ED SLOTT'S IRA ADVISOR

© 2014 Ed Slott, CPA September 2014

TAX & ESTATE PLANNING FOR YOUR RETIREMENT SAVINGS

Guest IRA Specialist

Russ Lane, AIF®
Ameritime, LLC
Olathe, KS

For 403(b) Plans, the "b" Can Mean Bountiful

Lesser-known than 401(k) plans, 403(b) plans may offer substantial opportunities for savvy advisors. Regulations that took effect in 2010 have changed the landscape and greatly increased employer involvement, as well as interest in 403(b)s.

The 403(b) market is large and growing. In June 2014, PLANSPONSOR magazine reported that total 403(b) assets topped $770 billion. More than 14.7 million participants were enrolled in over 150,000 403(b) plans.

Similar, but Different From 401(k)s

Of course, it's not that easy for advisors to succeed in the 403(b) market. To do so, you should become knowledgeable about 403(b) plans—and how they differ from other employer retirement plans such as 401(k)s.

Generally, 403(b) plans are similar to 401(k)s. For instance, they're funded by employee salary deferrals, with a $17,500 cap in 2014 ($23,000 for participants 50 or older). Contributions as well as earnings inside a 403(b) are tax-deferred until money is withdrawn. Early withdrawal penalties apply, with some exceptions, and tax-deferred rollovers to IRAs are permitted. Loans are also available in 403(b) plans, if the plan has a loan feature, just like 401(k)s.

Nevertheless, there are differences between 401(k) and 403(b) plans. For example, only some 403(b) plans are ERISA plans, as 401(k) plans are, but many are not subject to ERISA. (The differences between ERISA and non-ERISA plans is beyond the scope of this article.) Employees of public schools, employees of some tax-exempt organizations, and certain ministers can participate in 403(b)s. This article will refer to participants in K-12 plans as educators, which in this context refers to teachers as well as to any other school system employees who may be eligible to contribute to a 403(b).

Only some 403(b) plans are ERISA plans, as 401(k) plans are, but many are not subject to ERISA.

RMDs (required minimum distributions) are another way in which 403(b)s are unique. Although the 403(b) RMD rules generally follow the RMD rules for 401(k) plans, there are some key differences. For starters, there is a grandfather rule that applies to "old money" in 403(b) plans. This old money, which is defined as plan balances prior to 1987, have no RMDs until the participant reaches the age of 75. Furthermore, unlike 401(k)s, which require a separate RMD be calculated and taken from each plan, multiple 403(b) RMDs can, after calculation, be aggregated and taken from any one or more of a client's 403(b)s. This rule mirrors the aggregation rule for IRA RMDs.

Recent Regulations Have Increased 403(b) Oversight

Historically, 403(b) plans resembled the "Wild West." Most 403(b) investments were tax-sheltered annuities (TSAs), usually offered by multiple insurance companies. Employers, including public school systems, may have done little to administer these plans.

For example, say that Jan invested in a TSA with Insurer A many years ago. At some point Jan might have borrowed against that annuity. If Jan also had a TSA from Insurer B, she might have borrowed against that annuity as well, with no oversight to inform her employer or the insurers of the debt she had incurred (and the possible violation of the employer plan loan limits).

In most states, 403(b) participants can purchase "pension service credits" with their 403(b) pretax dollars.

Many 403(b) participants also had the ability to move their 403(b) funds from one provider to another without any constraints, notice, or knowledge of the employer. Such "90-24 annuity transfers" may have allowed a participant to engage in transactions that were not allowed in their plan. In the past few years though, federal regulations have increased employers' responsibilities to administer their employees' 403(b) plans. Such administration can be handled by the employer or by a third-party administrator.

As 403(b)s become more and more like 401(k)s, with increased employer involvement, the need for educating eligible participants has become more apparent. No longer are employees limited to TSAs from various providers and they also have new plan rules to deal with.

