TAX SMART ADVICE FOR LAID OFF CLIENTS AND FRIENDS

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You know, when business appraisers like us at Abo Cipolla Financial Forensics prepare valuation reports, we typically analyze the subject company's position considering the national, regional, state and local economy and the industry in which it finds itself. Whoda thought assisting business clients with PPP loans, tax planning for 2021 and addressing 2020 tax returns would be a nice respite from dealing with the fragile economic blight before us? Well, working on a business valuation this past weekend, we just researched the most recent available economic and job date from July 2020. Oy!

Fresh reports of layoffs abound, and the unemployment rate continues to climb. It's now hovering at 10% in quite a few states, almost triple its level before the pandemic. The November 2020 statistics cited for states where we see most of our clients focused are even more disheartening although lower than we witnessed in July 10.2% in New Jersey 6.6% in Pennsylvania 11.3% in Florida 8.2% in California and 11% in New York. Alas, some of Abo and Company friends and clients will probably be on the receiving end of the dreaded pink slip. Job cuts are coming just as pandemic assistance expired.

Perhaps we all can be diligent in alerting the newly laid off to seek advice as they are likely to trip themselves up by taking ill-advised actions that trigger income tax liabilities. Feel free to pass this email alert along to those who are not in touch with seasoned CPA like us.

With cash already scarce, owing extra taxes just makes things worse. The sad thing is, these extra tax bills can often be avoided with a little planning. That's why it's important for those so hit to stay in touch with professionals, so they know what's going on before damage has been done.

We here at Abo and Company are not trying to cast a shadow of doom and gloom but we wanted to give some basic financial planning and tax-avoidance tips for clients recently laid off, those self-employed who had to shut down and those who suspect they will be laid off soon. Let's start with the latter group, since they have a lot more flexibility.

WHAT AT-RISK CLIENTS SHOULD DO IN ADVANCE OF GETTING CANNED

This is obvious advice, but some people react to expected bad news by doing the exact opposite. They go on spending sprees to make themselves feel better. But, when the bills come due, they will feel a whole lot worse. So, the at-risk client is well counseled to postpone spending money on things not strictly necessary.

Keep Creditors Happy. A good credit report and the resulting access to additional credit will come in very handy if the anticipated layoff materializes. You should not be afraid to put necessary expenses on credit cards to build up a cash reserve.

If the layoff occurs, the cash reserve provides a margin for error, and the credit card balances can be paid off over an extended period. The key point here is to put only necessary expenses that would be incurred on the credit cards.

Arrange Additional Credit (When Possible). Lining up new credit can be challenging in a stingy lending environment, and it may be nearly impossible for some clients, but it will be downright impossible for just about anyone who has just lost a job. The client should consider a Home Equity Line of Credit (HELOC), if available. While HELOCs may be harder to obtain too (lenders will often impose an 80% loan-to-value limit), they are still available to many individuals who bought their homes quite a while ago and who have not already overindulged in borrowing against them. HELOC interest rates are reasonable for borrowers with good credit. Time to put the Abo tax hat on but we should remind you that individuals can generally no longer deduct the interest on the first $100,000 of home equity indebtedness, including a HELOC, as you could before the December 2017 tax act. Different rules might apply regarding deductibility if the proceeds are used to purchase or improve your property (considered acquisition indebtedness).

Observation: Compared to a traditional home equity loan (second mortgage), the HELOC alternative is often preferred because you can borrow against your home equity on an "as needed" basis rather than taking out a larger lump-sum loan. Alas, a line of credit is revocable, just like a credit card, if your financial situation worsens or your home's market value declines, your lender could lower your credit line or close it altogether.

Refinance the Home (When Possible). In the best-case scenario, you can reduce your mortgage interest rate plus arrange for a new loan that is larger than the existing mortgage. You can then add the excess proceeds from the new loan to your cash reserve. Exceeding the new loan principal over the old loan balance is treated as a home equity loan for federal income tax purposes and you generally cannot deduct all the interest.

Get Overdraft Protection (When Possible). Your next stop should be to go to the bank to arrange for overdraft protection and an unsecured line of credit.

Borrow from the IRS (When Possible). Next, let's say you are a laid off contract worker considered self-employed for tax purposes. Here, you can effectively borrow from the IRS. How? By underpaying or suspending estimated tax payments for a period of time. The only cost of this strategy is the underestimation penalty/interest factor, which is currently 5% (subject to quarterly adjustment). The catch: you must then catch up on your estimated payment obligations by 4/15/21. Otherwise, the IRS will impose the .5% per-month failure to pay penalty, on top of the interest/underpayment penalty charge. So, this "borrow from the IRS" strategy should be only a short-term solution to cash flow woes, and you should obviously avoid getting in too deep. Note this strategy can also be helpful if your spouse earns income from self-employment activities.

