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John F. Fatino

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The Tax Treatment of Verdicts and Settlements Following the Adoption of the Jobs Creation Act of 2004: Paradise Found for the Employment Lawyer?

JOHN F. FATINO*

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I. INTRODUCTION

According to at least one author, no attorney can be ignorant of tax changes because “obsolete knowledge is a synonym for malpractice.”¹ A previous incarnation of this article discussed the taxation of verdicts and settlements in the employment law context under post-1996, pre-2004 legislation.² Since that time, a significant Supreme Court decision and the passage of the American Jobs Creation Act have significantly altered the landscape of tax treatment of verdicts and settlements in the employment

* John Fatino, a 1991 graduate of Drake Law School, formerly served as chair of Whitfield & Eddy’s Employment Practice Group. Mr. Fatino, a member of the firm, is licensed to practice in Iowa, Minnesota, the United States District Courts for the Northern and Southern Districts of Iowa, the United States Courts of Appeals for the Seventh and Eighth Circuits, and before the United States Supreme Court.

In addition to advising clients and litigating employment matters, Mr. Fatino has extensively lectured and written on employment matters. The opinions expressed herein are expressly his own. The article was based upon a presentation given in 2006 to the Iowa State Bar Association’s Bridge the Gap meeting.

1. Steve Johnson, *Major Changes to Taxation of Tort Damages*, 13 NEV. LAW. 12 (April 2005).

2. See, e.g., John F. Fatino, *Planning for Tax Impact of Lost-Wage Awards*, 26 NAT’L L.J., A25 (2002). The author gratefully acknowledges the assistance of Gary D. Goudelock, Jr., an associate with Whitfield & Eddy, P.L.C., in the preparation of the original presentation.

law context. In spite of these changes, the practitioner must know that the in the event of a settlement or verdict in the employment law context the client runs a significant risk of being taxed on the recovery.

Since 1996, verdicts or settlements in the employment law context are no longer excludable from gross income.³ As will be discussed in more detail below, only damages recovered on the basis of personal injury or physical sickness are excluded from gross income.⁴ Stated otherwise, “all wage loss[es] recovered by way of settlement or verdict in the absence of actual physical injury” are taxable income.⁵ As discussed in Section II(C), *infra*, however, Congress has now altered the taxation of awards specifically in the employment context by allowing certain deductions for attorney fees and costs in these actions. This article will examine the taxability of verdicts and settlements, define the contours of the statutes and regulations, and discuss the deductibility of attorney fees in certain types of cases.

Shortly before this article went to press, a panel of the United States Circuit Court of Appeals for the District of Columbia held section 104(a)(2)⁶ unconstitutional, in so far as it permits the taxation of an award of damages for mental distress and loss of reputation, because such items would not have been income to the framers of the Sixteenth Amendment to the United States Constitution.⁷ Practitioners should closely examine this opinion for additional grounds of attack on the taxation of physical and non-physical injuries. Moreover, there is an excellent discussion as to whether a payment on account of physical injury is compensation for loss of capital.⁸ At the same time, at least one commentator has suggested that employers (which are not located in the D.C. Circuit) should continue to issue form 1099 to the employee “and leave it to the plaintiff/employee to battle the IRS over the taxability of the payment.”⁹ The case, however, does not change the analysis for those taxpayers, which are in circuits other than the District of Columbia Circuit. Consequently, the article still functions effectively for practitioners in all circuits.

3. Richard A. Williams, Jr., *More is Now Less: Taxability of Employment Settlements*, Bench & B of Minn., Apr. 1997, at 17 [hereinafter “Williams”].

4. *Id.*

5. *Id.*

6. 26 U.S.C. § 104(a)(2) (2000).

7. *Murphy v. I.R.S.*, 460 F.3d 79, 92 (D.C.C. 2006).

8. *Id.* at 86-91. For further direction on whether to litigate a refund on behalf of the tax-paying employee, see T. Herman, *Court Ruling in Damages Case Deals Big Setback to the IRS*, WALL ST. J., Aug. 30, 2006, at D2.

