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Understanding 403(b) Retirement Plans

Answers to frequently asked questions

A 403(b) plan can be a valuable way to save for retirement on a tax-deferred basis. This report provides an overview of key characteristics regarding these plans and helps you better understand their benefits.

What is a 403(b) plan?

403(b) retirement plans are similar to 401(k) plans in that participants can defer a portion of their salaries into the plan, which you deposit into approved investments. The amount deferred into a before-tax 403(b) plan is not subject to federal taxes until it is distributed. In some situations, the employer may also make contributions into the employees' accounts.

Only certain employers can offer a 403(b) plan. They include:

- Public schools, colleges, or universities
- Churches
- 501(c)(3) organizations

How the plan operates and its specific features are outlined in the required plan document.

What is a 501(c)(3) organization?

A 501(c)(3) organization must meet the tax-exempt requirements under the Internal Revenue Code. To do so, the organization must:

- Be organized a specific way
- Have one or more tax-exempt purposes stated in its organization document
- Operate with the intention of furthering its tax-exempt purpose while limiting specific outside or unrelated activities

Examples of 501(c)(3) organizations include:

- Health care organizations (hospitals, nursing homes, etc.)
- Humane societies
- Social welfare agencies
- Charitable institutions
- Museums
- Private schools

What is a Roth 403(b)?

Similar to a Roth IRA, the Roth 403(b) lets participants contribute after-tax dollars to a 403(b) account that has the potential to grow tax-deferred. Earnings withdrawals are potentially tax-free after age 59½, assuming at least five years have passed since the first Roth 403(b) contribution.

If a Roth 403(b) provision is offered, participants may elect to direct 403(b) contributions into either a regular (before-tax) account, the Roth 403(b) account, or a combination of the two. The combined contribution into both accounts cannot exceed each year's limit.

Are 403(b) plans subject to the Employee Retirement Income Security Act (ERISA)?

In general, a 403(b) plan is considered to be "qualified" and, therefore, subject to ERISA unless it falls into one of the following exempt categories:

- Governmental plans sponsored by a public school or public university.
- Church plans sponsored by a church, an association of churches, or an elementary or secondary school that's controlled and operated by a church.
- Plans with limited employer involvement. Not making employer contributions into the plan is not enough in itself to qualify for this exemption. Meeting it is based on the employer's actions. For example, some employer responsibilities that would prevent the plan from being exempt from ERISA are if the employer:
  - Makes any discretionary decisions about the plan's operations, such as approving or disallowing participant loans or hardship distributions
  - Hires a third-party administrator
  - Retains the right to change investment vendors and move employee balances to the new vendor

If the 403(b) plan is ERISA-governed, it is generally subject to government "nondiscrimination testing"[1] and the employer is subject to fiduciary responsibilities similar to a 401(k) plan. For more information about these responsibilities, ask your Financial Advisor for a copy of our report, "Understanding Your Fiduciary Responsibilities."

Even if a plan is considered exempt from ERISA, the sponsor should still act in accordance with fiduciary standards because many state laws impose similar standards.

Who is eligible to participate?

A sponsoring organization's employees are eligible to make contributions to the plan. Typically, participants include teachers, school administrators, school personnel, nurses, doctors, professors, researchers, librarians, and ministers.

To meet one of the IRS nondiscrimination requirements, once a plan sponsor permits an employee to defer a portion of his or her salary into a 403(b), the opportunity to contribute must be extended to all of the organization's employees. This is known as "universal availability."

However, even with universal availability, some employees may be excluded, including those who:

- Will contribute $200 or less annually
- Are participants in an eligible deferred-compensation plan [such as a 457 or 401(k) plan] or participate in another tax-sheltered annuity (TSA) that the employer sponsors
- Are non-resident aliens
- Normally work fewer than 20 hours per week
- Are certain student employees

What are the contribution limits?

Employee salary deferral contributions are limited to the lesser of 100% of compensation or $19,500 for 2021 (as indexed for inflation).

Certain employees can also make catch-up contributions:

- Participants who are 50 years of age or older can defer an additional $6,500 in 2020 (as indexed for inflation).

