Teachers Deserve Better From Retirement-Plan System

Barry Ritholtz
Mar 15 2019

(Bloomberg Opinion) -- How is it possible that two variations of tax-deferred retirement accounts, born of similar ideals and motivations, have evolved into shockingly different animals?

I refer to 401(k) and 403(b) investment accounts. Despite being part of similar tax codes with nearly identical goals, in practice the portfolios of each bear little resemblance to each other. As a result, millions of American teachers, among others, are retiring with less in savings than they deserve.

It's a problem policymakers know about but haven't fixed. A subcommittee in the House of Representatives has been hearing disquieting testimony about it since February, but the politics of the issue are tough.

This is lamentable considering the shared purpose of the two kinds of retirement accounts: both are tax-qualified, each is a defined-contribution pension account and both are treated as retirement accounts for legal purposes. The main distinction is that 401(k)s are governed by 26 U.S. Code § 401 and are covered by the Employee Retirement Income Security Act, known by its acronym Erisa. 403(b)s were orginally created in 1958 and were modified by subsequent legislation. There are a handful of technical differences as well.

But the key difference — the one that determines who qualifies for one kind of savings plan or the other — is simply the type of employer involved. If it's a for-profit corporation, partnership or limited-liability company, then the retirement plan is the 401(k). People who work for a nonprofit organization like a school, hospital, religious group or another kind of tax-exempt entity qualify instead for a 403(b).

That factor makes all the difference in the world. For many 403(b) account holders, the plan sponsor and the employer are two different entities. This small, anomalous distinction turns out to have enormous repercussions for a huge swath of plan participants — notably the 3.6 million teachers who work for public or not-for-profit private schools.

If you work for the typical for-profit company, your 401(k) plan sponsor is also your employer. That means your assets are protected by Erisa, which is intended to ensure that the money is available when a participant retires. Employers who sponsor 401(k) plans are required, according to the Department of Labor, "to run the plan solely in the interest of participants and beneficiaries and for the exclusive purpose of providing benefits and paying plan expenses."

Teachers who are 403(b) participants are not so lucky. Most of them are state employees, covered by state laws pertaining to salary, collective bargaining agreements and old-fashioned, defined-benefit pensions.

But their defined-contribution plans are usually administered not by the state but by a local school district or other local government entity. When the employer (in this case the state) is not the entity responsible for the plan (the local board), associated employer fiduciary obligations specified by Erisa go away.

That means that the people who are in charge of the 403(b)s have no obligation to treat the retirement accounts as if they are salary and compensation, the standard that applies to the private sector regarding 401(k)s.

This often has terrible consequences in practice. Most significant, 403(b) plans tend to invest way too much money in annuities — 76 percent on average. Annuities have much higher costs than typical mutual funds. While the past decade has seen most of the country enjoy falling portfolio costs, 403(b) participants have not. Comprehensive research on the topic has been published by Aon Hewitt, which concludes that 403(b) customers waste $10 billion dollars per year in excess fees.

It's noteworthy that 403(b) plans were legislated in 1958, predating 401(k)s by 20 years. At that time, annuities were the only allowable investment vehicles for 403(b) participants. The 1958 legislation codified what was a savvy savings practice by a few charitable organizations into a tax law available for all nonprofit employees. As the IRS noted in a white paper, Congress made available "a tax-deferred savings device for employees of certain section 501(c)(3) organizations." Previously, this was accomplished via purchases of annuities, but the 1958 legislation created a formal vehicle for nonprofit retirement savings.

That changed in 1974 when the Erisa laws were amended, allowing for the creation of 403(b)(7) custodial accounts that allowed investments in mutual funds, which are much cheaper than annuities, a type of tax-deferred insurance product.

As an old expression goes, "insurance is sold, not bought." The historical infrastructure of insurance salespeople working with school districts was originally considered a convenience. Now, school districts grant insurance salespeople access to teachers, occasionally for a fee to the district, despite decades having passed since that was useful to anyone but the salesperson.

This explains why three-fourths of non-Erisa 403(b) holdings in portfolios are these expensive annuities. There are practically none in 401(k)s. If an employer and 401(k) plan sponsor put a high-cost, tax-deferred annuity into a tax deferred 401(k), they would be warned by counsel to expect litigation.

And they'd probably lose, because paying a high fee to put a tax-deferred component into a tax-deferred account is pointless. Unless you want to generate a sales commission; then it makes perfect sense.

The solution to protect teachers and others similarly situated is simple: Extend Erisa protections to all 403(b) accounts, regardless of employer. But as my Bloomberg Opinion colleague Nir Kaissar wrote last October, any such proposal is bound to produce shrieks of outrage from the insurance-industry lobby. “Providers are often big insurers such as Valic, Voya, AXA and Lincoln Financial, with lots of resources to repel challenges to their 403(b) business,” Kaissar wrote.

My colleague, Dina Isola, recently testified on the subject before the House Subcommittee on Investor Protection, Entrepreneurship and Capital Markets. She noted, “There has never been greater access to low-cost, high-quality investment opportunities, yet the lack of fiduciary protections leave many investors paying excessive fees and suffering from poor outcomes.” Let’s hope Congress is paying attention.

Prior to 2001, the tax treatments were similar, and after the Economic Growth and Tax Relief Reconciliation Act of 2001, the tax treatments became effectively identical. The act made tax rates lower, simplified qualified plan rulesand reconciled most of the differences between individual retirement accounts, 401(k) plans, 403(b)s, and pension plans. See Tax Policy Under President Bush, Cato Institute.

In 1958, Congress made available a tax-deferred savings device for employees of certain section 501(c)(3) organizations by adding section 403(b) to the Internal Revenue Code.

In 1961, IRC 403(b) was extended to employees of public education institutions.In 1974, custodial accounts in which contributions are invested in mutual funds were made available as funding vehicles.In 1982, the law was expanded to cover retirement income accounts for employees of church organizations.

For example, the annual reporting requirements of IRS Form 5500 for 403(b) plans tends to be simpler and less costly, and does not require an independent auditor for plans with more than 100 participants. The 2005 Bankruptcy Abuse Prevention and Consumer Protection Act also changed the sorts of bankruptcy protections that existed for both 403(b) plans and account holders.

There are lots of anecdotes about how teachers’ 403(b)s participant-borne costs are far in excess for services than comparable 401(k)s – see for example this or this – but I want to focus instead on the hard data. For the mathematically minded, it paints a picture of public servants not being served by their own school districts.

Technical Amendments Act of 1958, Pub. L. No. 85-866, §23, 72 Stat. 1606 (1958). The most current version is found in IRC §403(b).

The IRS notes: “In 1961, IRC 403(b) was extended to employees of public education institutions, including colleges and universities. In 1974, certain custodial accounts in which contributions are invested in mutual funds were made available as funding vehicles. IRC 403(b) was further expanded in 1982 to cover retirement income accounts for employees of church organizations.”