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Factors Affecting the Decision of Which Pension Payout to Take

Upon retirement, a participant in a defined benefit plan has a relatively limited number of payment options to choose from. But how does a retiree best determine which option is best?

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Those fortunate to still have a defined benefit pension plan often can choose among payout options. A married employee typically has the choice of taking a payment over the employee's life, or a smaller payment designed to continue over the lifetime of both the employee and the employee's spouse.

One oft-discussed strategy is to take the larger payments over the single lifetime of the employee instead of the smaller payments over their joint lives and use life insurance to "replace" the lost payments which would otherwise be paid to the surviving spouse. While on its face this strategy appears to result in maximum payments and benefits to the couple, there are other factors which need to be considered. Continued pension payments to the surviving spouse often come with other benefits such as health insurance. The couple also needs to make sure the life insurance death benefit is large enough to replace the income and that the policy never lapses.

Background – Example

Let's assume Dan, age 60, is an executive at an insurance company and is getting ready to retire. His spouse, Cathy, age 60, is already retired. In anticipation of his retirement, Dan's employer presents him with a variety of options to choose from with regards to the defined benefit ("pension") plan payments that he will receive in retirement. They are:

- Single life annuity – $10,000 per month until Dan's death;
- Joint & survivor annuity –
    - 100% to survivor – $8,000 per month until the second death;
    - 75% to survivor – $9,000 per month until first death, $6,750 until second death;
- Lump sum – $1,900,000 one-time payment.

Given that he needs to make a one-time, irrevocable election, Dan needs to make this decision very carefully. Here are some of the factors that he should consider when weighing the various options.

1. Single life annuity

The first payout option is a lifetime annuity which will pay Dan the same amount every month ($10,000) for the rest of *his* life. At first, Dan is very attracted to the single life payout because the monthly payout is the highest that the plan offers. However, if he predeceases Cathy the payments cease altogether.

Cathy could lose even more than that. Sometimes employer-provided health insurance for retirees and their families is linked to the pension plan. When pension payments cease upon Dan's death, Cathy loses her health insurance. This will generally tip the scales away from the single life payout and in favor of one of the joint and survivor options.

2. Joint & survivor annuities

Joint and survivor is another annuity option that pays until both spouses pass away. Depending on the specifics of the annuity, if Dan dies first the amount that Cathy receives after Dan's death could be the same as that paid while Dan was still alive (joint and survivor 100%), or some smaller amount (typical examples are joint and survivor 75% or 50%). Because the payments are more likely to continue for a longer period of time, Dan and Cathy will receive less money each month than with a single life payout. As noted above, if they choose the joint and survivor 100% option, their monthly payment will be $8,000.
With the joint and survivor 75% option offered by Dan's pension, the payout climbs to $9,000 per month while both are alive, but drops to $6,750 per month after the first death.

3. Lump sum

An additional option is for Dan to receive a lump sum payment from the pension plan, which he can roll over into an IRA.[1] Although a defined benefit plan participant will rarely benefit from a lump sum payment, there are several factors Dan should consider.

a. *Will employer be around to pay?* Even if an employer declares bankruptcy, the Pension Benefit Guarantee Corporation (PBGC) protects employee retirement plans. However, not all plans are covered by the PBGC. If Dan's plan is not, he might consider taking the lump sum distribution if he has concerns about the viability of his employer. But he must weigh this decision against the market risk he takes by doing so. Unless his employer is in imminent danger of declaring bankruptcy or otherwise reneging on its pension obligations, there's a good chance he'll find any of the annuity options (with their shifting of market risk to the employer) more attractive than the lump sum.

b. *Can Dan's investments beat the pension?* Dan might believe he can transfer the lump sum to an IRA he controls and obtain sufficient investment growth to provide him more income than the pension pays. Whether Dan's belief turns out to be true essentially boils down to whether the IRA's rate of return will be large enough – and steady enough over many years – to endure for both their lives as it makes monthly distributions. Such success is hardly a sure thing, and as Dan and Cathy get older, they might find it was unwise to shift all the market risk and longevity risk from the pension plan to themselves.

[1] The monthly payments taken under any of the annuity options generally could not be rolled over to an IRA. Treas. Reg. §§ 1.401(a)(9)-6, Q&A 1, 10(a), and 1.401(a)(9)-8, Q&A 4.

c. *How about a commercial annuity?* Dan could transfer the lump sum to an IRA that purchases a commercial annuity, thereby transferring market and longevity risks to an insurance company. Typically, this will be a fixed annuity with a joint life payout.

