403(b) Quick Guide for Employees

What is a 403(b)?

A 403(b) is a type of retirement account that allows you to save money directly from your paycheck to fund your retirement. Money within the plan is invested, allowing the funds you contribute the potential for growth. A 403(b) is similar to a 401(k), but is only available to certain people who work for certain types of organizations; examples include certain public school employees, nonprofit employees and ministers. A 403(b) derives its name from the section of the Internal Revenue Code its rules are found under and is also referred to as a tax-sheltered annuity (TSA) plan.

Do I have to participate in a 403(b)?

No. Participation in your employer's 403(b) is completely voluntary—although not participating will likely mean that you are able to save less for retirement.

Do I have to pay if I want to participate in a 403(b)?

No. However, you may have to pay a fee for your account's investment management as well as administration fees. Fees will vary based on your plan.

How is a 403(b) funded?

Both you and your employer can contribute to your 403(b). You can set your contribution as a percentage of your salary, and your employer will take that percentage out of your paycheck each pay period and contribute it directly to your account—these are known as "elective deferrals." Your employer can also choose to make matching contributions, which means that they will match your own contributions up to a certain amount. Depending on the plan document, your employer may choose to contribute 50 cents to the dollar of each of your contributions, or they may choose to match 100 percent of your contributions up to a fixed percentage of your salary. Subject to the terms of your plan, your employer may also choose to make additional contributions to employee accounts that are not based on your own contributions—these are referred to as "employer nonelective contributions."

You may or may not be fully "vested" in your plan immediately. Vesting determines whether or not you can take the money that your employer has put in your 403(b) with you when you leave your employer. Many plans have a "gradual" vesting schedule, in which you vest a certain percentage each year. For example, if you received 25 percent vesting for each year of service to your employer, you would be able to take the full amount of your employer's contributions with you when you leave after you had worked there for four years. Other plans offer "cliff" vesting, in which you vest 100 percent after a certain number of years of employment. You are always 100 percent vested in your own contributions to your 403(b).

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

There is an IRS limit on the amount of money you can contribute per year to your 403(b) in order to receive the tax benefits that come with the account. For 2021, the limit for employee elective deferrals in a 403(b) is $19,500. However, for employees that are 50 years old or older, an additional $6,500 annual contribution is allowed. Certain employers that offer 403(b) plans also allow employees with 15 years of service to the organization to make additional contributions of the lesser of: (1) $3,000 (2) $15,000 minus the total amount of additional elective deferrals made in years prior due to this provision or (3) $5,000 times the number of years the employee has worked for the organization, minus the total amount of additional elective deferrals made in years prior due to this provision. If both catch-up provisions apply (if you are both over age 50 and have worked for the organization for 15 years or more), the IRS requires that the employees extra deferrals first go toward the 15-year catch up and then to the age 50 catch-up. If you are also participating in another type of retirement plan, such as a 401(k), SIMPLE IRA or other 403(b), your elective deferral limit applies to the total of contributions you make to all of these plans.

How much can my employer contribute to my 403(b)?

While your employer isn't subject to a dollar limit for contributions to your 403(b), there is a total annual limit to what can be contributed to your plan. This total includes your own elective deferrals, employer matching contributions and employer nonelective contributions. The sum of these cannot exceed the lesser of either 100 percent of your annual compensation or $58,000 (for 2021).

Do I pay taxes on money held in my 403(b)?

Yes. However, the way you pay tax on this money is different than normal income. If you have a **traditional** 403(b), your contributions will not be taxed at the time of contribution. Income tax will be assessed at the time of withdrawal, with tax penalties applying if you choose to withdraw before you reach age 59 ½. If your employer offers a **Roth** 403(b) and you choose to use it, your contributions will be taxed at your current income tax rate, but your contributions will grow completely tax-free, as you may be able to withdraw funds federal income tax free after you reach the age of 59 ½.*

*Qualified distributions from a Roth account are federal income tax free. A qualified distribution is a distribution taken (1) 5 or more years after your first contribution to the Roth account and (2) after you reach age 59 ½, become disabled or die.

Are my contributions tax deductible?

Contributions to a traditional 403(b) are tax deductible. However, contributions to a Roth 403(b) are not.

How is my 403(b) invested?

