Retirement Program Lump-Sum Distributions: Hundreds of Billions in Hidden Pension Income

- This Issue Brief presents data on the number and amounts of lump-sum total distributions made from retirement programs and also on the number and amounts of rollover contributions made to individual retirement accounts (IRAs) for the years 1987–1990. It also discusses the implications of workers' rollover decisions for retirement income security and the legislative history of benefit preservation.

- The number of lump-sum total distributions rose from 11.4 million in 1987 to 12.2 million in 1988 and then declined to 10.8 million in 1990. While the number of distributions declined over this period, the amount distributed increased steadily from $80.3 billion in 1987 to $125.8 billion in 1990. By comparison, retirement benefit annuity payments from employment-based plans totaled $197 billion in 1987 and $234 billion in 1990.

- While 61 percent of all 1990 distributions were premature, i.e., they occurred before the recipients reached age 59 1/2, 38 percent of all funds distributed were from a premature distribution. Normal distributions, i.e., those made to recipients who were at least aged 59 1/2, accounted for 25 percent of all distributions and 34 percent of all funds distributed in 1990.

- Twenty-nine out of every 100 lump-sum total distributions in 1990 resulted in an IRA rollover contribution, indicating that more than 70 percent of all distributions were not even partially rolled over into an IRA in that year. Focusing on the funds involved, 57 percent of all money distributed in a lump-sum total distribution was rolled over into IRAs.

- More and better data are needed to fully assess the preservation issue. To the extent we are better able to gauge the perceptions and expectations of distribution recipients, a clearer picture emerges as to the extent that distributions are being preserved, invested in other ways, used for consumption in hard times, or used simply for current gratification. Whether a lack of preservation is due to shortsightedness or current hardship, it may be at the expense of future retirement income security. A deeper understanding of these issues is needed for informed policy decisions.
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programs between 1987 and 1990, totaling more than $406 billion; in 1990 alone, there were almost 11 million such distributions totaling approximately $126 billion. By way of comparison, between 1987 and 1990 annuity payments from pension plans totaled $858 billion ($520 billion of which was from private-sector pensions), and Social Security Old-Age and Survivors Insurance benefit payments were $810 billion; in 1990, annuity payments from pension plans totaled $234 billion ($141 billion of which was from private-sector pensions), and Social Security Old-Age and Survivors Insurance benefit payments were $223 billion. The sheer magnitude of the distribution numbers is indicative of the importance such lump-sum distributions have for retirement income security. As is discussed below, most of these funds move to personal balance sheets or individual retirement accounts (IRAs) and thus do not show up as pension income in any income statistics, even though the accumulation of these funds was generated by tax-preferred pension plans.

These distributions, a large proportion of which are accounted for by pre-retirement distributions, represent a tremendous pool of financial resources. Consequently, recipients’ decisions regarding the use of these funds is a significant public policy issue. Recipients may roll this money over and preserve it for retirement on a tax-deferred basis, save it on a nonpreferred basis, or consume it. Some consumption, such as home purchase or increased education, may enhance retirement income security. Some consumption may be necessitated by current economic hardship, i.e., a worker is laid off and needs the money to cover his or her family’s current living expenses. Other consumption may result from a desire for current gratification combined with a lack of foresight, i.e., on changing jobs a worker decides to use some of the money to take a vacation rather than preserve it for retirement. Consumption of such distributions, particularly among current workers, whether as a result of financial hardship or shortsightedness, sacrifices funds that might otherwise be available for retirement. This raises the risk that workers will not be able to retire in the lifestyle they desire or will be forced to remain active in the labor force longer than they desire.

Such issues are heightened by ongoing developments within the employment-based retirement system. While defined benefit plans have remained the primary type of retirement plan offered by large employers, there has been significant growth in the number of defined contribution plans both as primary plans for smaller and mid-size employers and as supplemental plans for mid-size and larger employers. The growth in defined contribution plans has been accompanied by an increase in the availability of lump-sum distributions because nearly all defined contribution plans provide for such distributions. In addition, a significant number of defined benefit plans now offer lump-sum distributions. In a recent survey, 34 percent of the surveyed companies with defined benefit plans for salaried employees had a lump-sum option in the plan, and of these 67 percent made the option available to terminated employees who were vested in their plan, 72 percent to early retirees, and 75 percent to normal retirees (Hewitt, 1992). Thus, lump-sum distributions and their preservation are an issue with both defined benefit plans and defined contribution plans.

With lump-sum distributions, the cash value of vested benefits is portable on job termination for current workers, i.e., the participant receives a distribu-

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2 A worker is vested when he or she is entitled to a nonforfeitable and nonrevocable benefit.
tion of his or her vested benefits and then has the opportunity to roll the funds over into an IRA or other tax-qualified savings vehicle. Such rollovers result in preservation of the retirement benefit. The rollover decision is completely up to the individual. The recipient may decide not to roll over all or part of the distribution and instead use it for some other purpose such as paying off debt, non-tax-preferred savings, starting a business, buying a home, covering living expenses during a period of unemployment, or any other type of consumption. Recent policy changes have sought to encourage rollovers. A participant who receives a distribution prior to age 59 1/2 must pay regular income tax plus a 10 percent penalty tax on any taxable portion of the distribution that is not rolled over into an IRA or other tax-qualified savings vehicle. The 10 percent penalty tax is not imposed if the worker has died, become disabled, or has reached age 59 1/2. Participants are permitted a one-time election of 5-year forward averaging for a lump-sum distribution received after age 59 1/2 that is not rolled over. In addition, most distributions not directly transferred into a qualified savings vehicle, such as an IRA or another employer’s plan, are now subject to a 20 percent withholding.

