

4-2017

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Recommended Citation

Pension Action Center, Gerontology Institute, University of Massachusetts Boston, "Lump Sum vs Annuity Payments: Which is right for me?" (2017). *Pension Action Center Publications*. 18.
http://scholarworks.umb.edu/pensionaction_pubs/18

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Fact Sheet

PENSION ACTION CENTER, GERONTOLOGY INSTITUTE
McCORMACK GRADUATE SCHOOL OF POLICY AND GLOBAL STUDIES

Lump Sum vs Annuity Payments: Which is right for me?

As employers are looking to reduce pension plan liabilities, more and more participants are being given the option to receive a one-time lump sum payment from their pension plan in lieu of receiving monthly annuity payments for life. Deciding on which form of pension benefit to take is a very important decision that requires careful consideration. Unfortunately, there is no one-size-fits-all answer. While a lump sum may make sense for one person, it may be a serious mistake for another. **And it is a decision that you will have to live with for the rest of your life.** Anyone who accepts the lump-sum offer will lose the benefits of a lifetime income stream and will be responsible for taking care of their own investments and making sure the money lasts through retirement.

This fact sheet will briefly discuss the benefits and risks of lump sum and annuity payments in order to help you achieve a better understanding of your payment options.

UPDATE: In July of 2015, the IRS and Treasury announced that they would move to prohibit companies from offering lump-sum buyouts to retirees who are already receiving a monthly pension. This is good news for retirees and will help to stop the most harmful of these risk-transfer practices (also known as “de-risking”). Lump sum buyouts can still be offered to former employees who are qualified for a pension but haven’t started getting their benefit yet.

When can I receive a lump sum or begin collecting my monthly benefits?

Your pension plan contains plan specific rules that dictate in what form and when benefit payments may be made. Many plans offer participants the option to elect either a lump sum or an annuity, though some plans do not permit lump sum payments. Generally speaking, pension payments begin when you reach normal retirement age, which for the majority of pension plans is age 65. Often participants also have the option of electing early retirement benefits, which results in a reduced benefit in exchange for receiving benefits prior to normal retirement age. While early retirement benefits are often available as a lump sum or as an annuity, it is increasingly common for pension plans to offer special early retirement windows where participants have the option of taking a lump sum now, as opposed to waiting until early or normal retirement age to begin annuity payments. Your company will be able to provide you with specific details as to when your pension benefits are payable and the forms of payment available.

Important considerations in choosing a payment option

Perhaps the most important thing to understand when considering a lump sum vs. annuity payments is that if you elect a lump sum, it will be the only pension payment you receive. Once a lump

sum is paid, your pension plan no longer has any future or continuing obligations to you with respect to your pension benefits. In addition, there are numerous other considerations that should be taken into account. Some of the more important considerations are described below.

Guaranteed income

Choosing a life annuity means guaranteed income each month that will not vary as a result of market performance. Coupled with Social Security benefits, lifetime pension payments generally ensure that you will have a fixed amount of monthly income for the remainder of your life. Taking a one-time lump sum cash payment leaves it up to you to ensure that the money lasts as long as you need it.

Longevity

Your health and expected longevity should play an important role in determining which form of payment is right for you. Monthly annuity payments may be a prudent choice if you are in good health and expect to have an above average life span. You cannot outlive lifetime annuity payments; as long as you are alive, you will have the comfort of knowing you will receive a monthly pension. You can also elect a joint and survivor annuity with your spouse which means your spouse will continue to receive monthly benefits after your death.

Most experts would agree that, **for most retirees, a guaranteed stream of income for life is a better option than a lump sum.** The only situations where a lump sum should be seriously considered are: if you are in poor health or do not expect to have a long lifespan, and you will not have a surviving spouse who will need lifetime income; or if you already have a substantial nest egg or other secure source of adequate income, such as a spouse's pension.

Investment risk

If you chose to invest your lump sum payment, the value of your investments will be subject to market fluctuations. This means that while the value of your investments may increase, it also may decrease. If you elect annuity payments, the investment risk remains with your company and the pension plan. If the market struggles, your annuity payments will remain the same and your company will likely be required to make greater contributions to the pension plan to compensate for lower than expected investment returns. If you take a lump sum, no one is responsible for taking care of your money other than you.

