August 2016

Volume 8, Issue 1

Leslie A. Cesario, Ltd.
Monthly Newsletter

Employer Offered You Health Insurance but You Got Yours through the Marketplace. You May Be in for an Unpleasant Surprise!

Article Highlights:

- Premium Tax Credit
- Employer "Offer" of Insurance
- Affordable
- Denial of Premium Tax Credit
- Form 1095-C

One of the key provisions of Obamacare is the premium tax credit (PTC), which serves as a subsidy for the cost of health insurance for lower-income individuals and families. Although the credit is determined at the end of the year based upon income, taxpayers are allowed to estimate their income and receive the credit in advance, thereby reducing their premium costs.

Another key provision of Obamacare requires large employers to offer full-time employees affordable healthcare insurance. The term "affordable" means that the employee's insurance costs less than 9.66% (2016 percentage) of the employee's household income. In addition, because the government wants to limit its outlay for the PTC, the law denies PTC to employees who are offered affordable healthcare insurance by their employer.

This is where a potential problem arises! Quite often, the cost of insurance subsidized by the advance PTC obtained through the Marketplace is substantially less costly than the "affordable" insurance offered by the employer; as a result, the employee will instead obtain the less expensive insurance through the Marketplace, while not realizing that they are not entitled to the PTC because the employer offered them "affordable" insurance.

Prior to 2015, the government had no way of determining who was offered "affordable" insurance by their employer and therefore was unable to enforce the "no PTC rule." However, beginning in 2015, employers with 100 or more equivalent full-time employees were required to file the new Form 1095-C, which shows month-by-month when an employee was offered "affordable" healthcare insurance. Generally, the employer is required to furnish a copy of Form 1095-C (or a substitute form) to the employee. Beginning in 2016, even employers with 50 or more equivalent full-time employees are required to file 1095-Cs.

The IRS will begin matching the information on the 1095-Cs that the employers have filed with taxpayers who claimed the PTC for months during which they were also offered "affordable" insurance by their employer. Those taxpayers will be receiving notices from the IRS requiring them to repay the premium tax credit for the months when they were offered affordable care.

If you are concerned that you claimed the PTC and might be subject to repayment, you can look at your copy of Form 1095-C from your employer. Check line 14 and see if there are entries in any of the months. The entries will be codes, which are explained on the reverse of the form.

If you need assistance or additional information related to Form 1095-C and its impact on the PTC, please give this office a call.

Are You a Non-Filer? Ready to Escalate Problems with the IRS?

Article Highlights:

- Non-Filers
- IRS Information Reporting
- IRS Prepared Substitute Return
- Notice of Deficiency
- Tax Court Appeal
- Liens and Levies

There are millions of individuals who do not file a tax return each year, many of them simply because their income is below the filing threshold levels for the year based upon their filing status.

Still others simply procrastinate and risk forfeiting their rightful refunds, including earned income tax credits, child tax credits, tuition credits and excess withholding.

Then there are others who believe they owe, whether they actually do or not, and don't file because they think they can't pay what they owe. Not filing on time and owing money can result in a 5% per month (maximum 25%) failure-to-file penalty, plus failure-to-pay penalties and statutory interest in addition to what is owed. It does not make sense to incur unnecessary penalties, especially when the IRS has payment options and, in certain hardship situations, compromise options that may apply.

If you are in the situation just described and think the IRS is not aware of you, think again. The IRS information reporting system knows a lot more about you than you might imagine. Here is just a short list of items that get reported to the IRS's computer and added to your file:

- W-2s for wages filed by employers.
- W-2Gs for wagering winnings from racetracks, casinos, poker parlors, etc.
- 1099-MISC forms from businesses you have contracted with.
- 1099-INT and 1099-DIV showing interest and dividends earned from financial accounts.
- 1099-B forms showing the gross proceeds from the sales of securities.
- 1099-K forms showing the credit card transactions for your business.
- 1099-S forms reporting the gross proceeds from sales of real estate.
- K-1s from businesses and trusts you are connected with.
- Form 8300 transaction forms from banks showing large transactions.
- The list goes on and on.

