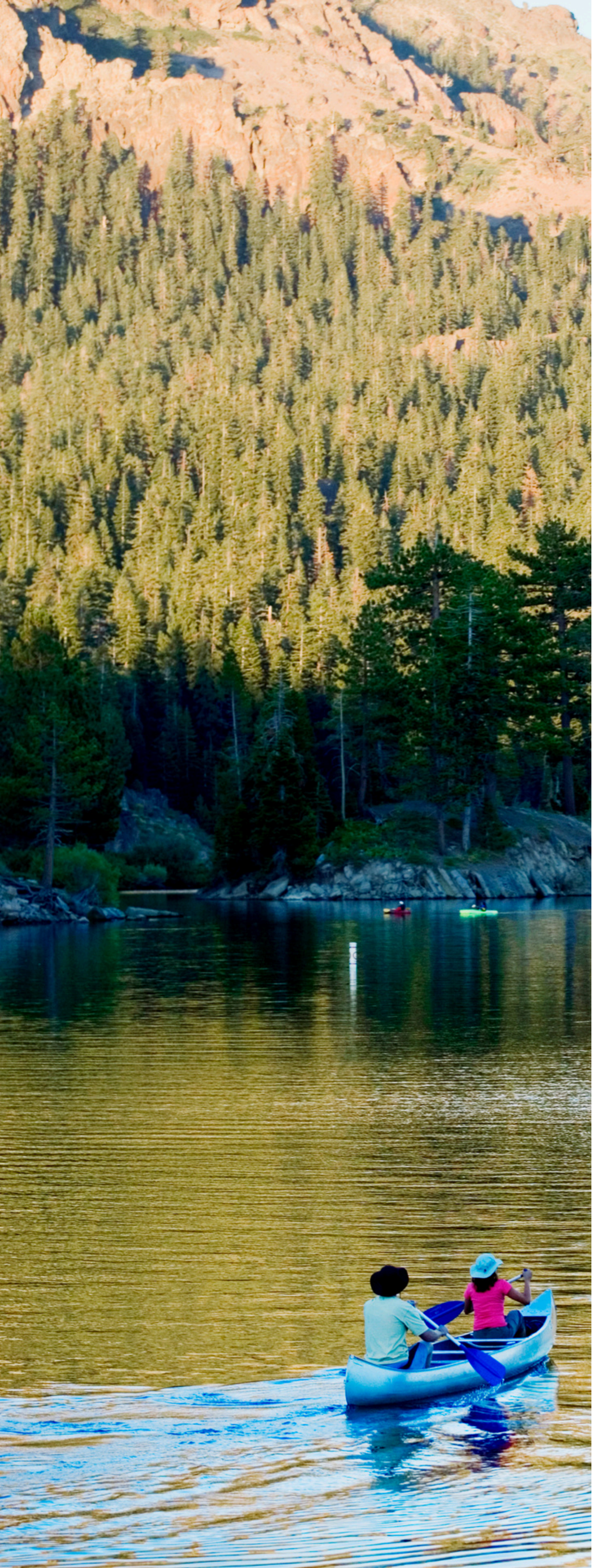
THE RETIREMENT GROUP LLC
PARTNERS IN RETIREMENT

Pension Lump-Sum Payment Windows Are Back



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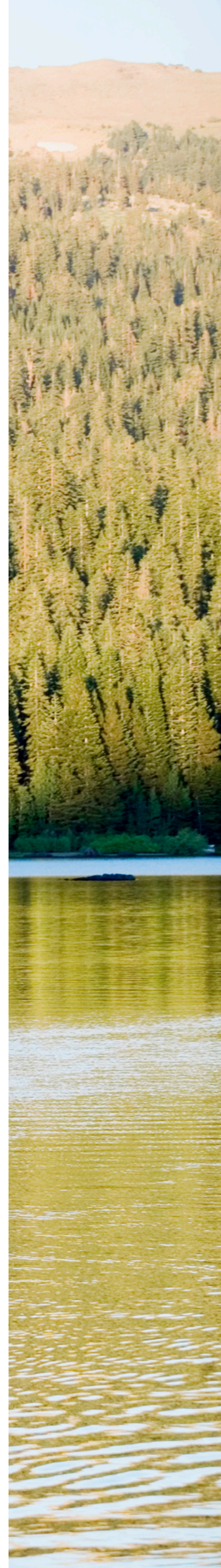


