A job loss is bad but the tax implications could make it worse

Unemployment has been holding steady recently at 3.7%. But there are still some people losing their jobs — particularly in certain industries including technology and media. If you're laid off or terminated from employment, taxes are likely the last thing on your mind. However, there are tax implications due to your altered employment circumstances.

Depending on your situation, the tax aspects can be complex and require you to make decisions that may affect your tax bill for this year and for years to come. Be aware of these three areas.

1.Unemployment and payments from your former employer

Many people are surprised to find out that federal unemployment compensation is taxable. (Some states exempt unemployment comp from state tax.) In addition, payments from a former employer for any accumulated vacation or sick time are taxable. Although severance pay is also taxable and subject to federal income tax withholding, some elements of a severance package may get special treatment. 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's 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 very 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.

2.Health insurance costs

Under the COBRA rules, employers that offer group health coverage generally must provide continuation coverage to most terminated employees and their families. While the cost of COBRA coverage is usually expensive, the amount of any premium you pay for insurance that covers medical care is an eligible medical expense for tax purposes. That means it's deductible if you itemize deductions and if your total medical expenses exceed 7.5% of your adjusted gross income.

If your former employer pays some of your medical coverage for a period of time after termination, you won't be taxed on the value of the benefit.

3.Retirement plan balance

Employees whose employment is terminated may need tax planning help to determine the best option for amounts they've accumulated in retirement plans sponsored by former employers, such as a 401(k) plan. In many cases, a direct, tax-free rollover to an IRA is the best move. You may also choose to leave the account in your previous employer's 401(k) plan (although the employer may elect to distribute the funds to you). Or, if you get a new job, you may want to transfer the money in the account with your former employer to your new employer's 401(k) plan.

If you're under age 59½, and make withdrawals from your former company's plan or IRA to supplement missing income, you may owe an additional 10% penalty tax unless you qualify for an exception.

If a 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.

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

If you need assistance, contact us. We can help you navigate the best path forward during this transition period.