Building Emergency Savings Through Employer-Sponsored Rainy Day Savings Accounts

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Abstract

Many Americans live paycheck to paycheck, carry revolving credit balances, and have little liquidity to absorb financial shocks (Angeletos et al. 2001; Kaplan and Violante 2014). One consequence of this financial vulnerability is that many individuals use a portion of their retirement savings during their working years. For every $1 that flows into 401(k)s and similar accounts, between 30¢ and 40¢ leaks out before retirement (Argento, Bryant, and Sabelhaus 2015). We explore the practical considerations and challenges of helping households accumulate liquid savings that can be deployed when urgent pre-retirement needs arise. We believe that this can be achieved cost effectively by automatically enrolling workers into an employer-sponsored payroll deduction "rainy day" or "emergency" savings account, and present three specific implementation options.

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Introduction

Many Americans live paycheck to paycheck, carry revolving credit balances, and have little liquidity to absorb financial shocks (Angeletos et al. 2001; Kaplan and Violante 2014). For example, forty-six percent of U.S. adults report that they either could not come up with $400 to cover an emergency expense, or would have to borrow or sell something to do so (Board of Governors of the Federal Reserve System 2016). In the 2013 Survey of Consumer Finances, liquid net worth for the median household with a head aged 41-51 is only $813, while at the 25th percentile it is -$1,885 (Beshears et al. 2017).[2] The picture is only slightly better for households nearing or entering retirement (after a lifetime of saving). Among households whose head is age 61-70, median liquid net worth is $6,213, while the 25th percentile is $1. As a consequence of limited liquidity, many working-age households spend savings that was intended to finance retirement consumption. Using IRS tax return data, Argento, Bryant, and Sabelhaus (2015) find that for individuals under age 55, the annual distributions *out* of defined contribution retirement plans (i.e., 401(k) plans, IRAs, etc.) equal 30 to 40 percent of the flows into those plans.[3]

These patterns of behavior can be explained by several behavioral biases (see Beshears et al. 2017), including present bias, the propensity to overweight the present relative to the future. Individuals with present bias tend to act impatiently in the present while *planning* to act patiently in the future. They will overspend today while simultaneously enrolling in a 401(k) plan that reflects their preference to save in the future. In the long run, they accumulate significant stocks of illiquid assets (e.g., home equity) and essentially no liquid wealth (Angeletos et al. 2001; Beshears et al. 2017); the liquid wealth is spent on instant gratification, whereas the illiquid wealth is protected from such splurges. Relative to normative benchmarks, households with present bias hold

[2] Liquid net worth includes all assets and debt except pension wealth, retirement savings accounts (e.g., 401(k) accounts and IRAs), student loans, durable assets, homes, and collateralized debts (e.g., mortgages and car loans).

[3] This leakage does *not* include loans that are repaid, IRA rollovers, or Roth conversions.

sub-optimally low levels of liquid wealth and will deplete their partially liquid retirement savings (e.g., through 401(k) loans or pre-retirement distributions) when adverse shocks arise. Present bias combines with other behavioral biases such as limited foresight, myopia, over-optimism, and other factors to contribute to households' propensity to accumulate and hold sub-optimally low levels of liquid wealth.

This paper explores the practical considerations and challenges of helping households accumulate liquid savings that can be deployed when urgent pre-retirement expenditure needs arise. We believe that this can be achieved cost effectively by automatically enrolling workers into an employer-sponsored payroll deduction "rainy day" or "emergency" savings account, terms that we use interchangeably in this paper.

Automatic enrollment into 401(k) and similar retirement savings plans through payroll deduction is already familiar and has long been widely accepted in the U.S.[4] Using payroll deduction for non-retirement savings also has substantial precedent: during World War II and for decades thereafter, payroll deduction was used to purchase U.S. Savings Bonds. Payroll deduction, sometimes through automatic enrollment, is also widely used in employer-sponsored health plans, cafeteria plans, and other employee benefit arrangements. We believe that it will also work to fund rainy day accounts.

While there are many existing options for individuals to save for both retirement and non-retirement purposes, the available evidence indicates that in the domain of retirement savings, employer-sponsored plans substantially increase household savings, especially when they are enhanced with automatic enrollment. The Employee Benefit Research Institute's Retirement Confidence Survey (2017) finds that 71 percent of households with an employer-sponsored retirement plan report being somewhat or very confident that they will have enough money to live comfortably in retirement, a sentiment expressed by only 33 percent of households who do not have an employer-sponsored retirement plan. These statistics highlight the important role of employer-sponsored

[4] E.g., Orszag et al. 2006.

retirement plans in facilitating financial preparedness for retirement. Over the past nearly two decades, since the U.S. Treasury Department and IRS first issued their landmark rulings defining, approving, and setting the basic terms for permissible automatic enrollment in 401(k) plans,[5] the fraction of 401(k) plans using automatic enrollment has increased substantially, and the majority of medium-sized and large 401(k) plans now automatically enroll employees unless they opt out (Plan Sponsor Council of America 2016). Automatic enrollment results in high savings plan participation rates for employees of all ages and income levels, for both genders, and for all racial and ethnic groups (Madrian and Shea 2001; Choi et al. 2002, 2004; Beshears et al. 2008; Gale et al. 2009). Moreover, 97 percent of surveyed employees whose company uses automatic enrollment are glad their employer does so, and support is high among all demographic sub-groups, including those who opt out of participation (Harris Interactive 2007). We believe that worker participation in and support of automatic enrollment into employer-sponsored rainy day savings accounts are also likely to be significant. The substantial fraction of Americans with only limited emergency savings reinforces our belief that the use of automatic enrollment into an employer-sponsored emergency savings account is worth serious consideration.

Increasing savings in a rainy day account could be counterproductive if contributions to these accounts are funded not by decreased consumption, but by reducing other assets or increasing household debt. There is mixed evidence on the potential for such "crowd out" effects. The mere creation of a new savings account may discourage consumption. In a field experiment among construction workers in rural India, Soman and Cheema (2011) find that partitioning a fixed savings amount across multiple accounts increases asset accumulation by reducing savings account withdrawals. Having multiple accounts has no impact on the likelihood that individuals tap into their savings, but it dramatically reduces the amount that individuals withdraw when needs arise, as many

[5] Revenue Ruling 1998-30, Revenue Ruling 2000-8. See fn.19, below.

individuals with multiple accounts tap into only one account while leaving the other untouched. Spending out of a previously unbreached account may create guilty feelings that deter consumption, or may direct more attention to the consumption decision. Having multiple accounts in which to save may also increase savings flows. Beshears, Choi, Laibson, and Madrian (2017) find using a survey experiment that subjects recommend higher total 401(k) contribution rates when they have to separately recommend both a before-tax and a Roth contribution rate, rather than first recommending a total contribution rate that is later split across a before-tax and a Roth account. Chetty et al. (2014) find that when mandatory employer pension contributions increase, an employee's total savings increase by 80 percent of the employer contribution, implying a 20 percent rate of crowd-out from other assets. Finally, Beshears, Choi, Laibson, Madrian, and Skimmyhorn (2017) find that automatic enrollment of government employees into the Thrift Savings Plan did not cause a statistically significant change in the amount of non-collateralized debt at any time horizon up to four years (the longest time horizon studied); it did increase automobile loan and first mortgage balances at longer time horizons, but these liabilities have an uncertain impact on net worth as they are accompanied by the acquisition of a new asset. Overall, the existing literature suggests that crowd-out effects may be small, although it will be important to measure the extent of crowd-out effects if and as companies adopt rainy day savings account programs.

This paper discusses the potential design of employer-sponsored rainy day savings accounts. In Section A, we discuss the key conceptual issues that should be considered when establishing such accounts, including the ability of the rainy day account to provide liquidity when the funds are needed; the tax treatment of withdrawals; the ability to achieve effective separation between rainy day savings and retirement savings so that rainy day accounts do not encourage leakage of retirement savings; the targeted size of the rainy day account; the ability to automatically enroll employees in the rainy day account; the ability to make employer matching contributions to the rainy day account;

compliance and potential interactions with the nondiscrimination rules that apply to tax-qualified employer-sponsored plans; issues relating to investment of the rainy day savings including fees and expenses; and the need to manage account transitions when employees separate from an employer.

In Section B, we discuss three specific implementation models. First, we discuss using after-tax 401(k) contributions as a vehicle for rainy day savings. Second, we discuss using deemed Roth IRA contributions within a 401(k) plan as the vehicle for rainy day savings. Finally, we discuss going outside the qualified and ERISA plan system and using bank accounts or other depository institution accounts as the vehicle for rainy day saving. We highlight the pros and cons of each of these solutions given the existing regulatory regimes.

A. Framework for Designing and Evaluating Employer-Sponsored Rainy Day Savings Account Structures

This section outlines the conceptual issues that should be kept in mind as we consider the three potential approaches to providing rainy day savings within, or at least to some degree in coordination with, a 401(k) or other employer-sponsored tax qualified plan. Two of the strategies involve a rainy day account within the 401(k) regulatory structure: an after-tax employee contribution account, and a deemed Roth IRA under the plan. The third alternative is to maintain the rainy day savings account at a bank, credit union, or similar depository institution (and possibly, to the extent permissible under existing regulation, also coordinating this account with a 401(k) plan).

Because rainy day account structures connected to or coordinated with a 401(k) or similar plan are limited to employees who have access to such a plan, other approaches to employer-sponsored rainy day accounts are needed for both workers whose employers do not offer such a plan and those who are self-employed or otherwise do not have a traditional employer-employee relationship. Indeed, rainy day savings for those without access to a 401(k)-type plan could be even more important than for those already saving

for retirement. Even for those with access to a 401(k), significant simplicity might be gained by forgoing the advantages of coordination with the 401(k). This tradeoff between potential effectiveness and greater simplicity is another reason it is important to further explore effective rainy day savings approaches that are not connected to or coordinated with employer-sponsored retirement savings plans. While much of this paper focuses on rainy day structures that are coordinated with such plans, many of the same considerations apply even if there is no attempt at coordination.

This paper is not intended to provide a comprehensive analysis of the possible alternatives. Many of the relevant considerations involve legal issues that have yet to be resolved, including the uncertain application of a body of complex and often technical plan qualification, tax, ERISA, banking, and other laws and regulations, together with numerous issues of practical implementation. Rather, our intent is to briefly outline the salient features of three leading potential approaches, including what currently appear to be their most significant advantages and disadvantages, and focus on the more significant design and implementation issues.