Because defined contribution plans are now an integral source of future retirement income for more workers and not merely a supplemental savings vehicle, and lump-sum distributions are not uncommon within defined benefit plans, the use of preretirement distributions has increased implications for retirement income adequacy. Preretirement erosion of lump-sum distribution values through consumption (whether necessitated by hardship or strictly discretionary), loss of tax deferral, and payment of the penalty tax and regular income tax can erode potential retirement income. Without preservation, portable benefits may not contribute to retirement income security.

Calculations by VanDerhei suggest that a...
hypothetical worker holding four jobs with increasing tenure over 30 years, with constant defined contribution plan coverage, would lose 55 percent of the value of his or her retirement benefit by spending the preretirement lump-sum distributions rather than rolling them into a tax-qualified account at a moderate nominal interest rate (VanDerhei, 1992). The effect of spending preretirement distributions from final-pay defined benefit plans rather than rolling them over at a similar interest rate would be smaller. Because final-pay plans are more back-loaded than defined contribution plans, i.e., benefit accruals as a percentage of pay increase with worker tenure, the plan sponsored by the final employer (from which the worker retires) would contribute a disproportionately large share to retirement income, mitigating the loss. However, VanDerhei's calculations suggest that final-pay plan participants who spend their preretirement distributions will receive 19 percent to 27 percent less in benefits than workers who roll over such amounts. These values suggest that, in general, participants in both defined contribution and defined benefit plans that provide for lump-sum distributions can substantially increase their retirement income by preserving their preretirement distributions.

In 1990 there were 3.1 million IRA rollover contributions, totaling $71.4 billion. Thus, for every 100 lump-sum total distributions in 1990, there were 29 IRA rollover contributions, and for every $100 distributed, $57 was rolled over into IRAs. These figures are consistent with previous Employee Benefit Research Institute (EBRI) research based on the employee benefit supplement of the May 1988 Current Population Survey (CPS), which indicated that most distributions were not rolled over into tax-qualified savings vehicles (Piacentini, 1990). However, the proportion of distributed funds rolled over is higher than previously believed.

This Issue Brief presents data tabulated for EBRI by the Internal Revenue Service (IRS) on the number and amounts of lump-sum total distributions made from retirement programs and also on the number and amounts of rollover contributions made to IRAs for the years 1987–1990. It also discusses the implications of workers' rollover decisions for retirement income security and the legislative history of benefit preservation. Previously, the only broad-based data available regarding distributions and rollover behavior were from the employee benefit supplements of the 1983 and 1988 May Current Population Surveys. While these supplements were a rich source of information regarding who had received distributions and what they had done with them, they asked only about the most recent distribution received and thus did not provide good aggregate data on the number of distributions in a given year and participation, and vesting. They also gathered information regarding coverage and participation in salary reduction plans and the receipt and use of lump-sum distributions. Similar surveys were conducted in 1972 and 1979, with each generally providing more comprehensive information than the last. The survey was repeated again in April 1983, and results will be available in 1984.

9 Final-pay defined benefit plans base benefit amounts on the participant’s final average earnings and his number of years of service.
10 However, a worker who rolls over lump-sum distributions from defined benefit plans into a tax-qualified retirement savings vehicle generally will not gain relative to leaving the benefits in the plan to be paid out as a deferred annuity, unless he or she realizes above-market investment returns on the rollover amount. This is particularly true if, by taking a distribution, the worker has forgone the possibility of a partial cost-of-living adjustment to monthly benefits that the plan might have provided at a later date.
11 Employee Benefit Research Institute was not directed or indirectly provided with any individually identifiable tax return information.
12 The employee benefit supplements of the 1983 and 1988 May Current Population Surveys gathered detailed information on pension coverage, participation, and vesting. They also gathered information regarding coverage and participation in salary reduction plans and the receipt and use of lump-sum distributions. Similar surveys were conducted in 1972 and 1979, with each generally providing more comprehensive information than the last. The survey was repeated again in April 1983, and results will be available in 1984.
13 For a complete discussion of data in these supplements, see Joseph Piacentini, “Preservation of Pension Benefits,” EBRI Issue Brief no. 98 (Employee Benefit Research Institute, January 1990); and G. Laurence Atkins, Spend or Save It? Pension Lump-Sum Distributions and Tax Reform, EBRI-ERF Research Report (Washington, DC: Employee Benefit Research Institute, 1986).
the dollars involved or the number of rollovers and the dollars involved in a specific year. The EBRI/IRS tabulations presented here fill this void. These numbers are perfectly suited for the task because they are based on the relevant information forms filed directly with IRS.14

**Lump-Sum Distributions**

The number of lump-sum total distributions15 rose from 11.4 million in 1987 to 12.2 million in 1988 and then declined to 11.6 million in 1989 and to 10.8 million in 1990 (table 1). These numbers include not only preretirement distributions on job change but also other distributions such as retirement distributions (see discussion below on types of distributions). These distributions are from defined benefit and defined contribution pension plans as well as from IRA and simplified employee pension (SEP) accounts. The number of distributions from defined benefit and defined contribution plans, i.e., non-IRA/SEP distributions, decreased from 8.8 million to 8.2 million over this time period (tabulations cannot be provided for defined benefit plans and defined contribution plans separately), while the number of IRA/SEP distributions remained essentially constant at 2.6 million (table 1).

While the number of distributions declined over this period, the amount distributed increased steadily, implying a rise in the average amount distributed (table 1). The aggregate amount distributed rose from $80.3 billion in 1987 to $85.2 billion in 1988 to $115.3 billion in 1989 to $125.8 billion in 1990. This increase in the amount distributed was driven largely by the increase in the amount distributed from defined benefit and defined contribution plans, i.e., non-IRA/SEP accounts, from $65.9 billion in 1987 to $107.2 billion in 1990. The amount distributed from IRA/SEP accounts rose by $4.2 billion, from $14.4 billion to $18.6 billion over the same time period. The average amount distributed was $11,656 in 1990 as opposed to $7,063 in 1987. The average distribution from non-IRA/SEP accounts rose by almost $6,000 over the four years, reaching $13,155 in 1990. The growth in the average IRA/SEP distribution was more modest over this period; distributions from IRA/SEP accounts averaged $5,657 in 1987 and $7,035 in 1990.

