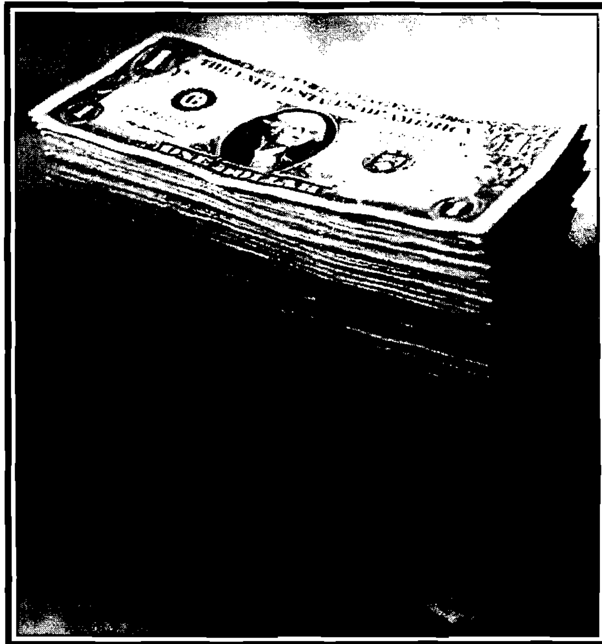
A Consumer's Guide To



403(b) Plans

nysut
A Union of Professionals
Member Benefits Trust

NYSUT Member Benefits Trust wants NYSUT members to be the best-informed consumers in the state. This Consumer's Guide is one of our contributions to achieving that goal. We hope you will find it helpful and informative.

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Saving for retirement is one of the most important financial actions you will ever take. With increasing longevity, it is possible that many people alive today will experience a retirement of 30 years or more. How do you prepare for that? For most NYSUT members, one of the best ways is by making regular contributions to your 403(b) plan.

What's a 403(b) plan?

403(b) is the section of the Internal Revenue Code that allows employees of not-for-profit organizations to make pre-tax contributions to a retirement plan. A 403(b) plan is similar to the 401(k) plans found in for-profit companies.

How much can I contribute to my 403(b) plan?

The normal contribution limit for 403(b) plans is $15,500 in 2007. But there are two types of "catch-up" elections that might enable you to contribute more.

If you have 15 or more years of service with your current employer and have contributed less than $5,000 per year, on average, over your entire working career, you may be eligible for a special $3,000 catch-up with a lifetime limit of $15,000.

If you are over age 50, or turn age 50 any time in the calendar year, you can contribute an extra $5,000 under what is called an "age-50 catch-up" election. These limits are indexed for inflation in $500 increments.

The interactions between the two catch-up provisions are complicated, so you will want to talk to a tax advisor or your 403(b) account representative.

Other contributions

Though the most popular contribution type is your own voluntary contribution, referred to as an employee elective deferral, your employer may contribute to your 403(b) plan as well. There are two main types of employer contributions: base and matching. A base contribution is made to every eligible employee, regardless of whether the employee contributes to the plan. A matching contribution is given only to those who contribute to the plan. It matches a certain percentage of the employee's contributions. In addition, there may be employer contributions made upon retirement, typically in the form of local retirement incentives and buyouts for unused sick leave.

You can also roll over money from a previous employer into your current plan. There are some advantages to this:

- It's simpler to have your money in one place

- It may increase the amount of loan you are able to take, if you need one

- You can withdraw money from your employer's plan without penalty at age 55 instead of age 59 ½, if you separate from service in or after the year you attain age 55.

What are the advantages and disadvantages of 403(b) plans?

The biggest advantage is that your contributions can be made pre-tax. If your pay is $50,000 per year, and you contribute 10 percent ($5,000), you are only taxed on $45,000 of income. That could save you a lot of money in taxes.

Your money builds tax-deferred. You will not pay tax on any investment gains or interest earned until you withdraw the money.

It's automatic, once you sign up. That makes it easy to save. And the easier it is to save, the more likely you are to do it.

Your advantages continue into retirement. The first $20,000 you withdraw from your 403(b) plan each year after age 59 ½ may be exempt from New York state income taxes, depending on distributions you receive from any other retirement plans and IRAs.

Disadvantages? The money has restrictions placed on it. If you take it out early, before age 59 ½, you may have to pay a 10 percent excise tax. And if you are retired, you must start taking the money out at age 70 ½.

