

Payment Options under Retirement Plans

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Under both defined benefit plans and defined contribution plans, employees are given the option of various payment methods at retirement.

Various payment options may be offered to an individual under the two basic types of retirement plans--*defined benefit plans* and *defined contribution plans*. According to data on benefits from the [National Compensation Survey \(NCS\)](#),¹ in 2000 virtually all employees covered by a defined benefit plan were given the option of a joint and survivor annuity at retirement.² (See table 1.) Under a joint and survivor annuity, a portion of the retiree's annuity is provided to the spouse upon the retiree's death.

The most prevalent type of joint and survivor annuity gives the employee a choice of different options at retirement--for example, 50 percent, 75 percent, or 100 percent of the retiree's benefit may be provided to the spouse. This type of payment option is provided to approximately three-fourths of the employees with a joint and survivor annuity.

Although the traditional form of payment option at retirement under defined benefit plans has been an annuity, in recent years there has been a sharp upward trend in plans offering a lump-sum benefit as a form of payment option. In the 2000 [NCS](#) benefits survey, 44 percent of covered workers were given the option of a lump-sum payment at retirement.

Defined contribution plans also offer different payment options at retirement. Defined contribution plans can be categorized by various plan types, with the most common being savings and thrift plans, followed by profit-sharing plans, and money purchase plans.³ In 1978, the Internal Revenue Code was amended to include section 401(k), allowing employees the ability to contribute to employer-sponsored defined contribution plans through salary reduction agreements. These types of arrangements are called 401(k) plans.⁴ Savings and thrift plans almost always have a 401(k) feature, which may also be present in certain of the other defined contribution plans.

While there are various types of defined contribution plans, the methods of distribution at retirement are similar regardless of the type. Because savings and thrift plans are the most common type of defined contribution plan, most data from this article are based on these kinds of plans. The most prevalent type of payment option at retirement is a lump-sum distribution, available to 87 percent of all participants in savings and thrift plans. (See table 2.) Installments paid out for a specified period of time were provided to 54 percent of participants, while 34 percent were given the option of an annuity at retirement.

Defined Benefit Plans

Under a defined benefit plan, the employer guarantees the employee's future benefit with a predetermined formula most commonly based on the employee's earnings. Traditionally, there have been three types of defined benefit formulas. The most prevalent type of formula is related to a percentage of an individual's average earnings over the final years of the work career. For example, this final pay formula may be based on the employee's highest earnings for 5 consecutive years in the last 10 years of service multiplied by each year of service. A less common type of earnings formula, a *career earnings formula*, is based on an individual's earnings over all years worked. The third type of traditional formula provides a specified dollar amount for each year worked--for example, \$30 per month multiplied times the employee's number of years of service.

In recent years a new type of defined benefit formula known as a *cash balance plan* has emerged as an alternative to the traditional formulas. A cash balance plan credits a dollar amount to a hypothetical account, generally based on a percentage of the employee's earnings. The account is then credited with a specified interest rate each year. Both traditional defined benefit plans and cash balance plans have various payment options at retirement.⁵

By law, defined benefit plans must make available an annuity option at retirement. An annuity provides monthly or yearly payments for a set number of years or for life. For married employees, the plan must offer a survivor annuity, which continues benefits to the spouse in the event of the retiree's death. The joint and survivor annuity--an option under which the employee's benefit is reduced--is the most prominent method of providing a survivor annuity. For example, a joint and survivor annuity option of 75 percent might require a 20-percent reduction in the employee's benefit at retirement. Thus, the employee's benefit at retirement would be 80 percent of the accrued benefit and the surviving spouse would receive 75 percent of that benefit.

Joint and survivor options typically provide the surviving spouse a monthly income of at least 50 percent of the employee's benefit at the time of his or her death. In addition to the typical 50-percent annuity, many plans make available to the employee a choice of more than one option. For example, the employee might have a choice of 50, 75, or 100 percent. The greater the percentage provided to the surviving spouse, the larger the employee's benefit is reduced at retirement.

