

Tax & Business Alert

JULY 2023

LOST YOUR JOB? HERE ARE THE TAX ASPECTS OF AN EMPLOYEE TERMINATION

Despite the robust job market, some people are still losing their jobs. If you're laid off or terminated from employment, taxes are probably the last thing on your mind. However, you may face tax implications due to your changed personal and professional circumstances. Depending on your situation, these can be complex and require you to make decisions that may affect your tax picture — both this year and in the future.

UNEMPLOYMENT AND SEVERANCE PAY

Unemployment compensation is taxable for federal tax purposes, as are payments for any accumulated vacation or sick time. Although severance pay is also taxable and 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, part or all of your gain may be taxed at lower long-term capital gains 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 complex rules. In addition, the excess parachute payment also is 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.

HEALTH INSURANCE



Also, be aware that under the COBRA rules, employers that offer group health coverage typically must provide continuation coverage to most terminated employees and their families. While the cost of COBRA coverage

may be expensive, the cost of any premium you pay for insurance that covers medical care is a medical expense, which is deductible if you itemize deductions and if your total medical expenses exceed 7.5% of your adjusted gross income.

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

RETIREMENT PLANS

Employees whose employment is terminated may also need tax planning help to determine the best option for amounts they've accumulated in retirement plans sponsored by their former employers. For most employees, 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’re under the age of 59½ and must make withdrawals from your company plan or IRA to supplement your income, there may be an additional 10% penalty tax, unless you qualify for an exception.

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

Contact us so that we can chart the best tax course for you during this transition period. ■

FAMILY BUSINESSES MUST BEWARE OF FRAUD

Family businesses make up a huge percentage of companies in the United States and produce much of the country’s gross domestic product. Often defined as companies that are majority owned by a single family with two or more members involved in their management, family businesses can be a significant source of wealth.

However, for various reasons, they may also potentially face higher fraud risks. Here’s why, and how you can reduce those risks.

MAJOR OBSTACLES INVOLVED



Why might family businesses be more vulnerable to fraud than other companies? For one thing, prevention efforts can be hampered by loyalty and affection. One of the biggest

obstacles to fraud prevention is simply acknowledging that someone in the family could be capable of initiating or overlooking unethical or illegal activities.

But like any other business, family enterprises should include a system of internal controls that make fraud difficult to perpetrate. It may be awkward to exercise authority over members of one’s own family, but someone needs to take charge if or when issues arise. Sometimes family businesses need to hit the reset button and reestablish a hierarchy and process of authority while moving forward with the enterprise.

ADVANTAGE OF INDEPENDENT ADVICE

Of course, the person in charge potentially could be the one defrauding the company. That’s why independent auditors and legal advisors are critical.

Your family business should look outside its immediate circles of relatives and friends and retain professional advisors who can be objective when assessing the company. Audited financial statements from independent accountants protect the business and its stakeholders.

If your company is large enough to have a board of directors, it should include at least one outsider who’s strong enough to tell you things you may not want to hear. In some extreme cases, members of all-family boards have been known to work together to bilk their companies. This becomes much more difficult when collusion requires the assistance of an outsider.

PUNISHING THE PERPETRATOR

Another factor that makes preventing fraud in family businesses hard is how they tend to handle fraud incidents. Even when legal action is an option, families rarely can bring themselves to pursue action against one of their own. Sometimes families choose to save the fraudster from public scandal or punishment rather than maintain ethical professional standards. Many fraud perpetrators know that.

If you discover a family member is committing fraud, consult with a trusted attorney or accountant. An advisor may want to explain to the perpetrator the illegality and possible consequences of the fraudulent actions. If such interventions don’t work, however, you and other family members may have no choice but to seek prosecution.

AVOID BLIND TRUST

There are plenty of advantages to working with family members, but you also need to watch for pitfalls. To maintain high ethical standards and prevent fraud, rely on professional advisors and nonfamily officers to provide perspective and objective advice. Contact us for help with internal controls. ■

ARE SCHOLARSHIPS TAXABLE?

If your child has been awarded a scholarship, that's cause for celebration. For some students, it will mean the difference between going to the college of their choice or starting at community college — or even not going at all. But be aware that scholarships may bring tax implications.

GENERALLY, BUT NOT ALWAYS

Scholarships (and fellowships) are generally tax-free for students at elementary, middle and high schools, as well as those attending college, graduate school or accredited vocational schools. It doesn't matter if the scholarship makes a direct payment to the individual or reduces tuition.