9. A.B.A. LAB. & EMP. E-Alert, *Marrita Murphy v. Internal Revenue Service* (Aug. 31, 2006).

II. THE TAXPERSON COMETH

A. WAS THERE A PHYSICAL INJURY?

Congress adopted the Small Business Job Protection Act of 1996¹⁰ which states the following exclusion from gross income: “the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness¹¹. . . [but] emotional distress shall not be treated as a physical injury or physical sickness.”¹²

As a result, in order for the award to be tax free, the client must demonstrate that the payment was made on the basis of physical injuries or physical sickness.¹³ These include “ ‘the traditional harms associated with personal injury, such as pain and suffering, emotional distress, harm to reputation, or other consequential damages.’ ”¹⁴ The House Report for the 1996 amendments to section 104(a)(2) stated that “damages based on ‘employment discrimination or injury to reputation accompanied by a claim of emotional distress’ ” do not constitute a physical injury or physical sickness within the meaning of the exemption.¹⁵

“In order for damages to be nontaxable, [the verdict or settlement] must arise from an actual physical injury.”¹⁶ Consequently, “emotional distress damages are nontaxable only if they are secondary to a physical injury or physical illness for which the defendant is legally responsible.”¹⁷ Ordinary emotional distress damages are therefore insufficient to prevent an award from being taxable.¹⁸ However, the IRS makes the final determination.¹⁹ In the event of a dispute, the IRS will resolve the issue based upon the facts of record. The IRS in a private letter ruling described

10. Pub. L. No. 104-188, 110 Stat. 1838 (1996); Williams, *supra* note 3, at 17.

11. 26 U.S.C. § 104(a)(2) (2000).

12. 26 U.S.C. § 104(a) (2000).

13. Murphy v. I.R.S., 362 F. Supp. 2d 206, 214 (D.D.C. 2005).

14. *Id.* (quoting United States v. Burke, 504 U.S. 229, 239 (1992)).

15. *Id.* (quoting H.R. REP. NO. 104-737, pt. 1, at 55 (1996)).

16. Williams, *supra* note 3, at 19.

17. *Id.*

18. *Id.*

19. Helmelt v. United States, 122 F.3d 204, 209 (4th Cir. 1997). *But see* Dotson v. United States, 87 F.3d 683, 686 (5th Cir. 1996) (“The characterization of damages received is not affected by the shifting sands of statutory interpretation after a bona fide settlement has been reached or a damage award rendered.”). *See also* Rivera v. Baker West, Inc., 430 F.3d 1253, 1257 (9th Cir. 2005) (indicating the court will look at settlement agreement signed by both parties as evidence of allocation of damages; and in absence of language in settlement agreement, the intent of the payor will control).

the types of evidence, which demonstrate personal physical injuries.²⁰ In contrast, emotional distress that results in physical injury is taxable.²¹

Most likely, a discrimination award will be taxed.²² The new legislation discussed below will not change the taxability of the award. Rather, the new legislation provides an above-the-line deduction for attorney fees, allowing the successful plaintiff to reduce the taxable amount of the award. The problem is compounded by the fact that “wages” are deemed received when they are paid.²³ As wages are taxed in the tax year that they are paid, significant changes could have occurred such as marriage or divorce, higher annual wages resulting in a higher tax bracket, or legislative increases in the tax rates, all of which would affect the rate at which the income is taxed.²⁴ Not only are wages deemed earned when they are paid, but also, any other awards that might be given in an employment case are included in the taxpayer’s gross income in the year in which they are paid.²⁵ This can result in a taxpayer’s gross income being significantly more than the typical annual gross income of the taxpayer, which results in the income being taxed at higher rates.²⁶ This phenomenon is called “bunching” and may also subject taxpayers to the dreaded Alternative Minimum Tax (“AMT”), which will be discussed more thoroughly *infra*.²⁷

B. DEDUCTIBILITY OF LEGAL FEES

The deductibility of attorney’s fees in employment cases has been the area which has seen the most change within the past years. Until recently, the United States Circuit Courts of Appeals were split over the issue of whether attorney fees recovered in non-physical injury cases could be deducted against the award prior to the application of the tax rate.²⁸ In

