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Tax on the Sale or Assignment of Legal Claims

By Robert W. Wood

Sales and assignments of legal claims have generated increasing interest in recent years. Quite apart from the tax impact of such transactions, various nontax issues may arise. They include what types of claims can be transferred as a matter of nontax law, and what formalities need to be observed. There also may be questions whether the court or defendant may respect the transfer. The attorney-client relationship and the lawyer's legal right to a fee may also be impacted.

But apart from any nontax issues, how taxes will be impacted can be a surprisingly nuanced question, or group of questions. Parties may talk of assigning or selling their claim, and they may assume that there is a one-size-fits-all set of tax rules for how their taxes will be impacted. However, the tax treatment is likely to depend largely on the documentation.

FAMILY TRANSFERS

Outside the commercial context, sometimes plaintiffs transfer some or all of their claim to someone else as part of their own financial and tax planning. Likely suspects are family members, a family entity (such as a partnership or LLC), or even a charity. The idea, typically, is to shift some or all the income to someone other than the plaintiff—usually someone in a lower tax bracket—before the case is resolved and money is paid.

Whether it will be effective for tax purposes depends on timing and other factors, including continuing involvement by the plaintiff. It may be necessary to value the claim at the time of transfer, and to treat it as a gift for tax purposes. Unless the plaintiff is assigning the claim to their wholly owned entity, it may be a gift or a sale for tax purposes, and timing is important. Tax worries are likely to be less if a transfer occurs years before a settlement or verdict.

For example, suppose that you file a complaint, and shortly thereafter assign the claim to a family-owned LLC. There may be few tax worries if the case is not resolved by settlement or judgment for three years. The transferee may pay tax on the recovery without incident. In contrast, the original plaintiff may be stuck paying all the taxes if the transfer happens a month before settlement, despite the

transfer. The assignment of income doctrine is a classic tax rule, and many tax cases give the IRS the ability to disregard a purported transfer if you have already earned—or almost earned—the income. More about that issue below, after we review the other varieties of transactions.

OUTRIGHT SALE OF CLAIMS

Some transfers are to unrelated third-party buyers, such as where a commercial buyer offers a plaintiff a flat fee to take over any entitlement the plaintiff has. A common fact pattern involves a class action where recoveries are expected but still face appeals or other procedural hurdles. Some plaintiffs may not want to wait months or years before receiving any payment. It may also be clear that a settlement will be paid out in installments when it eventually arrives.

In such cases, plaintiffs may find it attractive to sell their claim at a discount and to collect a lesser amount without delay. Properly documented, these can be among the simplest transactions to analyze from a tax viewpoint. The seller/plaintiff receives money and pays tax on it in the year of receipt. Usually, sellers/plaintiffs are taxed on the sales price the same way that they *would have* been taxed had they held onto their claim and ultimately received a settlement or judgment from the defendant. For example, if the underlying claim is about royalties or interest, when selling the claim, the plaintiff should have royalty or interest income.

The buyer then typically stands in the shoes of the selling plaintiff. That should mean that the buyer is paid out and taxed (although not necessarily in the same way as the original plaintiff) when the case finally resolves—assuming that the defendant treats the sale as effective and agrees to pay the buyer. This kind of sale usually raises no special tax issues. But what if the contract isn't as clear as this?

LOANS

What if the "sale" document is really a nonrecourse loan? Loans may be used for several reasons, including if the plaintiff cannot agree to an outright sale of the claim for nontax reasons. The loan might *function* a little like a sale, if it is clear that the loan never has to be paid back. Nonrecourse litigation funding is usually the norm, so that if the litigation fails, the loan need not be repaid.

But what happens for tax purposes? Technically, even a nonrecourse loan is still a loan. That means that the plaintiff still owns the claim and is still entitled to the settlement or judgment when the case is ultimately resolved, subject to the rights of the lender. On the positive side, it also means that the loan proceeds are not income to the plaintiff, so they should not trigger taxes when they are received.

