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Retirement Savings vs. Emergency Savings: The Dual (and Competing?) Uses of 401(k) Plan Assets

By Avi Bernstein[*]
Epstein, Becker & Green
New York, NY

401(k) plan assets represent a significant portion of America's retirement savings. Per the Investment Company Institute, as of June 30, 2021, 401(k) plans held an estimated $7.3 trillion in assets, which represented nearly one-fifth of the $37.2 trillion U.S. retirement market.[1] But unlike traditional pension plans, 401(k) plans, no matter how big a portion of the country's retirement savings they represent, are not exclusively retirement savings. Congress recognized that 401(k) plan assets sometimes have to be accessed prior to retirement. The Internal Revenue Code (''Code'') contains various provisions, including amendments by the recently passed SECURE Act 2.0 of 2022,[2] reflecting attempts to balance the competing needs of preserving savings for retirement versus making them available to address certain life circumstances, such as may be of high interest to participants as well plan administrators and employers.

401(k) NON-RETIREMENT ACCESS PROVISIONS

Plan Loans for Emergencies

One such Code provision is §72(p),[3] which allows 401(k) participants to borrow from their accounts. Plan loans (assuming they are repaid) would largely satisfy both needs, as the assets are available to meet the present need and will be repaid in time for the participants' retirements. But plan loans require regular repayments that start almost immediately after the loan is taken.[4] Moreover, plan sponsors will often limit the availability of loans to active employees who can make loan repayments via payroll deduction. Participants in urgent need of money may not be able to start making loan repayments. Participants who have been laid off may not even have the options of plan loans available to them. Plan loans, while a useful tool to address accessing 401(k) assets in cases of emergency, are insufficient to meet the needs of many participants.

Accordingly, the Code allows for non-retirement distributions from 401(k) plans.

401(k) Distribution Events

Section 401(k)(2) of the Code allows participants to take distributions of employee pre-tax contributions[5] (also known as elective deferrals) of 401(k) plans upon the occurrence of the following distribution events:

- severance from employment, death, or disability;

[*] Avi Bernstein brings more than 25 years of experience to bear when working with public and private companies and nonprofit organizations on their ERISA and non-ERISA employee benefits and executive compensation issues. This article may be cited as Avi Bernstein, *Retirement Savings vs. Emergency Savings: The Dual (and Competing?) Uses of 401(k) Plan Assets*, 51 Tax Mgmt. Comp. Plan. J. No. 2 (Feb. 3, 2023).

[1] https://www.ici.org/faqs/faq/401k/faqs_401k.

[2] Division T of the Consolidated Appropriations Act of 2023, Pub. L. No. 117-328 (Dec. 29, 2022).

[3] All section references are to the Internal Revenue Code, as amended, unless otherwise indicated.

[4] §72(p)(2)(C).

[5] The requirement for a distribution event can also be applicable to certain employer contributions, including employer match or non-elective contributions intended to meet the safe harbor requirements under §401(k)(12) or §401(k)(13).

- the attainment of age 59½;[6]
- in the event of hardship; and
- in the case of a qualified reservist distribution;
- termination of the plan.

In addition, §72(t)(2)(H)(vi)(IV) allows plans to permit participants to take qualified birth or adoption distributions without violating §401(k)(2). Newly adopted legislation discussed below creates a new distribution event for victims of domestic abuse.

Death, disability, and the attainment of age 59½ distributions are arguably end-of-work/old-age distributions that are proxies for retirement. Termination of the plan is something beyond the control of a participant. Qualified birth or adoption distributions are limited in amount to $5,000 per birth or adoption,[7] and can be repaid to the plan or an IRA within three years.[8] Even hardship distributions are generally limited to amounts needed for specified emergency expenses. But the availability of a distribution upon separation of employment, without any other age or need conditions, is porous enough to allow a 401(k) plan participant to withdraw 401(k) assets for virtually any reason.

Disincentives to Early Distribution

Distributions of pre-tax money from a 401(k) plan are generally subject to income tax.[9] Current taxation and losing the ability to accumulate tax deferred investment earnings should serve as something of a deterrent to withdrawing 401(k) elective deferrals frivolously. The Code, however, contains an additional provision intended to deter non-urgent early distributions from retirement plans. Section 72(t) imposes a 10% early distribution penalty on the amount of the distribution which is includible in gross income (i.e., the amount of the distribution that has previously been subject to tax).

Section 72(t) contains exceptions to the 10% penalty for pre-retirement exceptions for distributions in case of emergency. They include distributions for certain unreimbursed medical expenses (if they exceed 7.5% of adjusted gross income),[10] distributions for unemployed people to pay health insurance premiums,[11] for individuals called to active military duty,[12] and for qualified birth or adoption distributions.[13] The Secure Act 2.0 adds additional exceptions to the 10% penalty, and one other provision for emergency distributions.

