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Pension Issues: Lump-Sum Distributions and Retirement Income Security

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Summary

About half of all workers age 21 and older participate in an employer-sponsored retirement plan, but not all of these workers will receive a pension or retirement annuity from the jobs they now hold. Many will receive a “lump-sum distribution” from their retirement plan when they change jobs. A typical 25-year-old today will work for seven or more employers before reaching age 65, and thus could receive several such distributions before reaching retirement age.

Lump-sum distributions allow workers to re-invest their retirement assets so that they will continue to grow until retirement. However, many recipients of lump-sum distributions use all or part of the distribution for current consumption rather than placing it in another retirement plan. To encourage individuals to “roll over” these distributions into another retirement plan, Congress in 1986 enacted a 10% excise tax on pre-retirement pension distributions that are not rolled over. In 1992, Congress required employers to withhold for income tax payment 20% of distributions that are paid to recipients rather than rolled into another retirement plan. In 2001, Congress required that, unless the plan sponsor is otherwise directed by the participant, it must deposit distributions of \$1,000 or more into an individual retirement account

According to data collected by the Bureau of the Census in 1998, 39.5 million workers age 21 or older participated in retirement plans that offered a lump-sum distribution as a payment option. This represented 74.2% of the 53.3 million workers who were covered by a pension, profit-sharing, or retirement savings plan in 1998. Approximately 14.3 million people reported that they had received at least one lump-sum distribution at some time in their lives. The average (mean) value of these distributions was \$15,400 and the median value was \$5,000. The typical recipient was between 36 and 39 years old at the time of the most recent distribution. Thus, most recipients of lump sums were more than 20 years away from retirement.

Of those who reported that they had received at least one lump-sum distribution, 36% said that they had rolled over the *entire amount* of the most recent distribution into another retirement plan, accounting for 59% of the dollars distributed as lump sums. Another 48% of recipients said that they had saved at least *part* of the distribution in some other way. Of those who reported receiving a distribution after 1992, 42% said that they had rolled over the *entire amount* into another plan, accounting for 70% of the dollars distributed as lump-sums. Another 44% of this group said that they had saved at least *part* of the distribution.

Lump-sum distributions that are spent rather than rolled over into another retirement account can reduce future retirement income. If the lump-sum distributions received up to 1998 that were not rolled over had instead been rolled over into accounts that grew at the same historical rate as the *Standard & Poor's 500* Index, they would have grown to a median value of \$12,930 by 2002. If these distributions had been rolled over into accounts that paid the same historical rates of return as U.S. Treasury bonds, they would have grown to a median value of \$7,980 by 2002.

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Pension Issues: Lump-Sum Distributions and Retirement Income Security

Overview: Pension Coverage and Tax Policy

About half of all workers age 21 and older in the United States participate in an employer-sponsored retirement plan.¹ (Table 1) Not all of these workers, however, will receive a pension or retirement annuity from their current jobs. Some workers will not participate in their employer's retirement plan long enough to earn the right to a pension – a process called “vesting.” Others will receive a “lump-sum distribution” from the plan when they retire or when they change jobs. A typical 25-year-old today will work for seven or more employers before reaching age 65.² Thus, most workers can expect to receive one or more distributions from a retirement plan before reaching retirement age. What an individual does with a lump-sum distribution – even a relatively small one – can have a significant impact on his or her wealth and income during retirement. Lump-sum distributions that are spent on current consumption rather than saved for retirement will not be available to augment a worker's retirement income.

Today, most retirees rely on Social Security for the majority of their income. In 2001, nearly two-thirds (65%) of the program's beneficiaries received more than half of their annual income from Social Security, and Social Security was the *only* source of income for one in five (20%) beneficiaries.³ Workers whose employer sponsors a retirement plan have the opportunity to achieve higher standards of living and greater financial independence in retirement than those who must rely on Social Security alone. To the extent that workers *spend* lump-sum distributions from employer-sponsored plans rather than *save* them, they may be undermining their future financial security.

Congress has provided incentives for workers to prepare for retirement by granting favorable tax treatment to retirement plans that meet certain requirements as to eligibility, benefits, and funding. Employers are permitted to deduct from income amounts they contribute to employee retirement plans. These employer contributions are not taxed as income to participating employees until they begin receiving distributions from the plan. Employers who sponsor retirement plans do

¹ This figure includes full-time and part-time workers in both the public and private sectors. A “retirement plan” may be either a traditional defined benefit pension plan or a retirement savings plan, such as those authorized under Internal Revenue Code §401(k).

² Estimated by CRS, from data published by the U.S. Census Bureau

³ Social Security Administration, Office of Policy, *Income of the Aged Chartbook, 2001*.

so voluntarily. However, an employer who chooses to sponsor a retirement plan must comply with both the *Employee Retirement Income Security Act of 1974* (P.L. 93-406), popularly known as “ERISA,” and the Internal Revenue Code. A plan that fails to meet the standards set forth in federal law may be denied the status of a “tax-qualified” plan.

The tax revenue forgone by the federal government as a result of the deductions and exclusions granted to qualified retirement plans is substantial. According to the congressional Joint Committee on Taxation, the net exclusion for employer pension plan contributions and earnings will result in \$493 billion in forgone tax revenue over the 5 fiscal years from 2003 through 2007.⁴ This is the largest so-called “tax-expenditure” in the federal budget.

Pension Portability, Asset Preservation, and Lump-Sum Distributions. Pension plans and retirement savings plans such as the popular “401(k)” promote financial security in retirement by setting aside income during employees’ working years.⁵ This pool of assets is invested in securities that earn interest, dividends, and capital gains. In retirement, these assets can be used to purchase an “annuity” – a lifetime stream of monthly income – or, alternatively, the retiree can spend the accumulated assets over the course of his or her retirement. Sometimes, however, retirement plan assets are distributed before retirement. This can happen in the event that a plan is terminated or, more commonly, when a worker moves from one job to another. In such cases, the present value of the benefit that the employee has earned to date – his or her “accrued benefit” – is typically paid out in a single lump-sum distribution from the plan. In the case of a 401(k)-type plan, the distribution is equal to the balance in the employee’s account: employee contributions, earnings on those contributions, and the part of employer contributions and earnings to which the employee has earned a legal right through length of service (a process called *vesting*).⁶ In the case of a traditional pension, the lump-sum must be equal to the *present value* of the employee’s accrued benefit. The present value calculation *discounts* the stream of benefits that would be paid in the future to an amount that could, if invested by the recipient, pay an equivalent income at retirement.

