

MAYER | BROWN

Litigation Finance – A New Asset Class

January 10, 2023

Mark Leeds

MLeeds@mayerbrown.com
(212) 506-2499

Matthew Stevens

Matthew.Stevens@ey.com
(202) 327-6846

How are attorneys taxed now?

- **Under current law, lawyers working on contingency-fee cases generally cannot deduct expenses incurred for depositions, expert testimony and discovery until the conclusion of the case.**
- **Current law suspends deductions for these expenses until the lawyer receives the corresponding income at the conclusion of the case or the case otherwise concludes.**
- **Upfront payments received by the plaintiff or the law firm from a litigation funder for the sale of the underlying legal claim are immediately taxable to the party being funded as income.**

Litigation Funding

- **Litigation funding from outside investors is historically more common in countries with restrictions on contingent fee arrangements.**
- **Contingent fee arrangements are not uncommon in the USA.**
- **Nevertheless, litigation funding is rapidly increasing in the USA.**
- **Funding provided to both lawyers and plaintiffs.**
- **Basic Issues: (i) characterization, (ii) character and timing of income/expense, and (iii) source or ECI.**

- **Typical Transaction**
 - **Investor provides cash to a lawyer or plaintiff in exchange for a share of contingent fee or litigation recovery.**
 - **The investor's right to payment is non-recourse. Thus, if the lawyer or plaintiff does not win the case or settle, the investor gets nothing.**
- **If the litigation is successful, investor returns are calculated based on several different formulas ranging from a fixed percentage to complex waterfalls.**

Litigation Funding - Characterization

- **Many investors have strong desire to avoid debt treatment**
 - **If debt, nearly all gain could be ordinary**
 - **Investor could be required to accrue income in advance of receiving cash**
- **Lawyers and plaintiffs have strong desire to avoid sale treatment**
 - **Investors could recognize capital gain**
 - **But, lawyers or plaintiffs might have to recognize gain at the outset**

Litigation Funding – Characterization (cont.)

- **Whether an arrangement is a “sale” depends on the transfer of benefits and burdens/rights and obligations. Many advisors take the position that the funding arrangements are not likely treated as a sale of the litigation claim (or a portion thereof) because the more complex waterfall return formulas do not replicate the litigation claim.**
- **Even a straight pass-through lacks the rights the owner of a litigation claim would normally possess.**

Litigation Funding – Character and Timing

- **If derivative, then the investor can argue that they recognize a capital gain at settlement under Section 1234A assuming that they hold the investments as capital assets and/or the underlying claim relates to a capital asset.**
- **If debt, then the return would likely be treated as ordinary income applying accrual principles.**
- **If sale, then investor holds the litigation claim directly. Is there a § 1001 event when the claim becomes fixed? If not, realization occurs at settlement. Section 1234A? Origin of the claim doctrine?**

Litigation Funding – Source / ECI

- **If the investor is off-shore, consideration will need to be given regarding whether the income generated by the litigation funding transaction is effectively connected to a US trade or business (ECI).**
- **Many advisors take the position that passively investing in litigation funding rights is not sufficiently active to constitute a trade or business.**
- **If, however, the advance fundings are treated as loans, then the investor would probably be treated as being engaged in a lending business.**

Novoselsky v. Commissioner

- In *Novoselsky v. Commissioner*, TC Memo 2020-68, the IRS successfully challenged a litigation finance transaction structured as a loan.
- The facts of that case are as follows:
 - During 2009 through 2011, the taxpayer, an attorney, executed “litigation support agreements” with various individuals and entities. Under those agreements, the individuals and entities made upfront payments to the taxpayer to support the costs of litigation.
 - If the litigation was successful, the taxpayer was obligated to pay the counterparty, from his award of attorney’s fees and costs, the initial payment advanced to the taxpayer, plus a premium. However, if the litigation was not successful, the taxpayer had no obligation to return any funds to the counterparty.
 - The taxpayer did not report any of the funds advanced to him pursuant to the agreements in which he had no obligation to repay the counterparty on his tax returns. The IRS audited his returns and found that the payments were not loans and that he was required to include them in gross income.

