403(b) Plans and Saving for Retirement

Understanding how much you can contribute as well as the catch-up limits

In 1958, the Internal Revenue Service created 403(b) plans to encourage employees of certain organizations to begin saving for retirement. In 2001, the Economic Growth and Tax Relief Reconciliation Act increased the amount employers and participants could contribute and created a Roth option. Thanks to the Pension Protection Act of 2006, these changes will be permanent.

A Closer Look

403 (b) plan contribution amounts are subject to annual inflation increases. An employee's contributions to a traditional 403(b) are made with pre-tax dollars, and earnings grow tax deferred. In retirement, distributions will be subject to income tax; withdrawals made before the age of 59½ may be subject to a 10% federal income tax penalty. The following guidelines outline the amount that employees may contribute to 403(b) plans:

- There is an elective salary deferral limit of $19,500 in 2021.
- As much as 100% of compensation, as long as that amount is less than the elective deferral limit.
- Those above age 50 may contribute an extra $6,500 for 2021.

In addition, under the 15-year rule, employees with 15 years of service for the same employer (not necessarily consecutive years) may contribute an additional $3,000 per year, if previous contributions were not higher than an average of $5,000.

The Roth Option

With the Roth option, 403(b) participants make after-tax contributions to a Roth account. Earnings grow tax deferred, and distributions are tax free, provided the participant has reached the age of 59½ and has owned the account for five years.

Any matching contributions made by employers must be invested in a traditional 403(b) account, not a Roth account. This means that, even if employees make all of their contributions exclusively to a Roth account, they would still owe tax in retirement on withdrawals from funds contributed on a pre-tax basis by their employers.

Workers should also be aware that the 403(b) annual deferral limits apply to all 403(b) contributions, regardless of whether they are made on a pre-tax or after-tax basis. If employees contribute to a Roth 403(b), they may have to reduce or discontinue their contributions to their employer's traditional 403(b) plan to avoid exceeding these limits. Provided employees comply with these limits, however, they are allowed to put money into both types of 403(b) plans.

Rollover Guidelines

Funds in 403(b) plans are eligible for rollover into a 401(k) plan as long as the following apply:

- The individual must be a 401(k) participant.
- Rollovers must be allowed in the 401(k) plan's rules.
- Distributions from a 403(b) plan must be qualified, such as: death, disability, employment severance, or reaching [attainment of] age 59½.

The Pension Act permits any beneficiary to roll over his or her interest in a 403(b) plan to an IRA, upon the death of the account owner. Taxes will only be due when normal distributions are taken. Formerly, only spousal beneficiaries were permitted this option.

403(b) participants may roll over funds from a 403(b) plan directly into a Roth IRA, and the rollover will be treated as a conversion. However, participants must satisfy all conversion requirements. In addition, 403(b) participants are now able to make hardship withdrawals on behalf of any listed beneficiary.

The combination of favorable legislation and the personal advantages of 403(b) plans make participation more appealing than ever. Even employees who expect benefits from a traditional pension plan should consider building additional retirement savings with a 403(b) plan, if possible. Don't wait: Start participating in your plan today. After all, it's your retirement.

Withdrawals prior to age 59 ½ or prior to the account being opened for 5 years, whichever is later, may result in a 10% IRS penalty tax. Future tax laws can change at any time and may impact the benefits of Roth IRAs. Their tax treatment may change.

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