Detroit Free Press

Consider tax-deferred options for buyout cash

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February 24, 2008

Grab the money now? Or do something dull and roll that buyout into the 401(k)?

As employees at General Motors Corp. and Ford Motor Co. ponder the latest round of buyout offers, there's a new enjoy-the-money-later, save-taxes-now option that's worth considering.

Employees who are eligible for early retirement at both GM and Ford can decide to take the buyout cash and run.

Or they can pick a tax-deferred option, such as rolling the lump-sum money directly into their 401(k) or choosing an annuity.

Stuffing a retirement account isn't as exciting as buying a new F-150 or Cadillac Escalade -- or even paying off bills. But using buyout money to juice up a 401(k) is a savvy strategy.

There are two big benefits:

• The buyout amount would not be initially taxed if it is rolled directly into a 401(k), Individual Retirement Account or annuity.

At Ford, for example, some hourly, UAW-represented employees can take an early retirement and get a lump-sum, pretax check that ranges from $50,000 for production workers to $70,000 for skilled trades workers.

To qualify, the employees must have 30 years or more of service and be at least 55 years old -- or they must be at least 65 years old with one or more years of service.

Yet you could be looking at some pretty big tax hits, if you take the cash and work awhile in 2008.

A Ford employee who gets a $50,000 pretax buyout, for example, might only get a check for $35,000 or so after taxes are taken out initially.

Once you fill out the 2008 tax return next year, you also could find yourself in a higher tax bracket, thanks to the extra income.

By contrast, if you rolled the money into the 401(k) or annuity, you'd get the full amount of the incentive -- $50,000 or $70,000 -- and avoid an immediate tax hit.

Ford spokeswoman Marcey Evans said the company wanted to give retirees a tax-efficient option for the buyouts.

Ford has 10 buyout packages available now for hourly workers. One of the 10 -- the enhanced retirement plan incentive -- includes the tax-deferred option. Ford employees have until March 18 to decide to accept a buyout. Some employees would leave the company as of April 1 while others would leave at different times during the year. Most would leave Ford by July 1, but some could leave even later in the year.

• If you roll over more money into a 401(k) or IRA, you could have even more money later.

David Kudla, chief executive officer for Mainstay Capital Management in Grand Blanc, ran some numbers based on the GM offer.

Take a skilled trades retiree who takes the current $62,500 buyout offer at GM. Let's say the retiree, though, got the full $62,500 by rolling it over and immediately investing it in the 401(k) or an Individual Retirement Account.

By Kudla's calculations, the retiree could have an extra $162,000 in the 401(k) in 10 years, assuming a 10% rate of return.

"They avoid the immediate tax hit, and they have tax-deferred growth," Kudla said.

By contrast, if you took the lump sum after taxes and invested an estimated $42,500 in this example in mutual funds or stocks in a taxable account, you'd have about $110,000 in 10 years, again assuming a 10% annual return.

What happens in 10 years?

Kudla calculates that the retiree would net about $110,000 out of the $162,000 in the 401(k) or IRA -- if we were looking at withdrawing all the money at once and paying a 32% income tax rate.

By contrast, the retiree would owe capital gains taxes after selling the stocks or mutual funds in a taxable account. Then, the retiree might have about $100,000 out of that taxable account after taxes. Most retirees wouldn't take out the money all at once, so that tax hit from a 401(k) could be reduced even further, if the money is withdrawn over several years. Taxable accounts also mean you're paying taxes on some dividends or capital gains distributions each year, too.

For some workers, it will be smart to leave that money in a 401(k) for other reasons.

If you turn 55 or older in the year that you are "separated from service" -- such as quit, get fired, or retire -- you can take money out of a 401(k) plan and not pay a 10% penalty. If you take money out one year, you won't be required to take money out in the future. (You still have required minimum distributions after 70 1/2.) That tax break isn't offered with an IRA.

If a retiree is 59 1/2 or older, there isn't a 10% penalty for withdrawing money from an IRA or a 401(k).

Another point to consider: Both GM and Ford will allow retirement-eligible employees to take some of the lump some money now -- and roll over a portion of it into the 401(k) now as well.

So maybe you splurge a little -- or pay a few bills now -- and try to use a good chunk of the buyout money toward an enjoy-it-later strategy.