Investment Topic

LANDMARK WEALTH MANAGEMENT, LLC

Registered Investment Advisor

October 2017

How To Handle Your Pension Options

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Over the years, one common choice individuals are faced with is how to receive their pension benefit when it is offered to them at retirement. There are more numerous options routinely available, such as a *single life payment*, *joint life payment* or even more common in recent years, the *lump sum option*. Let's first start by pointing out that for individuals who are employees of a government agency, a lump sum option is typically not a choice you will be offered.

The lump sum option has become more common for those in the private sector that have worked for large multinational corporations, and even some mid-sized businesses. This is largely due to the longer than expected life expectancies we are facing, as well as other demographic changes that can impact the actuarial projections of a pension fund. It is very difficult to predict in a pension fund what these legacy costs will be due to a variety of reasons. Companies may have a smaller number of employees in the future contributing to the fund. They may have slower than expected business cycles that force layoffs and reduce staff. As a result, there is and will continue to be more of a push towards defined contribution plans (401k/profit sharing) in the future. The largest challenge is the substantial increase in life expectancies since many of these pension funds were initiated many decades ago.

Let's first address the **lump sum option**. In many of the cases, the lump sum option is the more prudent choice. Pension funds are using the same actuarial data to make projections about life expectancy to determine their liabilities as an insurance company that sells an **immediate fixed annuity**. An immediate fixed annuity bought privately has the same characteristics to the individual as a private pension benefit once the receipt of income begins. The distribution rate is typically very similar. However, in some cases the entirety of the pension benefit offered as an income is not needed at the moment the individual retires.

Let's imagine a 65 year old retiree who is being offered **$60,000** per year, or a lump sum of **$1,000,000**. What if the retiree after examining their financial needs, determines they only need about **$40,000** per year based on their current lifestyle and other income sources? The individual could simply opt to take the entire **$1,000,000**, roll it to an IRA on a non-taxable basis, and then choose to buy an immediate fixed annuity by shopping the best payment with multiple insurance carriers. Except, in order to achieve the desired income, they would likely only have to utilize approximately **$670,000** at a *6% distribution rate*, which would generate an income in the range of **$40,000** annually. This would then permit the investor to keep the additional **$330,000** in their IRA on a tax deferred basis to keep growing until the income was needed in the future, or to be left to their heirs as beneficiaries. The key is ultimately the flexibility. *Please note that these income assumptions are close to current norms, but are not specific to any one insurer or annuity offering*.

Solvency is also a key issue. If you are a participant of a private sector pension fund, the only real guarantee you have if a pension fund is taken into receivership is through the **Pension Benefit Guarantee Corporation (PBGC)**. However, PBGC only secures a portion of these pension funds under a formula that is rather complex, and can greatly limit the benefit of someone that would have been entitled to a sizeable pension. Pension funds can and do go bankrupt. It happens more often than most workers realize, and some are substantially underfunded. On the contrary, your 401k, while subject to the same market risk on investments that the pension fund is also subject to, remains 100% yours once you have become vested. At a maximum that is likely to be six years of service with your employer. The difference is a pension fund is a liability of the corporation, whereas a personal account is a segregated asset, and not a liability of your employer, therefore not subject to the claims of their creditors.

The next common sense question is ***"What happens if I annuitize money from a pension lump sum and then the insurance company goes under?"*** This is an important consideration, and requires some homework to be done. In many states, there is a state guarantee fund on benefits issued to the purchaser of an insurance product in the event of a default. As an example, New York State has the **Life Insurance Company Guaranty Corporation of New York**, which currently guarantees benefits of 100% up to **$500,000.00** per individual.

