Part IV

Floor Plans of the Other Types of "4" Plans

The 5th Wave By Rich Tennant

"I think it's time to institute a 401(k) plan, Robin. The men aren't looking too merry as of late."

In this part . . .

Does your employer offer a retirement plan that starts with "4" but ends with something other than "01(k)"? This part looks at 403(b) plans (offered by public schools, hospitals, and many nonprofits) and 457 "deferred comp" plans (offered by state and local governments and their agencies). These plans are moving closer to 401(k)s in their rules and regulations, but important differences remain.

Chapter 10

Making Sense of the Bizarre 403(b)azaar

In This Chapter

- Understanding why public schools, hospitals, and churches offer 403(b)s
- Using a 403(b) to save on taxes and build up retirement savings
- Figuring out whether your plan is governed by ERISA rules (like a 401(k))
- Looking at where 403(b) plans are headed

If you're a public school employee, hospital worker, member of the clergy, or employee of a 501(c)(3) nonprofit organization, chances are that you have a 403(b) plan for your retirement savings. Although these plans are often similar to 401(k)s, they're not exactly the same.

TIP

This chapter gives a basic overview of 403(b) plans. For more detailed information about your plan, we recommend consulting your 403(b) provider. In the meantime, two Web sites that provide a lot of information about 403(b)s are mPower Cafe (`www.mpowercafe.com`) and 403(b)wise (`www.403bwise.com`). Another good resource is IRS Publication 571, available free at `www.irs.gov`. (The direct link is `www.irs.gov/pub/irs-pdf/p571.pdf`.)

Different Name, Same Tax Breaks

403(b) plans let you put off until tomorrow what the tax man would have you pay today. In other words, they offer the same tax advantages to you as 401(k) plans. Specifically,

- Your contributions to a 403(b) are deducted from your salary before taxes, reducing your taxable income.
- Money grows tax-deferred in the account — you don't pay income tax on your contributions, any employer contributions, or earnings in your account until you withdraw money from the account.

What's in a name?

The name *403(b)* comes from the section of the Internal Revenue Code that made these plans possible. You may have heard 403(b) plans referred to as tax-sheltered annuities (TSAs) or tax-deferred annuities (TDAs). These names come from the earliest retirement plans of this type — first created in 1958 — which only allowed participants to invest in annuities (see the section "Trekking Through Your Investment Options" later in this chapter for details).

In addition, many rules and contribution limits are the same for both 403(b) and 401(k) plans. (This wasn't the case before the tax laws changed in 2002; luckily, we don't have to explain what 403(b)s used to be like!) But some 403(b)s are very different from 401(k)s, because the employer isn't very involved. See the section "Understanding ERISA versus non-ERISA 403(b) Plans" later in the chapter for more details.

Stashing Away As Much As You Can: Contribution Info

Contributions to a 403(b) may come from the employee only, the employer only, or a combination of the two — for example, an employee contribution plus an employer matching contribution.

The 403(b) regular contribution limits and age-50 catch-up limit are the same as for 401(k)s. An individual can contribute up to $11,000 before taxes to a 403(b) in 2002; the limit rises by $1,000 a year until 2006 (see Chapter 2, Table 2-1 for a table with limits for each year). Additionally, contributions to the 403(b), including employer contributions, can't be more than 100 percent of pay or $40,000, whichever is less.

Workers who are age 50 and over can contribute an additional $1,000 as a catch-up contribution in 2002 if the plan has been amended to permit this type of contribution; this limit rises by $1,000 a year until 2006. Table 2-1 in Chapter 2 has these limits, too.

Playing catch-up

Certain employees qualify for *another* type of catch-up contribution, often referred to as the "15-years-of-service" catch-up. (Guess how many years you have to work at your employer before you're eligible?) The following requirements apply:

- You must be employed by a qualified organization, such as a public school system, hospital, health and welfare service agency, church, or church organization.
- You must have at least 15 years of service with your employer (the years don't have to be consecutive, and you can get some credit for part-time work).

If you meet these conditions, and you haven't contributed the full amount to your 403(b) in past years, you can contribute up to $3,000 extra per year. After you make contributions of this type totaling $15,000, you can't make any more. The formula for calculating how much extra you can contribute is complicated, so you should ask your employer or 403(b) provider to help you figure it out.

