Tax and Financial Issues
Related to Loss of Employment

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Introduction

I. The final paychecks
   A. Review your withholdings
      1. Federal and state withholdings ***can*** be manipulated, but ***should*** they be?
         a. Have you been over- or under-withheld during the year?
         b. Do not arbitrarily reduce or exempt withholding without a clear and comprehensive understanding of the consequences.
      2. If you have already earned maximum wages for Social Security purposes, it may make sense to accelerate any severance payments.
   B. Will you or should you continue with payroll deferrals?
      1. Section 401(k) contributions can be expensive to recover, once the deferral has been made.
      2. Will the employer continue to match after notice of termination?
   C. Should you or can you continue with Flexible Spending/Cafeteria or Section 125 Plan contributions?
      1. Will you be able to recoup the contributions already made?
      2. What is your timeframe for making claims against the Plan(s)? Many plans require that claims be made for expenses ***incurred*** prior to severance.
   D. What are the terms of your severance arrangement?
      1. Will you receive a lump-sum amount? This can skew withholding for Federal and State income taxes.
      2. If some sort of salary continuation program, withholding should perhaps continue at a higher rate than before, depending upon the previously noted issues regarding 401(k) plans, and pre-tax contributions to flex spending plans.

II. What to do about retirement plans?
   A. Most of the options are dictated by the retirement plans themselves.
      1. You must investigate what your options are. If you have multiple plans, you may make different decisions concerning the separate

plans, or, depending upon the types of plans, you may have no choice in the matter.

2. The classic pension plans will ordinarily not offer any lump-sum option, but future benefits at retirement.

B. What about the portable retirement plans like 401(k) plans?

1. For plans in which you are vested:

a. May be able to leave the funds where they are if the plan allows

i. This will not be an indefinite arrangement, as the former employer will continue to incur costs for maintenance of the account balance

b. If you have found new employment with an employer with a similar retirement account, you may be able to transfer directly from one employer's plan to another.

i. This is a transfer of funds from trustee to trustee.

c. You may decide to transfer into an Individual Retirement Account (IRA).

i. Transfers are never made directly to the plan participant, and are therefore not subject to back-up withholding.

ii. This gives you the opportunity to mitigate tax and penalty, by only taking what you absolutely need in a tax year, then going back into the IRA for the tax and penalty in the subsequent year.

Example: You need $7,500 to help with your living expenses for the next six months. If you withdraw only what you need on a month-by-month basis, you will only incur tax and penalty on the funds actually withdrawn in the tax year. However, if you were to take the net $7,500 all at once from the 401(k) plan, then your distribution would be $9,375, less $1,875 for the 20% withholding. You would owe penalty of $937.50, and income tax on the entire $9,375. Assuming a 30% tax rate, the income tax would be over $2,800.

iii. If you wish the ability to transfer these funds into another employer's 401(k) plan from the IRA, you would not want to combine the 401(k) proceeds from the prior employer with another IRA account.

d. You may decide to take a partial or total distribution of the 401(k) assets.

i. If not age 59 ½ at the time of distributions, or permanently and totally disabled, then the distribution will be subject to a ten percent penalty for premature distribution, and will be taxed at ordinary income tax rates.

ii. Mandatory withholding rate is twenty percent, which will not be sufficient to cover federal and state income taxes and penalties.

iv. **The real income tax and penalty rate is closer to forty percent!!!!!**

2. What if you've previously borrowed from your 401(k), and still owe the plan money when you terminate employment?

   a. You will have a limited time in which to repay the loan (usually thirty days).

   b. If you are unable to repay the loan within the prescribed timeframe, the remaining loan balance will be treated as a distribution, and the twenty percent withholding on the distribution will be taken from the other funds available.

      Example: In 1999, you borrowed $30,000 from your 401(k) plan to buy a car. Your employment is terminated in June of 2001. The remaining loan balance is $18,500. You are unable to repay the 401(k) plan within thirty days. The remaining loan balance is treated as a net distribution, and the total distribution is deemed to be $23,125, so that $4,625 is withheld and paid over to IRS as the twenty percent withholding on the distribution. The taxable distribution is then $23,125, not the $18,500, and the ten percent penalty is computed on the $23,125. Assuming a thirty percent income tax rate and the ten percent penalty, the tax and penalty cost of the distribution is $9,250.

C. ***<u>You absolutely want to sit down with a tax and financial planning professional to understand and explore your options with regards to qualified (retirement) plans.</u>***

III. How about those stock options?

A. Will you be exercising any stock options in which you are vested?

   1. Generally, you will have a short timeframe in which to exercise.
   2. Are the options Non-Qualifying or Incentive Stock Options?
   3. Will the transaction be taxed as it occurs?

B. Are the options economically viable?

   1. Are they under water?
   2. Is a cashless exercise an option for the purchase?

C. A great reference for information concerning stock options is: <u>Stock Options: An Authoritative Guide to Incentive and Nonqualified Stock Options</u>, by Robert Pastore, CPA, CFA.

IV. Some new deductions……….

A. Job search expenses are deductible as a miscellaneous itemized deduction on Schedule A of your 1040.

1. Job search expenses include:

a. Fees to placement agencies

b. Postage or overnight fees

c. Travel, including airfare, ground transportation, lodging and tips

d. Mileage to and from interviews @ $.345 per mile for 2001 (the rate increases to $.365 on January 1, 2002)

e. Parking costs

d. Resume services

f. Registration fees for posting resumes

g. Meals away from home (while interviewing, for example) and entertainment expenses (buying someone a lunch on an informational interview) are deductible, but only fifty percent of the cost is allowed as an expense

2. Keep contemporaneous records of all these costs – they do add up!

B. What if you go back to school?

1. Doesn't have to be in traditional setting – could be seminar format for refreshing interview skills

2. Education expenses may be deducted as a miscellaneous itemized deduction if the schooling does not qualify you for a new trade or business.

3. Even if the education costs qualify you for a new trade or business, you may be eligible for the Hope Scholarship Credit or the Lifetime Learning Credit.

V. Should you consider going into business for yourself, or contracting services as an independent contractor?

A. Obviously, no benefits provided to you. You'll be on your own for:

1. Health insurance

a. Will you continue on COBRA?

b. Colorado does have "Group of One" health insurance plans for self-employed individuals. Restrictions do apply. You should discuss with an insurance broker who deals with these programs.

c. Premiums paid qualify for a deduction as medical expenses. If eligible, a percentage of the premiums paid can be taken as an adjustment to income.

2. Disability insurance

a. Most commonly forgotten insurance

b. More likely to be disabled than to die before retirement

c. Premiums are not deductible unless paid by a "C" corporation

3. Life insurance
    a. Are you insurable?
    b. Coverage through former employer will disappear
    c. Premiums are not deductible unless paid by a “C” corporation
4. No one will be “matching” your Social Security and Medicare taxes, so the rates double to 15.3%
5. You will have no paid vacation, sick leave, comp time, unemployment benefits, etc., etc.

B. New recordkeeping responsibilities
1. Have to maintain some sort of accounting records for income and expenses.
    a. Look at some lower end “money management” programs like Quicken or Money
    b. Depending on type of business may need to consider smaller accounting packages like QuickBooks or MYOB
2. How will you pay your taxes?
    a. No withholding at source
    b. May need to make quarterly estimated tax payments throughout the year to avoid penalties

VI. Unemployment benefits are taxable as ordinary income.