



Retirement Pension Plans

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Background

A [PENSION](#) plan is an organized investment program designed to provide income during older age or retirement years. Pension plans may be individually arranged or come through an employer. Because most qualified programs and plans offer a form of social insurance, the federal government treats them favorably, with deferred [TAXATION](#) and portability benefits.

- **Tax Treatment:** Pension fund contributions from both individuals and contributing employers are tax [DEDUCTIBLE](#). Fund earnings on the invested contributions are tax deductible. Benefits are not taxed until they are actually paid out—during retirement years when retirees would presumably be in a lower tax bracket. It is this treatment that provides the incentive for most persons to invest in pension plans rather than savings accounts or other investments, which are taxed when the interest is earned or the investment growth is "realized."
- **Portability:** Formal pension plan administrators may invest pension funds in various portfolio schemes and may move funds around to maximize investment return. Likewise, individuals may "roll-over" funds from one account to another, without invoking a tax penalty (in most cases) and without losing the funds' distinction as constituting part of a "pension plan."

Employer Provided Pension Plans

A pension plan is a contract between employer and employee. However, an employer can modify or alter the plan unilaterally in most cases. In the United States, most employer-provided pension plans are "defined benefit plans"; the other major type is referred to as a "defined contribution plan."

- **DEFINED BENEFIT PLANS:** Under such plans, employees receive benefits based on a formula, usually years of service and percent of salary. This arrangement promises the employee a benefit in the form of a specific dollar amount per payment period during retirement. For example, the plan might specify that a worker will receive an annual pension equal to 1.5 percent of his or her average salary over the most recent five years, times the years of service. Upon retirement, the employer or plan administrator pays that specific amount.
- **DEFINED CONTRIBUTION PLANS:** Under these plans, employers pay a specific amount or percentage into a pension fund annually. The funds are allocated to individual employee accounts. Retiring employees receive benefits according to how much money they have in their fund upon

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retirement. This may be taken as a lump sum or used to purchase an [ANNUITY](#) that will pay monthly benefits for a set number of years. The amount of annuity benefit and the years payable depends on how much was in the fund at retirement.

- **EMPLOYEE STOCK OPTION PLANS (ESOPs):** ESOPs are considered defined contribution plans. In such plans, employees either earn (as an employee benefit) or purchase company stock. At least 51 percent of the assets of an ESOP must be invested in the company. (Conversely, regular defined benefit or defined contribution pension programs may not invest more than ten percent of funds into company stock, excepting some 401(k) plans.) ESOPs enhance employee motivation and productivity but also create risk because a large portion of an employee's retirement wealth is all in one investment.
- **SIMPLIFIED EMPLOYEE PENSION PLANS (SEPs):** Under these plans, employers merely contribute to employees' private individual retirement accounts (IRAs).

Plan Termination

Pension plan terminations may be standard, distress, or involuntary in nature. The Single Employer Pension Plan Act of 1986 provides extensive detail regarding the conditions of each, not relevant here. What is relevant is that all terminations must be reviewed by the Pension Benefit Guarantee Corporation (PBGC) (see below).

When plans are terminated by employers, benefit accrual ceases. With defined contribution plans, the employer may cease contributions and pass fund management responsibilities to an insurance company. With defined benefits plans, the options are more complex, as well as controversial if fund assets do not at least equal the present value of promised benefits. However, if fund assets exceed pension liabilities, the excess assets may legally be reverted back to the company, although that practice has been severely hampered by the Pension Protection Act of 1990. (As of 2002, companies must pay a 50 percent [EXCISE](#) tax on any surplus funds pulled out of pension plans.)

Employee Rights

Under provisions of the **EMPLOYEE RETIREMENT INCOME SECURITY ACT** of 1974 (ERISA), employees that are part of a pension program are entitled to certain information and/or access to certain information regarding their individual accounts and the entire fund or plan. Generally, employees are entitled to the following:

- A copy of the plan within 90 days of enrollment
- Notice regarding any changes in the plan (an updated version must be furnished every five years)
- An accounting of the total benefit to which the employee is entitled at any given point
- Notification of the specific vesting schedule being used
- Final statement of account upon leaving employment with the company

Individual Retirement Pension Plans

For those persons who do not have employer-sponsored pension programs, the federal Internal Revenue Code (IRC) offers comparable advantages to private pension fund participants. It is intended to encourage individual workers to set aside a percentage of their earnings, tax-free, until retirement.

Individual Retirement Accounts (IRAs)

Individual Retirement Accounts (IRAs) are private accounts into which persons may contribute up to \$2000 (for individuals) or \$2250 (for individuals and a non-working spouse) annually. Starting with the 2002 tax year, the amounts are \$3000 for individual accounts, and \$3500 for persons over 50 years old. The contributions are tax-deductible. As with other plans, benefits are taxed upon withdrawal at retirement.

