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Pension Issues: Lump-Sum Distributions and Retirement Income Security

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Patrick Purcell
Specialist in Social Legislation
Domestic Social Policy Division

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Summary

Slightly fewer than half of all workers age 21 and older participated in an employer-sponsored retirement plan in 2003, 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 could receive several 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 depositing the funds into an individual retirement account (IRA) or 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 over into another retirement plan. In 2001, Congress required that, unless directed otherwise by the participant, the plan sponsor must deposit distributions of \$1,000 or more into an individual retirement account.

According to data collected by the Census Bureau, 51.8 million workers age 21 or older participated in retirement plans that offered a lump-sum distribution as a payment option in 2003. This represented 84.8% of the 61.1 million workers who were covered by a pension, profit-sharing, or retirement savings plan in 2003. Approximately 16.0 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 \$21,900 and the median value was \$6,000. The typical recipient was between 37 and 40 years old at the time of the distribution. Thus, most recipients of lump-sum distributions were more than 20 years away from retirement.

Of survey respondents who reported that they had received at least one lump-sum distribution, 44% said that they had rolled over the entire amount of the most recent distribution into an IRA or other retirement plan, accounting for 67.2% of the dollars distributed as lump sums. Another 40% 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, 47% said that they had rolled over the entire amount into another plan, accounting for 72% of the dollars distributed as lump-sums. Another 38% of this group said that they had saved at least part of the distribution.

Lump-sum distributions that are spent rather saved can reduce future retirement income. If the lump-sum distributions received through 2002 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 had a median value of \$7,214 by 2003. For the typical recipient, if this amount were to remain invested, it would grow to an estimated value of \$31,100 by age 65, which would be sufficient to purchase a level, single-life annuity that would pay \$225 in monthly income.

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Pension Issues: Lump-Sum Distributions and Retirement Income Security

Overview: Pension Coverage and Tax Policy

Slightly fewer than half of all workers age 21 and older in the United States participated in an employer-sponsored retirement plan in 2003.¹ (**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 2003, more than two-thirds (68.3%) of Social Security beneficiaries age 65 or older received more than half of their annual income from Social Security, and Social Security was the *only* source of income for nearly one out of four (24%) beneficiaries over the age of 65.³ The median monthly Social Security retired worker benefit in 2003 was \$925 per month, or \$11,100 annually. 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. However, to the extent that workers spend lump-sum distributions from employer-sponsored retirement 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

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 the Congressional Research Service (CRS) from data published by the U.S. Bureau of Labor Statistics, “Employee Tenure in 2004,” BLS News Release, USDL 04-1829, Sept. 21, 2004.

³ CRS analysis of the Census Bureau's Mar. 2004 *Current Population Survey*.

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.

Table 1. Participation in Employer-Sponsored Retirement Plans, 2003

(all wage and salary workers age 21 and older)

Participate in a Retirement Plan?	Yes (in percent)	No (in percent)	Total Persons (in thousands)
Age			
21 to 24	18.9	81.1	12,646
25 to 34	41.9	58.1	31,363
35 to 44	52.0	48.0	34,052
45 to 54	59.0	41.0	31,252
55 to 64	56.7	43.3	16,925
65 or older	28.6	71.4	5,014
Race/ethnicity			
White	48.7	51.3	107,570
Black	44.3	55.7	15,077
Asian/Native American	42.1	57.9	8,606
Sex			
Male	49.1	50.9	68,740
Female	46.3	53.7	62,513
Marital status			
Married	53.5	46.5	78,907
Not Married	39.0	61.0	52,346
Education			
High School or less	37.0	63.0	52,634
Some college	47.7	52.3	38,304
College graduate	61.9	38.1	40,315
Earnings in 2003			
Under \$25,000	23.0	77.0	53,940
\$25,000-\$49,000	59.3	40.7	45,670
\$50,000-\$74,999	73.3	26.7	18,316
More than \$75,000	73.3	26.7	13,326
Firm size			
Under 25 people	20.7	79.3	33,839
25 to 99 people	40.8	59.2	17,901
100 or more people	60.9	39.1	79,513
Employment			
Year-round, full-time	56.9	43.1	93,096
Part year or part-time	25.6	74.4	38,157
Total	0.5	0.0	131,253

Source: The Congressional Research Service (CRS) analysis of the March 2004 *Current Population Survey*.