Generally, 403(b) plan offerings are limited to annuities and mutual funds by ERISA and the IRS. However, the types of annuities and mutual funds offered will vary from plan to plan. Unlike with a pension plan, in a 403(b) *you* will have control over the investment decisions for your account, not your employer. Investments may be subject to investment management fees, which are typically assessed as a percentage of assets invested.

When can I withdraw money from my 403(b)?

Generally, most plans will not let you withdraw money from your 403(b) before age 59 ½ unless the withdrawal meets certain requirements. If you withdraw money from your 403(b) before you reach age 59 1/2, you may be subject to a 10% additional tax. Keep in mind that if you withdraw money before you retire, you also lose the potential for growth that leaving the money in the account offers you. When you reach age 72 after you retire, you must begin taking "required minimum distributions" regardless of whether you have a traditional or Roth 403(b). Your required minimum distribution account will be calculated based on your account balance from the previous year.

What if I need to withdraw money from my 403(b) before age 59 ½?

If you have a financial need to withdraw from your 403(b) prior to age 59 ½, you may be eligible to take a withdrawal by using what is called a "hardship distribution." Hardship distributions are limited to your elective deferrals; you will not be able to withdraw any earnings or employer contributions. A withdrawal only counts as a "hardship distribution" if it is made on account of an "immediate and heavy financial need" and is "necessary to satisfy that need." Examples of this type of withdrawal include distributions for medical care, for the purchase of a home, for the payment of educational expenses, for funeral expenses or for payments necessary to avoid eviction. Hardship distributions allow you early access to your retirement funds, but will still incur income taxes and a 10 percent early withdrawal tax.

There are certain exceptions to early withdrawals that will allow you to avoid the 10 percent penalty tax (although income tax for traditional 403(b)s will still apply). A full list of these exceptions can be found on the IRS website, but includes distributions made due to a disability or death, or made for medical care up to the amount allowable as a medical expense deduction.

Can I borrow money from my 403(b)?

Depending on your plan, you may be able to borrow against the balance of your 403(b). You can generally borrow up to 50 percent of your vested account balance, up to a maximum of $50,000. You must repay the loan with interest within five years, unless it is being used to buy your primary residence. Meeting these requirements means that you will not owe tax on the loan; if you fail to meet these requirements, the loan will be fully taxable. Keep in mind that borrowing from your 403(b) will have a negative impact on your account growth and ultimately reduce your retirement income.

What happens to my 403(b) if I quit my job or am fired?

The money you've contributed to your 403(b) is yours and moves with you, no matter whom you work for. If you are not fully vested in the plan, however, you may lose a portion or all of your employers' contributions. Unlike a 401(k), however, certain 403(b) plans allow employers to make non-elective contributions to your account for up to five years after the date you stop working there. Provisions will vary from plan to plan. You have four basic options for what to do with your 403(b) when you switch jobs:

Roll your account balance into an IRA. This option offers you a large amount of control over your money, ensures that your funds will continue to grow in a tax-advantaged account and frees you from the limitations of your former employer's investment choices. A direct rollover means that your employer writes a check to the financial institution where your IRA will be held, which prevents you from being taxed. If the rollover check is made out to you (an indirect rollover), your former employer will withhold 20 percent for taxes, and you will have 60 days to contribute that check plus 20% to a new plan or IRA for it to be considered a tax-free rollover.

Move your balance into your new employer's plan. This functions similarly to a direct rollover of a 403(b) into an IRA, except you would be rolling the account into your new employer's plan. Not all plans will allow this option, so you should check with both your new employer and your financial professional before pursuing this option.

Leave your money in the old employer's plan. If you leave the money in your old employer's plan, you will no longer be able to make contributions, and any employer contributions will also cease. Not all plans or companies will allow this, and most will require a minimum account balance to do so. Keep in mind that this may also cause you to miss important plan information, as you are no longer an employee and won't receive communications of this kind. However, this can be a convenient choice if you are happy with the investment options offered by your former employer and you can't yet contribute to your new employer's retirement plan.

Cash out and take your account balance as one large distribution. This should be your last option, as it will make you subject to both income tax and a 10 percent penalty if you are under the age of 59 ½. Withdrawing money from your 403(b) also means that you lose the opportunity for future growth and ultimately lessen the money you will have at retirement. There is a mandatory 20% federal income tax withholding from this payment. ■

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