5. Defined Benefit and Defined Contribution Plans: Understanding the Differences

Introduction

Both defined benefit and defined contribution pension plans offer various advantages to employers and employees. The features of each are generally distinct and quite different. This chapter describes the basics of each plan type, then looks at the specific factors that make each approach different.

Defined Benefit Plans

In a defined benefit plan, each employee’s future benefit is determined by a specific formula, and the plan provides a nominal level of benefits on retirement. Usually, the promised benefit is tied to the employee’s earnings, length of service, or both. For example, an employer may promise to pay each participant a benefit equal to a percentage of the employee’s final five-year average salary times number of years of service at retirement, or the employer may pay a flat dollar amount per year of service. A defined benefit plan is typically not contributory—i.e., there are usually no employee contributions. And there are usually no individual accounts maintained for each employee. The employer makes regular contributions to the plan to fund the participants’ future benefits. The employer bears the risk of providing the guaranteed level of retirement benefits. In 1993, 56 percent of full-time employees of medium and large private establishments were covered by defined benefit plans (U.S. Department of Labor, 1994).

Defined benefit plan sponsors may choose from several formulas for determining final retirement benefits. These include:

- **Flat-Benefit Formulas**—These formulas pay a flat-dollar amount for every year of service recognized under the plan.

- **Career-Average Formulas**—There are two types of career-average formulas. Under the first type, participants earn a percentage of the pay recognized for plan purposes in each year they are plan participants. The second type of career-average formula averages the participant’s yearly earnings over the period of plan participation. At retirement, the benefit equals a percentage of the career-average pay, multiplied by the participant’s number of years of service.

- **Final-Pay Formulas**—These plans base benefits on average earnings during a specified number of years at the end of a participant’s career (usually five years); this is presumably the time when earnings are highest. The benefit equals a percentage of the participant’s final average earnings, multiplied by the number of years of service. This formula provides the greatest inflation protection to the participant but can represent a higher cost to the employer.

Defined Contribution Plans

In a defined contribution plan, employers generally promise to make annual or periodic contributions to accounts set up for each employee. (Sometimes defined contribution plans are referred to as individual account plans.) The current contribution is guaranteed but not a level of benefits at retirement, as in a defined benefit plan. In 1993, 49 percent of full-time employees in medium and large private establishments participated in one or more defined contribution plans, up from 45 percent in 1988 (U.S. Department of Labor, 1994).
The contribution to a defined contribution plan may be stated as a percentage of the employee’s salary and/or may be related to years of service. Sometimes there are only employer contributions, sometimes only employee contributions, and sometimes both. The benefit payable at retirement is based on money accumulated in each employee’s account. The accumulated money will reflect employer contributions, employee contributions (if any), and investment gains or losses. The accumulated amount may also include employer contributions forfeited by employees who leave before they become fully vested, to the extent such contributions are reallocated to the accounts of employees who remain. These are called forfeitures.

There are several types of defined contribution plans, including money purchase plans, profit-sharing plans, 401(k) arrangements, savings plans, and employee stock ownership plans (ESOPs). These are described briefly below. (For more detail, consult individual chapters on these plans.)

**Savings, or Thrift, Plan**—A savings, or thrift, plan is essentially an employee-funded savings plan. An employee generally makes contributions on an after-tax basis to an account set up in his or her name. The contributions are often stated as a percentage of pay. The contributions may be matched (in full or in part) by the employer, but there is no statutory obligation for employer contributions.

**Profit-Sharing Plan**—A profit-sharing plan provides for contributions to the plan sometimes based on annual profits for the previous year. However, profits are not required for contributions, and a company is under no obligation to make contributions on a regular basis. Contributions are typically divided among participants in proportion to their respective earnings.

**Money Purchase Pension Plan**—Employer contributions are mandatory in a money purchase plan. They are usually stated as a percentage of employee salary. Retirement benefits are equal to the amount in the individual account at retirement.

