



# Is my Company Retirement Plan a Suitable Plan for my Company?

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The Employee Retirement Income Security Act (ERISA) covers two types of retirement plans: ***defined contribution plans and defined benefit plans.***

## ***Defined Contribution Plans***

***A defined contribution defines the contribution to the employee account but does not promise a specific amount of benefits at retirement.*** In these plans, the employee or the employer (or both) contribute to the employee's individual account under the plan, sometimes at a set rate, such as 5 percent of earnings annually. These contributions generally are invested on the employee's behalf. The employee will ultimately receive the balance in their account, which is based on contributions plus or minus investment gains or losses. The value of the account will fluctuate due to the changes in the value of the investments. Examples of defined contribution plans include 401(k) plans, 403(b) plans, employee stock ownership plans, and profit-sharing plans.

A **Simplified Employee Pension Plan (SEP)** is a relatively uncomplicated retirement savings vehicles. A SEP allows employees to make contributions on a tax-favored basis to individual retirement accounts (IRAs) owned by the employees. SEPs are subject to minimal reporting and disclosure requirements. Under a SEP, an employee must set up an IRA to accept the employer's contributions. Employers may no longer set up Salary Reduction SEPs. Typically, the employer makes the same percentage of salary contribution to the account of every eligible employee.

A **Profit Sharing Plan or Stock Bonus Plan** is a defined contribution plan under which the plan may provide, or the employer may determine, annually, how much will be contributed to the plan (out of profits or otherwise). The plan contains a formula for allocating to each participant a portion of each annual contribution. A profit sharing plan or stock bonus plan includes a 401(k) plan.

A **401(k) Plan** is a defined contribution plan that is a cash or deferred arrangement. Employees can elect to defer receiving a portion of their salary which is instead contributed on their behalf, before taxes, to the 401(k) plan. Sometimes the employer may match these contributions. There are special rules governing the operation of a 401(k) plan. For example, there is a dollar limit on the amount an employee may elect to defer each year. An employer must advise employees of any limits that may apply. For 2020, the salary contribution limit is \$19,500. Employees who are age 50 or older can defer an additional \$6,500. Employees who participate in 401(k) plans assume responsibility for their retirement income by contributing part of their salary and, in many instances, by directing their own investments.

An **Employee Stock Ownership Plan (ESOP)** is a form of defined contribution plan in which the investments are primarily in employer stock.

A **SIMPLE (Savings Incentive Match Plan for Employees of Small Employers) IRA Plan** offers potential advantages for businesses that meet two basic criteria. First, your business must have 100 or fewer employees (who earned \$5,000 or more during the preceding calendar year). In addition, you cannot currently have another retirement plan. For 2020, employees are allowed to defer salary up to \$13,500, with an additional \$3,000 for employees age 50 or older.

### ***Defined Benefit Plans***

A **defined benefit plan, on the other hand, promises a specified monthly benefit at retirement.** The plan may state this promised benefit as an exact dollar amount, such as \$100 per month at retirement. Or, more commonly, it may calculate a benefit through a plan formula that considers such factors as salary and service, for example, 1 percent of average salary for the last 5 years of employment for every year of service with an employer. The benefits in most traditional defined benefit plans are protected, within certain limitations, by federal insurance provided through the Pension Benefit Guaranty Corporation (PBGC).

A **Money Purchase Pension Plan** is a plan that requires fixed annual contributions from the employer to the employee's individual account. Because a money purchase pension plan requires these regular contributions, the plan is subject to certain funding and other rules.

A **Cash Balance Plan** is a defined benefit plan that defines the benefit in terms that are more characteristic of a defined contribution plan. In other words, a cash balance plan defines the promised benefit in terms of a stated account balance. In a typical cash balance plan, a participant's account is credited each year with a "pay credit" (such as 5 percent of compensation from his or her employer) and an "interest credit" (either a fixed rate or a variable rate that is linked to an index such as the one-year treasury bill rate). Increases and decreases in the value of the plan's investments do not directly affect the benefit amounts promised to participants. Thus, the investment risks and rewards on plan assets are borne solely by the employer. When a participant becomes entitled to receive benefits under a cash balance plan, the benefits that are received are defined in terms of an account balance. The benefits in most cash balance plans, as in most traditional defined benefit plans, are protected, within certain limitations, by federal insurance provided through the Pension Benefit Guaranty Corporation (PBGC).

\*Information taken from Department of Labor website, [www.dol.gov/general/topic/retirement/typesofplans](http://www.dol.gov/general/topic/retirement/typesofplans)

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