SECURE ACT 2.0

Emergency Savings Account (Effective for Plan Years Beginning After December 31, 2023)

Although current law allows for in-service withdrawals from 401(k) plans in the event of hardship, there is no specific arrangement within a 401(k) plan for a separate emergency savings account (ESA). SECURE Act 2.0 specifically allows employers to provide an ESA for non-highly compensated employees under the plan,[14] which must be funded with Roth contributions. The plan may automatically enroll eligible participants in an ESA at 3% of compensation.

Once the ESA account balance reaches $2,500 (indexed for inflation) or a lower amount determined by the plan sponsor, no further contributions are allowed until the participant makes a withdrawal. There can be no minimum contribution or balance requirements. Participants must be allowed to take at least one withdrawal per month, and the first four withdrawals per year cannot be subject to fees. ESAs may be invested in cash, interest-bearing deposit accounts, and principal preservation accounts. The Code does not appear to define what constitutes an emergency, suggesting that such withdrawals can be made for any purpose.

New Exceptions to the 10% Early Distribution Penalty

Withdrawals for Emergency Personal Expenses (Effective for Distributions Made After December 31, 2023)

SECURE Act 2.0 allows an exemption to the 10% early withdrawal penalty for one withdrawal of up to $1,000 per year ''for purposes of meeting unforeseeable or immediate financial needs relating to necessary family or personal emergency expenses.''[15] The plan administrator is entitled to rely upon an employee's written certification that the distribution is for unforeseeable or immediate financial needs without further investigation. Participants who take distributions have the option of paying them back to the plan (if the

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[6] Applicable only to 401(k) plans which are profit-sharing or stock bonus plans.

[7] §72(t)(2)(H)(ii).

[8] §72(t)(2)(H)(v)(I), as amended by SECURE Act 2.0 §311.

[9] §402(a).

[10] §72(t)(2)(B).

[11] §72(t)(2)(D).

[12] §72(t)(2)(G).

[13] §72(t)(2)(H).

[14] SECURE Act 2.0 §127.

[15] SECURE Act 2.0 §115.

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plan permits) under rules similar to those relating to repayment of qualified birth or adoption distributions. A participant who takes an emergency personal expense distribution may not take another one from the same plan during the next three years unless (1) the participant has paid the emergency personal distribution back to the plan or (2) the aggregate amount of elective deferrals and employer contributions to the plan since the original emergency personal distribution is at least equal to the portion of the original distribution that was not repaid to the plan.

Distributions for Terminally Ill Participants (Effective Immediately)

SECURE Act 2.0 provides an additional exception to the 10% early withdrawal penalty for distributions to terminally ill participants.[16] ''Terminally ill participants'' are defined as those certified by a physician as having a terminal illness or condition that can reasonably result in death within 84 months of the date of the certification. Terminally ill participants who take distributions have the option of paying them back to the plan (if the plan permits) or to an IRA under rules similar to those relating to repayment of qualified birth or adoption distributions.

Long-Term Care Distributions (Effective for Distributions Made After December 28, 2025)

SECURE Act 2.0 creates a new exception to the early withdrawal tax for distributions used to pay for certified long-term care insurance. ''Certified long-term care insurance'' has a very technical definition that loosely covers a qualified long-term care insurance contract, within the meaning of §7702, or a rider or other provision under a life insurance or annuity contract that either covers the risk that the insured becomes chronically ill or provides meaningful assistance if the insured requires home-based or nursing home care. The exception from the 10% early withdrawal penalty will be limited to the lesser of (a) the cost of the insurance, (b) 10% of the participant's vested account balance, or (c) $2,500 annually (to be adjusted for the cost of living).

Distributions for Victims of Domestic Abuse (Effective for Distributions Made After December 31, 2023)

Under SECURE Act 2.0, a domestic abuse victim is entitled to take a penalty-free distribution from a 401(k) plan of up to the lesser of $10,000 (indexed for inflation), or 50% of the participant's vested account balance.[17] The distribution can only be taken during the one-year period that starts on the date on which the individual is a victim of domestic abuse by a spouse or domestic partner. ''Domestic abuse'' is defined as ''physical, psychological, sexual, emotional, or economic abuse, including efforts to control, isolate, humiliate, or intimidate the victim, or to undermine the victim's ability to reason independently, including by means of abuse of the victim's child or another family member living in the household.'' Domestic abuse victims who take distributions have the option of paying them back to the plan (if the plan permits) or to an IRA under rules similar to those relating to repayment of qualified birth or adoption distributions. As discussed above, SECURE Act 2.0 creates a new distribution event to facilitate distributions to domestic abuse victims.

CONCLUSION

While the Code generally disincentivizes the use of retirement savings for pre-retirement needs, it does provide for early access to funds to address emergencies and other significant life circumstances. Congress seems to be recognizing non-retirement needs by creating additional exceptions to the strongest disincentive to pre-retirement distributions, the 10% early distribution penalty. The newly adopted SECURE Act 2.0 continues this trend by introducing several such exceptions, some of which are already in force.

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[16] SECURE Act 2.0 §327.

[17] SECURE Act 2.0 §314.

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