PERSPECTIVE
Los Angeles | Daily Journal
JUNE 30, 2025

# Litigation Funding Deals Could Get Uglier Under 'Big Beautiful Tax Bill'

By Robert W. Wood

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, when and how is it taxed? Funding deals can be loans, purchases, or prepaid forward purchases, a kind of hybrid. 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 it produces clear capital gain income.

But the tax treatment usually prevailing in the litigation funding industry could change in a big way. If it does, it's not just going to impact the funders, it's going to hit lawyers and law firms that do funding deals too. For that reason, many lawyers, law firms and funders alike are worried about a provision inserted in the Republicans big pending tax bill. Senator Thom Tillis (R-NC) introduced the Tackling Predatory Litigation Funding Act in the Senate, and a companion bill was introduced in the House by Kevin Hern (R-OK). 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 Senator Tillis when he introduced it is to prevent foreign influence in the US court system and stem frivolous lawsuits. Some insurers and trade groups support it. Investors (both foreign and domestic) often help fund lawsuits, and the U.S. is full of lawsuits. But given the elephant gun approach, 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.

Supporters of the Tillis bill claim 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.

<u>40.8% Excise Tax</u>

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 this as a tax on qualified litigation *income*.

<u>Broad "Covered Parties"</u>

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 documented or what kind 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.

<u>No Offsets, No Relief</u>

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. Forget special tax exclusion, such as that for foreign governments, the capital gain rules, U.S. tax treaties with foreign countries, etc.

<u>Enforced Withholding Tax</u>

The 40.8% tax is an excise tax, but its enforcement key is withholding. Any party in the litigation or 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 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 tax does have a couple of limited exemptions, but they are very limited. That is, it would exempt 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

As if all this were not enough, there is also the controversial effective date. This new tax would apply to all tax years starting after December 31, 2025. That means payments in 2026 and beyond will be subject to the new tax and withholding requirement, even if the payments are under funding contracts that have been in place since before the bill was enacted. Existing funding deals are not grandfathered.

**Robert W. Wood** *practices law with www.WoodLLP.com, and is the author of "Taxation of Damage Awards & Settlement Payments" (www.TaxInstitute.com). This discussion is not intended as legal advice.*