

403(b) ABC's

*The wisest mind has
something yet to learn.*

George Santayana

What is a 403(b)?

Simply put, the 403(b) is an amazing way for educators and other non-profit workers to set aside money on a tax-deferred basis for retirement. Vincent D. Tate, author of *The Complete Teacher's Guide to Retirement*, calls the 403(b) “the last million dollar tax shelter around.” When managed Wisely, that is exactly what it can become. It is not uncommon for 403(b) contributors to accumulate hundreds of thousands of dollars, and in some cases, millions of dollars over time. The emphasis is on the word time. The 403(b) is a long-term investment that requires a long-term view of investing. The quicker one gets started, however, the longer and the more attractive the view.

The 403(b) is often referred to as a TSA, or tax sheltered annuity. This is a misnomer because the actual IRS code governing the plan is called 403(b). Back in 1958, when the plan was created, participants could only invest in annuity products, so the name tax sheltered annuity took root. Despite the fact that Congress granted 403(b) participants mutual fund privileges as an option way back in 1974, the TSA name remains very common today.

The 403(b) is a defined contribution plan which means the employee makes contributions and investment decisions, as opposed to a defined benefit plan (like a pension) where the employer (or a state agency) makes all the contributions and investment decisions. Employers can make contributions to 403(b) accounts on behalf of employees, but they are under no obligation to do so.

One thing the 403(b) is not, however, is a get-rich-quick scheme—unless of course you are selling high-fee annuities. Just kidding! But only a little. Successful 403(b) investing requires knowledge, patience, and discipline. Seriously.

How Does a 403(b) Work?

Participants set aside money on a pre-tax basis through something called a salary reduction agreement with their employer. This is an arrangement under which the employee agrees to take a reduction in salary. The amount reduced is directed to one or more investment(s) offered through the employer. These contributions are called “elective deferrals” and are excluded from the employee’s income. Contributions grow tax free until the time of retirement when withdrawals are taxed as ordinary income.

Are part-time employees eligible to contribute to a 403(b)?

In order to meet nondiscrimination requirements of the law, once a plan sponsor permits any employee to elect a salary deferral into a 403(b), the opportunity must be extended to all employees of the organization who may elect to have the plan sponsor make contributions of more than \$200 pursuant to a salary reduction agreement. Certain employees may be excluded. Employees who may be excluded include employees who are participants in an eligible deferred compensation plan—457 or 401(k)—or participants in another 403(b), non-resident aliens, certain students and employees who normally work less than 20 hours per week. Employers must take special care to comply with this requirement. Non-compliance could result in the entire 403(b) losing its tax-favored treatment.

Tax Advantages of the 403(b)

Two features make the 403(b) especially powerful:

- Pre-tax component
- Tax deferral component

You are probably thinking that that is two too many mentions of the word tax to be good. On the contrary. Or as Martha Stewart would say, “this is a very good thing.” Lets look at these very good components...

Pre-tax component

How would you like to reduce your taxable income by up to \$12,000 (year 2003) and save thousands of dollars in the process?

For every dollar you contribute to a 403(b), your taxable income is reduced by one dollar. Another way to look at this is that a \$100 contribution to a 403(b) costs you only \$73 (\$100 contribution minus the \$27 tax savings for those in the 27% marginal tax bracket). Over 12 months that’s \$324

(\$27 x 12 months) in tax savings. The Wise never walk away from these kinds of deals. The tax savings magnifies as 403(b) contributions increase.

Tax deferral component

The term tax deferral is thrown around a lot these days. What exactly does this mean? *Webster's New World Dictionary* first defines the word [to] defer as: "to postpone; delay." While true, we prefer the second definition: "To yield with courtesy." That is exactly what you are doing by contributing to a 403(b). You are not paying taxes on earnings now, instead you are yielding with courtesy. The government knows this. In fact they encourage it. They will catch you later (in retirement).

Tax Savings by Contributing \$5,000 to a 403(b) Plan*

	<i>Without 403(b)</i>	<i>With 403(b)</i>
Earned income	\$ 46,000	\$ 46,000
Other taxable income <i>(interest, dividends, rental income, etc.)</i>	\$ 5,000	\$ 5,000
Total income	\$ 51,000	\$ 51,000
Adjustments to income	\$ -	\$ -
Adjusted gross income before 403(b) contribution	\$ 51,000	\$ 51,000
403(b) contribution	\$ -	\$ 5,000
Adjusted gross income after 403(b) contribution	\$ 51,000	\$ 46,000
Deductions	\$ (4,700)	\$ (4,700)
Exemptions	\$ (3,000)	\$ (3,000)
Taxable income	\$ 43,300	\$ 38,300
Federal tax	\$ 8,044	\$ 6,694
CA state tax	\$ 2,617	\$ 2,152
Total tax	\$ 10,661	\$ 8,846
Investment	\$ -	\$ 5,000
Taxes saved	\$ -	\$ 1,815
Your actual out of pocket cost to make a \$5,000 investment	\$ -	\$ 3,185

* assumes single California wage earner in the 27% federal tax bracket, year 2003.