Lump-sum distributions promote “portability” of retirement assets for workers who change jobs. Portability allows workers to re-invest their retirement assets so

⁴ Joint Committee on Taxation, (JCS-5-02) December 19, 2002.

⁵ “401(k)” refers to the section of the Internal Revenue Code (IRC) that excludes from taxable income amounts contributed to, and earnings on, these plans. 401(k) plans are authorized for private, for-profit employers. A similar arrangement for non-profit employers is authorized by Section 403(b). (Employees of state and local governments can participate in deferred compensation arrangements authorized under IRC Section 457).

⁶ ERISA allows sponsors of defined benefit plans to choose between two methods of vesting. Under “cliff” vesting, a participant is 100% vested after 5 years of participation, but has no vested rights to a benefit under the plan before that time. Under “graded” vesting, a participant is 20% vested after 3 years, 40% vested after 4 years, 60% vested after 5 years, 80% vested after 6 years, and fully vested after 7 years. Employers can, if they choose, vest participants in their accrued benefits faster than these schedules.

that they will continue to grow until retirement. A transfer of assets from one tax-qualified retirement plan to another is referred to as a “rollover” of assets into another plan. A pre-retirement distribution that is not rolled over into another retirement plan and is instead spent on current consumption is said to have “leaked” from the pool of retirement assets.

Lump-sum distributions can result in leakage of retirement assets if the recipient uses some of the distribution for current consumption rather than rolling over the full amount into another retirement plan. To discourage such leakage, Congress has amended the Internal Revenue Code to provide incentives for individuals to roll over these distributions into other retirement plans.

- The *Tax Reform Act of 1986* (P.L. 99-514) established a 10% excise tax – in addition to ordinary income taxes – on lump-sum distributions received before the age of 59½ that are not rolled over into an Individual Retirement Account (IRA) or another employer’s tax-qualified retirement plan.⁷
- The *Unemployment Compensation Amendments of 1992* (P.L. 102-318) required employers who sponsor retirement plans to give departing employees the option to have lump-sum distributions directly transferred to an IRA or to another employer’s plan. If the participant chooses to receive the lump-sum distribution directly, the employer is required to withhold 20%, which is to be applied to any taxes due on the distribution. If the participant does not deposit the distribution into an IRA or another tax-qualified plan within 60 days, he or she will owe both regular income taxes and the 10% excise tax on the entire amount of the distribution.⁸
- I.R.C. §411(a)(11) allows a plan sponsor to distribute to a departing employee his or her accrued benefit under a retirement plan without the participant’s consent if the present value of the benefit is less than \$5,000.⁹ The *Economic Growth and Tax Relief Reconciliation Act of 2001* (P.L. 107-16) required that, if a plan makes such a distribution and the present value of the benefit is at least \$1,000, the plan must deposit the distribution into an individual retirement account unless otherwise instructed by the participant.

Obviously, there may be times when the recipient of a lump-sum distribution faces short-term expenses that are more pressing than concerns about retirement. This is especially so when the recipient is in a period of unemployment or must pay

⁷ The 10% penalty is waived if the distribution is made in a series of “substantially equal periodic payments” based on the recipient’s life expectancy or if the recipient has retired from the plan sponsor at age 55 or older. For more information, see CRS Report RL31770, *Retirement Savings Accounts: Early Withdrawals and Required Distributions*.

⁸ If the distribution is not rolled over within 60 days, the 20% withheld is applied to the taxes owed on the distribution. If the distribution is rolled over within the 60-day limit, the 20% withheld is credited toward the individual’s total income tax owed for the year. Note that to roll over the full amount after receiving a lump-sum distribution, the recipient must have access to other funds that are at least equal to the amount withheld.

⁹ Distributions of \$5,000 or more require the participant’s written consent.

for the care of a relative who is ill or disabled. Previous research has shown that the event precipitating a lump-sum distribution (losing one's job, for example), is a key determinant of whether the distribution is rolled over into another retirement plan, saved in some other way, or spent on current consumption. Surveys of employers and employees indicate that the *availability* of lump-sum distributions has a positive effect on employee participation retirement plans. Consequently, Congress has sought to *encourage* recipients to roll over pre-retirement distributions, rather than *requiring* that such distributions be rolled over into an IRA or another retirement plan. Allowing lump-sum distributions but placing an excise tax on amounts that are not rolled over represents a compromise among several policy objectives: promoting pension participation, preserving assets until retirement, providing access to assets in time of need, and assuring that revenue losses do not exceed the minimum necessary to encourage employer sponsorship and employee participation.

Calculating lump-sum distribution amounts. When a lump-sum distribution is paid from a defined contribution plan, such as a 401(k) plan, the amount distributed is simply the account balance. In paying a lump-sum distribution from a defined benefit plan, however, the plan sponsor must calculate the present value of the benefit that would be payable to the plan participant when he or she reaches the plan's normal retirement age. In calculating this amount, the plan must use the interest rate that is specified in the Internal Revenue Code. I.R.C. §417(e) specifies the interest rate on 30-year U.S. Treasury Bonds as the discount rate to be used by plan sponsors when calculating the present value of a plan participant's accrued benefit. Because the Treasury no longer issues 30-year bonds, Congress is considering alternative interest rates that could be used to calculate the present value of accrued benefits under defined benefit plans. **H.R. 1776** (Portman/Cardin) of the 108th Congress would replace the interest rate on 30-year Treasury Bonds as the rate for calculating lump-sum distributions with an interest rate based on an index of high-quality, long-term corporate bonds. The corporate bond rate would be phased in over 4 years beginning in 2006.¹⁰

¹⁰ For a detailed discussion of the factors to be considered in selecting a discount rate, see GAO Report GAO-03-313, *Private Pensions: Process Needed to Monitor the Mandated Interest Rate for Pension Calculations*, (February 2003) at [<http://www.gao.gov>].

