Litigation Funding, Gross-Ups, and Taxes — Still Beautiful?

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In this article, Wood and Board examine a provision — ultimately removed from the One Big Beautiful Bill Act for violating the Byrd rule — that would have imposed steep excise and withholding taxes on litigation funding profits, and they consider how this or similar legislation would interact with the tax gross-up provisions that appear in many litigation funding contracts.

This discussion is not intended as legal advice.

The litigation funding industry and its eager lawyer constituents were not the only people watching the run-up to the enactment of the One Big Beautiful Bill Act (P.L. 119-21), which President Trump signed into law on July 4. But litigation funders and lawyers — those with existing funding contracts, those negotiating funding deals, and those just planning on getting funding someday — were all transfixed. In late May, Senate Finance Committee member Thom Tillis, R-N.C., introduced the Tackling Predatory Litigation Funding Act (S. 1821, the Tillis bill). Does that name alone tell you anything?

The Tillis bill would have imposed a steep new 40.8 percent excise tax on all litigation funding profits, including those earned by non-U.S. persons, sovereign wealth funds, and tax-exempt organizations that invest in these transactions. Attorneys receiving funding would have been required to withhold 20.4 percent of all amounts they pay to their funders. Because this withholding requirement was not limited to profits, it was a blunt instrument. For example, an attorney would have been required to withhold even if it was clear that the funder had suffered a loss on the transaction and that no excise tax would have to be paid.

As lawyers and funders reacted, the provision grew somewhat less draconian. A modified form of the Tillis bill (the Senate proposal) was inserted in the Senate's June 27 version of the OBBBA. The Senate proposal would have reduced the excise rate to 31.8 percent and the withholding rate to 15.9 percent of the funder's profits. But even with those changes, more than one industry participant labeled the proposed new taxes an existential threat to litigation funding in the United States.

Lobbyists pro and con may have leapt into action, but the fate of the Senate proposal was decided on curiously procedural grounds. On June 20 the Senate parliamentarian ruled that the Senate proposal was essentially regulatory legislation and would have only incidental revenue effects overall. As such, the parliamentarian said it violated the long-standing Byrd rule, so it could not be adopted using the reconciliation process.

False Alarm?

Lawyers and litigation funders alike breathed a sigh of relief, and there were smiles all around, perhaps even about the save coming via the parliamentarian. Any win is a win, after all. As for Tillis, he announced that he would not seek reelection one day after the president expressed his ire over the senator's "no" vote on the OBBBA. Does that mean litigation funders and lawyers are out of the woods?

Although the Senate proposal didn't make it into the OBBBA as finally enacted, some observers expect similar proposals using the normal legislative process in the future. That makes who will actually pay the new tax — if it comes — worth considering. Attorneys who have already received funding or are interested in obtaining it in the future should reflect on this basic question.

As we discuss below, many sophisticated litigation funding contracts in use today require the recipient of the funding, not the funder, to bear the cost of any required tax withholding. This is also important to parties to litigation who receive funding, since both proposals would have applied to them as well. Plaintiffs regularly get funding too, either on their own or in tandem with their lawyers. For convenience, we will focus here on lawyers who receive funding, but the issues can apply equally to plaintiffs.

Gross-Up Provisions

Decades ago, litigation funding transactions were typically structured as loans, and a few still take that form today. Because the contracts documenting them were based on traditional bank loan agreements, litigation funding contracts came to include standard loan agreement terms requiring that all payments be made "free of withholding" (or words to that effect). Sometimes this requirement was set out as a separate boilerplate provision, but often it was buried as just one more clause in long provisions devoted to payment mechanics.

These days, sophisticated litigation funding agreements are usually structured as prepaid forward contracts. Lawyers like them because they help defer taxes until later, like a loan. Funders like them, too, because these contracts may help them claim capital gain treatment. Interest on a loan, in contrast, is ordinary income and is especially anathema to the non-U.S. investors in funding transactions. Still, many prepaid forward contracts continue to include traditional provisions requiring that payments to funders be made free of withholding.

Even if a contract says nothing further on the subject, this will generally impose a practical obligation on the attorney to "gross up" payments to the funder. That is, to avoid a default, the lawyer will need to increase the gross amount payable to whatever amount is necessary to ensure that the funder comes away with the same amount, net of the tax withheld, that the funder would have received if no withholding had been required.[1]

A minority of litigation funders have taken to spelling out the attorney's gross-up obligations in detail. Some include a provision that expressly obliges the attorney to withhold any required tax. However, they go on to specify that the amount of any payment due is automatically increased (that is, grossed up) to preserve the funder's intended after-tax return. This approach may be intended to block a potential argument that the provision requiring payment free of withholding is unenforceable because it is somehow illegal or contrary to public policy. After all, the funder is actually requiring the attorney to withhold tax.

