Chapter 1

Navigating the Ins and Outs of Pensions

In This Chapter

- Getting acquainted with pension plans and the rules that govern them
- Making sure you receive your rightful pension
- Dealing with employer changes that impact your pension
- Understanding the impact of divorce, loans, and bankruptcy on your pension
- Finding out what to do when you don't get the pension you earned

You've worked hard for years, and you're looking forward to your well-deserved retirement. But are you truly ready? With this book, you'll be on your way. We want to help you prepare for this exciting time in your life, but we don't want to bog you down with legal details. We'll let the pension experts argue the fine points of pension law. Instead, in this book, we give you just the information that you need to understand your pension so you can protect it effectively.

For instance, we explain the differences between a defined benefit plan and a defined contribution plan. Already know that? Well, we go on from there to tell you about accrued benefits and vesting, how to take a loan from your plan (if you need one), and what happens to your pension in a divorce. You can also find out what happens when your plan goes broke or your company is sold. Finally, we give you information about fighting back when the plan takes advantage of you.

We introduce all these topics (and more) in this chapter; all of this information can help you grab hold of the pension that you worked so hard to earn.

Checking Out Pension Rules

The basic idea behind pension plan rules is to hold companies accountable for the promises they make to their employees regarding retirements. In exchange for following the rules, Congress provides pension plans special tax benefits. The pension plans that are given these special tax benefits are called *tax-qualified pension plans* (see the next section for more info).

The federal law that regulates pensions is called the Employee Retirement Income Security Act, but it's also known by its nickname, ERISA. ERISA has been around since 1974, and despite its amendments and the other retirement plan legislation enacted since then, the act was in need of a face-lift. After several years of wrangling, on August 17, 2006, the Pension Protection Act, known to friends and foes as the PPA, was enacted to update ERISA. The PPA is the most comprehensive pension legislation since ERISA. Both pieces of legislation, however, are alive and well. These federal laws apply to private pension plans — from your dentist's small plan to the billion-dollar plans of our country's biggest corporations.

Government employees, public school teachers, police officers, and firefighters participate in state pension plans that are created and regulated by state law, not federal law. This book doesn't cover these types of plans; we focus primarily on private plans that are governed by ERISA.

Pension plans covered under ERISA must do the following:

- Disclose certain plan information
- Set minimum standards for eligibility, accrual, and vesting
- Spell out fiduciary obligations
- Provide the right to file suit

For more about ERISA and the basics of pension rules, see Chapter 2.

Getting a Grip on Tax-Qualified Plans

For the most part, tax-qualified pension plans for private companies boil down to two basic varieties that are known as *defined contribution plans* and *defined benefit plans.* More and more companies are replacing their defined benefit plans with defined contribution plans. In Chapter 3, we explore the various types of plans that are included within these two groups.

Building your pension with defined contribution plans

A defined contribution plan is set up by your employer. Once it's set up, the plan provides you with an individual account until the money is distributed upon retirement. With this type of plan, you make tax-free contributions while you're still working. Your company may or may not match those contributions and make additional contributions, tax-free, to your plan. The benefit you receive at retirement is based on the amounts contributed to your account and the investment gains and losses it experiences. When you retire, your account balance is the amount that you have available — and when it's gone, that's all there is.

Here are some of the varieties of defined contribution plans that we cover in Chapter 3:

- Profit-sharing plans
- 401(k) plans
- Money purchase plans
- Employee stock ownership plans (ESOPs)
- Target benefit pension plans

Receiving cash for life with defined benefit plans

The defined benefit plan is more like traditional Social Security — after retirement it provides you with a fixed amount each month for as long as you or your designated beneficiary live. It doesn't matter whether your pension fund makes a bundle with its investments or loses a bundle; you're always entitled to the same monthly benefit or annuity. Here are the three types of defined benefit plans that we discuss in more detail in Chapter 3:

- The traditional defined benefit plan
- The cash balance (or hybrid) plan
- The 412(i) plan

