



Pension Income Planning

JLZ Business Services, Inc.
830 E. Santa Clara Street
Ventura, CA 93001
(805) 643-3295
mbigelow@jlzinc.com
www.jlzinc.com



Pension Income Planning

An employee nearing retirement may face a dilemma when it comes to choosing his or her pension. Pension options from a defined benefit retirement plan generally include a lifetime payment with no survivor benefit, a joint and 50% survivor payment, or a joint and 100% survivor payment. The joint and survivor benefits are reduced amounts from the lifetime payment option.

Predicament

If the employee selects the lifetime payment and then dies before the surviving spouse, no monthly pension will be left for the spouse. If the employee selects one of the survivor options, and the spouse dies before the employee dies, the employee will be locked into the lower payout for the rest of his or her life.

The amount of potential loss of income can be devastating to the retired employee or spouse. Emotionally, an employee may be inclined to choose one of the pension options that give an ongoing benefit to his or her surviving spouse. However, this may not be the best financial decision.

Example: Henry, age 65, will be retiring soon. He and his wife, Louise, also age 65, are reviewing his pension options.

Option	Monthly Pension	Survivor's Monthly Pension
Life	\$2,000	\$ 0
50% survivor benefit	\$1,600	\$ 800
100% survivor benefit	\$1,200	\$1,200

If Henry chooses the life option and subsequently dies, Louise will be left without any portion of his pension. With the 50% survivor benefit, Henry would have \$400 less per month than the life option, and Louise would receive a pension of half of

Henry's if Henry were to die. With the 100% survivor benefit, Henry would receive \$1,200 per month and if he were to die, Louise would receive \$1,200 per month.

Insuring the Pension

An employee who is in good health could consider purchasing a life insurance policy that will provide a death benefit to the spouse in the event the employee dies and leaves the spouse without a continuing pension payout. The spouse can then use the death benefit from the insurance policy to create an ongoing income for the rest of his or her life by purchasing an immediate annuity. This income could replace all or some of the amount of income the pension could have provided. This would allow the employee to select the lifetime payout option for the pension.

Retired Employee's Death

If the retired employee dies after choosing the lifetime payout and a life insurance policy, the lifetime payout from the pension will cease. The life insurance will then be paid to the beneficiary income-tax free. The spouse could use the death benefit from the life insurance to purchase an immediate annuity that would generate guaranteed lifetime income.

Spouse's Death

If the employee's spouse were to die before the retired employee, the retired employee would have several options. First, the lifetime payout would continue on for the retired employee (at the full amount as no survivor benefits were chosen). The life insurance could be continued for other beneficiaries, such as children, or the policy could be modified to provide a reduced paid-up insurance amount, or the policy could be terminated



Pension Income Planning

completely and any cash value returned to the retired employee.

Tax Consequences

The pension amount received by the retired employee or the surviving spouse is taxable at the time of payment. Payout from a life insurance policy is income-tax free to the beneficiary. Annuity payouts, from an annuity purchased from the death benefits, will be paid to the spouse as part interest and part return of principal. Depending on the age of the person taking the annuity, the interest rate, and the guaranteed period of time the annuity will pay out, most of the annuity payment will be return of principal. The taxable income from the annuity payments is determined by calculating the exclusion ratio of how much of each payment is return of principal and how much is interest.

If a life insurance policy is changed to a reduced paid-up amount, there are no tax consequences to the retired employee. The death benefit would still be income-tax free when it is paid out to beneficiaries. For a policy that is terminated and cashed in, the amount received greater than the amount of premiums paid into a policy would be taxable income.

Tax Summary

- Death benefits from a life insurance policy are income-tax free to the beneficiary.
- Pension income is taxable income to the recipient or beneficiary.
- Immediate annuity payments represent a return of principal and interest. Only the interest portion of the annuity payment is taxable.

Possible Risks

- Life insurance policies generally have an incontestability clause which can allow the insurance company to dispute the death benefits should the insured person die within two years of issue of the policy. Incontestability clauses can differ from state to state.

This brochure contains general information for taxpayers and should not be relied upon as the only source of authority. Taxpayers should seek professional tax advice for more information.

Copyright © 2020 Tax Materials, Inc.
All Rights Reserved

- Not all defined benefit pension options are as illustrated in the example (Henry and Louise). Some pension plans are expanding options to include guaranteed payouts for a certain number of years or a guaranteed specified amount. Employees should research all options before choosing and/or buying life insurance to protect the benefit.
- If the employee is not in good health, and a life insurance policy would have a higher premium, it may not be financially beneficial to purchase an insurance policy.
- In order to keep life insurance premiums minimal, many universal life insurance policies will lapse, or end, at age 100 with no cash value. If an insured person lives to age 100, the insurance will have been 100% cost with no benefit. Universal life insurance policies can offer a guaranteed provision; however, premiums will be more expensive.
- Only an insurance contract can guarantee a death benefit and premium amounts. The example is for illustrative purposes only.
- The entire pension amount is taxable and the life insurance premium is not tax deductible. For example, all of the \$2,000 per month Henry receives in pension income is taxable. A \$400 per month insurance premium is not tax deductible. He therefore would have taxable income of \$2,000 but constructive use of only \$1,600.
- The decision to take a full pension or to take a reduced pension can impact the employee's future retirement income for many years to come. Before selecting the pension option, retiring individuals need to explore all the pension options the company is providing. Some pension plans now create a hybrid payout. For example, a specific lump-sum dollar amount is established and is guaranteed to be paid out through monthly distributions, whether the payment is made to the employee or the spouse.

Contact Us

There are many events that occur during the year that can affect your tax situation. Preparation of your tax return involves summarizing transactions and events that occurred during the prior year. In most situations, treatment is firmly established at the time the transaction occurs. However, negative tax effects can be avoided by proper planning. Please contact us in advance if you have questions about the tax effects of a transaction or event, including the following:

- Pension or IRA distributions.
- Significant change in income or deductions.
- Job change.
- Marriage.
- Attainment of age 59½ or 72.
- Sale or purchase of a business.
- Sale or purchase of a residence or other real estate.
- Retirement.
- Notice from IRS or other revenue department.
- Divorce or separation.
- Self-employment.
- Charitable contributions of property in excess of \$5,000.