> *Example:* Dan elects a lump sum payment of $1,900,000 dollars, which he rolls into a traditional IRA annuity. If Dan decides to immediately annuitize the funds in the IRA (with a joint life payout and no remainder), he and Cathy will receive roughly $6,386 every month for the rest of their lives.[2] This is compared to the joint and survivor annuity of $8,000 that he can elect to receive for the rest of their lives from the defined benefit plan.

d. *Cost-of-living adjustment*. Although few pension plans have a cost-of-living adjustment feature, those that do will tip the analysis even more heavily in favor of electing an annuity over a lump sum option.

e. *Dan's life expectancy.* Conventional wisdom is that a pension plan participant should opt for a lump sum payment if he has reason to think he might not live long enough to benefit from the annuity (*e.g*., maybe Dan's father died young, so Dan thinks he might too). This idea might be true enough, in that a participant dying prematurely is more likely to have "something left over" if he had chosen a lump sum rather than a life annuity. But with medical advances and increasing life expectancies, many people – even those with imperfect family histories – will live longer. They might view this factor as not weighing too heavily in favor of a lump sum.

Should Dan elect single life payout and buy life insurance policy on himself?

Dan might consider choosing the defined benefit plan's single life payout – with its higher monthly payments – and hope to replace the income that Cathy won't be receiving after his death with proceeds of a life insurance policy he owns on himself. Here's how that analysis might go:

- If Dan and Cathy opt for the joint and survivor 100% annuity, they will receive monthly payments of $8,000. Assuming a combined federal and state income tax rate of 40%, they net $4,800 per month.

- In order to generate $4,800 per month post-tax for a 60-year-old female (Cathy's age if Dan dies the day after retiring), any monthly annuity payment would have to be $4,940 before taxes.[3]

- To determine the amount of death benefit that needed to produce this monthly payout, Dan obtains quotes for immediate annuities that would pay a lifetime monthly income of $4,940 for a 60-year old female. The cost of an immediate annuity from Northwestern Mutual is $1,332,242.[4] Adding an additional 10% cushion is strongly recommended to account for future annuity pricing changes, *resulting in a total death benefit need of $1,465,466*.[5]

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[2] Using Northwestern Mutual's Fixed Annuity Presentation System, joint life with 100% to survivor. Illustrated income is based on July 14, 2020 settlement rates.

[3] Using Northwestern Mutual's Network Illustration System, a proposal from July 2020 indicates that the taxable portion of a straight life (no period certain) annuity payment for a 60-year old female is 7.1%. Relying on this number, convert the after-tax payment ($4,800) to a pre-tax annuity payment ($4,800 divided by .9716 (1- (.4 x .071)) = $4,940.

[4] Based on current pricing as of July 2020.

[5] $1,332,242 x 1.1 = $1,465,466.

1. Buying life policy *upon* retirement rarely works. It is generally a mistake to think that Dan can use the "excess" payout – the difference between the payouts for single and joint life annuities – to purchase a life insurance policy at or around retirement. In most cases, the premium for a newly purchased policy on a soon-to-be retiree (whether age 55, age 70, or older) will exceed the amount "gained" by selecting a single life payout from the pension.

For example, the annual premium for a policy providing $1,465,466 of death benefit for Dan's entire life (*i.e.*, not term insurance) is $31,555.[6] Since this exceeds the $24,000 additional annual amount that Dan would receive by opting for the single life annuity over a joint and survivor 100% annuity, it does not make sense to purchase a new life insurance policy for this purpose alone.

2. But it can work if the policy is bought well *before* retirement. If Dan has a pre-existing single life policy, it can be "earmarked" to replace the income that Cathy would forego if he chooses a single life annuity and predeceases her.

For example, assume Dan owns a life insurance policy with a death benefit of at least $1,465,466 that he purchased when he was younger. Now he could elect the larger single life annuity payout. If he dies before Cathy, she can use the income tax-free death benefit from the life insurance to purchase a commercial annuity that provides income that is as large as what the pension's joint and survivor option would have provided.

If Cathy dies first, Dan still receives the larger single life payments and can use the life insurance to provide a legacy for his children.

Conclusion

For clients who are lucky enough to still participate in pension plans, the decision of which payout to choose is something that should be planned for in advance, and not made on the eve of retirement. Regardless of the timing, factors such as health insurance, market risk, cost of living adjustments, and potential life expectancy should be considered. One way to preserve the most options is to buy life insurance well before retirement age. Such life insurance, purchased to replace the lost income for a death before retirement, can provide the survivor's share of benefits upon death of the retiree. The earlier this possibility is discussed by financial advisors and clients, the more likely the numbers will work.

[6] Assumes Northwestern Mutual's blended whole life plus on 60-year-old male, non-smoker, best class.

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