Tap Other Available Credit Sources. These can include informally arranging with relatives. You should understand the only reason for building up your borrowing power is to create a margin for error. The enhanced borrowing power must not be used to finance unnecessary expenditures.

COUNSEL FOR OUR RECENTLY LAID OFF CLIENTS AND FRIENDS

Now let's talk about advising those who have been laid off. One big goal here is to prevent you from making the situation even worse by inadvertently or impulsively taking actions that result in otherwise avoidable tax liabilities.

Arrange Additional Credit (When Possible). Explore any opportunities to expand your borrowing power (see the preceding discussion) making no misrepresentations on credit applications. This is more likely to be possible when the spouse is still employed. A client with much home equity may still arrange a HELOC or second mortgage, regardless of employment status. The "borrow from the IRS" strategy explained earlier may also be available. Borrowing from relatives may also be an option.

Make Tax-smart Retirement Account Rollovers. Next up is deciding what to do with your qualified retirement plan account(s) with your former employer. You may be sorely tempted to withdraw all your money in a lump sum. Depending on the size of the distribution(s) and 2020 income from other sources, the following negative tax effects may result.

- You may be pushed into higher tax brackets.
- You may lose out on various AGI (Adjusted Gross Income)-sensitive tax breaks.
- If you are under age 55, you may owe the 10% premature withdrawal penalty, unless one exception for early payouts from qualified retirement plan accounts applies.

The CARES Act provides for expanded distribution options and favorable tax treatment for up to $100,000 of coronavirus-related distributions from eligible retirement plans (certain employer retirement plans, such as section 401(k) and 403(b) plans, and IRAs) to qualified individuals, and special rollover rules regarding such distributions. It also increases the limit on the amount a qualified individual may borrow from an eligible retirement plan (not including an IRA) and permits a plan sponsor to provide qualified individuals up to an additional year to repay their plan loans. Still, you may be well-advised to roll over your retirement plan money tax-free into an IRA. This allows you to take over management of the retirement funds, while continuing to defer taxes until IRA withdrawals are taken.

If the IRA rollover option is selected, be sure to arrange for a direct or "trustee-to-trustee" transfer from your qualified retirement plan account into the rollover IRA. This involves making a transfer directly from the company plan account into the IRA or having the distribution check made payable to your IRA custodian or trustee. If the distribution check is instead made payable to you personally, 20% of the taxable distribution amount will be withheld for federal income taxes.

Because 20% of the payout is now missing in action, you cannot make a totally tax-free IRA rollover unless you can somehow scrounge up the 20% shortfall and get that amount into the rollover IRA within 60 days. Obviously, this will often be very difficult for a person who has just become unemployed. Failure to roll over the missing 20% means you will owe income taxes on that amount, and possibly the 10% premature withdrawal penalty.

Someone who is age 55 or older (when laid off) may need to access some of his or her retirement account money between the layoff date and attaining age 59 1/2. In this scenario, rolling over all the qualified retirement plan money into an IRA can cause a significant tax problem. While qualified plan distributions to participants who separate from service after attaining age 55 are exempt from the 10% premature withdrawal penalty, this exemption doesn't apply to withdrawals from IRAs. Therefore, once your retirement account money has been rolled into an IRA, it's hard to get the money back out before age 59 1/2 without getting socked with the 10% penalty. So, if there is an immediate critical need for some of the retirement plan money, keep some outside the rollover IRA and roll over the rest. The taxable plan distribution not rolled over will be subject to income tax, but not the 10% penalty.

Another way to avoid the 10% premature withdrawal penalty for pre-age 59 1/2 IRA distributions is to arrange for "annuity-like" IRA withdrawals. (This can work for anyone under age 59 1/2.) These are so-called substantially equal periodic payments. "Annuitizing" the IRA to liberate some much-needed cash may the tax-smart thing to do. However, once the annuitization program has commenced, you must stick with it for at least five years or until age 59 1/2, whichever comes later.

Appeal Property Tax Assessments. Anecdotal evidence indicates that many homeowners are being hit with property taxes on inflated assessed values nowhere close to the truth. Often, it is relatively easy to appeal property tax assessments, and doing so could save your client hundreds, or maybe even thousands, of dollars. If you own one or more rental properties, the potential savings are even greater. This is not necessarily something that we as accountants at Abo and Company to be directly involved with. A laid off client should have time to do it for yourself but feel free to call if you need us to recommend an attorney well versed in this arena. Strict deadlines usually apply to property tax appeals.

Sell the House (When Possible). Here's a final, relatively drastic, measure for the laid off client to contemplate. Sell the house. When you have substantial equity and the home-sale gain exclusion break is available (i.e. $500,000 on a joint return), the result can be a large chunk of federal-income-tax-free cash. At the appropriate point in time, that becomes something to think about. In theory, selling a vacation house should be easier to swallow, and this will often be a very sensible thing to consider in today's lousy economy. However, the Section 121 gain exclusion break will generally not be available for a vacation home. Rats!

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