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Pension Plans: Lump Sum or Annuity—or Both?

by Richard F. McCleary, MSPA, COPA

Many companies have struggled recently with underfunded defined benefit pension plans. As pension plans become more vulnerable due to underfunding or corporate bankruptcies, participants must decide whether to take their payouts in a lump sum or an annuity. When they terminate employment or retire, participants often need assistance from financial advisors and pension professionals in their decision between an annuity and lump sum form of payment.

By law, pension plans must offer annuities to plan participants. Typically, an annuity benefit is paid monthly for the lifetime of the annuitant. In the case of married participants, the monthly pension benefit is paid over the joint life of the annuitant and his or her spouse. After the death of the participant, the benefit continuation to the spouse varies, but is most often 50% of the benefit that was paid while both the participant and spouse were alive. A married participant may choose to receive payments for his or her life only, but by law the spouse must sign off on that decision.

In lieu of an annuity, pension plans may, but are not required to, also offer a one-time lump sum payment. A lump sum is a cash value that is mathematically equivalent to the sum of future payments and is calculated using interest rates and life expectancies mandated by the IRS. Theoretically, if a participant deposited this cash value in an account bearing the same interest rate for the participant's life expectancy, or the term of the annuity, the accumulated amount would equal the sum of all of the future annuity payments.

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Comparison of Benefits

The value of annuities and lump sums can vary based on interest rates, retirement age and life expectancy. The provisions and operation of the pension plan can also impact the comparison of these benefits.

For example, a pension plan provides a life annuity of $40,000 per year at age 65. The lump sum value of this benefit for a 65-year old participant is $501,000, using the December 2008 transitional segment rates under Internal Revenue Code Section 417(e), or an effective rate of approximately 4.5%. This calculation is also based on the assumption that, at age 65, a healthy person lives to age 84.

Comparatively, for a 60-year old participant, the reduced life annuity under the same plan might be $28,000, since the benefit payments start five years earlier. The immediate lump sum value in this situation is $398,000.

The decision of whether to take the lump sum is not obvious. The choice needs to be made based on many variables. The interest rate is one consideration. For instance, if the participant thinks that he or she could take the lump sum at age 65, invest it and earn more than 4.5% while withdrawing annual payments of $40,000, then the lump sum is the better choice. The better the investment performs, the more the participant will be able to receive in total annuity payments.

Another way to look at it is based on life expectancy. If a male participant dies before age 84, then the lump sum is the better choice. If the participant outlives the assumed life expectancy, then the annuity may have been the better choice.

However, when given the option, most participants would elect the lump sum over the annuity in the above scenarios just based on the mere size of the payment. This outcome is mainly due to the low interest rates that have been used in determining larger lump sum amounts over the past few years. Also, most retirees seize the opportunity to gain control of their pension funds for mere emotional reasons if nothing else. It is a lot of your money to put someone else in charge of.

Law Changes

The Pension Protection Act of 2006 (PPA) reformed funding and other rules for defined benefit pension plans, introducing a corporate bond yield curve that is used in determining lump sum payments. (Before PPA, 30-year Treasury yields were used.) The yield curve is based on high-grade corporate bonds. The new interest rates will be phased in gradually, starting with lump sums paid in 2008 and implemented fully for lump sums paid in 2012.

These changes in the law lower lump sum amounts, mainly because corporate bond rates are typically higher than US Treasury rates. As

	Pros	Cons
Annuity	• Certainty: The amount of pension benefit is fixed and continues for life. • Low risk: Participants do not have to invest the money or worry about investment performance.	• Inflation: Unlike Social Security benefits, most corporate pension plans do not increase pension benefits with inflation. • Unexpected expenses: Surprise medical bills, home repairs, vacations, etc., require more individual budgeting discipline. • No guarantees: Pension benefits are not guaranteed. Healthy companies sometimes run into problems, and they may renege on pension promises. There is a federal agency called Pension Benefit Guaranty Corporation (PBGC) that can step in to help, but there are limits to the protection that PBGC offers.
Lump Sum	• Control: Participants have more control over pension money, including investing and the ability to withdraw amounts at any time. • Succession: Cash balances may be passed on to heirs instead of being lost when the participant dies.	• Responsibility: Participants must invest and maintain their accounts so that they do not outlive their pensions. • Taxes: Immediate tax bill can be high if the amount of the lump sum is taken in cash and pushes the participant into a higher income bracket. • Risk: Cash assets could be at risk if the participant or spouse become terminally ill or need to enter a nursing home.

an example, under the new rules fully phased in, the lump sum for the 65-year old participant in the above example would be $411,000 (the effective interest rate is around 6.75%). Fortunately for participants retiring in the near future, this full reduction will not occur until 2012. Those employees who took a lump sum distribution before 2008 were not affected at all by the new rules.

PBGC Guarantees

Most corporate pension plans are insured by a government agency called the Pension Benefit Guaranty Corporation (PBGC). PBGC sets an annual maximum benefit for plans that it takes over. The PBGC maximum benefit was $54,000 for plans terminating in 2009.

Certain types of benefits may not be guaranteed by PBGC, such as disability benefits or death benefits sometimes provided under pension plans. Also, participants within a few years of satisfying retirement eligibility may be out of luck with PBGC. For example, an employee who has 28 years of service but needs 30 years of service to receive full retirement benefits may not be allowed those benefits when the plan is terminated and taken over by PBGC.

PBGC has reported large deficits in recent years, including a deficit of more than $33.5 billion in 2009. Most of its funding is from insurance premiums paid by sponsors of defined benefit plans. Finally, its obligations are not backed by the "full faith and credit of the US government."

Current Participant Behavior

In situations where a pension plan participant is offered the choice of receiving a lump sum, there recently have been more retirees attempting to compromise and get the best of both worlds. Because annuities and lump sum benefits both have advantages, a popular approach has been to take the lump sum from the pension plan and roll it over directly to an IRA, so that the money will not be taxed immediately. Once the money is in the IRA, a portion of it can be used to purchase an annuity from an insurance company. The annuity may be larger or smaller than the monthly benefit from the company-sponsored pension plan, but it should be comparable. An advantage of using this approach is that a participant can shop around for the highest benefit provided by one or more of many reputable insurers. But also attractive is the partial lump sum remaining in the IRA, which can be used for travel, boats and other large retirement expenses.

The decision about splitting up the IRA is personal and can be based on many things, such as other personal assets, monthly budgets, Social Security benefits, healthcare insurance, comfort level in managing a lump sum, tax treatment and personal health. The main idea is to have the security of a monthly annuity, while still having a lump sum as protection against inflation and unexpected expenses.

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