So what does the IRS do with all this information when you haven't filed a return? Well, if the gross income is enough that they believe you have a filing requirement, the IRS will prepare a substitute return for you based upon the information they have.

This is when things can get really nasty, because the substitute return is based solely on the income reported to the IRS without the benefit of exemptions, itemized deductions, any of the many credits to which you may be entitled, or cost basis for any property or assets sold. In addition, the substitute return will treat you as married filing separate (the filing status for which the higher tax rates kick in quicker).

Along with the substitute return, you will generally receive a notice of statutory deficiency (commonly referred to as a 90-day letter), which will give you 90 days to file an appeal with the Tax Court. At this point things really get expensive because you will need a tax attorney to handle the appeal. If you ignore the 90-day letter or the 90 days run out, the tax assessment becomes final and the IRS can institute liens and levies. Then life really gets miserable. Your credit rating will take a nosedive, liens will be put on your property, and wages and refunds will be attached.

Although there are further remedies, they are increasingly expensive in terms of legal costs. Don't let things escalate to this point; give this office a call so we can get your past returns filed before you start receiving notices from the IRS. If you've already received notices and have been ignoring them, gather them up in chronological order and bring them to the office so we can figure out the next steps required. If you have lost or misplaced past years' records, we can order a transcript from the IRS that includes the information reported from various sources for each unfiled year. There are even ways to get penalties waived.

Tax Consequences of Losing Your Job

Article Highlights:

- Severance Pay
- Unemployment Compensation
- Health Insurance
- Employer Pension Plan
- Job Search Expenses
- Moving Expenses
- Home Sale

If you have lost your job, there are a number of tax issues that you may encounter. How you deal with these issues can profoundly impact both your taxes and your finances. The following are typical issues along with their tax treatment:

Severance Pay – Your employer may provide you with severance pay. Severance pay and payment for unused vacation time will be included in your W-2 income, and both are fully taxable.

Unemployment Compensation – If you do not find another job right away, you generally will qualify for unemployment compensation. Unemployment benefits are taxable for federal purposes and may or may not be taxable by your state of residence.

Heath Insurance – When you lose your job and you had health insurance through your employer's group health coverage plan, you will need to determine your available options for continued coverage via COBRA or a replacement policy. If you give up coverage, you may be subject to Obamacare penalties for not being insured.

- *COBRA* Coverage - The Consolidated Omnibus Budget Reconciliation Act (COBRA) requires continuation coverage to be offered to covered employees, their spouses, former spouses, and dependent children when group health coverage would otherwise be lost. COBRA continuation coverage is often more expensive than the amount that active employees are required to pay for group health coverage because the employer usually pays part of the cost of employees' coverage, whereas 102% of the total cost can be charged to individuals receiving continuation coverage (the extra 2% covers administration costs). COBRA generally applies to private-sector employers with 20 or more employees and state or local governments that offer group health coverage to their employees. In most cases COBRA coverage is limited to 18 months.
- *Obamacare* – When existing health coverage is lost, a family may enroll in Obamacare through a government health insurance Marketplace outside of the normal enrollment window. In addition, depending upon your income for the year, you may qualify for the premium tax credit for the part of the year when you don't have coverage through your employer, which will help pay for the insurance.

Employer Pension Plan – Depending upon the provisions of your employer's pension plan, you may be able to leave your retirement funds in the employer's plan or have the option of moving the funds to your IRA account. You can have the funds transferred to your IRA or take a distribution and roll it into your IRA within 60 days. However, this is where a tax trap exists; for a distribution, the employer is required to withhold 20% for federal taxes, meaning only 80% of the funds will be available to roll over and the remaining 20% will end up being taxable unless you can make up the difference with other funds.

In the event you should ever want to roll those funds into a new employer's retirement plan, those retirement distributions should not be comingled with other IRA accounts.

Should you be tempted not to roll the funds over, be aware that the distribution will generally be taxable, and if you are under the age of 59.5 there will also be a 10% early withdrawal penalty.

