Should You Accept a Lump Sum from Your Pension Plan?

A wise decision is within your reach
with help from CREWS – "Retirement at Work"

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Introduction

You've been told you have the option of converting all or part of your pension plan to an immediate cash payment (a "lump sum"). What should you do?

Just as important, how do you even think about this in a sensible way?

First, let's distinguish three circumstances under which you might have the option of taking a lump sum from your pension plan:

1. You are retiring from an employer that offers a traditional pension plan (a plan that pays a monthly retirement benefit for life), and that plan allows you to take all or part of the value of your pension as a lump sum *when you retire*, with reduced or zero future payments.
2. Your employer is restructuring a traditional pension plan, and you are being offered a *one-time opportunity* to take a lump sum in exchange for giving up any future benefits you otherwise would be entitled to.
3. You have a 401(k), 403(b), or other similar plan where you already have a specific account balance, and because of a job termination, retirement, or other event you have a right to withdraw some or all of your account from the plan.

Although each of these situations is different, most of the thought process you should go through is the same.

Even so, there is more than one way to think about this decision.

> Taking the lump sum means you have an immediate financial windfall. What's more exciting than that? And who doesn't have a mental list of great things that could be done with a windfall?
>
> Then again, if you take the lump sum, you may be cheating your own future, or that of people who depend on you. Maybe that money is going to mean a whole lot more to you later than it does now, not least of all because if left alone, it is likely to grow.
>
> Of course, if the lump sum amount is small, none of this matters a great deal. But if it represents more than a few paychecks to you, then it's worth putting some serious thought into.

And that's what this guide is for.

There are other places you can get advice, and you should explore those, too. But this booklet has been developed and presented by the creators of decision-

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making software, not by anyone who has anything to gain or lose by the outcome of your decision. Yes, we will point you to where you can find our software if it would be helpful, but whether you take the lump sum or not, or what you do with it if you do take it, does not affect us. We are trying to be as objective as possible, thinking about what might benefit you.

We do this in three different sections. Feel free to skip around among them:

What's your situation?

What are your options?

How do you decide what to do?

What's your situation?

Fifteen things to think about…

1. ***Can you trust yourself?*** Be honest (no one needs to know what you're thinking except you). If you know that receiving a lump sum, especially a large one, is going to burn a hole in your pocket until it's gone, then you probably should leave it someplace where you can't get at it, or can do so only with difficulty.

   The same is true if you're a soft touch for people in need – maybe your children, or maybe other relatives, friends, people in your community, or church or charitable organizations. Giving is wonderful, but if you end up broke, you'll need to be receiving instead of giving. Is that a risk for you?

2. ***How much risk can you tolerate?*** A traditional pension involves very little risk. Most traditional pension plans pay what's been promised, and pay it for as long as you live. Taking a lump sum and purchasing an individual annuity with it *might* create a similar benefit, but taking a lump sum and doing anything else with it means that you might not end up as well financially. If you cannot afford any risk, or if taking it would cause ongoing stress for you, then that's an important consideration.

3. ***How big is the lump sum?*** If it represents less than one paycheck, or even if it's as much as two or three paychecks, it might not make much difference what you do with your windfall. But if you decide to take the money and run, keep in mind that you'll have to pay income taxes on the lump sum first (more about this later).

4. ***What's your age, and how long until you retire?*** Younger people have a lot more unknowns in their future, including issues that have nothing to do with retirement. But they also have more time and usually more options for changing course. Older people may have more clarity about what retirement looks like, but unless they are quite aged or quite ill, they still don't know how many years they might have in

front of them. So either way, unless you have plenty of financial resources elsewhere, the decision to give up a monthly pension for a lump sum can have big consequences.

5. ***Are you under financial stress now?*** If you are truly under the gun, a lump sum might be irresistible, and using it to solve your immediate problems might make all the sense in the world. But if you're not under a lot stress at the moment, then either not taking the lump sum or else taking it and investing it for the longer term is often the more prudent choice,

6. ***What are your retirement needs?*** Does your retirement look financially secure, or not? If not, you need to think hard about doing anything that detracts from it. Leaving your pension plan intact might make more sense – or, as just noted, you might find other things you can do with the money that would work out better.

7. ***What are your other financial needs?*** Providing for retirement is important, but so is paying for serious illness, sending children or grandchildren to college, finding the right place for you (and your family, if you have one) to live, starting a new business or keeping one afloat, paying off high-interest debt or family loans, and any number of other concerns. In the end, money has little value other than to support someone's lifestyle at some stage of life, and providing for retirement is a way of investing in that stage of life. But other stages, and other lives, also sometimes demand some investment. A lump sum gives you flexibility you might prudently take advantage of.

