



## End the Third-Party Litigation Funding Tax Loophole

by James Carter

Third-Party Litigation Funding (TPLF) has grown into a multibillion-dollar industry in the United States, drawing capital from global investors—including foreign hedge funds and sovereign entities—who finance lawsuits in exchange for a share of any resulting judgment or settlement. While initially intended to improve access to justice, TPLF has evolved into a financial product with characteristics more akin to private equity than legal aid. Its growing footprint in commercial litigation raises concerns not only about transparency, fairness, and judicial integrity, but also about distortions created by the U.S. tax code.

This *Legal Backgrounder* examines a specific, underappreciated issue: the tax treatment of TPLF arrangements, particularly prepaid forward contracts commonly used by foreign funders. These contracts are often structured to qualify for capital gains treatment, enabling foreign investors to extract litigation-based profits from U.S. courts without paying U.S. tax. Plaintiffs, by contrast, are generally taxed at ordinary income rates on any taxable award they receive.

The tax code does not require this result. Congress has carved out numerous exclusions from capital asset treatment under Internal Revenue Code §1221 and has explicitly denied capital gains treatment for certain income derived from intellectual property enforcement—common in TPLF-backed cases. Additionally, the economic substance of these contracts often mirrors loans or business income, raising serious questions under the “substance over form” doctrine and IRC §7701(o).

Left unaddressed, this tax treatment undermines the neutrality of the tax code, encourages foreign capital inflows into speculative U.S. litigation, and allows unregulated offshore actors to profit from U.S. legal outcomes with no tax obligation. At the same time, it denies revenue to the U.S. government as policymakers face difficult fiscal decisions. Correcting this loophole would promote tax fairness, reduce harmful incentives, and generate offsetting revenue which could be used to fund a Tax Cuts and Jobs Act extension.

### TPLF Defined / Market Survey

**What is TPLF?** TPLF is the practice whereby outside investors provide funding to a plaintiff or their legal team in exchange for a share of the financial recovery from the lawsuit or settlement.<sup>1</sup> In simpler terms, TPLF is the act of investing in someone’s lawsuit. If the case succeeds, the funder takes a portion of the award; if it fails, the funder typically loses their investment, much like a high-risk financial asset. Today, TPLF is increasingly viewed and marketed as an alternative asset class, drawing billions in capital from hedge funds, private equity firms, and institutional investors.

**How Did TPLF Originate?** Inspired in part by similar models in Australia and the United Kingdom, TPLF began gaining traction in the U.S. in the late 1990s and early 2000s. This occurred because, in the U.S., the rules against maintenance and champerty—old doctrines that once barred third-

<sup>1</sup> See <https://instituteforlegalreform.com/what-you-need-to-know-about-third-party-litigation-funding/>.

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party involvement in lawsuits—are a matter of state law. Some States have eliminated or relaxed these prohibitions, creating a patchwork system where litigation funding is allowed under varying conditions across the country.<sup>2</sup> It remains largely unregulated at the federal level.

In its naissance, TPLF was used mostly in personal injury and mass tort cases, but the industry expanded rapidly during the 2010s, especially in commercial litigation and arbitration, as hedge funds and private equity firms entered the space. TPLF is now a multibillion-dollar industry in the U.S., with specialized firms leading the market.

**What is the Current Landscape of the TPLF Industry?** U.S. litigation funding operates across two primary segments: the commercial and consumer markets. The commercial segment generally involves disputes between businesses, such as those related to antitrust issues, intellectual property rights, or trade secrets, and often involves high-dollar claims—sometimes exceeding \$10 million. On the other hand, the consumer segment is predominantly made up of personal injury lawsuits.<sup>3</sup>

The U.S. commercial litigation finance industry managed \$16.1 billion in assets across 42 active capital providers from mid-2023 to mid-2024, according to the Westfleet Advisors *2024 Litigation Finance Report*. New capital commitments totaled \$2.3 billion, marking a 16% decline from the previous year and nearly 30% below the levels reached in 2022. The downturn reflects broader financial market conditions, with funders facing greater difficulty securing fresh capital.

Despite these challenges, the industry continues to adapt, with trends such as increased average deal sizes and a rise in claim monetization strategies. While short-term growth may be tempered by current financial constraints, the industry’s resilience and adaptability suggest potential for recovery and expansion as market conditions improve. The market is [predicted](#) to grow to \$25.8 billion by 2030.