A well-designed rainy day or emergency savings arrangement needs to be easy for savers to be enrolled in and to use and easy for employers and payroll or financial providers to establish and manage. It should also minimize unintended adverse consequences. In designing such an arrangement, we suggest below several key features and concerns that should be taken into account. These include:

— Liquidity (at reasonable cost) when the rainy day funds are needed;

— Tax treatment of both withdrawals from the rainy day savings account (which affects liquidity) and contributions to the account, as well as any investment gains;

— Partitioning of the rainy day and retirement savings accounts to encourage separate mental accounting by employees so that rainy day accounts do not encourage leakage of retirement savings;

— Targeted size of the rainy day account balance, if any, and what happens to further contributions once the targeted balance is reached;

— Ability to automatically enroll employees in the rainy day savings account;

— Ability to make employer matching contributions with respect to individuals' contributions to the rainy day savings account, and the destination of those matching contributions (e.g., into the rainy day account, or into the 401(k) account);

— Compliance and potential interactions with the nondiscrimination rules that apply to tax-qualified employer-sponsored plans;

— Investment of rainy day savings account balances, as well as fees and expenses; and

— Discouraging balances in rainy day accounts from becoming inefficient cash distributions when employees separate from an employer.

Ability to provide liquidity

Rainy day funds are of little use if they cannot be easily and quickly accessed when needed. At the same time, to help ensure that funds are available for actual emergencies, the account would not be intended to be used for routine consumption. Trading off these two needs is not easy, and the right balance between them could vary according to the account owner's specific circumstances.

For example, a middle-to-upper-income saver may find it best to have an account that requires a three-day delay before withdrawals are wired to his or her checking account. This saver might not suffer (and might even benefit) from a brief delay and may also be able to bear the cost of wire transfer fees. In contrast, an account owner with lower or more volatile income is likely to have a greater need for an account that is instantly available and that charges no wire transfer or other withdrawal fees.

The issue of liquidity is particularly complex for rainy day accounts that are established as part of a 401(k) plan. Qualified employer-sponsored plan accounts are

subject to two layers of withdrawal restrictions. First, they generally have withdrawal rules intended to preserve tax-qualified contributions and earnings for use in retirement as opposed to earlier consumption (the "leakage" discussed above). In many circumstances, these rules prohibit withdrawals while an individual is still employed by the employer sponsoring the plan. Second, withdrawals from qualified plans are subject to tax treatment (including regular income tax, additional tax on early withdrawals, and, in some cases, mandatory 20 percent withholding) designed in large part to discourage early withdrawals.

Plan sponsors would need to decide whether to design additional withdrawal restrictions for emergency savings accounts to provide liquidity while ensuring that the accounts are used for their intended emergency purposes, rather than as checking accounts for minor, routine, or discretionary expenses. Such withdrawal restrictions might take the form of a minimum dollar withdrawal threshold (if it were possible to impose such a restriction without violating the qualified plan nondiscrimination rules), a limit on the number of withdrawals an employee can make within a given time period, or a requirement to certify or substantiate that the withdrawal is for a permitted purpose. However, if such restrictions were – or were perceived as being – cumbersome, unduly time-consuming, or burdensome to plan administrators or to employees, they could undermine emergency savings by dissuading potentially interested employers from offering emergency savings programs or by discouraging employees from using them.

Given the initial hurdle of persuading employers to extend their voluntary benefit programs to include rainy day savings, a very strong case can be made for not imposing additional restrictions on withdrawals from rainy day accounts, or at least the rainy day accounts with smaller balances. The unrestricted approach would be simpler for plan sponsors and their recordkeepers or other providers to administer. It would be simpler to describe to participants and simpler for participants to use. It would recognize that the tax treatment of withdrawals (discussed below) already subjects withdrawals to one layer of friction and reduces the simplicity of the arrangement, and that messaging – framing

the arrangement as an emergency savings account that the employer has established solely for that purpose – should help to discourage excessive withdrawals.

Not all plan sponsors and providers will necessarily react similarly to the notion of not imposing additional restrictions on withdrawals. Some might balk at the risk that the arrangement could become, in effect, a tax-favored checking account equally available for sunny and rainy days. Some employees also might feel more comfortable knowing that certain limitations are in place to help them protect themselves against the temptation to dissipate the account through discretionary spending. For these employers and employees, the option of a somewhat restricted rainy day account could be made available; and here, as with most aspects of rainy day savings, experimentation through pilot projects and early implementation efforts should be informative.

Another liquidity-related design issue is how best to coordinate emergency savings withdrawals with withdrawals of pre-tax elective contributions to retirement plans. Presumably, employees could be expected to view the plan's emergency savings account as the source of first resort for emergency withdrawal needs because it is designated as such and because of its relative ease of withdrawal (possibly including more favorable tax treatment for withdrawals). Hardship withdrawals of pre-tax retirement plan contributions could be expected to involve more time and paperwork and would be subject to taxation (potentially including the 10 percent additional tax on early withdrawals).

In addition, the section 401(k) hardship withdrawal rules generally require an employee applying for a hardship withdrawal to be able to demonstrate that alternative sources of funds are not reasonably available to meet the immediate financial need. This requirement could work well in the case of a financial emergency need of the sort the emergency savings account is intended to serve. The employee would withdraw first from the emergency savings account, and if this amount is insufficient, the employee would then seek a hardship withdrawal.

Other kinds of financial need, however, might not be of the type the emergency savings account is designed for, but could come within the scope of the 401(k) hardship withdrawal rules. An example might be the need to pay college tuition, which will often be a permissible basis for requesting a hardship withdrawal. Would the 401(k) hardship withdrawal rules view an employee's emergency savings account under the plan as a reasonably available alternative source of funds that the employee should be required to exhaust before being permitted a hardship withdrawal? If so, could this unduly divert the use of the emergency savings account away from its core purpose as a means of meeting a more limited and perhaps unexpected kind of financial "emergency," such as an immediate need to pay for car repairs, when other funds are not available?

A plan might address this issue by imposing explicit conditions on withdrawals from the emergency savings account, such as prohibiting withdrawals for certain purposes (payment of college tuition, for example) that might be permissible justifications for hardship withdrawals. Under the hardship withdrawal rules, an emergency savings account that did not permit withdrawals for specified purposes would not be treated as reasonably available for those purposes. In that case, for example, a pre-tax account hardship withdrawal might be made to help pay a child's college tuition while preserving the emergency savings account to meet the types of emergencies for which it was intended. Of course, there is considerable potential for overlap between permissible purposes for emergency savings account withdrawals and hardship withdrawals. Where the plan sponsor views those common purposes as intended to be served by the emergency savings account, this presents no problem. However, if an emergency savings account was intended only for emergency purposes but was designed, in the interest of administrative simplicity, with no restrictions on the employee's ability to withdraw from it, the account would constitute a reasonably available alternative source of funds that must be tapped before a hardship withdrawal is permitted.

Whether this presents a practical problem depends on how the plan sponsor views the intended scope – and how it designs the actual scope – of its emergency savings account compared to the plan's hardship withdrawal provisions. It also might depend importantly on the availability of plan loans to participants, the intended and actual scope of the purposes for which the plan permits loans, and the way the plan coordinates hardship withdrawals and loans. (Some plans restrict loans to purposes that would otherwise justify a hardship withdrawal under the plan.)

More generally, adding an emergency savings account to a typical 401(k) plan, which offers loans as well as hardship withdrawals, would present a three-way coordination issue. Loans might entail less risk of leakage than emergency withdrawals because loans must be repaid by payroll deduction, but an emergency savings account that is replenished automatically by further employee contributions (unless the employee opts out of it) might not be very different in this regard. In addition, loans might not be sufficiently speedy to obtain and might require more cumbersome administrative procedures than emergency withdrawals.

Potential delay and cost of emergency savings withdrawals. An additional operational question may apply to rainy day accounts located within retirement plans. Typically, investment managers return funds to investors by selling assets during hours when financial markets are open. Providers we have consulted say that this means that requests for withdrawals received during a weekend would not be considered until Monday, and that funds may not be available to go to the account owner until 24 hours or more after that. In addition, some providers may use wire transfers to send the money to the saver's bank or credit union, a process that could incur fees from the receiving depository institution. Actual operational processes may differ from provider to provider, but it will be important for those considering a rainy day account within a retirement plan to review withdrawal procedures as the accounts are set up.

This type of operational constraint is not likely to apply to accounts located in a depository institution, as such institutions regularly provide funds quickly. However, certain accounts may have restrictions or fees attached to them. In addition, while some funds are available through ATMs when banks and credit unions are closed, there is usually an upper limit on how much can be withdrawn from ATMs during a 24-hour period. Amounts above that limit usually are available only during regular business hours.

Tax treatment of contributions, earnings, and withdrawals

The taxable portion of a withdrawal from a retirement savings plan is subject to income taxation and might also be subject to a 10 percent additional tax on early withdrawals. This 10 percent additional tax, often referred to informally as a "penalty," is designed as a disincentive for early withdrawals and does not apply under certain circumstances. In addition, the taxable portion of a lump-sum withdrawal from a qualified plan made during or after employment that is not rolled over to another plan or IRA generally will be subject to 20 percent mandatory income tax withholding unless it is a hardship withdrawal or a withdrawal that includes taxable funds less than $200 (when aggregated with other such withdrawals in the same year). The withholding is not an additional tax on the withdrawal but an advance payment of tax that might be due, and it is refundable if it is not fully due at the time the household files its annual taxes.[6]

To the extent that regular income tax, 10 percent additional tax, and 20 percent tax withholding apply to a withdrawal, they entail obvious drawbacks in the context of an emergency savings system. While some employees experiencing an emergency might pay little or no attention to the tax consequences, and while adverse tax consequences might even be viewed by some as a source of friction that could help discourage withdrawals for nonemergency purposes, adverse tax consequences generally would be an unwelcome complicating factor in the administration of the arrangement. In particular,

[6] Treas. Reg. section 31.3405(c)-1, Q&A-14. The 20% mandatory withholding requirement does not apply to withdrawals from IRAs, including deemed IRAs, as discussed below.

the necessarily complex disclosure of these rules could undermine the appeal of the arrangement and the desired simplicity of communications to employees.

In almost all conventional depository institution accounts, contributions or deposits would be made using after-tax dollars, and withdrawals would be nontaxable. However, any earnings would be taxable income in the year they are earned and would be reported as such to taxpayers and the IRS on a Form 1099-INT.