Moving Forward with 401(k) Plans

Because the PPA now requires that defined benefit plans be fully funded and because defined benefit plans provide less flexibility to employers and are flat-out expensive to administer, many companies have been making a big shift in their pension plans to *401(k) plans.* These plans are an increasingly popular type of defined contribution plan. As we point out in Chapter 4, the following different types of 401(k) plans exist:

- Traditional 401(k) plans
- Safe Harbor 401(k) plans
- SIMPLE 401(k) plans
- Individual (or solo) 401(k) plans
- Roth 401(k) plans

REMEMBER

401(k)s are popular with both employers and employees. Employees like them because their elective deferrals to the plan and the investment gains aren't subject to taxes until they're distributed from the plan. Also helpful is the fact that employee deferrals are always 100 percent vested. Employers enjoy 401(k) plans because contributions are deductible on their federal income tax returns. It's a win-win situation for everybody. The type of 401(k) plan that your employer may offer usually depends on its size and financial situation.

Funding Your Retirement with the Help of IRAs

An *individual retirement account,* or IRA, is a plan that allows employees (under age 70½), self-employed individuals, and certain other individuals to put money into personal retirement accounts. You may be able to deduct some or all of your contributions to a traditional IRA depending on whether you, your spouse, or both of you are covered by a qualified retirement plan. If you and/or your spouse are covered, the amount of your tax deduction may be reduced depending on your adjusted gross income at the time you file your taxes. Generally, the amount in your traditional IRA, including earnings, isn't taxed until it's distributed to you.

TIP

An IRA is especially beneficial if you aren't already participating in an employer-sponsored retirement plan because it provides you with a way to save for your retirement on a tax-advantaged basis.

Varieties of IRAs include the following:

- Traditional IRAs
- Roth IRAs
- SIMPLE IRAs
- Simplified Employee Pension (SEP) Plans

Chapter 5 covers the different types of IRAs, including the rules about contributions, penalties, and distributions.

Tracking Pension Investments

When it comes to investing the money contributed to your pension, one of two things can happen: Either the plan officials direct the investments or you're permitted to direct the investments yourself. Naturally, the latter type of investment is called a *self-directed investment*.

When plan officials direct the investments in your pension plan, it's important that you do the following:

- Check on exactly who's investing your money.
- Examine your plan's selected investments.
- Track the performance of your plan's investments.
- Watch out for signs that the plan isn't following investment rules (and take action if something's amiss).

If you have the option of self-directing your investments, follow these guidelines:

- Find help in selecting your investments (for example, consult your plan's financial advisor, if there is one, or get a second opinion from your own financial advisor).
- Check your investments regularly (and change them if they aren't working for you).

Head to Chapter 6 for the scoop on investments in pension plans.

Ensuring That You Get Your Pension

To make sure that you get the pension that you deserve, you need to know the rules about a few important issues: eligibility, accrual, vesting, and distributions. You also need to use the right tools to plan for your retirement. We explain what you need to know in the following sections.

Getting the skinny on eligibility, accrual, and vesting

You can't participate in your employer's pension plan until you become eligible. And only after you become eligible do you begin to accrue benefits. (*Accrual* is the growth you earn in your account as you work.) At some point, your accrued benefits *vest,* meaning that they can't be taken away from you. Simple enough, right? Of course, the devil is in the details: How do you become eligible? What determines how you accrue benefits? When do these accrued benefits vest? Here are the basics (see Chapter 7 for more details):

- **Eligibility:** Your retirement plan can set age and service requirements before you can be part of its pension plan. But these requirements, by law, can't be unreasonable.
- **Accrual:** Your plan has a formula it uses to calculate how your benefits accrue. This formula is contained in your *summary plan description* (SPD), which is a plan document that must be made available to you upon your request. Your plan can't reduce the rate of the accrual of the benefits that you've already accrued, but it may do so for future benefits.
- **Vesting:** It's up to your company to determine when your benefits become vested, and this information must be specified in your SPD. Don't worry, though; your company must comply with minimum vesting schedules. Your company can vest your benefits in the following two ways:
    - With *cliff vesting,* which is an all-or-nothing approach where you become totally vested after a passage of time
    - With *graded vesting,* which is a method where you vest a percentage of your accrued benefit each year that you work

  REMEMBER

  Your own contributions to a defined contribution plan are yours no matter how long you've been working and how young or old you are.