**What are the Financial Returns?** The potential returns for litigation funders hinge on several elements, such as the strength of the legal claim, the jurisdiction’s legal framework, the caliber of legal representation, the structure of the funding arrangement (whether provided upfront or in stages), and how long the case is expected to take, including appeals and judgment enforcement.<sup>4</sup>

A 2021 [paper](#) assessing the financial returns of litigation funds found that “in-sample returns in the space have been in excess of 20% annually with limited correlation to other investment areas.” This limited correlation underscores the added value litigation finance offers to investors; it presents an attractive opportunity to diversify portfolio risk with returns that are largely separate from broader market performance.

Two illustrative cases highlight the strong return potential of litigation finance. Apex Litigation Finance, holding over 12% of the market, has funded more than 500 cases with an average case size of approximately \$400,000. With a [reported](#) success rate of around 70%, Apex’s selective approach to case underwriting has yielded an average return on investment of roughly 30%. Similarly, Longford Capital Management LP raised \$56.5 million for its first fund, which focused on claims involving contracts, antitrust issues, and other commercial disputes. That fund delivered impressive early returns, [reportedly](#) ranging between 70% and 90%, underscoring the outsized gains possible in this asset class when managed effectively.

**Who is Participating in the U.S. Litigation Finance Market?** The secrecy surrounding TPLF and funding arrangements makes it impossible to know the precise source of much of the billions of dollars flowing into U.S. litigation pursuant to this practice. However, available information suggests that non-U.S. persons, including sovereign wealth funds, are participating in the U.S. TPLF market.<sup>5</sup>

<sup>2</sup> See <https://clp.law.harvard.edu/knowledge-hub/magazine/issues/litigation-finance/a-brief-history-of-litigation-finance/>.

<sup>3</sup> See [https://lawrecord.com/files/49\\_Rutgers\\_L\\_Rec\\_118.pdf?utm](https://lawrecord.com/files/49_Rutgers_L_Rec_118.pdf?utm).

<sup>4</sup> See <https://thehedgefundjournal.com/the-emerging-market-for-litigation-funding/?utm>.

<sup>5</sup> See, e.g., LexShares FAQs, <https://www.lexshares.com/faqs>; Burford Capital 2021 Annual Report, <https://s201>.

For example, Burford Capital, based in Guernsey, has funded numerous U.S. cases, as well as high-profile litigation against Argentina.<sup>6</sup> Therium, a U.K.-based funder, financed a \$14.9 billion arbitration involving the heirs of the Sultan of Sulu and the Malaysian government.<sup>7</sup> Other examples include A1, a subsidiary of Russia's Alfa Group, and the Black Eagle Litigation Fund, based in the Cayman Islands, both of which have reportedly funded cross-border disputes with links to the U.S. or its allies.<sup>8</sup> These examples illustrate the increasingly global nature of litigation finance, with a significant and growing presence of foreign capital in U.S. commercial litigation.

## Tax Treatment of TPLF Agreements

***How Does the Structure of a TPLF Agreement Affect its Treatment Under U.S. Tax Law?*** The structure of a TPLF agreement determines its tax treatment under U.S. law. As litigation finance has evolved into a sophisticated asset class, funders have adopted a range of structuring strategies tailored to their risk appetite, desired returns, and—increasingly—tax considerations, particularly when capital is sourced from offshore investors.

TPLF arrangements are generally structured in one of three ways: (1) as loans, (2) as equity participations, or (3) as derivative-based contracts, most commonly prepaid forward contracts.

In a loan structure, the funder provides capital in return for interest income, which is taxed at ordinary income rates under the IRC. For foreign funders, such income is considered U.S.-source fixed or determinable annual or periodical income and is generally subject to 30% withholding, unless a reduced rate or exemption applies under an income tax treaty. For the plaintiff, the loan proceeds are typically not taxable upon receipt, as they constitute debt rather than income.