Table 1. Participation in Employer-Sponsored Retirement Plans, 2001
(all workers age 21 and older)

Participate in a Retirement Plan?	Yes	No	Persons (thousands)
Age			
21 to 24	20.7%	59.3%	12,220
25 to 34	43.6%	56.4%	31,818
35 to 44	54.3%	45.7%	35,540
45 to 54	59.9%	40.1%	30,437
55 to 64	56.5%	43.5%	15,456
65 or older	27.1%	72.9%	4,635
Race			
White	50.1%	49.9%	107,733
Black	45.3%	54.7%	15,076
Other	43.0%	57.0%	7,297
Sex			
Male	51.2%	48.8%	68,231
Female	46.9%	53.1%	61,875
Marital Status			
Married	54.8%	45.2%	78,629
Not Married	40.5%	59.5%	51,478
Education			
HS or less	38.7%	61.3%	53,578
Some college	48.7%	51.3%	37,616
College graduate	64.0%	36.0%	38,913
Earnings in 2000			
Under \$20,000	20.5%	79.5%	42,422
\$20,000-\$40,000	53.9%	46.1%	45,367
More than \$40,000	72.7%	27.3%	42,317
Establishment Size			
Under 25 people	21.5%	78.5%	31,609
25 to 99 people	40.9%	59.1%	17,509
100 or more people	61.7%	38.3%	80,989
Full-time/Part-time			
Worked full-time	58.1%	41.9%	92,576
Worked part-time	27.2%	72.8%	37,531
Total	49.1%	50.9%	130,107

Source: CRS analysis of the March 2002 *Current Population Survey*.

How Many Workers Are Eligible for Lump-Sum Distributions?

Employers often pay departing employees their accrued pension benefits as a lump-sum, rather than requiring them to wait until reaching the plan's normal retirement age to claim their benefits. Consequently, many workers receive lump-sum distributions long before reaching retirement age. Federal law requires the plan sponsor to secure the employee's written consent before making a lump-sum distribution of \$5,000 or more. An accrued benefit of less than \$5,000 can be paid as a lump-sum without asking for the employee's permission.¹¹ Congress allows employers to "cash out" these relatively small pension benefits for departing employees to relieve them of the administrative expenses they would otherwise incur to maintain records for former employees who had earned only a small pension benefit. In the case of defined benefit plans, cashing out the benefit also relieves the sponsor of the obligation to pay insurance premiums to the Pension Benefit Guaranty Corporation (PBGC). Because PBGC premiums are assessed on a per capita basis, they are disproportionately large for those whose accrued benefit is relatively small.¹²

During the first six months of 1998, the Census Bureau asked participants in the *Survey of Income and Program Participation* (SIPP) a series of questions on retirement expectations and pension plan coverage. According to this survey, 82% of the 53.3 millions workers age 21 or older who were included in a retirement plan at work participated in a plan that offered a lump-sum distribution as a payment option.¹³ (**Table 2**)

Almost all defined contribution plans offer a lump-sum payment option. The proportion of defined benefit plans offering lump-sum distributions has been rising in recent years due to the conversion of several hundred large defined benefit pension plans to "cash balance plans."¹⁴ These are hybrid pensions that have some of the characteristics of defined contribution plans, most significantly in that a participant's accrued benefit is reported as an "account balance." Nevertheless, cash balance plans are funded on a group basis and are treated as defined benefit plans under the Internal Revenue Code. Virtually all cash balance plans offer a lump-sum distribution option to departing employees who are vested in their benefits.

¹¹ The \$5,000 limit was established by the *Taxpayer Relief Act of 1997* (P.L. 105-34). The amount had been set at \$3,500 by *Retirement Equity Act of 1984*. It was originally established at \$1,750 by ERISA in 1974.

¹² The current base premium – which is set by Congress – is \$19 per participant per year.

¹³ This includes all participants in defined contribution plans as well as participants in defined benefit plans who reported that the plan offered a lump-sum distribution option.

¹⁴ For more information see Allan P. Blosin, "Distribution of Retirement Income Benefits," *Monthly Labor Review*, April 2003, Vol. 126, No. 4.

Table 2. Percentage of Workers Whose Retirement Plan Offered a Lump-Sum Payment Option, 1998

(Workers 21 and older who participated in an employer-sponsored retirement plan)

Does plan have a lump-sum option?	Yes	No	Persons (thousands)
Age			
21 to 24	81.4%	18.6%	1,507
25 to 34	83.2%	16.8%	12,860
35 to 44	81.8%	18.2%	17,241
45 to 54	81.3%	18.7%	14,996
55 to 64	81.2%	18.8%	5,954
65 or older	88.9%	11.2%	710
Race			
White	82.6%	17.4%	45,717
Black	75.8%	24.2%	5,527
Other	86.0%	14.0%	2,024
Sex			
Male	82.4%	17.6%	29,810
Female	81.6%	18.4%	23,458
Marital Status			
Married	81.9%	18.1%	36,111
Not Married	82.3%	17.7%	17,157
Education			
HS or less	80.1%	19.9%	17,664
Some college	81.9%	18.1%	16,728
College graduate	84.0%	16.0%	18,876
Income in 1998			
Under \$20,000	80.4%	19.6%	10,937
\$20,000-\$40,000	81.4%	18.6%	22,746
More than \$40,000	83.6%	16.4%	19,585
Establishment Size			
Not reported	89.4%	10.6%	1,335
Under 25 people	84.0%	16.0%	10,098
25 to 99 people	83.3%	16.7%	12,556
100 or more people	80.5%	19.5%	29,280
Total	82.0%	18.0%	53,268

Source: CRS analysis of the 1996 Panel of the *Survey of Income and Program Participation*.

How Many People Have Received Lump-Sum Distributions?

