

Choosing the Most Appropriate Pension Distribution Option

This Document provides information on common pension options (joint and survivor, single life, term certain, etc.) offered to employees under defined benefit plans. Also highlights the pros and cons of taking a lump sum distribution vs. monthly pension payments.

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While defined benefit pension plans are becoming less common, there are still a significant number of workers that will rely on a pension as an important source of their retirement income. Most pension plans have a variety of distribution options to choose from once the pension plan participant decides to retire. Life expectancy is the variable that determines which option will be best for you. Unfortunately, that variable is also unknowable. Because of the uncertainty surrounding life expectancy, it is important to understand the features and benefits of the various pension distribution options offered by your plan, and which option will best fit your family's circumstances. The key characteristics, along with pros and cons of some of the most common distribution options, are discussed in more detail below to help you with this decision.

LUMP SUM DISTRIBUTION VS. MONTHLY PENSION PAYMENTS

Many pension plans give the participant a choice between taking a monthly annuity payment, or a lump sum distribution which can be rolled over into an IRA. Choosing the distribution option that best fits your situation will be one of the most important decisions a retiree will make. Matching a participant's personal circumstances with the benefits of the most appropriate distribution option is the key to making the right decision. The below table summarizes the key features of each distribution option that should be considered when selecting a pension distribution option.

Feature	Lump Sum Distribution to IRA	Monthly Pension Payments
Investment Options	<ul style="list-style-type: none"> IRAs offer an extremely diverse universe of investment options, including mutual funds, ETFs, stocks, bonds, separate account managers, etc. You take on the investment risk of the account, as you would with any type of investment account. 	<ul style="list-style-type: none"> Investments are selected by the plan sponsor (employer). The employer takes on the investment risk.

Choosing the Most Appropriate Pension Distribution Option, *continued*

Distributions	<ul style="list-style-type: none"> You can take a withdrawal in any amount, at any time. Amounts available for withdrawal depend on the performance of your investments. Payout amounts are not guaranteed unless an annuity with income guarantees is purchased. Required minimum distribution rules apply beginning in the year you reach age 72. 	<ul style="list-style-type: none"> The plan sponsor/employer guarantees a monthly payment amount for life. The decision to receive monthly payments is typically irrevocable.
Cost of Living Adjustment (COLA)	<ul style="list-style-type: none"> There are no formula-based COLA adjustments. However, the performance of your investments will determine whether or not the purchasing power of your assets keeps up with inflation. 	<ul style="list-style-type: none"> COLA adjustments are becoming less and less common. Some public/government-sponsored pensions still offer COLA adjustments, while private pensions almost never have these types of adjustments anymore.
Ownership	<ul style="list-style-type: none"> You own the IRA and have full control over your investment choices. 	<ul style="list-style-type: none"> The plan's assets are owned by a trust and your employer administers the plan. You may have a vested right to income or an equivalent lump sum.
Beneficiary and Estate Planning	<ul style="list-style-type: none"> You may leave an IRA to any person or entity, even multiple beneficiaries. Beneficiaries generally have access to the entire account, however distributions can typically be stretched over their lifetimes. Access to IRA assets can be restricted by naming a qualified trust as a beneficiary. 	<ul style="list-style-type: none"> Payments usually stop at death. A spouse can be named as the beneficiary via a joint and survivor election. Some plans offer a term certain option, which guarantees that the payments will be made for a minimum period of time.
Roth IRA Conversion	<ul style="list-style-type: none"> You can convert to a Roth IRA through a taxable rollover from the employer's plan, or convert the IRA to a Roth IRA later on. 	<ul style="list-style-type: none"> There is no Roth conversion opportunity if monthly payments are elected.
Fees	<ul style="list-style-type: none"> Annual IRA custodial fees may apply, depending on the size of your account. Investment management fees and/or commissions could be charged, depending on the investments chosen for the account. 	<ul style="list-style-type: none"> Typically, there are no fees paid by the pension plan participant.
Taxation of Withdrawals	<ul style="list-style-type: none"> Typically, withdrawals will be taxed at your ordinary income rate. 	<ul style="list-style-type: none"> Typically, pension payments will be taxed at your ordinary income rate.