8. ***What's your life expectancy?*** If you are weighing the value of a lifetime retirement income stream against the value of a lump sum today, keep in mind that the lump sum you are being offered has been calculated by experts to equal the expected value of the future pension payments. But that assumes you die when the average person your age is expected to die. If you have a legitimate expectation that your life will be shorter than average – because you're male (pension calculations generally, by law, cannot take gender into account), because you already have a serious illness, because you smoke, or for other reasons – then that's a point in favor of taking the lump sum. Conversely, if you expect to live longer than the average person your age, the monthly pension might have more value.

9. ***What are interest rates today, and what's their likely direction?*** Those experts calculating the amount of a lump sum you would get instead of a traditional pension have to use current interest rates. If interest rates go down and stay down, your monthly pension will be an especially good bargain compared to taking the lump sum. But if interest rates go up, the lump sum is likely to have more potential. We can't know, of course, what the future will bring, but you should be aware of this issue, and if you feel strongly that rates will move one way or the

other over time, you might want to take it into account.

10. ***What are your other financial resources?*** Between Social Security, other pension plans you (or a spouse or partner) participate in, personal savings, and other resources, you might not need to worry about liquidating the pension benefit in question. Then again, you might very much need to worry about it.

11. ***What about taxes?*** A lump sum is going to be taxed as ordinary income when you take it, unless you roll it over into another pension plan (such as an IRA account). If you don't take the lump sum, or if you roll it over into another plan, the pension benefit will be taxed later, as you or your beneficiaries receive pieces of it. If you are under age 59½, there may be a 10% penalty tax as well. There are other complications, too. These can make a big difference.

12. ***What are your alternative investment opportunities?*** If you take the lump sum, even if you roll it into an IRA, you will have a lot of flexibility about how those funds are invested and can grow in the future. In a 401(k) or other employer-sponsored account, your choices are much more limited. In a traditional pension plan where you get a monthly benefit for life, you have no say at all in how the money is invested. So taking the lump sum gives you an opportunity to do better, but also exposes you to the risk of doing worse.

13. ***What about early retirement?*** Some traditional pensions, in effect, give an extra boost to your benefit if you retire early – in which case, if you are not yet retired but think you might want to retire early, you could be giving up something extra. On the other hand, most pension plans have a minimum age for benefits to begin, and if you prefer to retire sooner than that, you have more flexibility with a lump sum.

14. ***What about peace of mind?*** Traditional pension plans that pay a benefit for life pay it no matter how long you live. If you live a long time, that's a big deal, and you would be unlikely to match that by taking a lump sum and investing it yourself. (In theory, you could take a lump sum and buy an annuity from an insurance company that would also guarantee you a lifetime benefit – and you would probably have more options about how this was done, which is a good thing. But in most circumstances, an individual annuity would come up short compared to the benefit the pension will pay – unless you invested it wisely and waited until you were older and could time the annuity purchase for when interest rates were higher.)

15. ***What about your spouse or ex-spouse?*** By law, if you're married, your spouse (or if you're divorced, your ex-spouse, oftentimes) would have to approve a decision to take a lump sum option. That may limit your choice.

What are your options?

You have four main options, though some of them come in multiple flavors:

1. Keep the pension

This option applies only if the lump sum offer is coming from a traditional pension plan that provides a guaranteed retirement income for life. It does not apply to most 401(k) plans, or other similar plans where you have a specific account balance.

Advantages:

- It's the simplest choice: just keep things as they are.
- You get retirement income for life, which might also include the life of a spouse, partner, or other beneficiary. You don't have to worry about outliving it, generally speaking. And some pension plans even offer an inflation adjustment, though this applies mostly to government pensions, and usually not to corporate pensions.
- Your monthly benefit is determined by formula, based on your years of service and compensation. It is not affected by fluctuations in the financial markets, or to other events. You know what you will get, and when.
- You might get a bit of a bonus in your benefit if you retire early, if your pension plan provides for this.
- Since the pension will dole out money on a monthly basis, you can't readily spend it or give it away prematurely and then be left broke. You're protected against yourself, and against others who might try to influence you (especially when you are older and perhaps more vulnerable).
- Pension benefits are also exempt from garnishment by creditors (other than the IRS), though once you actually *receive* payments creditors may be able to try to get them from you, depending on state law.
- Even if your employer goes out of business, your pension is owed to you. In a traditional plan, payment (within limits) is guaranteed by the Pension Benefit Guaranty Corporation (PBGC), a U.S. government-backed organization; if your pension will be funded by an annuity instead, the full amount is guaranteed, but by an insurance company and a state guaranty fund.

Disadvantages:

- Although you have an opportunity now to "cash in" your future pension benefits, this may be a one-time offer. Keeping the pension as-is may lock you into that for life. Taking a lump sum gives you a lot more options, including the option to lock yourself into an irrevocable lifetime payment arrangement later, if and when you choose to do so.

