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summaries

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Pension Buyout Offers

Defined benefit pension plans have for the most part been replaced by defined contribution 401(k) plans for younger workers. Many retirees (or soon to be retirees) are often offered opportunities to "cash in" their defined benefit pensions for lump-sum payments. Those who accept the offers trade in a guaranteed stream of lifetime income for a large infusion of cash, which will in essence resemble a traditional, self-managed IRA on a go-forward basis.

Depending on several factors, some of these lump sum offers could be worth several hundred thousand dollars. At first glance, some may be licking their chops in anticipation of receiving a large six-figure payout. On the flip side, those who are more pessimistic may think their employer is trying to shortchange them.

With any defined benefit pension plan, the employer agrees to make lifetime payments to retirees and must continually "fund" those future obligations. The employer shoulders all of the investment risk. The amount that the company must put into the fund in any one year is a function of the current assets in the fund, the anticipated rate of return on the fund's assets, employees' years of service with the company, employees' current and future pay, current interest rates, and the life expectancy of the pension fund participants. Some of these inputs are predictable, but many are not. As a result, companies with pension plans have had to traverse a lot of uncertainty, especially as workers have grown older, the number of retirees has increased and life expectancies have continually inched upward. Further, fund investment return estimates have become more conservative following the most recent bear market (i.e. targeting lower investment returns and lower levels of risk), while interest rates on bonds have plummeted.

So who should take these buyouts? The following sections look to highlight several points that should be considered before making a decision.

Life Expectancy

A defined benefit pension payout will be calculated based upon the retiree's life expectancy. The fund assumes that the beneficiary and their spouse (if named as a survivor) will live to be an average age. The longer a beneficiary actually lives, the harder it will be to justify taking the lump sum distribution.

For example, if a retiree has a long family history of great health and longevity, then retaining the lifetime pension may be the best option. On the other hand, if the retiree and their spouse (if named as a survivor) are in poor health, then taking the lump-sum distribution may be more advantageous.

Spouse Survivor Option

Almost all defined benefit pensions allow for the beneficiary to take their benefit as a single life annuity (i.e. income ceases when they die) or as a life annuity with a survivor option (i.e. their spouse is entitled to a predetermined percent of the benefit after the retiree dies). Further, this election is irrevocable. In some cases, a retiree may have opted to not include their spouse as a survivor because doing so would reduce their own lifetime payments – how selfish! That retiree may come to regret their decision if they've now become ill and their spouse will soon be left with no pension income. If this is the case, taking the payout will allow those assets to be used for the spouse's support, even after the retiree has passed.

Plan Funding Status

This is different for each company and plan. If a plan is severely underfunded, there is a risk that retirees may not receive the benefits that they have been promised. Information regarding the company's funding levels and contributions can be analyzed to help determine the plans status.

PBGC Coverage

Every private sector defined benefit pension plan is required to pay insurance premiums to the Pension Benefit Guaranty Corporation (PBGC). Much like the FDIC does for failed banks, the PBGC is a government entity that takes over failed pension plans. Similarly, just as the FDIC has limits on the amount of assets that it will cover for any single depositor at a failed bank (currently $250,000), the PBGC has limitations on what benefits it will guarantee for private sector retirees that are covered by a failed pension plan. For those who have pension benefits that are above PBGC guaranteed maximums, which vary based upon age, a lump-sum payment may make sense if the pension plan in question is severely underfunded.

Income Tax Flexibility

Private pension benefits are considered taxable income to the recipient. As a result, income tax is due on benefits as they are received evenly over time. With an IRA, distributions are taxable income as well, but the owner has more control over the timing of distributions. This income tax flexibility most often comes into play when a retiree has high deductible expenses (usually medical or nursing home related). Sometimes, substantial balances can be distributed out of an IRA without any tax being due, because of offsetting deductible expenses. In other instances, a retiree may find themselves in a low tax bracket, at which point converting some pre-tax IRA dollars to after-tax Roth IRA dollars may make sense. This is especially applicable if the retiree anticipates a future rise in their tax rate, or if their heirs are in a higher tax bracket. A pension cannot be converted to a Roth IRA, while a traditional IRA account can be converted.

Income Needs and Generational Planning

Some pension recipients do not need the current income that their pension provides. Rather than having continual taxable income, some would prefer to have an IRA account and only take out the IRS mandated required minimum distribution. By doing

so, any assets remaining in the IRA would continue growing on a tax-deferred basis over time for their heirs. Further, a pension essentially acts like a bond. It is conservative in nature and pays a predictable amount of cash for a pre-determined period of time. For some retirees whose income needs are already met without the pension, there may be a desire to invest those assets more aggressively for long-term growth, whether it be for their children's or grandchildren's eventual benefit. If this is the case, then a lump sum distribution may make sense.

Willingness to Forgo Predictability

Arguably the most beneficial aspect of a defined benefit pension plan is the predictability that it affords the retiree. The retiree does not have to look at fluctuating market values or ride out equity bear markets in order to meet predetermined income goals. A check shows up every month and all investment risk is shouldered by the employer. Even if the payout offer is quite attractive, one must not underestimate the value that lifetime predictability brings.

Self-Control

Finally, it should be noted that any retiree who opts to cash out their pension plan and roll the balance over into an IRA must be able to exhibit self-control. What was previously a predictable stream of cash flow from an asset base that could not be accessed will immediately become fair game for current consumption.

All of the above considerations should be carefully considered when considering a lump sum payout. From a mathematical point of view, with the numbers in hand, one will be able to say "if I live to be age X and I can earn Y percent on my investments, then it makes more sense to cash out". In reality, one must be uniquely suited on a number of fronts in order to benefit in a material way from cashing out a defined benefit pension plan.

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