The discussion below assumes, therefore, that bank or credit union accounts are funded with after-tax contributions from the employee, possibly augmented by taxable employer contributions or matches, and does not assume any new tax advantage for rainy day accounts. While a new tax credit or other tax incentive to encourage saving in rainy day accounts might be seen as helpful, it would need to be justified based on the usual factors used to judge tax policy, including cost, efficiency, equity, complexity, and consistency with other tax treatment. Of course, any new tax incentive would also require legislative action.

Ability to encourage separate mental accounting to achieve effective separation between rainy day and retirement savings

A successful rainy day savings account must "first do no harm:": it needs to avoid having the unintended consequence of actually promoting leakage from or dilution of retirement savings or other long-term savings accounts (by, for example, having the effect of encouraging employees to get in the habit of making mid-life withdrawals from retirement funds).

In general, this would appear to require effective separation between the two types of accounts – rainy day as opposed to retirement savings – and their purposes, whether achieved by the actual structure of the accounts or the way they are presented by the sponsor and perceived by the owner, i.e., separate "mental accounting." How the information is delivered could also matter: depending on how the communication is structured, a joint statement from a single source concerning both accounts might heighten confusion by muddying their distinctions, or it might provide clarity by offering

a unified explanation of their similarities and differences. Even if the saver is enrolled in both accounts at the same time, each has a specific use that should not be confused with the other. To that end, the rainy day account could be presented as designed expressly to facilitate emergency saving, in contrast to the longer-term purpose of retirement savings accounts.

Size of the rainy day account: target and potential maximum

Two related questions apply to all three types of account: (i) whether and at what level to set a target account balance and (ii) whether to cap the amount savers can hold in the account if they exceed the target and, if so, what that maximum amount should be. Most studies of consumers' ability to handle financial emergencies measure a household's ability to pay a specific dollar amount, such as $400, $1,000, or $2,000, which serves as a proxy for a typical expenditure in a minor financial emergency (e.g., car repair, modest home repair, appliance replacement, or a non-catastrophic out-of-pocket health expense). Other normative benchmarks for optimal "rainy day savings" incorporate such modest expenditure shocks and also include the risk of more severe events, like a long spell of unemployment, a major medical expense, or a major, uninsured home repair (e.g., property damage from flooding). Typical rules of thumb are expressed as a proportion of annual earnings, such as savings equal to three, four, or six months of take-home pay.[7]

We believe that rainy day accounts should have a target balance of at least $2,000. But we view this as a lower bound. Households can get unlucky and experience multiple bad shocks in a short period of time, and even one shock – e.g., unemployment – can leave a household needing to replace income for many months. Our recommendation for a target balance is much more ambitious and aligned with the advice that financial planners tend to give—three to six months of income.

[7] There is very little formal analysis on this quantitative question. However, blogs are rife with advice (e.g., https://www.nerdwallet.com/blog/banking/life-build-emergency-fund/).

Example:

Assume that a 401(k) plan has automatic enrollment, including automatic enrollment into a rainy day account. Assume the default contribution rate is 10 percent of pay, with 4 percent of pay allocated to rainy day contributions and 6 percent of pay allocated to pre-tax 401(k) contributions.

Also assume that the pre-tax account receives all employer matching contributions.

The rainy day account has an accumulation target equal to 25 percent of annualized compensation. Once the 25 percent target is reached, the default switches to a 10 percent contribution to the pre-tax account and no contribution to the rainy day account. (This would take about six years, if no withdrawals were made from the rainy day account.)

Participants would be free at any time to opt out of the default contribution system and affirmatively elect to make *additional* rainy day savings contributions, even if the balance in the rainy day account exceeded the 25 percent target, or to make fewer or no contributions.

There could also be a contribution cap. Contributions to the rainy day account could be mandatorily redirected to the pre-tax account if the rainy day balance reached (or exceeded) 50 percent of annual compensation.

Under the default, contributions to the rainy day account would be restarted, if the balance in the rainy day account fell below 25 percent of annualized compensation.

This set-up would encourage participants to accumulate a meaningful emergency savings balance (25 percent of annualized income) while permitting them to accumulate even more rainy day savings if they preferred to do so (up to 50 percent of annualized income).

Having a pre-set target balance, at which the rainy day account would stop accumulating incremental savings, would help to differentiate it from other types of non-retirement savings and would make it more likely that the account is reserved for emergencies and does not displace too much retirement saving. However, setting the target balance too low would limit the account's usefulness, as the balance available would be less likely to be sufficient for a given emergency.

One option would be to allow the saver to have a choice of target balances. For example, employees could be automatically enrolled in emergency savings contributions up to a pre-specified target balance, with the option of affirmatively electing lower or higher contributions up to a different target balance. For different households, these targets would vary substantially. However, we would encourage default target balances between 15 and 33 percent of income.

Under an ideal design, contributions to a rainy day account with a target balance would stop once that level is reached, but restart once the balance falls below the target

level (either because of withdrawals or increases in income). Ideally, contributions when the account has reached the target would be redirected to the retirement account, thus increasing that type of saving while also keeping the total contribution level the same (or gradually increasing in a predictable pattern) from pay period to pay period. Unfortunately, redirecting contributions is more complex than it sounds, even if the 401(k) rules would permit advance pre-tax contribution elections of this sort that would automatically turn on, off, and back on, depending in some instances on the amount of pre-tax or after-tax (or deemed IRA) contributions previously made or on the emergency savings account balance. Redirecting the contributions might be operationally complicated, especially if the rainy day account has different tax treatment than the retirement account or is located at a different provider. Ultimately, 401(k) compliance issues and practical complexities associated with this feature may make it difficult to implement. Since this design issue potentially applies to all three of the types of accounts discussed below, we mention it only in this section.

Ability to use automatic enrollment

Automatic enrollment, whereby employees automatically contribute to an employer-sponsored savings plan unless they opt out, is extremely popular with employees, and has substantially increased plan participation, especially among younger workers, lower-paid employees, women, and minorities (DCIIA 2017; RMS 2015).

It is just these groups who would most benefit from a rainy day account. Simultaneous automatic enrollment of workers in a retirement savings plan and a rainy day account seems likely to greatly increase participation in emergency saving and therefore could sharply reduce the proportion of adults who cannot come up with enough savings to handle a basic financial emergency (like a car repair or a large medical payment).

However, while automatic enrollment is explicitly allowed for tax-qualified retirement savings plans, whether it is allowed for generic rainy day accounts is less clear.

In some cases, the ability to use the mechanism can be assumed, but in other circumstances, questions arising from a variety of laws and regulations would need to be resolved.

Ability to provide employer matching contributions

Employer contributions to a retirement plan can be a key factor in building sufficient resources for a secure retirement. They can also be a factor in encouraging participation, although this effect is small (Engelhardt and Kumar 2007). Employer contributions to a rainy day account could play a similar role in better enabling account owners to handle financial emergencies.

In principle, when an employer matches employee rainy day account contributions, the matching contributions could be deposited in the rainy day account, in a retirement savings plan's regular employer matching account, or in a combination of the two. Certain account structures make it easier for employers to match contributions than others, but other factors are also important. These include whether employer contributions would be treated as taxable income for the employee and how easily they could be withdrawn. In structures with easy withdrawal options, the potential for an employee to treat employer contributions as additional income rather than savings raises questions. Similarly, the likely effects of potential employer contributions to a rainy day account as compared to employer contributions to retirement accounts must be considered with care to ensure that retirement security would not be undermined.[8]

Nondiscrimination and other compliance issues

Rainy day savings arrangements within a 401(k) plan could well have an impact on a plan's compliance with the plan qualification rules designed to prevent discrimination in favor of highly-compensated employees.[9] (Highly compensated employees and non-

[8] A key issue, of course, is whether an employer's contributions to a rainy day account would be made in at the expense of or in addition to employer contributions to a retirement account.

[9] These are defined under the tax-qualification rules to include, among others, employees whose annual compensation from the plan sponsor is at least $120,000 (indexed for cost of living).

highly compensated employees are referred to here as "HCEs" and "NHCEs," respectively.) Those rules apply, among other matters, to the amounts and available rates of pre-tax, after-tax, and employer matching contributions. Plans generally are required to test for compliance of plan contributions with the nondiscrimination standards. Many plans, however, have instead adopted a "design-based safe harbor" that permits plans to avoid periodic testing of the contributions that are actually made by instead conforming to a statutorily prescribed plan design that requires the plan to make or make available specified levels of contributions.

An opportunity for employees to make emergency savings contributions could make it easier or harder for a plan to comply with the nondiscrimination rules and therefore would need to be taken into account in formulating a plan's nondiscrimination compliance strategy. This issue is discussed below with respect to each of the three main options considered in this paper. Compliance with a number of other requirements will also need to be considered.

Investment issues and fees

A 401(k) plan that uses automatic enrollment must designate a default investment option for contributions made in cases where employees do not affirmatively elect an investment option. Plan sponsors using automatic enrollment commonly select a qualified default investment alternative (QDIA) from among the types permitted under Department of Labor regulations on the ground that this choice limits at least to some degree the plan sponsor's potential fiduciary liability under ERISA when the sponsor selects a default investment.[10] The most widely used QDIA is a target date or life cycle fund, although QDIAs also include balanced funds and managed accounts as defined in the Department of Labor regulations.

Whether or not emergency savings contributions are encouraged via automatic enrollment, the short-term nature of the account and its need to maintain sufficient

[10] 29 CFR section 2550.404c-5.

liquidity so that funds are readily available in times of need will suggest to many plan sponsors that the emergency savings account balance should be a known amount that does not fluctuate unexpectedly. Accordingly, in determining how emergency savings should be invested, plan sponsors and their advisors might find a cautious approach to be appropriate, forgoing significant investment gains in the interest of protecting employees from investment losses.

Similarly, certain structures may incur higher fees and administrative and investment management expenses than others. In conjunction with their approach to the qualified plan as a whole, plan sponsors will need to consider how to share with employees (if at all) the costs of opening and maintaining a rainy day savings arrangement. One factor to consider in this connection is the likely relationship between investment earnings and investment and administrative expenses. Among other considerations, an investment that focuses on principal protection would be more likely to minimize or avoid the net earnings that would give rise to the tax consequences of withdrawals from certain types of rainy day savings accounts (described below).

