Government Executive

Providing For Each Other

By Tammy Flanagan

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In last week's column, we looked at the critically important question of whether to take a reduced retirement benefit to provide a survivor annuity. This week, I'd like to explore a more specific scenario based on an e-mail I recently received about a situation involving two married federal employees.

Kat and Charlie are both high-level federal managers, and are planning to retire at the end of this year under the Civil Service Retirement System. They're looking forward to retirement benefits computed at $112,000 per year for him and $90,000 per year for her. (But their level of benefit in this scenario wouldn't really affect their decision.) If Charlie were to provide a full spousal survivor annuity to Kat, the reduction to his benefit would be $10,930 a year, or $910.83 a month. If Kat were to do the same, the reduction to her annuity would be $8,730 per year, or $727.50 per month.

Instead of providing survivor annuities for each other, Charlie and Kat decided to buy life insurance:

- Charlie bought a 20-year term life insurance policy worth $400,000 with a premium of $1,541 a year. The term will expire at age 77. He also purchased a permanent life insurance policy worth $600,000 with a premium of $7,097 per year.
- Kat bought a 20-year term life insurance policy worth $400,000, with a premium of $873 a year. The term will expire at age 75. She also purchased a permanent life insurance policy worth $600,000, with a premium of $5,181 per year.

The annual insurance premiums total $14,692, paid with after-tax dollars. The reduction to Charlie and Kat's retirement benefits to provide each other with a survivor annuity would be $19,660 a year, but would reduce their taxable income by this amount. The after-tax cost of the survivor annuity election would be $14,155. (They will be in the 28 percent marginal federal tax bracket and their state does not tax federal retirement benefits.) So the cost of their choice to provide insurance is slightly more than providing survivor annuity benefits.

What They Get

The survivor annuity would provide 55 percent of $112,000, or $61,600 a year, to Kat for the rest of her life if Charlie dies first. Keep in mind that this amount will increase by cost-of-living adjustments before and after Charlie's death. If Kat dies first, Charlie would receive 55 percent of $90,000, or $49,500 per year, for the rest of his life. In addition, their own retirement benefits would be restored to their unreduced amount upon the death of the other spouse. For Kat, that would mean an additional $8,730 in annual income; for Charlie, the figure would be $10,930.

Charlie's insurance policy would provide Kat $1 million tax-free if he dies before age 77 and $600,000 if he dies after 77. Kat's policy would provide Charlie $1 million tax-free if she dies before 75 and $600,000 if she dies after 75. Would this be enough to replace the loss of Charlie's $112,000 annual retirement benefit or Kat's $90,000 benefit?

The surviving spouse could invest the proceeds of the insurance and withdraw monthly payments, but what if the investments didn't perform well? Would Charlie or Kat continue paying the insurance premiums for the insurance on their own life? What if she outlives him by 30 years (or vice versa)? What if there is a downturn in the economy or something happens that makes it impossible for Charlie and Kat to continue paying their insurance premiums? Using a conservative 4 percent withdrawal rate, $1 million invested in a well-diversified portfolio could provide about $40,000 a year of income that could last 30 years or longer. What if they spent more? What if there was a period of high inflation?

Whether or not purchasing insurance was the best choice depends on how long Charlie and Kat live and the inflation rate over their lifetimes. It also depends on how reliant they are on each other's income and what other assets are available in the event one of them dies before the other.

This insurance will pay the same death benefit when they are 70 as it would today. The retirement benefit will receive annual COLAs. If Charlie's retirement receives 3 percent annual COLAs, then it will double in 24 years -- meaning that when Charlie is 82, his retirement would potentially increase to $224,000. The survivor annuity at that time would pay Kat a benefit of $123,200 a year.

Charlie's life insurance would pay Kat a benefit of $600,000 at age 82, since the term insurance would have expired earlier. What would Kat do to replace the $224,000 that stopped when Charlie died? She would be able to use the $600,000, but she would only be able to withdraw some of the lost income because she would not know how long she might outlive her husband. Charlie and Kat will need to do some careful estate planning to be sure they're prepared to implement a prudent plan upon the death of either spouse.

Kat and Charlie believe they both have good individual pensions if the other passes. The insurance provides them each with a cushion if either died unexpectedly. They are both currently in good health and longevity runs in their families. If they both live into their 90s, that leaves only a few years to collect a survivor benefit.

Complicated Decision

Charlie also said he might reduce or eliminate the life insurance if at some point he and Kat don't believe it's necessary. The good news about the survivor annuity is that it's a permanent choice. Unless Charlie or Kat are only living on a portion of their retirement income, the survivor will always need money to replace the lost retirement income of the deceased partner.

Another thing to keep in mind is that not everyone can purchase life insurance -- you have to be insurable. In addition, your age will have a major effect on the cost of the insurance. Couples should not be too quick to discount the value of the spousal survivor annuity options available. Although the cost of the benefit is steep, the value can be tremendous.

By the way, while Charlie and Kat are retiring under CSRS, the decision doesn't get much easier for those under the Federal Employees Retirement System. The difference is that the FERS annuity benefit is only one piece of the retirement income pie. A FERS couple also needs to consider what happens to Social Security when one spouse dies before the other.

If both husband and wife are receiving their own Social Security retirement benefits, the surviving spouse will generally receive only the higher of the two benefits, but not both. Also, they'll need to consider what to do with the money each of them has invested in the Thrift Savings Plan. In many cases, the TSP will continue to be a valuable source of income to supplement the monthly FERS retirement benefit and Social Security payments. A surviving spouse may choose to transfer the TSP account of their deceased spouse into their account and continue to receive a monthly payout.

No matter which retirement system you are covered under, deciding how to protect your spouse is an important and sometimes very complicated decision. The best place to start is to have your retirement benefit computed with the survivor annuity election to show your reduced retirement as well as the survivor benefit amount. Consider all of your retirement income, which may include additional pension benefits and other retirement savings along with Social Security.

Remember that if you live a long time in retirement, inflation can become a major factor. Ask each other one big question: "If I die first, how will that leave you financially?" Or, conversely, "If you die first, how will that leave me financially?"

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