U.S. News & World Report

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WHAT IS A 457(B) PLAN?

A 457(b) plan allows government employees to defer paying tax on their retirement savings.

By: Rachel Hartman - November 20, 2019

Individuals working for state and local governments, as well as some tax-exempt organizations, may be eligible for a 457(b) plan. This type of account is designed to help government and nonprofit workers save for retirement. Wendy Carter, vice president and defined contribution director at The Segal Group in the District of Columbia, says 457(b) plans are "very similar to 401(k) plans, except they are exclusively for public sector workers."

If you invest in a 457(b) plan, you'll have access to certain advantages like tax-deferred growth and the opportunity to choose how to invest funds. There are also potential disadvantages to keep in mind, including fees that may be higher than other types of investments and no employer match.

Before contributing to a 457(b) plan, it can be helpful to understand the fine print associated with this type of retirement savings vehicle. Here's how 457(b) plans work and what factors to keep in mind when managing this type of account.

Basics About 457(b) Plans

If you are a police officer, firefighter, high school teacher, employee of a state college or have a different position in the public sector, you may be able to contribute to a 457(b) plan while you're employed. These plans are "usually used in conjunction with pensions and other benefits typically offered by state and local governments," says Stewart Darrell, president of Harris Financial Advisors in Torrance, California.

Public sector organizations sponsor 457(b) plans on a pre-tax basis. "Contributions are made through salary reductions," Darrell says. When funds are taken from your paycheck and put into the account, it reduces your overall taxable income. The contributions and interest earned won't be taxed until they are distributed.

The contribution limit for a 457(b) plan is $19,500 in 2020. If you are 50 or older, you can put up to $26,000 in a 457(b) plan. When contributing, you're allowed to put up to 100% of your salary into the account, provided the total amount doesn't surpass the designated contribution limits. If you leave the workplace, you won't be able to put more funds into the account.

Advantages of 457(b) Plans

When you save through a 457(b) plan, you'll typically be able to decide how you want to allocate your contributions. "You will have different mutual funds to invest in," says Galen Bargerstock, founder of Government & Civil Employee Services in Indiana, Pennsylvania. This allows you to align your savings with your risk tolerance. If you are risk averse, you might opt for a low-risk fund. If you're a decade or more away from retirement, you might feel more comfortable with a higher risk fund.

If you have left your employer and want to take funds out of your 457(b) plan early, you won't have to pay a 10% fee on the amount withdrawn. This is different from other retirement plans like the 401(k), which charges a penalty if funds are withdrawn before age 59 1/2. "A 457(b) plan will have no tax penalty if you take out before age 59 1/2," Bargerstock says. "This will help if you are projecting an early retirement."

For workers who are near retirement and want to save even more, 457(b) plans offer a special three-year catch-up feature. "Under this provision, an employee who has not contributed to the maximum contribution limit in past years can contribute additional contributions up to twice the normal limit," Carter says. This can be beneficial if you directed funds toward different financial goals earlier in your career, such as paying off debt or funding your child's education. You can contribute substantially more during the three-year window to increase your savings and better prepare for retirement.

Disadvantages of 457(b) Plans

If you invest in a 457(b) plan but need the money before retirement, it may not be easy to access the saved funds while you are employed. This is distinct from 401(k) plans, which often allow current employees to take distributions for a financial hardship such as a home purchase or education expenses. With a 457(b), there are different requirements you'll have to meet in order to take out funds for an emergency. With a 457(b) plan, "there is a higher standard than 401(k)s, as the hardship also has to be unforeseeable," Carter says. This means you may be able to take a withdrawal for an unexpected medical emergency but not to pay for college costs.

With some retirement accounts, the funds you invest will be protected from creditors. If you have debts that need to be paid, lenders will not be able to access the safeguarded cash in the retirement account. That is not the case for some 457(b) plans. If you invest in these accounts, "they are not protected from creditors," Darrell says.

While a 401(k) plan may offer an employer match, meaning your company will contribute up to a certain amount every year, a 457(b) plan usually does not have this feature. If an employer does make a contribution, it will typically be calculated as part of the total amount allowed during the year. If your contribution limit is $19,000 in 2019 and your employer puts $3,000 into the account, you'll only be able to place $16,000 into the fund during the year.

Some 457(b) plans may have higher fees than other types of retirement plans. Before signing up for one, you can ask about the charges included with the account. If you don't understand the information given to you, sit down with a financial professional to sort out the costs before starting contributions.