TIP

You're allowed to make both types of catch-up contributions in the same year if you qualify for both. After you exhaust the 15-years-of-service contributions, you can continue to make the age-50 catch-up.

Mix 'n match: Combining a 403(b) with other plans

Some employers offer a 403(b) along with another plan, either a 401(k) or 457. (What's a 457? Don't worry, just turn to Chapter 11.)

If you're eligible for a 401(k) and 403(b), the most you can contribute to both plans, combined, is the federal maximum limit for a single plan — $11,000 for 2002, $12,000 for 2003, and so on (not counting catch-up contributions). We explain these limits further in Chapter 2.

If you have a 403(b) and 457, though, the plot thickens (along with your retirement account, we hope!). You can contribute the federal maximum to *each plan*, for a total of $22,000 in 2002, $24,000 in 2003, and so on (not counting catch-up contributions).

Trekking Through Your Investment Options

One big difference between 403(b)s and 401(k)s is the types of investments commonly offered. Many 403(b) plans only offer *annuities*, a type of investment sold by insurance companies. Annuities come in many different forms; 403(b) plans generally offer *variable annuities.* With variable annuities, your investment choices usually include either mutual funds or *separate accounts,* or *subaccounts*, which are like mutual funds but are run by the insurance company. Variable annuity accounts don't guarantee any return, nor do they necessarily guarantee your principal. You may have an option called a *fixed account* that guarantees your principal and a certain return. Annuity investments often carry higher fees than mutual funds outside an annuity.

Some 403(b) plans, called 403(b)(7) accounts, offer mutual funds. Mutual funds entered the 403(b) arena years after annuities did, so fewer employers have traditionally offered them. However, as more employees demand mutual fund choices, employers are increasingly looking for 403(b) providers to offer mutual funds.

You can't invest in individual stocks and bonds within a 403(b). You're only allowed to invest in mutual funds or an annuity contract.

Your 403(b) may have a fairly short list of providers, which are pre-selected by your employer. Or, it may have a laundry list of many providers, which are not screened by your employer, offering dozens of possible investments. Either one is possible with a 403(b).

You should research exactly what's available to you *before* making a decision about what to invest in. Yes, we know that this takes time, but the saying "act in haste, repent at leisure" couldn't be more true when it comes to 403(b)s. If you invest in the first thing that comes along, you may spend a lot of time regretting it.

Investing tips in Chapters 4, 5, and 6 can help you decide how to invest after you know what your options are.

Withdrawing Money: Watch Out for That Fee!

While you're working, withdrawal rules for 403(b)s are generally as restrictive as for 401(k)s. Getting your money out is difficult, but if you have a hardship, you may be able to take a hardship withdrawal. Some plans also allow loans.

With a hardship withdrawal, you generally owe a 10 percent early withdrawal penalty if you're under 59½, in addition to the income tax.

If your 403(b) money is in an annuity, you may be charged an *exit fee* (or *surrender fee*) for withdrawing money, if you're even allowed to take it out. If you want to withdraw or transfer money from an annuity, find out how much the exit fee is. (Better yet, find out before you invest in the annuity!) Remember the cartoon character George of the Jungle? He always slammed into trees because he didn't look where his vine was swinging. Don't get caught in the same trap, slamming into fees because you don't look where you're investing.

After you retire, you may receive your money in one of several ways. Be sure to find out what all your options are. For example,

- If you have an annuity investment, the insurance company offers you the chance to convert the annuity into a stream of payments. You should have a choice of how the payments are structured — whether they're for your lifetime, for yours and your spouse's jointly, and so on.
- Some annuities may offer a lump-sum payment or installment option, which you can roll over into an IRA. With a lump-sum option, you may have to pay a surrender charge; you can usually avoid this by withdrawing the money in installments. You can set up an annuity payment to last for your lifetime, but if you choose installment payments, the payments will end after a specific number of years. Confusing? You bet it is, which is why you may want to get help from a professional advisor before you make your decision. You usually can't change your mind after you pick your distribution method.

If you have a mutual fund account, your options at retirement should be similar to those with a 401(k) (we describe the 401(k) options in Chapter 9.) You may be able to leave the money in the 403(b) and eventually set up a schedule of withdrawals from that plan, or you can roll the 403(b) into an IRA.

