Legislative and regulatory bulletin

Accessing DC plans for emergencies

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SECURE Act 2.0: Emergency savings accounts and other emergency savings proposals

Nearly everyone at some time or another incurs an unplanned expense. Whether it's the water heater dying or the car suddenly needing a repair, some expenses simply can't be put off. But many people don't have ready cash available to meet emergencies like these. According to a survey by the Federal Reserve, when faced with a hypothetical expense of $400, 32% of all adults in 2021 said they could not cover the expense using cash, savings or a credit card paid off at the next statement. Rather, they would need to sell something or take on debt.[1]

Plan loans and hardship distributions

If available, some people tap their 401(k) or other defined contribution (DC) plans by taking a loan or a hardship distribution to meet a pressing need for cash. But these are far from ideal solutions. If the employee terminates employment with an outstanding loan, the balance usually becomes immediately due and, if not paid, is subject to tax and possibly a 10% penalty. Hardship distributions in most 401(k)s are only allowed for certain deemed hardships, such as medical expenses, described in the Internal Revenue Service's 401(k) regulations. The participant's emergency need might not be one of the specified hardships. Hardship distributions are taxed, potentially subject to the 10% penalty and can't be recontributed to the plan.

Pending legislation would create new ways to access DC plans for emergencies

In June, two U.S. Senate committees—the Finance Committee and the Committee on Health, Education, Labor and Pensions (HELP)—unanimously approved separate retirement plan bills that include emergency savings provisions. [2]

[1] Federal Reserve, "Economic Well-Being of U.S. Households in 2021," May 2022.
[2] The Enhancing American Retirement Now (EARN) Act; the Retirement Improvement and Savings Enhancement to Supplement Healthy Investments for the Nest Egg (RISE & SHINE) Act.

The Emergency Savings Act. The HELP Committee's bill includes a section called the Emergency Savings Act, which would permit employers to offer "pension-linked emergency savings accounts" (ESAs) within their DC plans, to which participants and employers could contribute. The maximum account value would be $2,500. Contributions that exceeded $2,500 would spill over to the long-term retirement savings portion of the plan. Employers could even opt to automatically enroll participants into ESAs at a rate of up to 3% of pay.

Participant contributions to ESAs would be treated as Roth contributions, and any employer contributions would be included in the employee's gross income. The accounts' investments would be limited to cash, interest-bearing deposit accounts or other principal-protected investments.

Participants could withdraw from their ESAs at their discretion, but the plan could limit such withdrawals to one per month. Participants would have to deplete their ESAs before taking a plan loan or a hardship distribution. The plan couldn't charge fees for withdrawing from the ESA, other than reimbursement for paper mailings and paper checks.

Penalty-free withdrawals for emergencies. A provision in the Finance Committee's bill would waive the 10% early withdrawal penalty on distributions of up to $1,000 in a calendar year from DC plans and IRAs used for emergency purposes. Participants could self-certify that they had an emergency. The maximum penalty-free emergency withdrawal amount in any calendar year would be the lesser of $1,000 or the amount by which the participant's vested balance exceeded $1,000. Thus, for example, if the participant's account value was $1,900, the emergency withdrawal would be limited to $900. But if the account value was less than $1,000, a withdrawal would not be permitted.

Participants could recontribute the amount within three years from the date the distribution was received. The recontribution would be treated as a tax-free rollover. Participants would not be able to take additional penalty-free emergency withdrawals during the three-year period unless they recontributed.

Disaster relief. The Finance Committee's bill contains another emergency relief provision. This one would be available to individuals affected by federally declared disasters and is similar to the temporary measures Congress put in place after the COVID-19 outbreak and natural disasters like Hurricane Katrina.

Under the bill, affected individuals could take penalty-free withdrawals of up to $22,000 from IRAs and DC plans. For tax purposes, the amount withdrawn would be included in income ratably over a three-year period unless the individual opted to be taxed on the entire amount in the year withdrawn. Individuals could recontribute withdrawn amounts within three years as a tax-free rollover. The bill would also increase the maximum retirement plan loan to the lesser of $100,000 or 100% of the vested account balance and delay the due date for any loan repayment for one year.

Penalty-free withdrawals and increased loan limits would generally be available for 180 days after the disaster. To be eligible for this relief, individuals must live in the disaster area and suffer an economic loss.

Participants would like emergency savings tied to their DC plans

Participants seem to favor the idea of looking to their DC plans when faced with an emergency expense. In J.P. Morgan's Plan Participant Survey, 77% of participants said they would be interested in participating in an emergency savings account offered through their employer's plan.[3] While survey respondents of all ages liked the idea of in-plan emergency savings accounts, low and moderate income participants and those under age 49 were even more likely to find them attractive.

[3] J.P. Morgan Plan Participant Research 2021.

Could be included in a "SECURE Act 2.0" legislative package

There is significant momentum in Congress to enact bipartisan retirement legislation this year. Often considered a sequel to the major retirement bill passed in 2019—the Setting Every Community Up for Retirement Enhancement (SECURE) Act—SECURE 2.0 would make several improvements to the retirement system. If some or all of the emergency savings provisions described above were to be included in the final package, plan sponsors would be able to offer their participants more ways to access their DC plans to meet their emergency spending needs.

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