Preretirement Distributions: Can You Take Them with You?

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Editor's note: This is the second of two companion articles, the first of which was published last month in Compensation and Working Conditions Online. The earlier article, entitled "Retirement Plan Design and the Mobile Workforce," addressed plan design issues and their effect on employees who work for short periods for many employers. The present article looks at what those employees can do regarding their retirement benefits after they have switched employers.

Workers may accumulate retirement benefits from several employers over a lifetime; complicated rules and choices make it difficult to ensure that such workers have adequate income when they reach retirement age.

Only 31 percent of workers in 2004 had been with their current employer 10 years earlier.[1] Among those who left jobs with retirement coverage, only 35 percent chose to transfer benefits directly to another retirement account. The largest percentage of those receiving a lump sum from the retirement plan of a prior employer chose to use the funds for current consumption.[2]

These data suggest that a large number of U.S. workers face a decision regarding retirement benefits from a former employer at some point in their careers. They also suggest that many of these workers are not putting those benefits toward their future retirement. When leaving an employer that provided retirement income benefits, former employees generally receive a *preretirement distribution of benefits*, giving employees access and control of their retirement assets prior to retirement age. As with many facets of retirement benefits, there are competing trends and rules associated with such distributions. There may be tax consequences, which may differ based on the type of plan or how the plan assets are distributed.

This article explores the options available to employees who receive preretirement distributions. For background, it includes some information on employee tenure and mobility. Data on employment and retirement income trends from the Bureau of Labor Statistics form the basis for much of the analysis. The article discusses how employees who have changed employers have chosen to use their preretirement distributions and what effect these choices have on the adequacy of future retirement benefits. It concludes with a brief discussion of the aging baby boomers, who will soon be faced with these choices.

Employee Tenure

A few facts can help to define today's "mobile workforce":

- Data from surveys of individuals indicate that in January 2004 workers had been with their current employer for a median of 4 years.
- Among workers aged 25 and over, only 31 percent had been with their current employer for 10 or more years.
- These and other data suggest a lot of job "churning" exists in today's labor market; over the past few years, nearly 50 million hires and 50 million separations have occurred in any 12-month period.[3]

Short job tenure can impact employer-provided retirement benefits in a number of ways. First, many retirement income plans impose eligibility requirements; new employees are not allowed to participate in the plan until they have been working with the employer for a period of time, typically 1 year.[4] Second, plans often include a vesting requirement, which is the amount of service an employee must complete before he or she obtains a nonforfeitable right to the benefits of the plan. Lastly, tenure affects the amount of retirement benefit, either because the benefit formula incorporates years of service or because more years of contributions have accumulated. These issues are largely the same for both defined benefit plans (which specify benefits available to employees at retirement, and require employers to provide sufficient funds to pay these benefits) and defined contribution plans (which specify contributions placed in individual employee accounts and identify retirement benefits as the accumulated contributions and earnings in the account). The earlier article covered these features in more detail; the present article looks at the choices and consequences available once an employee has chosen to leave his or her employer.

Employee Choices

Employees who leave their employer prior to retirement age typically face one or more of the following consequences:

- Forfeit benefits
- Receive benefits
    - Take the benefits in a lump sum
    - Transfer them to a personal account
    - Transfer them to the plan of a new employer
- Leave benefits with the former employer until some future time.

Which of these consequences actually occurs may depend upon the type of plan, the rules of the plan, and the choices of the employee. Also, as discussed in the paragraphs that follow, these choices may not be mutually exclusive. In some cases, individuals may make one choice only to make another choice subsequently, or they may make one choice for some part of their account and another choice for the remainder.

Forfeit benefits. For those who are not yet vested, benefits from employer funds are forfeited. Some plans have partial vesting features, meaning that a portion of the accumulated benefit will be available to the former employee, calculated on the basis of length of service. The remainder is forfeited. Any benefits attributed to employee funds, such as employee contributions to a 401(k) plan, are never forfeited; they may be received by the employee or transferred to another account.

