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GETTY

Weighing a Pension Payout

Take the money and run? It is a question advisors face as retirees get offered lump-sum bonanzas. By George Yacik

A growing number of U.S. companies are offering their current and former employees the option of taking early retirement benefits, including lump-sum payments. This places a large financial and investing decision in the laps of thousands of Americans – and opportunities for financial planners to help them make those decisions.

Some 35% of the more than 500 large American companies surveyed in a recent Aon Hewitt study said they were very likely or somewhat likely to offer a lump-sum payout to their retirees and employees in order to put a cap on their pension liabilities. Some of the biggest have already done so.

FLURRY OF OFFERS

Last spring, Ford said it would offer a lump-sum pension payment option to about 90,000 eligible U.S. salaried retirees and former employees. (This was in addition to the lump-sum payout option available to future retirees as of July 2012.) Ford was followed shortly by General Motors, which began offering lump sums to 42,000 of its 118,000 salaried retirees and beneficiaries. Other large companies taking similar steps include Archer Daniels Midland, The New York Times and Thomson Reuters.

The reason, of course, is to save money. The GM buyout was part of a program the company said would eliminate $26 billion in pension liabilities by the end of last year. ADM said its plan could "reduce its global pension benefit obligation by approximately $140 million to $210 million and improve its pension underfunding by approximately $35 million to $55 million."

"Post-retirement benefits have become so expensive for companies, and they're only just realizing it," says Kathy Johnson, a financial planner and tax consultant in Suwanee, Ga.

This is just the latest development in a trend that has been going on for more than two decades – namely, moving employee retirement benefits away from defined benefit pension programs to defined contribution plans, like 401(k)s.

Back in 1985, some 89 of the *Fortune* 100 companies offered a traditional defined benefit to newly hired salaried employees, according to human resources consulting firm Towers Watson. That has changed dramatically.

"Almost 30 years later, the pattern has completely flipped," Towers Watson found. "In the *Fortune* 100 of today, 89 companies now offer only account-based retirement plans to new salaried hires."

That places a big responsibility on individuals, their financial planners and other advisors. When given the option, most workers take the lump-sum offer.

But is that always the right option? And if so, what's the best plan for the money, which for many people can be a sizable amount?

"There is no one-size-fits-all answer," says Johnson, adding that she has been doing this type of analysis for many of her clients. "It depends on each individual situation."

BIRD IN THE HAND

One immediate consideration is whether the recipient needs money right away. But even if the answer is no, most people opt for the lump-sum payout – largely because of the "bird in the hand" argument.

"I usually tell people that the lump sum is the better way to go," says Jay Marsden, an estate planning and elder-law attorney in Holliston, Mass. "The main reason is to control your own destiny. First and foremost, the lump sum offers the client more flexibility."

For one thing, he notes, if the recipient waits to collect his pension but dies sooner than expected, he may not collect anything – or will have received a lot less than if he had taken the lump sum.

"If you wait and don't take the lump sum and pass away, it's all over – your heirs don't get anything," he says. If the money is in an IRA, the spouse or children can inherit it.

The death of the recipient isn't the only concern. What if the employer itself doesn't survive? "Many people today are worried about whether or not the company is going to be around when it comes time to start collecting the pension," Marsden says. As a result, they would rather handle the pension themselves.

ROLLING IT OVER

Unless specific exclusions apply, any lump-sum distribution is likely to be taxed as ordinary income, possibly with a mandatory 20% withholding applied for income taxes. If it's a "premature distribution" (that is, before age 59½) from a qualified plan, there may be an additional 10% penalty.

If the money is rolled over into an IRA, however, taxes and penalties can be avoided. But the rollover must be done according to IRS regulations. That means it can't be sent to the recipient directly.

Any rollovers from the plan to the IRA should be accomplished as trustee-to-trustee transfers, in which the plan's trustee transfers the proceeds directly to the new custodian of the IRA or moves funds by check payable to the new custodian for the benefit of the new account owner.

INVESTING THE CASH

The next question is how the assets should be invested to provide for retirement. Marsden says clients should be looking to "replicate" in their IRA what their pension plan would have provided. The private market actually offers more alternatives than some pension plans offer, he adds.

