The Motley Fool

What You Should Know About Tax-Sheltered Annuities (403 b Plans)

Has your employer offered you participation in a tax-sheltered annuity, also known as a 403(b) plan? Here's what you need to know.

Asit Sharma

Aug 11, 2016

If you're a public school employee, or work for a tax-exempt organization, you may have been offered the opportunity to participate in a tax-sheltered annuity, or TSA, also referred to as a "403(b)" plan. While not as prominent as the more widely recognized 401(k) plan, the 403(b) retirement framework is often used by school systems, churches, hospitals, and many other types of "501(c)(3)" organizations. Below, let's dive into the essentials you should understand if you're participating in a 403(b), or planning to do so in the near future.

The 403(b) structure: How it works

An individual account within a 403(b) plan typically takes the form of an annuity contract offered by an insurance company. In exchange for a premium, which can be a lump sum or series of payments, the insurance company agrees to make fixed or variable payments beginning at a future date, either for a specified term, or for the rest of the "annuitant's" life. Thus, you can think of contributions to the contract, along with earnings from the contract's investments, as building up a post-retirement income stream not unlike a pension.

A 403(b) plan can also be structured as a custodial account that invests in mutual funds. Additionally, some 403(b) plans specific to churches take the form of an account that invests in either annuity contracts or mutual funds.

You can't contribute directly to your 403(b) account. Instead, under a salary-reduction agreement, your employer withholds an amount you specify from each paycheck. This amount is referred to as an "elective deferral." Elective deferrals are exempt from income tax, although employees must pay Medicare and Social Security tax on these contributions.

Plan earnings are also exempt from income tax until the participant withdraws them -- this is one of the primary benefits of the tax-sheltered annuity structure. Note that some plans also allow for after-tax elective deferrals. In these cases, of course, the deferral amounts aren't deductible on your Federal tax return.

In addition to elective deferrals, your employer can contribute directly to your plan via "non-elective contributions." Current regulations allow your account to be funded through a combination of elective deferrals and employer contributions.

How much can be contributed to your 403(b) plan each year?

Contributions to a 403(b) account depend on each participant's annual "Maximum Amount Contributable," or MAC. The rules for determining your MAC are rather involved, and the IRS provides a worksheet to help walk you through the calculation in its Publication 571: Tax-Sheltered Annuity Plans. Broadly speaking, however, your MAC rests on two major limits:

1. **Limit on annual additions.** This is the limit on all employer and employee contributions that can be made on your behalf, including any after-tax contributions. For 2016, the limit on annual additions is the lesser of $53,000, or 100% of eligible compensation for your most-recent year of service.
2. **Limit on elective deferrals.** This is the amount you are allowed to contribute to your 403(b) plan through a salary-reduction agreement. For 2016, the limit on elective deferrals is $18,000. Bear in mind that if you contribute to other retirement accounts, such as a separate 401(k) plan, you must include contributions to all qualified accounts in arriving at your annual 403(b) limit on elective deferrals.

Your MAC will depend on the types of contributions made to your account during the year. According to IRS guidelines, if you've only made elective deferrals, and haven't received any employer contributions, your MAC will be the lesser of the limit on annual additions, or the limit on elective deferrals.

Is this just a little confusing? Here's a simpler way to look at it: If your employer isn't contributing to your account, you can make elective deferrals equal to your total eligible compensation for the year, but this amount gets capped at $18,000.

If you've only received non-elective contributions from your employer, or if you've made elective deferrals and also received non-elective contributions, then your MAC is the limit on annual additions.

The 15-year rule

In certain situations, you can increase your limit on elective deferrals. If you have 15 years of service with an educational organization, church, or other eligible non-profit organization, and your employer's plan documents allow, you may be able to increase your annual elective deferral up to $21,000.

Like the MAC calculation, however, this depends on pretty specific calculation rules -- in this case, concerning the definition of "years of service." So it's helpful to use Publication 571, mentioned above, to see if you qualify for this additional contribution.

Catch-up contributions

Most 403(b) plans also contain provisions for "catch-up" contributions for those who start deferring a bit later in the game. If your employer's plan documents allow for catch-up contributions, and you've reached age 50 by year-end, *and* **you've maxed out your elective deferrals, you may be eligible to contribute the lesser of:**

- **$6,000 in 2016, or**
- **The amount by which your compensation for the year exceeds elective deferrals that aren't catch-up contributions.**

Because similar catch-up provisions are allowed in other types of qualified retirement plans, your total catch-up contributions among all plans you participate in cannot exceed $6,000 in 2016.

Suppose you're over the age of 50, and also meet the 15 years of service requirements -- can you take advantage of both deferral increases? The answer is yes! In figuring the total, you must first allocate deferrals under the 15-year rule, and then allocate to the age 50 catch-up provisions.

Inquiring about your particular plan

As you can see, tax-sheltered annuities contain a lot of contribution flexibility, but have their own complex issues, such as the annuity component and years of service calculations. It's a good idea to work with your employer to understand your particular plan's characteristics and investment options. Becoming knowledgeable about your account now is a key to maximizing those cash flows waiting for you in the future.