Windfalls: Be Prepared

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First, the good news. You're the sole winner of the Powerball jackpot. Let's assume it's a cool $200 Million jackpot, and the lump-sum cash option is an even $100 Million. Now, the bad news. Swept up in the excitement of collecting your jackpot, you've neglected to contact your accountant to properly plan for the windfall and the associated taxes.

First, any lottery winning greater than $5,000 will be subject to mandatory withholding. The standard withholding for Federal Income Taxes (FIT) is 25% and 4% for Ohio Income Taxes (SIT). Therefore, assuming you've chosen the lump-sum cash payment, your net prize, after withholdings, would be $71 Million [$100,000,000 - $25,000,000 FIT - $4,000,000 SIT]. However, these withholdings are the standard withholdings for gambling winnings, and may not reflect the actual tax owed on your winnings.

With the maximum federal income tax rate currently at 39.6% and the maximum Ohio income tax rate at 5.333%, you may receive a shocking bill come April 15th. You would owe an estimated additional $14,600,000[$39,600,000 - $25,000,000] in federal income taxes and $1,333,000[$5,333,000 - $4,000,000] in Ohio income taxes. This could cause quite a shock should you fail to seek tax planning advice on your windfall. In addition to the increased taxes, you may also lose out on some of your deductions, due to income based phase-outs. For example, you may lose out on personal and dependency exemptions, higher education credits and deductions, and up to 80% of other itemized deductions, such as qualified mortgage interest, state and local income taxes, and charitable donations. The tax on the $100 Million could be as much as $44,933,000 [$39,600,000 FIT + $5,333,000 SIT], leaving you with $55,067,000. You may also have to pay a local income tax, depending on the rules for the city in which you live.

It's also important to be mindful of your generosity should you encounter a windfall. Assuming you've decided to give gifts totaling $30 Million to friends and family and ignoring the annual gift tax exclusion of $14,000, you may be surprised by yet another significant tax bill. The federal gift tax exemption is $5.43 Million, and the gift tax rate for gifts is the same as the estate tax rate of 40%. Therefore, should you give $30 Million to friends and family, your federal gift tax bill for this gift would be $9,828,000 [($30,000,000 - $5,430,000) x 40%]. This is assuming that the gifts are not structured as "net gifts", in which the recipient would owe the gift tax.

Now, should you feel compelled to include any grandkids you might have in your generosity, your gift would be subject to the generation-skipping transfer tax (GST). This tax imposes an additional tax on gifts given to family members more than a generation away. Assuming trusts are not involved and you provided your grandkids with a $10 Million gift, you would owe an estimated $1,828,000 [($10,000,000 – $5,430,000) x 40%] in generation skipping tax on the gift. Plus, you would also owe an estimated $731,200 [$1,828,000 x 40%] on the amount of tax you had paid for the original gift, since the GST paid is treated as a taxable gift. In total, should you provide your grandkids with a $10 Million gift, you'd owe an additional $2,559,200 in gift and GST taxes.

To summarize, you have just hit the Powerball and received the $100 Million lump-sum payout. After making gifts to your family, you are left with $60 Million [$100 Million - $30 Million - $10 Million]. Now, when you file your 2015 tax returns, you find you owe a total of $51,987,200 [$39,600,000 + $9,828,000 + $2,559,200] in Federal income, gift, and GST taxes and $5.333 Million in Ohio Income Taxes. After all is said and done, you're left with $2,679,800 after taxes and gifts, having only given away $40 Million.

Now, instead of having won the Powerball, let's assume you had inherited this $100 Million windfall from a close relative. Currently, the federal estate tax exemption is $5.43 Million in 2015. Assuming the relative had not diminished their lifetime exemption due to making other gifts, the estate would owe a 40% tax of approximately $37,828,000. Fortunately, Ohio's estate tax was repealed in 2013. Therefore, being an Ohio resident, your net inheritance after estate taxes would be $62,172,000 [$100,000,000 - $37,828,000]. Although, it should be noted that it is the estate that is liable for the taxes due, not the beneficiary. Nonetheless, the taxes paid would decrease the inheritance received by the beneficiary. For residents of other states, there could be a state estate and/or inheritance tax levied as well.

Another form of windfall could come from a big bonus from work or cashing in a nonqualified stock option. These amounts, while not only bumping up your federal income tax bracket, may also be subject to the additional 0.9% Medicare tax. The additional 0.9% Medicare tax applies when your combined net self-employment and wage income exceeds $200,000 if single, $250,000 if married filing joint. The additional Medicare tax is treated as other payroll taxes, and is withheld from your gross pay. So, although you won't actually have to draft a check to the Treasury, you are still paying the tax. In addition, if your portfolio income were to surge in 2015, some or all might be subject to the 3.8% net investment income tax as well.

As satisfying as being the recipient of a large windfall may be, it's important to seek proper advice and plan so as to mitigate the tax bill as much as possible. Although many taxpayers have a basic understanding of federal and state income taxes, it's important to take into account all relevant taxes to minimize your significant tax exposure.

For more information on income and gift taxes and estate planning, contact one of the tax professionals at Zinner & Co. LLP.