



# Defined Benefit vs. Defined Contribution Plans

Qualified retirement plans fall into two broad categories based on the formula that defines them. The first is the Defined Benefit (DB) Pension Plan. These plans specify the amount the plan will pay to participants upon retirement. The second category is the Defined Contribution (DC) plan. DC plans define the amount that will be contributed to the plan rather than the amount to be disbursed. Here we will outline the key differences between the two.

## Defined Benefit Plan (DB)

- Benefit is a defined formula
- Benefit equals promised distribution based on formula
- Employer bears the investment risk
- Investment performance affects employer contribution
- PBGC (Pension Benefit Guarantee Corporation) guarantees a portion of benefit (when covered)
- Minimum funding requirements
- Preferred by older employees
- Trending downward in popularity (except for Cash Balance plans)

## Defined Contribution Plan (DC)

- Contribution is a defined formula
- Benefit equals accumulated account value
- Participant bears the investment risk
- Investment performance does not affect employer contribution
- Benefits are not guaranteed (no PBGC coverage)
- No required funding unless safe harbor
- Preferred by younger employees
- Trending upward in popularity

## Paradigm Shift

Within the private sector employer-sponsored plan marketplace, there is a clear shift away from traditional DB plans, and toward DC plans. The most common plan type today is the participant-directed 401(k) plan, a type of DC plan that allows both employee and employer contributions. Since DB plans are entirely funded by the employer, sponsors have been quick to mitigate the responsibilities of funding and investing by embracing the DC model. Participants also appear to prefer the DC approach where they can control their asset accumulation, direct investments, and watch their balance adjust daily. Another aspect to consider is the risk of superannuation. Pension (DB) plans have long been popular for their lifetime monthly payouts, usually not available directly from a DC plan. However, there is growing sentiment to add this feature to DC plans. In any event, participants can use their benefit from a DC plan to purchase an annuity-type investment after receiving their distribution. Ultimately this option is not entirely unavailable when using a DC plan, but rather one step removed.

## Cash Balance Plans

While DB plans have declined in popularity, there is one type of DB plan that is rapidly gaining ground. Cash Balance (CB) plans are DB plans that look like a DC plan. These so-called “hybrid plans” contain a promised benefit formula, but also disclose a hypothetical account balance to participants annually. The key advantages to the CB plan are the increased contribution limits achieved through the DB testing method, which can be far in excess of those afforded under a DC stand-alone plan. Combining both a CB plan and a 401(k) can often produce the optimal tax-deductible employer contribution. This is a great way for successful business owners with stable cash flow to meet their retirement goals while providing a quality plan for their employees.

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