Is a 403(b) plan the best way to save for retirement?

For most people, the answer is yes, for two reasons: 1) it's pre-tax, and 2) once you enroll, the payments are automatically taken out of your pay. Saving "off the top" by means of payroll reduction is the most effective way for most people to save money. If you don't see it, you won't spend it. And saving pre-tax means that your taxable income will go down in your prime earning years. That's a combination that's hard to beat.

But what about the Roth 403(b)? I've heard that's a good deal, and it's after-tax.

You may have the option of a Roth 403(b), depending on where you work. It is an interesting twist on the traditional 403(b) plan. Instead of putting money away pre-tax, you save after-tax, but, if you comply with its rules, you can take qualified distributions tax-free.

A qualified (tax-free) distribution is generally a distribution that is made after a five-taxable-year period of participation and that is either:

- Made on or after the date the employee attains age 59½,
- Made after the employee's death, or
- Attributable to the employee's being disabled.

Roth 403(b)s have the same limits on contributions as regular 403(b)s – $15,500 in 2007 and a $5,000 catch-up if you are over age 50 or reach it in the calendar year. The limit is combined for pre-tax and Roth contributions, which means you may not contribute $15,500 to a regular 403(b) and $15,500 to a Roth; the combined amount that may be contributed to both plans is limited to $15,500. However, unlike a Roth IRA, there is no limit on the amount of money you can earn and still contribute.

Roth 403(b)s have the same rules for loans and hardship withdrawals as regular 403(b) plans. Roth 403(b) accounts also have the same required minimum distribution rules, starting at age 70 ½, as regular 403(b)s. However, Roth accounts can be rolled into Roth IRAs, which have no required minimum distributions.

Roths make sense for certain individuals who:

- Are in a low tax bracket now
- Have many years to go until they plan to use the money
- Think they may be in a higher tax bracket at retirement
- Would like to leave some or all of their retirement plan money to their heirs.

If you think a Roth 403(b) might work for you, you may wish to talk to a tax professional who can run calculations to test the benefits of the Roth versus the regular 403(b), given your specific situation.

If I need money, can I take it out of my retirement plan?

Yes, subject to certain restrictions and penalties. Remember that the government regards these plans as retirement savings, not emergency money.

Loans

If your employer's written plan and vendor contract permit it, you can take a loan. You may borrow up to 50 percent of your vested account balance, to a maximum of $50,000. (The $50,000 maximum is reduced if you have an outstanding loan from the plan.)

The loan must be repaid within five years, unless it is used to pay for your principal residence. A principal residence loan may be repaid over as many as 30 years, depending on your vendor contract.

The loan repayments must be made in substantially level payments over the life of the loan.

Are there any disadvantages to loans?

Yes. Your money will not be invested while it's out of the plan, and you will lose out on any market gains that may occur during that time. You are also paying back pre-tax contributions with after-tax money, so, if your tax rate is 25 percent, you are paying 25 percent per year to pay the loan back, in addition to the normal interest that's attached to the loan.

Hardship withdrawals

Your plan may permit hardship withdrawals. A hardship withdrawal is defined as an "immediate and heavy financial need." The IRS defines this as:

- "Expenses for medical care previously incurred by the employee, the employee's spouse, or any dependents of the employee or necessary for these persons to obtain medical care;
- "Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);
- "Payment of tuition, related educational fees, and room and board expenses, for the next 12 months of postsecondary education for the employee, or the employee's spouse, children, or dependents;
- "Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence;
- "Funeral expenses; or
- "Certain expenses relating to the repair of damage to the employee's principal residence."

Source: *www.irs.gov*

The vast majority of plans and vendor contracts restrict hardship distributions to the circumstances listed above, but it is possible for a plan to set its own rules for such distributions or not permit hardship distributions at all. You will need to pay taxes on any of these hardship distributions, and may need to pay an additional excise tax of 10 percent if you are under age 59 ½ when the distribution is made.

When can I take my money out without a penalty?

- When you reach the age of 59 ½
- If you separate from service in or after the year you attain age 55
- If you choose to receive distributions over your life expectancy, no matter what age you are
- If you become totally and permanently disabled
- As part of a qualified domestic relations order
- To your heirs if you die
- For medical expenses that are more than 7.5 percent of your adjusted gross income.