Making retirement planning a priority

Quite obviously, it's best to plan for retirement while you're still working. This means, first off, that you have to know your *net worth.* Add up your assets (for example, your savings accounts, your investments, and the equity in your home) and then subtract your debts (expenses such as credit card debt, home mortgage, car loans, and so on). Hopefully your assets are greater than your debts; those assets that are left add up to be the value of your net worth.

After you calculate your net worth, you need to consider the type of retirement that you want to have (frugal, extravagant, or something in between). Then you have to figure out how much you need to save along with your pension. Again, the time to set up a budget and begin figuring out how much you need to save is while you're still working and actually have money to budget.

Your pension plan documents are instrumental in helping you understand how your pension benefits are calculated, so it's important to assemble your pension documents and keep them safe. But also be sure to go a step further — get in the habit of checking the accuracy of the personal information that your plan maintains for you. Review the pension SPD, plan amendments, and other items you have in your possession.

Chapter 8 has all the info that you need to help you plan your retirement, including painting a complete picture of your retirement and finding financial help.

Receiving your pension distribution

When it comes to your pension, the bottom line goal is to actually receive your benefits. The first step, then, is to follow your plan's requirements for applying for a pension benefit. Keep in mind the following considerations:

- If you take your distribution before you're 59½ years old, you may be socked with a penalty tax for taking it too soon.
- You may be forced to take a distribution in some instances.
- If you wait until you become 70½, you may be socked with a penalty for taking your distribution too late.
- Special rules apply if the distribution is made after your death.

Also, if your plan offers the option to take your benefits in a lump sum or as an annuity (in which you receive monthly payments for the rest of your life), you need to decide which option is best for you.

One more thing: You need to decide whether you want to roll over your pension money from one tax-qualified plan into another tax-qualified plan or into an IRA. If so, you must be aware of the restrictions regarding what can be rolled over and what it can be rolled over into.

For example, only eligible rollover distributions can be rolled over. These distributions include lump-sum distributions (not annuity payments) that aren't minimum required distributions (that are required at age 70½) and that aren't due to hardships. Your plan administrator will provide you with notice about this prior to your distribution, and you'll have 60 days to roll over part or all of your benefits currently in a tax-qualified plan. If you don't roll over your eligible distribution into an IRA or other tax-qualified plan within 60 days, it will be considered a taxable distribution.

If you fail to roll over your eligible distribution *directly* from the qualified plan to an IRA or other tax-qualified plan, 20 percent of the distribution will be withheld for federal income tax (and 80 percent will be distributed to you). You can still roll over an amount equal to 100 percent of the distribution within 60 days, but because you're receiving only 80 percent, you'll have to come up with the other 20 percent from somewhere else, like your savings account.

You can find many of the answers to your rollover and distribution questions in Chapter 9.

Keeping Your Pension Safe from Your Employer

Sometimes the major pension issue that you face is keeping an eye on the fox that was hired by the farmer (your company) to guard the henhouse (your pension). In other words, your company, like our proverbial farmer, hired a financial advisor called a fiduciary, whose job it is to look after your interests and see that your plan money is invested wisely. This assignment is full of temptations for the fiduciary, who truly can be like a fox in a henhouse. The fiduciary, for example, must resist the temptation to recommend investments that have high fees or that are sold by a broker who might provide a referral fee for the business. In the following sections, we introduce you to the employer issues that can significantly affect your pension.

Watching your fiduciary

A *fiduciary* is someone who offers investment advice to a plan or who has control over plan assets. Your plan fiduciaries may include plan trustees, the plan administrator, pension consultants, and other investment professionals. To remain ethically sound and unbiased, fiduciaries must

- Do what's in the best interests of plan members
- Act with skill, prudence, and diligence
- Follow the plan documents
- Diversify plan assets and minimize expenses

Fiduciaries must not

- Invest the plan's money for their own benefit
- Involve themselves in transactions that aren't in the plan's best interest
- Get money for themselves in exchange for giving another person business

As a member of a pension plan, you need to know who your fiduciaries are. Ask questions. And be curious if your fiduciaries are abusing their power. The fastest way to end a negative practice is to expose it. See Chapter 10 for more information about fiduciaries.

