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Opinion

Planning for the Future: Maximizing Your Defined Benefit Pension Plan

By William J. Goldsmith

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Do you work for a town, state or the federal government or are you an employee of a company that still provides a defined benefit pension plan to its employees? If you are, it is very important that you understand how your plan works and the options that are available to you at your retirement.

With a defined benefit plan, the employees contribute a percentage of their wages to the plan. At retirement, the employer promises to pay the employees a percentage of their preretirement wages based on a formula that considers age, years of service and income. The employee will receive a specific income or "defined benefit" for life. When the employee dies. The income benefit ends. This is known as a single life option. The single life option pays the highest retirement benefit to the retired employees. But, if the employee is married, the surviving spouse would receive nothing once the retired employee dies. For this reason, there is also a joint and survivor retirement option that allows the retired employee to receive a reduced benefit when compared to the single survivor option but also provides a retirement benefit for the surviving spouse. In many plans, there are more than one joint and survivor option to choose from.

Each defined benefit pension plan has its own unique way of calculating retirement benefits for both single life and joint life retirement options. In addition, there can be different groups within the same plan with each group's retirement options being calculated differently. Since I have had the privilege of working with many employees of the State of Massachusetts, especially state troopers, police officers, firefighters and teachers, I am going to focus on how the state's retirement plan works.

The retirement plan provided by the State of Massachusetts has four employee group classifications and three retirement options (not including a disability option) - Options A, B and C. Retirement benefits are calculated differently depending on the employee classification.

Let's look at an example. John Smith is a state trooper. Let's assume John is retiring from the state police after serving for 25 years. Based on his 25 years of service, John is entitled to receive the maximum of 75% of his pre-retirement income if he elects Option A. His benefit is paid monthly. While this is a tremendous benefit for John and his wife Sarah, the benefit ends when John dies. So, if John died one year later, Sarah would never receive any future benefits under Option A. Option A is called a single life option. Option B is another single life option. Option B provides a monthly benefit that is 1% to 5% less than Option A. In return, with Option B, John's wife Sarah would receive the unpaid balance of the annuity that was funded by John during his working years. If all the funds from the annuity have been paid to John during his retirement, then Sarah would receive no benefit at all, the same as Option A. This is not a very popular option.

If John wants to provide Sarah with her own survivor benefit once he dies, he would need to elect Option C, the joint survivor option. The amount John would receive under Option C is based on the ages of both John and Sarah at the time of John's retirement. Typically, John would receive 7% to 15% less than Option A. In return, Sarah would receive 66% of John's Option C retirement benefit. These are excellent benefits provided by the state.

But, is there any way to improve upon the available options? Sarah's retirement income is locked in when John retires. Both John and Sarah's retirement benefit can only be inflation adjusted up to the first $12,000 of their respective benefits and that is only if the state legislature approves the adjustment each year. So, as a result, Sarah's reduced retirement benefit may not keep up with inflation. This is true for John's benefit as well. But, at least it is at a higher amount. Finally, once Sarah dies, the retirement benefits end and their children receive nothing. What if there was a way to provide a retirement benefit for Sarah and avoid the downsides just mentioned?

In many cases, a Pension Maximization Plan can be used to do just that. Using this approach, John would select Option A to receive the maximum retirement benefit. Prior to retiring, he would apply for a life insurance policy. At John's death, Sarah could use the death benefit proceeds to purchase an annuity that matches or exceeds the retirement benefit she would have received under Option C. There are two main benefits to this option. First, when purchasing the annuity, Sarah's monthly benefit is locked in at John's death not at his retirement. If John lives 20 years in retirement, that means Sarah is also 20 years older. As a result, her future life expectancy is now shorter. So, the monthly income she receives from the annuity will be much higher. Depending on her age and other assets, she may decide to invest the money and live off the interest. By doing so, she would then be able to pass the death benefit proceeds to her children. With Option C, her monthly benefit ends at her death.

There are many ways to design a Pension Maximization Plan. Each option has its pros and cons and depends on other factors to include ages, health, other assets, sources of income and planning goals. But, with a Pension Maximization Plan in place, you may be able to increase the retirement benefit to your spouse as well as provide additional money to your children.

While this article has focused on the State of Massachusetts's retirement plan, this same concept can be applied to any private or public defined benefit pension plan. The key is to become an educated consumer and understand all your options so that you can best meet your needs and goals and protect your family.

William J. Goldsmith, CFP®, CLU® is the President and Owner of LifeTime Financial Strategies, LLC, an independent financial services firm. Bill was born and raised on the South Coast and lives in Middleborough with his wife Lisa and their children. Bill can be reached by email at bill@lifetimefinancialstrategiesllc.com.