Under a *single life only* option, the employee will be the sole beneficiary of a monthly pension for the term of his or her life. Payments will end upon the employee's death. Under the Employee Retirement Income Security Act (ERISA), this option--along with any other option--can only be chosen if the employee and the spouse reject the joint and survivor annuity in writing.

In addition to offering different kinds of annuities at retirement, defined benefit plans may also provide the option of lump-sum benefits. Under this option, the present value of the employee's benefit is converted to a lump-sum amount and paid out in a single cash payment. The present value represents the total amount that must be invested to pay a series of future payments. After the lump-sum benefit is provided to the employee, no additional payments are made to the beneficiary upon the former employee's death. Under current law, the employer may make a lump-sum payment of \$5,000 or less without approval from the participant or surviving spouse. When the lump-sum value is over \$5,000, the participant must be given the option of a lump sum or an annuity.

A lump-sum benefit is virtually always a payment option at retirement for cash balance plans. It is less prevalent among traditional defined benefit plans. Lump-sum payment options were provided to 44 percent of all defined benefit participants in the 2000 NCS private industry benefits survey.

Defined Contribution Plans

Defined contribution plans designate the amount of employer contributions that must be put in individual employee accounts. Only the employer contributions to the account are guaranteed, not the future benefit. Future benefits under defined contribution plans vary on the basis of investment earnings. The various types of defined contribution plans (described previously) generally follow the same pattern of payment options at retirement. Thus, the discussion of payment options in this section will apply to defined contribution plans as a whole.

Under defined contribution plans, the employee is frequently given more than one choice of payment option at retirement. Nearly all defined contribution plan participants are offered a lump-sum payment option. Another method of payment at retirement is through an installment option, which provides equal payments at set periods of time for a specified number of years. For example, installment payments may be provided on a quarterly, monthly, or annual basis for a period of 5, 10, or 20 years.

Employees in defined contribution plans also may be given the option of selecting an annuity as a method of payment. When an annuity is offered, it is usually similar to those offered under defined benefit plans. Other forms of distribution options at retirement include payments in company stock, the option of rolling over the taxable account balance to another employer plan or to an *individual retirement account* (or IRA, also called *individual retirement arrangements*), and some combination of these options.

Data On Payment Options

The kinds of payment choices offered at retirement vary among defined benefit plans and defined contribution plans. According to the 2000 NCS private benefits survey, 51 percent of all participants in defined benefit plans had some form of joint and survivor annuity option without being offered a lump-sum benefit. (See table 1.) This compares with 44 percent that were provided both a joint and survivor annuity and a lump-sum option. Of those workers that were offered both, more than 9 in 10 had available to them a choice of different types of joint and survivor annuities—for example, 50 percent, 67 percent, and 100 percent. The proportion of employees with more than one type of joint and survivor annuity option was somewhat lower when a lump-sum payment was not offered at retirement.

Under savings and thrift plans, the overwhelming majority of workers are given the option of a lump-sum benefit payment at retirement. Participation was evenly distributed among workers offered a lump-sum payment as the only option (29 percent), those offered lump-sum benefits and installments (25 percent), and those receiving the option of choosing lump-sum payments, annuities, and installments (28 percent). (See table 2.) In addition, 23 percent of the participants were offered other forms of payment options at retirement. These other payment options included distribution in company stock and rollovers into an IRA or other qualified employer plan.⁶

While the basic purpose of the survey is to estimate the number and percent of workers currently participating in benefit plans and the percent covered by specific plan features, limited data are available on the number and percent of workers offered benefit plans, regardless of whether the workers are current participants. Workers may be offered a plan but may not be allowed to participate because they have not met an eligibility requirement (such as the completion of 1 year of service) or have not made required contributions.

For defined benefit plans, the data show only minimal differences between the number of workers offered a plan and the number participating. This is because these plans generally cover all workers within specific groups (such as full-time employees completing 1 year of service) and rarely require employee contributions. On the other hand, the number of workers offered a defined contribution plan is almost 50 percent more than the number of workers participating, which is probably due to most defined contribution plans requiring employees to make contributions to be a participant. (See table 3.)