Sometimes, such loans involve lockboxes or other payment protections, so that the lender collects what is due without the plaintiff having the chance to divert the funds. For tax purposes, this is most likely a loan, but the IRS may treat it as a sale

in some cases. However, assuming that the form of the loan is respected, the upfront loan money is not taxable to the plaintiff, but the later settlement payment will be—even if it goes directly to the lender.

Hopefully, the plaintiff will have enough money left to pay the tax. Unfortunately, a large part of the settlement is likely to go to the lender for interest. And under surprisingly complex tax rules about what interest payments are and are not tax deductible, some plaintiffs may not be able to claim a tax deduction for the full amount of a large interest payment.

PREPAID FORWARD CONTRACT

Another type of contract is a variable prepaid forward purchase agreement, or prepaid forward contract. It is a sale document, but with a curious twist. It calls for an advance payment—a kind of deposit—of the purchase price. However, the *amount* of property that the buyer will actually purchase is not determined under the contract until later, when the sale closes. These contracts are popular in the securities industry, and with many litigation funders.

The idea is that the plaintiff still owns the claim and receives a nontaxable deposit representing the purchase price under a sale contract. How could the advance payment not trigger immediate tax? The trick is that the contract has a price with conditions involving timing and amount that prevents the sale from being taxed immediately, as it would be if the identity and amount of the property being sold were already fixed. Done properly, the deposit is not immediately taxable, and the plaintiff still owns the claim.

Then, when the case is resolved, the sale contract closes, and the plaintiff is paid. But as in the loan example, usually there is a payment mechanism so that the funder actually collects the money. From a tax point of view, the plaintiff is still required to take the full amount of the settlement payment into account.

The plaintiff takes the payment to the funder into account, but separately, as part of the settlement of the prepaid forward contract. In most cases, the plaintiff reports ordinary gain or ordinarily loss from the settlement of the contract equal to the difference between the amount the funder paid at the outset (the advance) and the amount the plaintiff paid to the funder when the claim was resolved. In cases where the payment to the funder results in a loss, the plaintiff should generally be able to use the loss to offset all or a portion of the income they report from the settlement of the litigation claim.

In cases where the claim generates a disappointing recovery, the plaintiff may end up paying the funder less than the amount of the advance. If the litigation is a total bust, there will be no recovery, and the plaintiff usually pays the funder *nothing*. In that case, the plaintiff should have no taxable recovery to report, but they will have to report an ordinary *gain* under the contract equal to the funder’s advance.

This illustrates the deferral element in these transactions. The plaintiff was not taxed on receipt of the advance but later pays tax on that amount when they settle the prepaid funding, without having to pay anything to the funder. If the litigation is unsuccessful and no more money is coming to the plaintiff, they still must pay tax on the advance—albeit in that later tax year.

TIMING AND ASSIGNMENT OF INCOME ISSUES

Let's turn back to the timing question and the assignment of income tax authorities. The assignment of income doctrine is usually not a concern in the case of loans or in the case of prepaid forward contracts. In both of those situations, the plaintiff should still be treated as the owner of their claim despite a funding transaction. But in the assignment or the sale, the first two items we discussed above, a major goal is for the plaintiff to no longer to be taxed on the recovery.

Can that goal be achieved? It depends on the formalities that are observed and on timing. Tax lawyers are accustomed to worrying about the assignment of income doctrine. When income is too close to being earned, it typically cannot be transferred to someone else without tax effects. That is why it is unlikely to shift the tax burden if an independent contractor finishes a job and says, "Don't pay me, please pay my cousin instead." In fact, in some cases, the act of assigning the item can accelerate the income, making a bad situation worse.

Under the assignment of income doctrine, a taxpayer who earns or otherwise creates a right to receive income will be taxed on any income or gain realized from it. If you transfer the right after you earn it, but before receiving the income, it remains your income.[1] A review of the tax case law suggests that the assignment of income doctrine can require the transferor to include the proceeds of the claim in gross income when recovery on the transferred claim is certain at the time of transfer.

Conversely, that is not required when recovery on a claim is doubtful or contingent at the time of transfer. Accordingly, in general, one who transfers a claim in litigation to a third person before the expiration of appeals should not be required to include the proceeds of the judgment in income. If the plaintiff assigns their entire interest in the case while it is on appeal and before any settlement or final judgment, it should usually be okay (although it still may trigger gift tax consequences).