- A lump sum could be invested differently, using a plan tailored to your specific needs, or following a strategy that might provide a much better long-term return – though you could also come out worse that way, depending on the specifics of what you do with the funds.
- You have limited (perhaps no) control over the timing and amount of what you receive out of a traditional pension plan. If you need money sooner, you can't get it. If you don't need money that soon, you probably don't have the option of leaving it where it is. There is very little flexibility.
- Although you "win" the bet if you live a long time, you "lose" the bet if you don't. You could die the day after you receive your next pension check, and under most pension plans that would be all you'd get. (A spouse or other beneficiary might or might not be able to get something more out of it, depending on what options the plan offers and which you choose at the time your pension begins. But choosing an option that covers someone else means a smaller pension during your own lifetime – there's no free lunch there.)
- While the rigid nature of future pension payments does protect you from making bad decisions about your money, it also prevents you from making good decisions about them. Committing to a steady stream of monthly income for a long period of time may (or may not) be the single best thing you could do with your financial resources right now.
- The PBGC guaranty is limited. In 2016 the limit at age 65 is $60,136 a year (if your benefit is payable for your life only), so that if your own pension is higher than that, the extra amount you receive is at risk if your pension plan goes broke. Note, however, that in some cases your pension plan may actually be transferring the risk to an insurance company, in which case your guarantees come from the insurance company, the insurance industry, and/or your state government.

2. Take the lump sum and roll it over into a tax-advantaged retirement plan

This could be an employer-sponsored plan, such as a 401(k) or 403(b) plan, or an Individual Retirement Account (IRA or Roth IRA).

Advantages:

- You can keep your lump sum intact, if you roll it over into an employer-sponsored plan or a traditional IRA, and defer taxes. (Warning: make sure you elect a direct rollover, or your current pension plan will be obliged to withhold income taxes – which you can get back later as a refund, if you complete the rollover within 60 days of the distribution, but in the meantime your tax-advantaged rollover is smaller than it otherwise would be.) By

keeping the funds in another retirement plan, you defer taxes until the money is withdrawn, most or all of which could occur years down the road, some of it even after your own death. Although you are obliged to start taking some withdrawals once you turn age 70½, for most people this is later than they would have to start taking a traditional pension. And compared to paying taxes on the lump sum and then investing the money in places that are going to produce further taxable income, the financial advantage of rolling over to a tax-advantaged plan can be enormous, unless you are in a zero tax bracket anyway.

- Or you can pay your taxes now, rolling the funds into a Roth IRA, but then having the opportunity for tax-free growth and tax-free withdrawals from the Roth IRA after you satisfy the Roth IRA requirements. Nothing like this exists with a traditional pension, or for that matter in most 401(k) plans. If you (and/or your spouse / partner) expect to live a long time, this can be a good choice – either immediately, or perhaps postponing the Roth IRA conversion to some future year, if you expect to be in a lower tax bracket then.
- You have more choice about how your funds are invested. If you have the option of rolling over a lump sum from a traditional pension into a 401(k) or other employer-sponsored plan, you probably have several and maybe dozens of choices for investing your money that suit your own preferences. Or you can have a virtually unlimited number of choices if you roll the money into an IRA, including investing in individual stocks and bonds, certificates of deposit, investment real estate, and many other possibilities that are just not allowed in plans that resemble 401(k) plans. If you are thinking of rolling a lump sum <u>out</u> of such a plan into an IRA, this is one strong reason for doing so.
- You choose who manages your money. In a traditional pension, you probably have no idea who's responsible for investing the plan assets. In a 401(k) or 403(b) or other similar plan, you usually do have a number of choices, but still only a limited number of them. With an IRA, it can be a "self-directed" IRA where you are totally in control, or it can be managed by a financial company of your own choosing – whoever you trust the most, or who you think will do the best for you.
- You can also choose the style of investment, from very conservative to very aggressive (especially in an IRA). This does mean you might end up taking more risk and perhaps losing some or all of your funds, or that you might be too conservative and get low returns on your investment. But it can also mean that you have the opportunity to invest in a way that totally suits your needs and your tolerance for financial risk. The benefit is that it's your choice (though a good outcome is by no means guaranteed).
- You have more flexibility about how the money is used. You might have some urgent financial needs right now, and you could take a part of the lump sum in cash and roll the rest of it over into a tax-advantaged retirement plan. Or you might know of some other important needs that are coming up.

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Or you might just want to keep this money as an emergency fund. Or maybe you're not sure you'll need it at all, and you want to have your children or grandchildren inherit the plan and its tax advantages. A traditional pension plan gives you none of this flexibility. A 401(k) or other employer-sponsored plan gives you some of it. An IRA gives you all of it.

