Verrill

Pension-Linked Emergency Savings Accounts: Something Old, Something New, Something Borrowed, Something Forthcoming

by Anna Mikhaylina on January 24, 2023

Following the initial flurry of publications summarizing the retirement plan enhancements under the SECURE 2.0 Act of 2022 ("SECURE 2.0"), this post takes a deeper dive into one of those enhancements: the optional "pension-linked emergency savings account" ("PLESA"). Plan sponsors may add PLESAs to their defined contribution retirement plans (*e.g.*, 401(k), 403(b), and governmental 457(b) plans) starting in 2024. The PLESA provision in SECURE 2.0:

- breaks away from the traditional notions of when funds can be distributed from retirement plans by providing flexibility for participants to withdraw all or a portion of their PLESA balance at least once per calendar month;
- borrows from and builds on features from Roth contributions, non-Roth after-tax employee contributions ("after-tax employee contributions"),[1] and savings accounts; and
- *requires* plan sponsors to make matching contributions on participant PLESA contributions if the employer otherwise makes matching contributions to the plan.

Something old. The Internal Revenue Code limits the ability of participants to withdraw funds from a defined contribution retirement plan prior to retirement or termination of employment. For example, elective contributions to a 401(k) plan may "not be distributable to participants […] earlier than" the occurrence of one of several qualifying events, including severance from employment, death, disability, the attainment of age 59½, and certain hardships.

Withdrawal restrictions apply even to *after-tax employee contributions* if this type of contribution is matched by the employer. For example, plan provisions often require a suspension of after-tax employee contributions for six months after a participant takes a withdrawal from their after-tax employee contributions account. The six-month suspension requirement dates back to a 1974 Revenue Ruling that treats this as a substantial enough limitation to prevent participants from making after-tax employee

[1] In general, after-tax employee contributions are contributions that an employee has already paid tax on and enjoy tax deferral on earnings until distributed from the plan.

Verrill

contributions only to obtain a match and then withdrawing the employee contributions after the match is obtained.[2] Despite the lack of more recent guidance from the IRS, the failure to include substantial limitations on participant withdrawals of matched after-tax employee contributions is generally viewed as having the potential to disqualify a qualified retirement plan.

The advent of PLESAs changes the statutory and regulatory landscape for withdrawals from defined contribution retirement plans because withdrawals from a PLESA may be made at least once a month, up to the balance then in the PLESA, at the participant's discretion, without any questions asked. In other words, a participant does not need to wait for one of the "qualifying events" to take a withdrawal from their PLESA. For retirement plans that include matching contributions, this would seem to make PLESAs particularly susceptible to the manipulation just described with respect to matched after-tax employee contributions. SECURE 2.0 calls for PLESA regulations or other guidance to prevent manipulation of a plan's rules to cause matching contributions to exceed the intended frequency or amount. Thus, like matched after-tax employee contributions in the old IRS Revenue Ruling, PLESAs create the need for anti-abuse rules.[3]

Because of similarities between a PLESA and matched after-tax employee contributions, the forthcoming PLESA guidance could reasonably be expected to fill the fifty-year-long regulatory vacuum regarding what provisions are needed to ensure that an in-service withdrawal of after-tax employee contributions does not result in plan disqualification.

Something new. SECURE 2.0 permits plan sponsors to add a PLESA feature to their defined contribution retirement plan. With a PLESA, participants may make contributions that are in addition to the types of contributions already available under the plan. If a plan sponsor decides to add a PLESA feature, the plan document must be amended. The plan sponsor can either offer to enroll participants in a PLESA <u>or</u> automatically enroll participants in a PLESA at a rate of not more than three percent of their compensation,

---

[2] Rev. Rul. 74-56, 1974-1 C.B. 90. Treas. Reg. §1.401-1(b)(1)(ii) states that a profit-sharing plan "must provide a definite predetermined formula for allocating the contributions made to the plan among the participants," and withdrawal provisions that could result in the manipulation of allocations have been seen as violating this requirement. Plan provisions that impose substantial limitations on the right of participants to withdraw contributions have been adopted as a means to ensure compliance with the regulation. Rev. Rul. 74-56, 1974-1 C.B. 90 concludes that a plan provision imposing a six-month suspension on employee contributions following a withdrawal of participant contributions is a substantial limitation.