**Employee Stock Ownership Plan**—An ESOP is a tax-qualified employee benefit plan that provides shares of stock in the sponsoring company to participating employees. An ESOP is required to invest primarily in employer stock and is permitted to borrow money on a tax-deductible basis to purchase this stock.

**401(k) Arrangement**—A qualified cash or deferred arrangement, under sec. 401(k) of the Internal Revenue Code (IRC), allows an employee to elect to have a portion of his or her compensation (otherwise payable in cash) contributed to a qualified profit-sharing, stock bonus, or pre Employee Retirement Income Security Act of 1974 (ERISA) money purchase pension plan. The employee contribution is most commonly treated as a pretax reduction in salary.

An employer may adopt a defined contribution plan:

- as a step toward achieving employees’ retirement income security;
- to supplement an existing defined benefit plan;
- to avoid the long-term funding and liability commitments, as well as the more burdensome regulations, of a defined benefit plan; and
- to create a program that provides benefits for short-term workers.

To illustrate the basic differences between the two approaches, the discussion in this chapter will focus on the major considerations involved in an employer’s selection of a plan and the differences for employees. These include achievement of objectives, plan cost, ownership of assets and investment risk, ancillary benefit provisions, postretirement benefit increases, employee acceptance, employee benefits and length of service, plan administration, taxes, and regulations.
Achievement of Objectives

A foremost objective for many employers in adopting a retirement plan is to provide future retirement income to employees. Another is to help to maintain organizational efficiency and vitality. Sometimes a goal is to help reward long-term employees. Such goals usually require plans to be available for long periods of benefit accumulation.

A defined benefit plan can provide a meaningful retirement benefit for employees who remain with one employer throughout their career. An employee's earnings generally grow over the years, and if years of service are calculated, the longer the employee works for one employer, the greater the benefit. In addition, employees who begin employment with a new employer later in life can benefit from a defined benefit plan that is based on final average pay or career earnings. However, for employees who change jobs frequently, especially at younger ages, a defined contribution plan offers more portability. A defined contribution plan often has a shorter vesting period—i.e., the period of service required before the employee becomes entitled to the benefit.

Plan Cost

In adopting a defined benefit plan, an employer accepts an unknown cost commitment. Numerous factors determine the cost of promised benefits, including the rates of return on investment, the number of employees working until they become vested in a benefit, the nature of future government regulatory changes, and future employee pay levels. The unknown cost aspect of defined benefit plans is sometimes considered a deterrent. Employers estimate the unknown cost by projecting future interest earnings, mortality rates, personnel turnover, and salary increases; thus, they attempt to establish a reasonably level funding pattern. Moreover, the plan’s assets and liabilities are evaluated periodically (usually annually), and contribution adjustments can be made on a regular basis. Within legal limits, the employer is permitted to vary contributions from year to year. Therefore, defined benefit plan sponsors are permitted a certain amount of contribution flexibility.

Defined contribution plan sponsors generally know the plan’s cost on a yearly basis. The employer pays a set amount—usually on a regular basis. This cost control feature appeals to many employers, particularly newer and smaller companies. Some funding flexibility is possible under some types of defined contribution plans by basing employer contributions on profits, thus allowing the employer to temporarily forgo contributions during economic hardship.

Ownership of Assets and Investment Risk

The ownership of plan assets differs between defined benefit and defined contribution plans. In a defined contribution plan, contributions can be viewed as a deferred wage once an employee has become vested. The full vested value of each participant’s account can be considered owned by the employee. Vested benefits are often distributable to employees on employment termination. Under defined contribution plans it is the employee who bears the investment risk. Favorable investment results will increase benefits, while unfavorable results will decrease benefits.

In a defined benefit plan, vested benefits can again be viewed as a deferred wage. It is here, however, that the difference in investment risk becomes important. Defined benefit plan sponsors assume an obligation for paying a stipulated future benefit. Consequently, the employer accepts the investment risk involved in meeting this obligation. If the pension fund earns a lower-than-expected yield, the employer will have to make additional contributions in order to provide the promised benefits. If the pension fund investment...
results are better than expected, the employer can reduce annual contributions or increase the level of benefits, perhaps on an ad-hoc basis. (See the following section on postretirement benefit increases.)