According to the information reported on the *Survey of Income and Program Participation* in 1998, an estimated 14.3 million individuals age 21 or older had received at least one lump-sum distribution from a retirement plan at some point during their lives. The average (mean) value of these distributions in nominal dollars was \$15,391. Expressed in constant 1998 dollars, the mean value of the distributions was \$18,497.¹⁵ (Table 3) As was noted earlier, however, the mean value of lump-sum distributions is skewed upward by a relatively small number of large distributions. The “typical” distribution is more accurately portrayed by the median, which in nominal dollars was \$5,000. Adjusted to 1998 dollars, the median distribution was \$5,490. The average recipient was between the ages of 36 and 39 at the time of the most recently received lump-sum distribution. Thus, most people who received these distributions were more than 20 years away from retirement age.

Table 3. Characteristics of Individuals Who Reported Ever Having Received One or More Lump-Sum Distributions

Recipient age and amount of distribution:	Mean	Median
<i>All recipients of lump-sum distributions:</i>		
Age when lump sum received	39	36
Amount of lump-sum distribution in nominal dollars	\$15,391	\$5,000
Amount of lump-sum distribution in constant 1998 \$	\$18,497	\$5,490
<i>Rolled over the distribution to another account :</i>		
Age when lump sum received	43	41
Amount of lump-sum distribution in nominal dollars	\$26,159	\$10,000
Amount of lump-sum distribution in constant 1998 \$	\$30,574	\$12,030
<i>Did not roll over the distribution to another account:</i>		
Age when lump sum received	37	34
Amount of lump-sum distribution in nominal dollars	\$9,360	\$3,000
Amount of lump-sum distribution in constant 1998 \$	\$11,732	\$3,708

Source: CRS analysis of the 1996 panel of the *Survey of Income and Program Participation*.

¹⁵ We adjusted the dollar amount of all lump-sum distributions reported on the SIPP to constant 1998 dollars, based on the Personal Consumption Expenditure Index of the National Income and Product Accounts (NIPA).

How Did Recipients Use Their Lump-Sum Distributions?

Research into lump-sum distributions has consistently found that the majority of *distributions* are *not* rolled over into other qualified retirement savings plans, but that the majority of *dollars* are rolled over. In other words, small distributions are less likely to be rolled over, but large distributions – which account for most of the money distributed – are more likely to be rolled over. Researchers also have found however, that most recipients of lump-sums saved at least *part* of the distribution, even if none of the money was rolled into another retirement plan.

Of those who reported on the SIPP that they had received at least one lump-sum distribution, 36% said that they had rolled over the *entire* amount of the most recent distribution into another tax-qualified plan, such as an IRA. (**Table 4**) These transactions accounted for 59% of the dollars distributed as lump sums. (Not shown in table.) Of those who reported receiving a distribution *after 1992*, 42% said that they had rolled over the entire amount into another plan, accounting for 70% of the dollars distributed as lump-sums.

Rolling over a lump-sum distribution into another tax-qualified retirement plan is the most efficient way to preserve these assets for retirement, because direct rollovers are not subject to taxes, tax penalties, or employer withholding. Nevertheless, it is not the *only* way to save a lump-sum distribution. Participants in the SIPP who reported that they had not rolled over the entire amount of a lump-sum distribution were asked what they did with the money. Eighteen options were listed, and respondents could indicate more than one if they used the money for more than one purpose. (Survey participants were asked only *how* they used the money, not *how much* was used for each purpose). Nine of the categories listed fit the standard economic definition of “saving” in that they lead to (or are expected to lead to) an increase in a household’s net worth.¹⁶ These were:

- invested in an IRA, annuity, or other retirement program,
- put into a savings account or certificate of deposit,
- invested in stocks, mutual funds, bonds, or money market funds,
- invested in land or other real property,
- invested in family business or farm,
- used to purchase a home, pay off mortgage, or make home improvements,
- used to pay bills or to pay off loans or other debts,
- saved for retirement expenses, and
- saved or invested in other ways.

Among those who reported that they had received at least one lump-sum distribution, 83.9% said that they had saved at least *some* of the most recent distribution. (**Table 5**) In addition to the 35.9% who had rolled over the entire

¹⁶ The other categories listed on the survey were: bought a car, boat, furniture or other consumer items; used for vacation, travel, or recreation; paid expenses while laid off; used for moving or relocation expenses; used for medical or dental expenses; paid or saved for education; used for general or everyday expenses; gave to family members or charity; paid taxes; and spent in other ways.

amount into another tax-deferred retirement plan, another 48.0% had saved at least part of the distribution in one of the other ways listed above. Of those who had received their most recent lump-sum distribution after 1992, 86% said that they had saved at least part of the distribution. Of this group, 42.4% rolled over the entire amount into another plan, and 43.6% saved part of the distribution in another way.

Table 4. Percentage of Lump-Sum Distribution Recipients Who Rolled Over the Entire Amount into Another Retirement Plan
(All recipients of lump-sum distributions)

Entire lump-sum rolled over?	Yes	No	Persons (thousands)
Age When Received			
21 to 24	12.4%	87.6%	1,269
25 to 34	29.6%	70.4%	5,068
35 to 44	39.2%	60.8%	3,568
45 to 54	45.3%	54.7%	2,052
55 to 64	51.1%	48.9%	1,759
65 or older	42.8%	57.4%	599
Race			
White	37.1%	62.9%	13,042
Black	20.5%	79.5%	893
Other	31.2%	68.8%	380
Sex			
Male	39.7%	60.3%	6,684
Female	32.6%	67.5%	7,631
Marital Status			
Married	39.9%	60.1%	9,240
Not married	28.6%	71.4%	5,075
Children Present			
No Children	37.4%	62.6%	9,052
One child or more	33.3%	66.7%	5,263
Education			
HS or less	29.7%	70.3%	4,354
Some college	31.3%	68.7%	4,681
College graduate	45.1%	54.9%	5,279
Home ownership			
Home owner	40.3%	59.7%	11,036
Not a home owner	21.2%	78.8%	3,278
Income in 1998			
Under \$20,000	30.4%	69.6%	5,677
\$20,000-\$40,000	33.1%	66.9%	4,951
More than \$40,000	48.1%	51.9%	3,686
Amount of distribution*			
Less than \$3,500	21.8%	78.2%	5,632
\$3,500 to \$9,999	33.3%	66.7%	3,359
\$10,000 to \$19,999	41.3%	58.7%	2,093
\$20,000 or more	59.6%	40.4%	3,230
Year distribution received			
Before 1987	24.2%	75.8%	3,384
1987 to 1992	33.8%	66.2%	3,662
After 1992	42.4%	57.6%	7,269
Total	35.9%	64.1%	14,315

Source: CRS analysis of the 1996 panel of the *Survey of Income and Program Participation*.

