What is a Tax-Sheltered Annuity (TSA)/403.B Plan?

Deferred Compensation Plan (457 plan), too, a Good, Generally Lower-Cost Alternative

Richard Stutman (rstutman@btu.org)
BTU President

T*he information below is offered because both TSAs (403B) and the Deferred Compensation Plan (457) provide a great tax benefit to school employees. The information below touches on many of the benefits of having a TSA or a 457 Plan, but it is not meant to be all-inclusive. You may want to consult a Certified Financial Planner or other financial professional before making any decisions. Neither the BTU nor the school department endorses any TSA/403.B plan or product or the 457 Plan. A full listing of TSAs can be obtained by looking here (http://bostonpublicschools.org//site/Default.aspx?PageID=3178)under 403b plans.*

****

A Tax Sheltered Annuity (TSA) or 403.B plan is a tax-saving/retirement planning device available to school employees that allows one to shelter income from federal taxation and state taxation. Your funds are invested in a financial vehicle (mutual fund, variable annuity, fixed annuity) of your choosing, and they are allowed to grow tax-deferred until withdrawal. At withdrawal, all funds are taxed as regular income.

Under most circumstances a 10% IRS penalty is imposed on withdrawals prior to age 59½. (With some restrictions, loans are allowed in some TSAs prior to age 59½.)

Similar in many regards to a *deductible* IRA or a 401.k plan, a TSA is generally more flexible.

Here's how a TSA works:

Let's say one wants to save $50 per paycheck using a TSA. (Incidentally, TSA's must be done through payroll deductions.) Assume the person grosses $2,000 per paycheck for 26 checks, at an annual salary of $52,000. Over 26 paychecks this person's TSA will amount to $1,300. For federal and state tax purposes this person will show an income of $52,000 - $1,300 or $50,700.

In effect, the above teacher has "sheltered" the $1,300 from federal and state taxation and will be taxed on the $50,700, not the $52,000. Assuming a tax bracket of 28% federal and 6% state, the $1,300 deduction in effect *costs* the teacher only $858. Not only that, the interest (or the growth, depending on which savings mechanism you choose to invest in) earned on the $1,300 will be allowed to accumulate tax-deferred year after year until withdrawal.

Although you are merely postponing taxes, not avoiding them, this process of tax-deferral works to your financial advantage by allowing what moneys would ordinarily be lost to yearly taxation to ‘work’ for you by being reinvested and generating income themselves.

A few last points: The 2016 limit is $18,000 per year, with an additional ‘catch up’ $6,000 for those over 50. In addition, under certain circumstances, there is a lifetime ‘catch-up’ provision that allows an even greater yearly reduction.

With a 403.B/TSA plan you are required to take a minimum distribution from your account balance, as defined by the IRC, no later than by April 1 of the year after you reach age 70 ½ or by April 1 of the year following your separation, whichever is later.

It is suggested that you choose a few companies and research each plan by talking to a sales representative. Should you decide that you want to get a TSA, the company representative will provide you with a ***Salary Reduction Agreement*** that you will bring or mail to the School Department's Payroll Office. You can get a copy here at http://bostonpublicschools.org//site/Default.aspx?PageID=3178 and scroll down.

To cancel an annuity, you must write your insurance or mutual fund company, the School Department's Payroll Office, and the City Treasury, Room M-38 Boston City Hall, 1 City Hall Plaza, Boston, MA 02201. Enclose your social security number.

All 403B companies are not created equal. Some companies and the plans they offer are better than others. You are advised to investigate fully before you sign on the dotted line. You are advised to seek independent assistance before signing up with a sales representative. What's more, some of the companies are insurance companies, and their plan offering includes variable annuities, which are insurance products that contain higher fees. (See a list here: http://bostonpublicschools.org//site/Default.aspx?PageID=3178)

As an insurance product, variable annuities often contain expensive insurance fees for the consumer. It is often said that these plans are 'sold,' not 'bought.' You are advised to investigate the differences in plan costs before you sign on the dotted line. Once your money lands in a 403b plan, you cannot generally retrieve those funds without paying what is called a 'surrender' charge, which is aptly named. The differences between plans are varied, and include insurance fees, 'mortality' fee charges, and plan design fees. All of these fees-- which are taken out of your savings years for the life of your savings plan -- should affect your decision and bear serious investigation. Again, you are urged to consult with an independent financial professional before committing to any plan and any salary reduction agreement.

N.B. *A word of caution: TSA insurance vendors are no longer allowed under the district policy to wander your school's hallways, enter your classrooms, or visit your teachers' rooms. The district policy is very explicit: Insurance vendor, TSA representatives and the like are allowed to stay in the central office ONLY. Some companies have over the years developed a reputation for being overly aggressive salespeople—hence the district, at the urging of our members, has put the following policy in place:*

> *"Any vendors seeking to solicit business from teachers or sell products to teachers shall remain in the main office and shall be prohibited from entering teacher's rooms or teacher lounges."*

What is the State's Deferred Compensation Plan?

Similar or better in many ways to a 403.B Plan, the State's Deferred Compensation Plan (457) http://www.mass.gov/smartplan/ administered by Great West 1-877-457-1900. It allows one to place pre-tax money into a tax-deferred account composed of a variety of stock and bond mutual funds. Your account is allowed to grow tax-deferred without being taxed until withdrawal, normally at retirement. The city's contact person is Lisa.Cardinal@empower-retirement.com. To make an appointment with Lisa, email Lisa.Cardinal@empower-retirement.com.

In the state's 457 plan all the *homework* has been done for you, as the state has chosen the mutual funds for you. The funds chosen are both actively and passively managed (index) funds. You choose only how much you wish to set aside and where you wish to allocate your funds. The funds are low-cost and monitored by the state. Again, just about all of the homework and monitoring has been done for you.

Unlike loans from a TSA, 457 loans are just about impossible to obtain, as they must meet strict Federal guidelines as to the definition of an 'unforeseeable financial emergency' resulting from specific reasons beyond your control. On the other hand, upon separation from service at any age, one may withdraw funds without an IRS penalty being imposed. Contribution limits are as above with a TSA. As above, too, the 457 Plan has a make-up provision that allows a greater contribution in limited circumstances.

Many other former restrictions of 457 plans have been eliminated under the 2001 tax law changes. The elimination of those former restrictions equalizes many of the former discrepancies between TSAs and 457 plans.

Under the 457 plan, you can set aside up to $18,000 this year (most people start with a much lower amount) and take advantage of other special catch-up provisions including the over-50 provision at $6,000. The web page is excellent and has complete information at www.mass-smart.com. The 457, while offering just about all of the advantages of a 403b or tax-sheltered annuity (the inability to take a loan, the chief disadvantage), offers NONE of the high fees associated with the 403b. Saving via the 457 plan offers a far more efficient means of growing your savings than does the typical 403b plan that is marketed to school employees.

The 457 Plan is subject to IRC *minimum distribution rules*, as is a 403.B/TSA plan.

The 457 Plan also offers a Roth 457 plan that allows after-tax contributions to a Roth plan sponsored by Great West. This is a new offering and may be attractive to some. Information can be found on their website at (https://mass-smart.gwrs.com/preLoginContentLink.do?accu=MassachusettsWR&contentUrl=prelogin.educate.resourcesLinks&specificBundle=preLogin).

Questions on the above, please email Richard Stutman, rstutman@btu.org.