

What is a 403(b)?

401(k) retirement plans are available for businesses, corporations, and for-profit institutions.

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Section 403(b) of the Internal Revenue Code (IRC) describes a special type of defined contribution retirement plan available only to public schools, tax-exempt organizations, and certain ministers. Section 403(b) provides an exclusion from current income for employer contributions and employee pre-tax elective deferrals if certain requirements are satisfied.

There are three categories of funding arrangements to which Section 403(b) applies:

1. Annuity contracts issued by an insurance company;
2. Custodial accounts (held by a bank) invested solely in mutual funds; and
3. Retirement income accounts (permitted only for church plans). Employers typically adopt a 403(b) plan by arranging to purchase contracts from one or more Section 403(b) "vendors." A 403(b) plan is sometimes referred to as a tax-deferred annuity or a tax-sheltered annuity plan (TSA).

Section 403(b) plans are similar to Section 401(k) plans in many respects. However, there are some important differences. In addition to the restrictions on eligible employers and funding vehicles described above:

- Employee elective deferrals to a 403(b) plan are subject to their own special nondiscrimination rules, and not the average deferral percentage (ADP) test that generally applies to 401(k) plans
- There is no special income tax averaging for lump-sum distributions from 403(b) plans
- Section 403(b) includes a special catch-up rule for certain long-term employees



Tip: Throughout this article, the term "Section 403(b) contract" includes annuity contracts, custodial accounts, and retirement income accounts.



Tip: Throughout this article, the term "church" includes traditional ("steeple") churches as well as "qualified church-controlled organizations" (QCCOs), as defined in IRC Section 3121(w)(3)(B). Church plans are subject to numerous special rules, the full treatment of which is beyond the scope of this article.

Caution: All Section 403(b) contracts you purchase for an employee are generally treated as a single contract for purposes of complying with Section 403(b)'s requirements. Other aggregation rules may also apply.

Ten requirements for a valid Section 403(b) contract

In order for employee pretax elective deferrals and employer contributions to enjoy the benefit of exclusion from immediate taxation, a Section 403(b) contract must satisfy all of the following requirements:

1. The contract must be maintained pursuant to a written plan
2. The contract must be purchased by an eligible employer — it cannot be purchased by a qualified plan or a governmental 457(b) plan
3. Employee benefits under the contract must be nonforfeitable at all times (employer contributions may be subject to a vesting schedule, but nonvested contributions must be accounted for separately, and are not treated as 403(b) assets until they vest)
4. The plan (other than a church plan) must meet applicable nondiscrimination requirements

5. The contract must provide that employee elective deferrals to the plan, and all other plans of the employer, do not exceed the annual employee elective deferral limit (\$20,500 in 2022, up from \$19,500 in 2021), plus applicable catch-up contributions)
6. The contract cannot be transferable
7. The contract must comply with required minimum distribution (RMD) rules
8. The plan must allow eligible rollover distributions to be directly rolled over to other eligible retirement plans
9. The contract must satisfy the "incidental benefit rule" requirements of the Code
10. The contract must provide that contributions to an employee's account do not exceed the annual additions limit in any year (the lesser of 100% of includible compensation, or \$61,000 [up from \$58,000 in 2021] plus certain catch-up contributions)

Failure to satisfy these requirements can have serious adverse tax consequences.

Which employers can have a 403(b) plan?

Your organization is eligible to adopt and maintain a 403(b) plan if it is exempt from federal income tax under IRC Section 501(c)(3) (a "tax-exempt organization"), or if it is a state-sponsored public school. Section 403(b) plans may also be adopted for certain ministers.

Tax-exempt Section 501(c)(3) organizations include entities organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or education purposes. Section 501(c)(3) organizations can also include certain qualifying organizations that sponsor amateur competition, or that exist for the purpose of preventing cruelty to children or animals. Qualifying tax-exempt organizations include:

- Charities
- Social welfare agencies
- Private hospitals
- Healthcare organizations
- Private schools
- Religious institutions
- Research facilities

Public employers that have the same attributes as nonpublic 501(c)(3) organizations (for example, government-operated hospitals, libraries, and museums) may also qualify as 501(c)(3) organizations, and may adopt 403(b) plans.

State-sponsored educational organizations that can adopt a Section 403(b) plan are those described in IRC Section 170(b)(1)(A)(ii), regardless of whether they qualify as Section 501(c)(3) organizations. An educational organization must normally maintain a regular faculty and curriculum, and must normally have a regular enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. Included in this category are public schools, state colleges, and state universities.