These rules can be complicated to interpret. Before you make any kind of withdrawal from a retirement plan, it makes sense to speak with a tax professional.

Types of 403(b) investment providers

There are two main types of investment providers:

- Those offering variable annuities [403(b)(1) plans]
- Those offering mutual funds [403(b)(7) plans]

What's the difference between variable annuities and mutual funds?

Variable annuities are insurance company contracts. They hold all the same kinds of investments as mutual funds, but they have an extra insurance component built in. For most of them, the

insurance takes the following form: if you die, the amount of money (principal) you put into the annuity is insured. That means your heirs will inherit at least as much money as you put in less any withdrawals you have made.

Mutual funds are collections of investments grouped together. The investments can be stocks, bonds, short-term investments or a combination of all three. An S&P 500 index mutual fund, for example, holds stock from the largest US companies (like ExxonMobil, General Electric, Citigroup, AT&T, Microsoft).

Should I buy a variable annuity for the extra insurance?

That depends on how much the insurance costs and how important it is to you. This brings us to the important topic of costs.

What are the costs of investing in my retirement plan?

The costs are largely invisible but still important. For mutual funds, much of the cost will be found in the expense ratios of the funds in the plan.

Let's take that S&P 500 index fund we talked about earlier. You see on the news that the S&P 500 index was up 15.79 percent in 2006. You own an S&P 500 index fund in your retirement plan. Does that mean you earned 15.79 percent last year?

No, because your fund will have an expense ratio. An expense ratio is what a fund charges you to own it. What you earn, your *total return*, will be the S&P 500's return less the fund's expenses.

Fund expense ratios are expressed as fractions of a percent, called basis points. One hundred basis points equals 1 percent. S&P 500 index funds can cost anywhere from 7 basis points to 148 basis points. That's a wide spread. If you were holding an

S&P 500 index fund with a 7 basis point expense ratio in 2006, your return would have been 15.72 percent. If you were holding a fund with a 148 basis point expense ratio, or 1.48 percent, your return would have been 14.24 percent.

Variable annuity expenses

Variable annuities work a bit differently than mutual funds. There is an expense ratio for each of the options in the plan, but there is also a mortality and expense fee. That fee covers the insurance portion of the variable annuity contract and has a wide range, depending on the contract, of anywhere from 20 basis points to 242 basis points. Some annuities have surrender charges, or charges to withdraw your account balance or transfer your account balance to another vendor, as well.

Other costs

The funds in the plan may have loads, or sales charges, attached to them. There are many kinds of loads. They can be charged when you buy the fund (front-end loads, usually known as Class "A" shares), when you sell (back-end loads, usually known as Class "B" shares), or over the time you own the fund (level loads, usually known as Class "C" shares). Loads are expressed as percentages or basis points. If a fund charges you a front-end load of 200 basis points, that means it will cost you 2 percent to buy it.

How do you know what kind of funds your vendor is offering? That information will be typically included in the name of the fund. "ABC Bond Fund A" will be the "A" (front-end load) share class of ABC Bond Fund.

It is possible, especially with "A" shares, that you will not have to pay the sales charge. Some retirement plans offer "A" shares that are "load-waived." They do not charge the load because they know that retirement plan money tends to stay put for a long time. So they waive the load on the fund.

How do you find this information? When in doubt, call the plan vendor and ask.

What kind of load is best? That will depend on you. A do-it-yourselfer may prefer a fund without any load at all, known as a "no-load" fund. Loads can be used to pay for additional services for a fund and to compensate financial advisors, brokers or salespeople. If you choose a fund with a load, "A" shares may be your best option, especially if you plan to hold the fund for a long time.

Your plan or vendor contract may have other costs as well, such as administrative charges, maintenance charges and wrap fees. There can be charges for taking out a loan, for preparing statements, or for doing retirement calculations.

It's important that you understand the total costs of investing in your plan, as well as the benefits you may derive from them, before making a decision. Ask your vendor for a schedule of all charges before you make a decision to buy.

If I have a choice of vendors, should I always pick the one with the lowest costs?

