

# Investing Flexibility That Teachers Enjoy May Get 'F' From IRS

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**T**HE RETIREMENT SAVINGS plans offered to teachers and employees of charities, hospitals and other nonprofits have a feature that participants in corporate 401(k)s might envy: Many teachers and nonprofit workers can transfer their savings to investment portfolios not on their employers' official menus.

But that option would be eliminated under a proposed rewriting of the Internal Revenue Service's

regulations for these programs, known as 403(b) plans, a much smaller cousin of corporate 401(k) plans.

The 401(k) plans don't allow transfers because corporate employers are obligated to pick good investment options for their employees, whereas school districts and most nonprofits that have 403(b) plans have a very limited role in administering them.

The proposal to bar outside transfers has fans of these plans fuming. The option has been "a valuable escape hatch" for workers in many school districts that offer employees

only annuities with high fees, says Dan Otter, a Maryland teacher and a founder of the 403bwise.com Web site for 403(b) investors. Restricting account shifts "would be a disaster for the participants," he says.

Scott Dauenhauer, a Laguna Hills, Calif., financial adviser who works with many teachers, says clients have moved money from annuities with annual charges as high as 3% of assets to low-cost mutual funds and annuities with charges under 1% from companies such as Vanguard Group, Fidelity Investments and TIAA-CREF. Allowing outside transfers gives workers "a way to have a broader array of options, especially lower-cost options," he says.

The proposed elimination of outside transfers in 403(b) plans is part of a broader effort by the Bush administration to bring order to the confusing array of retirement-savings vehicles offered to different groups of employees. As part of his fiscal 2006 budget last month, President Bush reiterated his desire to consolidate several types of savings plans into a single Employer Retirement Savings Account that would generally look like today's 401(k).

"The rules covering employer retirement plans

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## FUND TRACK

### Retiree Four-0...

#### 403(b)

■ **Total Assets**

\$578 billion

■ **Participants**

6.8 million teachers  
and non-profit  
employees

#### 401(k)

■ **Total Assets:**

\$1.925 trillion

■ **Participants**

41.0 million corporate  
employees

Source: Spectrum Group

## MUTUAL FUNDS

## IRS to Cut Option in Savings Plans

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are among the lengthiest and most complicated sections of the tax code and associated regulations," the budget proposal noted.

Some financial professionals say reshaping 403(b) plans to be more like

<b>FUND</b>
<b>TRACK</b>

401(k)s could ultimately backfire for the roughly 6.8 million participants in 403(b) plans. The

IRS is also proposing that 403(b)s have a written plan document, as 401(k) plans do now, adding another administrative task that small school districts and charities with limited staff might find burdensome.

Adding this requirement and other compliance chores associated with corporate plans could result in some employers dropping 403(b) plans altogether, in some cases leaving employees with a pension plan but no retirement-savings plan at work, warns the National Tax Sheltered Accounts Association, a group that includes 403(b) employers and providers of investment products.

Both 401(k)s and 403(b)s are named for sections of the tax code and allow workers to set aside part of their salary,

before tax, to save for retirement. Contributions and subsequent earnings aren't taxed until withdrawn. The basic contribution limits are the same for both plans—this year, as much as \$14,000 of pay, with an additional \$4,000 for participants age 50 or older—but certain 403(b) participants who have worked at an employer for 15 or more years can make additional contributions. That option would remain under the IRS proposal, but that could change if all employer-savings plans were brought under uniform rules.

The two plans ended up with different transfer rules because they were set up at different times to serve different constituencies. The 403(b) plans were authorized in 1958 to allow school districts and nonprofit employers to offer retirement-savings vehicles to their employees with only limited employer involvement. Initially, the only investments allowed were annuities, insurance contracts that allow people to withdraw their savings in the form of a guaranteed lifetime stream of payments. Mutual funds were added in 1974, but individual stocks remain off limits.

While plans at large colleges and national nonprofits can look a lot like corporate 401(k) plans, local school districts and

small charities still have a limited role in their 403(b)s. They allow financial firms to offer 403(b) accounts directly to employees and simply pass along contributions subtracted from employees' paychecks.

An employer typically gives the nod to a handful of firms to offer 403(b) annuities or mutual funds to employees, although the number is sometimes far greater. The marketing is commonly done by commission-paid salespeople, which can mean personalized service but added costs to investors.

From their start in the early 1980s, by contrast, 401(k) plans have involved significant oversight by employers. One rationale for barring participants from transferring their savings to outside investments is that a corporate employer is obligated under the Employee Retirement Income Security Act to run the programs in the employees' best interests. If workers could move their money elsewhere, employers would have little ability to make sure the money was in solid investments.

School districts, as arms of local government, aren't subject to the 1974 ERISA law, and small charities that have minimal involvement in their 403(b) plans also aren't subject to its provisions.

Many early 403(b) annuities didn't allow investors to pull their money out and move it elsewhere. TIAA-CREF, the dominant player in the college 403(b) market, started allowing transfers in the late 1980s. That led the mutual-fund industry and others to request clarification from the IRS that shifting money from one 403(b) product to another wouldn't trigger a tax bill for the investor. A 1990 IRS ruling opened the door for 403(b) participants to freely move their money around—unless their own employer bars transfers to outside providers, as some do.

In the 403(b) regulations it proposed in November, the IRS didn't specify a reason for eliminating transfers of 403(b) money to outside providers. But the new IRS rules, which are proposed to take effect next January, say legal changes over the years have made rules for 403(b) plans more like those for 401(k)s. It didn't describe the changes.