* Amount of the lump-sum distribution, adjusted to 1998 dollars.

Table 5. Percentage of Lump-Sum Distribution Recipients Who Saved All or Part of the Distribution
(All recipients of lump-sum distributions)

Was any part of the distribution saved?	Yes	No	Persons (thousands)
Age When Received			
21 to 24	67.6%	32.4%	1,269
25 to 34	82.3%	17.7%	5,068
35 to 44	86.4%	13.6%	3,568
45 to 54	86.9%	13.1%	2,052
55 to 64	90.9%	9.1%	1,759
65 or older	87.2%	12.8%	599
Race			
White	83.9%	16.1%	13,042
Black	86.2%	13.8%	893
Other	79.3%	20.7%	380
Sex			
Male	86.8%	13.2%	6,684
Female	81.5%	18.5%	7,631
Marital Status			
Married	85.8%	14.2%	9,240
Not married	80.6%	19.4%	5,075
Children Present			
No Children	84.2%	15.8%	9,052
One child or more	83.5%	16.5%	5,263
Education			
HS or less	85.3%	14.7%	4,354
Some college	80.9%	19.1%	4,681
College graduate	85.5%	14.5%	5,279
Home ownership			
Home owner	85.1%	14.5%	11,036
Not a home owner	79.9%	20.1%	3,278
Income in 1998			
Under \$20,000	82.1%	17.9%	5,677
\$20,000-\$40,000	83.4%	16.6%	4,951
More than \$40,000	87.6%	12.4%	3,686
Amount of distribution*			
Less than \$3,500	75.7%	24.3%	5,632
\$3,500 to \$9,999	83.5%	16.5%	3,359
\$10,000 to \$19,999	90.2%	9.8%	2,093
\$20,000 or more	94.7%	5.3%	3,230
Year distribution received			
Before 1987	79.4%	20.6%	3,384
1987 to 1992	84.0%	16.0%	3,662
After 1992	86.0%	14.0%	7,269
Total	83.9%	16.1%	14,315

Source: CRS analysis of the 1996 panel of the *Survey of Income and Program Participation*.

* Amount of the lump-sum distribution, adjusted to 1998 dollars.

How Much Retirement Wealth Was Lost from Lump-Sums that Were Spent Rather than Saved?

Older workers are more likely than their younger colleagues to roll over a lump-sum distribution of any given size into an IRA or other retirement plan. For example, according to the SIPP, among workers who received a distribution between the ages of 25 and 34, only 29.6% rolled over the entire amount into an IRA or other retirement plan. Of those who received a distribution between the ages of 45 and 54, 45.3% rolled over the entire amount. Younger workers, however, are more likely to receive relatively small lump-sum distributions because they generally have fewer years of service and have lower annual earnings than older workers.

Among participants in the SIPP who had received at least one lump-sum distribution, the average (mean) value of the most recent distribution was \$15,391. Average values differed sharply for amounts that were rolled over versus those that were not. Among recipients who had rolled over the entire amount, the average distribution was \$26,159. Those who had not rolled over the entire distribution received lump-sums with a mean value of \$9,360. (See **Table 3.**)

Although younger workers often receive relatively small lump-sum distributions, substantial amounts of retirement wealth can be lost by spending rather than saving even a small sum, especially in the case of workers who are many years from retirement. To gauge the size of the potential loss in retirement wealth among people who reported on the SIPP that they *had not* rolled over their most recent lump-sum distribution, CRS calculated the amounts that these individuals *could have* accumulated if they had rolled over their entire lump sums into other retirement plans. For each individual who had not rolled over the most recent lump-sum distribution, CRS calculated the amount that would have been accumulated by 2002 if the entire lump-sum had been rolled over in the year it was received. The estimates were based on two possible rates of return:

- the annual interest rate paid by 30-year U.S. Treasury bonds in each year since the year the distribution was received; and
- the total annual rate of return of the *Standard & Poor's 500* (S&P 500) index in each year since the distribution was received.

In each case, CRS multiplied the nominal value of the recipient's most recent lump-sum distribution by the change in the appropriate index in every year between the year of the distribution and year-end 2002.

If all of the respondents who reported on the SIPP that they had *not* rolled over their most recent lump-sum distribution would have instead rolled over the full amount into a fund that earned an interest rate equal to that paid by 30-year U.S. Treasury bonds, the distributions would have attained a mean value of \$34,700 by year-end 2002. If the lump-sums had been rolled over into investments that grew at a rate equal to the total annual return of S&P 500 index, the distributions would have had a mean value of \$64,390 by the end of 2002.

As noted earlier, the *mean* value of lump-sum distributions is skewed upward by the effects of a relatively small number of very large distributions. Consequently, the “typical” distribution is more accurately portrayed by the *median*. If all of the distributions that had not been rolled over into another retirement plan had instead been rolled into a retirement account that was invested in stocks that matched the total annual rate of return achieved by the S&P 500 index, the lump sums would have grown to a median value of \$12,930 by 2002. If invested in bonds that earned the rate of return paid by 30-year U.S. Treasury bonds, the median lump sum would have been worth \$7,980 by 2002.

What Would these Amounts have been Worth at Retirement?

If we consider age 65 to be retirement age, the typical individual who had received a distribution but did not roll it over into another retirement account was from 28 to 31 years away from retirement in the year that he or she received the distribution. Their *mean* age in the year that they received their distributions was 37. Their *median* age in the year of the distribution was 34. In 1998 – the year of the survey – the mean age of these individuals was 46 and their median age was 44.

