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IN FOCUS

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Using Retirement Account Features for Short-Term Savings

Introduction

Workers can often use retirement savings for unexpected expenses. However, policymakers have expressed an interest in helping workers save for emergencies in ways that do not draw down their retirement assets. Employer-sponsored defined contribution (DC) plans—which facilitate long-term savings—could serve as a platform for workers saving for unexpected expenses. In DC plans—of which the 401(k) plan is the most common—employees and/or employers contribute to employees' individual accounts in the plan. Some proposals to increase short-term savings envision new add-on accounts (informally referred to as *sidecar* accounts in some cases; e.g., see S. 2601 in the 117th Congress). Other proposals would use existing features of employer-sponsored DC plans that allow funds to be used for unexpected expenses. This In Focus discusses two of such existing features: deemed Roth Individual Retirement Accounts (IRAs) and after-tax accounts (non-Roth) within qualified retirement plans.

Retirement Savings Accounts

Workers may be able to make one or more of the following types of contributions to their DC plans:

- *Pre-tax contributions* lower an individual's taxable income at the time of contribution. Withdrawals of savings (i.e., contributions and any investment earnings) attributable to pre-tax contributions are included in taxable income at the time of withdrawal.
- *Designated Roth account contributions* do not lower taxable income. Qualified withdrawals—which may include earnings—from designated Roth accounts *are not included* in taxable income when withdrawn.
- *After-tax (non-Roth) contributions* (hereinafter, "after-tax contributions") do not lower taxable income. Withdrawals attributable to after-tax *contributions* are not included in taxable income, whereas *investment earnings* attributable to those contributions *are included* in taxable income.

An individual's pre-tax and designated Roth account contributions (called *elective deferrals*) cannot exceed $20,500 ($27,000 for individuals age 50 and older) in 2022. After-tax contributions are not subject to the elective deferral limit. However, total contributions (which include elective deferrals, employer contributions, and any after-tax contributions) cannot exceed $61,000 ($67,500 for individuals age 50 and older) in 2022.

In 2021, 65% of private sector workers had access to, and 47% participated in, DC plans. Though Congress intended for DC plan savings to be used for retirement expenses, individuals may be able to access these savings prior to retirement by making withdrawals for specified hardship reasons or by borrowing from the account. A Plan Sponsor Council of America (PSCA) survey indicated that 91.7% of profit sharing and 401(k) plans in its survey permitted hardship distributions, and 83.9% of plans permitted loans in plan year 2020. Individuals who take hardship withdrawals from DC plans face a 10% penalty on the amount withdrawn unless an exception applies. A loan repaid in full by the plan-specified deadline is not subject to the 10% penalty.

Most DC plan participants do not withdraw funds from their accounts in a given year. The Investment Company Institute found that in each year from 2008 through 2020, fewer than 2% of DC plan participants took hardship distributions. At year-end 2020, 14.8% of DC plan participants had outstanding loans (similar to prior years).

Using Current Retirement Account Features for Short-Term Savings

The following sections describe two current features of retirement plans that could be used as a platform for short-term savings: deemed Roth IRAs and after-tax accounts in qualified DC plans. Proposals discussing these features note that modifications regarding withdrawal frequency or account balance restrictions might be necessary.

Deemed Roth IRAs

IRAs are tax-advantaged accounts most commonly used by workers to save for retirement *outside of the workplace*. However, P.L. 107-16 permitted qualified employer-sponsored DC plans to allow employees to make voluntary contributions to separate accounts designated as traditional or Roth *deemed IRAs*. Deemed IRAs follow the same contribution and withdrawal rules as their traditional or Roth IRA counterparts (26 C.F.R. §1.408(q)-1). Withdrawals from Roth IRAs are made in a specified order: first, from regular contributions; second, from conversion and rollover contributions (i.e., transfers from employer-sponsored plans and other IRAs); and third, from earnings on contributions. Because amounts attributable to regular contributions may be withdrawn tax- and penalty-free from Roth IRAs, they could possibly function for short-term savings.

A potential limiting factor in using deemed Roth IRAs for short-term savings is that DC plans must pass annual nondiscrimination testing, which ensures that pension plans benefit many workers rather than just highly compensated employees (HCEs). If non-HCEs were to contribute more to their deemed Roth IRAs and proportionately less to their pre-tax accounts or designated Roth accounts relative to HCEs, the plan might be more likely to fail a

nondiscrimination test called the actual deferral percentage (ADP) test (which compares elective deferrals of HCEs and non-HCEs).