Catch-up contributions can also be made by employees who:

- Have worked full time for the same employer for at least 15 years
- Are employed by an IRS-defined "qualified organization," such as a hospital, church-related organization, educational organization, or a health and welfare agency, including adoption and certain home health agencies

1. Nondiscrimination testing is designed to ensure that employer contributions are distributed fairly among participants.

- Have not contributed more than an average of $5,000 to a 403(b) plan in previous years

The plan participant must determine the maximum allowable catch-up contribution. However, the contribution cannot exceed $3,000 per year or a $15,000 lifetime maximum.

The total allocated to an employee's account, including any employer contributions, forfeitures, and any employee salary deferrals or after-tax contributions, not including catch-up contributions, cannot exceed the lesser of 100% of compensation[2] or $58,000.

When do employee contributions have to be remitted to the plan provider?

Employee contributions must be remitted to the plan provider within a reasonable period for proper plan administration but no later than 15 business days after the end of the month in which the amount would have been paid to the participant in salary.

What investment alternatives can the plan offer?

For most 403(b) plans, the available investment alternatives are limited to:

- Annuity contracts
- Mutual fund custodial accounts
- Church retirement income accounts

Note that life insurance cannot be offered.

When can plan assets be withdrawn?

To make withdrawals (distributions) from the plan, participants must experience a "triggering event" such as:

- Severance from employment
- Hardship (see "Can hardship withdrawals be made?" below)
- Disability
- Reaching age 59½
- Plan termination
- Death

Required minimum distributions (RMDs), subject to ordinary income taxes, must be taken from the plan starting no later than April 1 of either of the following:

- The year in which the participant reaches age 70½ if attained prior to 1/1/2020, or if attained on this date or later than the year in which the participant reaches age 72.
- The year following the year in which the participant retired.

How are distributions taxed?

In general, the same tax rules that apply to other qualified retirement plans apply to 403(b) plans. Withdrawals prior to age 59½ are generally taxed as ordinary income and assessed a 10%, IRS additional tax. Withdrawals made at or after reaching age 59½ are taxable in full as ordinary income. There are exceptions for participants who:

- Separate from service in the year they turn age 55 (and retire).
- Retire before age 55 and begin a series of substantially equal payments [also known as 72(t) payments]. It's important to note that this program of substantially equal payments must continue for five years or until age 59½, whichever is longer.
- Become disabled.
- Die.

Distributions not rolled over directly into an IRA or another qualified plan that accepts rollovers are subject to a required 20% federal income tax withholding. Assets can be rolled over only when one of the following occurs:

- The participant's employment is severed
- He or she reaches age 59½
- The plan is terminated

Can hardship withdrawals be made?

A hardship withdrawal provision allows a participant under severe financial distress to withdraw assets from a 403(b) plan. If the participant has no other resources available, a hardship withdrawal can be for:

- Non-reimbursed medical expenses of the participant or his or her spouse and dependents

2. Compensation is the amount shown on the employee's Form W-2 (wages, salaries, bonuses, etc.) and any self-employed earned income, or as defined in the plan document.

- Down payment on a primary residence
- Eviction or foreclosure on a primary residence
- Tuition and fees for higher education needs (only for the ensuing 12 months)
- Pay for burial or funeral expenses of your spouse, parent, child, or tax dependent
- Pay expenses for the repair to your principal residence that would qualify for the casualty deduction under Internal Revenue Code Section 165 (determined without regard to whether the loss exceeds 10% of adjusted gross income)
- Distribution to cover qualifying medical, educational, and funeral expenses for the primary beneficiary named under the plan
- Natural disasters as declared by Federal Emergency Management Agency
- Qualified birth or adoption expenses (up to $5,000)

Hardship withdrawals are subject to an IRS 10% additional tax (unless an exception exists) and are subject to ordinary income taxes in the year withdrawn.

Plan sponsors may prohibit hardship withdrawals. If the plan sponsor allows these withdrawals, it is the employer's responsibility to qualify (or approve) the hardship.

You can count on us

For more information about 403(b) plans or for help determining whether this type of plan may be right for your organization, contact your financial advisor. We offer a range of solutions and can help you match the right plan with your needs and objectives.

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