As noted above, the median value of the lump-sum distributions that were not rolled over would have reached \$12,930 by 2002 if they had been invested in a broad-based stock market index fund. Assuming a future average annual rate of return in the stock market of 8%, \$12,930 invested for 15 years would grow to \$41,000 by age 65.¹⁷ This would be enough to purchase a life-long annuity that would provide income of \$290 per month.¹⁸

If the lump sums that were not rolled over had been rolled into an account paying the same rate of return as 30-year Treasury bonds, they would have reached a median value of \$7,980 in 2002. Assuming that \$7,980 was invested in bonds for 15 years at an average rate of return of 5.0%, it would grow to \$16,590.¹⁹ This would be sufficient capital to purchase a lifetime annuity that would provide a monthly income of \$117.

What Factors Influence the Rollover Decision?

Older recipients and those who receive larger-than-average lump sums are relatively more likely to roll over their distributions into an IRA or other tax-qualified retirement plan. In other words, both the recipient’s age and the amount of the distribution are *positively correlated* with the probability that a lump-sum distribution will be rolled over into another retirement plan. Simple descriptive statistics such as these, however, can be misleading because they show the relationship between only two variables; for example, between *age* and the likelihood

¹⁷ In 2002, a person who was 46 in 1998 would have reached age 50.

¹⁸ Annuity estimates are based on a level, single-life annuity purchased at age 65 at 3.875%.

¹⁹ The long-run nominal interest rate assumed in the 2003 annual report of the Board of Trustees of the Social Security System was 6.0%.

of a rollover, or between the *amount of the distribution* and the likelihood of a rollover. In fact, there are *many* variables that simultaneously affect the rollover decision, and some of them have strong interaction effects on each other. In other words, the decision to roll over a lump-sum or to spend it is affected *not just* by the recipient's age, and *not just* by the size of the distribution, but by both of these factors, and many others. This decision, like all economic choices, is made in the context of numerous considerations.

To study the relationship between the rollover decision and a set of variables suggested by both economic theory and previous research, CRS developed a regression model in which the *dependent*, or response, variable could have two possible values: 1 (true) if the entire lump-sum distribution was rolled over into another retirement plan, and 2 (false) if any of the distribution was used for any other purpose. The *independent* variables we tested were the individual's age in the year the distribution was received, race, sex, marital status, level of education, presence of one or more children in the family, home ownership, monthly income, the amount of the lump-sum distribution, and the year the distribution was received.

The *Tax Reform Act of 1986* placed a 10% excise tax on pension distributions received before age 59½ that are not rolled over into another retirement plan. The *Unemployment Compensation Amendments of 1992* required employers to offer a direct rollover option to departing employees and to withhold for income taxes 20% of distributions paid directly to recipients. To test for the effects of these changes in law, we included in the model a variable indicating for whether the distribution occurred before 1987, between 1987 and 1992, or after 1992. Results of this model are shown in **Table 6**. We also tested another version of the model in which we restricted the sample to lump-sums received after 1986 by people under age 60 in the year of the distribution. Results of this model are shown in **Table 7**.

Interpreting the Regression Results

We used a logistic regression or “logit” for our analysis. This is a form of multivariate regression that was developed to study relationships in which the *dependent* (response) variable can have only a limited number of values, such as yes (true) or no (false). In this model, the dependent variable indicates whether a lump-sum distribution was rolled over into another retirement account (1 = yes; 2 = no). The model measures the likelihood of observing the dependent variable having a value of 1 (“yes”) when a particular independent variable is changed, given that *every other* independent variable is held constant at its *mean value*. The model estimates a coefficient (also called a *parameter estimate*) for each independent variable and calculates the *standard error* of the estimate. The standard error measures how widely the coefficients are likely to vary from one observation to another. In general, the greater the absolute value of the parameter estimate, the more likely it is to be *statistically significant*. Statistical significance is expressed in *confidence intervals* that are measured as the .10 level, .05 level and .01 level. If a variable is significant at the .05 confidence level, for example, there is only a one-in-twenty chance that it is *not* related to the dependent variable in the way that the model has predicted.

The model also generates for each independent variable a statistic called the *odds ratio*. The odds ratio is a measure of how much more (or less) likely it is for a specific outcome to be observed when a particular independent variable is “true” ($x=1$) than it is when that independent variable is “false” ($x=0$). For example, in this model, home ownership is measured as having a value of 1 if the recipient of a lump-sum distribution was a homeowner and 0 otherwise. In **Table 6**, this variable is shown as having an odds ratio of 1.917. This means that the dependent variable is 92% more likely to have a value of 1 (rollover = yes) when the dependent variable **own home** has a value of 1 (yes) as when it has a value of 0 (no). In other words, *other things being equal* (and measured at their mean values), a recipient of a lump-sum distribution who owned or was buying a home was about twice as likely as a renter to have rolled over the entire lump sum into another retirement plan.

Our analysis of data from the SIPP found that the variable with the strongest relationship to the likelihood that a lump-sum distribution was rolled over was the *amount of the distribution*. In the regression model, lump-sum distributions were divided into four size categories: less than \$3,500; \$3,500 to \$9,999; \$10,000 to \$19,999; and \$20,000 or more.²⁰ All amounts were adjusted to 1998 dollars. Relative to distributions of less than \$3,500, the probability that a distribution was rolled over was positive and statistically significant for all larger distribution amounts. Lump sums of \$3,500 to \$9,999 were 73% more likely to be rolled over than lump sums of less than this amount. Lump-sum distributions of \$10,000 to \$19,999 were 134% more likely to be rolled over than lump sums of less than \$3,500. Distributions of \$20,000 or more were 300% more likely to be rolled over than were distributions of less than \$3,500.

²⁰ We designated \$3,500 as the upper limit for the smallest category, because most of the distributions in this analysis occurred in years when \$3,500 was the largest amount that an employer could pay to a departing employee without securing written consent.

The variable with the second-largest coefficient was the *indicator for the year the distribution was received*. Relative to distributions received between 1987 and 1992, distributions that were received before 1987 were 44% *less* likely to have been rolled over into another tax-qualified retirement plan. Other things being equal, lump-sum distributions received after 1992 were 79% *more* likely to be rolled over into another retirement account than distributions received between 1987 and 1992.