Ancillary Benefit Provisions

Although retirement plans are intended first and foremost to provide retirement income, they must, under some circumstances, make some provision for paying benefits in the event of a participant's death. (For further discussion of death benefits, see chapter 4 on pension plans.) Most plans provide early retirement benefits as well. To receive ancillary benefits, employees may be required to satisfy certain eligibility requirements, although the law places limits on such requirements.

Defined contribution thrift and profit-sharing plans usually pay a vested employee's individual account balance in full on death, employment termination, retirement, or disability. Defined benefit plans frequently distribute the vested benefit as a stream of level monthly payments for life or for some stated period beginning at the time the employee retires early, at the normal age, or later. This is called an annuity.

Postretirement Benefit Increases

During periods of inflation, the pensioner's financial position is brought into sharp focus. In such periods, retired employees living on fixed pensions, or on incomes derived from investing lump-sum retirement distributions, have been affected by the dollar's declining value. Automatic Social Security benefit increases have helped, but they frequently have not provided total retirement income increases comparable with inflationary increases for above-average earners.

Most employers are concerned about their retired workers' financial problems. However, few sponsors of defined benefit plans can afford the uncertainty of providing automatic cost-of-living adjustments under their plans. If resources are available, many employers are willing to voluntarily grant ad hoc benefit increases after retirement to help offset inflation. Defined contribution thrift and profit-sharing plan sponsors usually provide the option of lump-sum distributions at retirement. Money purchase pension plans may require that pension benefits be taken in the form of an annuity.

Employee Acceptance

By nature, defined benefit plans are complex. The formulas are often complicated. The legal documents explaining the plan and employee rights under the plan can be difficult to understand. Numerous government regulations have added more and more complexity to the operation of defined benefit plans, making them more difficult to understand. Sometimes, promised future benefits may seem remote to the employee, and the current dollar value of benefits is not clear.

Defined contribution plans can also be complex, but their complexity is less apparent to employees. Defined contribution plan participants have individual accounts; their accounts usually have known values expressed in dollars rather than benefit formulas. And the ability of employees to take accumulations in a lump sum at employment termination is often appealing.

Pension Benefits and Length of Service
Defined contribution plans offer distinct advantages to employees who change jobs frequently. Vesting provisions in these plans are generally more liberal than those for defined benefit plans. Many defined contribution plans provide at least partial vesting of employer contributions after two or three years of service. Employee contributions are always immediately and fully vested—as they are in defined benefit plans. Additionally, vested benefits under thrift and profit-sharing plans are normally paid in a lump sum at employment termination, but under defined benefit plans they are usually paid as an annuity.

Alternatively, defined benefit plans often have cliff vesting, with no vesting of benefits promised by the employer until employees work a certain number of years (capped by law). And defined benefit plans do not usually provide payment of vested benefits at employment termination; participants receive deferred monthly income when they become eligible to retire from employment. However, the benefit amount is usually frozen at termination, and the employee is exposed to future inflation unless the benefit is indexed to reflect cost-of-living adjustments.

Defined benefit plan benefit formulas may anticipate late-age hirings; they may be designed to provide adequate retirement benefits for employees with fewer years of service. This offers an advantage for the employee making a permanent job commitment relatively late in his or her career. Under defined contribution plans, employees hired later in life are less likely to accrue meaningful retirement benefits.