As a practical matter, some plaintiffs may *think* that the assignment of income doctrine cannot apply to them. In that sense, whatever tax advisers may say, most assignment of income tax issues may arise in unfortunate audits where it is the IRS saying, "Hey, wait a minute, we think you are still taxable on this." If you are someone who transferred your claim and therefore did not collect the money, a later assignment of income claim from the IRS can ruin your day. Clearly, getting tax advice before any transfer is best.

Fortunately, the assignment of income doctrine seems more likely to be of concern with family transactions and gifts, rather than with commercial parties and arm's-length sale contracts.

TAX REPORTING AND FORM 1099

Finally, there is also the tax reporting end of the spectrum. Tax reporting may depend on the type of transfer and the degree to which the defendant respects the transaction. The easiest case to describe involves an outright sale of the claim, where the plaintiff is 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. 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. Apart from that factual setting, though, 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 the name, image, and likeness ("NIL") settlements for athletes, which generate an active sale market. 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 such payments are usually taxed as nonemployee compensation or royalty income.[2]

In multiple other contexts, the IRS and 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.

For example, in 1958, the U.S. Supreme Court issued its opinion in *Commissioner v. P.G. Lake, Inc.*,[3] which held that proceeds received for the purchase of future payments for oil production royalties were taxable as ordinary income to the recipient, because the future oil production royalty payments *would have been* ordinary income to the seller when received if he had not sold them. This same principle has been applied in other contexts, including in the following cases: *Hort v. Commissioner*,[4] *Fisher v. Commissioner*,[5] *Rhodes' Estate v. Commissioner*,[6] *Helvering v. Smith*,[7] and *Charles E. Sorenson v. Commissioner.*[8]

None of these authorities 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.

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.[9] 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.[10] 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."

CONCLUSION

Any transfer of all or part of a legal claim should be considered thoroughly and documented carefully. Plaintiffs can be vulnerable to the allure of money now rather than waiting for the slow grind of the legal process to play out. Yet sometimes, even deep discounts in claims can turn out to be shrewd financial planning if a lawsuit later results in a defense verdict or is reversed on appeal.

In other cases, the plaintiff may feel the pain of a relatively high cost of money, coupled with a later tax situation that is not something they planned on. In that sense, thinking through the specific type of contract involved, and running out some possible examples, can be time well spent.

Whatever the timing and financial impact on the upfront money and the later payment of a settlement or judgment, the tax impact may be more nuanced than the parties realize. No one wants to be taxed on money they did not receive. Moreover, receiving an unexpected Form 1099 can be alarming, even if you have confidence that you can explain to the IRS that the form is wrong and that you actually did not receive the payment.

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1. *See*, *e.g.*, Doyle v. Commissioner, 147 F.2d 769 (4th Cir. 1945) (taxpayer who assigned judgment award after it was affirmed on appeal was required to include the proceeds in income). ↥

2. *Name, image and likeness (NIL) income*, I.R.S. (last updated Oct. 15, 2025); *Name, Image, and Likeness Income Paid to Student-Athletes Is Taxable Income*, TAXPAYER ADVOC. SERV., I.R.S. (last updated Sep. 5, 2025). ↥

3. 356 U.S. 260 (1958). ↥

4. 313 U.S. 28 (1941) (sale of right to receive future rental income). ↥

5. 209 F.2d 513 (6th Cir. 1954) (sale of corporate notes with accrued but unpaid interest owed). ↥

6. 131 F.2d 50 (6th Cir. 1942) (sale of future stock dividends). ↥

7. 90 F.2d 590 (2d Cir. 1937) (sale of partnership interest in earned fees). ↥

8. 22 T.C. 321 (1954) (sale of stock options given as compensation by taxpayer's employer taxed as employment compensation to seller). ↥

9. *See, e.g.*, I.R.C. § 6041; Treas. Reg. § 1.6041-1(f) ("The amount to be reported as paid to the payee is the amount includible in the gross income of the payee."). ↥

10. *See* Treas. Reg. § 1.6041-1(e). ↥