



KAMP INSITE Fireside Chat

Your Monthly Update from KCS

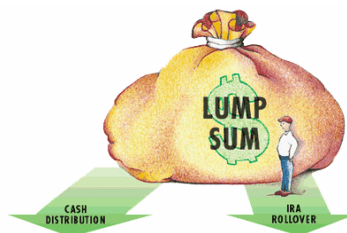
September 2012

Dump the Lump?

No ladies, we are not referring to your significant other!!

It's a call for a re-evaluation of lump-sum distributions (LSDs) from retirement programs, both defined benefit (DB) and defined contribution (DC). Why? Only a small percentage of employees eligible for LSDs are comfortable with the responsibility of re-investing the proceeds in a manner that ensures a retirement income through the end of one's life.

Unfortunately, today's employees are facing a retirement system different from the one that their parents knew, when a greater proportion of workers were covered by defined benefit plans. The shift from DB to DC coverage may pose several threats to an employee's retirement income security.



INSIDE THIS ISSUE

- 1 Dump the Lump?
- 1 Lump Sum Defined
- 2 LSD History
- 2 Who's Taking Them?
- 2 Does Size Matter?
- 3 LSDs Altering Effects
- 3 Good Reasons
- 4 Sponsor Responsibilities

What is a Lump Sum Distribution?

A lump-sum distribution, defined as a premature withdrawal, occurs when one receives full payouts in the same year from all:

- Pension plans maintained by the same employer,
- Profit-sharing plans (including any 401(k) plan) maintained by the same employer, and
- Stock-bonus plans maintained by the same employer, such as an ESOP

"Only a small percentage of employees eligible for LSDs are comfortable with the responsibility of re-investing proceeds in a manner that will ensure a retirement income..."

If a company operates several different plans, a participant is only assured of receiving a tax benefited LSD if all the plans are cashed out in the same calendar year. Favorable tax rules provide a benefit for LSDs, but a participant may only take one lump-sum distribution for tax-purposes. Note that a withdrawal from an IRA or SEP can never be considered a lump sum distribution, and as such, never qualifies for the special tax rules.

History of Lump Sum Distributions

The rapid growth of DC plans since the passage of the Employee Retirement Income Security Act (ERISA) has increased the importance of LSDs. DC plans typically make LSDs when participants retire, and may do so when participants terminate their employment before retirement. Unfortunately, LSDs can also arise when vested employees terminate employment at firms that offer DB pension plans, as ERISA permitted employers who sponsor a DB plan to “cash out” a terminated employee. This termination limit, without the employees consent, was increased to \$5,000 under The Taxpayer Relief Act of 1997 (TRA'97).

Lump sum distributions are included in taxable income in the year in which they are received. Prior to 1986, taxpayers receiving these distributions could elect a 10-year forward averaging option on their distributions. Unfortunately, this provision was repealed when the Tax Reform Act (TRA86) replaced it with a five-year forward averaging option for taxpayers over the age of 59 ½. TRA86 also imposed a 10% penalty (excise tax) on preretirement distributions to taxpayers younger than age 59 ½. In 1992, additional legislation imposed a 20% withholding tax on these distributions that weren't rolled over into a tax-qualified investment vehicle.

Who is Taking Lump Sum Distributions?

With regard to DC plans, anyone who changes or leaves an employer offering a defined contribution plan is likely to take a LSD. According to a study by Poterba, Venti and Wise titled, “Lump-Sum Distributions from Retirement Saving Plans: Receipt and Utilization”, more than 50% of all distributions from retirement plans were premature in nature, and only 31% of those distributions were rolled over into a qualified investment vehicle, such as an IRA. Importantly, more than 60% of the distributions had account balances less than \$5,000.

In their review of the behavior of LSD recipients, they discovered that younger people, minorities, and those less educated were least likely to roll-over their account balances. Unfortunately, these cohorts tend to be in more transient, lower paying jobs. In most cases, they are using the proceeds to pay outstanding debts, and not spending the proceeds on “luxuries”. Placing the burden of funding one's retirement on these individuals is almost a lost cause from the get go, as most can't set aside nearly enough to adequately fund their retirements. Importantly, they likely underestimate the benefit of compounding returns in tax-deferred investment vehicle(s).

Does Size Really Matter?

As the saying goes, little things add up. For instance, if a 27 year old with a \$3,500 LSD decides to roll-over this sum into a qualified

“...more than 50% of all distributions from retirement plans were premature in nature, and only 31% or those were rolled over to a qualified retirement vehicle.”

“Placing a burden of funding one's retirement on these individuals is almost a lost cause from the get go, as most can't set aside nearly enough to adequately fund their retirements.”