Employers who sponsor retirement plans do 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 \$568 billion in forgone tax revenue over the five fiscal years from 2005 through 2009.⁴ This is the largest so-called tax-expenditure in the federal budget.

Asset Preservation and Lump-Sum Distributions. Pension plans and retirement savings plans, such as “401(k)” plans, promote financial security in retirement by encouraging workers to accumulate assets to pre-fund their retirement income.⁵ Sometimes, however, retirement assets are distributed before the worker has reached retirement age. 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, investment earnings (or losses) on those contributions, and the part of employer contributions and earnings in which the employee has become vested.⁶ In defined benefit pension plans, a lump-sum distribution is required by law to be equal to the *present value* of the employee’s accrued benefit. The present value calculation discounts the stream of benefits that

⁴ Joint Committee on Taxation, JCS-1-05, Jan. 12, 2005. Other substantial tax expenditures are the exclusion of employer payments for health insurance, which is estimated to reduce federal tax revenue by \$494 billion from 2005 to 2009, the home mortgage interest deduction (\$434 billion), the reduced tax rates on dividends and long-term capital gains (\$357 billion), and the tax credit for children under age 17 (\$232 billion).

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. Similar arrangements for non-profit employers are authorized by §403(b) and for employees of state and local governments under §457.

⁶ ERISA allows sponsors of retirement plans to choose between two methods of vesting: “cliff” vesting and “graded” vesting. The maximum permissible vesting period differs between defined benefit plans and defined contribution plans. Under cliff vesting in a defined benefit plan, a participant is 100% vested after five years of participation, but has no vested rights to a benefit under the plan before that time. Under “graded” vesting in a defined benefit plan, a participant is 20% vested after three years, 40% vested after four years, 60% vested after five years, 80% vested after six years, and 100% vested after seven years. In a defined contribution plan, the vesting schedule applicable to an employer’s matching contributions may not exceed three years under year cliff vesting or six years under graded vesting. Employers can, if they choose, vest participants in their accrued benefits faster than these schedules.

would be paid in the future to an amount that could, if invested by the recipient, pay an equivalent income at retirement.⁷

Lump-sum distributions promote “portability” of retirement assets for workers who change jobs, allowing them to re-invest their retirement assets so 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. Pension analysts describe pre-retirement distributions that are spent on current consumption rather than being rolled over into another retirement plan as “leakages” from the pool of retirement assets. To discourage leakages from retirement plans, Congress has amended the Internal Revenue Code to provide incentives for individuals to roll over pre-retirement 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 age 59½ that are not rolled over into an Individual Retirement Account (IRA) or another employer’s tax-qualified retirement plan.⁸
- The Unemployment Compensation Amendments of 1992 (P.L. 102-318) required employers to give departing employees the option to transfer a lump-sum distribution directly to an IRA or to another employer’s plan. If the participant instead chooses to receive the distribution directly, the employer is required to withhold 20%, which is 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.⁹
- 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 \$5,000.¹⁰ The Economic Growth and Tax Relief Reconciliation

⁷ Lump-sum distributions from defined benefit plans are discounted both for the time value of money, based on a specific rate of interest, and also for mortality among plan participants.

⁸ Under I.R.C. §72(t), 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. See CRS Report RL31770, *Retirement Savings Accounts: Early Withdrawals and Required Distributions*, by Patrick J. Purcell.

⁹ 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.

¹⁰ Distributions of \$5,000 or more require the participant’s written consent. 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

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 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 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 in 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 while placing an excise tax on amounts that are not rolled over represents a compromise among the competing policy objectives of promoting retirement saving, preserving assets until retirement, providing access to assets in time of need, and assuring that lost tax revenue does not exceed the amount 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. When calculating this amount, the plan is required by law to 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. The U.S. Treasury stopped issuing 30-year bonds in 2001. Congress is now considering alternative interest rates that could be used to calculate the present value of accrued benefits under defined benefit plans. H.R. 2803 (Boehner) of the 109th 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 average of the interest rates on high-quality, long-term and short-term corporate bonds. The corporate bond rate would be phased in over five years beginning in 2006.