Race had the third-largest coefficient among the independent variables. White recipients of lump-sum distributions were 73% more likely than non-white recipients to have rolled over their distribution into an IRA or other retirement plan. On the one hand, this result may be seen as troubling because the regression model controls for the effects of other variables – such as income and education – that correlate with race. On the other hand, given that access to financial information and advice is partly dependent on one’s occupation and industry of employment, it may be possible to influence savings behavior through public policies, such as subsidizing the distribution of information to workers about the long-term consequences of spending rather than saving a pre-retirement pension distribution.

Home ownership and being **married** were positively and significantly related to the probability that a lump-sum distribution was rolled over. Homeowners were about 90% more likely to have rolled over their most recent lump-sum distribution. Purchasing a home is itself a form of investment, and – controlling for the effects of income – homeowners have what economists call a “revealed preference” for saving and investment compared to renters. Other things being equal, married individuals were 53% more likely than unmarried persons to have rolled over lump-sum distribution into a retirement plan. The *presence of children* in the family, however, had a *negative* relationship to the probability of rolling over a distribution. People with children under age 18 were 23% less likely to have rolled over a distribution compared to people with no children. The likely reason for the negative impact on rollovers of children in the family is that people with children face numerous expenses that childless individuals do not. These additional financial responsibilities could make the preservation of a lump-sum distribution a lower priority than it otherwise would be.

Age in the year of the distribution, education, and average monthly income were included in the model in broadly defined categories, both for simplicity of method and ease of interpretation. Recipients were grouped into four age categories according to when they received their most recent distribution: under 35; 35 to 44; 45 to 54; and 55 or older. Workers aged 55 and older were most likely to have rolled over a distribution. Relative to recipients under age 35, recipients aged 55 and older were 75% more likely to have rolled over their most recent distribution, and recipients aged 45 to 54 were 54% more likely than the youngest group to have rolled over their most recently received lump sum. Individuals who were 35 to 44 years old when they received their most recent distribution were 25% more likely than the youngest group to have rolled it over into another.

Recipients were classified into three groups designating their highest year of education: up to 12 years of school; 1 to 3 years of college; and 4 or more years of college. Having completed college bore a significant and positive relationship to the probability that a lump sum was rolled over. Relative to those with a high school

education or less, recipients with 1 to 3 years of college were no more or less likely to have rolled over their distribution into an IRA or other retirement plan. College graduates, however, were 92% more likely than those with just a high school education to have rolled over their most recent lump-sum distribution. This result could be considered encouraging to the prospect that savings behavior can be influenced by efforts to educate workers about the importance of saving pension distributions for their needs during retirement.

The SIPP collected information about respondents' current earnings, but not their earnings in the year they received their most recent lump-sum distribution. Current earnings were entered into the regression model as a proxy for income in the year the distribution was received. The respondents' average monthly income in 1998 was grouped into three categories: under \$1,500; \$1,500 to \$2,999; and more than \$3,000. On an annualized basis, these groupings correspond to yearly earnings of under \$18,000, \$18,000 to \$36,000, and more than \$36,000, respectively. Relative to recipients with monthly earnings of less than \$1,500, those who had earnings from \$1,500 to \$3,000 were neither more nor less likely to have rolled over their most recent lump-sum distribution into an IRA or other retirement account. (The sign for this variable was positive, but the coefficient was not statistically significant). Having monthly income of more than \$3,000 was significantly and positively related to the likelihood that a distribution was rolled over. Individuals with monthly income of more than \$3,000 were 46% more likely to have rolled over their most recent lump sum. The variable indicating the recipient's sex was not statistically significant and was dropped from the model.

The second model was similar to the first except that the sample was restricted to people who had received their most recent distribution after 1986 and were under age 60 in the year the distribution was received. An amendment to the Internal Revenue Code enacted in 1992 requires employers to withhold for income tax 20% of lump sums paid directly to plan participants and to establish means by which such distributions can be transferred directly to an IRA or another employer's plan. The indicator variable for distributions received after 1992 had a positive and statistically significant relationship to the probability that a lump-sum distribution was rolled over into another retirement plan. Other things being equal, lump sums received in 1993 or later were 91% more likely to have been rolled over than those received between 1987 and 1992. This result offers some encouragement about the effectiveness of these amendments on savings behavior. Also, in this model the variable indicating the recipient's sex was statistically significant. Other things being equal, men were 20% less likely than women to have rolled over a distribution into another retirement plan.

Table 6. Disposition of Lump-Sum Distributions
(All recipients of lump-sum distributions)

Logistic regression results				
Response Variable: Full distribution was rolled over into an IRA or other retirement account				
Analysis variable	Weighted mean	Parameter estimate	Standard error	Odds ratio
Intercept	—	-3.258 ***	0.197	—
Race (1 = white)	0.911	0.547 ***	0.140	1.728
Marital status (1 = married)	0.646	0.426 ***	0.085	1.531
Children in family (1 = yes)	0.368	-0.259 **	0.090	0.772
Own home (1 = yes)	0.771	0.651 ***	0.099	1.917
Age = 35 to 44	0.249	0.221 **	0.093	1.247
Age = 45 to 54	0.143	0.432 ***	0.116	1.540
Age = 55 or older	0.165	0.558 ***	0.120	1.747
Education: some college	0.327	0.137	0.095	1.147
Education: 4+ years college	0.369	0.655 ***	0.095	1.924
Monthly inc.: \$1,500-\$2,999	0.332	0.117	0.090	1.124
Monthly inc.: \$3,000+	0.317	0.377 ***	0.093	1.457
Lump sum: \$3,500 - \$9,999	0.235	0.547 ***	0.096	1.728
Lump sum: \$10,000-\$19,999	0.147	0.849 ***	0.109	2.338
Lump sum: \$20,000 or more	0.226	1.406 ***	0.102	4.081
Received before 1987	0.236	-0.587 ***	0.109	0.556
Received in 1993 or later	0.508	0.579 ***	0.088	1.785

Source: CRS analysis of the 1996 panel of the *Survey of Income and Program Participation*.