Job Search Expenses – Expenses incurred while looking for a new job in your ***current occupation*** are deductible, even if a new job is not obtained. Examples of eligible expenses include:

- Fees you pay to employment and outplacement agencies and for career counseling.
- Resume preparation costs, such as typing, printing and mailing.
- Travel and transportation expenses if the trip is primarily to look for a new job. Even if the travel expenses to an area aren't deductible because job search wasn't your primary reason for the trip, the expenses looking for work in the area are allowed.

Moving Expenses – If you end up moving to obtain employment, you may qualify to deduct your moving costs, which generally include shipping, moving van, truck rentals, packing, insurance and in-transit storage. To qualify, the distance from your former home to your new work site must be at least 50 miles further than the distance from your old home to your old job, and you must work in the new location for 39 of the first 52 weeks in the new location.

Home Sale – If you relocate and have to sell your home and have owned and occupied the home as your primary residence for 2 of the previous 5 years, you will be able to exclude up to $250,000 of the gain ($500,000 if you are married and both you and your spouse qualify for the exclusion). If you do not meet the 2-out-of-5-years qualifications because you have lost your job, you will be allowed a prorated gain exclusion.

As you can see, there are a number of issues that may apply when a job loss occurs. To learn more about how these issues might affect your particular situation, please give this office a call.

Married to a Non-U.S. Citizen?

Article Highlights:

- Worldwide Income
- Filing Status
- Resident Alien Spouse
- Non-resident Alien Spouse
- Undocumented Alien Spouse
- Substantial Presence Test

With modern transportation the world continues to shrink, and it is increasingly common for a U.S. citizen to marry someone from another country who is not a U.S. citizen. If this describes your marital circumstances, there are some special tax filing issues you will have to deal with. Based on your particular situation, the filing issues could be very complicated or straightforward. But in either case, someone knowledgeable with non-U.S. citizen issues should complete the preparation of your return.

There are two important tax principles that apply in all situations:

- U.S. citizens are taxed on worldwide income, and

- If you are married, you must either file jointly with your spouse, file as a married person filing separately or file as head of household if you otherwise qualify.

The next issue is the status of your non-U.S. citizen spouse, which dictates how you are taxed. Although there may be certain special situations, the status of your non-U.S. citizen spouse is generally one of the following:

A permanent resident of the U.S.– A permanent resident, also referred to as a green card holder, is taxed in the same manner as a U.S. citizen, so there are no special filing requirements and the return, or returns if filing separately, are prepared in the same way and under the same rules as they would be if you were married to a U.S. citizen.

A non-resident alien – A non-resident alien is someone who is not a U.S. citizen and who has not met the requirements to have a green card (which would give the non-U.S. citizen the privilege, according to immigration laws, of residing permanently in the United States as an immigrant) or who hasn't been in the U.S. long enough to meet the substantial presence test described later. Often a non-resident alien resides outside of the U.S. If you are married to a non-resident alien, you generally have the following two filing options:

- File as a married individual filing separately or head of household **if you have provided over half the costs of keeping up a home for a qualifying individual and you have not made the election described next to treat your spouse as a resident alien, or**
- Elect to file jointly with your non-resident alien spouse, effectively treating the spouse as a resident alien for tax purposes. However, this election is binding until revoked, and both spouses must affirmatively agree to the election. Once the election is made, the joint U.S. tax return must include the worldwide income of both spouses.

An undocumented alien – If you are married to an undocumented alien, there are two possible situations:

- **Spouse meets the substantial presence test** – An individual who meets the substantial presence test is taxed in the same manner as a U.S. citizen or resident alien, so there are no special filing requirements and the return, or returns if filing separately, are prepared in the same way as when married to a U.S. citizen or resident alien.

To meet the substantial presence test, your spouse must have been physically present in the United States on at least 31 days during the current year and 183 days during the 3-year period that includes the current year and the 2 years immediately before it, counting all the days present in the current year, 1/3 of the days present in the first year before the current year, and 1/6 of the days present in the second year before the current year.