[3] Notably, however, SECURE 2.0 provides that a plan with a PLESA feature is not required to suspend matching contributions after a withdrawal of contributions, including elective contributions and after-tax employee contributions.

with participants having the ability to contribute at a different rate or to opt out. By definition, a PLESA is a designated Roth account. Other key features include:

- only non-highly compensated employees who meet the plan's eligibility criteria can contribute to a PLESA;
- plan sponsors must follow specified notice and disclosure requirements;
- contributions to a PLESA are designated Roth contributions and cannot cause the portion of the PLESA balance attributable to participant contributions to exceed $2,500[4] at any time. (The $2,500 is a statutory maximum, a smaller amount could be set by the plan);
- if contributions would exceed the $2,500 maximum (or a smaller amount set by the plan) and the participant has a Roth account under the plan, the plan may provide that the participant can elect to increase their contributions to their Roth account and in the absence of an election, the participant is deemed to have elected to increase their contributions to their Roth account at the rate at which contributions were being made to their PLESA. If the participant does not have a Roth account, the PLESA contributions must stop;
- if the employer makes any matching contributions under the plan, PLESA contributions must be matched, at the same rate as any other matching contribution on the participant's elective contributions; provided the match on PLESA contributions is capped at $2,500 (as adjusted for cost of living increases) or the PLESA contribution limit set by the plan, if less, for the plan year;
- for purposes of any applicable limitation on matching contributions, any matching contributions made under the plan are treated first as attributable to participant contributions that are not PLESA contributions (in other words, PLESAs are not intended to increase the base for matching contributions);
- participants must be allowed to withdraw all or a portion of their PLESA account balance at least once a month;
- withdrawals from a PLESA, including earnings, are tax-free and are not subject to the 10 percent penalty tax on early withdrawals;
- the first four withdrawals in a plan year from a PLESA must be fee-free, but subsequent withdrawals in a plan year may be subject to reasonable fees; and
- the PLESA feature may be terminated by the plan sponsor at any time.

Something borrowed. Although part of a retirement plan, in terms of investment opportunity, a PLESA is most similar to a savings account because SECURE 2.0 requires that a PLESA be held, as determined by the plan sponsor:

[4] For PLESA contributions made after December 31, 2024, the $2,500 limit will be adjusted for inflation.

- as cash,
- in an interest-bearing deposit account, or
- in an investment product offered by a State- or federally-regulated financial institution that is designed to maintain the dollar value that is equal to the amount invested in the product and preserve principal and provide a reasonable rate of return (whether or not guaranteed), consistent with the need for liquidity.

Something forthcoming. SECURE 2.0 requires the Secretary of the Treasury, in consultation with the Secretary of Labor, to issue regulations or other guidance by the end of 2023, with respect to rules for preventing participants from making contributions to a PLESA to obtain a match and then withdrawing the PLESA contributions soon after the match is made. This guidance will be important for plan sponsors interested in adding a PLESA to their retirement plans and potentially, more broadly, for plan sponsors with plans that permit after-tax employee contributions. SECURE 2.0 also authorizes, but does not set a deadline for, the Secretary of Labor to issue guidance addressing the reporting and disclosure requirements for PLESAs, including simplified reporting procedures or requirements.

We recommend that plan sponsors gauge the level of participant interest in PLESAs, communicate with their recordkeepers and legal counsel regarding the risks and opportunities, and review retirement plan provisions regarding after-tax employee contributions to evaluate whether the upcoming guidance could be relevant for their plans.

If you have questions regarding the PLESA feature or amendments necessary to add a PLESA feature to your retirement plan, please contact any member of Verrill's Employee Benefits & Executive Compensation Group.

Anna Mikhaylina
Associate
T (207) 253 4902
email