However, subject to limited exceptions, a scholarship *isn't* tax-free if the payments are linked to services that your child performs as a condition for receiving the award — even if the services are required of all degree candidates. Therefore, a stipend your child receives for required teaching, research or other services is taxable, even if the child uses the money for tuition or related expenses.

What if you, or a family member, is fortunate enough to be an employee of an education institution that provides reduced or free tuition? A reduction in tuition provided to you, your spouse or your dependents by the school at which you work isn't included in your income or subject to tax.

RETURNS AND RECORDKEEPING

If a scholarship is tax-free and your child has no other income, the award doesn't have to be reported on a tax return. However, any portion of an award that's taxable as payment for services is treated as wages. Estimated tax payments may have to be made if the payor doesn't withhold enough tax.

Your child should receive a Form W-2, "Wage and Tax Statement," showing the amount of these wages and the amount of tax withheld. Any portion of the award that's taxable must be reported, even if no Form W-2 is received.

BASIC RULES

These are just a few of the basic rules. Other rules and limitations may apply. For example, if your child's scholarship is taxable, it may limit other higher education tax benefits to which you or your child are entitled. As we approach the new school year, best wishes for your child's success. Please contact us if you wish to discuss this or any other tax matter. ■

TAX CALENDAR

July 10

Employees must report June tip income of \$20 or more to employers (Form 4070).

July 31

Employers must report income tax withholding and FICA taxes for second-quarter 2023 (Form 941) and pay any tax due.

July 31

Employers must file a 2023 calendar-year retirement plan report (Form 5500 or Form 5500-EZ) or request an extension.

August 1

Employers must file Form 941 for the second quarter (August 10 if all taxes are deposited in full and on time). Also, employers must deposit FUTA taxes owed through June if the liability is more than \$500.

August 10

Employees must report July tip income of \$20 or more to employers (Form 4070).

August 15

If the monthly deposit rule applies, employers must deposit the tax for payments in July for Social Security, Medicare, withheld income tax and nonpayroll withholding.

September 11

Employees must report August tip income of \$20 or more to employers (Form 4070).

September 15

Third-quarter 2023 estimated tax payments are due for individuals, calendar-year corporations, estates and trusts, as follows:

- Calendar-year corporations must pay the third installment of 2023 estimated income taxes,
- Calendar-year S corporations must file a 2022 income tax return (Form 1120-S) and pay any tax, interest and penalties due if an automatic six-month extension was filed,
- Calendar-year S corporations must make contributions for 2022 to certain employer-sponsored retirement plans if an automatic six-month extension was filed, and
- Calendar-year partnerships must file a 2022 income tax return (Form 1065 or Form 1065-B) if an automatic six-month extension was filed.

September 30

Calendar-year trusts and estates on extension must file their 2022 Form 1041.

ESTIMATED TAX PAYMENTS: WHO OWES THEM AND WHEN?_

If you don't have enough federal tax withheld from your paychecks and other payments, you may have to make estimated tax payments. This is the case if you have taxable income from sources such as interest, dividends, self-employment, capital gains or other income. Here are the applicable rules for paying estimated tax without triggering the penalty for underpayment.

Individuals must pay 25% of a "required annual payment" by April 15, June 15, September 15 and January 15 of the following year to avoid an underpayment penalty. If one of those dates falls on a weekend or holiday, the payment is due on the next business day. So the third installment for 2023 is due on Friday, September 15. Payments are made using Form 1040-ES and may be made electronically or on paper.

The required annual payment for most individuals is the lower of 90% of the tax shown on the current year's return or 100% of the tax shown on the return for the previous year. However, if the adjusted gross income on your previous year's return was more than \$150,000 (\$75,000 if you're married filing separately), you must pay the lower of 90% of the tax shown on the current year's return or 110% of the tax shown on the return for the previous year.

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Most people who receive the bulk of their income in the form of wages satisfy these payment requirements through the tax withheld by their employers from their paychecks. Those who make estimated tax payments

generally do so in four installments. After determining the required annual payment, divide that number by four and make four equal payments by the due dates.

But you may be able to use the annualized income method to make smaller payments during part of the year. This method is useful to people whose income flow isn't uniform over the year, perhaps because the business is seasonal. For example, if your income comes exclusively from a business operated in a resort area during June, July and August, you may not have to make an estimated payment or as large a payment for the first two installments as you make for the last two. Contact us with questions you may have about how the estimated tax rules apply to you. ■