

THE SHINE REPORT

Randolph J. Shine, CFP, MBA SPECIAL REPORT Marianne Shine, CFP Pension Plan Options to Help Increase Retirement Income

Headlines of companies declaring bankruptcy and the Pension Benefit Guaranty Corporation (PBGC) having to take over large pensions have made plan participants concerned about corporate promises to pay.

State employees like teachers, police, state administrators and employees of large companies like IBM and Motorola still have defined benefit type pension plans, and over half of these plans have a lump-sum option. With the growth of cash balance plans, the lump-sum option will become more prevalent. Defined contribution plans only offer a lump-sum option at retirement.

1. There are two basic types of pension plans.

A. Defined Benefit: A monthly benefit amount will be paid to the participant based on his/her employment record, similar to Social Security.

B. Defined Contribution: The amount the participant will receive at retirement is dependent solely on the value of the account at retirement, based on contributions and market performance. Think 401k, 403b, Sep IRA.

2. Participants in a defined benefit plan with a lump sum option have four options on how to use the value built up in the plan to receive monthly retirement income:

A. Electing an annuity (monthly benefits) option offered by the pension plan.

a. Life Only. (Payments last until participant dies. Highest monthly pay out.)

b. Joint Survivor Benefits. (Spouse starts receiving monthly benefits after death of participant. The amount received by the spouse will depend on the percentage of benefit selected at commencement of contract.)

B. Collect the lump sum as an IRA transfer and invest funds as desired.

C. Collect the lump sum as an IRA transfer and buy an annuity from an insurance company.

D. Collect the lump sum as an IRA transfer, then invest some and annuitize the rest.

State employees like teachers, firemen, administrators and employees of large corporation like IBM, Motorola, etc. currently can and do participate in defined-benefit plans.

3. Defined Contribution plans have only a lump-sum option at time of retirement. Only options B, C, and D above would be considered for retirement income planning.

4. Should a portion of a retiree's wealth be annuitized? Although the amount of how much should be annuitized varies, based on the individual's financial and health conditions, **there is general agreement in the financial planning community that at least some portion should be annuitized to insure income for life.**

5. By law, participant in a pension plan must be offered a spousal benefit. This benefit is to insure that the spouse will continue to receive monthly income after the plan participant dies. Because two lives are being insured, the monthly pay out will be less than the "Life Only" payout. How much less depends on the percentage the spouse is to receive after the participant dies. If the participant selected the "Life Only" pay out option, all monthly payments stop at the participant's death.

Examples:

A. Life Only: \$1400 per month for life.

- B. Spousal Benefit equals 50% of monthly benefit. Monthly benefit while participant is alive would be \$1,200. Upon death of plan participant, the spouse would receive \$600 per month for life.
- C. Spousal Benefit equals 100% of monthly benefit. Monthly benefit while participant is alive would be \$950. Upon death of plan participant the spouse would receive \$950 per month for life.

6. Pension income options, once a decision is made that annuitization is the best option.

- A. The Key decision will be to take Life Only or Joint Life Survivor Benefit, because you do not know who will die first
- B. Male Life Only: \$1,300/ month
- C. Joint Survivor 50%: \$1,100/ month for husband until he dies. If he dies first, wife will receive \$550/month for as long as she lives.
- D. Cost to couple to protect spouse: \$200 per month until husband dies. If the wife dies first, he loses.
- E. Solution: Have husband select Life Only and receive \$1,300/ month until he dies. Then have husband purchase insurance that will pay wife \$1,100/ month until she dies. If the wife dies first he stops paying the \$200 per month and keeps receiving the \$1,300/month. If he dies first, she will receive \$1,100 per month instead of \$550 per month for life.
- F. All pension income is taxed as ordinary income. The annuity payments the wife receives from the insurance program will be tax advantaged, because some of each payment will be tax-free.

6. The Pension Protection Act (PPA) of 2006 allowed a change in the way companies can calculate the lump-sum amount offered at retirement. It is now more critical for participants to meet with an outside professional to research their options before committing to a course of action, because the lump-sums offered will be smaller.

Credit Risk:

7. Pension Benefit Guarantee Corporation (PBGC) is a federal corporation set up by Congress as part of the original ERISA (Employment Retirement Income Security Act) to cover private sector employers.

- A. Not all pension plans are covered by PBGC. You need to check with your plan provider.
- B. Unlike Freddie Mac and Fannie Mae PBGC is not backed by the full faith and credit of the federal government.
- C. Guarantee maximum benefits vary by commencement age and form of annuity up to \$4,125/month.
- D. In 2005 Congress raised premiums on pension plans insured by PGGC.
- E. PPA of 2006 passed more stringent funding requirements to protect PGBC.

8. States have Guaranty Associations that will guarantee purchased annuity payments up to state limits.

- A. Florida protects annuities to \$100,000 cash value or \$672 of monthly payment.
- B. Some states protect annuities to \$300,000 cash value or \$2,016 of monthly payments.

9. Generally speaking, participants will receive more in monthly benefits from the annuity offered by the pension plan than if a lump-sum is used to purchase an annuity from an insurance company. Because pension plans have to use unisex rates in determining benefits, males should always research their options.

If you have any questions about which pension option would be best for you in your situation, you can call us for assistance.

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