Interest Rates and Lump-Sum Distributions. The amount of a lump-sum distribution from a defined benefit pension is inversely related to the interest used to calculate the present value of the benefit that has been accrued under the plan: the higher the interest rate, the smaller the lump-sum and vice versa. Under current law, lump-sum distributions are calculated using the average interest rate on 30-year Treasury bonds. The interest rate on long-term Treasury securities has historically

¹⁰ (...continued)
by ERISA in 1974.

been lower than the average interest rate on long-term investment-grade corporate bonds because bond markets generally consider U.S. Treasury securities to be free of the risk of default. Since the Treasury Department stopped issuing the 30-year bond in 2001, the interest rate on 30-year Treasury bonds that have not yet been redeemed has fallen as the supply of bonds has shrunk. (Bond prices and interest rates are inversely related. As bond prices rise, bond yields — interest rates — fall.)

H.R. 2830 would require plan sponsors to calculate lump-sum distributions using three interest rates based on investment-grade corporate bonds. As a result, participants of different ages would have their lump sum distributions calculated using different interest rates. Lump-sum distributions paid to workers nearer to retirement would be calculated using a short-term interest rate, and distributions paid to younger workers would be based on a long-term rate. Because short-term rates are usually lower than long-term rates, all else being equal, an older worker would receive a larger lump-sum than a similarly situated younger worker.

Assuming that a participant were to take a lump-sum distribution at the plan's normal retirement age (typically age 65), a short-term corporate interest rate would be applied to the annuity payments he or she would have received during the first five years of retirement. A medium-term interest rate would apply to payments the participant would have received in years six through 20, and a long-term rate would apply to payments that would have been paid after 20 years. Because a 65-year-old can be expected to live about another 20 years, most of the lump-sum would be based on the medium-term rate. In contrast, a participant who takes a lump-sum distribution at age 45 would be 20 years away from the plan's normal retirement age. All of that person's lump sum will be discounted at the higher long-term rate. If a person took a lump sum at, say, age 59, the distribution would be calculated using the both the medium-term and long-term rates, but not the short-term rate.

Lump-Sum Distributions and Pension Plan Funding. Further increases in the proportion of plan participants taking lump-sum distributions from defined benefit pension plans could have important implications for pension plan funding. The Executive Director of the Pension Benefit Guaranty Corporation (PBGC) has stated that “plan assets are depleted when seriously underfunded plans allow retiring employees to elect lump sums and similar accelerated benefits.”¹¹ Likewise, the U.S. Government Accountability Office (GAO) has reported to Congress that:

. . . because many plans allow lump sum distributions, plan participants in an underfunded plan may have incentives to request such distributions. For example, where participants believe that the PBGC guarantee may not cover their full benefits, many eligible participants may elect to retire and take all or part of their benefits in a lump sum rather than as lifetime annuity payments, in order to maximize the value of their accrued benefits. In some cases, this may create a “run on the bank,” exacerbating the possibility of the plan's insolvency as assets

¹¹ PBGC Director Bradley Belt, statement to the Senate Finance Committee, June 7, 2005.

are liquidated more quickly than expected, potentially leaving fewer assets to pay benefits for other participants.¹²

How Many Workers Are Eligible for Lump-Sum Distributions?

During the first half of 2003, 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, 85% of the 61.1 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 (See **Table 2.**)

Almost all defined contribution plans offer a lump-sum payment option. The proportion of defined benefit plans offering lump-sum distributions has risen in recent years as many employers have converted traditional defined benefit pension plans to “cash balance plans.” 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. Cash balance plans typically offer lump-sum distributions to departing employees.

¹² U.S. Government Accountability Office, “Pension Benefit Guaranty Corporation: Structural Problems Limit Agency’s Ability to Protect Itself from Risk,” GAO-05-360T.

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.

Table 2. Percentage of Workers Whose Retirement Plan Offered a Lump-Sum Payment Option, 2003

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

Does Plan Have a Lump-sum Option?	Yes (percent)	No (percent)	Persons (thousands)
Age			
21 to 24	78.6	21.4	2,033
25 to 34	86.1	13.9	13,637
35 to 44	84.7	15.3	18,300
45 to 54	84.5	15.5	17,618
55 to 64	84.7	15.3	8,518
65 or older	86.8	13.2	976
Race			
White	85.3	14.7	51,658
Black	81.3	18.7	6,540
Asian/Native American	84.1	15.9	2,883
Sex			
Male	85.0	15.0	33,360
Female	84.6	15.4	27,722
Marital status			
Married	84.8	15.2	40,528
Not Married	84.6	15.4	20,554
Education			
High School or less	83.0	17.0	18,495
Some college	85.1	14.9	19,165
College graduate	85.9	14.1	23,422
Income in 2003			
Under \$25,000	82.8	17.2	15,007
\$25,000-\$49,999	84.1	15.9	26,401
\$50,000 or more	87.2	12.8	19,674
Establishment size			
Not reported	92.2	7.8	1,651
Under 25 people	85.5	14.5	13,058
25 to 99 people	84.5	15.5	14,782
100 or more people	84.2	15.8	31,591
Employment			
Full-time	84.4	15.6	48,606
Part-time	86.1	13.9	12,476
Total	84.8	15.2	61,082