20. I.R.S. Priv. Ltr. Rul. 2000-41-022 (Oct. 13, 2000).

21. *Tax Implications of Verdicts in Employment Suits Discussed*, 170 Lab. Rel. Rptr. 69 (June 17, 2002); *see also* Lindsey v. Comm’r, 422 F.3d 684, 686-88 (8th Cir. 2005) (recognizing taxpayer’s damages included hypertension, insomnia, impotence, indigestion, and fatigue, which the Tax Court and the Eighth Circuit both determined to be “ ‘the types of injuries or sicknesses that Congress intended to be encompassed within the definition of emotional distress.’ ”).

22. *See* Rev. Rul. 96-65, 1996 C.B. 6. *See also* I.R.S. Publ’n 4345 (June 2004).

23. *Helmelt*, 122 F.3d at 210 (refusing to allocate wages over period of time in which wages were purportedly earned).

24. *See, e.g.*, Gregg D. Polsky & Stephen F. Befort, *Employment Discrimination Remedies and Tax Gross Ups*, 90 IOWA L. REV. 67, 73 (2004).

25. 26 U.S.C. §§ 61, 441 (2000).

26. 26 U.S.C. § 1 (2000).

27. *See* Polsky & Befort, *supra* note 24, at 73.

28. *See, e.g.*, Campbell v. Comm’r, 274 F.3d 1312, 1313 (10th Cir. 2001) (finding “the end result is that the recovery of legal fees benefited her”); Kenseth v. Comm’r, 259 F.3d 881 (7th Cir. 2001); Young v. Comm’r, 240 F.3d 369 (4th Cir. 2001); Benci-

short, clients and their attorneys were uncertain over whether the client would be exposed to the AMT and, of course, this turned on the circuit in which the taxpayer resided. The AMT “precludes various miscellaneous itemized deductions including fees paid to attorneys by taxpayers.”²⁹ The full text of the statute is set out in the margin.³⁰

However, in *Comm’r v. Banks*, a unanimous decision published in January 2005, the United States Supreme Court finally resolved this circuit split and decided that contingent attorney’s fees were not deductible above-the-line.³¹ In *Banks*, the Court took up two related cases, one from the Sixth Circuit and one from the Ninth Circuit, to decide whether amounts paid from a money judgment or settlement pursuant to a contingent-fee agreement are income to the plaintiff under the Tax Code.³² The Sixth Circuit in *Banks* had determined that the net amount received by the plaintiff was included in gross income but the amount paid to the attorney was not.³³ The Sixth Circuit based its decision on the rationale that the

Woodward v. Comm’r, 219 F.3d 941 (9th Cir. 2000); Coady v. Comm’r, 213 F.3d 1187 (9th Cir. 2000); Alexander v. I.R.S., 72 F.3d 938, 944-46 (1st Cir. 1995) (rejecting argument that legal fees should be treated as “an ‘above the line’ trade or business expense under Section 162(a) rather than a ‘miscellaneous itemized deduction’ under Section 63”); Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995). *But see, e.g.*, Srivastava v. Comm’r, 220 F.3d 353 (5th Cir. 2000); Davis v. Comm’r, 210 F.3d 1346 (11th Cir. 2000); Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 855 (6th Cir. 2000) (involving a personal injury case where issue before the court was whether portion of interest payment paid to lawyer must be included in income to decedent); Cotnam v. Comm’r, 263 F.2d 119 (5th Cir. 1959).

29. *Campbell*, 274 F.3d at 1313; *Benci-Woodward*, 219 F.3d at 941 (“Tax Court correctly determined that the legal expenses at issue here are miscellaneous itemized deductions, *see* 26 U.S.C. § 67(b), and as such are not allowed as deductions for purposes of computing AMT liability, *see* 26 U.S.C. § 56(b)(1)(A)(i).”).