Note that with an employer-sponsored plan, you probably will not be able to get the money out until you stop working there. With an IRA, you can take your money penalty-free (though not tax-free) once you turn age 59½, but there are also ways to avoid the penalty before that age, if you are willing to spread out the withdrawal over a period of years. Plus you can take some, but not all – whatever you need.

Disadvantages:

- You lose the guarantee of a monthly income for life – unless you purchase an annuity inside of an IRA, or unless your 401(k), 403(b), or other such plan offers an annuity option. An "annuity" just means a guaranteed series of payments, usually for life (you can choose that kind, or other kinds). More about this in the next section, Option 3. But if you choose to take neither a traditional pension nor an individual annuity, there is no way you can be assured of a lifetime income that would be equal to that from a traditional pension. You might be able to equal it, and you might even do better, but not with any kind of guarantee behind it.
- You are also exposed to investment risk. Sure, you might do better financially over the long run, but you might do worse, maybe much worse. Unless you make very conservative investment choices – such as purchasing government bonds, or certificates of deposit from a bank – there are no guarantees. And if you do invest that conservatively, you might not end up with as much money as you would just taking a monthly pension, because pension funds can afford to take more risk than you probably can (they're bigger and are in it for the even longer run).
- And you face other risks: including the risk that you will withdraw and spend the money sometime just because you can, or because someone talked you into it, and then not having it when you most need it.
- There are various rules and limits that have to be met if you are going to be eligible for the tax benefits. So you have restrictions, for example, in what you can invest in – less so in an IRA than in an employer-sponsored plan, but even in an IRA there are limitations. There are rules about when, and sometimes how much, you can withdraw, and how. Employer-sponsored plans often allow loans instead of withdrawals, so that you can (you have to, really) pay the money back later and resume the tax benefits – IRAs don't offer this option. Compared to a traditional pension, these rules still leave you with lots of flexibility, but less than taking the lump sum, paying your taxes, and then saving or investing outside of retirement plan (Option 3).

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- There's more paperwork – not only in setting this up, but in keeping it going. This is not necessarily onerous, but it is definitely less convenient than Option 3 (managing your money outside of a retirement plan), and far less convenient than a traditional pension plan, where you can have your pension automatically deposited into your bank account every month.

3. Take the lump sum, pay your taxes, and save or invest what's left

This strategy has some of the same advantages and disadvantages as the previous one – these are just mentioned below (see above for more details). But depending on just what you do with your funds, there could be special advantages. Some of the key options are included below:

Advantages:

- You have more choice about how your funds are invested (see more, above). If you invest outside of an employer retirement plan and even outside of an IRA, you can invest in literally anything you want.
- You choose who manages your money (see more, above).
- You can also choose the style of investment, from very conservative to very aggressive (see more, above).
- You have more flexibility about when and how the money is used (see more, above).
- Instead of investing, you could use the lump sum to pay off high-interest debts. Many people pay 15%, 20%, or just under 30% interest on credit card balances that they carry from month to month. Getting rid of such debts is the equivalent of earning those percentages tax-free with zero risk – a deal you will never match anywhere else, and one that is worth far more than the tax advantages of an IRA.

  However, if you're the sort of person who will pay off your credit balances, then just run out and rack up more of the same, then this option isn't a wise one for you. Either leave your pension intact, or take the lump sum and put it someplace where you won't be tempted, or able, to get it out on an impulse.
- You could invest in an annuity that would allow you to lock in a lifetime income if that's what you want, or that would allow you to put off that decision and get a higher monthly income later. Insurance companies are delighted to sell individual annuities, which allow you to start collecting a life-time income either immediately or in the future. You usually have more options on how the pay-outs are structured than you do with traditional pension plans, including when you start receiving the payments. The older you are when you start collecting, the more you get.

  You can also get more by waiting to sign up for an annuity when interest

rates are high – another form of control you don't have with a traditional pension. Such an option makes the most sense if you have a relatively long life expectancy (in excellent health, not a smoker, and/or with a family history of long life). Annuities have their own tax advantages, and unlike payments from a pension or from an annuity bought inside a retirement plan, monthly pay-outs are only partly (instead of fully) taxable. Even so, you might be better off doing this inside of an IRA, instead of paying your taxes first (more on this in the Disadvantages section, below).

- Life insurance is another option. A lot of working people with dependents need more life insurance than they have, and this can be an opportunity to close that gap. Policies that include a cash value have higher premiums than those that don't, but the cash value builds up tax-free and usually can be gotten at tax-free when you retire – so you get protection both while you're working and afterwards. Life insurance benefits can also be a great way to pass wealth on to children and grandchildren. Unlike annuities, life insurance cannot be purchased inside of an IRA plan, so taking the lump sum and paying your income taxes first is the only way to use a lump sum offer to purchase a policy.
- You can easily mix-and-match these options, doing some of one and some of another.