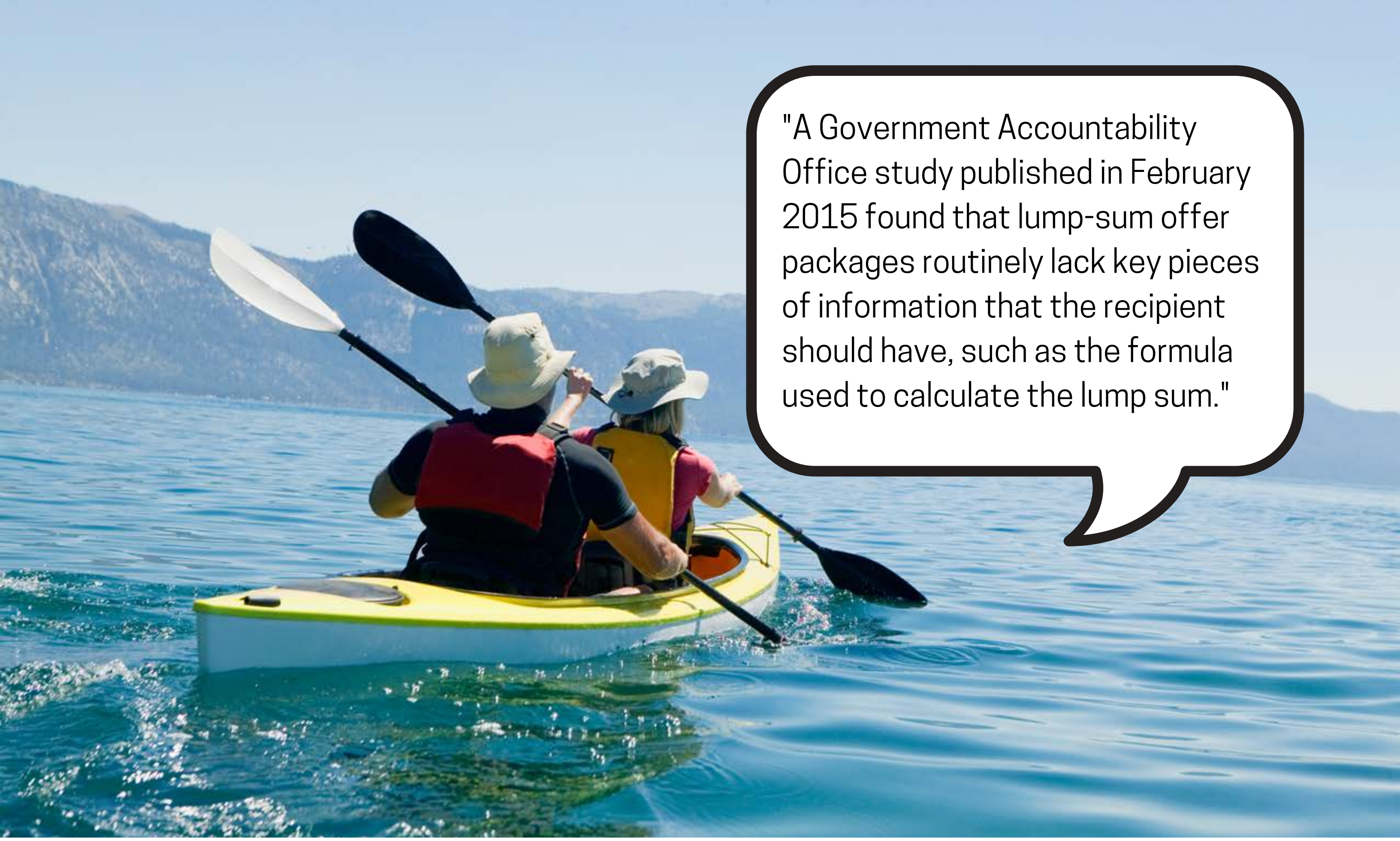
Introduction

The IRS recently announced a reversal of the 2015 decision that participants in pay status taking a lump-sum payment is a violation of required minimum distribution rules. With the move by the U.S. Treasury and IRS, private companies are allowed to offer lump-sum payments to retirees and beneficiaries instead of monthly payments. Pension plan sponsors had been looking for opportunities to manage their growing pension liabilities, with the 2015 IRS policy shutting the door on sponsors who were considering offering pension plan retirees a lump-sum settlement option. With that policy being rescinded, sponsors of pension plans may now, once again, consider whether a retiree lump-sum window is a viable option to help manage their pension liability.

Sponsors of pension plans sometimes use lump-sum windows as a way to “de-risk” their plans from market volatility, mortality table changes, changes in funding rules, and any number of other pension and market uncertainties. Prior to the 2015 policy, some plan sponsors would often offer defined benefit plan participants who were not yet collecting a short period of time (a “window”) a lump-sum payment of their benefit. In some cases they would also offer a “retiree lump-sum window” to retirees currently receiving lifetime annuity payments; in this case they could convert their remaining annuity payments into an immediate lump-sum.

The Treasury Department and the IRS will keep a close eye on retiree lump-sum windows, and left the door open for further guidance in the future. However it seems that plan sponsors can, once again, consider the suitability of a retiree lump-sum window without fear of action from the IRS. Just because a plan sponsor can now offer a retiree lump-sum window does not mean that all will offer that feature. Offering a retiree lump-sum window will require analysis, planning, and considerations such as:

- Who will be offered the window and how long will the window last?
- Amending the plan document to clearly state policy change and disclose all information.
- Communicating to participants who will have a chance to be offered the opportunity will have to be carefully framed and include the various required legal disclosures.



There are pros and cons to consider for both sides but there are rules and regulations in place to offer protections. The IRS specifies the discount rate and mortality table used for the calculations. This protects retirees and future retirees and makes sure employers offer a “fair deal” by making sure the calculation is the same whether it’s for a pension plan participant choosing the lump sum option at retirement or termination.