Equity participations treat the funder as having an ownership-like interest in the litigation proceeds, typically through a joint venture or partnership. This results in pass-through taxation, and the funder may be treated as engaged in a U.S. trade or business, thereby triggering tax on effectively connected income (ECI)—regardless of whether the income is ordinary or capital in character. For the plaintiff, receiving funds in an equity structure may trigger immediate income recognition, particularly if the arrangement is viewed as a sale or partnership contribution with no corresponding debt obligation.

More recently, funders have begun to adopt prepaid forward contracts as a preferred structure. Under this arrangement, the funder makes an upfront, nonrecourse payment to the plaintiff in exchange for a contingent right to future litigation proceeds. In simple terms, the funder gives the plaintiff money up front and, if the case is successful, receives a return out of the recovery; if the case fails, the funder recovers nothing.

From a legal perspective, prepaid forward contracts are generally not treated as debt because they lack a fixed, unconditional obligation to repay—a point confirmed by IRS Notice 94-97 and supported by relevant case law applying multifactor “facts and circumstances” tests. Nor are they treated as current sales of the legal claim. Instead, they are often classified as open transactions, with tax consequences deferred until the contract is settled—i.e., when the litigation concludes and proceeds are delivered.

This structure is increasingly popular as it aligns the tax incentives of both parties. For foreign funders, prepaid forward contracts are typically designed to qualify as derivatives under IRC §1234A, allowing their returns to be treated as capital gains rather than ordinary income. *Because capital gains earned by nonresident aliens or foreign corporations are generally not subject to U.S. withholding*

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<sup>6</sup> See <https://news.bloomberglaw.com/business-and-practice/burford-eyes-37-000-return-in-16-billion-win-over-argentina?utm>.

<sup>7</sup> See <https://news.bloomberglaw.com/business-and-practice/dutch-court-rules-in-favor-of-malaysia-adding-to-funders-loss?utm>.

<sup>8</sup> See <https://news.bloomberglaw.com/litigation-finance/putins-billionaires-sidestep-sanctions-by-financing-lawsuits?utm>.

*tax—provided they are not ECI—this structure enables foreign funders to avoid U.S. tax liability entirely while profiting from litigation in U.S. courts.*

To support this outcome, foreign funders often argue that they are not ECI because they do not maintain U.S. offices, employ U.S.-based personnel, or exercise direct control over case strategy—key factors the IRS considers in ECI determinations under IRC §864. At the same time, plaintiffs benefit from tax deferral, as the upfront payment received is not treated as a loan or a sale and is generally not taxed until the litigation resolves. Plaintiffs are typically taxed at ordinary income rates because litigation recoveries—such as compensatory damages for lost income or business revenue—are treated as ordinary income under IRC §61, unless a specific exclusion applies (e.g., for physical injury under IRC §104). This alignment of interests, deferred tax for the plaintiff, and tax-free returns for the offshore funder have made prepaid forward contracts increasingly common in commercial litigation finance strategy.

### **What This Tax Treatment Allows**

As outlined in section two, the growing use of prepaid forward contracts in litigation finance is not merely a technical development. It has profound tax and policy implications. These arrangements, while structured to resemble derivatives, function in many respects like contingent, high-return investments. Their current tax treatment enables both foreign funders and domestic plaintiffs to significantly reduce or defer U.S. tax obligations. This section explores three critical questions: (1) what this treatment enables in practice, (2) whether such arrangements should qualify for preferential tax status, and (3) why Congress should stop the distortion of U.S. tax policy, litigation incentives, and economic fairness.

***What Does This Treatment Enable in Practice?*** Prepaid forward contracts align the tax incentives of both funders and plaintiffs. But this alignment, when examined more closely, produces deeply problematic consequences. The current tax treatment enables two outcomes that, taken together, undermine fairness, accountability, and the integrity of the U.S. legal and tax systems.

*1. It imposes an unequal tax burden on plaintiffs relative to foreign funders.* In most cases, the plaintiff, who has a legitimate legal claim and stands to receive a damage award, is ultimately taxed at ordinary income rates on any taxable portion of that recovery. Plaintiff-side attorneys, paid on a contingency basis, are likewise taxed at ordinary rates on their fee income. In contrast, the foreign funder—who has no involvement in the underlying dispute other than fronting capital—can structure its returns as capital gains, often escaping U.S. taxation entirely. The result is that the party taking the real legal and reputational risk pays more in taxes than the passive financial speculator profiting from the case. This outcome undermines core principles of neutral tax treatment and equal economic participation, granting preferential treatment to offshore investors over American litigants.