Taxation of benefits

Taking a lump sum payment will result in being taxed on the entire amount all at once unless the payment is rolled over into an IRA or another employer sponsored retirement plan. Depending on the size of the lump sum you may be pushed into a higher tax bracket. Also if you take a lump sum distribution before age 59 ½ you may be subject to a 10% early withdrawal penalty in addition to the taxes owed. In the case of annuity payments, you will also be taxed each year on the value of monthly payments you receive, though given their smaller size, they are less likely to impact your tax bracket.

Financial health of your company and your pension plan

If your company is struggling financially and is no longer able to meet its required contributions to the pension plan, the plan may be turned over to the Pension Benefit Guaranty Corporation (PBGC). The PBGC has limits on the benefits that it can pay, so your monthly benefit might be reduced. The current

limit on benefit payments (in 2017) is \$5,360 per month, or \$64,320 per year. It is important to understand that the vast majority of retirees who get their benefits from the PBGC receive the same amount that they would have received if the plan had not terminated.

Taking a lump sum and buying a private annuity

If you take a lump sum and decide later that you want to use the money to purchase an annuity from an insurance company, you should know that individual annuities are typically very expensive, and you will likely get a lower monthly payment than if you had stayed with the monthly annuity under the pension plan. To see how much of an annuity you might be able to purchase with your lump sum, check out an annuity calculator, such as ImmediateAnnuities.com.

Individual annuities are expensive, particularly for women, because they are assumed, as a group, to have longer life expectancies. Women do not face similar discrimination in getting their monthly benefits under a pension plan.

Differences Between Lifetime Payments and Lump Sums (at a glance)

Differences Between Lifetime Payments and a Lump Sum		
	Lifetime Payments (Annuity) (whether from your pension plan or an insurance company)	Lump Sum
Is my income guaranteed?	Yes*	No
What if I live longer than expected?	I continue to receive my monthly income	I can run out of money
How is the money distributed?	In a continuous stream of lifetime payments	All at once, now
Am I responsible for investing the money?	No	Yes
What if the stock market falls or I make bad investments?	My monthly income is safe*	My money can be lost
Do I pay investment management or other fees?	No	Yes, and fees can be high
Is the money protected against inflation?	Only if my pension or annuity includes a cost-of-living adjustment	Only if I am willing to accept low returns or risk investment loss
Can I leave anything for my spouse or children?	Yes, if I chose a survivor benefit for my spouse or ex-spouse.	Yes, if there is money left when you die
*Subject to certain limits. Payments from your pension plan are backed by your employer and the Pension Benefit Guaranty Corporation. If your annuity comes from an insurance		

company, those payments are guaranteed by the insurance company and are backed by state insurance funds.

Which option is right for me?

Deciding between a lump sum payment and annuity payments is an important financial decision that should not be taken lightly. It is critical that the decision is made based on your circumstances and risk tolerance. If you have a financial advisor we strongly recommend that you discuss your options with that advisor. It is important to **check into the financial interests of anyone advising one option over the other**. For example, a financial adviser might urge an individual to take a lump sum because the adviser will get fees from managing the money or commissions for selling you certain products. These fees and commissions will lower your rate of return.

While the Pension Action Center cannot tell you what the right form of benefit is for your situation, we are happy to discuss the above considerations with you in further detail.

Do you have any questions about this fact sheet? Call the Pension Action Center at 888-425-6067 or visit us online at pension.umb.edu

About This Fact Sheet

This fact sheet was produced as part of the Pension Action Center's investor education program. Parts of the information provided were created by The Pension Rights Center, Founded in 1976, the Pension Rights Center is a nonprofit consumer organization committed to protecting and promoting the retirement security of American workers, retirees, and their families.

Disclaimer

This fact sheet is intended to provide general information about pensions and other retirement benefits and should not be used as a substitute for a consultation with an attorney or other legal professional. Individuals should always consult a legal or financial advisor to discuss the facts and circumstances of their specific situations.

Because of the rapidly changing nature of the law affecting pensions and other retirement benefits, the information published online by the Pension Action Center is subject to change without notice. Although every effort has been made to verify the accuracy of information presented, there may be errors.

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April 2017