- **Spouse does not meet the substantial presence test** – If the spouse does not meet the substantial presence test, the spouse is treated as a non-resident alien, as discussed previously.

Where your spouse is a non-resident alien and has U.S. source income and does not elect to file jointly with you, then your spouse must file a Form 1040NR to pay the taxes on the U.S. source income, generally at a flat rate of 30%.

If you reside in a foreign country with your non-U.S. citizen spouse, that does not exempt you from U.S. taxes. As was noted at the beginning of this article, U.S. citizens are taxed on worldwide income.

There are provisions that help shield you from double taxation, such as an exclusion of foreign earned income (limited each year to an inflation-adjusted amount, $101,300 for 2016), a foreign tax credit (not available on the same foreign income that is excluded), and provisions spelled out in the tax treaties between the U.S. and foreign countries.

These and other nuances encountered when you are married to a non-U.S. citizen need to be addressed based upon your particular circumstances. Please contact this office for assistance.

Have Fewer Than 50 Employees? Here is How the Health Care Act Affects You

Article Highlights:

- Under the 50-Employee Threshold
- Determining the 50-Employee Threshold
- Full-Time Employee
- Equivalent Full-Time Employees
- Information Return Requirements
- SHOP Marketplace
- Small Business Health Care Credit

When Congress came up with the Affordable Care Act (ACA), they carved out two basic categories of businesses, those with 50 full-time employees and/or full-time equivalent employees (FTEEs) and those with fewer than 50 employees. Under the ACA, businesses in the first category have a requirement to offer affordable insurance to their full-time employees and their dependents. If you are an employer with fewer than 50 full-time employees or FTEEs, you are not subject to the insurance requirement, but there are still some ACA issues you need to be aware of.

First of all, you need to make sure you are in the under-50 category, because the penalties can be backbreaking if you aren't and you didn't offer affordable health coverage. Determining if your business meets or exceeds the 50-employee threshold requires maneuvering through lots of special rules, and not all of these intricacies can be covered in this article.

Generally, the 50-employee threshold is determined by adding together the number of full-time employees and the total number of full-time equivalent employees for each calendar month of the prior calendar year and dividing that total number by 12.

Full-time employees are generally those working 30 hours or more per week, and the number of FTEEs is determined by dividing all the hours worked by part-time employees for the month by 120. In addition, certain employees, such as seasonal employees, are excluded from the count. If you have any doubt whether you are under the 50-employee threshold, please call this office for assistance.

If you are under the 50-employee threshold, you are not subject to any ACA information reporting that is required of larger employers—with one exception. If you provide insurance and you are self-insured, then you are required to annually file a Form 1094-C along with a 1095-C for each employee.

If you wish to provide insurance to your employees, even though you are not required to since you are under the 50-employee threshold, you are allowed to purchase health insurance coverage through the Small Business Health Options Program, better known as the SHOP Marketplace. Even though purchased through the Marketplace, this type of group coverage does not qualify your employees for the premium tax credit subsidy they might otherwise be entitled to if they acquired coverage directly from the individual policy Marketplace.

As an enticement for employers that have fewer than 25 FTEEs with average annual wages of less than $50,000 to provide health insurance to their employees, the ACA added a small business health care tax credit. To qualify, the business needs to purchase the health insurance through the SHOP Marketplace and cover at least 50 percent of their full-time employees' premium costs. However, this credit applies for only 2 years, after which time the employer will receive no further financial assistance from Uncle Sam. A recent General Accounting Office report noted that far fewer small businesses were taking advantage of the credit than expected by Congress.

If you have questions, need assistance in determining whether you meet the 50-employee threshold, or would like to determine the benefit of the small business health care tax credit, please give this office a call.

Combining a Vacation with a Foreign Business Trip? Here Are Some Tax Pointers

Article Highlights:

- Primarily Business
- Primarily Vacation
- Special Circumstances
- Foreign Conventions, Seminars and Meetings
- Cruise Ships
- Spousal Travel Expenses

When an individual makes a business trip outside of the U.S. and the trip is 100% devoted to business, all of the ordinary and necessary business travel expenses are deductible, just as if the business trip were within the U.S.