On one hand, the interest rates have shifted from the more favorable government bond rates to the less favorable corporate bond rates. On the other hand, since employers have to use the IRS mortality tables (based on a large database of employees and retirees and assumes life spans will continue to increase in the future), they cannot factor a person’s health history or see if they have been diagnosed with a terminal condition. In those circumstances, a retiree will be significantly better off taking the lump sum since it will be in excess of what they would have received otherwise.

Source: http://www.pensionrights.org/publications/fact-sheet/should-you-take-your-pension-lump-sum

How this Benefits Companies

Defined benefit plans generally provide beneficiaries with a monthly benefit for life, and as you could guess, this creates a gigantic pension liability for companies that offer these. Companies have had a hard time making sure their plans remain fully funded, and by offering both workers and retirees a lump sum, corporations could take the defined-benefit obligation off their books.

For companies like General Electric (which has an approximate $31 billion shortfall [5]), the ability to convert future payments into a lump sum benefit could significantly reduce their liabilities. By reducing their defined benefit liabilities, they can shift risk from them onto their workers and help them unwind their balance sheet.

Should you Convert Remaining Payments to Lump Sum?

Taking the lump-sum payment might be beneficial to some workers and retirees in certain cases. For people with large amounts of debt (credit cards, mortgages, etc.) entering retirement, using the lump sum to pay these off and reduce their risk to interest rate fluctuations in the future. By paying off the debt as soon as possible they could eliminate future payments that would require working into retirement or using other income sources such as social security to pay for. This would be especially beneficial for retirees who have a large portfolio of assets as the payments would be a drag on returns in their portfolio. Also, those who get a lump-sum payment could maintain a tax protection by rolling it over to an IRA. If invested properly and not drawn down upon significantly early in retirement, a retiree could end up being able to improve their standard of living and while being better prepared for unexpected healthcare expenses.

Generally speaking, the lump-sum option is beneficial when you do not have to rely on it as a significant source of income early in retirement, or it is used to reduce or eliminate significant liabilities that would require a large income stream to payoff many years into retirement. Taking a lump-sum requires more discipline and planning, but if utilized correctly, could provide more benefit over the course of retirement and allow you to leave something behind to beneficiaries.

Note: Be sure to check your maximum monthly guarantee before converting your pension. You might find that the PBGC won't insure your expected expenses in retirement." Source: https://www.pbgc.gov/wr/benefits/guaranteed-benefits/maximum-guarantee

Using Lump Sum to Purchase Annuity

Defined benefit pensions and annuities require the payer to bear the risk, which requires predicting market returns and life expectancies, two very difficult things to predict (a task not performed well based on the financial troubles of so many pension). On the other hand, defined contribution plans require the retiree to bear the risk, but that can be managed in either scenario.

With a significant portfolio from a defined contribution plan and the lump sum payout (invested at a low cost and with broad diversification), a portion of that can be put into a shock absorber to protect against market downturns and volatility. Funds from the portfolio could be used to purchase an annuity in line with RMD requirements (starting at 4% annually and then gradually rising), in monthly transfers, and then paid out from the "shock absorber" to the retiree to cover costs in the vital first years of retirement.

The remaining volatility and uncertainty can be tolerable if the retiree is willing to slightly tighten their belt when markets fall, because the shock absorber will ease some of the pain. With this strategy, one can have the benefits of being invested in the market to protect against inflation while having some protection against market downturns. Living off the portfolio as suggested will require a larger overall portfolio than having a defined benefit annuity pension, but the expenses should be low and the potential for outpacing inflation will be higher.

Conclusion

Ultimately, the decision from the IRS and Treasury Department benefits companies by helping them de-risk their pension liabilities. There are opinions that this change is more beneficial to companies than it is to retirees. Fears are that by dangling a big lump-sum payment in front of retirees, they will forgo the certainty of guaranteed income and end up short-falling earlier in retirement. However, there are many situations where having the opportunity to convert future payments into a lump sum is beneficial to the retiree.

In any case, the decision to take the lump-sum vs. the annuity is seldom an easy or straightforward one. Not everyone's situation is the same, so there is no blanket answer that is right for everyone. Individuals should consult a reputable financial advisor (one that provides comprehensive planning services) and look at each scenario to determine what is best for their situation.

CONTACT US!

Sources

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[1]https://www.natlawreview.com/article/irs-no-longer-forbids-pension-plans-offering-lump-sum-payouts-to-retirees-currently

[2]http://www.mondaq.com/unitedstates/x/789220/retirement+superannuation+plans+pensions+schemes/IRS+Lifts+Moratorium+on+LumpSum+Windows+for+Participants+in+Pay+Status

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Therefore, we encourage you to have your plan updated a few months before your potential retirement date as well as an annual review. It should be emphasized that neither The Retirement Group, LLC nor any of its employees can engage in the practice of law or accounting and that nothing in this document should be taken as an effort to do so. We look forward to working with tax and/or legal professionals you may select to discuss the relevant ramifications of our recommendations.

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