At the same time, if a plan sponsor uses automatic enrollment to encourage rainy day savings contributions, it might be risk averse with respect to potential fiduciary liability for the default investment and therefore prefer to use a QDIA (for simplicity, potentially the same QDIA the plan uses for pre-tax elective contributions). Under the Labor regulations, however, QDIAs generally do not include principal-protected investments (other than under a limited, 120-day short-term exception).[11]

On the other hand, it is worth recalling that beginning in the late 1990s, and increasing in the years leading to 2006, a considerable number of 401(k) plan sponsors used automatic enrollment with a default investment fund before the Department of Labor

[11] 29 CFR 2550.404c-5(e)(4). Some might wish to explore the possibility of persuading the Labor Department (or a court) that QDIA protection should apply on a theory that, in certain circumstances, a principal-protected investment might be deemed to be aggregated with a conventional QDIA taking into account the totality of assets under the plan.

issued regulations defining QDIAs and before the Pension Protection Act of 2006 called for such regulations. For some time, the most common default investment was a principal-protected investment (although some plans using automatic enrollment designated other investments as the default, such as life cycle, target date, or balanced funds) (Deloitte 2007). Some employers might bring a similar confidence to the choice of a default investment for automatic enrollment in a deemed IRA.

These employers might find an analogy in the Department of Labor's automatic rollover regulations. Those regulations establish a fiduciary safe harbor for ERISA-governed plans that automatically roll over (unless a terminating participant affirmatively elects otherwise) amounts not exceeding $5,000 to IRAs if "invested in an investment product designed to preserve principal and provide a reasonable rate of return, whether or not such return is guaranteed, consistent with liquidity."[12] The preamble to the regulations stated that the rationale for limiting the safe harbor to principal-protected investments in this case (by contrast to the QDIAs) was that the amounts being invested in these automatic rollover instances are limited to $5,000. A plan sponsor imposing a similar or lower limit on employee contributions to an emergency savings account might argue that the regulations on automatic rollovers provide indirect support, at least by way of analogy, for the use of a principal-protected default investment in this different context. In addition, some plan sponsors might conceivably conclude that the emergency savings balances and investments were sufficiently limited that litigation seemed relatively unlikely and that the plan sponsor's practical liability exposure from successful litigation seemed manageable.

Notwithstanding these factors, the fact that Department of Labor regulations have defined QDIAs without including funds that are principal-protected on an ongoing basis might well lead most plan sponsors and their counsel to be more cautious than they would have been before 2006. If they are interested in adding emergency savings to their plan,

[12] 29 CFR 2550.404a-2(c)(3)(i).

the investment concern might lead them to simply extend their qualified plan's self-directed investment menu to the emergency savings account. As part of this approach, to secure QDIA protection for the emergency savings account, some might, as noted above, use the same default investment that they use for their qualified plan. Other plan sponsors might be swayed by their judgment that a principal-protected investment is the appropriate emergency savings default investment. And the tension between these two views might lead some plan sponsors to simply avoid using automatic enrollment altogether with respect to the emergency savings account. However, so long as a sufficient number of plan sponsors were still willing, despite these concerns, to try out an emergency savings account, a disparity in approaches during this preliminary, experimental phase could accelerate the process of learning what works best.

Investment decisions for a rainy day account held in a depository institution are likely to be much simpler. Almost all high-liquidity bank and credit union accounts pay a regular interest rate that is set by the depository institution. Accounts with higher deposit levels may receive higher interest rates than those with lower levels. Some accounts may be invested in Certificates of Deposit, which may pay higher interest rates, but require minimum deposit levels and require the money to be on deposit for a set period of time. Premature withdrawals usually result in a loss of interest or some other penalty.

However, depository institution fees may present much more of an issue. Unlike 401(k) accounts, depository institutions tend to charge monthly account maintenance fees, especially if the account has low average deposits. They may also charge for a variety of other services, including withdrawals, the use of an ATM, or transfers to another account. Generally, credit unions have lower and fewer fees than commercial banks.

B. Three Options for Structuring a Rainy Day Savings Account

The discussion below reviews three specific alternative approaches for structuring a rainy day savings account. Applying the framework outlined in the previous section, we consider the specific features of each alternative and its major advantages and challenges.

1. Using After-Tax Employee Contributions Account as a Vehicle for Rainy Day Savings

Overview

Employer-sponsored 401(k) plans can offer employees not only the opportunity to make pre-tax salary reduction contributions, which can be matched by employer contributions, but also the opportunity to make voluntary after-tax employee contributions. A 401(k) plan could incorporate a separate rainy day savings account by adding voluntary after-tax employee contribution accounts to the plan or by repurposing such after-tax accounts if already offered under the plan.

After-tax employee contribution accounts offer many advantages for emergency savings purposes. In part because their tax treatment differs from that of pre-tax elective accounts and employer contribution accounts, they are already accounted for separately from the other plan accounts. This feature could promote separate "mental accounting" to distinguish longer-term (pre-tax) from shorter-term (after-tax) savings.

After-tax employee contributions are more liquid because they are exempt from the withdrawal restrictions that qualified plans are required to impose on pre-tax elective contribution and employer contribution accounts. In addition, each withdrawal from an after-tax employee contributions account would be mostly tax-free and penalty-free.

Plan sponsors could consider using automatic enrollment to encourage employees to make after-tax employee contributions for rainy day savings. In addition, sponsors might consider providing employees an incentive to save in the rainy day account by devoting at least a portion of the employer match to these after-tax employee rainy day savings contributions.

These accounts would also have drawbacks, however. While most of each withdrawal would be tax-free and penalty-free, a limited portion of each withdrawal would be deemed to consist of taxable earnings, which also would often be subject to the 10 percent early withdrawal penalty and 20 percent tax withholding. This feature would complicate communications to employees and, to some degree, administration of the arrangement, although there might be ways to avoid taxable earnings. Other potential concerns for plan sponsors would include questions about how to avoid or minimize potential ERISA fiduciary liability regarding the choice of investments and how to avoid potential operational delays in disbursing emergency funds. In addition, a number of questions would arise concerning the feasibility and practicality of automatic enrollment and of employer matching contributions relating to the emergency savings account.

Background regarding voluntary after-tax employee contributions

Voluntary after-tax contributions were common in the employer-sponsored thrift savings plans that were more prevalent before the spread of the 401(k) plan. Employee contributions to these accounts generally do not comply with the conditions for obtaining pre-tax treatment of contributions under qualified section 401(k) cash or deferred arrangements. Unlike pre-tax 401(k) salary reduction contributions, after-tax contributions are not exempted from current taxation. Accordingly, contributions to an after-tax account do not give rise to a tax deduction and are not entitled to an exclusion from income for tax purposes. This is the case even if the contributions are made by payroll deduction; the deduction from pay is a mechanical method of moving funds out of take-home pay and into a plan account but (unlike pre-tax salary reduction contributions) is not deemed to reduce the amount of taxable salary or wages.[13]

[13] In the interest of simplicity, amounts includable or excludable from gross income for tax purposes are often referred to here as taxable or nontaxable (or tax-free) even though their ultimate tax treatment would depend on the individual's tax-related circumstances.

After-tax employee contributions may be made only if the plan permits them. They are accorded a measure of favorable tax treatment insofar as earnings on those contributions are tax-deferred (i.e., not taxed until withdrawn). This is less tax-favored than a Roth IRA or a 401(k) plan Roth account (technically referred to as a "designated Roth" account, and sometimes referred to here, for simplicity, as a "Roth 401(k)" account) because earnings on the Roth IRA or Roth 401(k) account are not only tax-deferred but also tax-free if withdrawn at least 5 years after the year of the participant's first Roth contribution and after the participant has reached at least age 59 1/2 (or has become disabled or died).

Because of the greater tax advantages of pre-tax elective salary reduction 401(k) contributions and Roth 401(k) contributions, relatively few participants in 401(k) plans make voluntary after-tax employee contributions. However, some plans include after-tax employee contribution accounts for special purposes, such as providing for the possibility of recharacterizing pre-tax salary reduction contributions as after-tax contributions if necessary to avert a violation of the 401(k) nondiscrimination limits, or to set up an eventual conversion to a Roth IRA. After-tax contributions also allow households to generate total savings that exceeds the maximum annual elective deferrals allowed in pre-tax (or Roth) 401(k) accounts (generally $18,000 for 2017) because after-tax contributions (generally after taking into account any pre-tax elective deferrals, Roth contributions, and employer contributions) may be made, if the plan permits them, up to the overall defined contribution plan limit (generally $54,000 for 2017).

Ability to provide liquidity

For emergency savings purposes, after-tax employee contribution accounts would enjoy a singular advantage: unlike pre-tax 401(k) salary reduction contributions or employer contributions, after-tax employee contributions generally are free of withdrawal restrictions under the 401(k) or other qualified plan rules.[14] Therefore, plans can be

[14] IRC section 401(k)(2)(B).

designed to allow employees to withdraw from after-tax employee contribution accounts for any reason and at any time – without incurring a financial hardship and without having to await the passage of time or the occurrence of a specified event permitting withdrawal (such as termination of employment).

This should enable plans to provide the liquidity needed for emergency savings, but only if a plan can respond promptly enough from an operational perspective to meet participants' needs for emergency withdrawals. After-tax employee contribution accounts have not traditionally been designed to allow rapid and potentially frequent disbursements on an emergency basis. (This statement applies to qualified plan accounts generally.) If an account under a qualified plan is to be used to respond promptly and efficiently to emergency withdrawal requests, the plan probably will need to incur the costs and perhaps operational delays involved in making appropriate changes to plan recordkeeping and operations as well as payroll systems. How much of a deterrent this would be to adoption of an emergency withdrawal account under a qualified plan is likely to depend on the plan-specific operational factors and the costs of the specific provider.

Tax treatment of after-tax employee contributions, earnings, and withdrawals

Contributions to after-tax accounts are taxed when earned as salary or wages; they are not tax deductible or excludable from income when contributed. Earnings on after-tax employee contributions, like earnings on pre-tax contributions, are not taxable as they accumulate; they are taxed only when withdrawn from the plan. When previous contributions are withdrawn from the account, they are tax-free withdrawals because they were previously taxed when contributed.

Amounts withdrawn from after-tax employee contribution accounts are treated as consisting of both a distribution of employee contributions (similar to a distribution of the employee's "cost basis" in the account) and a distribution of earnings on those contributions. The distribution of the employee contributions is excludable from income for tax purposes, but the withdrawal of the *earnings* is taxable at ordinary income tax

rates. Each withdrawal from an after-tax employee contribution account is allocated between the nontaxable contributions and the taxable earnings in proportion to the cumulative amounts of those contributions and earnings held in the after-tax account as a whole.[15] Therefore, unless there are no earnings, any withdrawal from after-tax employee contribution accounts will be partially taxable. However, the taxable portion will tend to be relatively small if the withdrawal occurs in the earlier years after establishment of the account, when the cumulative earnings still represent a small percentage of the total account balance.

