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Legal Developments

"Pension-Linked Emergency Savings Accounts"—Qualified Plans Provide More Than Just Retirement Benefits

This column delves into the features of the Pension-Linked Emergency Savings Accounts under Section 127 of SECURE 2.0.

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Tax-qualified retirement plans are designed to provide savings for retirement. Accordingly, the Internal Revenue Code (Code) has historically provided numerous restrictions (and penalties) on in-service distributions to prevent savings leakage. But times are changing with the SECURE 2.0 Act of 2022. For the first time, the Code has a provision that is designed to provide special tax relief for an emergency savings account that is linked to a tax-qualified retirement plan. That's right, leakage is actually permitted, and, in fact, embraced to help facilitate lifetime savings. Although there are a number of options available for emergency savings accounts, this is the first one that provides both a way to encourage retirement savings (so no one outlives their retirement savings) and at the same time provide a tax-advantaged way to meet immediate financial needs that arise in one's day-to-day activities. So, let's take a closer look at the features of this Pension-Linked Emergency Savings Accounts (PLESA) under Section 127 of SECURE 2.0.

PLESA—The Basics

Linked to a Qualified Plan

The PLESA is available for plan years beginning after December 31, 2023. It is an optional provision for a plan sponsor to select to be a part of its individual account plan/defined contribution plan. This extends to 403(b) plans and 457(b) governmental plans, but excludes defined benefit plans. This definition should also extend to governmental defined contribution plans.

A plan amendment will be needed to adopt this new plan feature, but currently we have through the end of the 2025 plan year to adopt plan amendments, so there is no rush there. Also, SECURE 2.0 references guidance on sample plan amendments, which will assist with the plan drafting. This is particularly important for ongoing plans that are generally not eligible to file for an updated Internal Revenue Service (IRS) determination letter.

Notably, if the plan sponsor changes its mind about offering the PLESA, it can amend the plan to eliminate the feature at any time—there is no anti-cutback violation, as this feature is not a protected benefit. Upon elimination, the plan must permit the participants to elect to transfer some or all of their PLESA to a Roth account in the plan and make the remainder of the account available for distribution to the participant in a reasonable amount of time (which, importantly, is eligible for rollover treatment).

Participants Eligible To Have an Account

Each employee who meets the plan's general age and service (or other eligibility) requirements, and who is not a highly compensated employee (HCE, as defined under Code Section 414(q)) must be eligible to establish a PLESA. If the employee becomes an HCE after the account is established, no further contributions can be made to the account (but the HCE can still take withdrawals from the existing PLESA). Limiting PLESAs to non-HCEs is likely reflective of the fact that lower paid employees are more vulnerable to short term cash needs that would discourage savings of funds that cannot be accessed for those needs to a 401(k).

Contributions To the Account

Contributions to an emergency account are all funded by the employee via Roth contributions, that is, after-tax contributions. However, unlike normal Roth contributions, which get favorable tax treatment only if they are paid after certain requirements have been fulfilled, PLESA distributions are deemed to be qualified distributions subject to that treatment. Because the contributions to the PLESA are after-tax amounts (subject to employment taxes and withholding at the time deposited), they are not retaxed at distribution. In addition, any earnings on the account grow tax-free and are not taxed on distribution. Further, PLESA contributions by the employee are 100 percent immediately vested when contributed to the account. Even better, they are exempt from the 10 percent additional tax on distributions prior to age 59½ under Code Section 72(t).

The contributions can be initiated by employee election, or the plan sponsor can design the program to use automatic enrollment. The automatic enrollment provisions are unique to these accounts, which provide for a cap at 3 percent of compensation, and the automatic deferral rate set by the plan sponsor can only be changed once annually. SECURE 2.0 also includes state law exemption relief for this automatic enrollment, and additional Department of Labor (DOL) rules may be forthcoming.