Source: CRS analysis of the 2001 Panel of the *Survey of Income and Program Participation* (SIPP).

How Many People Have Received Lump-Sum Distributions?

According to the information reported on the Survey of Income and Program Participation in 2003, an estimated 16.0 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 \$21,895. Expressed in constant 2003 dollars, the mean value of the distributions was \$25,968.¹⁴ (Table 3) Because 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 \$6,000. Adjusted to 2003 dollars, the median distribution was \$7,581. The average recipient was between the ages of 37 and 40 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	40	37
Amount of lump-sum distribution in nominal dollars	\$21,895	\$6,000
Amount of lump-sum distribution in 2003 dollars	\$25,968	\$7,581
<i>Rolled over the distribution to another account :</i>		
Age when lump sum received	42	40
Amount of lump-sum distribution in nominal dollars	\$33,810	\$12,000
Amount of lump-sum distribution in 2003 dollars	\$39,400	\$13,332
<i>Did not roll over the distribution to another account:</i>		
Age when lump sum received	38	35
Amount of lump-sum distribution in nominal dollars	\$12,420	\$4,000
Amount of lump-sum distribution in 2003 dollars	\$15,288	\$4,464

Source: CRS analysis of the 2001 panel of the *Survey of Income and Program Participation* (SSIP).

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

¹⁴ CRS adjusted the dollar amount of all lump-sum distributions reported on the SIPP to constant 2003 dollars, based on the Personal Consumption Expenditure Index of the National Income and Product Accounts (NIPA).

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 to the Census Bureau that they had received at least one lump-sum distribution, 44% said that they had rolled over the entire amount of the most recent distribution into another tax-qualified plan, such as an IRA. (See **Table 4.**) These transactions accounted for 67% of the dollars distributed as lump sums. (Not shown in table.) Of those who reported receiving a distribution after 1992, 47% said that they had rolled over the entire amount into another plan, accounting for 72% of the dollars distributed as lump-sums after 1992.

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. Survey participants 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.¹⁵ 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, 84% said that they had saved at least some of the most recent distribution they received. (See **Table 5.**) In addition to the 44% who had rolled over the entire amount into another tax-deferred retirement plan, another 40% 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, 85% said that they had saved at least part of the distribution. Of this group, 47% rolled over the entire amount into another plan, and 38% saved part of the distribution in another way.

¹⁵ 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.

Trend From 1998 to 2003. Prior to 2003, the Census Bureau last collected information on the disposition of lump-sum distributions from pension plans in 1998. In the 1998 survey, 35.9% of respondents reported that they had rolled over the entire amount of the most recent lump-sum distribution they had received into an IRA or another employer-sponsored retirement plan. The data displayed in **Table 4** show that 44.3% of the respondents to the 2003 survey reported having rolled over their most recently received lump-sum distribution. While these figures may appear to represent a substantial increase in the percentage of recipients who chose to roll over their lump-sum distributions between 1998 and 2003, they primarily reflect changes in participant behavior that had already occurred by 1998.

In the 1998 Census Bureau survey, 35.9% of respondents reported that they had rolled over their most recent lump-sum distribution into another retirement plan. Of 7.0 million people whose most recent lump-sum distribution occurred before 1993, only 29.2% reported that they had rolled over the entire amount into an IRA or another retirement plan. Of 7.3 million people whose most recent lump-sum distribution occurred between 1993 and 1998, 42.4% reported that they had rolled over the entire amount into another plan.¹⁶

