You're Getting a Pension, What are My Payout Options?

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The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

If this headline caught your attention and you happen to be reading this, congratulations! You may be one of the minority of Americans who have a pension plan.

Pension plans are still common with local, state, and federal government jobs. However, only 15% of private workplace employees have a pension as part of their retirement package through their employer, according to the 2021 US Census.

A pension is a defined benefit plan by which the employer commits to paying a specific amount of money to their retirees. Unlike defined contribution plans, such as 401(k) plans, the market risk does not weigh on the shoulders of the employee. Pension plans are typically funded by the employer, who also takes responsibility to invest the asset. The pension plan itself is responsible to fund and invest and is eventually held accountable for meeting its obligations to current and future retirees.

Most pension plans provide retirees with a few options to choose from. This decision is crucial as it can have a dramatic impact on the likelihood of financial success during your retirement years. In many cases it is also irrevocable.

Let's go through some of the most common options that retirees might have when deciding which pension election to take.

Single-Life Payout

The single-life payout is often the default and sometimes the only option available. Under this option, the pension plan will guarantee a payment throughout the lifetime of the recipient. When the individual passes away, the payments cease.

Some people live for 40 years into retirement, enjoying this benefit for a long time. Others, unfortunately, pass away shortly after collecting their first pension check. Since there are no bells and whistles that come with this election, the single-life payout is almost always going to be the highest monthly benefit available to choose from.

This choice is often suitable for individuals who are single and who have a reasonable expectation to live for a long time after beginning to take distributions. This option is also sometimes taken by married workers who seek the higher payment so that they can purchase life insurance or make an alternative investment to protect their spouse if the spouse lives longer.

Joint-Life Payout

This is one of the most common alternatives to the single-life plan. Joint-life payouts are typically only available to married individuals and the monthly payment will be at a discount compared to the single-life option. With the single-life option, the payments are guaranteed throughout that individual's lifetime. With joint-life, payments are assured for as long as either the former employee or their spouse is alive.

If the spouse lives longer than the employee, then they will continue to receive either all or a percentage of the benefit. Often there will be different levels of percentage points to choose from. If you want your spouse to be guaranteed 100% of the full benefit, however, expect a lower monthly benefit than if you wanted to guarantee your spouse gets only 50%. Some pension plans offer a pop-up benefit, which is in a way a hybrid of single- and joint-life payouts. With pop-up benefits, the retiree takes a lower benefit to protect the interest of the spouse. If the spouse passes away first, however, then the benefit increases to the higher amount that the single-life option would have paid.

This option is common for recipients who are married. It might be important to weigh the age, health, and longevity of both partners to help forecast the need for taking this option.

An example:
The plan participant is a 75-year-old employee in poor health who is planning to retire. Their spouse is 65 and is in good health. In this scenario, the owner of the pension is more likely to select a reduced payment to protect the interests of their spouse than they would if the ages and health were reversed.

Life With Term Certain

Another common option is to add a guaranteed certain time to your life payment options. It works just as it sounds. Life with certain term is often available for both single- and joint-life options. The retiree and pension plan agree on a fixed payment guaranteed over their lifetime. If the individual passes away early into their retirement, the beneficiary can continue receiving the benefit for a certain number of years specified in the agreement.

An example:
A participant chooses a single-life option with 10-year certainty. Under the single-life option, if the person passes away early on, let's say after only receiving the benefit for six years, then the payments would stop immediately. Adding a 10-year certain rider allows the beneficiary to continue receiving payment for the remainder of the 10 years. If the retiree passes away after the 10-year period expires, then the payments cease.

Lump-Sum/Cash-Out Option

Taking the lump-sum option, although it might be suitable in some cases, does not always mean taking a check for the full amount and depositing it into your checking or savings account. It is important to understand that in most cases taking a lump sum and withdrawing, not rolling over, the asset will be fully taxable to the recipient and often not the best choice.

The alternative when taking the lump sum is to conduct either a direct or indirect rollover into another retirement-qualified account such as an IRA or another work-sponsored plan. When rolling the assets over into a qualified account, taxes aren't going to be due in the tax year of the transaction. Instead, only future amounts withdrawn from the rollover-qualified retirement account will be taxable.

Some individuals prefer rolling over their pensions into an IRA because it gives them more flexibility when it comes to investment choices. If guaranteed income isn't vital, or if there is another source providing this needed income, then perhaps a more traditional investment or savings option would be best to help optimize retirement planning. Not only are there countless different ways to invest within an IRA but they can also be accommodating plans when taking distributions.

Perhaps having guaranteed income is crucial to the success of someone's retirement plan. This doesn't necessarily have to eliminate the idea of rolling over the pension into an IRA or other tax-qualified account, however. Like the pension options discussed earlier, there are hundreds of annuity products on the market that are issued with insurance companies that can also be used to customize an income plan for you and your family. These types of products can be included in an IRA account.

Annuities can sometimes be costly, confusing, confining, and unnecessary. But annuities can also be an effective tool for retirement planning. Annuity products certainly have their critics within our industry, but they are often suitable for certain individuals depending on their specific situation.

A Caveat for Pension Plans

The employer bears the legal responsibility of making sure that the pension plan remains adequately funded to meet future obligations. That said, the employer could potentially enter bankruptcy and be unable to meet those obligations. Your pension may be safeguarded by the Pension Benefit Guarantee Corporation (PBGC). But not all plans are insured by the PBGC.

Review the summary plan description provided by your employer and know whether your plan is protected by the PBGC. If you are concerned with your employer's solvency, then perhaps you consider taking the lump sum option.

Why Financial Planning Is Essential

So which option is best for you and your family? The answer to this question would only be simple if you knew exactly how long you and your spouse (if married) will live. You would also need to know how well your other investment and savings accounts will perform throughout retirement. Knowing how much money will be required in the future to keep up with future inflation would also be important. Some pension plans increase payments in line with cost-of-living increases.

These types of plans are more of an exception than the norm, however. What expected and unexpected windfalls might you inherit someday? Conversely, what unanticipated major expenses might be in your future? Unfortunately, nobody has a crystal ball and can accurately forecast the future in the detail needed.

This is why planning is so essential.

A trusted advisor who specializes and is experienced in retirement planning can make sure that you are taking everything into consideration when making this big decision. Factoring in your marital status, health, age, and historical family longevity can help project how long you may need to make the money last. Reviewing other assets, debts, and incomes can help ensure that your pension election is complementing your overall financial picture.

We can work with you to compare several of the options and scenarios discussed in this article to aid in the decision of which payout option may be the most effective in your situation. We can consider a wide range of market situations and returns to test your options so you won't feel as though you are on your own in making this critical decision.

For more information, please contact your advisor.

About the Author

As an Associate Private Client Advisor for Key Investment Services, Jeffrey works with clients to define their financial goals and provides them a Key Wealth Analysis tailored to how they invest and what they want to achieve. Jeffrey is dedicated to helping clients advance their financial wellness and feel more confident about their financial future. Jeffrey works in concert with a team of national strategists to provide advice and solutions for clients to grow and protect their wealth. Jeffrey holds his Series 7, 65, 6, 63 and NY state insurance licenses, and also holds the CFP®, CIMA® and ChFC® professional designations. Jeffrey earned a bachelors degree from the School of Business at the State University of New York at Oswego.

230724-2177378