

ADDRESSING THIRD PARTY LITIGATION FUNDING ABUSE THROUGH TAX FAIRNESS

Problem

The U.S. justice system has been plagued in recent years by a dubious, secretive, yet highly lucrative practice that has operated out of the watchful eye of the U.S. government and the American public. It's known as third-party litigation funding (TPLF) and, if left unscrutinized and unchecked, will continue to allow investors – many of them foreign entities operating in the shadows – to make windfall profits on the backs of U.S. consumers and taxpayers.

TPLF is a practice that occurs when an outside agent – someone not involved in a legal dispute – pays a plaintiff's legal fees, with the expectation of financially profiting off any settlement or judgment that comes from the lawsuit.

TPLF remains hidden in the shadows, as there is no comprehensive disclosure regime for when a TPLF contract exists for a lawsuit. Despite this lack of disclosure, TPLF market participants acknowledge that the litigation funding industry has exploded over the last decade, with the largest year-over-year growth in capital commitments reported in 2022. According to one report, a combined \$15.2 billion in assets were allocated to U.S. commercial litigation investments in 2023, and a separate analysis predicts that commercial litigation funding could reach \$31 billion in the U.S. by 2028.

Outside of a variety of ethical concerns, TPLF invites sophisticated investors to use the U.S. court system like a casino with no measurable benefit to U.S. citizens. Despite trial attorneys' claim to the contrary, TPLF does not provide consumers with any new pathway to, or opportunities within, the justice system. TPLF essentially allows foreign actors, including adversaries, to use litigation to advance their own interests and harm U.S. competitiveness and growth by obtaining access to sensitive information through discovery; creating bad publicity for competing American businesses; or weaponizing our court system against U.S. national and economic security interests.

Worse yet, foreign investors pay no U.S. taxes – zero – on their litigation profits, which easily top millions of dollars. Perversely, this incentivizes foreign investment in more U.S. litigation because of the potential for lucrative, tax-free returns. The current situation is unfair, not only to the corporations that have to fend off frivolous lawsuits funded by nefarious investors seeking a windfall, but also to plaintiffs stuck with the entire tax liability.



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Solution

Congress must explore ways to ensure investment firms fueling TPLF pay their fair share in U.S. taxes on profits from litigation funding to protect U.S. consumers, taxpayers, and businesses.

By structuring TPLF contracts as complex investment vehicles, funders pay a more favorable tax rate on their share of a court award when compared to the actual injured plaintiff – while in many cases receiving more total money than the injured party. These profits currently get treated as capital gains for tax purposes, allowing foreign investors to create a situation in which they avoid any U.S. tax obligation on their returns, despite using the U.S. court system to generate profit.

Congress should create a specific tax on any income derived from litigation activities by a nonparticipant entering pre-judgment financing arrangements to close this tax loophole. Because of the complicated funding structures used by sophisticated foreign investors, a direct tax on the funding entities pegged to the ordinary income rate is the only way to ensure these funders pay their fair share. This solution utilizes the same rate that an actual victim would have to pay on a taxable lawsuit award (ordinary income rate), plus an additional percentage for using the court system, a public good, for profit.

Importantly, this legislative solution focuses on the abusive practice of TPLF for profit and carves out exceptions for plaintiffs acting in the public interest without the prospect of financial gain. The proposed fair tax treatment is levied solely on the third-party funders seeking windfall profits and does not create a new tax on actual plaintiffs or their attorneys. Simply put: this solution does nothing to prevent or impede the financing of lawsuits by a third party – it would only impact those litigation profiteers seeking to financially benefit by betting on the outcome of lawsuits.

Given TPLF is a relatively new phenomenon, Congress has not yet established the appropriate tax treatment, so now is the time to act. This tax policy would reduce the influence of foreign investors over the U.S. judicial system and protect economy-powering American individuals and businesses from frivolous lawsuits and from a major threat to their intellectual property and proprietary security information.



About Americans for Tax Litigation Fairness

Americans for Tax Litigation Fairness (A4LTF) is a coalition of U.S. companies and trade associations dedicated to ending the tax avoidance schemes of sophisticated – often foreign – investment firms seeking to profit from the U.S. justice system.