In the 2003 Census Bureau survey, 44.3% of respondents reported that they had rolled over their most recently received lump-sum distribution into another retirement plan. Of 4.7 million people whose most recent lump-sum distribution occurred before 1993, 38% had rolled over the entire amount into an IRA or another retirement plan. Of another 4.7 million people whose most recent lump-sum distribution was received between 1993 and 1998, 49.2% reported that they had rolled over the entire amount into another plan. Finally, of 6.7 million people whose most recent lump-sum distribution was received after 1998, 45.2% reported that they had rolled over the entire amount into another plan.¹⁷

The increase from 35.9% of lump-sum recipients reporting a rollover in the 1998 survey to 44.3% of recipients who reported a rollover in the 2003 survey largely reflects changes in behavior that had already occurred by 1998. In the 2001 survey, the percentage of individuals who reported rolling over their most recent lump-sum distribution was actually *lower* for distributions received after 1998 or later than it was for distributions received between 1993 and 1998. When comparing the disposition of recently received lump-sum distributions in the two surveys, the percentage of distributions that were rolled over into another plan was only slightly higher in the 2003 survey than in the 1998 survey. In 1998, 42.4% of respondents who had received a lump-sum distribution within the last five years reported that they had rolled over the full amount of the distribution into another retirement plan. In the 2003 survey, the comparable figure was 45.8%, an increase of just 3.4 percentage points. Thus, the higher overall percentage of recipients who reported having rolled over their most recent lump-sum distribution in the 2003 survey — 44.3%, as compared to 35.9% in the 1998 survey — results mainly from the fact that a much larger proportion of the distributions represented in the 2003 survey occurred after 1992.

¹⁶ The weighted average is calculated as $(7.0/14.3 \times .292) + (7.3/14.3 \times .424) = .359$.

¹⁷ The weighted average is $(4.69/16.0 \times .381) + (4.66/16.0 \times .492) + (6.65/16.0 \times .452) = .443$.

Table 4. Percentage of Lump-Sum Distribution Recipients Who Rolled Over the Entire Amount into Another Retirement Plan

Entire Lump-Sum Rolled Over?	Yes (percent)	No (percent)	Total persons (in thousands)
Age when received			
21 to 24	20.1	79.2	1,303
25 to 34	39.2	60.8	5,281
35 to 44	48.7	51.3	4,174
45 to 54	51.6	48.4	2,725
55 to 64	56.4	43.6	1,855
65 or older	39.2	60.8	669
Race			
White	45.8	54.2	14,452
Black	21.9	78.1	916
Other	43.1	56.9	640
Sex			
Male	47.6	52.4	7,575
Female	41.4	58.6	8,432
Marital status			
Married	47.6	52.4	10,350
Not married	38.2	61.8	5,656
Children present			
No Children	45.6	54.4	10,207
One child or more	42.0	58.0	5,800
Education			
High School or less	33.8	66.2	4,198
Some college	36.8	63.2	5,206
College graduate	56.9	43.1	6,603
Home ownership			
Home owner	47.8	52.2	12,931
Not a home owner	29.4	70.6	3,077
Income in 2003			
Under \$25,000	37.8	62.2	6,922
\$25,000-\$49,999	41.9	58.1	5,247
\$50,000 or more	59.3	40.7	3,838
Amount of distribution^a			
Less than \$3,500	28.0	72.0	5,460
\$3,500 to \$9,999	40.8	59.2	3,657
\$10,000 to \$19,999	46.4	53.6	2,347
\$20,000 or more	65.5	34.5	4,544
Year distribution received			
Before 1993	38.1	61.9	4,688
1993 to 1998	49.2	50.8	4,655
After 1998	45.2	54.8	6,664
Total	44.3	55.7	16,007

Source: CRS analysis of the 2001 panel of the *Survey of Income and Program Participation (SIPP)*.

a. Amount of the lump-sum distribution, adjusted to 2003 dollars.

Table 5. Percentage of Lump-Sum Distribution Recipients Who Saved All or Part of the Distribution

