FINANCIAL ADVISOR

Pensions: Lump Sum Or Annuity?

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The difficult retirement choice of whether to take a lump-sum distribution from your company's pension or a lifetime monthly annuity is getting more complex.

The recently enacted pension legislation is going to change the formulas for calculating lump-sum distributions from corporate pensions, substituting a new benchmark interest rate and adjusting mortality tables as well.

Even before the change, choosing between a lump sum and an annuity has meant guessing about unknowables such as your life expectancy, future interest rates, stock returns and inflation—all factors that affect the choice. The longer you live, for instance, the more attractive a lifetime annuity becomes.

"It's a really tough decision," says Martha Priddy Patterson, a director at Deloitte Consulting LLP's Human Capital Practice. "If you have a terminal disease and you're going to retire, take the lump sum, but beyond this dramatic situation, there is no easy answer."

For private-sector employees retiring with pensions, there are some rules of thumb that can help guide a decision. Women and early retirees, for example, may find that an annuity is a better option for various reasons. Individuals who don't immediately need a monthly income or who expect to receive a large pension from a company at risk of bankruptcy should consider taking a lump sum.

Currently, the lump sum is calculated using the yield of the 30-year Treasury bond, which was set at 5.13% in July, the most recent rate. Beginning in 2008, that number will be calculated using 80% of the Treasury rate and 20% of the corporate bond rate. Each year, the corporate bond rate will increase by 20 percentage points until it is 100% in 2012.

Lump Sum Expected To Be Lower

Under the new law, the lump sum is expected to be lower because the corporate bond rate is higher than the Treasury rate, says Chet Andrzejewski, vice chairman of the pension committee for the American Academy of Actuaries. The new legislation also will require the Internal Revenue Service to update the mortality tables by 2008.

"The net effect should be a drop" in the lump sum, says Andrzejewski.

No one should make any decision without getting estimates of lump sums and monthly annuity payments from plan providers. Retirees also should consider their personal circumstances, including their health, investment style, financial obligations and other assets.

Some pensions pay early retirees substantially smaller lump sums relative to annuities, according to the Pension Rights Center in Washington, D.C.

For many people, an annuity is often the safest bet.

"If you don't know what to do, take the annuity," advises Dallas Salisbury, president of the Employee Benefit Research Institute in Washington, D.C., "The last thing in the world you should do is deny yourself that paycheck in retirement."

Workers, he says, are often tempted by the lump sum, especially if they're among the 65% of Americans who are living from paycheck to paycheck.

"The lump sum looks like a lot of money, and the annuity doesn't look like much," Salisbury says.

He says about half of those with pensions are offered the lump sum, but as many as 85% to 95% of those offered take it. Some people haven't worked for an employer for long and the lump sum is small. Others are tempted to spend the cash immediately or want to invest it themselves.

More Control Over Assets

The argument for taking a lump sum "is it gives you more control over your assets," says Bob Leone, a principal at Hewitt. "A lot of people feel they want control over their assets. They feel they could a better job investing it."

David Kudla, a financial advisor in Grand Blanc, Mich., took the lump sum from a previous job "as soon as I could so I could manage the money," he says.

Kudla runs the numbers for his clients, many of whom are in the auto industry, to see what they could expect to receive from a company-provided annuity compared to potential returns on a lump sum.

"The benefit is flexibility," he says. "If you take the income stream, you are locked in that scenario, but if you take a lump sum, you could grow it a certain amount, distribute it and leave the rest for estate planning."

A retiree who doesn't need the income from an annuity because of other retirement income could roll over a lump sum into an IRA that could be handed on to heirs. "You also have the ability to reserve this decision," Kudla says. Later on, "you could always purchase an immediate annuity."

But someone thinking about an annuity should shop around before forgoing the company policy, which often provides a better deal, especially for women.

Women often get a better deal on a company-provided annuity because its payment calculations include all workers in the company, while an individual policy would take into account someone's personal circumstances including gender and health, explains Patterson of Deloitte. "Because women almost always live longer than men, they're going to do better taking the payments over their lifetime," she says.

People are better off taking the lump sum, she says, if they are ill or there is high inflation, which would eat up a fixed income.

Individuals also need to consider the condition of their companies. Those expecting to receive more than about $47,659 a year, the amount guaranteed by the Pension Benefit Guaranty Corp., from an unstable company should consider taking the lump sum, rather than risk losing some of their annuity in a future corporate bankruptcy.

"Realistically, that is not a concern for 90% of people," says Leone of Hewitt.

Retirees also need to find out whether their annuity provides spousal benefits, which could make a big difference to their families when they die.

As stressful a decision as this is, Patterson says, keep it in perspective. After all, more companies are ending their defined benefit pension plans.

"Having to make these decisions is not a bad thing when the alternative is not having a pension," she says.

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