CHOOSING THE BEST Pension Payment Option For You

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If you're eligible for a defined benefit pension, you may have several payment options from which to choose. Your pension plan will calculate a basic single life annuity automatically, and, if you choose a different payment option, it will recalculate the amount of your benefit based on mortality and interest rates. That means no one option is inherently better or worse than another, but each option needs to be evaluated in light of your financial and family circumstances and your expected longevity.

Exploring the Options

A single life annuity pays a monthly benefit for your lifetime. When you die, payments end. The single life annuity may be a good choice if you have a longer-than-normal life expectancy or if you do not have any survivors who rely on your income.

A joint and survivor annuity will pay a benefit for your life, and, when you die, a benefit will continue to your survivor, usually your spouse, at the percentage indicated. If you take a joint and 50 percent survivor annuity that pays $1,000 per month while you are living, your survivor will receive $500 per month for the rest of his or her life after you die. If your survivor predeceases you, payments will stop when you die.

If you are married, you are required to take a joint and survivor annuity, unless your spouse consents in writing to a different payment option. A joint and survivor annuity is a good choice if your survivor needs a steady income for life. If you think your spouse may predecease you, you might consider a joint and survivor with a pop-up benefit option. With this payment option, if your spouse dies before you do, your pension payout will revert to the higher single life annuity amount.

A period certain annuity will pay a benefit for your life, and, if you die within a certain period, payments will continue to the estate or your named beneficiary for the balance of the period. For example, if you take a 10-year period certain annuity and die after 7 years, payments will continue for 3 years after your death. If you live past the period certain, payments will continue for your life but will stop at your death. A period certain annuity might be a good choice if your survivor is a child who needs income until he or she finishes school.

A social security income-leveling annuity allows you to get larger payments before you are eligible for social security, then reduces payments once you reach social security eligibility, so that your combined income is level during retirement. For example, if you take the social security income-leveling option with a $1,000-per-month social security benefit available at age 62, you may get a $2,500-per-month pension benefit at age 60, then have pension payments drop to $1,500 per month at age 62. Under this option, you expect to receive a total of $2,500 per month before and after social security. Your actual social security benefit may be higher or lower than initially estimated.

This option might be beneficial if you retire early and cannot make ends meet with the pension alone, or if you have a shorter life expectancy and would prefer to get larger monthly payments up front. If you start your pension early, it may be permanently reduced to reflect the fact that payments will be made for a longer period of time. If your pension plan subsidizes early retirement reductions, you may be better off taking the benefit early and investing the additional payments from starting early if you do not need the money to live on.

Your employer's pension plan may offer a lump-sum payment option as an alternative to an annuity. A lump-sum payment gives you the flexibility to access money as your needs dictate, but you run the risk of outliving the lump sum if the money is managed poorly, if you live longer than expected, or if you have an overly aggressive withdrawal rate. You will assume the responsibility and risk of investing the money to get the required return to fund your retirement. The lump sum might be a good choice if you are disciplined when it comes to money, want more control of your cash flow, are prepared to manage a large sum of money and monitor your investments, need cash up front to fund a venture, want to provide money for survivors or to charity, or have a shorter-than-normal life expectancy.

Which Payment Option Is Right for You?

When weighing your pension payment options, be sure to look at both the quantitative and qualitative factors. Consider your needs and resources, as well as your survivor's. Here are some questions to help you get started:

- Are you comfortable investing and managing a large sum of money? Is your survivor? A survivor may feel anxious knowing that he or she has to rely on investment returns from a sum of money, whereas a monthly pension payment would be guaranteed.

- Do you have the discipline to take only the amount you need each year from a lump sum? If you have other investable assets to hedge against inflation, you might want a steady, guaranteed income from your pension.

- How will needs and resources change if you or your survivor dies?

- What are your and your survivor's life expectancies based on health, habits, and family history?

- Do you have life insurance that can potentially provide income to a survivor?

If your single life annuity benefit is significantly higher than a joint and survivor annuity, you might consider pension maximization using life insurance. This strategy may allow you to choose a higher single life annuity and take the difference in monthly cash flow to fund a life insurance policy to replace your pension income at your death. To use this strategy, you should be insurable as a preferred nonsmoker underwriting class, and your survivor should be comfortable monitoring his or her investments or have resources lined up to manage the money for him or her. It is important to consider the benefits you may be giving up by selecting a single life or lump sum payment. Are you or your survivor foregoing any retiree health or other retiree benefits? These are significant issues to mull over when making your pension decision.

Finally, although some government pension plans, such as military pensions and social security, adjust payments annually for inflation, most pension annuities from private-sector employers do not have a cost of living adjustment (COLA). You can't outlive a lifetime annuity, but you run the risk of losing purchasing power as inflation erodes its value. If your annuity doesn't have a COLA, one way to offset the effect of inflation is to allocate other retirement resources to a portfolio whose return has the potential to outpace inflation.

Important Resources and More Information

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