By comparison, retirement benefit payments from employment-based retirement plans totaled $197 billion in 1987, $206 billion in 1988, $221 billion in 1989, and $234 billion in 1990 (table 2). These numbers represent annuity payments

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14 Internal Revenue Service (IRS) Form 1099-R, Statement for Recipients of Total Distributions From Profit-Sharing, Retirement Plans, Individual Retirement Arrangements, Insurance Contracts, Etc., is filed by plan trustees for each person to whom any designated distribution that is a total distribution has been made from profit-sharing or retirement plans, IRAs, annuities, etc. A total distribution is defined as one or more distributions within one tax year in which the entire balance of the account is distributed. Information reported on the 1099-R includes gross distribution amount, taxable amount, amount eligible for capital gain, and type of distribution (i.e., normal, premature, death, disability, etc.). This information can be broken out by distributions from defined benefit and defined contribution plans (non-IRA/ simplified employee pension (SEP) accounts) and by those from IRA/SEP accounts. IRS Form 5498, Individual Retirement Arrangement Information, is filed by plan trustees for each person for whom an IRA or SEP is maintained. Information reported on Form 5498 includes regular contributions, rollover contributions, and fair market value of the account.

15 A total distribution is one or more distributions within one tax year in which the entire balance of the account is distributed. Some readers might be more familiar with the term lump-sum distribution, which is a subset of total distributions. A lump-sum distribution is a total distribution that is the result of one of the following: the employee's death, the employee attains age 59 1/2, the employee's separation from the service of the sponsor, or the employee has become disabled. In addition to lump-sum distributions, a total distribution may be the result of a prohibited transaction, IRC sec. 1035 exchange, excess contributions plus earnings/excess deferrals, and PS 58 costs (premiums paid by a trustee or custodian for current life or other insurance protection). These items are explained later in this Issue Brief. Most total distributions are lump-sum distributions; in 1990, 90 percent of all total distributions were lump-sum distributions and 79 percent of all funds distributed as a total distribution were due to a lump-sum distribution.
Table 1
Lump-Sum Total Distributions from Tax Qualified Plans, 1987–1990

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<td>Aggregate</td>
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<td>12.2</td>
<td>11.6</td>
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<td>Non-IRA/SEP</td>
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<td>8.2</td>
<td>c</td>
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<tr>
<td>IRA/SEP</td>
<td>2.6</td>
<td>c</td>
<td>c</td>
<td>2.6</td>
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<td>Aggregate</td>
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<td>$85.2</td>
<td>$115.3</td>
<td>$125.8</td>
<td>$406.6</td>
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<td>Non-IRA/SEP</td>
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<td>c</td>
<td>107.2</td>
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<tr>
<td>IRA/SEP</td>
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<td>18.6</td>
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<td>$7.0</td>
<td>$10.0</td>
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<td>$8.8</td>
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<td>IRA/SEP</td>
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Table 2
Retirement Benefit Payments from Private and Public Sources, Selected Years 1987–1990

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<td></td>
<td>($ billions)</td>
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<td>Private Pensions</td>
<td>$120.8</td>
<td>$124.1</td>
<td>$133.6</td>
<td>$141.2</td>
<td>519.7</td>
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<td>Federal Employee Retirement(^b)</td>
<td>44.9</td>
<td>48.1</td>
<td>50.6</td>
<td>53.9</td>
<td>197.5</td>
</tr>
<tr>
<td>State and Local Employee Retirement</td>
<td>31.2</td>
<td>34.1</td>
<td>36.6</td>
<td>39.2</td>
<td>141.1</td>
</tr>
<tr>
<td>Subtotal</td>
<td>196.9</td>
<td>206.3</td>
<td>220.8</td>
<td>234.3</td>
<td>858.3</td>
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<td>Social Security Old-Age and Survivors Insurance Benefit Payments(^c)</td>
<td>$183.6</td>
<td>$195.5</td>
<td>$208.0</td>
<td>$223.0</td>
<td>810.1</td>
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<tr>
<td>Total</td>
<td>$380.5</td>
<td>$401.8</td>
<td>$428.8</td>
<td>$457.3</td>
<td>1,668.4</td>
</tr>
<tr>
<td>Total (percentage of total)</td>
<td>100.0%</td>
<td>100.0%</td>
<td>100.0%</td>
<td>100.0%</td>
<td>100.0%</td>
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\(^a\)Includes only employment-based retirement benefits.
\(^b\)Includes civilian and military employees.
\(^c\)Includes payments to retired workers and their wives, husbands, and children.
only. The billions of dollars paid each year in lump-sum distributions and taken into personal assets result in asset income in national accounts. Therefore, when examining the sources of the elderly’s income, pension income includes plan annuity payments only. Income generated from preserved lump-sum distributions shows up as income from assets, not as pension income. Statistics on income of the elderly are thus misleading regarding the contribution of employment-based retirement plans.

If income generated by preserved lump-sum distributions could be accounted for as pension income, more retirees would show pension income. Also, a greater share of income would show up as pension income. Depending on the size of the distributions received and their preservation over recipients’ working years, it is possible that benefits from the employment-based retirement system might not appear as skewed in favor of higher income retirees with more accurate accounting.

Social Security Old-Age and Survivors Insurance benefit payments totaled $184 billion in 1987, $196 billion in 1988, $208 billion in 1989, and $223 billion in 1990 (table 2). While pension annuity payments and Social Security payments grew 19 percent and 21 percent, respectively, between 1987 and 1991, the amounts distributed in the form of lump sums from retirement plans grew 57 percent over the same time period (chart 1).

