Pensions, Buyouts, And Retirement Income

There was a time when pensions were the most common of retirement benefit plans. Employees looked forward to what could generally be described as a private version of Social Security offered via an employer. However, those days are gone, and only a small number of the US population have pensions now. If you do receive a pension, there are key decisions you'll need to make about how to utilize your benefits, so you make the best use of this retirement benefit that only a fraction of the population has access to.[1]

There are so many decisions for you to make about your retirement income as a retiree, and as a pension-holder, you'll want to be sure you make the most of this income-generating asset. The choices you make with your pension can impact your finances for the rest of your life. In this guide, we'll cover what you should know when making these decisions, such as:

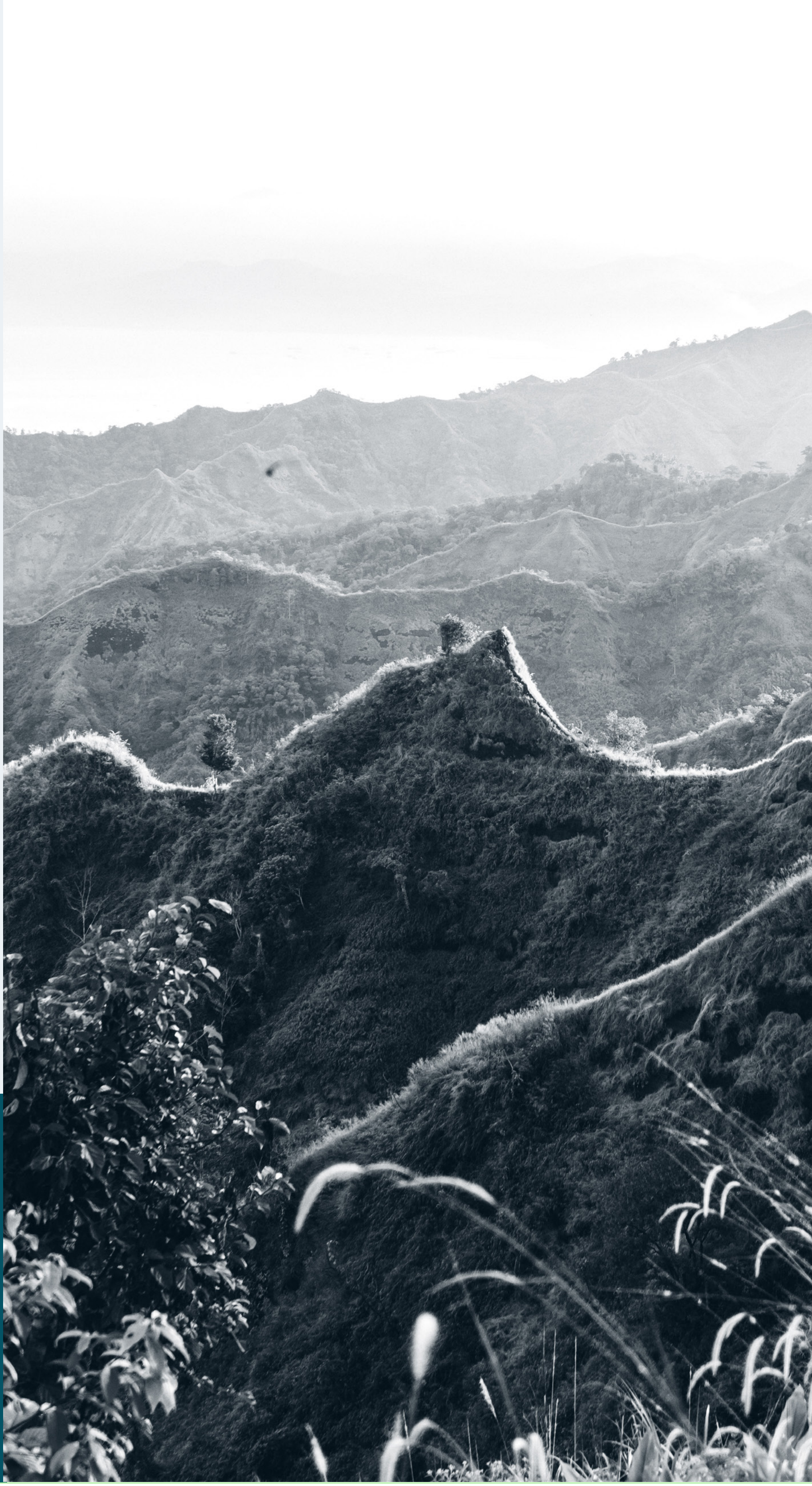
- Recent History Of Pensions In The US
- Pensions Vs. 401(k): Defined-Benefit Vs. Defined-Contribution
- What To Consider When Offered A Pension Buyout
- Deciding To Take The Lump Sum Or Monthly Payments
- Details On Taking Monthly Payments
- Details On Turning A Lump Sum Into Lifetime Income
- How Inflation Affects Costs Of Living