Depending in part on the extent to which the rainy day account is regularly used, earnings may not be much of a factor. However, any withdrawals of earnings are likely to be subject to both a 10 percent penalty for early withdrawal of tax-deferred buildup and 20 percent tax withholding. This is likely to be only a small amount, but account holders will need to be informed about this in advance.

Potential for zero net earnings. An emergency savings account with a sufficiently modest target balance might never experience earnings net of administrative expenses, depending on the relative levels of expenses and investment returns experienced by employees. Of course, strategies that might be deliberately intended to avoid net earnings in the rainy day savings account by imposing increased expenses on that account (or reallocating to it expenses associated with other accounts) or by seeking to suppress earnings for this purpose would raise concerns about propriety, ERISA fiduciary liability exposure, risk of attracting litigation,[16] and criticism. However, true expenses properly

[15] For purposes of figuring this allocation, contributions and earnings in the employee's plan accounts outside of the after-tax employee contributions account (such as the pre-tax elective contributions account or employer contributions account) are not considered. See IRC section 72(e)(8) and (d)(2).

[16] A relatively modest cap on an emergency savings account presumably would have the incidental effect of reducing the risk of litigation and criticism for selecting an unduly conservative investment that arguably failed to realize the earnings that could have been realized had the account been invested in the plan's QDIA. Even in a plan with a large number of participants who had emergency savings accounts, the arguably forgone investment earnings attributable to the principal-protected investment presumably might be small enough in the aggregate to make class action litigation to recover this amount less attractive to the plaintiffs' bar than other litigation alternatives.

allocable to the rainy day savings account might exceed earnings on an appropriate investment in a plan that provided for (i) a relatively modest target balance for the account that could serve as a maximum limit, and (ii) investment of the account in a principal-protected fashion (such as a money market fund).[17] For example, if the target (and maximum permitted) account balance were $2,000 and if account expenses were $50 per year,[18] net earnings should not occur unless annual returns exceeded 2.5 percent.

Depending in part on its general policy on sharing of plan expenses, a plan sponsor also might consider promising that it will protect participants from any diminution of their account balances by bearing any expenses that exceed earnings. In addition, if the employee's rainy day savings contributions gave rise to employer matching contributions (even if at a rate below the employer match of pre-tax elective contributions), that could help provide a further defense against criticism or complaints about lack of growth in the rainy day savings account (although participants focused on their static rainy day savings account balance might be less appreciative of the match because it would be credited to a different account).

Ability to encourage separate mental accounting

For purposes of providing access to emergency savings in a 401(k) plan, a voluntary after-tax employee contributions account could facilitate separate "mental accounting" by employees.

The "separation" from other types of accounts would be reinforced by the fact that an after-tax employee contribution account – a well-established existing administrative

[17] If, by contrast, the plan provided for investment of the rainy day account in a QDIA rather than a principal-protected investment, there would of course be little prospect that appropriate expenses would consistently exceed earnings.

[18] This assumption about the possible level of expenses is for purposes of illustration only; it is not intended to imply any estimate of the likely range of administrative or investment management expenses associated with a rainy day savings account of this sort. That the account would be an additional "bucket" added to existing accounts under a plan might be a factor militating in favor of reduced cost, but the need to administer potentially frequent withdrawals (perhaps combined with the novelty of the account) would cut the other way. Potentially reduced hardship withdrawals or loans might offset some of the cost, although, at least at the outset, this might be viewed as an unproven effect.

feature of many 401(k) plans – has long been accounted for separately from the other types of retirement plan accounts (mainly for tax reasons). After-tax employee contributions and the account to which they are credited are governed by qualified plan rules and tax treatment that differ from those governing other types of accounts. In fact, elective pre-tax, employee after-tax, and employer contribution accounts are sometimes referred to informally as "separate buckets." Accordingly, the attempt to encourage separate mental accounting of short-term from long-term savings would be underscored by actual separate accounting under the plan's recordkeeping system and by other tangible differences.

Ability to use automatic enrollment

Plans that use automatic enrollment typically apply it only to pre-tax salary reduction contributions and not to after-tax employee contributions. However, a plan sponsor that used after-tax employee contributions as a rainy day savings account would have good reason to consider the possibility of encouraging participation by automatically enrolling employees in that account up to a deferral limit set by the plan sponsor and the employee. Several considerations would bear on that decision.

A threshold question is whether automatic enrollment in after-tax employee contributions is permissible under the rules governing tax-qualified plans. Treasury and IRS have not issued explicit guidance on this point, but we are aware of nothing that explicitly prevents automatic enrollment in after-tax employee contributions, and such automatic enrollment is consistent with the basic rationale that under automatic enrollment employees are still electing (passively or affirmatively) whether or not a contribution will be made on their behalf (i.e., whether the default is contribution or non-contribution, employees retain their ability to choose). In addition, one of the seminal Treasury/IRS rulings making clear that automatic enrollment in pre-tax elective salary reduction contributions is permissible includes language implying that automatic

enrollment could apply also to after-tax employee contributions.[19] Accordingly, for purposes of this discussion, it is assumed that qualified plans are permitted to automatically enroll employees in after-tax employee contributions. It would follow that such automatic enrollment, like automatic enrollment in pre-tax elective salary reduction contributions in an ERISA-governed plan, should benefit from ERISA preemption of any state payroll and anti-garnishment laws that might otherwise be interpreted as prohibiting such automatic enrollment.

A second threshold issue relates to whether the plan already uses (or, if not, is willing to use) automatic enrollment with respect to pre-tax elective contributions. Many (including some of the co-authors of this paper) believe there is a strong case for the use of automatic enrollment in 401(k) plans.[20] However, a plan sponsor that has chosen not to adopt automatic enrollment for pre-tax contributions might think there is less reason to automatically enroll employees in contributions that are less tax-advantaged. Some such sponsors might also wonder whether the use of automatic enrollment for emergency savings but not retirement savings could have an unintended endorsement effect on employees, could be interpreted as sending a message that the sponsor does not wish to send, and could encourage too many employees who are not highly compensated to use the plan for emergency savings only, potentially affecting nondiscrimination compliance. On the other hand, some plan sponsors might view emergency savings as an even more

[19] See Treas. Reg. section 1.401(k)-1(a)(2)(ii); Rev. Rul. 2000-8, 2000-1 C.B. 617 (indirectly referring to automatic enrollment in after-tax employee contributions: "If plan A were to permit after-tax contributions then the amounts contributed to the plan would have to be designated or treated, at the time of the contribution, as pre-tax compensation reduction contributions or after-tax employee contributions."). Cf. Treas. Reg. section 1.401(k)-1(a)(3)(ii). Other revenue rulings permit automatic enrollment in section 403(b) plans (Revenue Ruling 2000-35, 2000-2 C.B. 138), section 457 plans (Revenue Ruling 2000-33, 2000-2 C.B. 142) and SIMPLE-IRA plans (Revenue Rulings 2009-66, 2009-67). A question could be raised regarding the significance of the fact that after-tax employee contributions are less tax-favored than the pre-tax 401(k), 403(b), 457, and SIMPLE-IRA contributions explicitly addressed in the rulings and that no comparable ruling explicitly applies to after-tax contributions. Arguably, this is because to date there has been less reason for the question to arise, given that after-tax employee contributions, while tax-favored, are less tax-favored than those other contributions, and perhaps because Rev. Rul. 2000-8 is seen as already indirectly indicating that automatic enrollment in after-tax contributions is permissible.

[20] E.g. Gale et al. (2009).

basic need than retirement savings and might also feel more comfortable automatically enrolling employees in an emergency savings account simply because the amount would be more limited.

Plan sponsors and record keepers that already use automatic enrollment for pre-tax elective contributions and are considering adding automatic enrollment for emergency savings after-tax employee contributions would need to engage in a similar balancing analysis. Would the take-up of emergency savings suffer unduly if automatic enrollment were used only for retirement savings? The appropriate mix and coordination of plan design features could include simultaneous or sequential automatic enrollment, employer matching contributions, and specification of a desired emergency savings target and liquidity provisions, as discussed in other portions of this paper.

The potential instruments available for striking an optimal balance of incentives and other provisions might also include "active choice" – requiring employees to affirmatively signal their decision whether or not to contribute – as a possible middle-ground alternative to automatic enrollment in emergency savings.

Another key issue would be the operational feasibility of implementing automatic enrollment in after-tax employee contributions. While almost all providers offer automatic enrollment, several have expressed concern about their ability to automatically enroll into two accounts that have different tax treatments. This would involve technical and employee communication issues relating to coordination of automatic enrollment in pre-tax and after-tax contributions, including the costs and perhaps delays involved in making the necessary operational and record keeping systems changes.

For purposes of this discussion, we also assume that if the operational steps were taken to adopt automatic enrollment in after-tax employee contributions, it generally would operate in a manner similar to automatic enrollment in pre-tax 401(k) salary reduction contributions. The default contribution level could be set at a uniform percentage of pay for all participating employees or conceivably at a specified dollar

amount per year or per pay period, with the usual opportunity for the employee to opt out or opt for a different contribution level). Alternatively, automatic enrollment in emergency savings might be designed to operate at a specified percentage of pay or dollar amount only for a specified number of pay periods.

In either case, however, as discussed earlier, automatic enrollment in emergency savings would be designed to be suspended (with the contributions potentially redirected to pre-tax 401(k) contributions) once a targeted balance was accumulated. The targeted balance might be expressed as a uniform dollar amount or percentage of pay for all employees. Alternatively, the target might be whatever amount was accumulated from contributions (and any earnings) once a specified time period, such as a year, had elapsed. The plan could provide that, once the limit was reached, automatic enrollment into emergency savings contributions would stop and automatic enrollment into pre-tax 401(k) contributions might begin.

On the assumption, discussed above, that automatic enrollment in after-tax employee contributions is permissible and operationally feasible, nothing would appear to prevent a plan from adopting a split-stream approach that automatically enrolls employees simultaneously, rather than only sequentially, in after-tax and pre-tax contributions. The default contribution rates could change once the emergency savings target had been met. For example, as noted earlier, automatic enrollment might be set at 6 percent of pay into pre-tax contributions and 4 percent of pay into after-tax contributions until the after-tax account reached a specified balance. At that point, the automatic enrollment into after-tax contributions would stop, and the automatic enrollment into pre-tax contributions would increase to 10 percent of pay.

