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Sales And Loans On Lawsuit Claims Can Trigger Taxes

Lawsuits take time to resolve, and sometimes plaintiffs may not be willing or able to wait until the case is truly resolved. Perhaps for that reason, there is a surprisingly active market of companies that buy lawsuit claims, and a similarly active market of companies that loan money to plaintiffs. But how are these transactions taxed? As with most tax matters, the wording of the contract is important and not every contract is the same.

Sale or Loan?

To begin with, some transactions involve outright sales, where the plaintiff sells their claim outright, and are effectively out of the case. Some transactions involve loans, in which the plaintiff borrows money but still owns his claim against the defendant. Loans are the easiest to analyze, since there is no transfer of the claim, and since loan proceeds aren't taxed by the IRS. Tax reporting by the funder, and by the recipient, can depend on the type of transfer and the degree to which the defendant in the lawsuit respects the transaction.

In an outright sale of the claim, the plaintiff is usually paid a discounted sum to walk away, and the buyer takes over the claim. What should happen tax-wise in such a case? Here, the plaintiff/seller usually has an immediate tax bill on their sale proceeds. The only exception should be if the plaintiff sold a claim for compensatory personal physical injuries that would be excludable under Section 104 of the tax code. After all, if the plaintiff would have a tax-free recovery if paid by the defendant, the same treatment should apply if the plaintiff sells their interest in the case.

Even though the plaintiff may collect sales proceeds, you need to know how the lawsuit proceeds would be taxed in order to know how the sales proceeds are taxes. Apart from the physical injury exception, most lawsuit settlements are taxed by the IRS.

Sales Proceeds Follow Character of Lawsuit

Apart from physical injuries, the plaintiff has sold a claim and should be taxed on the sales proceeds in the same way they would have been taxed had they collected from the defendant. An example is name, image, and likeness (NIL) settlements for athletes. In the case of outright sales, the athlete/sellers should be taxed on their sales proceeds, and the settlement payments post-sale should go to the buyers of those claims. The tax treatment and tax reporting should follow.

The IRS and the Taxpayer Advocate Service published guidance for athletes about the tax characterization of NIL payments, which generally confirm that these payments are usually taxed as nonemployee compensation or royalty income. In other contexts, the IRS and the courts have similarly ruled that streams of future income can be monetized in a sale to a purchaser in exchange for a lump-sum payment. These cases reflect that when a stream of future income is sold in a completed sale, the sales proceeds are taxed in the same manner as the income that was sold.

Double Tax Concerns

Anyone transferring a lawsuit claim should be wary about triggering taxes. However, the authorities do not suggest that a completed sale in which the sales proceeds are immediately taxed to the seller should be subject to tax to the seller *again* when the future payments are paid to the *purchaser* of the income stream. The sales proceeds *substitute* for the future income payments.

They are already subject to income tax by the seller when received as part of the sale.

IRS Form 1099 Reporting

The IRS Form 1099 rules follow this straightforward tax treatment. Form 1099 reporting to a seller is only required if a payment represents gross income under applicable tax rules. Because the future income payments are not gross income to the seller after the completed sale, none of the post-sale payments should be reported to the seller post-sale. The *sales proceeds* may be reportable to the seller, because the sales proceeds *are* gross income to the seller.

However, the responsibility to report the sales proceeds belongs to the “payor” of the payment, which in the case of the sales proceeds, should be the buyer. When the buyer is later paid by the defendant, the buyer will have tax obligations, generally treating the claim as an investment, paying taxes on the excess over its purchase price. Payments to the buyer may be subject to Form 1099 reporting, depending on a variety of factors. Often, though, the buyer might expect to receive a Form 1099-MISC, with the amount shown in Box 3 as “Other income.”