Disadvantages:

- You lose the guarantee of a monthly income for life – unless you purchase an annuity (see more, above).
- You are exposed to investment risk (see more, above).
- You face other risks: including the risk that you will withdraw and spend the money sometime just because you can, or because someone talked you into it, and then not having it when you most need it.
- You have to pay income taxes on the lump sum amount. In most states this includes state income taxes on top of federal taxes. If you are under age 59½, you will probably have to pay an additional 10% of the lump sum as a penalty (though you can avoid the penalty if you spread out the payments appropriately). Altogether taxes could remove a third, or even a half or more of the lump sum right off the top. In most cases, the tax payments mean you will end up considerably worse off than if you had invested inside of an IRA or other retirement plan.
- If you are retired and receiving Social Security, the lump sum could increase the amount of Social Security that is taxed.
- Unless you put what remains of your lump sum in a tax-advantaged investment, you will pay taxes every year on what the lump sum earns. Over the long run, the initial taxes and the ongoing taxes can end up costing you a whole lot of money.

- If you use the lump sum to pay off debts, the money is used up. You will have less to pay on your debt every month, which is a good thing, but unless you are disciplined enough to put aside those savings instead of spending them, you will end up with no further benefit, and your retirement will be the poorer for it.
- If you buy an annuity, your benefit is likely to be less than your pension benefit, because there is more overhead with an individual annuity. An exception is most likely to occur if interest rates are higher when you purchase the annuity than they were when you elected the lump sum – but you can't count on this happening.

  With an annuity, access to your lump sum is generally gone once you start receiving monthly payments, just the way it is with a traditional pension. There can be exceptions with an annuity, though. Some kinds of annuities allow you to make withdrawals, though this will reduce your future benefits. Some allow you to receive extra payments in case you need long-term care. But these benefits are not free, so expect your regular monthly payments to be lower if your annuity contract provides such rights.

  Annuity payments are not backed by the federal government, but by the life insurance industry and to some extent by state guarantee funds. As with the federal guarantee, some people have lost part of the benefit they thought they were going to get. (The federal guarantee is probably a little stronger than annuity guarantees if your pension is within the maximum covered by the PBGC, and weaker if it isn't.)
- If you buy life insurance, but are doing it <u>only</u> for the tax-free growth, you are probably not getting your money's worth. You're also paying for death benefits, the costs of which are significant as you age, so if you don't need that element, too much of what you pay for is not serving your real priorities.

4. Take the lump sum, pay your taxes, and spend what's left.

There are any number of ways you can do this. For example:

- Put the lump sum in the bank, and spend it as needed or desired.
- Pay bills you already have.
- Live your dream: travel, improve your home (or get a second one), or make that big one-time purchase you've always wanted.

- Invest in your own future, or someone else's: start a business or a not-for-profit, or pay for your own education or that of your children or grandchildren.
- Give it away: to family or to charity.

Advantages:

- You get immediate gratification.
- There might be some financial offsets. To the extent you are using the lump sum for things you would eventually pay for anyway, you will be saving money down the road. If you're investing in your own future or that of close family, this might more than pay you back financially. If you give some or all of the lump sum away to close family, that may reduce their dependency on you, in the short run, the long run, or both. If you give to charity, you can get a significant tax deduction.
- There are also likely to be non-financial benefits, to yourself and others. Unless your spending is completely foolish, it will provide enjoyment or security or opportunity or some combination of those and other good things, to yourself and/or to others. And it does so *now*, while you and others are around and able to enjoy the fruits of the expenditures – which may not be true in the future. Just as you can overdo immediate gratification, it is possible to overdo postponing it.
- It's simple. Other than having to make provision for paying income taxes (which normally would be deducted directly from the lump sum, so even that is easy), there's no extra paperwork, and no ongoing management.

Disdvantages:

- You lose the guarantee of a monthly income for life.
- You have to pay income taxes on the lump sum amount. In most states this includes state income taxes on top of federal taxes. If you are under age 59½, you will probably have to pay an additional 10% of the lump sum as a penalty (though you can avoid the penalty if you spread out the payments appropriately). Altogether taxes could remove a third, or even a half or more of the lump sum right off the top. And even if you are retired and are in a zero tax bracket, the lump sum could push you into a higher tax bracket and therefore be taxable.
- If you are retired and receiving Social Security, the lump sum could increase the amount of Social Security that is taxed.
- You lose flexibility. Once you spend the money, it's gone – perhaps totally gone, and gone for good. If the things you spent it for don't work out as you hoped, it might become a major cause of regret. But even if they do work out, your ability to deal with the unexpected is impaired. For that matter, even your ability to deal with the expected may be impaired.

How do you decide what to do?

Obviously, there is a lot to absorb here. How can you think about this in a clear, organized way? To help you, we present a series of questions, listed in the order you should answer them. If any don't apply to you, skip on to the next one:

1. Are you someone who is willing to take no risks at all?

This is a trick question.

