

## Tax-Deferred Plans Offer New Option for 2006

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Most employers are rightly focusing on benefits these days, particularly health benefits, as the costs for plans continue to increase by double-digit percentages. It is important that libraries, while thinking about the entire benefits package offered to employees, don't forget to spend some time thinking about pension plans. Many public-sector library employees are able to join a state-provided pension plan. In addition, library systems qualify for 403(b) plans – a tax-deferred plan defined by Section 403(b) of the Internal Revenue Code. 403(b) plans are retirement savings plans in which employees of certain tax-exempt organizations can participate. A qualified employer, in the eyes of the IRS, is an organization that is “organized and operated exclusively for religious, charitable, scientific, public-safety testing, literary, or educational purposes.” Libraries qualify to offer these plans under this definition.

Under 403(b) plans, contributions can be invested in tax-sheltered annuities issued by life insurance companies or tax-sheltered custodial accounts that invest in mutual funds. The amount of pretax dollars that employees may contribute annually is limited by a rather complex formula.

In most cases, contributions to a 403(b) plan are made from employees' elective deferrals. The employee signs a salary reduction agreement with the employer authorizing the employer to reduce a certain amount from the employee's wages. This money is used to purchase an annuity contract or invest in a mutual fund. The annuity or mutual fund is the vehicle in which the 403(b) plan is invested.

When calculating the amount that can be deferred to the plan, you will need to understand the exclusion allowance. An exclusion allowance is the maximum amount that can be deferred to the plan *free of tax*. Thus, if the exclusion allowance is \$2,000, up to \$2,000 worth of deferrals will be tax-free. Amounts exceeding that will be taxed. The IRS issues regulations and formulas to help compute an individual's exclusion allowance for the year. An employee may elect to defer an amount up to the exclusion allowance. This is pre-tax, so no deduction can be taken on a tax return. The employee's W2 will reflect the lower taxable income.

It should be noted that participation in a 403(b) plan qualifies as participation in an employer-sponsored retirement program. This may have consequences for an individual who is putting money into a second retirement plan. Someone who contributes to a tax-deferred annuity plan may not be eligible (depending upon his or her income) to deduct contributions to an individual retirement account (IRA).

All deferrals within the exclusion allowance are tax-deductible. Tax is also deferred on the contributions, the net investment income, and realized capital gains that accumulate in the plan, until the individual begins making withdrawals from it. For example, imagine a library employee who paid \$8,000 into a 403(b) over several years. Suppose that the account is now worth \$10,000. If the employee chooses to receive a lump-sum distribution, the entire amount (\$10,000) will be taxed as ordinary income. Instead of receiving a periodic distribution, an employee may instead elect to receive a lump-sum distribution.

As with any pension plan or any other benefit, for that matter, libraries have the responsibility of communicating their respective plans to employees and ensuring that those plans are available to the employees upon retirement. Employees have the responsibility of using these plans wisely so they will be able to better afford retirement.

More than half of recent retirees indicate that they regret not doing more to prepare for retirement before leaving their jobs, as polled by Fidelity Investments. Seventy-seven percent admit ignoring their employer as a source of guidance in the transition to retirement. / Retirees now realize that they should have: created a budget, determined an asset allocation strategy, better understood the 401(k) or other plan payout options, and developed an income source withdrawal strategy. At the same time, 81% of workers with less than one year before retirement are confident that they can afford a comfortable retirement but almost 70% have not planned what income they need for retirement and almost 75% do not have an allocation strategy for their retirement income.

There is clearly a disconnect between employees' retirement planning and the reality of post-retirement expenses and financial well-being. The statistics mentioned above support the fact that libraries need to consistently and effectively communicate to employees the importance of joining library sponsored pension plans as early as possible and continue to contribute to these plans on a regular basis. As an added benefit, libraries can consider providing retirement planning services to retiring employees by establishing a relationship with a financial advisor. This service helps retirees understand ways to gain a steady income through retirement without being forced to return to the workforce.

A new tool for 2006 that can be offered by libraries under 403(b) plans, is the Roth 401(k) account. This account will be similar to the Roth IRA in that it will allow employees to invest after-tax dollars in return for tax-free distributions. This option allows employees to take advantage of the tax benefit of having a Roth account included in their retirement planning.

Employers can match employees' contributions to the Roth 401(k), as with the typical 401(k), but in this case the match would be made on a pretax basis and kept in a separate account. Once employees withdraw the employer's match, they will owe income tax on it. The Roth 401(k) does not have income limits like those for the Roth IRA, to which contributions can no longer be made once a single person's adjusted gross income exceeds \$110,000 and a married couple's income tops \$160,000.

Maximum contributions to a Roth 401(k) are the same as those to a regular 401(k). Therefore next year, employees can contribute up to \$15,000. They will not be able to double their contributions by opening Roth and traditional 401(k) accounts, however. Employees age 50 and older can make additional contributions of \$5,000 next year to a regular 401(k), for a total of \$20,000. Catch-up contributions will also be available under the Roth 401(k).

Employees who are currently in a low tax bracket but expect to be taxed at a higher rate in retirement (typically younger employees) are better off in the Roth 401(k). High-income workers might be better off sticking with the traditional 401(k) in order to get the tax break up front. Some experts say that the Roth 401(k) will not work for employees close to retirement who will need to tap their accounts before the five-year holding period.

Legislators, employers, and employees must work together in order to preserve the pension system. Legislators must propose laws that will enhance the system, be practical for libraries and other employers to use and protect employees. Also, it is critical that employers communicate legislation and plan benefits to employees, up to and including providing counseling to retiring employees. Employees need to plan for retirement in a responsible manner and use all of the resources provided to them in order to be able to enjoy the retirement for which they have worked and planned so carefully.

## **Bibliography**

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