Plan Administration

Both defined benefit and defined contribution plans can be complex to administer; they usually require trained internal staffs and/or outside advisors. Defined contribution plans offer some administrative advantages over defined benefit plans. First, defined benefit plans require the use of actuarial projections that take into account the future number of employees, ages, life span, earnings, and other demographic characteristics. Defined contribution plans do not. Second, provisions of the tax code and ERISA tend to have less impact on defined contribution plans than on defined benefit plans. For example:

- Defined benefit plans must satisfy both minimum and maximum funding standards. (For more information on funding standards, see chapter 3 on ERISA.) Generally, defined contribution plans do not have to satisfy these standards.
- Most defined benefit plans must calculate and pay insurance premiums to the Pension Benefit Guaranty Corporation (PBGC) to protect pension benefits in the event of plan termination. Defined contribution plans are by nature fully funded; therefore, they do not present the risks of defined benefit plans and are not subject to the pension insurance program. This also makes it administratively easier to terminate a defined contribution plan because approval by PBGC is not necessary. (For further information on PBGC premiums, see chapter 3 on ERISA.)
- ERISA originally set limits on the maximum benefits that could be paid from defined benefit plans and on maximum contributions to defined contribution plans. Several laws since ERISA have made changes to those benefit limits but with generally fewer and less restrictive limits on defined contribution plans. The calculation of these limits can be quite complicated.
- Defined benefit plans usually must provide more detailed and complicated actuarial disclosure reports than defined contribution plans. But, for defined contribution plans, recordkeeping can also pose complications, especially when employees are allowed different investment options or when loan and/or withdrawal provisions are provided.
Taxes

For employers, the tax impact under defined benefit and defined contribution plans is quite different. Under a defined contribution plan, employer contributions are a deductible business expense in the year they are paid to participants’ accounts, subject to certain statutory limits. In a defined benefit plan, an employer must contribute a minimum amount to fund the future benefit, for which a tax deduction is also allowed. But the employer may not overfund the plan and has a maximum limit that cannot be exceeded without tax penalty.

For employees, the tax considerations associated with each plan are essentially the same. Employees do not pay taxes on employer contributions, investment income, or capital gains of retirement plan assets until they receive benefits. However, employees in defined benefit plans have traditionally paid taxes on their own plan contributions in the year such income was earned. Most private defined benefit plans do not require employee contributions, but public-sector defined benefit plans commonly do.

Under defined benefit and defined contribution plans, benefits are subject to income taxation when received by the employee. The tax consequences depend on the form of benefit payment, not on the type of plan. Lump-sum distributions are treated the same, for example, whether paid from a defined benefit or a defined contribution plan. If the benefit is in the form of an annuity, which is typical under defined benefit plans, ordinary income tax rates apply. (A portion of any employee contribution to the plan is considered a return of the contribution and therefore is not taxable.) The advantage here is that traditionally the employee has been in a lower income tax bracket when retired than during his or her working years, although this has become less likely under current tax laws. A distribution in the form of a lump sum may qualify for special tax treatment. Lump-sum distributions are common in defined contribution plans, especially for smaller amounts. (For further discussion of the taxation of lump sums and annuities, see chapter 4 on pension plans.)


Conclusion

In the past, defined benefit plans were generally adopted as the primary vehicle for meeting employees’ retirement income needs. More recently, due to changes in legislation, employee attitudes, and the mobility of the work force, there is more interest in defined contribution plans. Over the last 10 years, the number of defined contribution plans has grown at a much faster rate than that of defined benefit plans (Employee Benefit Research Institute, 1995). Some employers believe that the most effective retirement program combines the two types of plans, making maximum use of the particular cost and benefit advantages of each.

An employer could, for example, adopt a defined benefit plan that provides a modest level of benefits and supplement these benefits with a defined contribution thrift, profit-
sharing, or 401(k) plan. The employer’s cost risk under the defined benefit plan is decreased, while the two plans combine benefits to satisfy income adequacy standards.

Employers might also adopt a single plan that incorporates characteristics of both defined benefit and defined contribution plans. One type is a cash balance pension plan. (For a discussion of cash balance and other hybrid plans, see chapter 10.) Relatively new to the field, it is a defined benefit plan with features common to defined contribution plans. Another type is a target benefit plan, which is a defined contribution plan that has defined benefit plan features.

Defined benefit and defined contribution plans have distinctly different features that offer various advantages and disadvantages for both employers and employees. A close examination of all these features is important for employers in deciding whether to adopt a plan and for employees in understanding the plan in which they participate.

1 Disability benefits may also be provided.