Understanding the impact of acquisitions, mergers, and other major job changes

Your company is in the business of making money; that task is its first priority. So, to a large extent, it makes decisions based on the expected returns. And, well, some business decisions are great for the company but bad for your retirement. It's inevitable that you'll sooner or later come across sales, mergers, bankruptcies, job switches, and other changes that are neither anticipated nor expected. It's quite possible that these activities will affect your pension, so we suggest that you sit up and take notice. The list of possible changes in the case of such events may include the following:

- The termination of your existing pension plan and replacement by a new plan
- The merger of your plan into the plan of a successor company
- A transfer of all the records relating to your pension from one location to another (just think what happens to your luggage when you fly from one location to another)
- The conversion of your defined benefit plan to a defined contribution plan or a cash balance plan
- A reduction or an increase in how your future pension is calculated

The list of changes goes on and on. What's most important, however, is that you're proactive when it comes to protecting your pension. Therefore, when your company goes through big changes, be sure to do the following:

- Find out as soon as you can what changes your company will make and what impact they'll have on your pension.
- Determine the key people who administer the plan and, if appropriate, get to know them.

- Double-check that all of your pension documents have landed in the proper location.
- Make sure that you've received credit for the time that you worked at the previous company and that the rest of your file has the right information.

Head to Chapter 11 for more information on dealing with acquisitions, mergers, job changes, and employer bankruptcies.

Knowing what happens if your plan is changed or terminated

It's true that your pension plan can be amended. But if your plan wants to make changes, it must follow the rules; some options available under the plan are protected from amendments, but others aren't. The plan can ask the Internal Revenue Service (IRS) to issue a determination letter stating that the IRS believes the plan amendment conforms to IRS rules. However, no matter what, if the plan intends to make a significant change, it must provide you with a notice called a *summary of material modifications* (SMM). This document provides a summary of the changes.

Your employer also has the right to terminate its defined benefit plan or defined contribution plan. However, when a qualified plan is terminated, each affected participant becomes 100 percent vested in his or her accrued benefits as of the date the plan terminated. Depending on what kind of plan it is and why the plan is terminated, different rules apply.

A defined benefit plan can be terminated in the following three ways:

- **A standard termination:** Your employer can end the plan in a *standard termination* only after showing the Pension Benefit Guarantee Corporation, or PBGC (the federal agency that insures defined benefit pension plans), that the plan has enough money to pay all benefits owed to its participants. The plan must either purchase an annuity from an insurance company or, if the plan allows, issue a lump sum payment that covers your entire benefit.
- **A distress determination:** If the plan isn't fully funded and your company is in financial distress, your employer may apply for a *distress termination* from the PBGC. However, the application won't be granted unless the employer proves to the PBGC or a bankruptcy court that it can't continue in business unless the plan is terminated. If the PBGC grants the application, it usually takes over as trustee of the plan and pays the plan benefits, up to the legal limits, using the plan's assets and funds guaranteed by the PBGC.

- **An involuntary termination for lack of funds:** Sometimes the PBGC takes action on its own to end a pension plan. An *involuntary termination* usually occurs when the PBGC determines that plan termination is needed to protect the interests of plan participants (for example, if a plan won't be able to pay benefits when due) or of the PBGC insurance program itself.

When a defined contribution plan is terminated, the money in your plan account is yours; it can't be taken away from you for any reason. The PBGC doesn't provide any protection for defined contribution plans because the contributions made to your account are in your own individual account (meaning that whatever's in that account is yours). Interested in finding out more? Check out Chapter 12 for full details on plan amendments and terminations.

Safeguarding Your Pension from Life's Trials

Practically no one gets through life without some trauma, and that trauma may affect your pension:

- You may unexpectedly run short of money, and you may find that the only place to come up with ready cash is to borrow it from your pension plan.
- You may go through a divorce, and your ex-spouse may have rights to your pension that are governed by special provisions.
- You may have to file for bankruptcy. In this case, it's important to know whether your pension will be protected from your creditors.