Taking Your 403(b) on the Road

In theory, 403(b) plans are as portable as 401(k) plans. When you change jobs, you can transfer your 403(b) money into an IRA or another employer's 403(b), 401(k), or 457 plan. Like 401(k)s, though, you can only transfer a 403(b) into a new employer's plan if that plan accepts rollovers.

Before 2002, you weren't allowed to roll a 403(b) into a 401(k) or 457 plan when you changed jobs. You could only roll it into an IRA or another 403(b). Because the 401(k) and 457 rollovers are relatively new, employers may be slow to adopt them. If you change jobs, be sure to ask your new employer whether it will accept a rollover of your 403(b). If not, you can always roll it into an IRA (see Chapter 8 for more on how to do that).

Vesting

If your 403(b) includes an employer contribution, you may be required to work for the employer for a certain period of time before the contributions vest. Vesting rules for employer contributions in 403(b) plans are the same as for 401(k) plans (see Chapter 2 for details).

Understanding ERISA versus Non-ERISA 403(b) Plans

Now comes the tricky part. One important thing you need to know about your 403(b) plan is whether it is governed by the *Employee Retirement Income Security Act* (ERISA). 401(k) plans are governed by ERISA, but not all 403(b) plans are. We explain ERISA in Chapter 2, but to refresh your memory, it's the federal law that sets standards that these plans have to follow.

ERISA: Employer + plan provider

Whether a 403(b) plan is governed by ERISA depends on the level of employer involvement in the plan. A 403(b) plan that is covered by ERISA is essentially an agreement between the employer and plan provider, and it requires significant employer involvement. The employer selects a menu of investment options for participants to choose from, and it may make a matching contribution. If your 403(b) is covered by ERISA, it must follow ERISA rules outlined in Chapter 2. Your employer has fiduciary responsibility for running the plan in your best interests, you must receive an account statement at least once a year, and so on.

Non-ERISA: You + plan provider

However, a number of employers do not participate to this extent. Their plans are not covered by ERISA. Public schools often fall into this category. In this case, the 403(b) agreement is between you and the plan provider. Your employer simply agrees to send your 403(b) contribution each pay period to the plan provider that you've chosen. These employers give you a list of possible investments, but they aren't involved in pre-selecting the menu of investment options. It's often simply a list of 403(b) providers who've asked the employer to put them on the list. These providers may be (and often are) insurance agents selling annuities. (They can't just walk into a teacher's lounge and start signing up employees — they need the employer's permission.)

One disadvantage of the second type of plan is that it can be very hard to decide how to invest your money. There can be dozens of names (or in the case of the Los Angeles Unified School District, more than 100) on that list. A common criticism is that participants — usually lacking free time to research investments — may invest in a product simply because the vendor happens to hold a seminar on a day they can attend, or because a representative comes to see them at home. Frankly, that's no way to choose an investment.

TIP

If you're in this situation, the first thing you may want to do is talk to co-workers to see what they've invested in. Don't run out and invest in the first thing they mention, though; see if the same name comes up a few times. If so, it may be worth further scrutiny, particularly if your co-workers like the results.

Why can't a (b) be more like a (k)?

Congress created 403(b)s for nonprofits in 1958 and extended them to educational institutions in 1961, long before the arrival of 401(k)s. Because annuities were their only form of investment for many years, 403(b) plans have a very different history than 401(k)s.

Insurance companies had a lock on the 403(b) business during the 1950s and 1960s. There wasn't any competition from other financial organizations — mutual funds were generally sold only to individuals for personal investing, and banks only managed retirement money for employer-run retirement plans, such as defined benefit pension plans.