Tip: Indian tribal governments may also establish 403(b) plans for employees of their public school systems. Other special rules also apply to tribal governments.

Section 403(b) accounts can also be established for the following ministers:

- Ministers employed by Section 501(c)(3) organizations
- Self-employed ministers (a self-employed minister is treated as employed by an eligible tax-exempt organization)
- Ministers (chaplains) who are employed by organizations that are not 501(c)(3) organizations, and function as ministers in their day-to-day professional responsibilities with their employers

Caution: A self-employed minister cannot set up a 403(b) account for his or her own benefit. Only the organization with which the minister is associated can set up an account for the minister's benefit. However, a self-employed minister is allowed to make contributions directly to a retirement income account established by the organization for the minister's benefit (the minister is treated as both employee and employer for this purpose).

Caution: If your organization is a member of a controlled group (IRC Section 414), you may need to treat all employers in the group as a single employer when complying with Section 403(b)'s nondiscrimination rules and certain other requirements. The final regulations formalize the IRS position that separate tax-exempt employers may be treated as members of a controlled group if they share 80% or more of the same directors or trustees, or if one entity controls 80% or more of the other entity's directors or trustees (the "board control test"). The regulations also allow separate tax-exempt employers to voluntarily elect to be treated as a single employer in some cases. Regulations have not yet been issued covering the controlled group rules that apply to public schools (these employers can continue to rely on the guidance provided in Notice 89-23). (The controlled group rules do not apply to church plans.) The rules governing controlled groups are complicated. Be sure to consult a qualified professional.

Tax advantages of 403(b) plans

As with many other types of retirement plans, employees who participate in a 403(b) plan may enjoy significant tax benefits, including the following:

- **Employees can make pretax contributions**

If your plan permits, employee elective deferrals to a 403(b) plan can be made on a pretax (salary-reduction) basis. The contribution is taken directly from the employee's salary and invested in the 403(b) plan before any taxes are withheld. This means that the amount each employee defers to the plan is not included in his or her gross income. The employee pays less current income tax because his or her taxable income is lower than it would otherwise be. The annual limit for pretax contributions is \$19,000 in 2019 (up from \$18,500 in 2018).

- **Employees can make after-tax Roth contributions**

If your plan permits, your employees can elect to designate all or part of their elective deferrals as Roth 403(b) contributions. Your employees' Roth contributions are made on an after-tax basis. Roth 403(b) contributions don't provide any up-front tax benefit, but they're always tax-free when distributed from the plan. Earnings on Roth contributions are also tax-free if paid to the employee in a qualified distribution. The annual limit for elective deferrals (aggregate pretax and Roth) is \$19,000 in 2019 (up from \$18,500 in 2018).

- **Taxes deferred on employer contribution**

Employees are not taxed on employer contributions to 403(b) plans until those contributions are distributed from the plan.

- **Tax-deferred growth**

Funds held in a 403(b) plan grow on a tax-deferred basis. Any earnings on plan investments are not taxable as long as they remain in the plan. Only when an employee begins to receive distributions from the plan will he or she pay income tax on the earnings (earnings on Roth contributions are tax-free if paid to the employee in a qualified distribution). Depending on investment performance, this creates the potential for more rapid accumulation (and therefore a larger retirement fund) than money invested outside a tax-deferred plan.

- **Employees age 50 or older can contribute more than the annual deferral limit**

If your plan permits, employees age 50 and older may make an additional yearly "Catch-up" contribution to the plan (over and above the regular employee elective deferral limit,

and over and above the annual addition dollar limit). The Catch-up contribution amount is \$6,000 in 2019 (unchanged from 2018), and is indexed for inflation. The purpose of this provision is to help older individuals increase their savings as they approach retirement. Catch-up contributions can be either pre-tax elective deferrals or, if your plan permits, after-tax Roth contributions.

- **Long-service employees can contribute more than the annual deferral limit**

If your plan permits, employees with 15 or more years of service may also be eligible to make a special Catch-up contribution to the plan in addition to the age 50 Catch-up contribution. See "Special Section 403(b) catch-up limit," below. (This special Catch-up contribution is over and above the regular employee elective deferral limit, but is included in the annual addition dollar limit.)

- **Tax-free rollovers are allowed**

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