



TAXWATCH

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Unemployed? Filing taxes? Here are 4 common errors

By [Eva Rosenberg](#), MarketWatch

LOS ANGELES (MarketWatch) -- Losing a job is bad enough. Unfortunately, many people only compound the problem with personal-finance moves that lead to big tax bills later.

And these missteps may get more common in the year ahead. Some expect the nationwide unemployment rate to hit 9.5% by the end of 2010. That's almost one person in 10, or at least two or three people on your block. IBM just cut 4,200 people, Caterpillar slashed 20,000 jobs, Home Depot is laying off 7,000 people, and so on.

Perhaps you'll stay lucky and keep your job this year, or your business will remain solvent, but if not, think before drawing taxable funds.

Unemployment insurance income is rarely adequate to cover basic living expenses and fixed costs, and unemployed individuals generally tap into assets with the highest tax consequences, even though other options are available, said Mike Martin, an enrolled agent and president of Mike Martin & Associates in Independence, Mo.

Often, by the time folks go to a tax professional, the damage is done, Martin said.

Here are some of the most common tax errors -- and ways to avoid them.

1. Avoiding withholding

Plenty of people opt to collect unemployment income without having federal withholding deducted. Yes, it's tempting to receive the full check. But how are you going to pay the taxes on the unemployment income in April? You won't have the money.

Have the withholding taken out, or have the discipline to set aside at least 15% of the money in a savings account you don't touch.

If you get sick while you're on unemployment, remember to switch your benefits to disability benefits. Those checks are usually higher -- and the income is not taxable.

If your prospects for getting a job look really bleak for the year ahead, consider this interesting suggestion from Doug Thorburn, a

Tax programs for tough jobs

Tax-preparation Web sites such as TurboTax Online, H&R Block Online and TaxACT will help you figure your options in a year that will see many significant changes in tax policy.

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Northridge, Calif.-based enrolled agent: See if the tax benefits of being claimed as someone else's dependent are substantial. If they are, consider halting your unemployment benefits before your total income for the year reaches \$3,500. This definitely takes some planning.

2. 401(k) withdrawals

It's almost instinctive: The first thing you do when you're out of work and need money is tap into your 401(k) plan. Why is this a bad idea? Three reasons:

One, often people draw the money thinking it qualifies for exceptions to the penalties, but the exceptions often only relate to draws from IRAs, not 401(k)s.

Two, it's very expensive money, costing as much as 50% of the amount drawn. There's the penalty of 10% from the IRS and whatever your state penalty is (not all states have penalties). Then there's the tax: 25% plus state tax. In addition, the draw increases your tax bracket and may increase your income so you lose other deductions or credits. And, you permanently deplete your retirement savings.

Three, and worst of all, when it comes time to pay the tax, you won't have the money. You will start a pattern of tax debt overshadowing your life and finances for the next two to 10 years.

What is a viable alternative? There are two options.

One, if there is a lot of money in the account, you can roll the money into an IRA and set up withdrawals allowing you to take substantially equal periodic payments (monthly or annually) over your life expectancy. You will pay taxes on the money -- consider this a replacement for your wages - but you will avoid IRS and state early withdrawal penalties. [See this IRS page for more information on periodic payments.](#)

Two, start a business. With so many people unemployed right along with you, odds are that you will not get a job quickly, certainly not one earning what you used to earn. So you may well start a business.

If you start a business designed to generate a real stream of income, you can establish a solo 401(k) plan for yourself. Meet with an expert to ensure you meet all the guidelines. If your spouse works in your business, you can establish an account for him or her as well. Then, roll over the funds from your old 401(k) to your new solo 401(k) accounts.

Now you can borrow up to 50% from each account, up to \$50,000 per person. You pay no taxes at all (perhaps under \$500 in total fees). You must repay that money - to yourself; so you will be forced to replenish your retirement account.

3. IRA withdrawals

That's usually the next step for unemployed folks. Don't just take the money as you need it, without any planning. Think through your financial needs and withdraw the money properly. There are several ways for unemployed folks to pull money from IRAs without facing those harsh early withdrawal penalties. Taxes will still apply.

As part of your planning, assess your health. If you have been just hanging on thinking you had no choice but to work, it's time to start thinking about getting your health evaluated to see if you should still be working. Some special benefits that might result? You could switch your unemployment benefits to disability benefits, which are not taxable. Or, you might qualify for Social Security disability payments, which would allow you to draw Social Security funds early.

Another possible plan: Withdraw money to cover your health insurance premiums while you're unemployed.

Or, this may be a good opportunity to go back to school and get retrained for another career or profession. Funds paid directly to a qualified educational institution will avoid the penalty. In addition, you may qualify for the lifetime learning credit or the education expense deductions. [See more about education tax breaks on this IRS page.](#)

Another possible plan: Buying a home. You may draw up to \$10,000 for the down payment of a first home (if neither you nor your spouse owned a home within the last two years). With the real-estate market so depressed, now may be a good time to buy a new home. And, not only can you get the down payment money penalty-free, if you close escrow before June 30, 2009 you may qualify for the first-time homebuyers credit of up to \$7,500. That may be enough to help you get through the year.

Heck, if you can't find any other means of gainful employment, you could live in the house for two years, fix it up and sell it or rent it out - and collect the stream of income.

4. Dumping your home

Another pitfall is walking away from a home that is worth substantially less than the loan balance. You may find yourself facing taxes on phantom income -- cancellation of debt. The rules are complicated, depending on the nature of the loan contract, and your state of residence. There may be ways around the extra taxes, using IRS' insolvency rules or by filing bankruptcy before disposing of the home.

As you may have noticed, each pitfall has ways around it - if only you stop and plan before desperately grabbing money. Sure, you need the money, time is short and you're feeling pressured. But before doing anything rash, count to 10, take a deep breath, and get some advice. Who knows, your adviser may even come up with a job, or a great idea for a business that may change your life.

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