**Types of Distributions**

While 61 percent of all lump-sum total distributions, or 6.5 million, made in 1990 were premature, i.e., occurred before the recipient reached age 59 1/2, 38 percent of all funds distributed, amounting to $47.9 billion, were from premature distributions (charts 2a and b). These figures include premature distributions where an exception to the penalty tax applied. However, almost all premature distributions were subject to penalty tax if they were not rolled over into a tax-qualified savings vehicle. There were 0.3 million premature distributions with penalty tax exceptions in 1990; these distributions totaled $5.5 billion. Premature distributions most likely occur on job change or termination and thus are ones, in particular, where preservation is an issue.

Normal distributions, i.e., distributions where the recipient was at least aged 59 1/2, accounted for 25 percent, or 2.7 million, of all lump-sum total distributions in 1990, and they accounted for 34 percent, or $43.0 billion, of all funds distributed (charts 2a and b). Such distributions are received on retirement and are then available to fund consumption over the recipients’ retirement years. This may be achieved through the purchase of an annuity, or the funds may be saved in an IRA and drawn down over the recipients’ retirement years.
Chart 2a
Percentage Breakdown of Lump-Sum Total Distributions, 1990

Chart 2b
Percentage Breakdown of Lump-Sum Total Distribution Amounts, 1990

Chart 2c
Percentage Breakdown of Non-Individual Retirement Account/Simplified Employee Pension Lump-Sum Total Distributions, 1990

Chart 2d
Percentage Breakdown of Non-Individual Retirement Account/Simplified Employee Pension Lump-Sum Total Distribution Amounts, 1990

Chart 2e
Percentage Breakdown of Individual Retirement Account/Simplified Employee Pension Lump-Sum Total Distributions, 1990

Chart 2f
Percentage Breakdown of Individual Retirement Account/Simplified Employee Pension Lump-Sum Total Distribution Amounts, 1990

Table 3
Taxable Lump-Sum Total Distributions from Tax Qualified Plans, 1987–1990

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<tr>
<td>Aggregate</td>
<td>10.8</td>
<td>11.4</td>
<td>10.0</td>
<td>9.9</td>
<td>42.1</td>
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<tr>
<td>Non-IRA/SEP</td>
<td>8.2</td>
<td>c</td>
<td>c</td>
<td>7.5</td>
<td>c</td>
</tr>
<tr>
<td>IRA/SEP</td>
<td>2.6</td>
<td>c</td>
<td>c</td>
<td>2.4</td>
<td>c</td>
</tr>
<tr>
<td>Total Amounts Distributed ($ billions)</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Aggregate</td>
<td>62.1</td>
<td>72.2</td>
<td>82.5</td>
<td>89.1</td>
<td>305.9</td>
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<tr>
<td>Non-IRA/SEP</td>
<td>47.8</td>
<td>c</td>
<td>c</td>
<td>72.5</td>
<td>c</td>
</tr>
<tr>
<td>IRA/SEP</td>
<td>14.3</td>
<td>c</td>
<td>c</td>
<td>16.6</td>
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The average size of normal distributions, $15,944, is larger than that of premature distributions, $7,369. This is likely explained by such distributions being received by individuals aged 59 1/2 or over for whom the plans have generally been active over a longer period of time and thus have accumulated a greater benefit.

Five percent of all lump-sum total distributions in 1990 and 6 percent of the funds distributed were the result of Internal Revenue Code (IRC) sec. 1035 exchanges. (Tax free exchange of insurance contracts under IRC sec. 1035, which provides that no gain or loss will be recognized for income tax purposes on the exchange of one insurance or annuity product for another product if certain requirements are met.) Four percent of all distributions, accounting for 14 percent of the total amount distributed, were not coded; these should be primarily excess contributions plus earnings/excess deferrals taxable in 1988 or 1989, because these are the only types of distributions that do not require a numeric code to be reported. (However, in years prior to 1990 a code was not required for normal distributions, so it is also possible that some proportion of these uncoded distributions are normal distributions.) Four percent of all distributions were death distributions, accounting for 7 percent of the funds distributed. The remaining 1 percent of distributions and 1 percent of amounts distributed were other types of distributions from defined benefit and defined contribution plans (non-IRA/SEP accounts) (76 percent of all distributions and 85 percent of all funds distributed in 1990) versus those from IRA/SEP accounts (24 percent of all distributions and 15 percent of all funds distributed). For both types of accounts, most 1990 lump-sum total distributions are premature (61 percent for non-IRA/SEP accounts and 55 percent for IRA/SEP accounts) (charts 2c and e). Normal distributions account for most of the rest for both types of accounts (21 percent of non-IRA/SEP total distributions and 37 percent of those from IRA/SEP accounts). For both non-IRA/SEP and IRA/SEP accounts, slightly more money is distributed prematurely than is distributed normally (37 percent versus 33 percent for non-IRA/SEP accounts and 44 percent versus 42 percent for IRA/SEP accounts) (charts 2d and f). The premature proportions of IRA/SEP distributions and amounts distributed are surprisingly high, possibly indicating the cashing out of such accounts to fund current consumption. To the extent that such cashouts are actually occurring, it is at the price of potential future retirement income. Of course, some current expenditures, such as a home purchase or investment in additional education, may actually enhance retirement income prospects. Other consumption may be dictated by current economic hardship, which gives the worker no viable alternative to cashing out the IRA.