Another possible feature would be a provision that automatically resumed rainy day savings contributions for an employee if and when withdrawals reduced the employee's rainy day savings account balance below a specified level (which might be a uniform dollar amount, percentage of pay, or number of paycheck deductions, for all

employees). Such replenishment has obvious appeal from a policy standpoint. However, as stated earlier, periodically turning after-tax automatic enrollment back on and off while making the corresponding adjustments to pre-tax automatic enrollment is sensitive to different circumstances affecting particular employees. It therefore might prove complex for plan sponsors or record keepers to administer in an accurate and timely manner without undue risk of administrative errors.

In somewhat analogous circumstances, plan sponsors and their providers who are considering the use of automatic enrollment with automatic escalation of pre-tax contributions have periodically expressed concerns about the increased risk of administrative errors – failure to make the correct contribution to each employee at the correct time – and the need to correct such errors. To address such concerns, Treasury and the IRS have provided a more forgiving administrative correction regime for plans that use automatic enrollment and automatic escalation. This could readily be extended to apply to automatic enrollment in rainy day savings.

Ability to provide employer matching contributions

The use of employer matching contributions as an incentive to participate could apply to after-tax employee contributions as it can to pre-tax contributions.[21] A plan sponsor that wished to encourage employees to use after-tax employee contributions for emergency savings could gear at least a portion of employer matching dollars to after-tax contributions.[22] Employer matching contributions made on account of after-tax employee

[21] While employer contributions commonly are made to match pre-tax elective contributions, they also can be made to match after-tax employee contributions. See, e.g., IRC section 401(m)(4)(A)(i); Treas. Regs. section 1.401)(m)-1(a)(2)(i)(A).

[22] This need not increase the total amount of employer matching contributions; potentially a modest amount of an existing employer match could be reallocated to match emergency savings contributions.

contributions would be credited to an employer contribution account under the qualified plan.[23]

Given the more favorable tax treatment of pre-tax contributions, however, as well as many plan sponsors' presumed preference for longer-term savings, some might prefer to provide a different, less generous matching formula for after-tax than for pre-tax contributions. Such sponsors might view a less generous match as an appropriate signal for employees regarding the relative priority of the emergency contributions compared to retirement contributions, and some, for similar reasons, and in the interest of simplicity, might choose to provide no employer matching for emergency savings contributions.

Other sponsors might prefer the simplicity of using the same matching formula for both after-tax and pre-tax contributions, especially if accompanied by a relatively low account-balance ceiling on the amount of matched after-tax contributions. This might also reflect a concern that a less generous matching formula for emergency savings than for retirement savings could lead too many employees to opt out of the former in favor of the latter. However, it appears that plan sponsors should, if they wish, be able to provide for a less generous matching formula for after-tax contributions, provided that this did not lead to a violation of the nondiscrimination rules that apply to the amounts and available rates of pre-tax, after-tax, and employer matching contributions. The nondiscrimination constraint might apply, for example, to a plan that has adopted a "design-based safe harbor" to avoid nondiscrimination testing. Such safe harbors require use of an employer matching formula that satisfies specified conditions, which would limit plan design choices.

Another issue plan sponsors would need to weigh is the risk of manipulation of matching contributions and the rules designed to prevent it. Without appropriate

[23] These employer contributions would not violate the 401(k) "contingent benefit rule" because that rule prohibits making any benefits (except for employer matching contributions) contingent on an employee making or refraining from making elective pre-tax 401(k) contributions. In this case, the employer contributions would be contingent on employee after-tax contributions or on deemed Roth IRA contributions.

constraints, an employee could conceivably seek to game the system by "churning" matched employee contributions – making them chiefly to elicit an employer match and then withdrawing them as soon as possible rather than keeping them in the account until needed for the intended emergency purposes. A plan sponsor seeking to use employee after-tax contributions to build emergency savings accounts might need to consider whether other kinds of plan-specific restrictions might be advisable (to the extent permissible under the plan qualification rules) to prevent or discourage such manipulation without defeating the basic liquidity purpose of the emergency savings account.

Current law has the effect of addressing this risk of manipulation in many instances by requiring 401(k) plans in certain circumstances to impose a six-month suspension of an employee's ability to make additional contributions (indirectly suspending the employee's receipt of any related employer matching contributions) if the employee makes a hardship withdrawal. Old IRS rulings would apply a different six-month suspension provision if employees withdraw employer-matched after-tax employee contributions.[24] This could complicate a plan sponsor's emergency savings account strategy by interrupting the automatic flow of contributions designed to gradually replenish the emergency savings account.

The simplest matching paradigm would adopt matching rules so that pre-tax and after-tax accounts were treated symmetrically and jointly. In other words, the match would be calculated using the *sum* of the employee contributions to the pre-tax and after-tax accounts. This implies a neutral stance in weighing the two accounts (from the perspective of the matching contributions).

Nondiscrimination and other compliance issues

[24]Compare Treas. Regs. §1.401(k)-1(d)(3)(iv)(E) (a plan that seeks to satisfy the "safe harbor" hardship rules must suspend for at least six months after the hardship withdrawal the employee's ability to make pre-tax and after-tax employee contributions to the plan and other plans maintained by the employer) to Revenue Rulings 74-55, 74-56.

Greater proportionate utilization by NHCEs (compared to HCEs) of after-tax employee contributions for emergency savings would tend to assist a plan in complying with the nondiscrimination test for those types of contributions (the "actual contribution percentage" or "ACP" test). On the other hand, if HCEs were to make disproportionate use (compared to NHCEs) of after-tax contributions as a result of the plan's addition of an emergency savings account, that would make it harder for the plan to comply with the ACP test. A plan sponsor could avert this risk by limiting eligibility for the after-tax emergency savings account to NHCEs (i.e., precluding participation by HCEs). The nondiscrimination rules for qualified plans generally permit this kind of more favorable treatment of NHCEs than HCEs, as a class. Of course, HCEs might be unhappy about being denied the emergency savings account option, even though the plan sponsor might conclude that excluding them is justified because they are better able to provide for themselves in saving for emergencies. One possible means of addressing both the nondiscrimination risk and the possible employee relations issue might be to automatically enroll the NHCEs only, while making the emergency savings account available to HCEs if they choose to affirmatively enroll, provided that the plan sponsor is comfortable doing so.

There is, however, another potential discrimination issue that this approach would not address. The availability of the after-tax emergency savings account might have an indirect "crowdout" effect of reducing NHCEs' appetite or ability to make pre-tax elective retirement plan contributions. This might result in lower proportionate utilization by NHCEs (compared to HCEs) of those pre-tax contributions, making it harder for the plan to satisfy the separate nondiscrimination standards relating to those contributions (the "actual deferral percentage" or "ADP" test). Plan sponsors considering emergency savings arrangements would be well advised to keep an eye out for potential indirect effects such

as these. Should such effects arise, there are other means of mitigating or managing them.[25]

Investment issues

As discussed, a rainy day savings account would be designed to be liquid – available broadly for immediate needs, including those that are foreseeable. Accordingly, a principal-protected investment would seem to be a natural choice. While hardship withdrawals are made from pre-tax elective contributions often invested in funds that involve some risk and volatility, an appreciable degree of risk and volatility in a rainy day account might produce a suboptimal participant experience and could be seen as inconsistent with the intended purposes of the account. Department of Labor guidance under the Employee Retirement Income Security Act (ERISA) recognizes that the need for liquidity in particular instances could be taken into account in formulating and justifying certain retirement plan investment policies.

2. Using Deemed Roth IRA Under 401(k) Plan as a Vehicle for Rainy Day Savings

As discussed, one of the main drawbacks associated with the use of an employer plan's after-tax employee contributions account as a rainy day savings vehicle is that the tax treatment of withdrawals from such an account requires taxation of the earnings portion of each withdrawal. The next portion of this paper considers the possibility of facilitating rainy day saving by automatically enrolling employees in Roth 401(k) accounts, in deemed IRAs, and, especially, in a combination of the two (i.e., deemed Roth IRAs).

The possibility of automatic enrollment in 401(k) plan contributions other than pre-tax salary reduction contributions or after-tax employee contributions is a topic that has received relatively little attention in the 401(k) community.[26] However, one approach

[25] In addition, plans using a design-based nondiscrimination safe harbor – which imposes, among other things, specified constraints on employer matching contributions or other employer contributions – would need to ensure that nothing about the addition of rainy day savings contributions would cause the plan to run afoul of the safe harbor requirements. Ordinarily, this should not be a problem.

[26] Cf. fn.5, above. But see, e.g. Dold (2002).

to rainy day savings accounts is automatic enrollment (or traditional opt-in enrollment) directing contributions to an employee's designated Roth account within a 401(k) plan that provides for such accounts, instead of (or in addition to) automatic enrollment into the employee's pre-tax salary reduction account.[27] Roth 401(k) accounts, like Roth IRAs, can be used to augment pre-tax 401(k) accounts or traditional IRAs and help savers achieve greater risk diversification with respect to the tax treatment of their future withdrawals. However, the rules regarding withdrawals from this type of account would not be sufficiently attractive for the purpose of a rainy day savings account. Amounts withdrawn from Roth 401(k) accounts are pro-rated between a return of contributions and earnings (like withdrawals from after-tax employee contribution accounts, as described above). The earnings portion of a withdrawal from this type of account would be taxable unless the withdrawal occurred at least five years after the account was established and after the account owner had reached age 59 1/2. In addition, unlike the after-tax employee contributions account, a Roth 401(k) account generally is subject to the same restrictions on withdrawals during employment as a pre-tax 401(k) account (including the hardship rules). In view of these particular disadvantages of the designated Roth account for rainy day savings purposes, we do not pursue other issues that would arise in connection with the use of such an account.

Both of these drawbacks could be addressed, however, by another approach. Qualified plans are permitted to let employees make voluntary employee contributions to an account under the plan that can be treated in the same way as an IRA if it satisfies specified requirements. This type of account, associated with an employer plan, is called

[27] As in the case of automatic enrollment into after-tax employee contributions, we are not aware of any statute, regulation, or other administrative guidance explicitly providing that automatic enrollment is permitted to apply to designated Roth contributions under a qualified plan without causing a change in the character of those contributions (for example, causing them to be treated as pre-tax contributions). However, if automatic enrollment into designated Roth contributions were possible, it would raise with greater salience questions of which plan design (autoenrollment in pretax contributions or in designated Roth contributions) is more justified or defensible. The alternative of traditional opt-in enrollment in a designated Roth account would not seem promising.

a "deemed IRA"[28,29] Accordingly, another possible option for incorporating a rainy day savings account into a 401(k) or other qualified plan would be to establish a deemed Roth IRA for that purpose.