30. 26 U.S.C. § 55(b) (2000) provides:

(b) Tentative minimum tax

For purposes of this part –

(1) Amount of tentative tax

(A) Noncorporate taxpayers

(i) In general

In the case of a taxpayer other than a corporation, the tentative minimum tax for the taxable year is the sum of–

(I) 26 percent of so much of the taxable excess as does not exceed \$175,000, plus

(II) 28 percent of so much of the taxable excess as exceeds \$175,000.

The amount determined under the preceding sentence shall be reduced by the alternative minimum tax foreign tax credit for the taxable year.

31. 125 S. Ct. 826 (2005).

32. *Id.* at 827-28.

33. *Comm’r v. Banks*, 345 F.3d 373 (6th Cir. 2003), *rev’d*, 125 S. Ct 826 (2005).

award was not earned or vested when the contingent-fee contract was made and, as such, was not an anticipatory assignment of income.³⁴ However, in deciding that the portion of the award paid to the attorney was not income to the plaintiff, the Ninth Circuit had looked to Oregon law, which granted a superior lien in favor of the attorney on the contingent-fee portion of the award.³⁵ The Ninth Circuit had held that this was a transfer to the attorney of some of the client's property and should not be taxed as income to the plaintiff.³⁶ The Supreme Court rejected both of these arguments and held unanimously, with Chief Justice Rehnquist not participating, that the portion of an award which was paid to the plaintiff's attorney was an anticipatory assignment of income and under the precedent established by previous cases such as *Lucas v. Earl* and *Helvering v. Horst*, was taxable as income to the plaintiff.³⁷ The Supreme Court determined that this was an anticipatory assignment of income because the plaintiff maintains dominion over the income-generating asset – the cause of action.³⁸ The Court rejected the argument that the contingent-fee agreement was not an assignment of income because the income was, at best, speculative, at the time the attorney fee contract was entered.³⁹ “[T]he anticipatory assignment doctrine is not limited to instances when the precise dollar value of the assigned income is known in advance.”⁴⁰

The taxpayers in *Banks* also argued that the relationship between client and attorney was that of joint venturers and therefore they should be taxed as partners.⁴¹ The Court rejected this argument noting that the attorney-client relationship “is a quintessential principal-agent relationship” and that “[t]he portion paid to the agent may be deductible, but absent some other provision of law it is not excludable from the principal's gross income.”⁴² The Court noted passage of the American Jobs Creation Act during the pendency of the *Banks* litigation and observed that, although these cases would not have arisen had the provisions of the Act been in place for the tax years in which these cases were filed, the Act was not retroactive and did not apply to the taxpayers in *Banks*.⁴³ The holding in *Banks* is limited to awards arising prior to October 2004 and those cases which would not fall under the American Jobs Creation Act of 2004, as discussed *infra*.

34. *Id.* at 384.

35. *Banks*, 125 S. Ct. at 830.

36. *Banaitis v. Comm'r*, 340 F.3d 1074 (9th Cir. 2003).

37. *Banks*, 125 S. Ct. at 831-32.

38. *Id.*

39. *Id.* at 832.

40. *Id.* (citations omitted).

41. *Id.*

42. *Id.* at 832-33.

43. *Id.* at 831.

Thus, conceivably, there is still a narrow class of cases to which *Banks* would apply.

C. THE AMERICAN JOBS CREATION ACT OF 2004 AND THE ALTERNATIVE MINIMUM TAX REVISITED

As noted previously, in October 2004, the American Jobs Creation Act was passed by Congress and signed into law by President Bush, and its provisions took effect immediately.⁴⁴ Of note to the present discussion was an amendment to section 62 of the Internal Revenue Code which inserted a new paragraph 19⁴⁵ which allows for the following to be deducted in computing the taxpayer's adjusted gross income:

Any deduction allowable under this chapter for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination (as defined in subsection (e)) or a claim of a violation of subchapter III of chapter 37 of title 31, United States Code or a claim made under section 1862(b)(3)(A) of the Social Security Act.⁴⁶

The statute then goes on to define unlawful discrimination as an unlawful act under various sections of several anti-discrimination Acts including: the Civil Rights Act of 1991; the Congressional Accountability Act of 1995; the National Labor Relations Act; the Fair Labor Standards Act of 1938; the Age Discrimination in Employment Act of 1967; the Rehabilitation Act of 1973; the Employee Retirement Income Security Act of 1974; the Employee Polygraph Protection Act of 1988; the Worker Adjustment and Retraining Notification Act; the Family and Medical Leave Act of 1993; the Civil Rights Act of 1964; the Fair Housing Act; and the Americans with Disabilities Act.⁴⁷

The scope of the definition is, indeed, large. Also included in the definition of unfair discrimination are acts taken which would be unlawful under any federal whistleblower law, and:

Any provision of Federal, State, or local law, or common law claims permitted under Federal, State, or local law –

44. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004).