*2. It enables foreign investors to gamble on U.S. legal outcomes without any real stake.* By using prepaid forward contracts, foreign funders can treat U.S. litigation like an investment class—buying into future legal outcomes much like one would a stock option or commodity future. These funders are not victims seeking justice, nor are they regulated financial participants with a duty to the public interest. Instead, they operate as unaccountable speculators, gambling on high-stakes litigation outcomes without being subject to the same legal or tax obligations as the actual parties to the dispute.

That these investors can avoid U.S. taxation entirely on their winnings only exacerbates this speculative dynamic. Unlike domestic businesses or taxpayers, who must weigh after-tax returns against real financial risk, foreign funders face no such downside—only the potential for untaxed upside. This asymmetry removes any meaningful disincentive for over-funding, forum shopping, or pursuing marginal claims, effectively subsidizing risk-taking through the very structure of the tax code. The U.S. court system becomes, in this context, a low-risk, high-reward venue for offshore profit extraction, underwritten by a tax regime that fails to hold foreign actors to the same standard as U.S. participants.

The presence of foreign litigation funders—from Guernsey-based Burford to Cayman-based Black Eagle—demonstrates that the current structure of U.S. tax law actively draws capital into legal claims, not based on long-term investment in productive enterprise, but on the potential for untaxed

returns. In this context, litigation finance becomes not a neutral financial tool but a tax-preferred vehicle for offshore speculation in U.S. court outcomes.

***Should Prepaid Forward Contracts Qualify for this Type of Treatment?*** The current tax treatment of prepaid forward contracts in litigation finance is not inevitable. It is the product of aggressive structuring choices combined with a lack of regulatory clarity. Funders assert that these contracts should be treated as derivatives, eligible for capital gains treatment under IRC §1234A, and that they are not “effectively connected” to a U.S. trade or business. Yet these outcomes are not mandated by statute; they are simply positions taken in the absence of a definitive IRS ruling or legislative guidance.

The question as to whether these types of arrangements *should* qualify for this type of treatment is open, but in reality, there are legal and policy reasons to challenge it.

First, IRC §1221(a) defines what is a capital asset, but it also explicitly lists eight categories of property that are excluded. These carve-outs reflect Congress’s deliberate effort to limit the scope of preferential tax treatment in cases where the underlying income is tied to ordinary business activity, compensation, or non-investment assets. These exclusions were not accidental; Congress created them to preserve the integrity of the capital gains preference by ensuring it applies only to assets with genuine investment characteristics. A claim for damages—particularly a tort claim—is fundamentally different from a stock, bond, or transferable financial instrument. The notion that a personal injury claim, or even a commercial claim, should be treated as a capital asset transferable to third parties is deeply at odds with the foundational principles of the U.S. justice system and centuries of Western jurisprudence, and it is also inconsistent with the intent behind IRC §1221’s exclusions. Congress has drawn boundaries before, and this activity is a strong candidate for similar clarification to preserve the integrity of the capital gains regime and prevent further erosion of the tax base through legal structuring alone.

The argument for exclusion from capital asset classification is even stronger in the patent litigation space, which comprises a large share of the commercial TPLF market. Congress amended IRC §1221(a) (3) as part of the Tax Cuts and Jobs Act to exclude from capital asset treatment “a patent, invention, model or design,” reflecting a clear intent to classify profits from intellectual property assertion as ordinary income when held by non-creators. Many TPLF arrangements involve non-practicing entities (NPEs) who stockpile patents not to innovate but to assert them in litigation. Under current law, an NPE that earns revenue from asserting a patent it did not create cannot claim capital gains treatment on that income. The patent itself is not considered a capital asset.

Yet under current TPLF structuring, a foreign funder who purchases a fractional interest in a future legal claim involving that same patent may assert that their return qualifies for capital gains treatment under IRC §1234A. This is a significant inconsistency: the NPE that owns the patent and brings the lawsuit is barred from claiming capital gains, but an offshore investor—who had no role in developing, holding, or asserting the patent—can claim a portion of the expected proceeds as a capital asset. This approach stretches the definition of “capital asset” beyond its intended scope and contradicts the policy rationale underpinning §1221(a)(3). Allowing litigation finance contracts to override this intent—particularly in highly targeted, high-dollar patent litigation—undermines both the purpose of the capital gains preference and the integrity of the system that administers it.

