

# 403(b) Salary Deferral Plan

## *Tax-Sheltered Annuities*

### Eligibility

Employees of religious, charitable, educational, scientific and literary organizations described in IRC Sec. 501(c)(3) or public school systems are eligible.



### Making Employer Contributions

While employer contributions are allowed, typically the employee agrees to have his or her salary reduced by the contribution amount. If the employer contributes its own funds, the arrangement is subject to many of the same rules that govern regular qualified plans.

### Contribution Limits

The allocation total of employer contributions and employee deferrals to a participant's account may not exceed the lesser of 100% of compensation<sup>1</sup> (limited to a maximum of \$230,000), or \$46,000 per year. An employee's elective contributions to the plan are limited to \$15,500<sup>2</sup> on a calendar-year basis. Total elective deferrals for employees of qualifying organizations with 15 years of service may be as high as \$18,500.<sup>2</sup> For those age 50 or older, additional "catch-up" contributions of \$5,000 may be made.

Federal law allows a 403(b) plan sponsor to modify plan provisions to allow participants the option to contribute to a Roth account. Contributions to a Roth 403(b) account are made with after-tax dollars and are subject to the same employee elective deferral limits as the 403(b) plan.

### When to Setup a TSA

A TSA may be setup at any time during the year. However, salary-reduction agreements must be entered into before the reduced salary amounts are available to the employee. An employee can later modify the deferral amount, but only with respect to future income.

### Investing Funds

There are three investments from which to choose.

1. Annuities (fixed or variable and individual or group)
2. Custodial accounts invested in mutual funds
3. Combination of whole life insurance<sup>3</sup> and annuities

<sup>1</sup> The term "compensation" includes deferrals to TSAs under IRC Sec. 403(b) as well as deferrals made to IRC Sec. 125 and IRC Sec. 457 plans.

<sup>2</sup> These are the maximum values for 2008. These values are subject to adjustment for inflation in future years.

<sup>3</sup> Under proposed regulations, life insurance is permitted only if the policy was issued before 02/14/05.

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### Required Distributions

These funds are usually withdrawn at retirement. To avoid penalties, withdrawals must generally begin by April 1 following the calendar year in which the taxpayer became 70½ or, if later, by April 1 following the calendar year in which the employee actually retires.<sup>1</sup>

### Borrowing TSA Funds

Participants can borrow funds from their TSA and later repay them without incurring a tax, if established conditions are met regarding maximum loan amount, amortization requirements, time period for repayments, etc.

### Early Withdrawal Penalties

There is a 10% penalty for withdrawals prior to age 59½ and all withdrawals are taxed currently as ordinary income unless the distribution is rolled over; transferred to another TSA; or the annuitant is totally disabled, separates from service (after age 55) or dies.<sup>2</sup>

### Financial Hardship

The salary-reduction amount (but not the earnings) is available for financial hardship; e.g., an immediate and heavy financial need which cannot be met with other assets.

### The Death of a TSA Participant

When a participant dies, TSA proceeds become part of his or her taxable estate for federal estate tax purposes and they are generally considered as ordinary income to the beneficiary, except for any “pure” insurance proceeds provided by a 403(b) life insurance contract.

### Changing from One TSA to Another

The transfer of funds from one 403(b) investment to another will not be considered a taxable distribution if the funds remain subject to the same distribution restrictions as on the prior investment. See Revenue Ruling 90-24. If proceeds from a TSA are rolled directly into an IRA, it will defer taxation. If a distribution is paid directly to the participant first, it will be subject to the mandatory 20% income tax withholding rule.

### Federal Bankruptcy Impact

Federal bankruptcy law provides significant protection from creditors to participant accounts or accrued benefits in tax-exempt retirement plans.

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<sup>1</sup> If the first distribution is delayed until April 1 of the following year, two distributions will be required in that year.

<sup>2</sup> Other 10% penalty exceptions may apply.

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### Counting Deferred Amounts as Current Compensation

Deferred amounts can be counted as current compensation in computing benefits under a separate qualified pension plan, if the qualified plan so provides.

### End Result

- The employee avoids current income taxation on the deferred amount (except it is included in the Social Security base).
- The earnings on the accumulating funds are not taxed until they are distributed.

