



RETIREMENT PLANNING

Section 403(b)

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PLEASE NOTE

The Consolidated Appropriations Act, 2021 continues many temporary CARES Act provisions through 2021 to ease access to retirement funds, including:

- ◆ The exception to the 10% early withdrawal penalty for distributions prior to age 59½
- ◆ The elimination of the mandatory 20% withholding requirement on distributions
- ◆ The option to take out up to \$100,000 in a loan or withdrawal (if otherwise allowed under plan provisions)



RETIREMENT PLANNING

SECTION 403(b)

The Concept

- ◆ Section 403(b) tax-deferred annuities are retirement plans that are authorized for two specific categories of employers: (1) public school systems, state colleges and universities, and (2) tax-exempt 501(c)(3) organizations such as charities and hospitals.
- ◆ Employees of these qualifying employers can build a retirement income by deferring a portion of their salaries into individual accounts within the 403(b).
- ◆ Employer contributions are also allowed.

The Process

- ◆ The employee defers a portion of pre-tax salary into the 403(b) through a salary reduction agreement with the employer.
- ◆ A salary reduction agreement cannot be retroactive, and can only apply to earnings starting on the day of implementation and going forward. The same is true for any modification of the salary reduction agreement.
- ◆ Deferrals, while exempt from current federal income tax (unless designated as Roth deferrals), are still subject to Social Security and Medicare withholding taxes.
- ◆ The employer may elect to contribute to the 403(b).

Contributions

- ◆ There are annual limits on elective employee deferrals into a 403(b) plan, although additional contributions are permitted for participants age 50 and over. Employees elect the amount they would like to defer within these limits.
- ◆ The annual limit for participants under age 50 is \$19,500 in 2021. For participants age 50 and over, the limit is \$26,000. However, for participants with 15 years of service or more with the employer, the annual limit is increased by an additional \$3,000.



RETIREMENT PLANNING

SECTION 403(b)

- ◆ Some employers match all or a portion of an employee's deferral, so the amount actually deposited on behalf of an employee can exceed these limits.

Tax Treatment

- ◆ Employee salary deferrals, up to certain limits, are not currently taxed to employees unless designated as Roth deferrals (when such deferrals are allowed by the plan).
- ◆ Earnings inside the 403(b) plan accrue on a tax-deferred basis until they are withdrawn.
- ◆ Any employer contributions are tax deductible to the employer and not currently taxed to employees.
- ◆ Employee withdrawals from the account generally are taxed as ordinary income, except to the extent that they represent a return of the employee's after-tax contributions. However, Roth deferrals may be withdrawn tax free when certain requirements are met.

Withdrawals

- ◆ While a 10% penalty tax generally applies to withdrawals taken before age 59½, employees may avoid this penalty under certain conditions. Among them:
 - ◆ The employee leaves the employer after age 55, dies, or becomes totally disabled.
 - ◆ The employee receives the distribution as a series of substantially equal periodic payments for life (or life expectancy).
 - ◆ The employee receives the distribution for medical care, within certain limitations.
 - ◆ The employee takes the distribution upon the birth or adoption of a child.
 - ◆ The distribution is payable to an alternate payee under a "qualified domestic relations order" as defined by the IRS or by state law.
 - ◆ The distribution is to correct an earlier excess contribution or excess elective deferral.



RETIREMENT PLANNING

SECTION 403(b)

- ◆ Required minimum distributions from a 403(b) plan generally must begin no later than April 1 of the year following the year when the employee reaches age 72. However, distributions may be deferred until the employee's actual retirement if it occurs later than 72.
- ◆ Participants who fail to comply with the RMD rules face a 50% penalty tax on the amount that should have been distributed but was not.

The Bottom Line

403(b) plans offer an efficient, tax-advantaged way to prepare for retirement, often with a boost from employer contributions. The key to maximizing potential 403(b) retirement income is to start early, take full advantage of any matching employer contributions, and defer as much out of current earnings as the contribution limits allow.



RETIREMENT PLANNING

SECTION 403(b)

SUMMARY

WHAT IS A 403(B)?

A 403(b) is a tax-deferred retirement plan that can be established by two general categories of employers: schools (public school systems, state colleges and universities) and tax-exempt 501(c)(3) organizations (charities, hospitals and religious organizations).

In a typical 403(b) plan, employees in a qualifying organization defer a portion of their salaries into individual accounts according to a salary reduction agreement with the employer.

The salary reduction agreement applies to the employee's future earnings. If the agreement is ever modified, the modification will only affect the employee's subsequent earnings.

Salary deferrals, while exempt from current federal income tax up to certain limits, are still subject to Social Security and Medicare withholding taxes.

The employer may also make contributions up to certain limits.

ARE THERE CONTRIBUTION LIMITATIONS?

There are limits to how much an employee can defer into the account each year depending, among other things, on the person's age. The 2021 limit is \$19,500 (\$26,000 for people age 50 and over). However, for participants with 15 years of service or more with the employer, the annual limit is increased by an additional \$3,000.

There's also an overall limit on annual additions to the account from all sources—including any employer contributions. In 2021, the limit is 100% of the employee's compensation or \$58,000, whichever is lower.



RETIREMENT PLANNING

SECTION 403(b)

WHAT'S THE TAX TREATMENT?

Amounts deferred into the 403(b) plan are not currently taxed to the employee unless made on an after-tax basis, including those designated as Roth deferrals. Earnings inside the account accrue on a tax-deferred basis until they're withdrawn.

Employer contributions are deductible by the employer in the year they're made.

Employee withdrawals from the 403(b) account—except amounts representing a return of the employee's nondeductible contributions—are taxed as ordinary income. Roth deferrals are the exception, as they may be withdrawn tax free when certain requirements are met.

The special tax treatment available for lump-sum distributions to certain grandfathered participants in other qualified retirement plans is not available to 403(b) participants.

WHAT ABOUT DISTRIBUTIONS?

Withdrawals from a 403(b) plan prior to the employee's age 59½ may incur a 10% penalty tax unless certain exceptions apply.

Distributions generally must begin no later than April 1 of the year following the year the participant reaches age 72. Distributions may, however, be deferred until the participant's actual retirement if that is later than age 72.

Participants who fail to comply with the RMD rules face a 50% penalty tax on the amount that should have been distributed but was not.



RETIREMENT PLANNING

SECTION 403(b)

- 1. An employee of a public education organization or tax-exempt organization elects to defer a portion of salary into a 403(b) plan subject to annual contribution limits (which increase at age 50).
- 2. Deferrals within these limits are not taxed. (Any Roth deferrals are currently taxed but may then be distributed tax-free when certain requirements are met.) Earnings inside the plan grow tax deferred, allowing for greater accumulation.



- 3. The employee may begin taking distributions from the plan at age 59½, and must begin taking distributions by age 72 or actual retirement, if later. Early distributions face a 10% penalty (with some exceptions). Distributions after age 72 face a 50% penalty on the amount that should have been distributed but was not.
- 4. At the employee’s death, the plan (if so arranged) provides survivor benefits to the employee’s beneficiary.

- 5. Distributions are taxed as ordinary income. Survivor benefits are also taxed as ordinary income.