Receive benefits. If the employee is entitled to a benefit, the first thing that must be done is to determine the value of that benefit. In the case of a traditional defined benefit plan, the present value of vested benefits is computed. The present value is the amount the employer must have in the plan today, which is based on certain interest rate and life expectancy assumptions, to pay the separated employee’s retirement benefits when such benefits are scheduled to begin.[5] In newer types of defined benefit plans, known as "hybrid" plans, the present value is computed on a regular basis and shared with the employee. Thus, no additional calculation is needed.[6] Similarly, there is no need to calculate the present value of a defined contribution plan; the value of vested benefits in the participant’s account is the amount to be distributed.

What follows is an example of a present-value calculation for a person retiring at age 55:

Employee’s age: 55

Life expectancy (at age 55): 83

Annual benefit: $20,000

Interest rate: 5 percent

Present value of future stream of payments: $297,962

If the employee were to receive $20,000 per year from age 55 to age 83, the total benefit would be $560,000. To pay that benefit, the employer must have accumulated nearly $300,000. That amount is available to the employee who leaves the employer.[7]

By law, employers may distribute benefits to the former employee if the present value is less than $5,000. In such a case, the employee does not have the option to leave the benefits in the employer plan. This is designed to reduce the administrative burden of maintaining former employees with small benefits within the plan. If the present value is $5,000 or more, the employer must provide the separated employee with the option of leaving the benefit in the employer plan. With the consent of both the employer and employee, benefits of any amount may be distributed to the employee.

Take the benefits in a lump sum. Because accumulated benefits in employer retirement plans are intended for retirement purposes, and both employers and employees may receive tax advantages when funds are placed in a retirement plan, a distribution of benefits in cash can trigger certain Federal (and possibly State and local) income tax consequences. Preretirement distributions to employees are taxable in the year of receipt and may be subject to a 10-percent tax penalty. By law, plan sponsors must withhold 20 percent of the distribution and deposit such funds for Federal tax purposes. When individuals complete their Federal income tax returns for the year of distribution, the entire benefit is considered income, the 20 percent withheld from the payment is considered income tax paid, and the 10-percent penalty may be assessed. Depending on the recipient's tax bracket, the tax withheld may or may not cover the tax liability.

Individuals who receive a lump sum distribution from a prior employer plan may still transfer those funds to another retirement account. By law, the individual has a limited time from receipt of the distribution to deposit it into another retirement account. At the individual's option, only part of the benefit may be deposited in a retirement account. Because of the 20 percent withheld by the employer for income tax purposes, the decision to receive a lump sum and subsequently deposit some or all of it into a retirement account can be messy. First, the individual only has 80 percent of the funds. If only 80 percent is deposited, the other 20 percent is considered a preretirement distribution and is subject to income taxes and penalties. If the individual deposits 100 percent of the distribution (by using personal funds to make up the difference), there are no tax consequences but extra income tax has been withheld unnecessarily. This overpayment is reconciled upon completion of income tax returns for the year of distribution.

Transfer the benefit to a personal account. Rather than receive a cash payment and deal with the related tax complexities, employees interested in transferring benefits to another retirement account may have such a transfer handled by the former employer. To encourage such transfers, a 2001 law establishes an automatic process for such distributions.[8] Under this new provision, the standard method of distribution for accounts valued at over $1,000 is to transfer all vested funds into an Individual Retirement Account (IRA).[9] Employees leaving their job will still have the option of handling the distribution of their account in different ways--including receiving the funds with the appropriate tax withholding--but absent any other choice, the funds will be transferred automatically into an IRA.

Transfer benefits to the plan of a new employer. Employer plans can help to facilitate the transfer of preretirement distributions between one employer and another by accepting such distributions into their plan. In 2000, 72 percent of workers covered by a defined contribution plan were in plans that accepted contributions from other plans. In general, defined benefit plans do not accept distributions from other plans, largely due to administrative difficulties in coordinating benefits from two plans. Coordination of defined benefit plans does occur in limited cases, such as certain multiemployer plans and plans operated by employers who have a certain relationship, such as that resulting from a merger.[10]

Leave benefits with the former employer until some future time. What is the difference between leaving benefits in an employer plan and transferring them to an IRA? In general, the individual is likely to have fewer investment options in an employer plan than would exist with an IRA, although there may be certain advantages to the former, such as lower brokerage costs. Other differences that may affect the decision to leave funds with a former employer or transfer them to an IRA include future access to benefits, methods of distribution, and the consequences if the employee becomes disabled or dies.

