

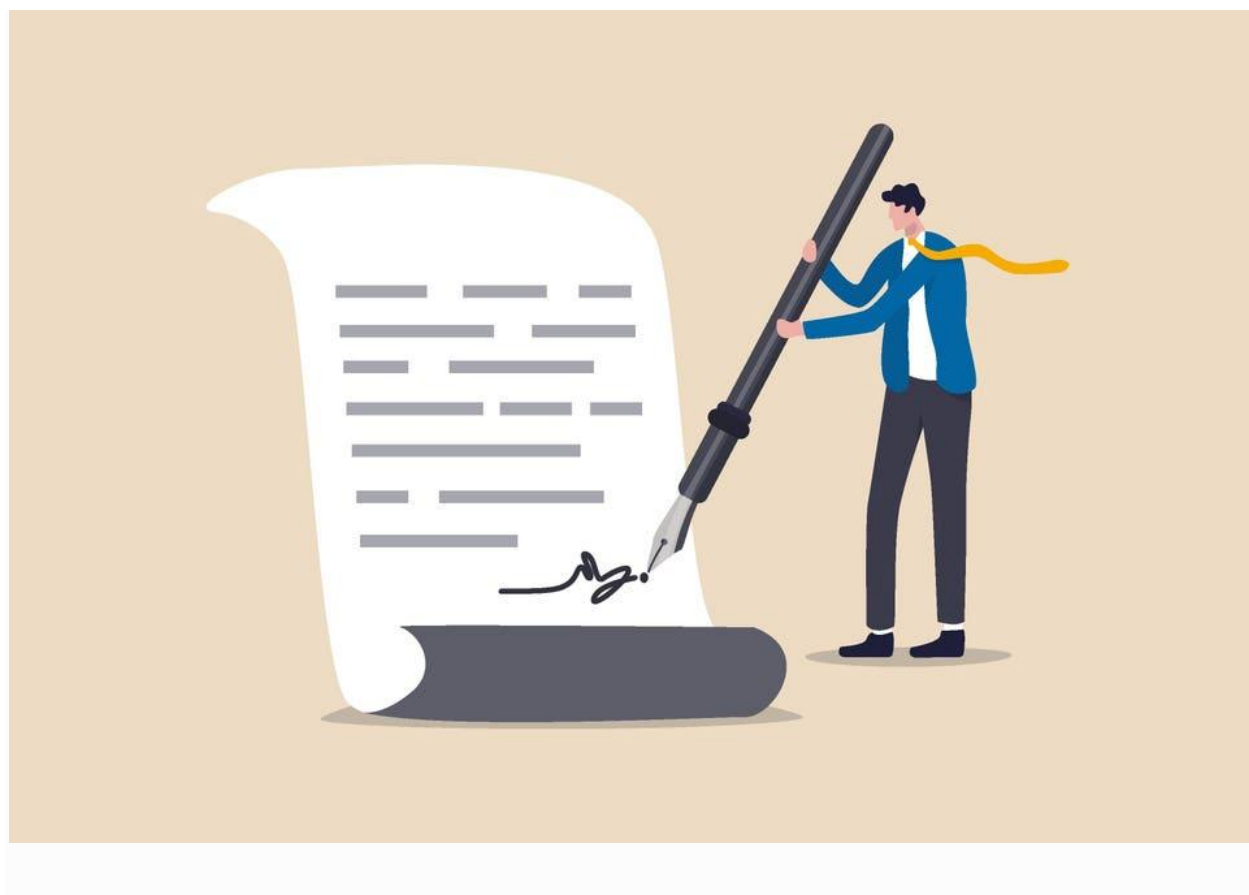


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## When Transferring A Lawsuit Claim Can Trigger Taxes



Sales or transfers of legal claims are becoming more common, and they can involve a variety of legal issues. The types of claims that can be transferred are relevant, as are the needed legal formalities. There may be tax considerations too. If you are paid something when you make the sale or assignment, is that payment taxable? Usually the answer is yes, unless you fit within narrow exceptions.

When it comes time to pay out the later settlement, there can be tax worries too. Will the defendant pay the eventual settlement to the buyer of the claim or to the original plaintiff? Will any IRS Form 1099 reporting for the settlement payment follow the payment to the right party? There may be a variety of practical issues, and depending on the case, timing and circumstances, the tax issues should be considered.

### Family Transfers

Sometimes, plaintiffs transfer some or all 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 his wholly owned entity, it may be a gift or a sale for tax purposes, and timing is important. For example, suppose that you file a complaint, and shortly thereafter, assign the claim to a family 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, despite the transfer, the original plaintiff may be stuck paying all the taxes if the transfer happens a month before settlement. The IRS can assert the assignment of income doctrine and disregard a transfer if you have already earned—or almost earned—the income.

### Sale to Third Party

Some transfers are to unrelated third-party buyers, such as where a commercial buyer offers a plaintiff a flat fee to take over the plaintiff's claim. This may occur in 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. 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, seller/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, and is paid out and taxed (though 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.