On the other hand, if the trip also incorporates a vacation, special rules determine the deductibility of the travel expenses to and from the destination; when the other business travel expenses, such as lodging, meals, local travel and incidentals, can be deducted; and when they must be allocated. So, whether you are just visiting one of our neighboring countries or traveling to Europe or even more exotic locales, here are some travel tax pointers:

Primarily Vacation - If the travel is primarily for vacation and only a few hours are spent attending professional seminars or meeting with foreign business colleagues, none of the expenses incurred in traveling to and from the general business location are deductible. Other travel expenses must be allocated on a day-by-day basis, and only the business portion is deductible.

Primarily Business - If the trip is primarily for business and meets one of the conditions listed below, the expenses incurred in traveling to and from the business destination are deductible in full (same as for travel within the U.S.).

(1) The travel outside the U.S. is for a period of one week or less (seven consecutive days, excluding the departure day but including the day of return). In addition, all other ordinary and necessary travel expenses are fully deductible.

(2) Less than 25% of the total time outside the U.S. is spent on non-business activities. In addition, all other ordinary and necessary travel expenses are fully deductible. (If 25% of more of the total time is spent on non-business activities, a day-by-day allocation of all travel expenses between personal and business activities is necessary and only the business portion is deductible.)

(3) The individual incurring the travel expenses can establish that a personal vacation or holiday was not a major consideration. In addition, all other ordinary and necessary travel expenses are fully deductible.

(4) The taxpayer did not have “substantial control” over arranging the trip. In addition, all other ordinary and necessary travel expenses are fully deductible.

When determining what constitutes business and non-business time, business days include: days en route to or from the business destination by a reasonably direct route without interruption; days when actual business is transacted; weekends or standby days that fall between business days; and days when business was to have been transacted but was canceled due to unforeseen circumstances.

Nonbusiness days are days spent on nonbusiness activities as well as weekends, holidays and other standby days that fall at the end of the business activity, if the taxpayer remains at the business destination for personal reasons.

Foreign Conventions, Seminars or Meetings – Tax law does not permit a deduction for travel expenses to attend a convention, seminar or similar meeting held outside of the North American area unless the taxpayer establishes that:

(1) The meeting is directly related to the active conduct of the taxpayer’s trade or business, **and**

(2) It is “as reasonable” for the meeting to be held outside of the North American area as it is within the North American area.

The IRS defines “North American area” quite broadly and includes not just the U.S., Canada and Mexico, as you would expect, but also Bermuda, several countries in the Caribbean basin, U.S. possessions such as American Samoa and other Pacific island nations, and some Central American countries as well.

Cruise Ship Conventions – In order for a taxpayer to deduct the cost of attending a convention related to his or her trade or business on a cruise ship, the ship must be a U.S. flagship, and all the ports of call must be within the U.S. or its possessions. In addition, the maximum deduction is limited to $2,000 per attendee. Substantiation requirements include certain signed statements by the both the taxpayer and an officer of the convention sponsor.

Spousal* **Travel Expenses** – Generally, deductions are denied for travel expenses for a spouse, dependent or employee of the taxpayer on a business trip unless:

1. The spouse is an employee of the taxpayer, and
2. The travel of the spouse, etc., is for a bona fide business purpose, **and**
3. The expenses would otherwise be a deductible business travel expense for the spouse.

**These rules also apply to a dependent or employee of the taxpayer.*

However, the law allows a deduction for the single rate for lodging on qualified business trips, and frequently, there is no rate difference between one and two occupants. Thus, virtually the entire lodging expense for an accompanying spouse will be deductible. When traveling by car, the law does not require any allocation because the spouse is also traveling in the vehicle. Thus, if traveling by vehicle, the entire cost of the business-related transportation would be deductible. This would generally also apply to taxis at the destination.

As you can see, determining the tax deduction for a foreign business trip that is combined with a vacation can be complicated. If you need additional tax guidance or help planning such a trip, please give this office a call.