All your options involve risk. No matter what you do, there are plausible circumstances where that choice will turn out to have been a loser. The only exception is where the amount in question is so minor that it can't really matter either way.

The way to minimize your risk is to consider the following questions very carefully, and work through the whole process.

2. Is the lump sum coming from a traditional pension plan (one that pays, or will pay, a monthly benefit for life)? If so:

a. ***Will your spouse or ex-spouse, if any, object to a lump sum?*** If someone else will have veto power over your decision, you need to have a clear idea of her or his concerns. Still it's best to go through the rest of this decision process first, so you can clearly explain your decision.

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b. ***Is the monthly pension amount in question small enough so that it has (or will have) an unimportant effect on your budget?*** If your lump sum offer is less than $5,000 (or maybe $10,000 or some other relatively modest figure), you may not even have a choice – the lump sum payment will be automatic. If you do have a choice, and the amount is small by your own standards, your life will probably be simpler if you take the lump sum. And then you can either put it aside for some unforeseeable future need (in a tax-advantaged plan or otherwise), or you can use it for some urgent or otherwise worthy purpose now.

c. ***Do you have an extraordinarily strong need for cash right now, with no other practical way of getting it?*** If so, you may truly need to take the lump sum. But we're not talking about some new thing or new experience you'd like to have. We're talking about a situation that is truly compelling. For example:

- You or someone in your family is seriously ill, or is in some other desperate situation, which the lump sum would alleviate.
- You or your spouse/partner has just lost a job, with no immediate prospect of finding another one.
- Your house is going into foreclosure.
- You have recently suffered losses in investments, business, legal matters, or uninsured property damage, and you are at significant financial risk.

Since probably you won't have the option of giving up only *part* of your pension (except in certain pension plans that allow such an option to be taken at retirement), this kind of financial necessity may force you into taking the lump sum, paying your taxes and using what you need to cover your current problem, and then to make a smart decision about what to do with the remainder.

d. ***If you are already receiving benefits, or you expect to start collecting benefits from this pension within, say, the next 5 years:***

i. ***Do you have a strong expectation that you (and your spouse or ex-spouse, if s/he is also covered by your pension plan) will die before most people your age(s) will die?*** If so, then the lump sum is probably a better option for you.

ii. ***Do you have a strong expectation that you (and your spouse or ex-spouse, if s/he is also covered by your pension plan) will live longer than most people your age(s)?*** If so, then you should probably either keep the pension as is, or else take the lump sum and purchase an individual annuity at an opportune time.

iii. ***Getting help:*** At your stage in life, where your options are narrower than they used to be, it is especially important that you understand the importance of this decision, both under expected and adverse future

circumstances. So unless your situation is entirely clear-cut, you should consider using CREWS's Retirement Works II software, which can help you evaluate this decision within the context of your larger financial situation.

e. ***If you are more than 5 years or so away from collecting on your pension:***

   Do you have a strong expectation that you (and your spouse, if s/he will be covered by your pension plan) will die <u>before</u> most people your age(s) will die? If so, then the lump sum is probably the better option for you. Conversely, if you are in exceptionally good health, this might seem like a strong indicator toward keeping the pension, but instead it is only a mild one – because you are young enough that your *long-term* health prospects are still very uncertain.

f. ***Do you already have other significant retirement income sources, or significant financial assets that could support retirement income?*** Put another way, are you confident that without the pension in question, your retirement will be adequately secure? If you are, then you should probably consider taking the lump sum. But if you are clearly not secure in your retirement without this pension, or if you are not confident that you are, then you need to further consider your options. You might (or might not) be able to do more for your retirement by taking the lump sum and handling it prudently.

g. ***If the answers to the preceding questions are not decisive for you, then weigh the following:***

   i. ***Additional reasons to keep your pension intact:***

      - You know you would probably spend the lump sum on unnecessary things.
      - You would rather have the security of knowing you will receive a steady and reasonably guaranteed amount every month than trying to work out something that might do better for you.
      - Without this pension, you are concerned that you (and your spouse/partner) won't have enough in the way of *guaranteed* retirement income from Social Security, pensions, and annuities.
      - Even though you could use the lump sum for something truly worthwhile, you would have to pay income taxes – and probably an additional 10% penalty tax if you are under age 59½ – if you did. Consider here whether you are already in a relatively high tax bracket because of other income you are receiving this year, or not. And also keep in mind that you could take the lump sum and defer taxes by rolling it into an IRA or other plan.
      - You are still working but think you might take an early retirement, and your plan pays extra generous benefits in such a case.

ii. ***Additional reasons to take the lump sum:***

- You have a track record of making prudent, responsible financial decisions, and sticking with them. You will manage the lump sum wisely, including making smart investment decisions, getting help if (like most of us) you are not a financial expert.
- You are comfortable that you have (or will have) enough income sources and financial assets for retirement even if you take the lump sum and things don't work out as well as you hope.
- You have other important uses for the lump sum, such as paying for college education, making a down payment on a house, paying off high-interest debt, starting a business, etc.
- You think that interest rates will be higher in the future than they are now, so that you could take the lump sum, hold it for a while, and get a better deal purchasing an individual annuity down the road, which would give you a different form of guaranteed income at a higher amount.