Overview

A deemed IRA is established under a qualified plan – and can be either traditional or Roth – but it generally is treated as a separate entity from the qualified plan. Accordingly, for the most part, the deemed IRA and contributions made to it are subject to the rules governing IRAs as opposed to qualified plans, including the general annual contribution limit of $5,500 ($6,500 if age 50 or older) for 2017.[30]

A deemed IRA could promote separate "mental accounting" to help wall off long-term from short-term savings because it would be accounted for separately from other plan-related accounts and, as an IRA, would be different in kind from the other accounts. In addition, deemed IRAs, like after-tax employee contribution accounts, are more liquid than pre-tax elective 401(k) or employer contribution accounts under qualified plans because IRAs are not subject to the basic withdrawal restrictions imposed on those accounts.

Another key advantage is that withdrawals from deemed Roth IRAs benefit from more favorable tax treatment. Like after-tax employee contributions, Roth IRA contributions are made on an after-tax basis and therefore are tax-free when withdrawn; but, unlike withdrawals from after-tax employee contribution accounts, no portion of a deemed Roth IRA withdrawal is taxable until all the employee's contributions have been withdrawn tax-free and penalty-free. Only after all the employee contributions have been withdrawn are withdrawals treated as consisting of earnings, which generally are taxable unless they meet the Roth age 59 1/2 and 5-year conditions.[31] For an individual

[28] This type of account is also sometimes referred to in the qualified plan context as a "sidecar IRA."
[29] Treas. Regs. section 1.408(q)-1(a).
[30] Treas. Regs. section 1.408(q)-1(a), (b), (c).
[31] As in the case of after-tax employee contributions, it might be possible to simplify administration and communications if net earnings could be appropriately avoided.

withdrawing from a deemed Roth IRA after age 59 1/2 and after five years have passed since the account's establishment, the tax-free treatment of withdrawn earnings is another advantage over after-tax employee contribution accounts. Also, as in the case of after-tax contributions, plan sponsors could consider using automatic enrollment to help fund deemed Roth IRA emergency savings accounts as well as providing an employer match to give employees an incentive to contribute to these accounts.

Deemed Roth IRAs would also have their drawbacks. Net earnings withdrawn before age 59½ or before the account has been open for five years are generally taxable and often subject to the 10 percent early withdrawal penalty. As in the case of after-tax employee contributions, the use of deemed Roth IRA contributions to fund an emergency savings account would raise questions about how to avoid or minimize potential ERISA fiduciary liability regarding the choice of investments, about how to efficiently reduce potential operational delays in disbursing emergency funds (potentially more of a problem in the case of IRAs than qualified plan accounts), and about the feasibility and practicality of automatic enrollment and of employer contributions matching employees' deemed IRA contributions (including managing the risk of manipulation of the match). And, unlike after-tax employee contributions, only employees whose incomes do not exceed $196,000 (if married and filing taxes jointly) or $133,000 (if unmarried) are permitted to contribute to a Roth IRA (deemed or otherwise) for 2017.[32]

[32] Those with higher incomes might still make nondeductible contributions to a traditional IRA, withdrawals from which would be taxed similarly to after-tax employee contributions in a qualified plan.

Ability to provide liquidity

For purposes of emergency savings, a deemed IRA has a particular advantage in terms of liquidity. This stems from the hybrid character of a deemed IRA: treated as part of a qualified employer-sponsored plan for some purposes but as an IRA for most purposes. Withdrawals from a deemed IRA can be made at any time and for any purpose. This liquidity advantage should facilitate emergency savings if the plan can respond promptly enough from an operational perspective to meet participants' needs for emergency withdrawals.

Like after-tax employee contributions accounts, IRAs (including deemed IRAs) have not ordinarily been designed to allow rapid and potentially frequent disbursements on an emergency basis. The earlier issues regarding operational feasibility, costs, and potential delays involved in changing recordkeeping and payroll systems to enable after-tax employee contribution accounts to respond promptly and efficiently to emergency withdrawal requests apply to deemed Roth IRAs as well.

Tax treatment of deemed Roth IRA contributions, earnings, and withdrawals

The tax treatment of deemed Roth IRAs gives them another distinctive advantage for emergency savings purposes. By contrast to withdrawals from a deemed IRA under a qualified plan (which generally would be taxable), withdrawals from a deemed *Roth* IRA would be largely nontaxable and would avoid the pro rata tax treatment of withdrawals that applies to Roth 401(k) accounts (and after-tax employee contribution accounts) under a qualified plan.

As in the case of a Roth 401(k) account, earnings withdrawn from a deemed Roth IRA would be taxable unless the withdrawal occurred after the individual had reached age 59 1/2 and after five years had passed since making the first Roth contribution. However, unlike the pro rata tax treatment of withdrawals from a Roth 401(k) account or an after-tax employee contributions account, the amounts withdrawn from a deemed Roth IRA would be accorded favorable "basis first" treatment. Each withdrawal would be treated solely as a return of the contributions the employee made to the account, and

therefore would be nontaxable, until the full amount of those contributions had been withdrawn by the employee.[33]

This more favorable tax treatment of deemed Roth IRAs should simplify the process and the communications to employees regarding withdrawals that do not exceed the amount of contributions to the deemed IRA account. The message to employees could explain that withdrawals would be tax-free so long as they did not exceed the employee's cumulative contributions to the account (sometimes referred to as the "principal" amount). These withdrawals not only would be tax-free; they also would be free of the ten percent additional tax on early withdrawals, which applies only to the taxable portion of a withdrawal, and would be exempt from 20 percent mandatory withholding because that withholding does not apply to IRAs.[34]

If the employee withdrew more than the amount of the employee's contributions, such as a withdrawal of the entire balance in the deemed Roth IRA account, the portion in excess of those contributions would be treated as earnings.[35] That portion therefore would be taxable unless it satisfied the 5-year and age-59 1/2 requirements for tax-free treatment of withdrawals of Roth account earnings.

Although not an advantage that is of particular relevance to rainy day savings or to most moderate- and lower-income participants, Roth IRAs (whether deemed or not) are exempt from the required minimum distribution rules (applicable after reaching age 70 1/2) before the death of the IRA owner. In contrast, a Roth 401(k) account is subject

[33] A complicating factor is that the tax treatment of an IRA owned by an individual is determined after aggregating it with any other IRAs the individual might own. A deemed Roth IRA would be aggregated for this purpose with any other Roth IRAs the individual might own. The burden of applying this aggregation would fall on the individual IRA owner. The plan sponsor would not be responsible for taking such aggregation into account because it would have no practical means of knowing about an individual's other IRAs (and the same is true of the IRA trustee or custodian). Excess contributions to an IRA (such as contributions that exceed the maximum permissible IRA dollar limits) are subject to a 6% excise tax on the excess amount unless the excess (including any income earned on the excess) is withdrawn by the tax return due date (plus extensions).

[34] IRC section 3405(c).

[35] IRC section 408A(d).

to the age 70 1/2 required minimum distribution rules, as are non-Roth 401(k) accounts. The required minimum distributions generally are taxable unless they represent a return of basis (previously taxed contributions) or are tax-free for other reasons, such as meeting the 5-year and age-59 1/2 conditions for tax-free treatment of Roth earnings. While the deemed Roth IRA would have these tax advantages relating to withdrawals, the ability to contribute to it would be subject to the income limits on eligibility to contribute to a Roth IRA. For 2017, the ability to contribute to a Roth IRA phases out for unmarried and head of household taxpayers over the $118,000-$133,000 family income range and phases out for married couples filing their taxes jointly over the $186,000-$196,000 family income range.

Ability to encourage separate mental accounting

Like the after-tax employee contributions account, a deemed Roth IRA would be accounted for separately and could be designated expressly as an emergency savings account with a view to facilitating separate "mental accounting." However, the deemed Roth IRA might even do somewhat more to promote separate mental accounting because its status as an IRA could emphasize that it is distinct from the rest of the plan.

Ability to use automatic enrollment

The advantages of a deemed Roth IRA provide good reason to consider applying automatic enrollment to deemed Roth IRA contributions (assuming that is permissible) up to an appropriate limit targeted by the plan sponsor and the employee.[36] Language in the preamble to the deemed IRA regulations suggests that automatic enrollment in

[36] Treas. Reg. section 1.401(k)-1(a)(2)(ii); Rev. Rul. 2000-8, 2000-1 C.B. 617 (indirectly referring to automatic enrollment into after-tax employee contributions): "If plan A were to permit after-tax contributions then the amounts contributed to the plan would have to be designated or treated, at the time of the contribution, as pre-tax compensation reduction contributions or after-tax employee contributions."). Cf. Treas. Reg. section 1.401(k)-1(a)(3)(ii). Other revenue rulings permit automatic enrollment in section 403(b) plans (Revenue Ruling 2000-35, 2000-2 C.B. 138), section 457 plans (Revenue Ruling 2000-33, 2000-2 C.B. 142) and SIMPLE-IRA plans (Revenue Ruling 2009-66).

deemed IRAs would be permissible.[37] Assuming that is the case, would automatic enrollment into deemed Roth IRA contributions be operationally feasible for plans?

Adapting operational and recordkeeping systems to make this feasible would be more of a stretch than achieving operational feasibility with respect to automatic enrollment of employees in after-tax employee contributions within a 401(k) plan. However, at least five states have enacted legislation thus far that requires employers that have chosen not to sponsor plans to automatically enroll their employees in IRAs to which employees would be connected through the workplace. The IRAs in the state programs follow the template of the federal automatic IRA proposal: payroll deduction IRAs (mostly Roths) that are not associated with an employer plan rather than deemed payroll deduction Roth IRAs that are associated with employer plans.[38]

For purposes of this discussion, it is assumed that, if the necessary operational steps are taken, then much of the earlier discussion of the issues and alternatives associated with automatic enrollment in emergency savings after-tax employee contributions generally would apply also to automatic enrollment in emergency savings deemed Roth IRAs. This would include the earlier discussion of the default contribution level, coordination with automatic enrollment in pre-tax 401(k) salary reduction contributions, suspension of automatic contributions to the emergency savings account once a target balance had accumulated, and potential replenishment following emergency savings withdrawals. In addition, because deemed IRAs generally are treated as ERISA-covered plans for the purposes of ERISA's preemption (and certain other) provisions, a good case can be made that ERISA would preempt state payroll or anti-garnishment laws that might otherwise be interpreted as prohibiting such automatic enrollment.[39]

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[37] 69 Fed. Reg. 43,738 (July 22, 2004).

[38] 29 CFR 2510.3-2(a), (h) (disapproved pursuant to Congressional Review Act).

