PRISM Wealth Advisors, LLC

Pension or Lump Sum: Which Should You Choose?

Traditional pensions, which promise lifetime income payments in retirement, have become less common in the private sector, with only about 10% of workers currently participating in a traditional pension plan. However, pensions are still widely offered in federal, state, and local government employment, and 61% of workers expect a pension to be a major or minor source of retirement income.[1]

About half of pension plan participants can choose to take their money in a lump sum when they retire.[2] In addition, companies may offer pension buyouts to vested former employees who are working elsewhere, and even to retirees who are already receiving pension payments.

By shrinking the size of a pension plan, the company can reduce the associated risks and costs, and limit the impact of future retirement obligations on current financial performance. However, what's good for a corporation's bottom line may or may not be in the best interests of plan participants and their families.

A Critical Decision

For most workers, there are clear mathematical and psychological advantages to keeping the pension. However, a lump sum could provide financial flexibility that may benefit some families. The prospect of a large check might be tempting, but cashing out a pension could have costly repercussions for your retirement. One study found that one out of five people who took a lump sum depleted the money within five and a half years, and an additional 35% were concerned that the money would run out.[3]

Given the risks, it's important to have a long-term perspective and consider the following factors when a sizable lump-sum offer is on the table.

Terms of the offer. The amount of a lump sum is based on the discounted present value of an employee's future pension, set by an IRS formula based on current bond interest rates and average life expectancies. Keep in mind that a pension's lifetime income may be more valuable for women than for men because women tend to live longer, but gender is not considered when calculating lump sums. In addition, companies may not include the value of subsidies for early retirement or spousal benefits in their buyout offers, the latter of which could be a major disadvantage for married couples.

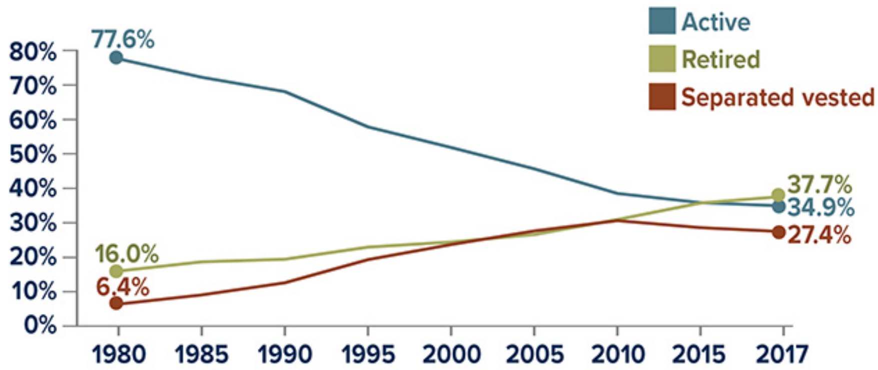
Taxes and potential penalties. Pension payments (monthly or lump sum) are taxed in the year in which they are received. Cashing out a pension before age 59½ may trigger a 10% federal income tax penalty, unless the lump sum is rolled into an IRA or to an employer-sponsored retirement plan (if allowed), which postpones taxes until withdrawals are taken later in retirement. IRA and employer plan distributions are also taxed as ordinary income, and withdrawals taken prior to age 59½ are subject to the 10% federal income tax penalty, with certain exceptions. Annual minimum distributions are required starting at age 72 (70½ if born before July 1, 1949).

Financial resources. A lump sum might be helpful for someone with little cash in the bank for emergencies or with debts to pay off. Those who are able to live comfortably on other sources of retirement income might also benefit from a lump sum.

Fewer Active Participants

More than 34 million people were covered by PBGC-insured single-employer or multi-employer pension plans in 2020. However, the proportion of active participants covered in their current job has declined dramatically since 1980, while the percentages of retirees and participants who are separated from the employer but vested in the pension have risen.

Participants in single-employer pension plans, by status



Source: Pension Benefit Guaranty Corporation (PBGC), 2020 (most recent data available)

Risk tolerance. A lump-sum payout transfers the risk from the pension plan sponsor to the participant. Individuals who opt for a lump sum must then manage that money and determine for themselves how much risk to take in the financial markets. Often the amount is not enough to replace the pension income given up, unless the investor can tolerate exposure to stock market risk and is able to achieve equivalent returns over time.

Health status. A lump-sum payment might make sense for a participant with potentially life-threatening medical issues, because pension payments end when the plan participant (or a surviving spouse) dies. Money held in an IRA could be withdrawn and spent as needed on health-related costs and/or custodial care. Any IRA funds that are preserved can be passed down to heirs.

Pension's prospects. A pension plan's "funded status" is a measure of its assets and liabilities that must be reported annually; a plan funded at 80% or less may be struggling. Most pensions are backstopped by the Pension Benefit Guaranty Corporation (PBGC), but retirees could lose a portion of the "promised" benefits if their plan fails. For single-employer plans, which are most common, the PBGC annual maximum is $69,750. However, for a multi-employer plan (created between employers and a union), the guarantee is much lower at $12,870.[4]

All investing involves risk, including the possible loss of principal, and there is no guarantee that any investment strategy will be successful. Investments seeking to achieve higher rates of return also involve a higher degree of risk.

1) Employee Benefit Research Institute, 2020
2, 4) Kiplinger, July 19, 2020
3) AARP, September 11, 2020