  Or, especially if you are male, you maybe can get a better deal from an individual annuity right now than from your pension plan. That's because almost all *pension plans* base their benefit payments on life expectancies using "unisex" assumptions – i.e., blending male and female life expectancies. But *an individual annuity outside of a pension plan* typically pays higher rates for males, because men tend to not live as long as women, meaning not as many payments are likely to be made. For females, the opposite tends to be the case: pension benefits are usually better, if all else is equal. Not that all else is necessarily equal – it's best to find out what current individual annuity rates actually are before deciding definitely between income from your pension and income from an individually purchased annuity. An insurance specialist can help you with this.
- You would use all or part of the lump sum in a way that means it would be taxable, but this happens to be a relatively good year for you to pay taxes, because you have less income or more deductions (or losses from business or investments) than usual.

h. ***Make your decision:***

After taking some time to reflect on all of this, you may now be in a position to decide whether to keep your pension or take the lump sum.

If not, perhaps it would be helpful to continue through the rest of the questions, so you can better visualize what you would do and what some of the consequences might be if you were to take the lump sum. And so…

Unless you have definitely decided not to take the lump sum, continue on.

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3. *Should the money from the pension be spent?*

Whether the lump sum is coming from a traditional pension, or whether it is coming from an IRA or an employer-sponsored plan that you have access to, the issues here are the same: spend it, or save it?

a. ***Is the lump sum amount small?*** If so, what you do with it is unlikely to have serious long-term repercussions. Go wild with it, if you like – though it still might be nice to save some or all of it, so you can go wild later, perhaps at a time when you need it more.

b. ***Is this an emergency situation?*** If so, then you may have no choice. But before you go ahead, consider the other questions in this section.

c. ***Is this an expenditure that you expect to be of benefit in the future?*** If you're investing in your own or your children's or grandchildren's education, in starting a business, in purchasing or improving a home, or in some other way that has clear long-term benefits, then the sacrifice of part of your retirement resources may be worth it. Only you can make this decision. But…

d. ***Do you have other funds you can use?*** You're going to have to pay income taxes (federal and state) and possibly a 10% penalty tax if you are under age 59½. That's a big hit to take. Using almost any other source of funds, if you have any available, may be preferable financially.

e. ***Can you borrow instead?*** This would *not* be a good idea if you would be borrowing from a credit account and then have to pay double-digit interest. But you might be able to borrow at reasonable terms from a life insurance policy, from a 401(k) plan, from a home equity line of credit, with some other kind of bank loan, or from family. This might make a lot more sense than paying income taxes (and maybe a penalty tax), especially if you are still working and therefore at a time in your life when your tax rates are probably higher than they will be when you're retired. If you can leave your pension intact for now, that usually provides a better long-term outcome. (If you have a *one-time* offer to cash in a traditional pension, and you think you might eventually need that money to pay off whatever you might borrow now, you could take the lump sum instead, preserve your tax benefits by rolling it over into an IRA, or maybe a 401(k) or other employer plan, and still be able to cash it out later if you need to.)

f. ***Do you have to spend it all?*** If not, then don't. Whatever you spend, you will have to pay taxes on. It's possible to postpone taxes (and totally avoid penalty taxes) on amounts you save, if you roll them over into an IRA or an employer-sponsored plan.

g. ***BEWARE OF THE TAXES:*** We keep referring to them, but don't forget that, depending on your tax bracket and whether you have to pay any penalty taxes, *you have to set aside enough money to pay the taxes on whatever you take out, including the money you take out to pay the taxes!* For

example, if you want to spend $10,000 of pension money on something, you might need to take out $15,000 (or more!) to cover the taxes not just on the $10,000 but on the total $15,000 withdrawal. If federal, state, and penalty taxes totaled 50%, which can easily happen to upper middle income people who are still working and under age 59½, you would actually need to take out $20,000 so you could spend $10,000. So you see why we're urging you to be careful about what you think you need to spend in this fashion.

4. Should money not being spent be rolled over into a tax-advantaged plan (IRA or employer-sponsored), instead of into a bank account or other private savings or investments?

In most cases, this is a no-brainer. Since the money is already in a tax-advantaged plan, moving it to a similarly tax-advantaged plan avoids all taxes right now, and enables you to earn money on those postponed taxes.

Getting help: If you want to see what kind of difference it makes in the long run, try out CREWS's Lump Sum Comparison tool. You'll probably be surprised at the results.

