WINNING THE LOTTERY: LUMP SUM OR ANNUITY?

A Massachusetts woman recently won one of the largest lottery jackpots ever: $294 million. Like most lottery winners, she took her winnings in a single-check lump sum. But is taking the lump sum always the best choice?

Few people, of course, will ever win a lottery jackpot of any size, let alone $294 million. But many retiring workers who belong to a defined-pension plan face a similar decision every year: do they take their pension in a lump sum or in monthly annuity payments for the rest of their lives? The decision in either case, according to financial planners, will depend on multiple factors including the person’s life expectancy, size of payout, financial circumstances, tax bracket, interest rates, investment acumen, and risk tolerance.

You don’t get the face value. In the case of the Massachusetts lottery winner, she received a lump-sum check for $168 million instead of the entire $294 million she would have received had she’d chosen the annual annuity payout—roughly $11.3 million for 26 years. That’s because it’s assumed that you can invest the lump sum and, with earnings, accumulate the equivalent total payouts you would have received had you chosen the annuity instead. The same principle applies to lump-sum payouts for pension plans: the lump sum is always considerably smaller than the total annuity payouts.

Taxes. Taking the money in a lump sum and subjecting it to taxes in a single year will likely bump you into a higher—possibly significantly higher—income-tax bracket. The Massachusetts lottery winner paid out roughly $65 million to federal and state taxes, leaving her with $103 million. But by spreading out her payments over 26 years, she would likely have ended up with more after-tax dollars than with the lump sum, assuming current tax rates.

The tax reduction benefits of annuitization would shrink and likely disappear eventually in the case of much smaller amounts, such as a pension payout. Fortunately for pensions, beneficiaries have the option of rolling the lump sum into an individual retirement account where they will pay taxes only on the amount they take out each year (required minimum distributions begin shortly after age 70 1/2).

Can you safely manage the money? The world of lottery winners is replete with examples of people who squandered their winnings within in a few years—in some cases, leaving them with more debt than before they won. By choosing annual annuity payments, you can generally confine any mistakes to just that year's payout, learn from your mistakes, and do better the next year.

Do you have the investing skills? Do you have the investing acumen and the risk tolerance to invest the lump sum in a way that successfully generates, on an after-tax basis, the equivalent of the annuity payment after taxes are taken out? Of course, you'll probably want to work with an investment expert such as your financial planner, but you still the carry risk of falling short—though, of course, you could end up earning more money than the annuity equivalent in the long haul.

Watch out for inflation. A major risk of annuity payments, whether through a lottery or a pension plan, is that the payouts are fixed. Annual inflation gradually reduces the buying power of those payouts, so that over a long period of even low inflation your buying power could easily be cut in half.

For that reason, some planners recommend investing part of the lump sum in a good commercial annuity and investing the remainder in assets such as stocks and real estate that ideally can keep ahead of inflation.

Financial circumstances. Some may want the lump sum in order to invest the funds in a second-career business, or to pay off debts.

Life expectancy. In the case of a defined-benefit pension plan, beneficiaries who think they'll live less than the average life expectancy for their age may want to consider taking the lump sum. That's because annuity payments typically cease upon the death of the beneficiary (or the death of the surviving co-beneficiary, as is often the case with a husband and wife).

With a lump sum, on the other hand, any money left upon death would pass to the beneficiary's heirs. This is less of a risk for lottery winners. Lotteries usually continue making any remaining annuity payments to the winner's heirs.

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