Defined Contribution or Defined Benefit: What is the difference?

Defined Contribution

A defined contribution plan includes profit sharing and 401(k) plans.

Once the contribution to the plan is made by the employer, all investment risk is placed upon the participant and the plan may permit the participant to direct their own investments.

The most a participant can receive from all sources is $51,000 (plus $5,500 in catch up contributions if over 50).

Defined Benefit

Promises a benefit funded by the company. The amount of the benefit is determined by the terms of the plan document.

The required contribution is actuarially determined as the amount necessary to fund the required benefit.

No limit on the contribution into the plan, but on the benefits paid by the plan.

- The maximum benefit is a life annuity of $195,000 per year, payable at age 62.

- There are certain compensation and service requirements necessary to receive the maximum benefit.

- In general, the closer a person is to retirement age, the larger the required contribution.

- Contributions in excess of $205,000 on behalf of a participant are possible.

Investment risk always lies with the employer since the benefit is guaranteed.

- Participant's benefit cannot vary based on performance of plan assets.

- If trust performs better than assumed, funding requirement decrease but if trust performs worse, increased contributions will be necessary.

- There is no participant direction of investments. All assets are pooled and trustee directed.

Drawbacks of Traditional Defined Benefit Plans

Contribution requirements increase with salary increases.

Older employees cost more than younger employees who earn the same amount.

Partners/shareholders could have significantly different benefit/contribution levels.

Benefits are difficult to understand or appreciate.

- What is $125 per month at age 62 worth when you're 48?

What are Cash Balance Plans?

A cash balance, or hybrid, plan is a defined benefit plan where the benefits are expressed in terms of a guaranteed account rather than a guaranteed benefit.

The maximum benefits are the same as for all defined benefit plans.

Each year the participant’s hypothetical account is given a pay credit and an interest credit. The pay credit could be defined as a percent of compensation, a flat dollar amount or some other non-discriminatory formula. The interest credit can be a fixed percentage or a variable rate tied to an index.

Because it is a defined benefit plan, the employer bears the investment risk. This will result in actual contributions varying from pay credits as actual earnings differ from the crediting rate.

Participants receive easily understandable statements showing the value of their account. Upon termination, their benefit is the value of their vested account balance.

Even though it looks like a profit sharing plan, it is not. Funding a cash balance plan is not discretionary and the required amount is determined by current funding rules.

What are the advantages?

Easy to understand benefits

Benefits paid directly track to contributions made

Age neutral contributions for employees

Can be designed to fund a buy-out for partners

Good candidates for Cash Balance Plan

- Any current cross-tested/new comparability profit sharing plan sponsor
- Highly profitable companies of all types and sizes
  - The owner's desire a larger tax deduction and principals earn more than $255,000 per year.
- Family businesses
  - The plan can be used as a component of succession planning.
- Closely-held businesses
  - Several owners want a greatly enhanced retirement plan.
- Law firms and medical groups of all sizes
  - Tax deferral and asset protection are often very important to these professions.
- Professional firms of all types
  - CPAs, engineers, architects...
- Older owners who have delayed saving for retirement
  - They need to squeeze 20 years of saving into 10 or 5.