Even more certain is the fact that everyone alive will someday wind up dead (sorry to be blunt!). In anticipation of that day, it's necessary to consider pension survivorship benefits for your loved ones.

In the following sections, we explain how to keep your pension safe through life's ups and downs.

Getting a loan from yourself

Imagine that you need some money to pay for an unexpected medical bill and that your pension plan is sitting there flush with cash. Your plan, in this case, may appear to be a big, fat available target. However, do remember that strict rules control loans from your pension plan, and real consequences will cost you real money if you break those rules.

A loan from your pension plan is like a loan from the bank. Consider these similarities:

- It must be in writing and must have a reasonable rate of interest.
- A repayment schedule must be prepared and the loan must be secured.

Also, your plan documents must specifically provide that loans are permitted. These documents must set out the procedure for applying for the loan and must establish the basis on which a loan will be approved or denied.

If you fail to pay back the loan on time (in other words, if you *defaulted* on the loan), it's treated as though the plan made a taxable distribution to you (referred to as a *deemed distribution*). This means that you must pay taxes on the outstanding balance of the loan at the time of the default. If this deemed distribution occurs before you're age 59½, you'll have to pay an additional 10 percent tax on the outstanding balance as well. Keep in mind that if the plan offers an annuity form of payment, you also need spousal consent for the loan.

WARNING!

All in all, if possible, try to avoid borrowing from your plan. When you take money out — for whatever reason — that money is no longer working to provide you a sound retirement.

But if taking out a loan from your plan is your only option, it's definitely one worth considering. For the scoop on taking out a loan from your pension plan, see Chapter 13.

Protecting your family

What happens to your pension benefits when you die? In many instances, you can provide for survivorship benefits to a spouse or other designated beneficiary. The extent of those benefits, however, depends on whether you die before or after retirement. The two means of providing survivorship benefits are the *qualified preretirement survivor annuity* (QPSA) and the *qualified joint and survivor annuity* (QJSA). The QPSA typically kicks in if you die *before* you retire while the QJSA kicks in if you die *after* you retire.

Not all plans offer survivorship benefits, however. The rule is that all defined benefit plans must offer survivorship benefits as well as defined contribution plans that provide for a life annuity (which provides a series of regular payments over your lifetime).We cover survivorship benefits in greater detail in Chapter 14.

Watching out for your ex

Divorce is a fact of modern American life. If you're facing a divorce, the judge who's hearing your case has the authority to make provisions from your pension plan for your soon-to-be ex. The judge makes this provision by issuing an order called a *domestic relations order,* which the plan administrator must approve. After approval, the order becomes final and is referred to as a *qualified domestic relations order,* or QDRO for short. The QDRO can allocate pension benefits to provide marital and child support and it can divide marital assets. Your pension benefits may be one of the most valuable assets accumulated during your marriage, and the QDRO is the legal mechanism used to split up those benefits, just as other marital assets are divided between you and your spouse.

The QDRO, however, can't (among other things)

- Provide for benefits that aren't available under your plan
- Provide for benefits for your ex's new spouse

The rules regarding QDROs are complicated, so take a look at Chapter 15 for more details.

Staying safe from creditors and personal bankruptcy

As a general rule, your pension benefits are protected from creditors if you have to file for bankruptcy. In fact, your typical defined benefit or defined contribution pension plan is protected from creditors whether or not you have filed for bankruptcy. This protection is one of the big benefits of a tax-qualified pension plan.

If you do file for bankruptcy, protection from creditors extends also to:

- Traditional and Roth IRAs, which are protected up to $1 million
- SEPs or SIMPLE IRAs
- Section 403(b) plans (tax-sheltered annuity plans) and Section 457 plans (plans for employees of state and federal government)

In some situations you get no protection from creditors. For instance, your pension distributions aren't protected. If you anticipate that creditors may come after you because of financial woes (or, worse, if you have to file bankruptcy), proper planning must be done to make sure that you have no assets available for your creditors. This is an area where the advice of a good bankruptcy or pension attorney is a must to ensure that your retirement savings are in the proper type of plan to receive sufficient protection from your creditors. Don't try to muddle through these issues on your own. For more information, head to Chapter 16.