45. I.R.C. § 62(a)19 has been redesignated as (a)20 through Act of Dec. 21, 2005, Pub. L. No. 109-135, 199 Stat. 2577, 2638.

46. *Id.* at § 703(a), 118 Stat. at 1546-47.

47. *Id.* at § 703(b), 118 Stat. at 1547.

- (i) providing for the enforcement of civil rights, or
- (ii) regulating any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.⁴⁸

By allowing the deductions as an above-the-line deduction, i.e., a deduction taken when figuring Adjusted Gross Income, rather than as a miscellaneous itemized deduction, this legislation does two things – it prevents the deduction from being wiped out by the AMT, and it means that the deductions are no longer subject to the two-percent floor, discussed *infra*. When figuring a taxpayer's taxable income under the AMT, certain deductions, which would be deductible when figuring the taxpayer's ordinary taxable income, are no longer allowed.⁴⁹ When figuring out the AMT, miscellaneous itemized deductions under section 67(b) were among those deductions not allowed.⁵⁰ As noted previously, attorney's fees were previously deductible only as miscellaneous itemized deductions. As a result of the generally large verdict amounts, successful plaintiffs were often subject to the AMT.⁵¹ Prior to the enactment of the American Jobs Creation Act, such plaintiffs were not allowed to deduct their legal expenses and could face the prospect of owing more in tax than was recovered as a result of the litigation.⁵² Under the new Act, in most types of employment-related litigation, such scenarios would not occur. Allowing above-the-line deductions for legal fees in these cases also means that such deductions are no longer subject to the two-percent floor.⁵³ As attorney's fees in these cases are now above-the-line deductions, they are no longer considered itemized deductions,⁵⁴ which would be limited to whatever

48. *Id.* at § 703(b), 118 Stat. at 1547-48.

49. Peter T. Beach & Michael G. Valentine, *Recent Developments in the Taxation of Settlements and Judgments*, 46 N.H. B.J. 46, 46 (2005).

50. 26 U.S.C. § 56(b)(1)(A)(i) (2000).

51. Beach & Valentine, *supra* note 49, at 46.

52. *See, e.g.*, Spina v. Forest Pres. Dist., 207 F. Supp. 2d 764 (N.D. Ill. 2002). A female police officer who won a three million dollar judgment had her award reduced to \$300,000 plus attorney's fees of \$950,000. Beach & Valentine, *supra* note 49, at 46-47. She was taxed on the entire amount and ended up owing \$399,000 in taxes. *Id.*

53. *See* 26 U.S.C. § 67(a) (1994) (allowing miscellaneous itemized deductions "only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income").

54. *See* 26 U.S.C. § 63(d) (2000) ("For purposes of this subtitle, the term 'itemized deductions' means the deductions allowable under this chapter other than - (1) the deductions allowable in arriving at adjusted gross income. . . .").

aggregate amount exceeded two percent of adjusted gross income⁵⁵ and would be phased out as the taxpayer's adjusted gross income increased.⁵⁶

However, deductions for legal fees will only be allowed for the year in which the damage award is recovered, not necessarily in the year the fees are paid.⁵⁷ As a result, if payments are made to an attorney during one year and the recovery is not received until the following year, a tax problem could result.⁵⁸

Finally, it should be noted that payment of attorney's fees in connection with a verdict or settlement in the employment context can still be subject to employment tax withholding. If the payment is made directly to the attorney, it is not subject to employment tax withholding.⁵⁹ If, however, the employer makes the same payment to the employee/plaintiff and then the plaintiff pays the attorney, the amount paid by the plaintiff to the attorney is subject to employment tax withholding.⁶⁰

Remember: interest,⁶¹ prejudgment interest,⁶² and punitive damages⁶³ are always taxable.