Importantly, if the plan that establishes a PLESA has a matching contribution on 401(k) deferrals within the plan, then the employer also must match the employee's PLESA contributions at the same rate as it does for regular 401(k) contributions (considering only PLESA contributions that do not cause the total participant contributions to exceed the statutory maximum). These employer matching contributions are held as part of the 401(k) plan account, not within the PLESA, so they are not available for periodic withdrawal when an emergency arises (but are available once vested for distributions in the same manner as a match on 401(k) deferrals), and will grow tax-free inside the tax-qualified plan. To address the concern that an employee puts money into the account, just to get the employer match, and then takes a distribution and reinvests the same amount again in order to get another employer match on the same funds—this is called "churning"—the IRS indicated that reasonable procedures to limit the frequency or amount of match may be used to prevent this type of abuse.

Account Limit

There is an overall cap on contributions to the account of $2,500 (indexed) (or a lesser amount, as determined by the plan sponsor). There also are special correction procedures available if this cap is exceeded. For example, excess contributions can be transferred to the Roth 401(k) account in the plan or, if no other Roth account is permitted under the plan, the plan administrator may simply not accept excess amounts. Notably, no amounts can be transferred to a plan from another plan's PLESA.

There also are special rules if the participant has an excess 402(g) contribution for the plan year. For this purpose, the account generally is treated as a designated Roth account. Therefore, in the event the plan distributes any excess deferrals, the distributions must be made from the PLESA first (if contributions to the PLESA were made in the tax year).

Account Restrictions

There are a number of requirements and restrictions on PLESAs, including:

- *No Account Minimums*. The plan cannot impose a minimum contribution or minimum account balance requirement.
- *Separate Accounting*. The plan must separately account for and maintain records for each account.
- *Withdrawals*. Full or partial withdrawals must be permitted at least once per calendar month, to be paid as soon as practicable to the participant. The plan's normal restrictions on in-service distributions do not apply.
- *Account Fees*. No fees or charges can be imposed in relation to the first four withdrawals during a plan year. After four withdrawals during the plan year, reasonable withdrawal fees can be imposed, which must be disclosed to the participants.
- *Investment*. The account can be either held in cash, an interest-bearing deposit account, or an investment product offered by a state or federally-regulated financial institution that is designed to preserve principal. All these investments are designed to be very conservative and to preserve principal. Notably, ERISA's 404(c) protection is available for these accounts (even if automatically enrolled).

Participant Disclosures

There are various disclosure requirements for these accounts, with additional DOL guidance pending. For example, the plan administrator must provide participants notice 30 to 90 days before the first PLESA contribution (or a change in the default contribution rate) and annually thereafter, providing various disclosures related to the account. The notice may be consolidated with other plan-related notices.

Taxation of Withdrawals

Withdrawals are treated as Roth qualified distributions, so there is no income tax as a result of the withdrawal, no 10 percent early withdrawal tax, and no federal income tax withholding required. These payments are *not* eligible for rollover treatment. There are two exceptions: (1) if the participant terminates employment, or (2) if the plan sponsor eliminates the account.

When an employee terminates employment, the plan must permit the participant to elect to transfer some or all of his/her PLESA to a Roth account in the plan and make the remainder of the PLESA available to the participant as a distribution in a reasonable amount of time. These amounts are treated as eligible rollover distributions, so they can be rolled to an IRA or another qualified plan. Similarly, as noted above, when the account is eliminated altogether by the plan sponsor, the participants can transfer some or all of their PLESA to a Roth account in the plan and the plan sponsor can make the remainder of the account available to the participant in a reasonable amount of time (which is eligible for rollover treatment).

Next Steps

We anticipate IRS guidance on the various complexities raised by this emergency savings account and understand that a lot of system programming and testing, plan sponsor and employee education, and additional IRS guidance will be needed to properly implement this new feature. But if all goes well, we anticipate this is just the beginning of financial wellness intertwined with qualified plans. ■