Taking Action When Necessary

There may come a time when you and the plan have a parting of the ways over what pension amount you're entitled to receive. Fortunately, when this happens, you can assert your rights. As you find out in the following sections, you don't have to like it or lump it. The company may have the big bucks, but a good lawyer on your side can quickly even the playing field. You must take certain measures to protect your rights, starting with filing an appeal to the plan if you're shortchanged and following the plan's appeal process until you've exhausted it. If you still aren't successful, you can bring a lawsuit in federal court.

Eyeing potential distribution problems

Your pension plan has attorneys, accountants, and pension actuaries to help it with its pension issues. At first glance, you would think that a lone pensioner has no chance against such a formidable opponent. Not true. If the plan makes a systemwide error, such as the use of the wrong interest rate, it impacts all retirees the same way. In that instance, it isn't just you against the plan — lots of pensioners who are in the same boat probably have the same claim.

Sometimes your plan may not be aware of its errors, so you should be on the lookout for problems. A few common errors include the following:

- Your wages or years of service haven't been properly reported.
- Your plan ignored new vesting requirements or increases in pension benefits.
- Cuts in benefits have been applied to you retroactively.

What you should *not* do is nothing. Be proactive and intercept small problems before they become big ones. Head to Chapter 17 for full details on potential distribution problems.

Filing your claim and appealing a denial

The first step in actually receiving your pension benefits is filing a claim with your plan. Plans have set procedures in their SPDs for how to file a claim. Make sure that you comply with the plan's rules for filing your claim. You can expect to hear back from your plan within a certain period of time after it receives your claim; if you don't file properly, you'll never know when your time starts to run or if the plan is even processing your claim.

After successfully filing, if your claim for benefits is denied in full or in part, you'll receive a denial letter. At this point, you must file an appeal to protect your rights. The plan and the denial letter tell you exactly how to file this appeal. If you fail to appeal the denial of your claim in a timely manner and you don't follow the plan's procedures as required, you may find yourself in the position of not being able to file a lawsuit down the road, if necessary. We cover the entire appeal process in Chapter 18.

If you lose the appeal, you must decide if you want to take the plan to court. If you decide that you do want to sue the plan, keep reading to find out what comes next.

Hiring a lawyer

There's really no magic in hiring the right lawyer. If you're involved in a pension case, hire a pension attorney. If your claim is going to be brought under ERISA, find an ERISA specialist who practices in federal court. You may also be able to find a lawyer who handles state-based pension cases. Whatever the case may be, the lawyer you choose should not only be familiar with the subject matter, but also should have some record of success in bringing these types of cases. Set up a meeting to interview the attorney under consideration to help determine if he or she is the right choice.

TIP

Before you see the attorney, gather the relevant documents and have a clear idea of what your concerns are. We explain exactly what you need to do to hire the best attorney for your needs in Chapter 19.

Litigating a pension claim

ERISA provides that you have a right to sue your plan. And you don't have to worry about backlash from your employer or plan because ERISA also forbids employers and plans from retaliating against a pension participant because of a claim that he or she brought against them. So if you need to file a claim, have at it.

Once a pension lawsuit is filed in court, it follows a predictable path. It starts with the filing of the complaint by the plan participant and the answer that's filed by the defendant (the plan). From there it moves to the discovery process by the parties to figure out the position of each side. Then it's time to file a motion with the court asking for a ruling in your favor. If you aren't fortunate enough to win this summary judgment motion, your case will most likely go to trial unless it's settled before that. We dissect the basics of pension litigation in Chapter 20.

Many pension cases are filed by one or two individuals on behalf of a group (called a *class action*), because the claims of the pensioners may be virtually identical. Court approval is necessary in order for the case to be considered a class action, but if it's granted, the court then monitors the class action to ensure that the rights of the group are protected by the representative client and the attorneys who file the case. Tens of thousands of pensioners have recovered large amounts of money through pension class actions. Obviously it's preferable to get the correct pension benefit right off the bat, but even years after your initial distribution it may not be too late to right a wrong.