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**Comparison of defined benefit plans versus defined contribution plans**

Defined benefit plans and defined contribution plans are two different types of plans designed to compensate, attract, and retain employees. Defined benefit plans or “pension plans” are post employment benefits calculated based on a variety of factors such as years of service, compensation, position within the company, and sometimes age. Defined benefit plans typically pay out an income stream determined by the aforementioned variables over the lifetime of a retired employee. The future payments are typically guaranteed by the company and have similarities to a lifetime annuity. The future stream of payments is often adjusted for other factors such as cost of living. An actuary assists in determining pension costs based on several variables. Accounting for defined benefit plans is cumbersome and involves many actuarial assumptions which may have questionable accuracy.

Defined benefit plans are costly to maintain and to fund. Many State and private pension plans are severely underfunded. Market losses on pension funds have been severe in recent years, further compounding the problem. Due to the complications, current, as well as future unknown expenses, defined benefit plans are being adopted less and less. Many companies with legacy plans, such as AT&T choose to give employees “Golden Parachutes,” so pension participants may exit the plan before their benefits increase due to the formula used to compute pension benefits. The California Public Employees' Retirement System (CalPERS), is struggling with underfunded plans and poor investment returns as well. All of these factors have resulted in many companies adopting defined contribution plans.

Defined contribution plans promise fixed contributions to an employer fund, typically based on employee participation or employee compensation. Section 401(k) of the Internal Revenue Code was added to allow employers to offer such a plan. Contrasted with pension plans, a typical defined contribution plan is much less costly for employers. The burden of investing and retirement savings is also shifted to the individual employee. Defined contribution plans offer both employer and employee tax advantages. Employer contributions appear as they are made in the employee’s individual account. Employer contributions can become vested (property of the plan employee) instantly, or be on a vesting schedule. Such a vesting schedule is designed to retain employees and further reduce the overall cost of the plan for employers. Employee contributions vest immediately.

Almost always, the employee is charged with the investment responsibility for the underlying funds. This feature is enjoyed by some, but arguably may place too much responsibility on employees not capable of making wise investment decisions. Defined contribution plans also carry the benefit and risk of portability. Plan assets can typically be conveniently consolidated at the termination date of employment. One possible downside of portability, however, is the amount of responsibility placed on the employee. Often, employees withdraw these funds with punitive tax consequences. The defined contribution plan is here to stay and has many good aspects. The benefit of mass availability cannot be overlooked. These plans are inexpensive enough for small businesses to establish. Defined benefit plans offers mass availability relatively cheaply, but arguably shifts the burden of retirement savings to the employee. I don’t think a “5% matching contribution” is going to realistically put much of a dent in my hypothetical retirement income.

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