Taxable Distributions and Capital Gains

The trends in the number and amounts of taxable distributions closely mirror those for all lump-sum total distributions. The number of taxable distributions fell from 10.8 million in 1987 to 9.9 million in 1990 after

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Other distributions include PS 58 costs, excess contributions plus earnings/excess deferrals (and/or earnings) taxable in 1990, prohibited transactions, and disability distributions.
The number of taxable distributions from defined benefit and defined contribution plans (non-IRA/SEP accounts) fell from 8.2 million in 1987 to 7.5 million in 1990, while the number of taxable IRA/SEP distributions remained relatively constant at about 2.5 million. **Taxable lump-sum total distribution amounts rose steadily from $62.1 billion in 1987 to $89.1 billion in 1990, with taxable non-IRA/SEP distributions increasing from $47.8 billion to $72.5 billion, and taxable IRA/SEP distributions increasing from $14.3 billion to $16.6 billion** (table 3). The trend in lump-sum total distributions qualifying for capital gains treatment is relatively stable by comparison. The number of total distributions qualifying dropped slightly from 312,945 in 1987 to 289,931 in 1990 after jumping to 505,224 in 1988 (table 4). The amounts distributed that qualified for capital gains treatment rose slightly from $6.2 billion in 1987 to $7.0 billion in 1990 (table 4). The breakdown of total distributions in 1990 qualifying for capital gains treatment also differs from that of all lump-sum total distributions. Only 41 percent of qualifying distributions were premature (chart 4), and only 28 percent of qualifying distribution amounts were premature (chart 4).

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**Table 4**

Lump-Sum Total Distributions Qualifying for Capital Gains Treatment, 1987–1990

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Comparison with May 1988 CPS Findings

Eight and one-half million civilian workers reported having received a preretirement distribution from a plan at a prior job, according to EBRI tabulations of the May 1988 CPS employee benefit supplement (Piacentini, 1990). Of these, 3.4 million indicated that they received their most recent distribution between 1985 and 1988, with an average distribution amount of $6,500. This figure is close to the $7,044 figure for 1987 (table 1) from the EBRI/IRS tabulations. Of course, the CPS figure is for preretirement distributions only, while the EBRI/IRS figure is for any type of total distribution, and therefore the CPS average could be expected to be smaller. As shown above, premature distributions tend to be smaller than normal distributions, and the EBRI/IRS tabulations include both (along with other distribution types), while the CPS tabulations consist almost entirely of preretirement distributions.

As discussed above, the rollover decisions of individuals receiving distributions have become an important retirement income policy issue as the incidence of such distributions has increased over time. Some uses of distributions besides tax-qualified savings, such as a home purchase, can be considered an investment for retirement. Other uses may be dictated by personal economic situations; a worker who is laid off and has dim job prospects for the near term may be forced to use the distribution for consumption even if he or she would prefer to roll it over. Other consumption, however, may be the product of shortsightedness combined with a desired for instant gratification. Consumption of lump-sum distributions generally raises the possibility of inadequate retirement income. If individuals do not, or cannot, preserve these distributions for retirement, they may not be able to retire in the lifestyle they desire or they may be forced to work longer than they desire. This is an area of concern for employers and policymakers as well as workers. If workers do not have adequate retirement funds, they may not want to retire when the employer would like. Furthermore, if such a situation becomes widespread, it would likely increase pressures on public programs such as Social Security to provide increased benefits.

19 Because the survey was conducted in May 1988, it includes only distributions received in the first four to five months of 1988.
# Table 5

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## IRA Rollovers

The number of IRA rollover contributions increased over the 1987–1990 time period from 2.6 million to 3.1 million. The amounts rolled over into IRAs rose by more than $30 billion, from $39.3 billion to $71.4 billion over the same period (table 5). The average rollover amount rose from $14,918 to $22,801. While only 25 percent of IRA contributions are rollovers, 82 percent of all amounts contributed to IRAs are the result of rollovers. This is due to the restrictions on who can make regular deductible IRA contributions and the $2,000 limit on such contributions; there are no such restrictions on IRA rollover contributions.

Twenty-nine out of every 100 lump-sum total distributions in 1990 resulted in an IRA rollover contribution. This compares with 23 out of 100 in 1987, 21 out of 100 in 1988, and 25 out of 100 in 1989 (chart 5). The 1990 figure indicates that more than 70 percent of all distributions were not even partially rolled over into an IRA in that year. Focusing on the money involved, 57 out of every 100 dollars distributed in a lump sum in 1990 was rolled over into an IRA. This compares with 49 out of 100 dollars in 1987, 54 out of 100 dollars in 1988, and 55 out of 100 dollars in 1989 (chart 5). The 1990 figure indicates that 57 percent of all money distributed in a lump-sum total distribution was rolled over into IRAs. Both the fraction of distributions rolled over and the proportion of dollars distributed that are rolled over have trended upward over the limited period for which data are available; however, a sizable fraction of lump-sum total distributions are not preserved on a tax-deferred basis.

Larger distributions tended to be rolled over more often than smaller ones, as indicated by the fact that the ratio of the rollover amounts is consistently larger than the ratio of the number of rollovers. This is not surprising given that recipients of larger distributions, in particular those who are current workers, have more to lose from penalty taxation if they do not roll the distribution over into a tax-qualified vehicle. But the fact that recipients of smaller distributions may not be rolling them over may be a reason for concern. If these recipients are lower wage earners, such distributions may represent most, if not all, of their retirement savings, and many appear to be consuming these distributions today rather than preserving them for retirement. If these recipients are younger workers who are not preserving their distributions, they may be sacrificing assets that would otherwise compound from these funds over time and thus provide a sizable source of retirement income.

