What are defined-contribution retirement plans?
Think savings accounts with tax benefits—and a lot of rules.

Tax-deferred defined-contribution plans include 403(b) plans for nonprofit employees, 457 plans, mostly for state and local government employees, and the more familiar 401(k) plans.

TRENDS

The share of employees with defined-contribution plans has slowly increased over the last 25 years. From 1991 to 2003, participation of full-time employees at medium-size and large enterprises rose from 48 percent to 51 percent; in 2013 that figure reached 55 percent. All told, about half of all workers have defined-contribution accounts. However, within the defined-contribution plan universe, participation in savings type plans has grown at the expense of profit-sharing plans, which benefit from employer contributions.

RISKS

Defined-benefit plans offer employees a contractually assured annuity at retirement; in contrast, owners of defined-contribution plans bear the risk of underperforming assets and the possibility of outliving the income generated. This risk can be managed if employees use the assets in their plans to purchase annuities from insurance companies at retirement.

CONTRIBUTIONS AND WITHDRAWALS

Contributions to defined-contribution plans are tax-deferred, meaning that neither the employer nor the employee pays tax on the initial contributions or accumulating plan earnings. However, employees pay when they withdraw funds. The major exception is Roth-type defined-contribution plans. With these plans, taxes are due on contributions when they are made rather than when the contributions are withdrawn.

Withdrawals from defined-contribution accounts incur penalties (above regular income tax), except for specified purposes ranging from financial hardship to higher education to the first purchase of a home.

FURTHER READING

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