The idea of employees saving for retirement through salary reductions actually started with tax-sheltered annuities (TSAs — the original 403(b)s) rather than 401(k)s. Ted's experience selling TSAs was one of the reasons he was able to put the pieces together to build the first 401(k) savings plan. Without TSAs, the Treasury Department would never have issued 401(k) regulations that supported the salary reduction approach that Ted included in the first 401(k) savings plan. Permitting employees to use this technique to make pre-tax contributions to a 401(k) gave employees of for-profit companies an opportunity similar to the one many employees of nonprofit employers had been enjoying for years, with a couple of significant differences:

- The first distinction is the special nondiscrimination test for 401(k)s, linking the amount that *highly compensated employees* (see Chapter 2) may contribute to the amount the non-highly compensated employees contribute. TSAs weren't subject to these tests, because few, if any, employees of nonprofit employers were highly paid at the time. As a result, achieving a high level of participation was never an issue with TSAs. Today, 403(b)s aren't subject to this test either, although they have to fulfill other nondiscrimination requirements for employer contributions, employee after-tax contributions, and overall plan participation opportunities.
- The second distinction involves investment products. Because 401(k)s weren't limited to annuities, insurance companies never controlled the 401(k) market. Certain products offered by insurance companies, such as *Guaranteed Investment Contracts (GIC)*, were used whenever appropriate during the early days of 401(k)s, but mutual funds were also used. (We explain GICs in Chapter 6.) Senior-level managers also had a much higher level of interest in 401(k) investments than was the case with 403(b)s. One reason was the desire to achieve a high level of participation in a 401(k) in order to pass the nondiscrimination test. This desire to achieve high levels of participation led to better investment selections and, frequently, to employer-matching contributions to help drive participation.

Things have changed in a number of ways. The need for employees to save for retirement is widely accepted, regardless of the type of employer. Due to the large number of employees who are now managing their own retirement savings, the level of investment awareness and knowledge is much higher than it was years ago. Competition among financial organizations to capture and retain retirement savings is intense. All these factors have resulted, and will continue to result, in better investment products for 403(b)s and 401(k)s. The 403(b) business is no longer limited to insurance companies. Their control will continue to decline as the investments under these plans move in the same direction as 401(k)s.

After you've narrowed your choices, do research as you would for any investment. The information about risk and investing in Chapters 5 and 6 pertain to you, also.

REMEMBER

If you're thinking of investing in an annuity, be sure that you find out all the fees you'll be charged, including the *surrender fee* if you eventually want out of the annuity. You should get this information in writing — don't rely on verbal assurances from the salesperson.

TIP

You may be able to get your employer to add a provider you like to the list of choices, particularly with a non-ERISA plan. Then you can use that provider's investment options. In any 403(b) plan, you should definitely let your employer know if you're not happy with the investments. For example, if you want your plan to offer mutual funds, ask your employer. Mutual funds are becoming more common in 403(b) plans precisely because more employees are requesting them.

For example, the California State Teachers Retirement System tapped a large financial institution during 2002 to provide 403(b) services, including investment advice and a self-managed account with access to more than 3,000 mutual funds.

Finding Out Rules for Church Plans

403(b) plans offered by churches and church-related organizations aren't required to follow ERISA rules, and most don't. Further, in addition to annuities and mutual funds, church plans can offer something called a Retirement Income Account (RIA) that offers more investment possibilities beyond what 403(b)(7)s offer. However, not all church plans offer RIAs. Churches may also offer 401(k) plans and may choose not to follow ERISA rules.

IRS Publication 571 contains a section explaining rules for 403(b) plans for ministers and church employees.

Chapter 11

The Wonderful World of 457 Plans

In This Chapter

- Understanding the advantage of saving in a 457
- Looking at contribution limits and other rules
- Using a 457 to put off taxes and build a nest egg

To know 457 "deferred comp" plans is to love them. Unfortunately, these plans have been put together in such piecemeal fashion, that it hasn't always been that easy to get to know them.

457s are tax-deferred retirement savings plans for employees of state and local governments as well as some tax-exempt (nonprofit) organizations. So how come everybody knows about 401(k) plans, but when they hear 457 they say, "Huh?"

The answer may be that the 457 isn't necessarily the retirement lifeline for public-sector employees that a 401(k) is for private-sector workers. Workers with 457 plans also generally have a defined-benefit pension plan (which means they'll receive a specified amount each month after they retire), and the 457 is the icing on the cake.

Firefighters, police officers, and other workers in potentially hazardous jobs often retire early, and a 457 can provide a cushion to tide them over until their regular pension benefits kick in.

If you have a 457 plan, you should take advantage of it to gain tax breaks now and, potentially, a bigger nest egg. We've never heard anyone complain about having too much money in retirement!