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20 Individuals who are not active participants in an employment-based retirement plan can make fully tax-deductible contributions up to a $2,000 maximum per year. Individuals who are active participants or whose spouse is an active participant in an employment-based plan and whose adjusted gross income (AGI) does not exceed $25,000 (single taxpayers) or $40,000 (married taxpayers filing jointly) may make a fully deductible IRA contribution. Individuals who are active participants or whose spouse is an active participant in an employment-based plan and whose AGI falls between $25,000 and $35,000 (single taxpayers) and between $40,000 and $50,000 (married taxpayers filing jointly) may make a fully deductible IRA contribution for the balance, as follows. The $2,000 maximum deductible deduction is reduced by $1 for each $5 of income between the AGI limits. Individuals who are active participants or whose spouse is an active participant in an employment-based plan and whose AGI is at least $35,000 (single taxpayers) or at least $50,000 (married taxpayers filing jointly) may only make nondeductible IRA contributions of up to $2,000; earnings on the nondeductible contribution are tax deferred until distributed to the IRA holder. IRAs can also be established as rollover vehicles for lump-sum distributions from employment-based pension plans or other IRAs.
More and better data are needed to fully assess the preservation issue. Such data would include the recipient’s age, occupation, industry, income, assets, household composition, and reason for the distribution (i.e., retirement, job change, layoff, plant closure, etc.) Such information, in combination with knowledge of how the distribution was used, would provide a clearer picture of individual rollover decisions. Specifically, in instances where the distribution was not rolled over, it could potentially be determined whether the recipient was forced by personal financial circumstances to use the money for current consumption. To the extent we are better able to gauge the perceptions and expectations of distribution recipients, a clearer picture emerges as to the extent that distributions are being preserved, invested in other ways, used for consumption in hard times, or simply used for current gratification. It is also important to realize that whether a lack of preservation is due to shortsightedness or current hardship, it is still at the expense of future retirement income security. A deeper understanding of these issues is needed for informed policy decisions.

Several points must be kept in mind when using these figures to gauge rollover activity. First, only data on rollovers to IRAs are available; there are no data on rollovers to other qualified plans such as employment-based 401(k) plans. Also, these data do not pick up cases where an individual has the option of receiving a distribution on job change but opts to leave the funds in his or her former employer’s plan. It can be argued that this should be considered a distribution with a subsequent rollover. Therefore, these figures may underestimate the aggregate number of rollovers and the aggregate amounts rolled over.

Second, direct transfers between trustees (or issuers) that involve no payment or distribution of funds to the participant (including the direct transfer to an IRA) are not reported as distributions (except exchanges of insurance contracts under which any designated distribution may be made). In addition, such direct transfers do not show up as an IRA rollover contribution in this data. To the extent that such direct transfers occurred, distributions and IRA rollovers are undercounted, and the ratios presented in chart 5 understate rollover activity. However, since such transfers represent full preservation, they would not affect the absolute number of distributions not rolled over or the absolute amounts of money not preserved.

Therefore, the number of distributions is double counted in these instances, but the amount distributed is not. FS 58 costs and a total distribution are not reported on the same 1099-R; a separate form is used for each. Again, this results in a double counting of distributions but not of the amount distributed. However, there were only 36,454 such distributions in 1990. Finally, beginning in 1989, the 1099-R instructions say that where more than one numeric code applies, multiple Form 1099-Rs should be filed. Again, the number of distributions is double counted but not the amounts. It can be argued on the other hand, however, that such instances should be considered separate distributions.

According to a 1991 survey by the Profit Sharing Research Foundation and the Gallup Organization, 24 percent of respondents eligible to receive a lump-sum distribution in 1990 left it in their previous employer’s plan, and 8 percent rolled it into their new employer’s plan.

This has changed since 1990. Currently, a transfer from a qualified plan to an IRA is not considered a trustee-to-trustee transfer. It is considered a distribution and subsequent rollover by the plan participant. Therefore, a Form 1099-R and a Form 5498 are required for such a transfer.

Also, if a total distribution includes a distribution of deductible voluntary employee contributions (DEC), then two Form 1099-Rs are filed—one to report the distribution of DEC, the other to report the remainder of the distribution.
While such direct transfer transactions may now become more common, such was not the case in 1990 and earlier. Therefore, the numbers presented here would not be greatly affected by such considerations. With the new mandatory provision of a direct trustee to trustee transfer option, such transactions are likely to increase in the future. Current versions of the relevant IRS forms now account for such activity.

Comparison with May 1988 CPS Findings

Eighteen percent of preretirement distribution recipients reporting their most recent distribution occurred in 1987 or 1988 reported using at least a portion of it for an IRA, according to EBRI tabulations of the May 1988 CPS employee benefit supplement (Piacentini, 1990). Twenty-three percent of those with their most recent distribution in 1988 and 20 percent of those with their most recent distribution in 1987 reported using at least a portion of it for any type of tax-qualified financial savings. Given the difference in the nature of the data sources and the fact that the CPS figures are for preretirement distributions only, these figures are surprisingly close to the distribution rollover ratios of 0.23 for 1987 and 0.21 for 1988 from the EBRI/IRS tabulations (chart 5) discussed above.

While the proportion of distributions rolled over reported in the EBRI/IRS tabulations is relatively close to that indicated by the May 1988 CPS, the proportion of distributed funds rolled over is higher than previously believed, according to the EBRI/IRS tabulations. According to the May 1988 CPS, 23 percent of aggregate preretirement distributions received in 1987 were used entirely for tax qualified savings, most of which is likely to have been accounted for by IRAs. Adding the 16 percent used for both consumption and any type of savings yields an upper limit estimate of 39 percent used for tax-qualified savings. The corresponding figures for 198824 were 36 percent and 3 percent, respectively, for an upper bound of 39 percent again. By comparison, the EBRI/IRS tabulations indicate that 49 percent of the lump-sum total distribution amounts in 1987 were rolled over into IRAs, and 54 percent were rolled over in 1988. Again, larger dollar rollover ratios may be expected from the EBRI/IRS tabulations because, unlike the CPS figures, they include normal distributions, which are correspondingly larger, and larger distributions are more likely to be rolled over.