Was any part of the distribution saved?	Yes (percent)	No (percent)	Persons (thousands)
Age when received			
21 to 24	66.7	33.3	1,303
25 to 34	82.7	17.3	5,281
35 to 44	85.9	14.1	4,174
45 to 54	88.4	11.6	2,725
55 to 64	89.7	10.3	1,855
65 or older	84.8	15.2	669
Race			
White	84.9	15.1	14,452
Black	73.8	26.2	916
Other	79.2	20.8	640
Sex			
Male	85.8	14.2	7,575
Female	82.5	17.5	8,432
Marital status			
Married	85.6	14.4	10,350
Not married	81.3	18.8	5,657
Children present			
No Children	83.8	16.2	10,207
One child or more	84.5	15.5	5,801
Education			
High School or less	81.7	18.3	4,198
Some college	82.0	18.0	5,206
College graduate	87.2	12.8	6,603
Home ownership			
Home owner	85.6	14.4	12,931
Not a home owner	77.6	22.4	3,076
Income in 2003			
Under \$25,000	82.0	18.0	6,922
\$25,000-\$49,999	83.3	16.7	5,247
\$50,000 or more	89.0	11.0	3,838
Amount of distribution^a			
Less than \$3,500	75.0	25.0	5,460
\$3,500 to \$9,999	82.5	17.5	3,657
\$10,000 to \$19,999	89.2	10.9	2,347
\$20,000 or more	93.6	6.4	4,544
Year distribution received			
Before 1993	81.1	18.9	4,688
1993 to 1998	84.3	15.7	4,655
After 1998	86.0	14.0	6,664
Total	84.1	15.9	16,007

Source: CRS analysis of the 2001 panel of the *Survey of Income and Program Participation (SIPP)*.
a. Amount of the lump-sum distribution, adjusted to 2003 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 39.2% 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, 51.6% rolled over the entire amount. (See **Table 4.**) 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 \$21,895. 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 \$33,810. Those who had not rolled over the entire distribution received lump-sums with a mean value of \$12,420. (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 that they had not rolled over their most recent lump-sum distribution, the Congressional Research Service (CRS) calculated the amounts that these individuals could have accumulated if they had rolled over their entire lump sums into another retirement plan. For each individual who had not rolled over the most recent lump-sum distribution, CRS calculated the amount that would have been accumulated by 2003 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 10-year U.S. Treasury notes in each year since the year the distribution was received; and
- the total annual rate of return of the *Standard & Poor's 500* stock index in each year since the distribution was received.

If all of the respondents who reported 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 10-year U.S. Treasury notes, the distributions would have attained a mean value of \$37,427 by 2003. 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 \$41,272 by 2003.

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 had a median value of \$7,214 by 2003. If invested in bonds that earned the rate of return paid by 10-year U.S. Treasury notes, the median lump sum would have been worth \$6,930 by 2003.

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 27 to 30 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 38. Their median age in the year of the distribution was 35. In 2003 — the year of the survey — the median age of these individuals was 46.

As noted above, the median value of the lump-sum distributions that were not rolled over would have reached \$7,214 by 2003 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%, a 46 year-old individual who invested \$7,214 for 19 years would have accumulated \$31,130 by age 65. At current interest rates, this would be enough to purchase a life-long annuity that would provide income of \$225 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 10-year Treasury notes, they would have reached a median value of \$6,930 in 2003. Assuming 46 year-old individual invested \$6,930 in bonds for 19 years at an average rate of return of 5.8%, it would grow to \$20,230 by age 65.¹⁹ This would be sufficient capital to purchase a lifetime annuity that would provide a monthly income of \$147.

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 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

¹⁸ Based on a level, single-life annuity purchased at age 65 at 4.125%.

¹⁹ The long-run nominal interest rate assumed in the 2005 annual report of the Board of Trustees of the Social Security System was 5.8%.

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. In the model, we restricted the sample to lump-sums received after 1986 by people under age 60 in the year of the distribution. Results of the model are shown in **Table 6**.²⁰

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 1.69. This means that the dependent variable is 69% 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 69% more likely than a renter to have rolled over the entire lump sum into another retirement plan.

²⁰ 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. Results were similar in a second model that included all recipients of lump-sums, regardless of age in the year of distribution or the year the distribution was received.

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.²¹ All amounts were adjusted to 2003 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 63% more likely to be rolled over than lump sums of less than this amount. Lump-sum distributions of \$10,000 to \$19,999 were 102% more likely to be rolled over than lump sums of less than \$3,500. Distributions of \$20,000 or more were 329% more likely to be rolled over than were distributions of less than \$3,500.

The variable indicating *the year the distribution was received* 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 38% more likely to have been rolled over than those received between 1987 and 1992.

Race was also a significant variable on the model. White recipients of lump-sum distributions were 96% 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 69% 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 35% 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 30% 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.

²¹ 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.