Even so, there are some exceptions:

a. ***Is it just a small amount?*** If so, it doesn't matter much, and it's probably less trouble just to take the cash now and pay your taxes on it, unless you already own an IRA you can just transfer the lump sum to.

b. ***Do you expect to need all of the funds in the next few years?*** If so, there are no long-term tax advantages, because there is no long term. And over the short term, the tax advantages don't add up to much. It might well be worth giving them up in return for the convenience of having your funds readily at hand, especially if you are going to be making quite a few payments – say, to cover a medical issue, or to pay for someone's college education. *But even so, taking a large lump sum all at once can push you into a higher tax bracket*, and so if this is likely, you might still be better off rolling the money over into an IRA (or other plan) and then making a fairly large withdrawal once a year, to spread out the tax liability and keep you in a lower tax bracket.

c. ***Are you going to invest it somewhere that would not be permitted in an IRA or other plan?*** Most kinds of legitimate investments are permissible in an IRA, but if you intend to purchase life insurance, buy into a privately held company, acquire antiques or collectibles, or purchase real estate that you will either live in or receive income directly from, you can't do it in an IRA, and definitely not in an employer-sponsored plan. Likewise, if

you have substantial funds and want to create a trust (trusts cannot own IRAs). So if you are dead set on any such arrangements, then you need to take the lump sum, pay your taxes, and then proceed with your plans. But again, if you anticipate having to, or being able to, spread out those transfers over more than one year, you might minimize your taxes by first rolling the funds into an IRA, then liquidating it more gradually.

5. Should tax-advantaged funds be in a 401(k) or similar employer-sponsored plan, or in an IRA (individual Retirement Account)?

You might have the option of rolling over a lump sum from a traditional pension plan into a 401(k) or other employer-sponsored plan. Or you might already have funds in such a plan that you are eligible to withdraw. Either way, should your funds be in an employer-sponsored plan or in an IRA?

IRAs may be better for most people, for two reasons. First, employer-sponsored plans have relatively few options for how your money is invested, while IRAs, despite a few limitations, allow a very wide variety of options. Second, you own the IRA and can withdraw from it relatively easily any time you want (as long as you're willing to pay any taxes that are due). Withdrawals from your employer-sponsored plan may be limited in various ways, especially if you are still employed there.

In addition, employer-sponsored plans may have relatively high fees – some that are disclosed, and some that are hidden. IRAs and other investments also involve fees, including some hidden ones, but you may be able to locate IRAs with lower fees.

As always, though, there can be exceptions:

a. ***What is your retirement date?*** *If you retire between ages 55 and 59½* and you want to withdraw your money without a 10% penalty tax, you can do so from an employer-sponsored plan, but not from an IRA. Actually you can also avoid the 10% penalty before age 59½ with an IRA as well, but you have to spread the withdrawal out over a number of years, which might not be what you need. On the other hand, *if you continue to work past age 59½*, you probably won't be able to take withdrawals from your employer plan until you do retire, but you will be able to withdraw from an IRA without any penalty (beyond normal income taxes).

b. ***Are you 100% satisfied with your 401(k) or other plan?*** If so, you might prefer to stick with it. But if you're not totally sure, you should look at your other options.

c. ***Do you think you might want to borrow from your plan?*** You can't borrow from an IRA, and you also may not be able to borrow from your 401(k)

or other employer plan, so you need to check on that. But if your employer plan does permit borrowing, this can be a better way to access your retirement funds *temporarily* than having them in an IRA and having to withdraw them.

Of course, with an IRA, you can probably withdraw some money, pay your taxes, and then later "repay" your IRA by contributing new money to it, and get a tax deduction for the new contribution (assuming your income is below the deductibility threshold, which depends on whether you're a participant in an employer-sponsored plan). And in fact this might be a much better way, depending on the details of both options in your case. But contribution limits on IRAs are fairly low, so if you are already contributing to an IRA, you may not be allowed to also make the "repayments" you would like to make – in which case borrowing from an employer-sponsored plan is better, if it's permitted.

d. ***Do you think you might get sued?*** If you owe money, creditors can usually make you cough up money from an IRA more easily than they can from an employer-sponsored plan like a 401(k). Rules differ from state to state, though.

6. What will you do?

You probably need to mull this over a bit – perhaps to gather some other ideas or information, or perhaps just to let it sink in. Review these questions as often as you need to, until the right answer becomes clear in your own mind.

Getting more help:

If you feel stuck and want more help, send an email to CREWS, care of help@CESCrews.com.

If you are planning to take the lump sum and invest all or part of it, especially if you are doing so inside an IRA or totally outside of any kind of tax-advantaged retirement plan, you probably should discuss this with a professional financial adviser. CREWS is not licensed to offer such advice.

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