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So in the event of pension replacement, or any form of an insurance product, it may be prudent to limit the purchase to no more than **$500,000** in the State of N.Y. If necessary, you can purchase more than one product from multiple insurance carriers to coordinate benefits. In the case of annuity payments there will typically be more than one company offering a similar payment option. Since insurance is regulated at the state level, you would need to inquire with your insurance commissioner's office as to what guarantees, if any, exist. *It should also be noted that many licensed insurance agents do not mention this backup fund, as they are prohibited from utilizing it as a sales incentive. The responsibility to inquire about any state guarantees rests upon the consumer.*

Furthermore, with a pension fund from an employer there may be an option for a survivor benefit to the spouse at a reduced rate. However, many pension funds offer no continuing benefit to children or other non-spousal beneficiaries. So in the event that you choose to retire after 30 years of service with a joint survivor benefit, and then you and your spouse pass away relatively young, there may be nothing left to your heirs. The amount that you either contributed to the pension fund, or that which was contributed on your behalf for your service, simply becomes a ***forfeiture reallocation***. This basically means the pension fund keeps your money, and it reduces the burden of liability they must pay to other families in the future. Should you opt to privately annuitize money in an immediate fixed annuity, insurers virtually always offer multiple guarantee options, such as ***a 20 year period certain*** guarantee. Such an option insures that someone of your choosing will receive a benefit equal to the amount of money funded, and it will not be lost.

What about cases in which someone is not offered a lump sum, but only ***a joint survivor benefit***, or what is sometimes called a ***pop-up option***? This is rather common among civil service employees. These should be examined closely, as there is usually more than one formula available. While there are no universal answers that apply to all, a survivor benefit of some type often makes the most sense for couples.

Creating Your Own Defined Benefit Can Be Beneficial.

In many cases, an insurance agent will show you an illustration of how you can purchase life insurance on the pension recipient at a cost that is less than the amount of reduced income one might realize by taking the joint benefit. The challenge in such a scenario is that it often requires a substantial amount of insurance to replace the loss of a pension. This usually requires **term insurance** to be issued on an individual that will receive a large pension benefit, because it is the least expensive. While term coverage makes excellent sense for a young couple, it can be risky for couples closing in on retirement benefits. If you are 65 (*assuming you are insurable*), a term policy will typically not cover you past age 80. So what happens if the pension recipient dies at age 81, and the survivor has neither the life insurance, nor the pension, and lives to age 95? The alternative is to utilize permanent life insurance such as ***whole life***, ***universal life***, or **variable life** policy. However, that will greatly drive up the cost of the annual premiums, often making it a poor choice, and possibly unaffordable.

When examining the cost of insuring the individual benefit versus the joint survivor options being proposed, you should try and think of the reduced annual benefit as the insurance premium. When examining it from that perspective, you are essentially purchasing the equivalent of a level term insurance policy that has no term limit. It will last your life expectancy.

As an example: If the **$60,000** pension is reduced to **$54,000** in order to capture the joint benefit for a spouse, the reduction should be compared to the cost of a term policy. The amount needed to replace a **$60,000** fixed annual income for a 65 year old is approximately **$1,000,000** (*6% annual distribution rate*). The cost to purchase a **$1,000,000** term insurance policy for 10-15 years may possibility be less than **$6,000** annually, if the individual receives favorable underwriting due to excellent health. However, at the end of the 15 years, the survivor is left with no benefit guarantee, and possibly a number of years remaining in retirement. By taking, the survivor benefit, the **$6,000** annual difference becomes the equivalent of a lifetime of level term insurance.

It is always important to note that each situation is unique, and there is no "*one size fits all*" in financial planning. Determining how to handle ones pension options is one of the larger financial decisions a person will make in their lifetime. In many cases, utilizing a lump sum strategy instead of an employer's annual payment, and annuitizing all or part of the benefit as a pension replacement makes the most sense. Keep in mind that not all annuity products are the same. Many are loaded with expensive and unnecessary "*bells and whistles*" like features. It is advisable to seek a second opinion from an independent financial professional on what options make the most sense, rather than simply take the word of a commissioned sales agent. It can be prudent to discuss these issues with your tax advisor and/or a fee-only financial professional that does not sell insurance products for some unbiased advice.