Recent History Of Pensions In The US

From the 1940s to 1987, the workforce with pension plans increased tenfold, from 4 million to 40 million. However, by the latter part of the 1980s, the 401(k) plan, established in 1978, was making significant strides, permanently altering retirement in the US. As per the data from March 2023, while three-quarters of full-time employees had a retirement plan available, a mere 15% had access exclusively to a defined-benefit plan, as reported by the US Bureau of Labor Statistics.[2]

This important part of retirement income is disappearing. Pensions have simply become too expensive for many private companies to provide, and the public sector is contending with increasing pension debt. In addition, there's always the risk that pension benefit obligations outpace pension fund investment returns, potentially leaving debt on the books for private or public institutions.[1]

However, pensions may be a preferable option for many employees because participants are guaranteed a certain benefit amount regardless of market performance.



Why Are Pensions Preferred by Employees?

One reason is that the pension fund is responsible for covering benefits promised by the employer rather than placing the onus on the employee to generate retirement benefits via investment returns.[3]

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Pension Vs. 401(k): Defined-Benefit Vs. Defined-Contribution

Workers with retirement benefits typically either have access to a defined-benefit plan (pension plan) or a defined-contribution plan (401(k), 403(b), or 457 plan). If you have a defined-benefit plan, your company defines how much monthly income from the pension you will receive in retirement based on certain qualifications. Usually, your years worked, average income level, and interest rates determine the value of your defined benefit.[3]

If you have a defined-contribution plan, you decide how much to contribute to a tax-advantaged account and can then withdraw the money as you see fit at a certain age in or near retirement. However, for defined-contribution plans, the company doesn't guarantee a monthly income amount and is instead a personal investment portfolio which you are allowed to withdraw from at a certain age. In other words, that investment portfolio is responsible for funding your income instead of the company or the pension fund the company uses.[4]

Each has its advantages and disadvantages, but at this point in your life, it's important to focus on how to make the most of what you have and what you're owed.

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Take The Lump Sum Or Monthly Payments?

Companies may offer pension buyouts to their current and retired employees. If you're offered a pension buyout or have the option between choosing a lump sum or monthly payments, you have a lot to think about.

On one hand, a lump sum distribution can give you more control over your money. You can spend it or invest it as you see fit and when you see fit. On the other hand, guaranteed income for a specified period or the rest of your life can certainly have its benefits, especially when you consider how it may help you regulate your spending, how many years you could spend in retirement, and the fact that this money is guaranteed regardless of what happens with the market.

Here are some things to consider when making this important decision:

01 DO THE MATH

Compare the lump sum amount to the monthly payment option over the course of your life. Calculate how much you would need to withdraw from the lump sum annually to meet your target income, and then compare that with the monthly payments.

