

Defined Contribution Plans...An Overview

Description:

In a defined contribution plan, the employer makes a stated annual contribution to the plan, which is then allocated to plan participants' accounts and invested on their behalf. When a plan participant retires, the amount of his or her retirement benefit is based on the value of the participant's account at retirement.

Types of Defined Contribution Plans:

- **Money Purchase Pension Plans:** Employer contributions are required and are generally based on a fixed percentage of employee compensation, such as 10% of compensation.
- **Savings or Thrift Plans:** Mandatory employee contributions, which the employer then matches to a stated degree, are usually required in a savings or thrift plan. For example, the employer may match, dollar for dollar, employee contributions up to 3% of compensation. Since mandatory employee contributions in a savings or thrift plan are not tax deductible, these plans are less popular than 401(k) plans, which provide for before-tax employee contributions.
- **Target Benefit Plans:** While classified as a defined contribution plan, a target benefit plan is a hybrid plan. As in a defined benefit plan, annual employer contributions are based on the amount needed to provide a "target" retirement benefit using an assumed interest rate, which produces larger contributions for older employees. The plan then operates like a money purchase pension plan, with the employer making the required annual contribution and the employee receiving a retirement benefit determined by the value of his or her account at retirement.

Advantages:

- Defined contribution plans tend to be easier to set up, administer and explain to employees.
- The employee assumes the risk of investment performance. The employer's only obligation is to make the contributions required by the plan.

Disadvantages:

- Since defined contribution plans tend to favor younger employees, who have a longer time period in which their retirement accounts can grow, it may not be possible with a defined contribution plan to provide a substantial retirement benefit to older owner-employees or key employees who have fewer years until retirement.