Implications of the Rollover Figures

While the fraction of lump-sum total distributions being rolled over into IRAs is increasing, as of 1990 it stood at under 30 percent, indicating that many recipients may not be thinking long term with their distribution money or may be prevented by present circumstances from focusing on the long term, and thus their retirement income security may be jeopardized. Undoubtedly, some people not rolling their distribution into an IRA are using the money for some other type of long-term financial savings that enhances retirement income prospects, such as an annuity purchase by retiring workers or a home purchase by younger workers. Others may need to use the money because of economic hardship, such as covering living expenses during a period of unemployment. But still others are likely using the distribution to fund current discretionary consumption without considering the consequences of sacrificing funds that would otherwise accumulate for retirement.

The average premature distribution from a defined benefit or defined contribution plan (non-IRA/SEP account) was a little less than $8,000 ($7,865) in 1990. Preservation of this size distribution could result in a sizable amount of money available for retirement, depending on the length of the investment horizon and the rate of return earned. To illustrate the potential of such distributions for producing retirement income, suppose that a worker

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24 Because the survey was conducted in May 1988, it includes only lump-sum distributions received in the first four to five months of 1988.
aged 30 who received a lump-sum distribution of $8,000 rolled it over and let it grow until his or her retirement at age 65. Assuming it earned a real rate of return of 2 percent annually, it would then purchase an annuity of $1,644 a year (assuming a 6 percent nominal interest rate in the annuity purchase price).25 Similarly, for a worker aged 40 years who received a distribution of $8,000 and rolled it over, the annuity purchased at age 65 would equal $1,349. For a worker aged 50 who received a distribution of $8,000 and rolled it over, the annuity at retirement would be $1,106.

These calculations highlight the benefits of distribution preservation by demonstrating that a relatively modest amount of money can grow into a nest egg over time, especially if it is preserved and invested for the long term.

Retirement benefit portability and preservation have long commanded the attention of policymakers. The Employee Retirement Income Security Act of 1974 (ERISA) established minimum standards for qualified private retirement plans’ vesting schedules. ERISA also established requirements for benefit accrual schedules to ensure that benefits from defined benefit plans would accrue on a pro-rata basis over the course of a career.

ERISA also established IRAs. Intended primarily to serve as vehicles for tax-deferred retirement savings for workers who lacked employment-based pension plans,26 IRAs were also designed to serve as a means for preserving retirement benefits paid out as lump-sum total distributions prior to retirement. Under ERISA, workers receiving distributions could continue to defer taxation on any amounts rolled over into an IRA within 60 days of receipt. Employment-based plans were also permitted, but not required, to accept such rollovers. Lump-sum total distribution amounts not rolled over were subject to regular taxation, although 10-year forward averaging27 and some special capital gains tax treatment were permitted in certain instances.

In addition to tightening vesting standards, the Tax Reform Act of 1986 (TRA ’86) sought to encourage preservation of preretirement distributions by imposing a 10 percent penalty tax (in addition to the regular income tax already required) on certain distribution amounts not rolled into an IRA or an employment-based plan within 60 days of receipt.28 The penalty tax is not imposed if the recipient has attained age 59 1/2, has died, become disabled, or if the distribution is converted to a stream of payments payable over the recipient’s lifetime or expected lifetime.29 In addition, TRA ’86 repealed 10-year forward averaging of lump-sum total

25 This calculation used no age setbacks. Assuming life expectancies increase over the next 35 years, an account balance of a given amount would purchase a relatively smaller annuity than those reported here because individuals would be expected to collect over longer periods of time.

26 Originally restricted to workers without employment-based plan coverage, eligibility for deductible contributions to IRAs was expanded to all workers in 1981. Under the TRA ’86 and current law, such eligibility for deductible IRA contributions was phased out for employment-based plan participants and their spouses over certain income thresholds.

27 One first determines the total taxable amount, which is the amount of the distribution that is includable in income. The tax on the total taxable amount is determined by taking one tenth of the distribution and calculating the ordinary income tax on this portion, using single-taxpayer rates and assuming no other income, exemptions, or deductions. The actual tax is then determined by multiplying this amount by 10.

28 As with regular income tax, the 10 percent penalty tax does not apply to after-tax employee contributions. However, it does apply to the earnings on such contributions.

29 The penalty tax does not apply to certain other total distributions that are made after the recipient has attained age 55 and separated from service, used to pay medical expenses that are deductible for federal income tax purposes (that is, in excess of 7.5 percent of adjusted gross income), or made to or on behalf of an alternative payee pursuant to a qualified domestic relations order. In addition, it does not apply to distributions that were received from an employee stock ownership plan before January 1, 1990, or received prior to March 1, 1987, if made on account of separation from service in 1986 and the recipient elected to be taxed on the distribution in 1986.
distribution income and the special capital gains tax treatment (subject to certain transition rules\(^{30}\)), allowing instead a one-time election\(^{31}\) of 5-year forward averaging for a distribution after the recipient has attained age 59 1/2. These provisions remain effective under current law.\(^{32}\)

More recently, the Unemployment Compensation Amendments of 1992\(^{33}\) imposed a mandatory 20 percent income tax withholding on eligible rollover distributions\(^{34}\) that are not directly transferred as rollovers. Mandatory withholding occurs even if the distribution is rolled over within the permitted 60-day period. The 20 percent withheld is applied toward any income tax, including the 10 percent penalty tax on distributions before age 59 1/2, owed on distribution amounts not rolled over into a tax-qualified vehicle. The act requires plans to provide workers with the option of a direct transfer of their account balance to an eligible retirement plan (defined to include IRAs and defined contribution plans.) Qualified plans are not required to receive such direct transfers, however. Participants must be provided a written notice within “reasonable” time before receiving an eligible rollover distribution that explains the availability of a direct transfer option, mandatory withholding if the direct transfer option is not chosen, 60-day rollover rules where the direct transfer option is not used, and income tax averaging treatment. A direct transfer rollover is to be treated as a distribution to the participant with a subsequent rollover; thus forms 1099-R and 5498 must be filed by the distributing plan and accepting IRA, respectively, for such transactions.