Effect of Gross-Ups

Under the Senate proposal, the excise tax on litigation funding profits would have been 31.8 percent, significantly less than the Tillis bill's 40.8 percent. But that would still have been considerably higher than the 23.8 percent tax on long-term capital gain that domestic litigation funders are accustomed to paying. The same 31.8 percent rate would have applied to foreign funders that have historically expected to pay no U.S. tax on their profits because they represented capital gain. Tax-exempt organizations and sovereign wealth funds, which typically do not pay tax on their investment gains, would have been subject to the excise just like anybody else.

[1] Failing to gross up payments to the funder is not really an option. Litigation funding agreements are nonrecourse if the case craters. However, once there is a recovery, they typically impose personal liability on the attorney to make the payments due under the contract to the extent of the fee earned. Although the point could be litigated, the funder has a strong argument that the attorney's personal liability extends to the obligation to pay the specified amounts to the funder "free of withholding."

Cutting down the after-tax return on litigation funding investments would likely have reduced the availability of litigation funding and increased its cost, which was exactly what the supporters of these proposals intended. For attorneys receiving funding, however, the more immediate concern would have been the withholding requirements. Under the Tillis bill, which required withholding at 20.4 percent, an attorney who was obligated to pay a funder $100 free of withholding would have had to gross up the payment to $125.63. The attorney would then have paid the required $100 to the funder and $25.63 of withholding to the IRS.

Under the Senate proposal, the attorney would have been required to withhold at a more modest 15.9 percent rate. Moreover, the withholding obligation would have applied only to the extent that a payment represented the funder's profit from the funding transaction. That seems appropriate, but it could have been tricky to implement because an attorney wouldn't generally know the amount of a funder's profit or loss.

As a first approximation, however, the funder's profit should be the excess of the attorney's payments to the funder over the funder's advances to the attorney. Both these figures would likely be known to the attorney. So perhaps it would have made sense to permit the attorney to withhold on that basis, rather than focus on the funder's actual bottom-line profit.

For purposes of discussion, however, assume it is clear that the funder is entitled to a payment representing $100 of profit, and the contract includes a gross-up provision. To withhold tax at 15.9 percent, the lawyer would have needed to increase the total payment to $118.90. That would be enough to pay $100 to the funder, as required, and $18.90 to the IRS.

Under the Senate proposal, the funder would have been subject to excise tax on the $118.90 payment at 31.8 percent. That would have worked out to $37.80 in tax. However, the funder would also have been entitled to a credit for the $18.90 withheld by the attorney, so it would have had to pay the IRS only the remaining $18.90.

This example illustrates an interesting feature of the Senate proposal. When the statutory withholding rate (which was set at 50 percent of the excise rate) is combined with a contractual gross-up requirement, the attorney and the funder each end up paying 50 percent of the excise tax. In the example above, the attorney and the funder both would have paid $18.90 to the IRS — that is, 50 percent of the $37.80 excise tax on the grossed-up $118.90 payment.

Next Steps?

Although the Byrd rule stymied the Senate proposal, its supporters may reintroduce it or something similar using the regular legislative process. But they could also take some other approach to increasing the tax burden on litigation funding transactions. With so much uncertainty about what kind of legislation may be in the works, it may not be easy for attorneys or funders to protect themselves from unpleasant tax surprises.

The uncertainty is exacerbated by the timeline of many funding agreements. After the funder advances funds, it may be years before the attorney makes a payment that could trigger tax withholding. Even so, parties to litigation funding agreements may adopt a wait-and-see approach, with the idea that they'll find a fair way to accommodate adverse developments if and when they happen.

The "we can work it out" approach is common in ordinary commercial circumstances when the parties have a shared interest in continuing a mutually beneficial business relationship. The parties may also have incentives to cooperate because of potential reputational damage if they press an advantage too far.

That dynamic applies to the relationship between attorneys and litigation funders, but it may not apply to plaintiffs. In any event, the ordinary incentives to cooperate and compromise could be seriously undermined if an existential threat were to materialize.

Worry about the Tillis bill and the Senate proposal was understandable. At the same time, there was likely some hyperbole in the claim that it would destroy the industry or even cause a widespread funder exit.

If attorneys and funders want to act now, one possibility might be to consider modifying their existing gross-up provisions to ensure that they share the economic burden that will be created if future legislation requires attorneys to withhold tax on payments to their funders. Although the Senate proposal required withholding on profits at only 50 percent of the excise tax rate, there is no guarantee that future legislation will include a similar limitation.

The current practice of requiring the attorney to pick up 100 percent of the withholding tab may be hard for some attorneys to swallow now that there may be more focus on potential tax withholding and gross-up provisions. Perhaps no one will laud Tillis for doing them a favor, but at least there will be more awareness now of the significant economic consequences that can flow from a gross-up provision.

Historically, large banks could often force their borrowers to submit to those terms in their loan agreements. That may help to explain why gross-up provisions persist in many litigation funding agreements. However, in what could be seen as an unstable legislative environment, it may be time for attorneys and funders to start talking.