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Tax Risks in Mediation Term Sheets

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Mediation is nonbinding, but the goal is a binding deal. If a case is resolved, there may be a handshake, an unsigned or signed term sheet, or a full-blown settlement agreement. In my experience, the most common conclusion of successful mediation is a signed term sheet that contemplates a comprehensive settlement agreement later. But that is not universal.

There may be a mere exchange of emails, or an unsigned mediator's proposal. Moreover, if there is a term sheet, it may say that it is fully binding, or more rarely, that it is not binding, or may simply not take a position one way or the other. As with any settlement, taxes should be considered, but when and how taxes should be addressed can vary.

The tax issues that can arise in a settlement are numerous. In an employment dispute, are all payments wages subject to withholding, or should there be an allocation between wage and nonwage damages on Form 1099? Can anything be excluded from income for physical injuries or physical sickness? Is any equity, or stock option compensation to be paid, and can anything be taxed as capital gain? How will IRS Forms W-2 and Forms 1099 come into play?

If a homeowner sues an insurer for not covering damage, relocation expenses, etc., what should the settlement agreement say about tax treatment? In an intellectual property dispute, is there a case for capital gain treatment to the plaintiff, and will particular wording help? If the case goes to verdict, has been appealed but settles during appeal, are the parties hamstrung by the verdict from a tax viewpoint? A complete listing of the potential tax considerations would be lengthy.

In each case, if a settlement is reached, monies will be paid and documents need to be prepared. But how should taxes be addressed during the mediation and later? The mediator may not want the parties to leave without signing a term sheet indicating that they are resolving the case for money, with a few other basic terms. Commonly, the term sheet will say that the parties will cooperate to produce a final longer settlement agreement which both parties will sign.

But what happens if a comprehensive settlement agreement is never executed? If the term sheet states that it is binding, and if it says nothing about taxes, where do the parties stand if they cannot agree on the terms of a long-form settlement

agreement? In my experience, both sides usually want to have a comprehensive settlement agreement for numerous reasons, and some of those reasons may be more important than taxes.

Perhaps for that reason, I rarely see a binding term sheet that ends up being the definitive agreement. However, if the parties cannot agree on a more fulsome settlement agreement, it does occasionally happen. In those cases, one or both parties are likely to be happy that they do have a binding settlement agreement, albeit in a term sheet that the parties likely thought would never end up as the operative settlement agreement.

Tax Considerations for Signing a Term Sheet at Mediation

Does the fact that this turn of events can and does happen raise the question whether you should try to address taxes in a binding term sheet? After all, you are unlikely to know at the time of the term sheet if your case is going to be one of those few cases in which no long-form agreement is ever signed. Litigators are usually not responsible for the tax issues, so if there is not a tax adviser involved at the conclusion of the mediation, the term sheet may not say anything about taxes.

However, some term sheets include a provision that the parties will cooperate on an appropriate tax allocation. Another approach is to say that “the tax allocation and treatment shall be subject entirely to the plaintiff’s approval.” Another possibility: “the entire settlement payment shall be made to a qualified settlement fund established by the plaintiff.”

You could get more specific, such as by providing that there will be no federal or state tax withholding taken on the settlement payment. Or you may want to say that the settlement payment is entirely on account of personal physical injuries. Or you could say that a Form 1099 for the settlement payment will be issued to plaintiff’s counsel only, and not to the plaintiff.

There can be value in each of these approaches, and they are better than nothing. That is, if your choice is a skeletal term sheet that says nothing about taxes or a term sheet that addresses the most important tax issues to you, the latter seems better. Of course, even these kinds of tax provisions may be very difficult to orchestrate at the end of a long mediation where only the dollar amount has been resolved, and when everyone wants to go home.

Ideally, of course, whatever the binding term sheet says, the more comprehensive settlement agreement will be ironed out and signed later to flesh out all the issues, including taxes. As noted, I only rarely see binding term sheets that end up being the definitive settlement agreement because the parties are unable to agree on the terms of a long-form agreement. Still, I have already seen it occur several times this year, so it does occur.

