified litigation proceeds cannot be offset by other ordinary or capital losses, even those generated by other litigation financing arrangements. The new law also trumps key tax exclusions, exemptions and preferences. You can forget about claiming special tax exclusions, such as that for foreign

governments, the capital gain rules, U.S. tax treaties with foreign countries, and so on.

Enforced Withholding Tax

The 40.8% tax is an excise tax, but its enforcement key is withholding. Any party to the litigation or any law firm involved with a litigation financing agreement that receives any case proceeds must withhold 20.4% of any payment it makes to the funder. This is 50% of the tax that would apply if the payment consisted entirely of gain or other income to the funder. However, whether the funder is *actually* realizing a profit or loss is irrelevant— withholding applies to the *gross payment*.

Many existing funding agreements include provisions addressing tax withholding, although these are rarely in the term sheet or actually discussed by the parties. A typical provision states that all payments to the funder will be made “without withholding,” unless withholding is required by law. If withholding is mandatory, the provisions will frequently specify that the lawyer must “gross up” any payments to the funder to ensure that the funder receives the same amount, after withholding, that it would have received if no withholding were required.

Even in the absence of a gross-up provision, the lawyer may find that increasing the payments to the funder is the only way to avoid an event of default under the funding agreement. These provisions are intended to shift the economic burden of the withholding tax from the funder to the lawyer. To insulate a funder from a 20.4% withholding tax, the lawyer will need to increase all payments to the funder to cover it.

Limited Exemptions

The new law has only very limited exemptions. It exempts loans with interest capped at the greater of 7% or two times the average annual yield on 30-year Treasury securities. Funding below \$10,000 and certain related-party transactions are also excluded.

No Grandfathering