Planning with the Educator in Mind

To begin, it's helpful to realize that TSAs remain a vital part of 403(b) portfolios for many educators. Aside from TSAs, the only acceptable 403(b) investments are mutual funds. Therefore, advisors should be able to explain how various types of mutual funds can complement existing TSAs and perhaps serve as preferred choices for future investments.

Some basic retirement planning strategies are especially appealing inside of 403(b) plans. For instance, many employers now offer Roth 403(b)s, which accept after-tax contributions and can eventually yield tax-free distributions, just like Roth 401(k)s. With Roth 403(b)s, though, the tax cost can be steep. A high-income client might have to pay 39.6% or even more in tax on their Roth 403(b) contributions.

That's not always the case, however. Educators' incomes tend to be moderate, compared with those of many other advisory clients. For those clients, contributing after-tax dollars to a Roth 403(b) might be an especially effective tactic. In 2014, married couples filing joint returns can have up to $73,800 in taxable income and stay within the 15% tax bracket, where Roth 403(b) contributions can be extremely effective.

Using 403(b) Funds to Increase Pension Payments

In most states, 403(b) participants have an unusual opportunity. They can purchase "pension service credits" with their 403(b) pre-tax dollars, effectively getting larger pensions without any out-of-pocket expense. Participants may be eligible if they have served in the military, worked in some other pension system, or forfeited some pension credits because of a prior refund. The exact terms will vary by state, but they are worth exploring.

For example, suppose Alice is an educator in a state with such an opportunity. Alice plans to retire at age 65, with a pension based on 25 years of service. Prior to working with her current employer, Alice worked as an educator in another state for five years. Alice's advisor helps her to look into a service credit purchase, and learns that Alice can purchase those five years of service towards her pension for $38,000.

Assuming Alice has enough money in her 403(b), she can transfer $38,000 directly to the pension system without triggering an income tax obligation, "buying" five years of additional service. With the extra five years of service credited to her work history, Alice now can retire at age 65 with a pension based on 30 years of service, which could conceivably pay her $460 a month more than she'd receive with a 25 year pension.

With an extra $460 a month, Alice will recover her $38,000 outlay in about 83 months: less than seven years. Many pension service credit purchases are structured so that they offer similarly favorable terms to educators.

Doubling Up With 457 Plan

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 created another substantial opportunity for some educators, allowing school districts to provide 457 retirement plans in addition to 403(b) plans. In 2014, this will allow an educator to contribute up to $35,000 into a tax-favored retirement plan, consisting of a $17,500 403(b) contribution and another $17,500 contributed to a governmental 457(b) plan. Educators 50 or over by the end of the year can utilize the $5,500 catch-up contribution for each plan, bringing their total annual tax-favored contributions to a whopping $46,000 ($23,000 to each plan).

This is a particularly valuable tool for educators nearing retirement, whose children may now be out of school, allowing them to make up for lost time by doubling tax-advantaged retirement contributions. Married educators with spouses who have ample incomes also might have the funds to make double contributions, at any time.■

Russ Lane is the founder of Ameritime, LLC in Kansas. He is a specialist on the Kansas education pension system and has more than 25 years of experience as a financial advisor. Russ is a member of Ed Slott's Elite IRA Advisor Group℠ and, in 2014, he earned the AIF® Designation from the Center for Fiduciary Studies. He is an Investment Advisory Representative with National Planning Corporation, and a member of both the Society of Financial Service Professionals and the National Association of Insurance and Financial Advisors (NAIFA). Russ can be reached at 913-747-2000 or by email at russ@compassfr.us.

ED SLOTT'S IRA Advisor

Editor - in - Chief: Ed Slott, CPA

Contributing Writers: Beverly DeVeny • Jeffrey Levine • Joseph Cicchinelli

Ed Slott's IRA Advisor

is published monthly (12 issues a year) for $125 by:

Ed Slott's IRA Advisor, Inc. • 100 Merrick Road, Suite 200E • Rockville Centre, NY 11570 • support@irahelp.com