Retirement Guide

The Shrinking Lump

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If you were planning to take a lump sum from a pension plan, don't wait.

Are you now or have you ever been covered by a defined benefit pension, the kind that pays so many dollars per month? Would you prefer to take your benefits in a lump sum?

Then pay attention: The lump sum benefit you've already earned is likely to shrink over the next five years. In 2006, in response to complaints from corporations that the old method for calculating minimum lump sums was too generous, Congress created a new, less generous one. It's being phased in over five years, beginning in 2008. Younger workers take the biggest hit; by 2012 lump sums for today's 35-year-olds are projected to be 44% lower than they would have been under the old law. And since this was Congress' doing, the Internal Revenue Service has ruled that employers don't even need to warn employees about the change.

If you're one of the 11.4 million folks entitled to pension benefits you haven't yet received from a previous private employer's plan, find out if you can take a lump sum payment now, before it withers. Maybe you could have taken one when you left, but you put it off. Perhaps the plan allows only those who have reached early retirement age (typically 55) to cash out, and you're finally old enough. It's even possible that the plan didn't allow lumps when you left, but does now. (In 2003, 48% of plan participants had a lump sum option, up from 13% a decade before.) Take the lump and stick it in an IRA.

If you're one of the 20.3 million workers who has a defined benefit plan at your current job, there's not much you can do, short of quitting; normally you can't claim a lump while you're still employed.

Still, if you're on the verge of retirement, or a job hop anyway, this is worth a look. "There are people who need to be aware that waiting for a few months might make a big difference," says Judith Miller, chief of actuarial issues for the American Society of Pension Professionals & Actuaries. She worries that workers nearing retirement "may have seen an estimate of their lump based on the old law and are going to feel they took a hit they weren't expecting and that it was not well explained."

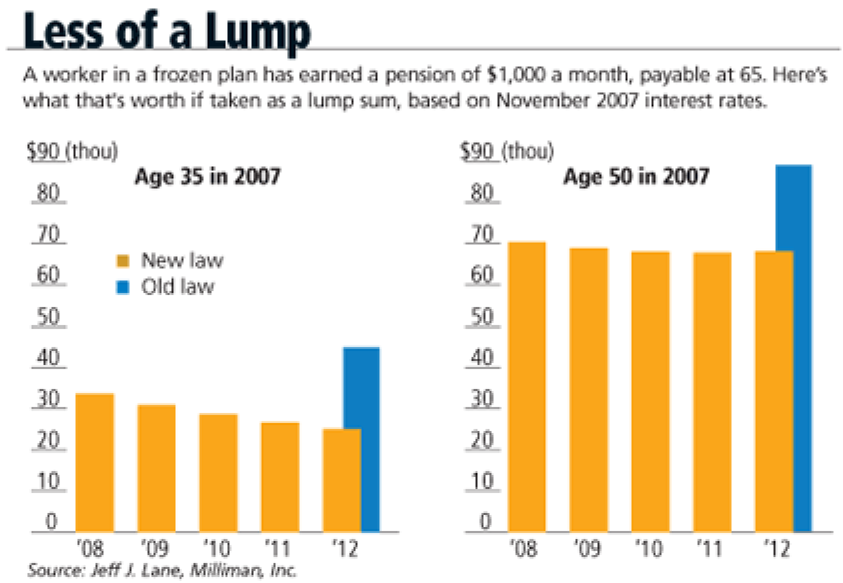
Over the five years the reduction will be most noticeable if you're owed a lump sum from a former job or the pension plan at your current company has been "hard frozen"--meaning your pension benefits won't grow, no matter how many more years you work or how much your salary rises. About a quarter of plans have been hard frozen or are likely to soon be, according to recent surveys.

Say you were 40 last year, earning $120,000 a year at a company you've been with for ten years. In a typical plan you would have earned a pension of $1,000 a month, payable at 65. Suppose that, as of Dec. 31, the plan was hard frozen. (Or, you left the company at the end of 2007, which has the same effect.) Assuming interest rates stay at their November 2007 level, your lump will fall from $42,900 this year to $34,500 in 2012, versus the $56,200 it would have been in 2012 under the old law, a 39% cut. (If a 40-year-old's plan isn't frozen, his lump, in 2012, will still end up 39% lower than under the old law, but the lump sum will grow a bit each year, since his pension benefits are growing.)

While older workers suffer less, percentage-wise, from the new law, their dollar loss could be bigger. Under that same frozen plan a worker who was 50 last year, earning $120,000, and had 20 years with the company, is entitled to a pension of $2,000 a month at age 65. Under the old law his 2012 lump would be $178,300; under the new law, $136,300.

Why do younger workers take a bigger percentage hit? A lump sum is supposed to equal the amount needed to finance the worker's future pension, assuming the lump is invested and earns a certain return until he retires. The higher the return or the more distant the date when the monthly checks would have started, the smaller the lump needed today.

Under the old law minimum lump sums were calculated using the return on 30-year U.S. government bonds. Under the new law earnings are calculated using a mix of short-, intermediate- and long-term corporate bond rates, with the longest, highest rates applied to any pension payments that aren't due for 20 years or more. For November 2007 (the month many plans use to determine 2008 lump sums), the IRS pegged the long-term corporate rate at 6.47% and the short-term rate at 4.92%, compared with the 4.52% government bond rate used under the old law.



If interest rates fall this year, it will soften the impact on those taking lump sums in 2009. Conversely, "the worst for the worker is if the rates start creeping up again over the next five years," says Jeff J. Lane, a research actuary for Milliman. He calculates that if rates rise one percentage point by 2011, the 40-year-old's lump in 2012 would fall to $26,500.

Moreover, once the new lump sum method is fully phased in, some of those companies with frozen pension plans might well use an interest rate spike to terminate their plans completely. At that point workers who are still at the company would likely have a choice: take an even smaller lump (smaller, because of then high interest rates) or receive a future annuity their employer would buy for them from an insurance company.

The new formula affects almost all private defined benefit plans. A separate provision that kicks in this April will apply only to underwater pension plans. Plans 40% or more underfunded can't pay any lumps; those that are 20% to 40% short can pay only partial lumps. If your plan has deficient assets and you can get your money out now, do so.

David Kudla, chief executive of Mainstay Capital, an investment advisory firm in Grand Blanc, Mich., generally favors lumps but offers a caution: If your company provides retiree health benefits, you could lose them if you take a lump instead of an annuity. So check that out first.