COMMON MONTHLY PENSION DISTRIBUTION OPTIONS

Understanding how each of the monthly distribution options in your pension plan work makes choosing the correct option much easier. Some of the more common monthly distribution options available and their key features are highlighted below:

SINGLE LIFE ANNUITY

Features:

- Payable to the pension participant for life.
- The monthly payment terminates at the employee's death.
- There is no death benefit payable to any beneficiary.
- Provides the largest monthly payment.

When to Use:

- The pension participant is *unmarried*.
- Pension participant is in very *good health* and has *longevity* in the family.
- The participant's *spouse is much older* or unlikely to outlive them.
- The pension participant is insurable and can purchase life insurance as part of a Pension Maximization strategy, where the death benefit would ensure the surviving spouse has sufficient income should the pension participant pass away earlier than expected.
- The participant's spouse has their own pension plan that would provide sufficient income.

JOINT AND SURVIVOR ANNUITY

Features:

- Payable to the pension participant and their spouse, if the participant pre-deceases him or her.
- The spouse will receive a pre-determined percentage of the participant's original monthly benefit. Most pensions offer several options for amount the spouse will receive. The most common options are 100%, 75%, or 50% of the participant's original monthly income amount.
- The larger the survivor's percentage, the smaller the pension participant's initial monthly payment will be.
- The initial monthly payment will be less than the single life option.
- Some pension plans allow the survivor to be a non-spouse, although this is uncommon and there may be additional restrictions if a non-spouse beneficiary is named.

When to Use:

- The pension participant is *married*.
- If a married pension participant were to die first, the surviving *spouse would not be able to meet their income needs without the pension* continuing.
- The participant's *spouse is close in age* or younger or is likely to outlive the participant.

TERM CERTAIN / PERIOD CERTAIN ANNUITY

Features:

- Payable to the pension participant for life.
- The pension is guaranteed to be paid for a minimum period of time (measured in months or years).
- If the pension participant passes away before the term is met, the remainder of the payments will be made to the designated beneficiary(ies) until the end of the stated term.
- Beneficiaries can typically be a spouse or non-spouse.
- Monthly income amount will typically fall between the single life and joint & survivor amounts.

When to Use:

- The pension participant wants to guarantee that the income will last for a *minimum period of time*.
- The surviving beneficiary(ies) only has an income need for a fixed period of time.

- The pension participant needs a higher income payment than the joint and survivor options will offer, but still wants some type of guarantee in the event of an early death.
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COMMON MONTHLY PENSION DISTRIBUTION OPTION

Features:

- Payable to the pension participant for life.
- Depending on the options offered by the pension plan, there may be joint & survivor variations, as well.
- The goal of this option is to create level monthly income throughout retirement when factoring in the pension payment plus Social Security.
- The pension amount is higher typically until the participant becomes eligible for Social Security at age 62, then drops by the estimated Social Security amount that they are estimated receive at age 62. Different pensions may assume Social Security is taken at different ages—it is important to understand the benefit calculations used by your plan, as they can be unique.
 - Example: A pension plan participant has an estimated Social Security benefit of \$1,200 per month at age 62. She retires at age 55 from her company and begins taking her pension immediately. Based on the pension plan's formula, it is estimated that she would receive a total of \$3,000 from both her pension and Social Security at age 62. The pension will pay \$3,000 per month from age 55 until age 62. At that time, the pension payment will drop to \$1,800 per month with the expectation that Social Security will pay the additional \$1,200 to keep her income level at \$3,000 per month. The pension plan makes an estimate, based on the participant's earnings history. If she would happen to receive a different amount from Social Security, the pension *will not* adjust its formula.
- Typically, this option can be selected as a variation to the other options within the pension plan, when offered.

When to Use:

- Pension participant is *retiring before they are entitled to Social Security*.
- There is a strong need for a level stream of income from the day you retire.
- The plan participant plans on taking Social Security at the age the pension plan's calculations are based on—usually age 62.
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COMMON MONTHLY PENSION DISTRIBUTION OPTION

The vast majority of pension plans in the United States no longer offer inflation adjustments. They are almost non-existent on private pension plans. Some public pension plans still offer inflation adjustments, although they are becoming less common due to government budget constraints. Cost of living adjustments on a pension can have a significant impact your retirement income picture, so it is critical to understand whether or not your pension has cost of living adjustments and how those adjustments are calculated.