A little history about the 457

457s are named after the section of the Internal Revenue Code that was added in 1978 to govern them. Here's a piece of cocktail-party trivia (although it may make you wonder what kind of cocktail parties we attend): The same tax law of 1978 that created 457 plans also contained the legislation that led to the creation of the 401(k).

The Scoop on Two Types of 457 Plans

457 plans are often referred to as *deferred compensation* or *deferred comp* plans, because you actually defer receiving part of your compensation until a later date in order to put off paying income tax.

These plans come in two flavors: 457(b) and 457(f). What's the difference? Take a closer look.

- The 457(b) is very similar to a 401(k) in terms of contribution limits and other rules, and it is offered to employees of state and local governments (governmental plans) as well as to rank-and-file employees of some nonprofits. Technically, 457(b)s are known as *eligible* plans, which means that they follow certain rules in order for employees to get certain tax breaks similar to those offered by 401(k)s.
- 457(f) plans, known as *ineligible* plans, are offered by some nonprofits, but only to selected highly paid employees as a way of letting them defer some of their compensation (and put off paying taxes on that compensation) until a later date. They're basically *golden handcuffs* (the promise of a certain sum of money for working at the employer for an agreed period of time).

457(f) plans have different rules from 457(b)s. For example, you can't roll over money from a 457(f) into another type of retirement plan — only into another 457(f) — if you change employers. Also, you may have to pay tax on the 457(f) money while you're still working rather than wait until you take money out of the account. With a 457(f), there aren't really "contributions" per se, usually just a promise from the employer to pay a certain amount after a set number of years. ("Work here for five years, and we'll pay you $100,000 for retirement," for example.)

Originally, 457 rules dictated that for both types of plans, assets in the plan would remain the property of the employer until they were distributed. The problem with this arrangement was that the money could go to the employer's creditors in case of bankruptcy, instead of to the retirees and future retirees to whom it belonged. After Orange County, California, declared bankruptcy in 1994, affecting the county's 457 retirement plan, the rule was changed for governmental 457(b) plans — now the money has to be kept in a separate trust, custodial account, or annuity contract. This rule is intended to keep it safe from the employer's creditors. (By contrast, in 457(f) plans it remains part of the employer's assets.)

In mid-2002, the IRS published proposed regulations for 457 plans for the first time since 1982. These rules included changes and clarifications to 457 plans made over the years in various tax bills. The proposed regulations are expected to be adopted largely without changes.

Because 457(b) plans are more common than 457(f) plans, the rest of this chapter is limited to 457(b)s. For more information about all kinds of 457 plans, some great resources are

- National Association of Government Defined Contribution Administrators (`www.nagdca.org`)
- ICMA Retirement Corporation (`www.icmarc.org`)
- mPower Cafe (`www.mpowercafe.com`)
- BenefitsLink (`www.benefitslink.com`)
- BenefitsAttorney (`www.benefitsattorney.com`)

Coughing It Up for the Coffers

With a 457(b) plan, you decide how much salary should be deposited into the account each pay period. The money is invested as you choose from the options available in your plan — usually mutual funds (Chapters 5 and 6 explain more about these investments). You don't pay income tax on your contributions or the earnings until you withdraw money from your account. You also get the added benefit of saving through deductions from your pay each pay period — the easiest way to save.

The federal limit on how much salary you can contribute pre-tax to a 457(b) plan is the same as for 401(k) plans ($11,000 in 2002, $12,000 in 2003, and so on, or 100 percent of your salary, whichever is less, as outlined in Chapter 2). Before you take these contribution limits for granted, note that 2002 was the first year that the limits were the same. Before 2002, rules were very different and the source of much confusion.

Approaching the retirement finish line? Get your second wind

457(b) plans may also offer an age-50 catch-up contribution with the same limits for 401(k)s explained in Chapter 2.

Another type of catch-up contribution, unique to 457(b) plans, is allowed for workers who are within three years of the plan’s normal retirement age. This catch-up contribution has been around from the start. A qualified worker who hasn’t contributed the maximum possible in previous years can contribute up to double the regular limit, depending on how much he or she didn’t contribute in the past.

A new twist in the 2002 regulations enables you to utilize the catch-up contribution more than once, at more than one employer, if you qualify. Also, qualifying police officers and firefighters can choose a lower retirement age than other plan participants, but it can’t be lower than age 40. The rules are fairly complicated, so if you think you qualify, ask your plan provider for help.

