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Pension Plans vs Defined Contribution Plans

A relic of the cold war may be making a comeback

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NEW YORK, NY, USA, July 26, 2022 /EINPresswire.com/ -- A pension plan is a type of retirement plan where employers promise to pay a defined benefit to employees for life after they retire. It's different from a defined contribution plan, like a 401(k), where employees put their own money in an employer-sponsored investment program. Pensions grew in popularity during World War II and became mainstays in benefit packages for government and unionized workers. While they remain common in the public sector, they've largely been supplanted by defined contribution plans in the private sector.

Pension Plan vs 401(k)

In the private sector, the 401(k) has largely replaced the traditional pension. A 401(k) is a defined contribution plan, where money is withheld from your paycheck and put into an investment account in your name. You may make money on your investments or you may lose it, but either way, the money belongs to you. By contrast, a defined benefit plan generally pools money in the company's pension fund. Your employer is obligated to pay you according to the terms of its pension plan, but no part of the pension fund is actually in your name. According to James Lukezic, Managing Director of Qualified Plans at Old Slip Capital, Cash Balance Plans are on the rise with smaller employers, that these type of Defined Benefit plans allow employers and upper management to put more money away pre-tax.

Traditional 401(k) plans are tax-advantaged. This means you don't pay taxes on your contributions or earnings until you retire and make withdrawals. Similarly, you don't pay taxes on pension payments until you receive them. But if you take a lump sum when leaving a company but before retiring, you'll have to roll it over into a tax-advantaged account, like an individual retirement account (IRA).

Also, some 401(k) plans have employer matches. If your employer offers one, it will match your contributions up to a set limit. Pensions, on the other hand, do not have employer matches, since all the money in the fund comes from the employer.

Risks of a Pension Plan

Although having access to a pension has many benefits, no retirement plan is without risks. Unlike a 401(k) plan or IRA, you have no say in how your company invests the money in your pension fund. If the manager of the fund makes bad investment decisions, that could potentially result in insufficient funds for the overall pension. This would presumably lead to a reduction of your benefits without warning.

Another risk of not being in control is that your company could change the terms of your pension plan. In particular, it could decrease the percentage of salary for each recipient, which will result in a lowered benefit amount. Seeing as pensions are much more expensive for employers than most alternatives, it’s in your employer’s interest to minimize costs. In the case of public pensions, there’s also the risk that the state or municipality will encounter economic issues and declare bankruptcy, which could result in a reduction of benefits for pension-plan participants.

For these reasons, it’s best to save on your own as a supplement to your pension. You don’t want to count on having a comfortable pension and then be unexpectedly short on funds.

Conclusion

In today’s retirement landscape, where defined contribution plans reign, it’s easy to feel nostalgic for pensions.

Wouldn’t it be nice to have a guaranteed income stream for life? But pensions have risks. The biggest one for private sector workers is that their company and pension will close. Federally insured payments will kick in, but if the pension had inadequate funding, employees may receive less than they were counting on.

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