The decision to maintain funds in a defined benefit plan or to deposit them in an IRA may be affected by additional factors. First, the defined benefit plan may restrict the time period when funds may next be distributed. A vested employee who chooses to leave benefits in the plan may not have another opportunity to access those benefits until reaching the plan's early or normal retirement age. Second, the availability of benefits at the plan's early retirement age--available subject to a reduction to account for the longer receipt of benefits--may be subject to certain additional reductions.[11]

Finally, an advantage of maintaining benefits in an employer plan--either a defined benefit or a defined contribution plan--may be the availability of distribution options when benefits are received. This is most likely to occur in a defined benefit plan, but may also occur in a defined contribution plan. The option that may be most advantageous to a deferred vested annuitant is a survivor income benefit that provides income protection for a spouse (or other survivor) in the event that the annuitant dies.[12]

Maintaining Adequate Retirement Income

Several studies have looked at what former employees actually do with preretirement distributions. These studies generally try to categorize distributions into those that are maintained for retirement and those that are used for personal consumption. An intermediate category can also exist, where distributions are used to pay off debt, invest in nonretirement assets, or take care of pressing financial needs (such as health care needs or income during periods of unemployment).

A 2002 study by James H. Moore, Jr., and Leslie A. Muller found that the largest percentage of individuals receiving preretirement distributions used the funds for personal consumption.[13] (See table.) The study also found that older individuals tend to use preretirement distributions for retirement purposes more often than their younger counterparts. In addition, the larger the distribution, the more likely it is to be used for retirement.

Given current trends in the U.S. retirement system,[14] a person would be better off in retirement if even the smallest preretirement distributions were to become part of his or her total retirement income plan, just as Social Security benefits account for a person's entire working life.[15] Thanks largely to the "miracle of compound interest," small distributions can grow and make a substantial contribution to an individual's overall retirement income. (See chart.)

An Issue For The Future

The oldest members of the post-World War II "baby boom" generation will turn 60 in 2006, and retirement is certainly on the mind of that population cohort. Because of the aging of the population, the availability of adequate retirement income will continue to be a policy concern for years to come. Some recent changes to retirement policy, such as the automatic transfer of lump sum benefits to an IRA, acknowledge the need for individuals to accumulate a lifetime of retirement income and help them meet that need. Job tenure patterns suggest that younger generations are more likely to work for multiple employers over their working lives and thus need continued encouragement to save for their retirement.

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Notes

1 See Employee Tenure in 2004, USDL 04-1829 (U.S. Department of Labor), September 21, 2004, table 2; on the Internet at http://www.bls.gov/news.release/pdf/tenure.pdf. The data in this news release are from the Current Population Survey (CPS); the cited figures are for wage and salary workers aged 25 years and over.

2 Studies on the use of lump sum payments received prior to retirement indicate a wide variation in the use of the funds, depending on the age of the recipient and the amount of funds. There are also differences in the way that studies classify the use of funds. For more information on this issue, see James H. Moore, Jr., and Leslie A. Muller, "An Analysis of Lump-Sum Pension Distribution Recipients," *Monthly Labor Review*, May 2002, pp. 29-46; on the Internet at http://www.bls.gov/opub/mlr/2002/05/art3full.pdf.

3 These data are from the BLS Job Openings and Labor Turnover Survey. For more information on this program, see Kelly A. Clark, "The Job Opening and Labor Turnover Survey: what initial data show," *Monthly Labor Review*, November 2004, pp. 14-23., on the Internet at http://www.bls.gov/opub/mlr/2004/11/art2full.pdf.

