

Tax aspects of employee terminations

Although taxes probably are the last thing on your mind after being terminated there are tax aspects of your changed personal and professional circumstances. 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 we should discuss in detail.

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 lightly taxed long-term capital gain, 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.
- 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 only if your total medical expenses exceed 7.5% of your adjusted gross income. However, if you have self-employment income following termination of employment, the cost of your medical insurance premiums may be deductible "above the line" (that is, deductible in arriving at 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 65% 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 you are under age 59½, 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.

Finally, the expenses, including travel expenses, of hunting for a new job in the same trade or business are deductible as miscellaneous itemized deductions if certain requirements are met.