Notes: Lump-sum distributions have been adjusted to 1998 dollars.

The “odds ratio” is a measure of how much more (or less) likely it is for a specific outcome to be observed when a particular independent variable is “true” ($x = 1$) than it is when that independent variable is “false” ($x = 0$).

n = 4,100 records

* significant at $\geq .10$

** significant at $\geq .05$

*** significant at $\geq .01$

Association of Predicted Probabilities and Observed Responses

Concordant = 75.1%, Discordant = 24.6%, Tied = 0.3%

Table 7. Disposition of Lump-Sum Distributions
(Lump-sums received after 1986 by persons under age 60)

Logistic regression results				
Response Variable: Full distribution was rolled over into an IRA or other retirement account				
Analysis Variable	Weighted Mean	Parameter Estimate	Standard Error	Odds Ratio
Intercept	—	-3.414 ***	0.231	—
Race (1 = white)	0.903	0.549 ***	0.162	1.731
Sex (1 = male)	0.473	-0.220 **	0.093	0.803
Marital status (1 = married)	0.653	0.460 ***	0.107	1.585
Children in family (1 = yes)	0.447	-0.430 ***	0.105	0.650
Own home (1 = yes)	0.729	0.758 ***	0.114	2.135
Age = 35 to 44	0.293	0.134	0.105	1.143
Age = 45 to 54	0.167	0.282 **	0.132	1.326
Age = 55 or older	0.069	0.362 *	0.188	1.436
Education: some college	0.352	0.216 *	0.116	1.241
Education: 4+ years college	0.370	0.872 ***	0.116	2.391
Monthly inc.: \$1,500-\$2,999	0.341	0.220 **	0.111	1.246
Monthly income: \$3,000+	0.333	0.689 ***	0.117	1.992
Lump sum: \$3,500 - \$9,999	0.244	0.660 ***	0.112	1.935
Lump sum: \$10,000-\$19,999	0.143	0.795 ***	0.132	2.215
Lump sum: \$20,000 or more	0.192	1.317 ***	0.129	3.731
Received after 1992 (1= yes)	0.664	0.649 ***	0.095	1.913

Source: CRS analysis of the 1996 panel of the *Survey of Income and Program Participation*.

Notes: Lump-sum distributions have been adjusted to 1998 dollars.

The “odds ratio” is a measure of how much more (or less) likely it is for a specific outcome to be observed when a particular independent variable is “true” ($x = 1$) than it is when that independent variable is “false” ($x = 0$).

n = 2,757 records

* significant at $\geq .10$

** significant at $\geq .05$

*** significant at $\geq .01$

Association of Predicted Probabilities and Observed Responses

Concordant = 75.4%, Discordant = 24.2%, Tied = 0.4%

Implications for Public Policy

The results of this analysis indicate that while fewer than half of lump-sum distributions are rolled over into IRAs or other retirement plans, more than half of the dollars distributed as lump sums have been rolled over. The trend in recent years has been that an increasing proportion of recipients have rolled over their entire lump-sum distribution into another retirement plan. Increases in the proportion of distributions that are rolled over followed both the imposition of an excise tax on non-rollovers by the *Tax Reform Act of 1986* and the tax withholding and institutional rollover mechanisms mandated by the *Unemployment Compensation Amendments of 1992*.

Responses to the *Survey of Income and Program Participation* indicate that many of the recipients of lump-sums who *did not* roll over their distributions into an IRA or other retirement plan saved at least some of the money in another way. While 36% of recipients rolled over the entire amount, another 48% used at least part of their lump-sum to purchase a home or business, invest in stocks or bonds, or to make a deposit to a savings account. Thus, 84% of all recipients saved at least *part* of their lump-sum distribution. Both the growing proportion of recipients who roll over their lump-sum distributions into other retirement accounts and the larger percentage of dollars being rolled over are encouraging signs that many workers realize the importance of preserving these assets until retirement. Nevertheless, many recipients do not roll over their lump-sum distributions into other retirement plans. While the lump-sum distributions that were not rolled over tended to be relatively small – with a median value of \$3,000, compared to a median value of \$10,000 for lump-sums that were rolled over – most were received by workers who were more than 20 years away from retirement. Consequently, many of these distributions could have grown to substantial amounts had they been preserved in IRAs or other retirement plans. Among the sample examined in this report, those who did not roll over their most recent lump sum distributions gave up retirement wealth with an estimated median value of \$41,000 at age 65 if invested in stocks, or \$16,600 if invested in bonds.

The tax policies that Congress has adopted toward early distributions from retirement plans represent a compromise among several competing objectives, including:

- encouraging participation among employers and employees in these plans,
- promoting the preservation of retirement assets,
- allowing participants to have access to their retirement savings when they would otherwise face substantial economic hardship, and
- assuring that the tax preferences granted to pensions and retirement plans are not used for purposes other than to fund workers' future financial security.

If any one of these objectives were paramount, devising the most effective policy would be a relatively straightforward undertaking. If preserving retirement assets were the only important consideration, Congress could require *all* distributions from pension plans to be rolled over into another account and held there until the

individual reaches retirement age. Stricter limits on access to retirement funds before retirement, however, could inhibit employee participation in retirement savings plans. This, in turn, could result in more people being unprepared for retirement than currently results from some pre-retirement distributions being spent rather than saved. Likewise, allowing easier access to retirement savings could help people meet other important expenses, like buying a home or paying for their children's education, but at the expense of less financial security in retirement.

Given the competing demands that Congress faces in devising tax policy for pre-retirement distributions from pensions and retirement savings plans, the most likely outcome is that these policies will continue to represent a compromise among competing objectives. Policy analysts who have studied the effects of federal tax laws on the disposition of lump-sum distributions have suggested several options for consideration, including: changing the tax rate or the withholding rate on lump-sum distributions that are not rolled over; having the tax rate vary with the age of the recipient or with the size of the distribution; requiring at least part of the distribution to be rolled over directly into another retirement plan; and encouraging plan sponsors to educate recipients about the importance of preserving these distributions so that the funds will be available to provide for their financial security during retirement.

Additional Reading

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