All other things being equal, yes. But be careful. Make sure you understand what services come with the expenses you pay. It makes sense to look at the combination of fund expenses and services that works for you. If you just want funds and don't need a lot of support, it may be that expenses are the most important criterion for you. But if it's important to you to have a representative who comes on site, for example, that company's funds may have a higher expense ratio. The cost of having the representative onsite may be part of the fund's expense ratio.

You also will want to look at your vendor's financial strength rating. Fitch, Moody's, A.M. Best and Standard & Poor's are companies that provide these ratings. You should also be able to find them on the vendor's Web site or by calling the vendor.

Pick a vendor with: 1) a good financial rating, 2) the level of service that's right for you and 3) a reasonable price.

Investment Options

In retirement plans, investments come in three main types:

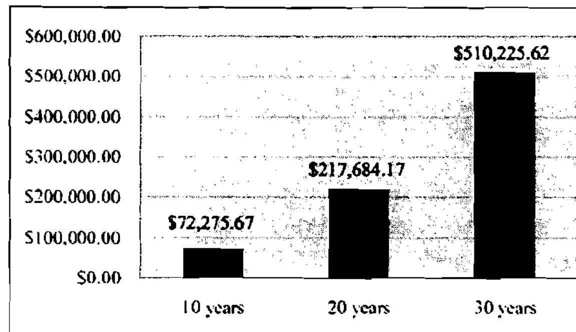
- Short-term investments, like cash, stable value funds and fixed accounts
- Bonds
- Stocks

These three types of investments all respond differently to economic and financial market conditions. Which type is best for you? For almost everyone, the answer is: all of the above. A diversified portfolio will tend to give you better returns for less risk over time.

The power of compounding

The real beauty of saving money systematically is how it compounds over time. The following graph is an example.

Assumptions: savings are $5,000 per year over 10-, 20- and 30-year periods; money is tax-deferred; contributions are made biweekly at the end of the period; and money grows at 7 percent per year.



When you retire...

Normally, your vendor will allow you to take withdrawals from the plan as a lump sum, a series of equal installment payments, or an annuity (monthly payments guaranteed for your lifetime or for the lifetime of you and your spouse).

Money you take out will be subject to federal, state and local income taxes for that year, though you may be eligible for New York state's annuity exemption of $20,000 as described earlier.

You will also be able to roll over the amount in your plan into an IRA.

If you are not age 59 ½ or older when you retire, be careful about rolling the money over. Remember, the date for withdrawal from a 403(b) plan without penalty is age 55, if you separate from service in the year or after you attain age 55. From an IRA, it's always age 59 ½, unless you take a series of payments over your life expectancy.

You must start taking payments (called Required Minimum Distributions, or RMDs) by April 1 of the year following the year in which you turn age 70 ½. Otherwise, the amount the IRS calculates that you should have withdrawn will be subject to a 50 percent excise tax.

There are IRS tables to determine the correct withdrawal rate once you reach age 70 ½, but this is a good time to speak with a tax professional.

Checklist

Questions to ask vendors

- What are the company's financial ratings?

- Does your plan have variable annuities or mutual funds?

- What are the investment options?
- What are the average expense ratios?

    - What share classes of funds are available?

- Give me a detailed breakdown of all charges pertaining to the plan, including, but not limited to

    - Loads

    - Surrender charges

    - Mortality and expense fees

    - Administration and maintenance charges

- Is there a loan provision in your plan?

    - What are the charges relating to loans?

    - What interest rate do you charge on loans?

- How often does a representative visit this location?

- Do you have a Web site for participants?

    - Can I see a demo?

How do I get started?

Speak to your school district's payroll department or business office. They will provide you with a list of approved providers for your school district. You will need to open an account with one of the approved providers and submit a salary reduction agreement to the school district. You decide how much money to contribute and which vendor (if there are several) you want to send your money to.

Other Retirement Savings Options

You may have the ability to participate in a 457 plan where you work. You can also choose to contribute money to an IRA or Roth IRA. If you have a second or part-time line of work, there are self-employment retirement vehicles available to you. When in doubt about which to choose, it makes sense to speak with a tax or financial advisor.

For more information

Contact NYSUT Member Benefits Trust:

- (800) 626-8101
- E-mail: *benefits@nysutmail.org*
- Web site: *www.memberbenefits.nysut.org*

NYSUT Member Benefits Trust offers Consumer's Guides on these additional topics:

- Automobile Insurance
- Long-Term Disability Insurance
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