Financial Planning* Asset Management* Investment Planning* Retirement Planning

COMMON ¢ENTS PLANNING

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KNOW ALL OF YOUR OPTIONS

“Back in my Arms Again” is a classic by The Supremes with the lyrics, “All day long, I hear my telephone ring friends calling giving their advice”. As you approach retirement those lyrics could easily be changed to all day long I hear my telephone ring with advisors giving their advice. The closer you get to retirement the more advice you receive, both solicited and unsolicited.

The majority of workers today participate in their employer’s 401(k) plan or if it's a nonprofit company, a 403b plan. We still work with many clients covered by an employer defined benefit pension plan. This is basically an old-fashioned retirement plan, where the retiree gets a monthly income for as long as they live. Some companies may provide a lump sum option, which allows their retirees to roll over their pension plan into an individual retirement account (IRA).

Many of the defined benefit plans we see today only offer monthly payout options for their retirees to choose from. The most common options include a monthly income for the retiree's lifetime; a monthly income for a guaranteed period of time; and a monthly income guaranteed for the lifetime of the retiree and their spouse.

We recently worked with a client who will retire this year. He is covered under his employer’s defined benefit pension plan which does not offer a lump sum distribution. For the sake of this article I will call the employee Bob and his lovely bride, Betty. Bob has worked for this company for 40 years. The good news is that Bob started looking at his retirement options one year in advance. Bob will turn 65 and he’ll retire this year. Betty is age 62. We evaluated which was the best pension option for them to choose to protect both of them. We also discussed when to elect Social Security.

I have to say Bob and Betty did it the right way. We reviewed their expenses and how much money they would need to truly enjoy their retirement years. At this stage in life, Betty and Bob's children are raised and self-sustaining. That in itself is wonderful that their kids will not be dragging down their retirement. Their main goal was to “travel until their legs fell off”. In other words, they wanted to maintain their standard of living but make sure they were able to travel extensively, while healthy enough.

Bob's pension options included the following:
Life Only - This is the maximum monthly income he could elect, which was $4200 per month. Upon his death Betty would receive nothing. This was a great deal for Bob but not Betty.

Life with 10 year guaranteed payment - This provided Bob with the second highest monthly amount which was $3900 per month. This was a good deal for Bob and did provide some limited protection for Betty. If Bob died in the first 10 years, then Betty would continue to receive the same amount for the reminder of the first 10 years of his retirement.

Joint Life with 100% to the Survivor - This provided Bob with a lower monthly payment of $3400. Upon his death, Betty would continue to receive the same amount for the remainder of her life. Although Bob worked for 40 years for this company, Betty put a lot of sweat equity into it raising their family. This would help them reach their goal to make sure both of them were protected.

I liked the idea of Bob electing a lifetime income of $3400 for each of them, but I also played the devil's advocate and asked Bob what happens if Betty dies first. Basically Bob will receive a lower payment for the balance of his lifetime. In a way, this is very similar to buying a very expensive term life insurance policy. In this instance Bob is paying $800 per month to guarantee Betty will always receive the same monthly income he would. Please keep in mind, as interest rates increase and Betty grows older, the cost to purchase the Life Annuity will decrease.

Since Bob was not eligible to elect a lump sum distribution, we talked about maximizing his pension. The caveat here is Bob is extremely healthy, works out five days a week and is only on one medication to control his cholesterol. With this in mind we looked to see if it was possible to insure Bob's life for the same amount of money he was giving up to protect Betty.

We started out knowing that Betty would need same amount of monthly income, after tax, as she would receive from the joint 100% survivor pension. Basically, we looked at what an annuity would cost today. Next we looked at life insurance quotes that guaranteed a death benefit until Bob turned age 100. Under both scenarios, we looked at top rated insurance companies.

Here is a look at the mechanics.
We needed to replace the <u>after tax</u> monthly income Betty would receive, which was $2,720 based on a 20% federal tax bracket. We found out it would cost $540,000 to buy a $2905 annuity at Betty's current age. We then obtained $540,000 life insurance quotes for Bob. The cost had to come in around $800 per month (difference between Bob taking a life pension and a joint life with 100% to Betty). This quote was based on Bob's qualifying for a preferred non-smoker rate, which was the second highest rating class for this insurance company.

Upon the completion of his insurance examination and offer of a policy, Bob and Betty now had another option. Bob could elect the life only pension of $4200 per month. Each month the life insurance company automatically withdrawals $800 from their checking account to pay the premium for the life insurance policy. If Bob predeceases Betty, Betty then can take the $540,000 tax-free life insurance proceeds and purchase a life annuity paying her $2905 per month for her lifetime. The majority of this monthly payment would be income tax-free. The after-tax monthly payment would be just about equal to the after-tax monthly payment on the joint and survivor benefit. State income taxes were not factored into this calculation since their state of residence does not tax pension income. Please consult your state tax laws when calculating your options.

Betty could also take the $540,000 and invest it. She could then possibly live off the earnings of that money for her lifetime and leave the balance to their children. But if Betty dies before Bob, he simply cancels the life insurance policy since it is no longer needed. He would then continue to receive the higher $4,200 monthly for his life.

This can be a win-win situation if you're healthy and disciplined. Again this is just another option when you are looking to maximize your pension. If Bob was not in good health, he would simply take the joint and 100% survivor option.

What Betty and Bob did so well was plan on which option was best for them to truly enjoy their retirement years. Once we had this in place, we then discussed which Social Security option would be best for them. That will be for another issue.

Remember only you can provide a great retirement for yourself. Seek out a professional if you're unsure of how to do it personally. Betty and Bob will now have a great retirement and they are grabbing their chairs, sunscreen and favorite beverage and heading down to the beach. Make it a super summer.

Fred Dunbar, CLU, ChFC, RFC, AIF,® is President of Planning Directions, Inc., a registered investment adviser, and Common Cents Planning, Inc. He is also a registered representative of and offers securities through Commonwealth Financial Network, member FINRA/SIPC. Advisory services offered through Planning Directions, and fixed insurance products and services offered by Common Cents Planning, are separate and unrelated to Commonwealth. Fred may be contacted at 800-647-0762, by e-mail at fdunbar@commoncentsplanning.com or by mail at 239 Baltimore Pike, Glen Mills, PA, 19342. He's always happy to meet with you 'down the shore' at 6606 Central Avenue N. Sea Isle City, NJ. 08243.