Note that interest rates at the time may affect your buyout offer. The higher the interest rate, the lower the offer may be comparatively.[5]

02 CONSIDER OTHER BENEFITS OF KEEPING THE PENSION

Find out if you would be forfeiting any benefits by taking a buyout, such as health insurance. Factor the value of these benefits into your calculations.

03 CONSIDER THE FINANCIAL STANDING OF YOUR COMPANY

Benefit guarantees are made based on the claims-paying ability of the insuring company. It's not impossible for a company or a pension fund to go bankrupt. In that case, a government insurance organization may be able to cover a portion of the benefits, but there's no guarantee that it will all be covered.[6]

04 CONSIDER THE TAX IMPLICATIONS OF BOTH OPTIONS

Would fixed pension payments increase your tax burden and prevent you from pursuing tax minimization strategies? Do you have a significant amount saved in an IRA, 401(k), or other taxable retirement account that may cause you to face an increased tax burden when you withdraw funds later?

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05 WILL YOU BENEFIT FROM MANAGING YOUR OWN FINANCES?

Consider how comfortable you would be managing a considerable sum of money so that it lasts the rest of your life. There's a reason why so many Americans fear outliving their savings. Longevity risk is the risk of outliving your money, and improperly managed investments can result in drawing down a retirement account too fast.[7]

06 HOW WILL YOUR SPOUSE PLAY INTO YOUR PENSION STRATEGY?

If you want to provide for a spouse after your passing, consider how you might do this by taking a buyout or if you have the option for a spousal benefit with your pension plan.

07 CONSIDER THE IMPLICATIONS FOR YOUR ESTATE PLAN

You likely cannot pass on your pension payments to non-spouse beneficiaries. However, you may be able to pass on a lump sum with an IRA or similar defined-contribution account to whomever you want (with some limitations).[8]

08 WOULD YOU BENEFIT FROM PROFESSIONAL ADVICE?

The right decision depends on your plan's benefits and your unique financial situation. Your company may not be able to provide the in-depth, personalized advice you want and need.

Conclusion

Taking the lump sum can offer more opportunities to take control of your finances and can potentially provide more flexibility for your retirement and estate plan. But if you're realizing that there are many complex moving parts to your pension strategy and financial situation, a financial professional can help you create a retirement income plan and an estate plan.

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Details On Taking Monthly Payments

If you decide to choose the monthly payment option, you may still have more decisions to make. Your options depend on your company's plan, but here are two questions to consider:

Lifetime Or Defined-Period Income?

You may have the option to receive larger monthly payments over a specific period or smaller payments for the rest of your life. It's important to factor in longevity risk when planning for retirement and compare the difference between these two payment methods.

Individual Or Added Spousal Benefits?

Will you receive income for the rest of your life or the rest of your spouse's life if you pass away first?

- Choosing to only receive payments for your lifetime could mean larger monthly payments while choosing to receive payments for both your and your spouse's lifetime could mean smaller payments.
- The right choice depends on several factors, such as you and your spouse's age difference, your Social Security spousal benefit, and what assets you will pass on to your spouse.[3]

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Details On Turning A Lump Sum Into Lifetime Income

You may decide that taking the lump sum payment is the better option, be offered a severance package, or simply have to rely on your own savings in retirement. No matter what you choose, there are various options to carefully compare to ensure you make a best-fit decision with your pension. Whatever the case, if you don't already have a source of lifetime income in retirement, you can create one with an annuity. An annuity is a financial vehicle that takes a lump sum of money and pays out a stream of income over a set period of time or a lifetime.

ADDRESSING LONGEVITY RISK

Annuities can help protect against longevity risk – the risk of outliving your money. There are various types of riders that can be attached to annuities, such as a rider that continues to pay the spouse of the annuity holder after the latter's death.

