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The Pension Vs. Lump Sum Debate

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A frequently asked question regarding retirement for people fortunate enough to have a defined-benefit pension is…should you take the lifetime monthly pension or lump sum option?

As companies look to shrink increasing pension costs and liability, they will frequently offer a pension lump sum buyout. This significant amount is usually the largest lump-sum payment any employee would be granted in their lifetimes, and is one of the most important decisions they will make when it comes to meeting their retirement goals.

In general, employees are given a date or time period that they must decide whether to exchange a monthly benefit payment stream in the future for a one-time lump-sum payment. If you select the lump-sum option, you will receive an amount that can be put into an eligible tax-qualified plan such as an IRA or rollover IRA account. The company's monthly pension obligation will the end. If you do not opt for the lump-sum, you will lose the lump-sum option, and you will begin to receive your pre-determined monthly pension income.

The process is simple, but the determination is often complex with many individual circumstances coming into play. As pension payments are generally made for life, your life expectancy is a major factor in this decision. Other life factors coming into play include marital status, children/heirs, and ability to manage money. Generally, if you have a shorter life expectancy, the lump-sum option may be more attractive, and any remaining money will be left to your heirs. Conversely, if you are uncomfortable or not skilled at managing a large amount of money, a guaranteed pension income stream may be more attractive to you.

There are also tax considerations that will play into your choice. Pension income is taxed as ordinary income, whereas a lump-sum amount can be rolled over to an IRA and avoid immediate taxation when received. You will have to pay income tax on the distributions, and eventually have to take Required Minimum Distributions (RMD) at age 72. If you do not put the lump-sum into a tax-deferred account, you will pay ordinary income tax on the full amount and often be stuck with a large income tax bill.

While pension payments are "guaranteed", there is the risk that the employer could go bankrupt and find itself unable to pay retirees. When anticipating decades of monthly payments, this risk is certainly a reality that should be taken into consideration. The Pension Benefit Guaranty Corporation (PBGC), which is the government entity that collects insurance premiums from employers sponsoring insured pension plans, does guarantee a portion of the annual pension amount. The PBGC has a yearly adjusted guaranteed maximum annual benefit that tops out at $69,750 for a 65-year-old retiree in 2020. This amount is also adjusted based on retirement age and survivorship benefits. As long as your pension benefit is below this amount you can be reasonably certain you will receive the full amount of your pension benefits.

Other considerations for pension payments include not being inflation protected or adjusted. You will most likely receive a fixed payment every month that will decline in purchasing power as the years go on. Also, as your income needs will most likely vary over the course of your retirement, constant pension payments offer little in the ways of liquidity and tax planning.

Lump-sums on the other hand, will make the individual responsible for making the funds last through their retirement. Their investments will be subject to market fluctuations, which can increase or reduce in value and the income you can generate for them. Lump-sums also are inversely affected by interest rates. As interest rates decline, lump-sum payout amounts increase. Currently, interest rates have fallen to historic lows, so anyone thinking about taking the lump-sum may receive a larger premium. Interest rates may also vary when given a choice between two different fiscal plan years for your company.

Of course when it comes to making the decision between taking the pension income stream or the lump-sum buyout, it should be taken into context with your overall retirement picture. This option should be consulted with retirement and tax professionals.