Age in the year of the distribution, education, and average monthly income were included in the model in broadly defined categories. 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. Relative to recipients under age 35, workers aged 35 to 44 and those aged 45 to 54 were 28% and 29% more likely, respectively than the youngest group to have rolled over their most recently received lump sum. Recipients aged 55 and older were 48% more likely than those under 35 to have rolled over their most recently received lump sum distribution.

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 27% more likely to have rolled over their distribution into an IRA or other retirement plan. College graduates, however, were 206% 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 2003 was grouped into three categories: under \$2,000; \$2,000 to \$3,999; and more than \$4,000. On an annualized basis, these groupings correspond to yearly earnings of under \$24,000, \$24,000 to \$48,000, and more than \$48,000, respectively. Relative to recipients with monthly earnings of less than \$2,000, those who had earnings from \$2,000 to \$3,999 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 \$4,000 was significantly and positively related to the likelihood that a distribution was rolled over. Individuals with monthly income of more than \$4,000 were 101% more likely to have rolled over their most recent lump sum.

The variable indicating the recipient's *sex* was statistically significant, but just barely (at the .10 level). Other things being equal, men were 15% less likely than women to have rolled over their most recent lump-sum distribution into another retirement plan.

Table 6. 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	—	-2.936 ^c	0.221	—
Race (1 = white)	0.893	0.675 ^c	0.144	1.964
Sex (1 = male)	0.474	-0.162 ^a	0.089	0.85
Marital status (1 = married)	0.656	0.299 ^c	0.101	1.348
Children in family (1 = yes)	0.434	-0.364 ^c	0.100	0.695
Own home (1 = yes)	0.781	0.525 ^c	0.111	1.690
Age = 35 to 44	0.291	0.244 ^b	0.102	1.277
Age = 45 to 54	0.203	0.256 ^b	0.124	1.294
Age = 55 or older	0.073	0.390 ^a	0.180	1.478
Education: some college	0.338	0.236 ^b	0.112	1.266
Education: 4+ years college	0.415	1.119 ^c	0.113	3.063
Monthly income: \$2,000-	0.346	0.164	0.100	1.178
Monthly income: \$4,000+	0.270	0.698 ^c	0.116	2.010
Lump sum: \$3,500 - \$9,999	0.240	0.488 ^c	0.109	1.628
Lump sum: \$10,000-\$19,999	0.141	0.704 ^c	0.129	2.022
Lump sum: \$20,000 or more	0.251	1.457 ^c	0.118	4.293
Received after 1992 (1= yes)	0.822	0.322 ^c	0.110	1.380

Source: Congressional Research Service (CRS) analysis of the 2001 panel of the *Survey of Income and Program Participation* (SIPP).

Notes: Lump-sum distributions have been adjusted to 2003 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 = 2,902 records.

- a. significant at $\geq .10$
- b. significant at $\geq .05$
- c. significant at $\geq .01$

Association of Predicted Probabilities and Observed Responses

Concordant = 75.9%, Discordant = 23.8%, Tied = 0.3%

Implications for Public Policy

The results of this analysis indicate that while fewer than half of lump-sum distributions from retirement plans have been rolled over into IRAs or another employer-sponsored plan, about two-thirds of the dollars distributed as lump sums have been rolled over. 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. However, the percentage of recently received lump-sum distributions that were rolled over into another plan was only slightly higher in the Census Bureau's 2003 survey than it had been in the 1998 survey. In 1998, 42.4% of respondents who had received a lump-sum distribution within the last five years reported that they had rolled over the full amount of the distribution into another retirement plan. In 2003, the comparable figure was 45.8%, an increase of just 3.4 percentage points in the percentage of recent distributions that were rolled over into another retirement plan.

Many 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 44% of recipients rolled over the entire amount, another 40% 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. However, taking a distribution and saving part of it is not a tax-efficient way to save. Distributions received before age 59½ that are not directly rolled over into another tax-qualified retirement plan are subject to both ordinary income tax and a 10% additional tax.

While the lump-sum distributions that were not rolled over tended to be relatively small — with a median value of \$4,000, compared to a median value of \$12,000 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 rolled over into IRAs or other retirement plans. Among the sample of lump-sum recipients examined in this report, those who did not roll over their most recent lump sum distribution gave up retirement wealth with an estimated median value of \$31,000 at age 65 if it had been invested in stocks, or \$20,000 if it had been 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, but only 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