4 Unless otherwise indicated, all data on benefit provisions are from the BLS National Compensation Survey. See *National Compensation Survey: Employee Benefits in Private Industry in the United States, 2002-2003*, Bulletin 2573 (Bureau of Labor Statistics, January 2005); available on the Internet at http://www.bls.gov/ncs/ebs/sp/ebbl0020.pdf.

5 The present value of a benefit payment--both preretirement and retirement--is determined in part by the interest rate used in the calculation. In the past, many employer plans used the interest rate of 30-year Treasury bonds; these bonds were discontinued in 2001, leading to increased debate over the relationship of interest rates to retirement plans.

6 The increased prevalence of nontraditional types of defined benefit plans, specifically cash balance plans and pension equity plans, is designed in part to make it easier for participants to understand the value of their benefit at any time. Such plans maintain an "account" balance for each participant; in essence, the plan is maintaining a present value calculation at all times. In 2002, 18 percent of defined benefit plan participants were in nontraditional plans, almost all of which were cash balance plans. For more information on hybrid defined benefit plans, see Kenneth R. Elliott and James H. Moore, Jr. "Cash Balance Pension Plans: The New Wave," *Compensation and Working Conditions*, Summer 2000, pp. 3-11; and L. Bernard Green, "What is a Pension Equity Plan?," *Compensation and Working Conditions Online*, October 29, 2003.

7 The calculation assumes a single annual payment paid at the end of each year. Changes to the number of payments per year and the timing of those payments will affect the present value calculation.

8 See Public Law 107-16, Economic Growth and Tax Relief Reconciliation Act of 2001.

9 This applies to both the present value of defined benefit plans and to the accumulated value of a defined contribution account.

10 For more information on defined benefit plan portability, see Ann C. Foster, "Portability of pension benefits among jobs," *Monthly Labor Review*, July 1994, pp. 45-50; on the Internet at http://www.bls.gov/opub/mlr/1994/07/art6full.pdf.

11 In most cases where deferred vested benefits are available at early retirement age, the reduction is the same as for those still working for the employer. But for about one in four participants in traditional defined benefit plans that offer deferred vested benefits at early retirement, the reduction is less generous (a greater reduction). In such cases, employers are granting a subsidy to those who remain at the job until early retirement but choose not to provide such a subsidy to those who have left the employer.

12 For more information on retirement plan distribution options, see Allan P. Blostin, "Distribution of Retirement Income Benefits," *Monthly Labor Review*, April 2003, pp. 3-9; on the Internet at http://www.bls.gov/opub/mlr/2003/04/art1full.pdf.

13 See James H. Moore, Jr., and Leslie A. Muller, "An Analysis of Lump-Sum Pension Distribution Recipients," *Monthly Labor Review*, May 2002, pp. 29-46; on the Internet at http://www.bls.gov/opub/mlr/2002/05/art3full.pdf. Recent changes to the law that make transfers to an IRA the default method of distribution may lead to changes in this trend in the future.

14 Consider, for example, the Savings Are Vital to Everyone's Retirement (SAVER) Act of 1997 (Public Law 105-92, November 19, 1997), which directs the Secretary of Labor to "maintain an ongoing program of outreach to the public designed to effectively promote retirement income savings among the public."