**Comparison of Federal Income Tax Payable<sup>1</sup>**

Without 403(b) Plan		With 403(b) Plan		Benefit
Taxable Income Before \$5,000 Salary Reduction	Tax Due Without Annuity	Taxable Income After Reduction	Tax Due with Annuity	Current Income Tax Reduction
\$25,000	\$2,948	\$20,000	\$2,198	\$750
35,000	4,448	30,000	3,698	750
45,000	5,948	40,000	5,198	750
55,000	7,448	50,000	6,698	750
85,000	13,938	80,000	12,688	1,250

### Final 403(b) Regulations

On July 26, 2007, the IRS issued its long-awaited final 403(b) regulations<sup>1</sup>. These are generally effective for plan years beginning after December 31, 2008, and require sponsoring non-profit employers or school districts to take on a greater role in the operation of their 403(b) plans. The following is a brief summary of some of the major points in these regulations:

1. The employer must have a written plan document. Among other requirements, the document will have to state plan eligibility requirements and coordinate operation of the plan among various 403(b) vendors. It will also have to state the type of funding vehicles offered. Previously, 403(b) arrangements that consisted of employee contributions only were not required to have a plan document.
2. The IRS will treat 403(b) custodial accounts as qualified retirement plans for purposes of governmental reporting requirements and limitations on death benefits offered in the plans.
3. Non discrimination rules apply to employer contributions, except for plans sponsored by state and local schools.

<sup>1</sup> Based on 2008 federal income tax rates and married filing jointly.

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4. The right to make 403(b) contributions must be universally available to all employees of a sponsoring organization with few exceptions. Union employees are not excludable.
5. Two or more non-profit entities will be considered a single employer (a “controlled group”), if there is 80% or more overlap of directors or trustees.
6. 403(b) plans will have to follow rules applicable to other qualified retirement plans (such as 401(k) plans) relating to participant loans, dividing accounts due to divorce, hardship distributions, and age 70½ required minimum distributions.
7. The regulations clearly state that Roth-type contributions (contributed after-tax, distributable tax-free) and age 50-plus catch up contributions are available in 403(b) plans.
8. The definition of who may sponsor a 403(b) plan has been expanded to include health and welfare agencies such as adoption agencies and home health care service agencies.
9. Distributions are permitted upon stated events, such as attainment of a stated age, completion of a number of years of service, and termination of the 403(b) plan.

# How a 403(b) Salary Deferral Plan Works



## Employer<sup>1</sup>

- Contributions are tax deductible to the employer.
- May make discretionary contributions<sup>1</sup> from year to year so long as allocation is nondiscriminatory.



## Employee

- Employee elects to defer a portion of salary.
- Amounts deferred subject to FICA and FUTA taxes but not current income tax.
- Employee's elective contributions limited to \$15,500 per year (2008).<sup>2</sup>

## Sec. 403(b) Plan

- Employer contributions, if any, are not currently taxable to employee and earnings accumulate tax deferred.
- Plan is self-directed (employee controls investments).
- Investment risk remains on employee.

## Early Withdrawal

- A 10% penalty generally applies if withdrawals are made before age 59½.
- Some exceptions to 10% penalty are available.
- Employee elective contributions can be withdrawn for financial hardship.<sup>3</sup>

## Retirement

- Distributions must begin by specified date.<sup>4</sup>
- Funds may be distributed as lump sum or periodic payments.
- Earnings + contributions taxed as ordinary income in year received.

## Death

- Value of account is included in owner's gross estate.
- Proceeds can pass to surviving spouse, with payments over survivor's lifetime.
- Income and estate taxes can severely reduce funds left to nonspousal heirs.

<sup>1</sup> If there are employer contributions, the arrangement must generally satisfy the minimum participation requirements as well as the nondiscrimination rules applicable to employer-sponsored qualified plans.

<sup>2</sup> For those age 50 and older, additional "catch-up" contributions of \$5,000 may be made.

<sup>3</sup> If provided for by the plan. Under Treasury regulations, financial hardship is defined as "immediate and heavy financial need where funds are not reasonably available from other sources."

<sup>4</sup> Withdrawals must begin in the later of the calendar year in which the taxpayer becomes age 70½, or, the calendar year in which the employee actually retires. The first distribution may be delayed until April 1 of the following year. If deferred, two distributions will be required in that year.