

Understanding defined benefit and defined contribution plans

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When planning for retirement, it is helpful to know the difference between a defined benefit (DB) and defined contribution (DC) plan. Here is a look at the two types of plans and what your employer may offer.

What is a defined benefit plan?

A defined benefit plan is a retirement plan sponsored by an employer that promises a specific benefit upon retirement. This is typically based on factors such as salary and years of service, which means that employees can anticipate a predictable income stream in retirement, regardless of investment performance.

Key advantages of defined benefit plans:

- **Guaranteed income:** Employees receive ongoing retirement income for life.
- **Employer-funded:** The employer bears the investment risk, reducing the burden on the employee.

- Potential for spousal and survivor benefits: Many DB plans offer benefits to spouses and dependents.
- Government insured: The benefits are protected, within limitations, by federal insurance provided by the Pension Benefit Guaranty Corporation.

Key disadvantages of defined benefit plans:

- Portability issues: DB plans are often tied to a specific employer, making them less portable when changing jobs.
- Not inflation protected: Most DB plans have a set monthly payout that does not increase with inflation.
- Potential for plan termination: If a company faces financial difficulties, it may be forced to terminate its DB plan.
- Limited investment control: Employees have little or no control over how their pension funds are invested.

What is a defined

contribution plan?

A defined contribution plan, such as a 401(k) or IRA, involves the employee contributing a portion of their income to a retirement account. The growth of these accounts depends on investment performance and employee contributions. Employers may also match contributions in certain plans.

Key advantages of defined contribution plans:

- Flexibility: Employees have more control over their investments and can generally choose from a variety of investment options.
- Portability: DC plans are typically portable, allowing employees to roll over funds to new accounts when changing jobs or retiring.
- Tax advantages: Contributions to DC plans may be tax-deductible.

Key disadvantages of defined contribution plans:

- Investment risk: The success of a DC plan depends on the performance of the investments, which can fluctuate.
- Limited income potential: DC plans generally do not provide a guaranteed income stream.

Now that you know the difference between the two, you can use this information to better understand your unique situation. It is recommended to consult with a financial advisor to maximize the benefit of your retirement plan. If you need help navigating your retirement plans, give us a call.

Need help with financial goal setting and accountability? Learn more about our Inspired Wealth program here: <https://www.liveinspiredwealth.com/offer>.

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