You can only make one type of catch-up contribution in a given year, even if you meet the requirements for both. For example, if you’re 57 in 2003 and plan to retire in three years, and you didn’t contribute the maximum possible in past years, you would meet the requirements for both. But you have to choose one. You’re allowed to figure out how much you can contribute with either one and choose the one that lets you contribute more. For example, the maximum age-50 catch-up in 2003 is $2,000. If you could contribute more than $2,000 using the other type of catch-up, then you would select the one that allowed you to contribute more than $2,000. However, if the other one only allowed you to contribute, say, $1,000, then you would go with the age-50 catch-up of $2,000.

Employer contributions: A double-edged sword?

Employers are allowed to offer a matching contribution in a 457(b), but most don’t. Unlike in a 401(k) or 403(b), an employer matching contribution in a 457(b) is counted toward the overall limit. For example, in 2003, the maximum contribution allowed is $12,000.

If your employer contributes $3,000 to your plan, the most you can put in is $9,000 (excluding any catch-up contributions) to reach the $12,000 maximum.

Some employers make contributions to a separate tax-deferred plan, called a 401(a), to avoid this complication. The 401(a) is essentially a 401(k) without any contributions from you, the employee. You may or may not be able to decide how the contributions are invested.

Combined plans: The sky's the limit

Some employees are lucky enough to have a 401(k) or 403(b) available to them, as well as a 457, allowing them to make cumulative contributions. For example, a schoolteacher may have a 403(b) plan through the school district and also be eligible for the county 457 plan. What's so lucky about that? It opens the possibility of quite a bit of retirement saving. You are allowed to contribute the maximum to both plans separately, for a total of $22,000 in 2002, $24,000 in 2003, and so on. (And you can contribute even more if you qualify for catch-up contributions.) This is a big change from the rules before 2001, when you could only contribute the 457 maximum, which was less than for the other plans.

A worker who has a combined 403(b) and 401(k) doesn't have the same opportunity. The maximum contribution limit for those two plans combined is equal to the limit for one plan.

Investing Your Money

A 457 plan generally offers a selection of stock, bond, and money market mutual funds as well as guaranteed investment contracts. For information about risk and choosing investments that are appropriate for you, check out Chapters 4, 5, and 6.

Taking Money Out of a 457

You can usually take money out of your 457 when you change employers or retire. You have to pay income tax on the withdrawal, but there's no 10 percent early withdrawal penalty as with a 401(k) or 403(b). (We discuss the early withdrawal penalty in Chapter 7.)

When you change jobs, you can roll over your 457(b) into another 457(b) or a 401(k), 403(b), or IRA. The rollover rules we discuss in Chapter 7 apply to 457(b)s, as well. (However, a governmental 457(b) can only be rolled over into another governmental 457(b), not into a 457(b) of a tax-exempt organization.) Remember that if you roll your 457(b) into an IRA, you won't be able to withdraw the money before age 59½ without paying an early withdrawal penalty unless you qualify for an exception (also listed in Chapter 7). Rolling into a 401(k) plan or 403(b) plan will make the money subject to withdrawal rules for those plans, which we discuss in Chapters 7 and 8 for 401(k)s, and Chapter 10 for 403(b)s.

You may also be able to withdraw money to pay for "unforeseen emergencies" while you're working. These rules have been stricter than rules for 401(k) withdrawals (discussed in Chapter 7). For example, buying a house or paying for higher education won't normally qualify as unforeseen expenses. Your best bet is to ask your employer what the rules are for your plan.

Loans are permitted in 457 plans, but not all plans allow them. You need to check with your employer to find out whether your plan allows loans.

When you turn 70½, you're required to start taking minimum distributions from your 457 each year. You calculate these as you calculate required distributions from an IRA or other tax-deferred retirement plan. We discuss required distributions in Chapter 9. More-detailed rules are available in IRS Publication 590, at `www.irs.gov`.

How you take your money out of the plan depends on what your plan offers. You may have to take a lump sum payment (which you can roll over into an IRA), or your plan may let you take installment payments. Plans are also allowed to let you make withdrawals on demand, but this is a new rule in 2002, and many plans may be slow to adopt it because it's an administrative hassle for them.