Tax Tips

Tax Aspects of Employee Terminations

Although terminations can be an extremely traumatic event, depending on your situation, the tax aspects can be quite complex, and require you to make decisions that can affect your tax picture this year and for years to come. Here are just a few of the factors that should be considered..

Although severance pay is taxable and is subject to federal income tax withholding, some elements of a severance package may be specially treated. For example: If you sell stock acquired by way of an incentive stock option (ISO), part or all of your gain may be taxed at lower long-term capital gain rates rather than at ordinary income tax rates, depending on whether you meet a special dual holding period. If you received or will receive what is commonly referred to as a golden parachute payment, you may be subject to an excise tax equal to 20% of the portion of the payment that's treated as an “excess parachute payment” under extremely complex rules, along with the excess parachute payment also being subject to ordinary income tax. The value of job placement assistance you receive from your former employer usually is tax-free. However, the assistance is taxable if you had a choice between receiving cash or outplacement help.

You should also be aware that under the so-called COBRA rules, most employers that offer group health coverage must provide continuation coverage to most terminated employees and their families. The cost of any premium you pay for insurance that covers medical care is a medical expense and as a general rule results in a tax benefit to you if you claim itemized deductions and your total medical expenses exceed 10% of your adjusted gross income. If your ex-employer pays for some of your medical coverage for a period of time following termination, you will not be taxed on the value of this benefit. And if you lost your job as a result of a foreign-trade-related circumstance, you may qualify for a refundable credit for 72.5% of your qualifying health insurance costs.

Employees who terminate employment also need tax planning help to determine the best course of action for amounts they've accumulated in retirement plans sponsored by their former employer. For most, a tax-free rollover to an IRA is the best move, if the terms of the plan allow a pre-retirement payout. If the distribution from the retirement plan includes employer securities in a lump-sum, the distribution is taxed under the lump-sum rules except that “net unrealized appreciation ” in the value of the stock isn't taxed until the securities are sold or otherwise disposed of in a later transaction. If you are under age 591/2 , and must make withdrawals from your company plan or IRA to supplement your current income, there may be an additional 10% penalty tax to pay unless you're positioned to qualify under one of several escape hatches.

Further, any loans you've taken out from your employer's retirement plan, such as a loan from a 401(k) plan, may be required to be repaid immediately, or within a specified period of your termination of employment, or be treated as it were in default. If the balance of the loan is not repaid within the required period, it will typically be treated as a taxable deemed distribution.

If you have any questions concerning this matter, please do not hesitate to call me at (562) 698-9891.

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