Does that mean you should not sign a binding term sheet? This may be where the tax tail starts to wag the dog. That is, if the settlement is a good one, nailing it down and signing a term sheet likely makes sense from a business perspective. Still, the fact that the term sheet just might end up being the *only* document that the parties sign should make you think a little about taxes, and perhaps seek tax input before the mediation, or at least before your client signs a term sheet.

I only address tax issues, but there may be many other aspects of a customary long-form settlement that the parties would also be giving up if the post-term sheet negotiations break down and the long form is never signed. With a possible long-form stalemate, the potential choices impacting taxes might include these, among others:

1. Include all the tax provisions in the term sheet that you think are critical before it is signed, based on the assumption that the long form will never be signed.
2. Don't bother with a term sheet and instead negotiate and sign a long-form settlement at the end of the mediation.
3. Don't sign a term sheet; rely on an exchange of emails. A mediator's proposal, which concludes some mediations, accomplishes the same, although some mediators may ask for a term sheet to be signed if the parties both accept the mediator's proposal.

Tax Considerations in Signing a Long-Form Settlement Agreement at Mediation

Signing a comprehensive settlement agreement at mediation has advantages and disadvantages. On the plus side, if the parties hammer out a full-blown settlement agreement the day of the mediation, by definition, the binding versus nonbinding term sheet issue will not arise. Also, when the case is concluded with a full settlement agreement, it will really be concluded, hopefully including the tax issues.

On the minus side, the parties will be rushing to address many issues and to complete a settlement agreement. That may be after many hours (or even days) of mediation. It may be late at night, and everyone will be tired. Proximity and resources can also be an issue. The mediation may occur in a third-party location such as a mediator's office.

The plaintiff and defense lawyers may be working on a draft settlement agreement on laptops or tablets. They may not have their full resources available, much less the time to reflect upon all the provisions and issues. If a binding settlement agreement is signed and there is no further documentation, there will be little opportunity to catch errors or to reflect on drafts over time.

Moreover, there may be little time to discuss the tax points or to solicit and implement tax advice. In some cases, there will be tax input by one or both sides prior to the mediation. It may be possible to have a template for what the plaintiff is

requesting and for what the defendant is willing to provide on the tax points. For example, in an employment dispute, the parties will probably have considered the wage versus nonwage question in at least a general fashion.

In addition, if there is an argument for excluding some damages for physical injuries/sickness under Internal Revenue Code Section 104, the parties should consider it in advance. Any insurance coverage restrictions should be considered, too. However, in some cases, the parties may not seriously consider tax issues until a dollar amount is agreed upon by both sides.

Even if there has been *some* tax discussion, the tax issues may become intractable or be ignored if the settlement agreement must be signed that night. If a full-blown settlement agreement must be signed that night and the parties do not have the time or expertise to consider tax issues, then the tax issues may fall where they may. Both parties may suffer, especially the plaintiff. The plaintiff may have a painstaking wait until January 31 of the next year when IRS Forms 1099 are issued and may end up locked into a tax position they do not like.

Conclusion

In the end, I suspect that most successful mediations are still likely to involve a binding term sheet at conclusion. One or both sides want to know that they truly have a deal, and in most cases, the details, including the tax details, can be worked out later. Even so, it is worth considering your position in the unlikely event that no comprehensive settlement agreement will ever be signed.

It might make you or your client more desirous of saying *something* about taxes in the term sheet. Despite my discussion of the pluses and minuses of forgoing a term sheet and moving directly to a comprehensive settlement agreement at the end of mediation, there is nothing (tax-wise at least) wrong with that approach either. However the case is concluded, the tax issues are likely to be resolvable. But as in so many other settings, the side that is most prepared and proactive on the tax issues is more likely to end up ahead on those points.