TAX BENEFITS

Certain annuities can offer tax benefits. Qualified annuities are funded with pre-tax dollars, and funds can grow tax-deferred until they are withdrawn. Withdrawals are then taxed as income. There can be a 10% early withdrawal penalty before age 59½ and early surrender penalties, depending on the contract.[9]

MARKET VOLATILITY PROTECTION

Many annuities can help protect the principal from market volatility by offering a competitive rate of return in the event of market downturns.

INFLATION PROTECTION

Some annuities can help to protect against inflation by offering a guaranteed rate of return pegged to the CPI inflation rate. This could help your portfolio keep pace with increasing costs of living.[10]

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Reasons To Consider Transferring A Lump Sum Into An IRA

IRAs offer very unique benefits in comparison to a pension plan. Before making decisions about what to do with your pension, it's important to know the benefits of transferring your funds into an IRA.

1. **Avoid A Higher Tax Burden**

   While it might be tempting to cash out your pension in tough times, this could dramatically increase your tax burden. On the other hand, funds rolled over into an IRA are not treated as withdrawals and are not subject to income tax until you start taking distributions. You can continue to enjoy tax-deferred growth by rolling over funds directly into an IRA.

2. **Gain Access To More Investment Options**

   If you transition your lump sum into an IRA, you can potentially be in charge of your own investments. With an IRA, you can often invest in almost any stock that trades on the official US public markets, a variety of mutual funds, ETFs, bonds, and more. By consolidating your retirement benefits into an IRA, you can gain more flexibility in your investment choices, allowing you to create a retirement plan customized to your unique needs.[11]

3. **Option To Convert To A Roth IRA**

   You have the option to convert funds from a traditional IRA, 401(k), or similar qualified retirement account into a Roth IRA. In this case, you would pay tax on the funds converted and then be able to withdraw them tax-free later on. You might consider a Roth conversion while your tax burden is lower if you think taxes might rise in the future or if you would like to pass on your wealth to loved ones in a tax-efficient manner. Be mindful that Roth IRA owners must be 59½ or older and have held the Roth IRA for five years before tax-free withdrawals are permitted.[12] Consider working with a tax advisor before deciding to make a conversion because it's a major financial move that may not make sense for everyone.

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Don't Forget That Inflation Affects Costs Of Living In Retirement

One of the foremost concerns retirees face, especially now, is the increase in the cost of living due to inflation over the course of their retirement.[13] When deciding what to do with your pension, it is smart to factor in the potential impact of inflation over the long term and consider what options you have to help address inflation's effect on your income.

- Some pension plans may come with inflation-adjusted fixed-income payments, which can greatly help your income stay on pace to cover your costs and can be an added benefit of sticking with your pension plan. But not all plans offer inflation-adjusted payments, and even if they do, they may not offer adjustments that keep pace with inflation.[14]
- Such options may entail taking a lump sum and converting it to an IRA holding assets that help adjust for inflation. Another option may be to include an annuity with inflation-adjusted payments. It may entail simply sticking with your pension payments if it commensurately accounts for inflation, but it's important that you make your decision carefully and weigh all your options.

Addressing inflation is just one factor that can illuminate your best options for how to make use of your pension. To make sure your risks are comprehensively addressed, your financial strategy should have the consistent oversight required to adjust and stay a step ahead. There's no replacement for advice from financial professionals with experience and knowledge in how to address financial risks to help meet retirement goals.

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You Have A Lot To Think About

More private companies are offering pension buyouts, there could be more market volatility to come, and interest rates are climbing back up. We're living in different times, and that means our retirement plans need to adapt. We've left you with a lot to think about, but don't feel that you're alone when planning for retirement. Our team of professionals is here to help you cover all aspects of your finances so you can retire with a solid plan in place. This means taking the time to learn about your unique situation to figure out the next course of action. Whether you're being offered a pension buyout, deciding between pension options, or trying to create lifetime retirement income from savings, we can help you assess your options and create a plan that fits your needs.

Contact the financial professionals at VestGen Wealth Partners at **vestgen.com** or **(833) 964-7526** to get started.

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