OEA COLLECTIVE BARGAINING & RESEARCH Bulletin

Section 403(b) Plans
2012

Section 403(b) plans represent a defined contribution approach to retirement funding for employees of nonprofit organizations such as schools, colleges and universities. In such a plan, employer and employee contributions and earnings accumulate tax-free. Distributions (withdrawals) from plans to employees in retirement are taxed as income. If money is withdrawn before the employee reaches the age of 59 ½, a 10 percent penalty is applied. When employees contribute to section 403(b) plans on a regular basis over the years, they can increase their retirement savings while lowering the amount of taxes they pay annually.

Contributions flow to section 403(b) plans mainly in one of two ways: through elective deferrals that occur through voluntary salary reductions, and through employer contributions on behalf of employees. If the district has negotiated a Roth 403(b) plan, after-tax dollars can be contributed to such accounts with tax-free earnings and withdrawals upon retirement. For 2012, the elective deferral limit for employees is $17,000. Eligible employees who are 50 or older during 2012 may contribute an extra $5,500, provided that they have deferred the maximum amount available to the 403(b) plan, including other available catch-up amounts.

While the benefits of saving for retirement are well known, participation rates in 403(b) plans tend to be low based upon national surveys of employee participation. While a variety of reasons for low participation have been cited in the literature, the two that are of greatest concern to employees are the lack of low-expense investment options and the complex regulations surrounding 403(b) plan management (Engdahl, 2006). While the latter may only be made worse by recent regulatory changes, the former can be dealt with in a straightforward manner.

Two investment choices are allowed in section 403(b) plans. In 403(b) plans, contributions may only be invested in fixed annuities, equity-indexed annuities or variable annuities. In a 403(b)(7) arrangement, contributions may also be invested in mutual funds. In both cases, employees need access to plans that offer low expenses. Fees can seriously degrade earnings over time costing participants tens of thousands of dollars; examples include 12(b)-1 fees, custodial fees, expense deductions and withdrawal charges. Another important aspect of section 403(b) plans is diversification. Diversification occurs by distributing investments across a variety of asset classes in a broad range of risk and return categories. The vendor offering the plan must be able to offer potential participants an analysis of investment performance relative to their benchmark indexes and a complete disclosure of all fees.

To add investment choices to a school district's current offerings, employees need to exercise their right to choose among viable 403(b) and 403(b)(7) choices. According to O.R.C. § 9.91, school district and public higher education institution employees have the right to designate company choices provided that the company can protect the district from any liability attendant to procuring the annuity, and that a number of employees support the choice of the company (1 percent of the institution's FTE employees or a minimum of five persons).

A number of regulations recently issued by the federal government will impact the procurement, administration and evaluation of 403(b) plans. In the case of a 403(b) plans that are administered in the context of one or more collective bargaining agreements that are in effect on July 26, 2007, some of the regulations (§§1.403(b)-1 through 1.403(b)-10) will not apply before the date on which the last agreement expires or July 26, 2010, whichever comes first. Each district will have to work with legal counsel and their employee unions to determine the eligibility date based upon law and the collective bargaining agreement(s) that are in force during the relevant time periods referenced in the new regulations.

Since December 31, 2009, employers that offer 403(b) plans must provide documentation on all terms and conditions for eligibility, benefits and limitations of the district's 403(b) plan program. This documentation must also be accompanied by a standard salary reduction agreement, a list of available fund vendors, copies of service agreements, annuity contracts and custodial account agreements, and the district's administrative procedures for the program. Within each plan, new restrictions on contract exchanges, plan loans and hardship withdrawals will also have to be implemented. Lastly, the employer must begin to notify all eligible employees of their ability to participate.

Guides to starting and managing a 403(b) plan are available through a number of sources. According to Dan Otter (2008) and Scott Dauenhauer (2003), employees can begin to invest through the employer's 403(b) program by taking several steps. To start investing in the employer's 403(b) program, employees need to identify the funds that are available through the vendors in the program. Once a list of funds is obtained, the fees and performances associated with each fund should be compared. Ideally, the employer will be able to provide a comparison of fees and the performances of each fund against its relative benchmark. For fixed and variable annuity contracts provided through insurance companies, this information should be provided by the company. For mutual funds, this information should be available in the each fund's prospectus. The Securities and Exchange Commission (SEC) provides excellent information on mutual fund fees and performances through their website (www.sec.gov) that can be obtained by clicking on the publications link under 'Investor Information' and selecting those that concern mutual funds. After choosing one or more funds to invest in, an employee can determine the amount to save each paycheck and fill out a salary reduction agreement with his or her employer.

A comparison of 403(b) and 457(b) plans can be found on the following page. For more information about the benefits of section 403(b) plans for education employees, please visit http://www.403bwise.com. This publication does not constitute legal, financial, accounting or other advice.

Questions regarding 403(b) plans should be directed to Gregg Gascon in the Research Division at gascong@ohea.org.

References

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Otter, D. (2008). *Teach and retire rich*. Albuquerque, NM: bWise Guys, LLC.

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Comparison of Section 403(b) and Section 457 Plans for 2012

	Section 403(b) Plan	Section 457(b) Plan
Eligibility	Employees of educational institutions and certain public institutions with an employer-sponsored 403(b) plan.	Employees of educational institutions and certain public institutions with an employer-sponsored 457(b) plan.
Contributions	Contributions and earnings are not taxed until withdrawal. Terminal sick leave/annual leave pay can also be used as contribution. Employer contributions are exempt from Social Security and Medicare taxes.	Contributions and earnings are not taxed until withdrawal.
Employee Contribution Limit	$17,000	$17,000
Post Employment Contributions (from Employer only)	Termination pay can be contributed over a period of five years ($49,000 annual).	None
Catch-Up Contributions Age 50+	$5,500	Greater of $5,500 or up to $16,500 if eligible for Last-3-Year Catch-Up.
Loans	Available	Not available.
Investments	Annuities in a 403(b); annuities and mutual funds in a 403(b)(7).	Annuities and mutual funds.
Distributions	Distributions before age 59½ are subject to a 10% penalty; certain exceptions apply to the penalty.	Distributions before age 59½ are not subject to any penalties.
Ownership of Account	Individual	Employer