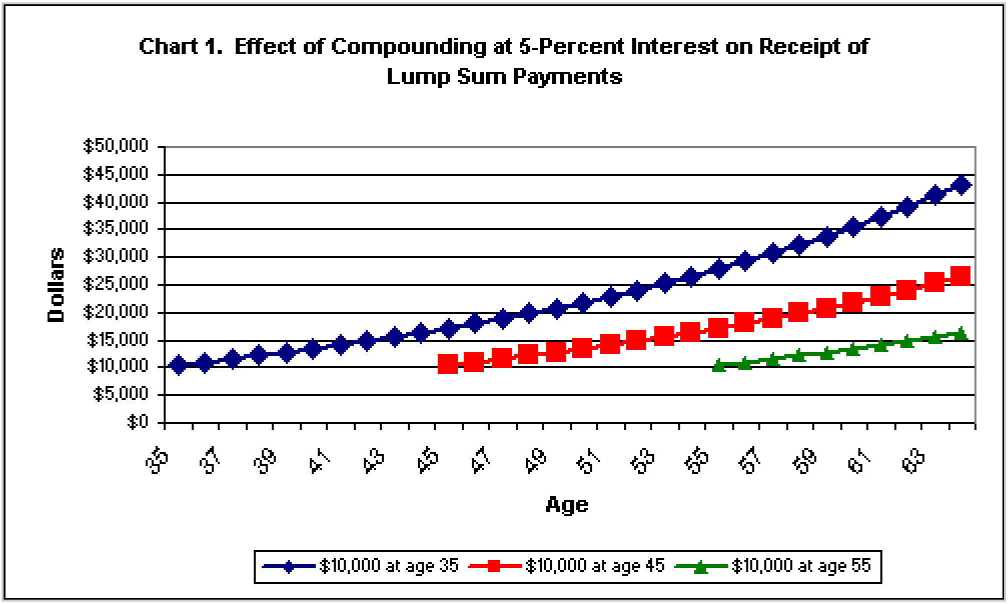
15 In contrast to employer-provided retirement plans, Social Security is considered a portable retirement plan, because credits toward future benefits can be earned from many different employers. Two employees who are the same age, have the same number of years of Social Security-covered work experience, and have the same pattern of earnings throughout their working lives will generally receive the same level of Social Security benefits, even if one of the workers was employed by the same organization their entire life while the other worked for many different organizations.

Table 1. Percent Distribution of Individuals Who Specified One Use for their Lump Sum Distribution, by Amount and Age at Distribution

Use of funds	All	Age of recipient at distribution			Amount of distribution			
		20 to 49	50 to 59	60 years and older	Less than $1,500	$1,501 to $5,000	$5,001 to $15,000	More than $15,000
Total	100	100	100	100	100	100	100	100
Transferred to another retirement plan	35	44	55	56	16	26	37	60
Other savings	17	14	16	21	13	25	20	20
Spent	42	36	26	17	63	51	36	17
Education	1	1	-	-	-	-	1	-
Unemployment expenses	2	3	1	1	3	3	3	1
Other	39	32	24	16	60	48	32	16
Not determinable	6	6	3	6	8	8	7	3

NOTE: Dash indicates less than 1 percent.

SOURCE: Survey of Income and Program Participation (SIPP), 1991, 1992, 1993; see James H. Moore, Jr., and Leslie A. Muller, "An Analysis of Lump-Sum Pension Distribution Recipients," Monthly Labor Review, May 2002, pp. 29–46, tables 2 and 3.



Data for Chart. Effect of Compounding at 5-Percent Interest on Receipt of Lump Sum Payments

Age	$10,000 at age 35	$10,000 at age 45	$10,000 at age 55
35	$10,500.00		
36	$11,025.00		
37	$11,576.25		
38	$12,155.06		
39	$12,762.82		
40	$13,400.96		
41	$14,071.00		
42	$14,774.55		
43	$15,513.28		
44	$16,288.95		
45	$17,103.39	$10,500.00	
46	$17,958.56	$11,025.00	
47	$18,856.49	$11,576.25	
48	$19,799.32	$12,155.06	
49	$20,789.28	$12,762.82	
50	$21,828.75	$13,400.96	
51	$22,920.18	$14,071.00	
52	$24,066.19	$14,774.55	
53	$25,269.50	$15,513.28	
54	$26,532.98	$16,288.95	
55	$27,859.63	$17,103.39	$10,500.00
56	$29,252.61	$17,958.56	$11,025.00
57	$30,715.24	$18,856.49	$11,576.25
58	$32,251.00	$19,799.32	$12,155.06
59	$33,863.55	$20,789.28	$12,762.82

Age	$10,000 at age 35	$10,000 at age 45	$10,000 at age 55
60	$35,556.73	$21,828.75	$13,400.96
61	$37,334.56	$22,920.18	$14,071.00
62	$39,201.29	$24,066.19	$14,774.55
63	$41,161.36	$25,269.50	$15,513.28
64	$43,219.42	$26,532.98	$16,288.95

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