After-Tax (Non-Roth) Accounts in Qualified DC Plans

After-tax accounts in qualified DC plans could also function as a structure for short-term savings. One reason is because withdrawals can be taken at any time if the plan allows. However, the pro-rata rule could limit their use for short-term savings because taxation and possible penalties may increase the cost of accessing funds. Unlike withdrawals from Roth IRAs—in which non-taxable amounts attributable to contributions and conversions can be withdrawn prior to any taxable amounts (such as early withdrawals of earnings)—withdrawals from qualified DC plans that include after-tax contributions must be proportional between pre-tax and after-tax balances (referred to as the *pro-rata rule*; 26 U.S.C. §72(e)(8)). This means that while withdrawals of after-tax *contributions* are tax- and penalty-free, *earnings* based on these contributions, if any, are taxable and may be subject to a 10% penalty unless an exception applies. For example, an individual who withdraws $100 from his or her $500 after-tax account ($450 of contributions and $50 of pre-tax earnings) would take $90 of the withdrawal from contributions and $10 from earnings. The $10 in earnings may be subject to tax and a 10% penalty. An exception to the pro-rata rule applies for after-tax contributions made before 1987.

Another potential limiting factor in the use of after-tax accounts is related to nondiscrimination testing. As described in the deemed Roth IRA section, if non-HCEs in a plan were to contribute more to their after-tax accounts and proportionately less to their pre-tax accounts or designated Roth accounts than HCEs did, the plan might be more likely to fail the ADP nondiscrimination test. However, another test—the actual contribution percentage (ACP) test—compares the average percentage of after-tax contributions and employer matching contributions as a proportion of compensation between HCEs and non-HCEs. Additional non-HCEs making after-tax contributions relative to HCEs could assist plans in passing the ACP test.

A PSCA survey indicated that 19.9% of profit sharing and 401(k) plans in its survey permitted after-tax contributions in plan year 2020.

Discussion

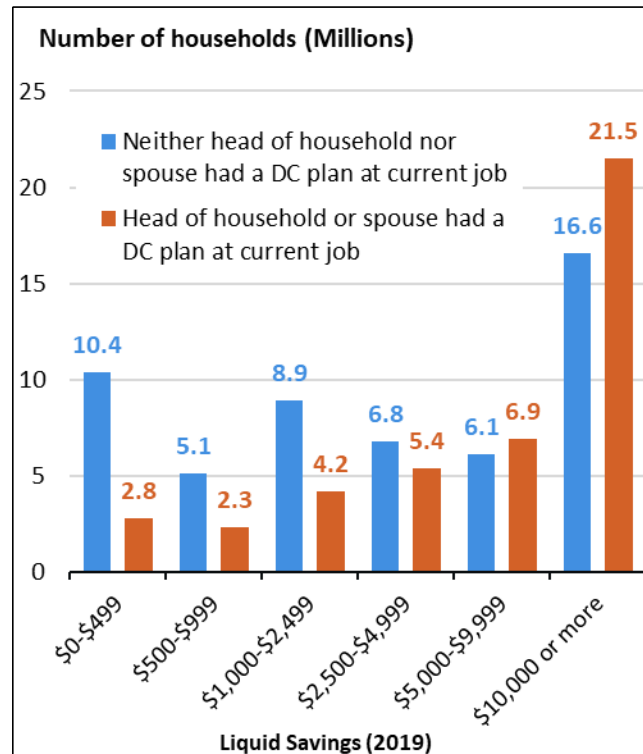
Behavioral economists note that the availability of separate accounts for short- and long-term savings may facilitate household financial decisionmaking (what is called *mental accounting*). In addition, more individuals might choose to participate in (or contribute more to) their retirement plans if they had the opportunity to save for emergencies in designated accounts.

Figure 1 provides data on the number of households with a head of household or spouse in the labor force, with and without DC plans at their current jobs, based on the amount of reported liquid savings (checking, savings, money market accounts, call accounts, and prepaid cards) in 2019.

Retirement account features used for short-term savings could assist these households that have both DC plans and low levels of liquid savings to save more. However, many households with low levels of liquid savings did not have a DC plan at their current jobs.

Figure 1. Household Liquid Savings Based on Defined Contribution Plan Coverage at Current Job, in 2019

For Households in Which the Head of Household or Spouse Was in the Labor Force



Source: CRS analysis of the 2019 Survey of Consumer Finances.

Notes: Liquid savings include checking, savings, money market accounts, call accounts, and prepaid cards. In 2019, there were 128.6 million households; 97.1 million had a household head and/or spouse in the labor force.

Existing state *automatic IRA programs* most commonly set up Roth IRAs for individuals without access to a workplace plan. Because the likelihood of access to an employer-sponsored plan increases with a worker's wage or salary, the state IRA programs may have a large number of workers who might benefit from short-term savings accounts attached to retirement plans. Research on state automatic IRA programs could examine whether participants use their Roth IRAs for short-term savings needs.

For Further Information:

John Beshears et al., "Building Emergency Savings through Employer-Sponsored Rainy-Day Savings Accounts," *Tax Policy and the Economy*, vol. 34, no. 1 (2020), pp. 43-90.

CRS Report RL34397, *Traditional and Roth Individual Retirement Accounts (IRAs): A Primer*.

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