Taxation of Employee Stock Options

Article Highlights:

- Employee Stock Options
- Stock Option Terminology
- Incentive Stock Options
- Non-qualified Stock Options
- Tax Strategies

If you are an employee of a corporation, the company may offer you the option to purchase shares of the corporation at a fixed price at some future date so that you can benefit from your commitment to the success of the company by sharing in the company’s growth through the increase in stock value.

There are generally two types of stock options: qualified, also referred to as incentive stock options (ISOs), and non-qualified. The taxation of the two can be quite different.

In case you are not familiar with the terminology used in employee stock option plans, here’s a rundown. The option price is the price the company sets as the cost you would pay for a certain number of shares should you decide to purchase the stock (exercise your option); this price will apply even if the stock is trading at a higher value when purchased. The opportunity to exercise the option is often limited to a specific time period in the future. The trading price at the time you purchase the stock is considered the fair market value (FMV) of the stock at the time you purchase it. You may even be granted (awarded) options at different prices and on different exercise dates.

- *Incentive Stock Options* - The big advantage of ISOs is the special tax treatment that permits delayed taxation of the difference between the exercise price and the FMV and allows the employee to benefit from long-term capital gains rates when the shares are ultimately sold. However, for that to happen, the stock must not be sold before 2 years have elapsed between the time the option was granted and the sale of the stock, and the stock must be held for more than one year after exercising the option.

There is a downside to ISOs. For alternative minimum tax (AMT) purposes, the difference between the exercise price and the FMV of the stock is considered a preference item, and although it is not taxable for regular tax purposes, it is included in AMT income in the year of the exercise. When the difference between the exercise price and the FMV of the stock at exercise is significant, it will trigger the AMT.

The AMT is generally a punitive method of computing income tax that does not allow some of the tax preferences and deductions that are allowed for the regular tax computation. When an AMT computation results in a higher tax, the higher tax applies. This can sometimes outweigh the benefits of ISOs. However, an AMT credit may be created to reduce the employee's tax in a future year. Unfortunately, using this credit applies only to years when there is an AMT, so its benefit is limited.

- *Non-qualified Options* - For non-qualified options, the difference between the exercise price and the fair market value (FMV) of the stock at the time the option is exercised is treated as ordinary income to the taxpayer in the year of the exercise, and for employees, this amount is generally included as income on their W-2. Even though the income is included on the employee's W-2, the stock sale generally still must be reported on Schedule D and sometimes will result in a loss when the employee has incurred sales costs or the purchase and sale were not simultaneous and have resulted in a gain or loss because of market fluctuations.

Where the option was an ISO, it may be appropriate to avoid the AMT in the year of exercise by selling the stock in the same year. Doing so means the difference between the exercise price and the FMV of the stock will be treated as ordinary income so that the income is the same for regular and AMT purposes; this eliminates the AMT preference for the year. The decision to sell the stock in the year the ISO is exercised or to hold it for long-term capital gain rates requires careful analysis to determine which is the best course of action.

Alternatively, when doing so is beneficial, the taxpayer can exercise an ISO option in small blocks over a period of years, thus avoiding or minimizing the AMT and taking advantage of long-term capital gain rates.
If you have options from your employer and need assistance with the tax ramifications of your particular situation or wish to plan a strategy to excise and sell the stock from options while minimizing the tax, please contact this office.

Win an Employment Lawsuit? Here Are the Good and Bad Tax News

Article Highlights:

- Physical Injury and Physical Sickness
- Wrongful Death
- Emotional Distress
- Previously Deducted Medical Expenses
- Employment Discrimination
- Age Discrimination
- Unpaid or Disputed Employment Earnings
- Interest
- Settlements
- Legal Costs

The tax laws related to the taxability of monetary settlements and damage awards as the result of employment legal actions are often complex and sometimes seemingly discriminatory. The actual taxation of the award is primarily based on the following factors:

- The nature of the legal action,
- Whether a settlement occurred before trial, and
- How the legal costs were handled.