> Many retirees argue for a bird in the hand, but it's getting harder to find a lifetime income stream that promises the same return as a pension.

"When you take a pension from the company, there is very little flexibility," Marsden explains. "The person receiving the pension gets a certain amount every month, with maybe a survivor benefit for a spouse. That's about it." But with a lump sum that is rolled over to an IRA, he says, "the client can then use that money to do a number of things." Marsden listed a number of possibilities:

- Buy a commercial annuity that replicates the options offered by the previous employer (annuity for life, survivor annuity payout as well).
- Buy any other investment vehicle (stocks, bonds, mutual funds, private placements) and have more control over the investment choices.
- Take a lump-sum payout for gifting to family.
- Take a lump-sum payout and use the proceeds to buy a long-term care insurance policy.

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One type of commercial annuity offers a potential increase in income, Marsden says. "This type of annuity allows for the possibility of keeping up with inflation over time as opposed to a straight payout from the company, which may never change," he notes. "A monthly pension that covers living expenses today may not do the same over time."

DEFINING NEEDS

Clients also need to define what they need the money for and for how long. If, for example, they need to provide a bridge before they start collecting Social Security or other pensions, an immediate annuity might be a solution. Or they may want the payout invested to supplement their income for the duration of retirement.

But in today's world of historically low interest rates, finding investments that can adequately fund retirement expenses isn't easy, especially with people living longer.

With average life expectancies increasing, the risk of outliving one's money cannot be ignored. For a married couple who are both 62 years old, for example, there is a likelihood that at least one of them will live to age 92 or beyond. Johnson says she advises her clients to plan as if they are going to live to 95.

Using the so-called Rule of 72 as a guide, at a 3% annual rate of inflation, the cost of living will roughly double in 24 years. So fixed income, by definition, would not seem to be an optimal solution over the long term.

Indeed, it's not easy to find an investment vehicle that provides a lifetime income stream that promises the same return as a pension. Immediate annuities, which currently return only about 1%, "don't get people excited," says Timothy Watters, CFP, principal at Watters Financial Services in Paramus, N.J.

Another solution, variable annuities, is going the way of, well, defined benefit pension plans. Several insurance companies, including Transamerica, Equitable and most recently The Hartford, have begun offering lump-sum payouts to holders of their variable annuities, which guarantee a lifetime income stream, to get customers to surrender the policies. Many companies have stopped selling the policies but are at risk for those they wrote in the early and mid-2000s, when they were popular.

Helping clients to choose the appropriate investments, then, is where financial planners add value — to provide advice about such important topics as asset allocation, and product and investment diversification.

Watters says that many otherwise intelligent people don't know what to do when it comes to investing. "401(k)s haven't worked out well for a lot of people," he notes.

THE OTHER OPTION

While taking the lump-sum option is the best decision for most people, that's not always the case. For example, clients who are likely to spend the money on discretionary purchases are better off keeping the money in the pension plan and waiting until their regular retirement age to start collecting, planners say.

"Sometimes clients are their own worst enemies," Watters says. "If they're big spenders, this is not a good situation. People will spend the money. With a monthly pension, you can't hang yourself as quickly."

"The only scenario where it might make sense to leave it with the company would be if you had a situation where giving it to the person would create a problem if they had that money in their hands," Marsden adds. "They may start to make some bad decisions. Don't give them a chance to make those decisions."

Another situation when it would be better to stay invested in the pension plan is if the person's health insurance benefits are tied to remaining in the plan, Marsden says. But those instances are rare, he says.

In addition to lump-sum payments, some companies are offering former employees the option of collecting their pensions at an earlier age, say 55, albeit at a sharply reduced monthly payout. While it may be attractive to some people to collect a little extra money each month, the decision may have negative tax consequences. If the client and the spouse are both still working, that extra income could push them into a higher tax bracket, Johnson warns.

"More income usually means more tax," she says. "So you would then be hit with a double whammy: a higher tax on a lower [pension] payment. But if you're retired, you're likelier to be in a lower tax bracket. So it may behoove you to wait."

Still, she notes, the tax bite may vary at the state level. Many states exempt retirement income from taxation, although they vary in what kinds of income are exempt and the age of the taxpayer they apply to. FP

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