For both types of retirement plans, payment options were tabulated for workers offered the plans and for those actually participating. As can be seen from tables 1, 2, and 3, there were virtually no differences in the options between these groups. This would be expected for defined benefit plans. For defined contribution plans, it suggests that distribution options are not a factor in an employee's decision to participate in a plan.

In summary, both defined benefit plans and defined contribution plans have various ways for distributing payment options at retirement. Historically, annuities have been the most prevalent method of distribution at retirement for defined benefit plans; in recent years, however, lump-sum payments have become more prevalent as an alternative to annuity payments. This is the direct result of the growth in cash balance plans, which generally give the employees the option of selecting a lump-sum benefit at retirement. For defined contribution plans, lump-sum payments have always been the most common method of distribution option at retirement. When alternatives to lump-sum payments are offered, they are generally in the form of an annuity, or both an annuity and installment option.

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Notes

¹ The 2000 BLS survey of benefits in private industry, part of the [National Compensation Survey \(NCS\)](#), includes data for both full- and part-time workers in private sector establishments, regardless of their employment.

² Under the Employee Retirement Income and Security Act (ERISA) of 1974, defined benefit plans must make a qualified joint and survivor annuity the normal form of benefit payment for married participants. This method of payment provides the surviving spouse at least one-half of the amount of the employee's benefit during the course of the lifetime.

3 Under a savings and thrift plan, an employee makes a contribution to a fund, generally on a pretax basis, all or a portion of which is matched by the employer. The employee's contribution is usually a percentage of earnings and the employer's match is most often based on a fixed percent. In a deferred profit-sharing plan, the employer credits a portion of company profits to the individual's account. Some of these plans may allow employee contributions, but employees are usually not required to make contributions. Under a money purchase plan, the employer makes fixed contributions to an employee's account. The fixed contributions are usually based on a percentage of employee earnings. Money purchase plans generally do not allow employees to make contributions.

4 For a more detailed discussion on 401(k) plans, see Marc Kronson, "Employee Costs and Risks in 401(k) Plans," *Compensation and Working Conditions*, Summer 2000, pp. 12-15.

5 For a more detailed description of cash balance plans, see Kenneth R. Elliott and James H. Moore, Jr., "Cash Balance Pension Plans: The New Wave," *Compensation and Working Conditions*, Summer 2000, pp. 3-11.

6 The survey did not code for these payment options separately, and therefore data are not available for each of these items individually.

Table 1. Percent of all employees offered and participating in defined benefit pension plans, by choice of payment option provided, private industry, National Compensation Survey, 2000

	Participated		Offered	
	Percent	Number	Percent	Number
Total	100	20,613,000	100	22,349,000
With joint and survivor annuity option	95	19,612,000	96	21,347,000
With choice of joint and survivor percents	76	15,672,000	77	17,240,000
With lump-sum option	41	8,532,000	42	9,430,000
Without lump-sum option	35	7,140,000	35	7,809,000
No choice of joint and survivor percents	18	3,753,000	18	3,912,000
With lump-sum option	2	444,000	2	462,000
Without lump-sum option	16	3,308,000	15	3,450,000
Choice of joint and survivor percents not determinable	1	187,000	1	196,000
Distribution options not determinable (1)	5	1,001,000	4	1,001,000
Total with lump-sum option available (2)	44	8,997,000	44	9,921,000

Footnotes:

(1) Includes all cases where the joint and survivor annuity data were unknown, the lump-sum data were unknown, and both the joint and survivor annuity and lump-sum data were unknown.

(2) Total with lump-sum option also included in other rows of the table.

NOTE: Because of rounding, sums of individual items may not equal totals.

Table 2. Percent of all employees participating in types of defined contribution plans by choice of payment options provided, National Compensation Survey, 2000

	All defined contribution		401(k)		Savings & thrift		Profit sharing	
	Percent	Number	Percent	Number	Percent	Number	Percent	Number
Total	100	45,091,000	100	32,104,000	100	28,597,000	100	8,364,000

Footnotes:

(1) Less than 0.5 percent.