Nature of the Legal Action – Generally, all monetary awards as the result of an employment-related legal action are fully taxable, with one exception. Under the exception, the tax code allows an exclusion from gross income for damages received due to a personal physical injury or a physical sickness. Consequently, when a lawsuit is based on a physical injury or sickness, all damages (other than punitive damages, which are always taxable) flowing from that suit are treated as payments received due to a physical injury or sickness, and are therefore excluded from income. This is true whether or not the recipient of the damages is the injured party. Here are some commonly encountered situations and their taxability:

- *Wrongful Death* – Wrongful death is considered physical injury or physical sickness for purposes of the income exclusion. In addition, punitive damages are excludable where state law provides that only punitive damages can be awarded in wrongful death suits.
- *Emotional Distress* - Emotional distress isn't considered physical injury or physical sickness for purposes of the income exclusion. However, the exclusion from gross income does apply to the amount of damages received for emotional distress that is attributable to a physical injury, but not in excess of the amount paid for medical care related to emotional distress.
- *Previously Deducted Medical Expenses* – Even though awards for physical injury or physical sickness are excludable, if any part of the award received is compensation for medical expenses deducted in a prior year, that portion of the award must be included as income, up to the amount of the deduction taken.
- *Employment Discrimination* - No exclusion is allowed for damages received in a suit involving employment discrimination or an injury to reputation that is accompanied by a claim of emotional distress. However, the exclusion would apply to a claim of emotional distress related to a physical injury or physical sickness.
- *Age Discrimination* - The law doesn't consider back pay or liquidated damages received under the Age Discrimination in Employment Act (ADEA) to be compensation for personal injuries; therefore, these payments are includable in income. But see the special treatment of attorney fees below.
- *Punitive Damages* – Punitive damages are made as a punishment for unlawful conduct and are always taxable; they cannot be excluded from income as damages received due to personal physical injury or physical sickness, except as noted above for wrongful death.
- *Unpaid or Disputed Employment Earnings* – Back pay, severance pay, overtime pay, etc., are all treated as W-2 type income and are both taxable and subject to payroll FICA withholding.
- *Interest* – Interest that may be included in an award, even one for personal injury or sickness, is not excludable and must be included in gross income.

Settlements – In legal actions, the plaintiff may frequently sue for both excludable and non-excludable damages. For example, an employee is injured on the job and sues for back vacation pay of $10,000 and damages for personal injury in the amount of $90,000 (a total of $100,000). If the suit is settled for $50,000 without a stipulation of how the settlement is applied, the settlement will need to be allocated in the same manner as the original suit. In this example, the settlement would be allocated $5,000 for back vacation pay (taxable) and $45,000 for personal injury (excludable).

Legal Costs – Generally, legal costs associated with employment-related legal actions can only be deducted as a miscellaneous itemized deduction on the employee's Schedule A itemized deductions. When all or some of the monetary award is excludable, the fees are prorated between the taxable and excludable award, and only the portion allocated to the taxable portion is deductible.

This is where significant tax problems are encountered because miscellaneous itemized deductions must be reduced by 2% of the employee-taxpayer's adjusted gross income (AGI), and the gross monetary award received is included in the employee's AGI, making it abnormally high. On top of that, miscellaneous itemized deductions are not even allowed for purposes of the alternative minimum tax (AMT), which is very frequently triggered in situations of this nature. This would result in the taxpayer having to include the entire monetary award in income and not being able to deduct much, if any, of the legal costs. The taxpayer, in effect, is paying taxes on just about the entire, or in some cases the total, amount, including what the attorney got.

> There is a very limited exception that allows attorney fees to be deducted above-the-line (without itemizing), thus eliminating the 2% reduction and the AMT issues. However, it only applies in connection with a claim of unlawful discrimination, certain claims against the federal government, or a private cause of action under the Medicare Secondary Payer statute.

So, before you rush out and spend any of the award money you received, you had better drop by the office and see what the government's share is, because it could be substantial. In addition, with some careful analysis, it may be possible to take actions that will reduce the tax.