III. PLAN, PLAN, PLAN

The new statute mandates counsel examine whether the plaintiff can assert one of the claims identified in the American Jobs Creation Act to create an opportunity to provide for the deductibility of attorney fees and costs. Indeed, it could come as a significant embarrassment to counsel that he or she had missed the opportunity presented by the new legislation.

Furthermore, a more recent development in this area which does not necessarily come from planning, but rather, from the invocation of the equity powers of the courts, is to allow an augmentation of the award to offset potentially negative tax implications.⁶⁴ This is known as "grossing-

55. 26 U.S.C. § 67 (2000).

56. See 26 U.S.C. § 68 (2000).

57. 26 U.S.C. § 62(a)(20) (2000) (subsection (a)(19) added by American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418, 1546-1547, redesignated as subsection (a)(20) by Act of Dec. 21, 2005, Pub. L. No. 109-135, 199 Stat. 2577, 2638) (stating that a deduction is not allowed "in excess of the amount includible in the taxpayer's gross income for the taxable year on account of a judgment or settlement (whether by suit or agreement and whether as lump sum or periodic payments) resulting from such claim").

58. Beach & Valentine, *supra* note 49, at 47.

59. Rev. Rul. 80-364, 1980-2 C.B. 294.

60. *Id.*

61. 26 U.S.C. § 61(a)(4) (2000).

62. *Rozpad v. Comm'r*, 154 F.3d 1, 7 (1st Cir. 1998).

63. Williams, *supra* note 3, at 19. See also Bagley v. Comm'r, 121 F.3d 393, 394 (8th Cir. 1997) ("[Taxpayer] first argued that punitive damages are not taxable, a position with which the Tax Court disagreed, and one that is no longer tenable. . .").

64. See Polsky & Befort, *supra* note 24, at 69.

up” the award.⁶⁵ Counsel will want to add this argument to her arsenal. In a recent case, the Washington Court of Appeals affirmed a trial court’s award of an additional amount in order “to compensate her for the tax consequences of that award.”⁶⁶ Washington has a statute which specifically authorizes courts to award “reasonable attorneys’ fees *or any other appropriate remedy*” in discrimination cases.⁶⁷ The Court of Appeals recited a Washington Supreme Court ruling which stated that “[a]n offset for additional federal income tax consequences is properly characterized under [RCW 49.60.030(2)’s] provision for ‘any other appropriate remedy.’ ”⁶⁸ While gross-ups are uncommon – only one reported case in addition to *Forbes* addresses the issue⁶⁹ – they could be a way to fill in the gaps left by the American Jobs Creation Act and the *Banks* decision.⁷⁰

Under existing legislation, physical injury verdicts and settlements are taxable. However, for most types of discrimination claims, attorneys’ fees are now deductible as an above-the-line deduction and these deductions will not be lost to the AMT. Planning for these contingencies must arise at the outset of a case by the selection of potential claims. In any event, as demonstrated by the foregoing discussion, the time for tax planning on an employment case begins at the outset of the case.

65. *Id.*

66. *Forbes v. ABM Indus., Inc.*, No. 22656-5-III, 2005 Wash. App. LEXIS 696, at *35, 2005 WL 914836, *13 (Wash. App. Ct. April 21, 2005).

67. WASH. REV. CODE ANN. § 49.60.030(2) (West 2002) (emphasis added).

68. *Forbes*, 2005 Wash. App. LEXIS 696, at *35-36, 2005 WL 914836, at *13 (quoting *Blaney v. Int’l Ass’n of Machinists & Aerospace Workers* Dist. No. 160, 87 P.3d 757, 762-63 (Wash. 2004)).

69. *Porter v. United States Agency for Int’l Dev.*, 293 F. Supp. 2d 152 (D.D.C. 2003).

70. This theory is discussed fully in Polsky & Befort, *supra* note 24.