(2) Other options such as rollover into an individual retirement account (IRA) were not tabulated separately.

(3) Total with annuity and installment also included in other rows of the table.

NOTE: Because of multiple payment options, sums of individual items may not equal totals. Dash indicates no employees in the row.

	All defined contribution		401(k)		Savings & thrift		Profit sharing	
	Percent	Number	Percent	Number	Percent	Number	Percent	Number
With lump-sum option	83	37,320,000	88	28,397,000	87	25,010,000	83	6,928,000
No other option	30	13,466,000	28	9,078,000	29	8,371,000	36	3,029,000
With annuity option	5	2,087,000	6	1,829,000	4	1,248,000	7	586,000
With installment option	21	9,252,000	23	7,533,000	25	7,254,000	14	1,145,000
With annuity and installment option	28	12,515,000	31	9,956,000	28	8,136,000	26	2,167,000
With annuity and installment option	(1)	142,000	(1)	128,000	(1)	113,000	-	-
Annuity only	1	339,000	1	339,000	1	339,000	-	-
Other distribution options (2)	20	9,191,000	22	7,089,000	23	6,604,000	14	1,130,000
Distribution options not determinable	12	5,418,000	10	3,241,000	11	3,135,000	17	1,436,000
Total with annuity option available (3)	33	15,083,000	38	12,252,000	34	9,836,000	33	2,754,000
Total with installment option available (3)	49	21,909,000	55	17,617,000	54	15,503,000	40	3,313,000

Footnotes:

(1) Less than 0.5 percent.

(2) Other options such as rollover into an individual retirement account (IRA) were not tabulated separately.

(3) Total with annuity and installment also included in other rows of the table.

NOTE: Because of multiple payment options, sums of individual items may not equal totals. Dash indicates no employees in the row.

Table 3. Percent of all employees offered types of defined contribution plans, by choice of payment option provided, private industry, National Compensation Survey, 2000

	All Defined Contribution		401(k)		Savings & Thrift		Profit Sharing	
	Percent	Number	Percent	Number	Percent	Number	Percent	Number
Total	100	65,299,000	100	47,427,000	100	43,320,000	100	11,033,000
With lump-sum option	83	53,977,000	88	41,665,000	87	37,623,000	85	9,432,000
No other option	31	20,556,000	30	14,187,000	31	13,385,000	39	4,357,000
With annuity option	4	2,641,000	5	2,322,000	4	1,674,000	6	617,000
With installment option	20	13,300,000	23	10,930,000	24	10,597,000	15	1,628,000
With annuity and installment option	27	17,480,000	30	14,227,000	28	11,968,000	26	2,830,000
With annuity and installment option	(1)	147,000	(1)	128,000	(1)	113,000	-	-
Annuity only	1	528,000	1	528,000	1	528,000	-	-

Footnotes:

(1) Less than 0.5 percent.

(2) Other options such as rollover into an individual retirement account (IRA) were not tabulated separately.

(3) Total with annuity and installment also included in other rows of the table.

NOTE: Because of multiple payment options, sums of individual items may not equal totals. Dash indicates no employees in the row.

	All Defined Contribution		401(k)		Savings & Thrift		Profit Sharing	
	Percent	Number	Percent	Number	Percent	Number	Percent	Number
Other distribution options (2)	22	14,074,000	23	10,855,000	24	10,266,000	16	1,786,000
Distribution options not determinable	12	7,699,000	11	5,106,000	12	5,056,000	15	1,601,000
Total with annuity option available (3)	32	20,796,000	36	17,205,000	33	14,282,000	31	3,446,000
Total with installment option available (3)	47	30,927,000	53	25,284,000	52	22,677,000	40	4,458,000

Footnotes:

(1) Less than 0.5 percent.

(2) Other options such as rollover into an individual retirement account (IRA) were not tabulated separately.

(3) Total with annuity and installment also included in other rows of the table.

NOTE: Because of multiple payment options, sums of individual items may not equal totals. Dash indicates no employees in the row.