Tax aspects of employee terminations

Many tax issues arise when an employee leaves, or is terminated, from employment. How they are handled can make the difference between having an employee leave feeling more in control of the situation and one who may perceive the need for a better severance package. Here are some considerations that should not be ignored.

Unemployment compensation: Unemployment insurance payments are taxable as income. Payments to laid-off employees from company-financed supplemental unemployment benefit plans (referred to as “guaranteed annual wage” plans) also constitute taxable income to the employees in the year received.

Severance payments: In some circumstances, terminated employees may receive a severance package. Severance pay is taxable and must be reported along with other employee salary or wages.

Golden parachutes: Highly compensated employees or independent contractors may have “golden parachute” clauses in their contracts specifying that they will receive certain benefits, beyond their usual compensation, in the event the ownership or control of the corporation changes. Golden parachute benefits can include a bonus, severance package, stock options or a combination. If the employee receives an “excess parachute payment,” a complex calculation under the tax code, the employee may be subject to an excise tax of 20 percent plus the income tax due.

Incentive stock options: Incentive stock options (ISOs) are not taxed as income at the time the stock option is granted to an employee, nor are they taxed as regular income at the time the employee exercises the option and buys the stock. Instead, tax is generally deferred until the employee sells the stock, at which time the lower capital gains tax rates apply, so long as the stock is held for at least two years after the options were granted and at least one year after they were exercised. If the holding period test is not met, the stock may be treated as compensation, which will result in tax being paid at regular income tax rates, rather than at capital gains rates, when the stock is sold.

Although no income tax is generally due when the stock option is exercised, the alternative minimum tax (AMT) can be triggered. Depending on your overall tax situation, you may have to pay AMT in the year you exercise your stock options.

IRA rollovers: In many situations, a distribution from a qualified plan may be rolled over to a traditional IRA or to another qualified plan, tax-free. Generally, the transfer must be accomplished within 60 days of the distribution or withdrawal. However, any portion of the withdrawal that is not rolled over within the 60-day period will be taxed as ordinary income and may be subject to a 10 percent penalty on premature distributions if the distributee is less than 59 ½ years old.

Job hunting expenses: Individuals may deduct all expenses incurred in seeking employment in the same trade or business regardless of whether or not the search is successful. Such expenses include the preparation and mailing of resumes, as well as travel expenses. Job-hunting expenses are not deductible, however, if an individual is seeking employment in a new trade or business. If an employee receives a severance package that includes assistance from a job placement or resume writing service, it can usually be arranged to come under the “tax-free fringe benefit” category while preserving a full deduction for the employer.

Health care issues: An itemized deduction is allowed for medical expenses that exceed 7.5% of adjusted gross income. The deduction can be taken for the taxpayer and his or her spouse and dependents. Also, the employee, spouse and dependents may be eligible for continued health care coverage through the former employer’s group plan, for a limited period of time, under the Consolidated Omnibus Budget Reconciliation Act (COBRA) rules.

Please contact this office if you have any particular questions on the tax aspects of employee terminations, or if you wish to investigate preparatory options such as setting up a severance plan package now for future use while obtaining some immediate tax deductions for making permitted contributions to that benefit plan.