

Defined Benefit or Defined Contribution

Given the choice of either, which one is best for you?

With the goal of providing more options for saving for retirement, some employers will offer their employees a choice of enrolling in either a defined benefit (DB) or defined contribution (DC) pension plan. Also, some employers who have only offered a defined benefit plan in the past are now asking their employees to choose between remaining in the DB plan or switching to a new DC plan.

If you are faced with the need to make a choice, it is important to be aware of the key differences and considerations before you confirm your decision. This article will briefly highlight some of the more common reasons why it may make sense for you to choose one type of plan as opposed to the other.

Understanding Your Options

The purpose of this article is to summarize some of the main decision criteria in general terms only. Together with your plan administrator, your RBC advisor can help you better understand the specific alternatives made available to you by your employer, and provide some guidance as to which one may be best in the context of your overall financial situation.

For a detailed explanation of the differences between a DB plan and a DC plan, ask your RBC advisor for copies of Part 1 and Part 2 of our series of articles explaining employer sponsored pension plans, “*Understanding Defined Benefit Pension Plans*” (Part 1) and “*Understanding Defined Contribution Pension Plans*” (Part 2).

When an employer provides the choice between the two types of plans, they will often aim to provide a similar financial contribution towards an employee's participation in one plan or the other. However, for any given employee there can be a difference in the amount of expected retirement income eventually received, even though it may not be the employer's intention for this to happen. For example, in some cases an employer may limit the maximum dollar contribution they will make to the DC plan in the year, but for employees with pensionable earnings beyond a certain amount, that employee may accrue a pension benefit of a greater value under the DB option.

With all of the required details of your plan and your input to ensure the appropriate assumptions are used, it may be possible for your RBC advisor to produce an illustrative forecast of your retirement income under both alternatives. While the expected income stream is what most people seem to be interested in comparing, there are several other items which you should also consider before making your choice. Some of these main issues are outlined in point form below.

When a DC Plan May be Better for You

The following is a list of the typical conditions under which the DC option may be the preferable option for you:

- The probability of you changing employers throughout your career is high
- You wish to have possession and control of your retirement funds during the accumulation period, and after you retire

- If enrolled in the DC plan, you would intend on investing the funds with a balanced or more aggressive investment approach
- You wish to have an enhanced degree of flexibility over the amount of funds that you withdraw in any given year when you retire
- You expect to have other sources of retirement income and wish to have the option of deferring the use of your pension funds beyond the normal retirement date (typically 65 years of age)
- You place a significant importance on preserving the value of your pension to be eventually transferred to a surviving spouse, or other beneficiaries
- You have a shorter than normal life expectancy
- In the event of premature death after retirement, the degree to which your spouse or other dependants would rely on income from your pension is high

When a DB Plan May be Better for You

If most or all of the above-mentioned reasons why the DC option may be better do not apply to you, then it may be preferable for you to choose the DB option. To summarize, the DB option may be better for you if:

- You intend on remaining with your current employer for most, or all of your remaining career. This is particularly important if you have already accumulated service as a DB plan member and wish to retire as early as possible with an unreduced pension.
- The DB retirement benefit is based on the "average of best years earnings" or "final average earnings" AND you expect to enjoy significant increases in your pensionable earnings in the future
- You wish to ensure that you have a known amount of regular income for your entire life, and are willing to sacrifice some flexibility in order to have this
- You and/or your spouse have a longer than normal life expectancy
- You do not wish to be involved in managing the investments that will be used to pay for your pension
- You would be inclined to invest your pension funds in a very conservative manner, if you were to enroll under the DC option
- You do not have, or expect to have a spouse, or other dependants when you retire
- Your spouse has a shorter life expectancy than you, or your spouse would not be highly dependant on this source of income during retirement in the event you predeceased them

If Your Circumstances Change

The decision to enroll in one type of plan does not necessarily mean that you will never be able to enjoy the benefits provided by the other type of plan. For example:

- Many DB plans are designed to offer multiple options for survivor benefits. It may therefore be possible for you to provide enhanced protection for your spouse or dependants, subject to a reduction to the initial pension amount.
- If an income for life is desired, it is possible to take the amount accumulated in a DC plan and purchase a life annuity contract that could provide an income stream similar to what would have been available under the DB option (depending on how much has accumulated during the time you were working).
- There are several cases where a member of a DB plan may become entitled to receive a commuted value (lump sum) when they retire, provided this occurs before a certain age as per the applicable pension legislation, or specific design of the pension plan. In such a case, it would be possible to transfer most or all of this lump sum to a locked-in retirement plan, and have an eventual result similar to that if you had participated in the DC plan.

Conclusion

Generally speaking, the DC option will require a greater degree of involvement on your part. Ultimately, you will enjoy the benefits of successful investment performance, and assume the risks of poor investment performance. Under the DC option you will likely enjoy more flexibility when receiving your income, and potentially better protection for a surviving spouse and any dependants in the event of your premature death.

The DB option will usually provide you with a more predictable and stable recurring source of regular income, without the flexibility to receive lump sums during retirement. You will receive payments for however long you live. In most cases, there will be little or no opportunity to transfer the value of your pension to anyone other than your spouse. Once you begin to receive your pension income, you will not be required to make any further decisions.

While you may be able to make some changes after enrolling or at retirement, it is important that you take the time to review your options and make the best decision possible for you and your family.

Note: The above information is based on the tax law in effect as of the date of this article. The article is for informational purposes only and should not be construed as offering tax or legal advice. Individuals should consult with a qualified tax and legal advisor before taking any action based upon the information contained in this article.