Second, prepaid forward contract treatment is vulnerable to challenge under the substance-over-form doctrine, a core principle of tax law reaffirmed by the codified economic substance doctrine in IRC §7701(o). While prepaid forward contracts are *labeled* as derivatives, their economic *substance* often mirrors that of a loan or equity investment. The funder provides capital in exchange for a return contingent on a future event—the resolution of a lawsuit—and in many cases exercises meaningful influence over litigation strategy or settlement. Courts and the IRS have repeatedly recharacterized transactions where the formal structure was inconsistent with their economic function. If the funder’s activity amounts to a business of speculating on litigation outcomes, the IRS could determine that the return is more appropriately classified as ordinary income or as effectively connected income (ECI) in the hands of a foreign funder.

## Should Congress Close the Loophole?

Congress can close the tax loophole that allows foreign litigation funders to extract returns from the U.S. legal system without paying U.S. tax. First, this is a matter of tax integrity. As outlined in section two, the current practice violates core principles of neutrality, consistency, and fairness in the tax code and runs counter to congressional intent, as reflected in provisions like IRC §1221.

Beyond the direct tax code implications, reforming the tax treatment of third-party litigation finance would help mitigate the broader harms associated with this practice. TPLF arrangements have been linked to longer litigation timelines, inflated settlement costs, weakened attorney-client relationships, and, in the case of foreign funders, potential national security risks. By eliminating the tax preference that currently makes these arrangements attractive, Congress would reduce the incentive for foreign capital to distort U.S. civil litigation.

Third, closing this loophole would generate new federal revenue at a moment when Congress must consider how to pay for any extension of the Tax Cuts and Jobs Act. In fact, Americans for Tax Reform [recommends](#) closing this loophole, going so far as to highlight it in a report titled “List of Good Reforms that Raise Revenue for Trump’s Tax Cuts.”

Unlike proposals that would raise taxes on U.S. households or businesses, this reform would target foreign entities profiting from the U.S. legal system without contributing to its fiscal upkeep. It is a fiscally responsible, politically palatable step that supports both economic and legal sovereignty.

With that in mind, in an [open letter](#) dated May 19, 2025, and addressed to House Speaker Mike Johnson and Senate Majority Leader John Thune, eighteen “consumer, free-market, and taxpayer organizations” urged “the U.S. Congress to consider measures that would correct the tax treatment of third-party litigation funding (TPLF), which currently allows unscrupulous foreign investors to reap massive tax-free profits at the expense of U.S. businesses and working families. Congress should not pass up the opportunity to use the current reconciliation bill to address this problem and achieve the first federal tort reform win in decades.”

If Congress were to add language to the reconciliation bill—the One Big Beautiful Bill Act—to remove the unwarranted tax treatment enjoyed by third-party litigation funders, the U.S. Congress’s Joint Committee on Taxation estimates the provision [would raise](#) \$3.5 billion over 10 years and finance a portion of TCJA’s extension.

### Conclusion

The current tax treatment of third-party litigation funding, particularly when structured as prepaid forward contracts, creates a clear and perverse policy mismatch. By allowing foreign investors to characterize litigation-based returns as capital gains, U.S. tax law permits substantial offshore profit-taking without corresponding tax contributions. This not only erodes tax neutrality and encourages legal structuring for arbitrage purposes but also creates asymmetric treatment between foreign funders and domestic plaintiffs, who face ordinary income taxation on the same case outcome.

More broadly, the legal and policy concerns raised by TPLF—including national security risks, increased costs for defendants, and potential distortion of litigation incentives—are amplified when those driving the lawsuits are foreign actors operating outside the scope of U.S. regulatory or tax authority.

Congress has acted before to protect the integrity of the capital gains regime through targeted exclusions and clarifications under IRC §1221. It can do so again here. By denying capital gains treatment to prepaid litigation finance arrangements and subjecting foreign funders to appropriate tax obligations, Congress can restore consistency to the tax code, reduce unproductive litigation incentives, and raise revenue in a way that is economically sound and fiscally responsible.