Does Size Really Matter? (con't)

investment vehicle, they should expect to accumulate a little more than \$34,000 by age 65 (assuming no additional contributions and a 6% annual return). Combine this sum with any other proceeds that they will have accumulated during the remainder of their working years, and they will certainly be better off than the average “retiree”.

If a 40 year old decides to switch jobs and takes a LSD with \$25,000 accumulated, they should expect to have a balance at age 65 of nearly \$112,000 if they roll it into a qualified plan, which is about 80% greater than the average 401(k) account at either Fidelity or Vanguard.

These are only a couple of examples related to how one can benefit from investing tax-deferred over a fairly lengthy period, but without the benefit of a DB plan for most of today’s workforce, the retirement community must educate participants on the benefit of compounding over time.

LSDs: Potential Mind - and Retirement - Altering Effects

Surprisingly, some DB and DC participants with larger balances are uninformed of their rights to remain in their plan. They may unknowingly believe they have to take a LSD and then rely on themselves for investment through an IRA or similar investment vehicle. LSDs can be a trap for people unaware of the risks of trying to generate a lifetime retirement income. The big question is knowing how long you’ll live. A monthly pension offers a financial guarantee of a retirement paycheck for life, no matter how long that may be.

Investment risk is another concern. If a participant takes the lump sum and invests it, they may lose some of their money due to stock market volatility or interest rate changes. By contrast, a monthly pension is immune to stock market and interest rate fluctuations.

One more important advantage of a monthly pension is that a check comes in the mail or gets deposited automatically in a bank account. This is particularly important as participants get older and are less able to manage their finances. Elderly people may lose their life’s savings due to fraud or mistakes, and a monthly pension makes this unfortunate situation almost impossible.

Can a Lump-Sum Distribution Make Sense?

In some cases, a LSD is a good decision. A participant (and their spouse) who may be in poor health and expect to die earlier than their projected life expectancy might realize more money with a LSD. A cash-out also can make sense if a participant doesn’t need the monthly pension and may want to use it for estate purposes, such as a family trust or charitable contribution.

“LSDs can be a trap for people unaware of the risks of trying to generate a lifetime retirement income.”

“...a monthly pension is immune to stock market and interest rate fluctuations.”

Plan Sponsor Roles and Responsibilities

We understand that carrying a pension liability (DB plans) is not something to be taken lightly, and as a result, many organizations have frozen or terminated their DB plans. However, we don't believe that DC plans provide the same level of retirement protection primarily because the investment and funding decisions are placed upon employees who may be overwhelmed with this responsibility.

“While DB plan sponsors have to juggle organizational demands such as plan expense control and administration time with their fiduciary responsibilities to participants, policies regarding premature LSDs should be reviewed in conjunction with the potential long-term impact on their constituents’ financial welfare.”

While “Dumping the Lump” may not be as easy as stated, plan sponsors and their consultants must approach the situation with different solutions. For instance, DB plans should take the lead from the DC world with programs to establish IRAs for terminated participants with smaller account balances. While DB plan sponsors have to juggle organizational demands, such as plan expense control and administration time with their fiduciary responsibilities to participants, policies regarding premature LSDs should be reviewed in conjunction with the potential long-term impact on their constituents’ financial welfare. Sponsors should also educate participants on the benefits of receiving a monthly check upon retirement.

On the DC side, sponsors should consider an automatic enrollment feature to start the savings cycle. Furthermore, a competitive match feature, while an organizational expense, will always be an attractive employee benefit, especially for retention and morale. In addition, it is important that plan participants are educated and trained on basic investment concepts, such as the power of compounding over time, on funding DC accounts to maximize any employer contributions and on the investment options offered, such as life cycle funds. Most importantly, the process must begin with each participant understanding their needs in retirement, and then building a roadmap to put them on a successful path.

At KCS, we understand these issues, and as such, we are prepared to assist those DB and DC plan sponsors and their participants with advice that will help them along the path to a more successful retirement outcome. Our economy and society will not function to the extent that we need it to if we can't find ways to retire people successfully.



Kamp Consulting Solutions LLC
Office: 973-509-4616

34 Third Street
Cell: 201-675-8797

Midland Park, NJ 07432
Fax: 201-670-4454

Twitter: @kampconsulting
Facebook: Kamp Consulting Solutions

LinkedIn: Kamp Consulting Solutions
Web: www.kampconsultingsolutions.com

rkamp@kampconsultingsolutions.com
dmurray@kampconsultingsolutions.com

lzielinski@kampconsultingsolutions.com
ljones@kampconsultingsolutions.com