PERSPECTIVE

Los Angeles | Daily Journal

WEDNESDAY, MAY 29, 2019

When it Comes to Litigation Funding, Don't Forget About Tax Implications

By Robert W. Wood

Lawyers and clients often need cash. Lawyers with contingent fee practices may need cash more than others, even very successful plaintiffs' lawyers. Clients hoping for a recovery also often need cash. There is also the element of risk. Lawyers and clients alike may want to lay off some of the risk of a case on someone else.

It can be nice to get some guaranteed money, even if the case does not turn out well. The litigation finance industry overwhelmingly offers non-recourse money, so lawyers and clients alike may find it alluring. The money might be expensive, but the cost may be worth it. Besides, sometimes the cost can be more reasonable than you might think, particularly if the financing is done when the case is far along and seems to involve little risk.

The lawyers may source money entirely for themselves, the clients alone may seek it, or each may get some, depending on how the deal is structured. But one of the questions consistently facing clients and lawyers is how taxes will be handled. Often, lawyers and clients alike ask, but how and when taxes apply can depend entirely on the documents.

Financing documents can 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 you might be surprised how difficult they can be to answer. Documentation varies, so read your documents carefully.

Get some tax advice, and (if the client is getting money), suggest that your client do so. 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. Make sure you know if it is a loan or a sale and how it will be taxed.

You can ask the litigation funding source, but they are generally not in the business of providing tax advice. The primary dichotomy is loan vs. sale, but from there it gets more complicated. In a loan, you receive loan proceeds which are not taxable because you have to pay them back.

For lawyer or client, a loan has the advantage of deferring any tax on the receipt of the initial funding. However, the lawyer must later include the entire amount of the contingent fee in income, and try to claim a very large offsetting interest deduction. Under new limits on the tax treatment of interest, the lawyer may not be able to deduct the very large interest. That means paying tax on money you didn't get to keep.

Some litigation financing documents are written as sales. The lawyer might sell part of the contingent fee, or the client might sell part of his claim. Sales are taxable, so the normal rule would be that the lawyer or client must pay tax when the sale is made and the up-front money comes in.

For lawyer or client, 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. In all situations, running out hypothetical numbers and timing under loan vs. sale scenarios can be helpful.

Better Mousetrap?

Some funders are willing to use an unusual structure called a prepaid forward contract. It is a sale, not a loan. Because it's a sale, 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 as a prepaid forward contract, 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. Only then will it be clear exactly how much the funder will receive. Although the up-front money you receive is not a loan, it is not taxed until later.

A loan arrangement is easiest to document, and some lawyers and clients prefer it. However, most litigation funders do not like straight loans because of usury concerns, regulatory issues or their own tax issues. Some documents are not clear whether they are a loan or a sale. Many documents call for a sale, but the general rule is that sales are immediately taxable.

Thus, if the parties are hoping for prepaid forward treatment, they need to be careful. 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 make sure they can come out even on taxes when the case is concluded. You do not want to receive taxable money, pay a litigation funder a steep return, and find that you cannot deduct the payment or offset it against your recovery. It pays to be careful and to run some examples on the numbers.

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