

# Difference Between Defined Benefit and Defined Contribution Pension

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## Key Difference - Defined Benefit vs Defined Contribution Pension

Defined benefit and defined contribution pension are two forms of [investments](#) that enable planning an income for retirement age; however, these two terms are often used interchangeably. As a result, it is important to clearly identify the difference between the two. The key difference between defined benefit pension and defined contribution pension is that **a defined benefit pension is a [pension plan](#) in which an employer contributes with a guaranteed lump-sum on employee's retirement that is determined based on the employee's salary history and other factors** whereas **a defined contribution pension is a savings and investment plan that provides income after an employee has ceased employment.**

## What is a Defined Benefit Pension?

A defined benefit pension is a pension plan in which an employer contributes with a guaranteed lump-sum on employee's retirement that is determined based on the employee's [salary](#) history, age, number of years of service and other various factors. At retirement, employees are entitled to receive the pension funds as a lump sum or a monthly payment upon discretion. Employees have little control over the amount of funds they will receive upon retirement. The following formula is used to calculate the defined benefit pension amount.

**Pension income= Pensionable service/Accrual rate\* pensionable earnings**

Pensionable service - Number of years the employee had been a part of the pension scheme

Accrual rate - Proportion of earnings for each year the employee will receive as pension (this is generally denominated as 1/60th or 1/80th)

Pensionable earnings - Salary at retirement/ salary averaged over the career

E.g. Employee A had been a part of a pension scheme for 12 years and retires with a salary of \$58,000 per year. The scheme has an accrual rate of 1/80th. Thus,

Pension income =  $12/80 * \$58,000$

= \$ 8,700

Varieties can be found in defined benefit pensions where employee contributions are also common, especially in public sector. Defined benefits are fully taxable if no contributions were made by the employee and if the employer did not withhold contributions from employee's salary. In that case, the funds will be included in the total amount due as [income tax](#). Furthermore, in case that the employee retires before the age of 55 years, the pension could be subject to a 10% tax as a penalty. Having said that, there are some exceptions for illness and disability as well in certain cases.

## What is a Defined Contribution Pension?

A defined contribution pension is referred to as a savings and investment plan that provides income after an employee has ceased employment. In other words, it is a [retirement plan](#) in which both the employee and the employer make periodic contributions. These contributions are tax deferred (tax payments can be delayed to a future date) until the withdrawals are being made. In defined contribution pension plans, there is no guaranteed fixed pension. A defined contribution pension can even be started at a very young age, and a number of options are available to choose from, depending on the individual requirements. [IRA](#), [401 \(k\)](#) plan and [403 \(b\)](#) plan are the most widely available defined contribution pension plans.



## **Individual Retirement Account (IRA)**

With an IRA, the employee invests a certain amount of money for retirement savings in an account set up through the employer, a banking institution or an investment firm. In IRAs, funds are dispersed into different investment options to generate a return

### **401 (k) Plan**

401(k) plan is an investment plan established by employers to make salary deferral contributions for eligible employees on a pre-tax basis. 401 (k) is generally subjected to high contribution limits, and have limited flexibility

### **403 (b) Plan**

403(b) plan is a retirement plan similar to 403 (b) for employees of public schools and tax-exempt organizations. This is also referred to as Tax Sheltered Annuity (TSA) plan.

Defined contribution pension plans are also subjected to an early withdrawal tax of 10% if the funds are withdrawn before the age of 59 years.

## **What are the similarities between Defined Benefit Pension and Defined Contribution Pension?**

- Funds in both defined benefit pension and defined contribution pension are subjected to a tax of 10% on early withdrawal.

## **What is the difference between Defined Benefit Pension and Defined Contribution Pension?**

### **Defined Benefit Pension vs Defined Contribution Pension**

Defined benefit pension is a pension plan in which an employer contributes with a guaranteed lump-sum on employee's retirement that is determined based on the employee's salary history and other factors.

Defined contribution pension is referred to as a savings and investment plan that provides income after an employee has ceased employment.

Contribution	
In general, the employer makes contributions to the defined benefit pension.	In a defined contribution pension, both employer and employee make contributions to the retirement plan.
Amount	
The pension amount is a defined benefit plan is derived from the formula (Pension income= $\text{Pensionable service} / \text{Accrual rate} * \text{pensionable earnings}$ ).	The amount of contribution in defined contribution plans varies depending on the type of plan in consideration.

## Summary - Defined Benefit Pension vs Defined Contribution Pension

The difference between defined benefit pension and defined contribution pension mainly depends on who funds the plan. While defined benefit pension is a plan usually funded by the employer, defined contribution pension is based on the contributions made by both employer and employee. Defined contribution pension is more flexible compared to defined benefit pension since it gives the investor a wide variety of options to choose from. However, both types of plans are initiated to fulfill a similar objective, which is to ensure the availability of a lump sum at the retirement period.

### References:

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3. "Defined Contribution Retirement Plans." Defined contribution retirement plans | MyRetirementPaycheck.org. N.p., n.d. Web. [Available here](#). 26 June 2017.

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