Novoselsky v. Commissioner (continued)

- **The Tax Court held for the IRS that the payments the taxpayer received from the third parties constituted gross income to the taxpayer and not loans. Specifically, the payments were not loans because any obligation for the taxpayer to repay was contingent on future events, and therefore did not constitute debt for federal income tax purposes.**
- **In addition, the Tax Court held that the payments under the litigation support agreements did not represent bona fide loans under factors used by federal courts to distinguish between debt and other payments because: (i) the taxpayer did not execute a formal promissory note; (ii) no fixed schedule for repayments was established; (iii) the taxpayer provided no collateral or security; and (iv) no payments of principal or interest were ever made.**

Litigation Funding – Characterization (cont.)

- **Many litigation funding transactions are structured as prepaid forward contracts.**
- **A prepaid forward contract is an upfront cash payment in exchange for the later delivery of an asset on the contract maturity date.**
- **In general, prepaid forward contracts generally are not treated as debt for tax purposes; nor are they treated as a current sale of the underlying asset. They are generally treated as open transactions subject to taxation when settled at maturity.**

Litigation Funding – Characterization (cont.)

- **The prepaid forward contract structure is intended to be treated as a derivative for tax purposes.**
- **Whether an instrument is treated as “debt” is a facts and circumstances inquiry governed by factors identified in many cases. These factors are nicely summarized in IRS Notice 94-47. Most advisors take the position that the litigation funding arrangements are not likely debt because lack a sufficiently fixed, unconditional return.**

The use of forward contracts

- **In order to avoid the immediate taxability of upfront payments where the transaction is structured as a sale, many litigation financings are structured as forward contracts.**
- **Forward contracts must be over “property.”**
- **Under this structure, the litigation funder makes an upfront payment for a payment determined with reference to portion of the plaintiff’s case or a portion of the law firm’s contingent fee when the lawsuit is resolved.**
- **The litigation funder is treated as having made a financial wager, in which it makes the upfront payment, and in return receives the right to receive an uncertain amount if there is a recovery.**

The use of forward contracts (continued)

- **By structuring the litigation financing as a forward contract, the party being funded would not be taxed on the upfront payment and the parties would be taxed on their net recoveries at the end of the transaction.**
- **In order to receive the advantage of no immediate tax on the upfront payment under a forward contract structure, it is critical that the transaction properly be treated as a forward contract (i.e., reflects that recovery is subject to variation and not guaranteed).**
- **If the litigation financing is treated as a sale of the underlying claim, the upfront payment will be immediately taxable to the party being funded.**

Is there a solution for mass tort financings?

- The Build Back Better Act (BBBA) would **have** alleviated **d** some of the pressure to structure litigation finance transactions as non-taxable forward contracts.
- The BBBA would change the accounting for costs incurred by lawyers working contingency fee cases to allow them to immediately deduct costs paid or incurred by them in such litigations.
- This change would permit lawyers to currently deduct contingency-fee case expenses, even if there is a possibility that such expenses will be reimbursed by a court order or other award in a later year.

[Americas](#) | [Asia](#) | [Europe](#) | [Middle East](#)

mayerbrown.com

Mayer Brown is a global services provider comprising associated legal practices that are separate entities, including Mayer Brown LLP (Illinois, USA), Mayer Brown International LLP (England), Mayer Brown (a Hong Kong partnership) and Tauil & Chequer Advogados (a Brazilian law partnership) (collectively the "Mayer Brown Practices") and non-legal service providers, which provide consultancy services (the "Mayer Brown Consultancies"). The Mayer Brown Practices and Mayer Brown Consultancies are established in various jurisdictions and may be a legal person or a partnership. Details of the individual Mayer Brown Practices and Mayer Brown Consultancies can be found in the Legal Notices section of our website. "Mayer Brown" and the Mayer Brown logo are the trademarks of Mayer Brown. © Mayer Brown. All rights reserved.