401(k) Plans

Officially, these are cash or deferred profit sharing plans, more often referred to as "401(k) plans," after the section in the Internal Revenue Code, discovered by a pension consultant in 1978, that provided a tax loophole permitting the creation of these plans. Under 401(k) plans, participants contribute portions of their earnings (which are matched or enhanced by employer contributions) to private pension accounts. Participants elect to receive direct cash or stock payments from the employers or choose to have them contributed to a trust. All taxes on the contributions, as well as any investment earnings, are tax deferred until the funds are withdrawn at retirement. Like ESOP plans, 401(k) plans put "many eggs in one basket." That is risky and yet may prove extremely profitable.

Keogh Retirement Plans

Keogh Plans, also known as H.R. 10 plans, are intended for self-employed individuals who want to establish private pension plans. A self-employed individual may contribute up to 15 percent of earned annual income into a Keogh account, with yearly caps.

Pension Fund Protections

Employee Retirement Income Security Act of 1974 (ERISA)

ERISA is the controlling body of law governing retirement plans, and preempts ("trumps") any state law addressing them. The original goal of ERISA was to reform defined benefit plans by ensuring diversification of invested funds. It prohibited the investment of any more than ten percent of a pension fund's assets in company stock (ESOPs and other profit-sharing plans such as 401(k) plans are exempted.) Some of the many protections that ERISA affords are:

- Employers can no longer decide who is qualified to belong to a pension program. Under ERISA, any worker aged 21 or older who has worked for at least one year qualifies for participation.
- Employers can no longer withhold "vesting" rights (the percentage of benefit an employee is entitled to receive after a specified period of employment) until retirement. ERISA established three vesting schedules that employers must follow.
- Prior to ERISA, there were no rules regarding proper funding for pensions; thus, underfunded programs became every retiree's nightmare. ERISA now formulates funding of pension programs to ensure that fund assets cover accrued liabilities. Under complex rules, it permits companies to amortize funding deficiencies over several years.
- Under ERISA, widows and widowers are generally protected by survivor's rights to pensions. These protections are afforded through "joint and survivor annuity" provisions, which must be affirmatively elected by the plan participant.
- ERISA creates [FIDUCIARY](#) duties (duties of trust and confidence, requiring that the person act primarily for the benefit of another and not for himself/herself) on the part of plan administrators, who must act in the interest of plan beneficiaries.

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- ERISA requires that investment funds be diversified to minimize risk to plan participants.
- ERISA imposes severe penalties for under-funding of pension plans.

Pension Benefit Guarantee Corporation (PBGC)

A provision in ERISA created the non-profit Pension Benefit Guarantee Corporation (PBGC) to afford certain protections against insolvent pension plans. Importantly, PBGC remedies and assistance only come into play for defined benefit plans. PBGC insures vested pension benefits up to the legally established amounts and guarantees payment of benefits under certain types of employer insolvencies.

Other Remedies

The U.S. Supreme Court has ruled that a company's pension plan liability is a debt that cannot be transferred to the PBGC while the corporation continues to operate following Chapter 11 [BANKRUPTCY](#) proceedings and reorganization. Companies who under-fund their pension programs or companies that are financially troubled may be forced to [LIQUIDATE](#) in Chapter 7 bankruptcies.

Federal Laws that Impact Pension Plans and Pension Programs

The following federal laws (not a comprehensive list) affect a variety of issues relating to pension benefits and underscore the scope and complexity of pension plan programs. Persons are encouraged to seek legal [COUNSEL](#) for any issue relating to pension plans or fund participation.

- Employee Retirement Income Security Act of 1974 (ERISA)
- Welfare and Pension Plans Disclosure Act of 1958 (WPPDA)
- Labor-Management Reporting and Disclosure Act of 1959 (LMRDA)
- Tax Reform Act of 1976
- Revenue Act of 1978
- Multi-Employer Pension Plan Amendments Act of 1980 (MPPAA)
- Economic Recovery Act of 1981 (ERTA)
- Tax Equity and FISCAL Responsibility Act of 1982 (TEFRA)
- Retirement Equity Act of 1984 (REA)
- Deficit Reduction Act of 1984 (DRA)
- Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA)
- Single Employer Pension Plan Amendments Act of 1986 (SEPPA)
- Omnibus Budget Reconciliation Act of 1986 (OBRA)
- Tax Reform Act of 1986 (TRA)
- Pension Protection Act of 1987 (PPA)
- Worker Adjustment and Retraining Act of 1989 (WARA)
- Uniformed Services Employment and Reemployment Rights Act
- Pension Protection Act of 1990 (PPA)
- Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)
- Pension Security Act of 2002 (As of 2002 Pending)

Additional Resources

"A Predictable Secure Pension for Life." Federal Consumer Protection Information Center. Available at http://www.pueblo.gsa.gov/cic_text/money/secure-4life/secure...

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Fundamentals of Employee Benefits Programs. 5th ed., Employee Benefit Research Institute (EBRI), 1997.

Managing Corporate Pension Plans. Logue, Dennis E., HarperCollins Publishers, 1991.

"Pensions." McMillan, Henry. Available at <http://www.econlib.org/library/Enc/Pensions.html>.

Organizations

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