The new rules are generally effective for distributions made after December 31, 1992. Plan amendments required to reflect the new rules do not have to be made before the first plan year beginning on or after January 1, 1994. However, until the plan is amended, it must be operated in accordance with the new rules, and the plan amendment must be made effective retroactive to the effective date of the new rules.

### Conclusion

Current workers are often faced with explicit decisions that will directly impact their retirement income levels. Such decisions can involve participation in voluntary salary reduction plans, the amount of money to contribute to such plans, and how such money is to be invested. However, such issues are moot points regarding retirement income security if workers do not or cannot preserve preretirement lump-sum distributions from such defined contribution plans. In addition, workers with defined benefit plans are often faced with the same question of what to do with a job change distribution from their pension plan. The preservation of such distributions can result in the accumulation of substantial assets to fund living expenses in retirement. As the public and policymakers begin to focus more attention on the retirement prospects of the baby boom generation, this issue will loom as a critical consideration and thus will necessitate further analysis based on more and better data.

\(^{30}\) Individuals who attain age 50 before January 1, 1986 are grandfathered.

\(^{31}\) This election can be made only once by the participant.

\(^{32}\) Several bills have been offered in Congress over the past few years that would repeal 5-year forward averaging. Proponents of repeal argue that it would encourage pension preservation. Moreover, such a provision raises revenue, which could be used to expand access or simplify pension rules. H.R. 3419, a bill sponsored by Rep. Dan Rostenkowski (D-IL), would repeal 5-year forward averaging. The bill was pending action at the close of the first session of the 103rd Congress.

\(^{33}\) For a complete discussion of the act’s rollover rules, see Shipp, 1993.

\(^{34}\) Eligible rollover distributions include all taxable distributions except required minimum distributions under IRC sec. 401(a)(9) or distributions that are part of a series of substantially equal payments payable for the life or life expectancy (or joint lives or joint life expectancies) of the participant (or the participant and his or her beneficiary) or over a specified period of 10 or more years.
This Issue Brief has documented the significant amount of funds distributed from qualified plans; there were 10.8 million lump-sum total distributions totaling $125.8 billion in 1990. While the number of distributions is down 5 percent from its 1987 level of 11.4 million, the amount of money distributed is up 57 percent from the 1987 level of $80.3 billion. Most lump-sum total distributions are accounted for by normal distributions to workers after age 59 1/2 and by premature distributions received by those younger than age 59 1/2.

By way of comparison, annuity payments from pension plans totaled $234.3 billion in 1990 ($141.2 billion of this was from private-sector pensions). These numbers represent annuity payments only. The billions of dollars paid each year in lump-sum distributions and taken into personal assets result in asset income in national accounts. Therefore, when examining the sources of the elderly’s income, pension income includes plan annuity payments only. Income generated from preserved lump-sum distributions shows up as income from assets, not as pension income. Statistics on the elderly’s income are thus misleading regarding the contribution of employment-based retirement plans. If income generated by preserved lump-sum distributions could be accounted for as pension income, more retirees would show pension income. Also, a greater share of income would show up as pension income. Depending on the size of the distributions received and their preservation over recipients’ working years, it is possible that benefits from the employment-based retirement system might not appear as skewed in favor of higher income retirees with more accurate accounting.

Regarding rollovers, actual behavior does not tend to correspond with expressed intentions. In two recent public opinion surveys by EBRI and The Gallup Organization, Inc., the majority of respondents said that if they left their job and received a cashout from their retirement plan, they were likely to save it for retirement (as in an IRA). In a 1991 survey, 45 percent responded that they were most likely to save such a distribution for retirement, and an additional 36 percent said that they would save part of the distribution (Employee Benefit Research Institute/The Gallup Organization, Inc., 1991). In a 1992 survey, 61 percent of the respondents said that they were most likely to save the major part of such a distribution for retirement (as in an IRA), (Employee Benefit Research Institute/The Gallup Organization, Inc., 1992). In actuality, in 1990, 71 percent of all distributions were not even partially rolled over (3.1 million rollover contributions were made), and 43 percent of the money distributed was not rolled over ($71.4 billion was rolled over).

Current workers who do not roll over a distribution into an IRA may preserve it through rollover into their new employers’ plan or opt not to receive a distribution and instead leave the funds in their former employer’s plan when this is an option. Workers may also choose to save the distribution on their own. Such savings can be indirect, e.g., through a home purchase or investment in education, or direct through financial savings. However, once a distribution is not rolled over into a tax-qualified vehicle, even if it is saved, e.g., in a bank account, the tax advantage is gone and with it the tax-deferral incentive to save the money until retirement.

Current consumption of lump-sum distributions means the sacrificing of funds that would otherwise accumulate for retirement. Of course, some current spending, such as a home purchase or additional education, may well result in enhanced retirement income security. Other current consumption may be dictated by economic hardships such as a period of unemployment. Still other consumption is likely for current gratification without thought for long-term tradeoffs of consumption.
in retirement. To the extent that workers are not focusing (or are prevented from focusing) on the tradeoffs involved with such a decision, they may find themselves with inadequate assets to finance the retirement lifestyle they had planned on, or they may be forced to remain active in the work force longer than desired. Potentially, there could also be increased demands placed on the Social Security System.

Finally, tax incentives for retirement plans have been regularly reviewed by Congress since 1981. Retirement plan participation and the pension annuity income of retirees have been used to determine the effectiveness of the tax incentives. This Issue Brief shows that those numbers understate what the nation gets from the retirement system. Millions of individuals leave the ranks of pension participants each year and move billions of dollars from the assets of the retirement system to personal balance sheets. In short, snapshots of the retirement system do not present the full picture of the system’s contribution to economic security.

Bibliography


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