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5 Important Questions to Ask Before You Take Your Pension

Should you take your pension as a lump sum? That's the first thing people tend to ask, but it shouldn't be the last. Here are five important points to consider before making any moves.

From a
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Most 20-somethings will never know the sweet security of a defined-benefit plan. To their generation, a workplace pension is something from a bygone era — or, at least, a perk that's mostly limited to government employees and those who work at giant corporations.

For the dwindling percentage of workers who still have a pension, it's an important asset that should be treated with care. Yet, this guaranteed-income stream is often overlooked as pre-retirees tend to focus on their investment savings accounts (IRAs, 401(k)s, etc.) and Social Security benefits.

Maybe that's because a pension seems so simple in comparison. The options for how you can receive your benefits are pretty limited compared with the hundreds of strategies used to help maximize Social Security. And — unlike your IRA, which is under your control — somebody else is watching over your pension money, making sure it's there when you need it.

But that doesn't mean you can just mark a few boxes and hope for the best when you take your pension at retirement. Every bit of income is vital at this stage of your life, and if you make a mistake with your claiming options, you won't get a do-over. Here are five important questions to check into before you sign on the dotted line:

1. SHOULD YOU TAKE A ONE-TIME LUMP-SUM PAYOUT OR CHOOSE A MONTHLY PAYMENT THAT YOU'LL RECEIVE FOR THE REST OF YOUR LIFE?

Obviously, the thought of receiving that money all at once — let's say it's $400,000 — is far more appealing than a lifetime of $2,000 monthly deposits. But you really need to do the math on this one to decide which is the better deal. Here's how it works:

- The age-old question is, "How much can I pull out of my IRA every year and not run out of money?" The standard used to be 4%, but in recent years, studies have suggested — based on a low-interest-rate environment and longer life expectancy — that your annual withdrawal amount should be closer to 3%. If you want to take $40,000 a year from your portfolio, a 4% withdrawal rate would require having $1 million. If your withdrawal rate is 3%, you would need $1,333,333 to get your $40,000 yearly income.

- Now, apply this same concept to your pension. At $2,000 a month, you'd be getting $24,000 a year in income. Divide that amount by your lump-sum offer of $400,000, and you get a withdrawal rate of 6%. In this case, that makes taking the income option a smart move, because if you took the $400,000 and rolled it into an IRA to produce income, you'd have to pull 6% of the money out each year to get the same result. Most professionals would agree you would have a chance of running out of money at that rate (depending on how long you live).

- If you do the math and choose the lump sum, make sure you roll it over directly into an IRA so you don't end up paying taxes on it, or, if you're under 59½, an early withdrawal penalty.

2. Should you go with the "single-life annuity" option and get a bigger monthly check, or downsize that amount but help protect your spouse with a "joint-and-survivor" option that offers a smaller payment?

Obviously, there are many factors to consider here, including each spouse's health and life expectancy. I recommend comparing different scenarios side by side. If you find the surviving spouse would be fine financially without the pension money, you might decide to take the highest income option. Just know that if you choose the "single-life annuity" and you pass away after Day 1, your surviving spouse may not get any more money. At the same time, he or she will lose the lower of your Social Security payments. It's up to you to determine if the risk is worth the reward.

3. How does your pension money fit into your legacy goals?

This one is pretty simple: If you do a lump-sum rollover into your IRA, it becomes an asset in your estate. That means when you and your spouse pass away, the money is completely inheritable. If taking care of your loved ones in the future is a priority, the lump-sum option may be more desirable. When you roll your money into a lump sum IRA, it is now simply an asset in your estate, fully inheritable to anyone you choose.

4. What could be the tax consequences?

If you're fortunate and have other strong sources of retirement income (Social Security, rental income, etc.), you may not need any more money coming in. And adding yet another income stream with your pension might push you into a higher income-tax bracket. In that case, you might find it advantageous to take the lump-sum payout, roll it into an IRA and leave it there untouched to avoid the taxes. Yes, at age 70½ you'll have to deal with required minimum distributions, but the total taxable income should be less overall. Here's an example*:

- Let's say you have $500,000 in your IRA at age 70½. Your first required withdrawal is at 3.649%, which is $18,245 for the year. If you choose the monthly income option of $2,000, your total taxable income for the year is $42,245.

- If you roll the $400,000 lump sum into your IRA, your total IRA balance would be $900,000. At 3.649%, your RMD would be $32,841. So, in this example, the lump sum would produce less taxable income.

5. HOW HEALTHY IS THE COMPANY OR GOVERNMENT ENTITY THAT'S PROVIDING YOUR PENSION?

If the monthly income option makes sense to you, but you don't feel good about the employer (public or private) that's handling your pension, you still may want to take control of this important asset. A pension is generally used to be a reliable income source for life. Unfortunately, failures and closures have become more common, leaving retirees who depend on those benefits to scramble. Of course, pensions so have the protection of the Pension Benefit Guarantee Corp., however the full balance of your pension may not be what you ultimately receive. Employers who offer pensions are required by law to send participants an annual notice with details on how well-funded the pension is. Be sure your company and the pension are both in good financial shape.

If you're one of the fortunate few who still have a defined-benefit pension coming, don't take it for granted. Treat it as a critical part of your plan. Your goal should be to get the most from every source of retirement income you worked hard to earn.

**The hypothetical example provided is for illustrative purposes only; it does not represent a real-life scenario and should not be construed as advice designed to meet the particular needs of an individual's situation. Neither the firm nor its agents or representatives may give tax or legal advice.*

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