[39] See ERISA's preemption provisions and deemed IRA exemption provisions at 29 USC 1144(e) and 29 USC 1003(c), respectively. See also the Labor Regulations at 29 CFR 2550.404(c)-5(f)(2) (relating to QDIAs).

The household income limits on eligibility to contribute to a Roth IRA would present a different challenge for the use of automatic enrollment in deemed Roth IRAs. The plan sponsor generally would not know the employee's household income or the employee's possible contributions for the year to other IRAs; only the individual could be responsible for compliance with the Roth IRA income limits. Those whose income or other IRA contributions make them ineligible to contribute to a Roth IRA would need to opt out of automatic enrollment in a deemed Roth IRA.[40] This responsibility to avoid contributing if their income exceeds the Roth IRA limits rests with individuals in the case of contributions to all Roth IRAs (not only deemed ones). Furthermore, as a broad generalization, individuals in these income brackets tend to be better able than others to take such limits into account.

Ability to provide employer matching contributions

A plan sponsor might well wish to use employer matching contributions as an incentive to encourage employees to make their own contributions, by payroll deduction or otherwise, to an emergency savings account that is structured as a deemed Roth IRA.

[40] See also fn.29, above. A similar issue arises under automatic IRA programs (enacted to date in five States and proposed at the federal level) that use Roth IRAs as the default type of IRA. However, the issue is mitigated in that context by the fact that, consistent with the proposed federal automatic IRA legislation and most of the state automatic IRA statutes, employees who are ineligible generally could not only opt out but could also elect to have the contributions made to a traditional IRA, for which they usually would be eligible. In addition, the automatic IRA programs are designed to cover employees whose employer does not offer a qualified plan. See generally Iwry (2006a, 2006b). Because the incomes of employees who lack access to an employer plan tend to skew lower than the incomes of those who have access, the issue of ineligibility by reason of income is likely to arise less frequently in an automatic IRA program (and is likely most often to affect business owners, who can often more readily fend for themselves).

In the context of a qualified plan using deemed Roth IRAs for emergency savings, the employees who are ineligible to contribute to Roth IRAs because their income exceeds the Roth IRA limits would likewise be ineligible to contribute to a deductible (traditional) IRA because they are eligible for the qualified plan and their income would exceed the (lower) traditional IRA limits for such individuals. Another question, beyond the scope of this paper, is whether it would be permissible and, if so, workable, to use, for Roth-ineligible employees, nondeductible deemed IRAs (i.e., after-tax contributions to deemed traditional IRAs that, being neither deductible contributions nor Roth contributions, would not be subject to income eligibility limits).

This would present three threshold questions:

1. Would such employer matching contributions be permissible? (It appears that nothing prohibits this; see the discussion below.)
2. If so, would these matching contributions be treated differently from more conventional contributions made by employers to match pre-tax salary reduction contributions or after-tax employee contributions rather than employee contributions to a deemed Roth IRA? (Apparently; see the discussion below.)
3. Should the employer matching contributions be deposited in the deemed IRA or in a conventional employer contributions account under the plan? (See the discussion below.)

As noted, a deemed IRA established under a qualified plan generally is treated as a separate entity from the qualified plan; for the most part, the deemed IRA and the contributions made to it are subject to the rules governing IRAs, while the qualified plan and the contributions made to it are subject to the rules governing qualified plans.[41] Accordingly, the discussion that follows considers separately the consequences of depositing the employer matching contributions in the deemed IRA and the consequences of depositing them in the qualified plan's employer account.

If the match is deposited in the deemed IRA. Employer contributions to IRAs are rare, but the possibility is recognized in the Internal Revenue Code. The Code provides that any such employer contributions are to be treated for tax purposes as employee contributions to the IRA[42] (so those contributions to an IRA would be taxable to the employee when made) and does not prohibit employer contributions under a qualified plan from matching an individual's contributions to an IRA (nor does it refer explicitly to this practice). Because the employer contributions, if deposited in the IRA, would be

[41] Treas. Regs. Section 1.408(q)-1(a), (c).
[42] IRC section 219(f)(5).

treated as employee contributions to the IRA, the aggregate of the employer and employee contributions to the IRA would be subject to the normal annual dollar (and compensation) limits on an individual's contributions to IRAs.

Employer contributions that match an individual's contributions to the deemed IRA rather than to the qualified plan might well be treated differently for qualified plan purposes than employer contributions that match an employee's qualified plan contributions, whether pre-tax elective salary reduction or after-tax employee contributions. In other words, employer contributions that match an employee's contributions to a deemed IRA might well be treated as something other than "matching contributions" for qualified plan purposes. See the non-discrimination section for a discussion of the implications of this.[43]

Directing the employer contributions to the deemed IRA (rather than to an employer contributions account in the qualified plan) also would tend to more quickly accumulate the IRA balance to reach the emergency savings target level. Because they would be treated as employee contributions to the deemed Roth IRA, the employer contributions presumably would be accorded Roth IRA tax treatment (taxable when made and, when withdrawn, entitled to Roth IRA basis-first treatment and tax-free return of earnings after 5 years and age 59 1/2).

If the match is deposited in the plan's employer contribution account. If the employer contributions were instead deposited in an employer contribution account in the qualified plan, they generally would be non-taxable when made, but fully taxable (including any earnings on the contributions) as ordinary income when withdrawn. In general, the earlier discussion – regarding potential differential matching formulas for matching emergency savings contributions that take the form of after-tax employee contributions and for matching pre-tax elective salary reduction 401(k) contributions, and regarding the related anti-manipulation issues – would apply also where the emergency

[43] Treas. Regs. section 1.401(m)-1(a)(2)(ii).

saving takes the form of contributions to a deemed Roth IRA. The employer contributions matching the individual's contributions to a deemed IRA probably would not be considered "matching contributions," even if deposited in an employer contributions account in the qualified plan instead of in the deemed IRA. However, they generally should be subject to the qualified plan rules governing employer contributions, presumably including nondiscrimination in the availability of benefits, rights, and features under a plan.

Nondiscrimination and other compliance issues

Employees' contributions to a deemed IRA rainy day savings account would not be considered in the qualified plan's nondiscrimination testing because of their treatment as individuals' contributions to IRAs (which are not subject to nondiscrimination standards).[44] The same would be true of employer matching contributions that were deposited in the deemed IRA. However, if employer contributions matching emergency savings contributions were deposited in a regular qualified plan employer matching contribution account, disproportionate emergency savings matched contributions by HCEs or NHCEs could exacerbate or ease nondiscrimination compliance, respectively.

In addition, emergency savings contributions by NHCEs to a deemed IRA (or, for that matter, any rainy day or emergency savings account, whether inside or outside of the qualified plan) might have the indirect effect of reducing the NHCEs' pre-tax elective salary reduction contributions to the plan. This could make it harder for the plan to satisfy nondiscrimination standards with respect to pre-tax contributions, although the extent of this potential "crowd-out" effect should depend, among other things, on the relative amounts and perhaps durations of emergency savings contributions and pre-tax contributions by HCEs and NHCEs.

[44] Treas. Regs. section 1.408(q)-1(c), (f)(6).

Investment issues

A deemed IRA is subject to ERISA's fiduciary rules and exclusive benefit rule. ERISA's administration and enforcement provisions would also apply to the deemed IRA, but most other provisions of ERISA Title I (reporting and disclosure, participation, vesting, funding, and others, which would apply to the qualified plan) should not apply. Ordinarily, a deemed IRA will be associated with a 401(k) plan that designs its investment choices in accordance with the requirements of the Department of Labor's regulations that limit fiduciary exposure for investments that are self-directed by plan participants from among the choices in a specified investment menu.[45] To simplify compliance, a plan sponsor might use the same investment menu (including QDIA) for the deemed IRA. However, the deemed IRA investment menu could be designed separately to comply with the self-directed investment regulations. In general, it would appear that the application of some of ERISA's rules to the deemed IRA should not present a major concern for plan sponsors, as ERISA would already apply to the qualified plan to which the deemed IRA is attached.

A plan that used a deemed Roth IRA emergency savings account without automatically enrolling employees in it would not need to designate a default investment. However, if the plan automatically enrolls employees in the deemed Roth IRA, it would need to designate a default investment for employees who do not affirmatively elect an investment option, and this could be a QDIA.

Alternatively, the plan sponsor could decide to forgo the limited protection of the Labor Department's regulations and designate a single safe investment for the deemed IRA without allowing employees any choice of investments. As discussed earlier, plan sponsors might reasonably conclude that a principal-protected investment would be appropriate for an emergency savings account given its purpose, short-term nature, and need to maintain liquidity. Under such an approach, the U.S. Treasury Department's

[45] ERISA section 404(c) and the regulations thereunder.

*my*RA might have been a particularly good fit as a principal-protected investment for the plan's deemed IRA, including distinctive features that would facilitate separate "mental accounting" for the rainy day account – but for Treasury's announcement in July 2017 that it had decided to terminate the *my*RA program.[46]

Another feature of a deemed IRA is the ability to be invested on a commingled basis (in the same trust) with the qualified plan's other investments (while still accounting separately for contributions and earnings under the deemed IRA and the other plan accounts).[47] Commingled investment might entail cost efficiencies for the plan and might to some degree simplify the combination of the main plan and the deemed IRA. It also might conceivably help some employees feel more comfortable with their investment decisions for the deemed IRA (if, for example, it was invested in the same QDIA in which the main 401(k) plan was invested).

On the other hand, the advantages of commingling investment of the deemed IRA with investment of other plan assets might be outweighed for plan sponsors by the risk that, if any commingled deemed IRA violated the IRA requirements, all deemed IRAs apparently could be treated as noncompliant with those rules, calling the qualified status of the plan into question. While a plan sponsor might conclude that it was not concerned about any such risk of "contagion" from a noncompliant deemed IRA in view of the sponsor's control over the design and operation of the deemed IRAs, such a risk could be

[46] The *my*RA is a Roth IRA "starter account" for new savers that Treasury has made available to individuals at no cost and that simplified the choices for individuals by holding only a single investment: a specially designed non-marketable U.S. savings bond available to individuals at no cost. The value of the bond increases with additional contributions plus interest at a variable rate (based on a weighted average of the rates on Treasury securities of 4 or more years in duration) that tends to roughly track the rate of inflation. Even if interest rates rise, the *my*RA involves no risk to principal because the terms of the security provide that its face amount can never decline (Treasury 2017).

[47] The deemed IRA is permitted to be held in a trust that includes the qualified employer plan, provided that the trust contains a separate account for each. Alternatively, the deemed IRA is also permitted to be held in a separate trust.

avoided by investing the assets of the deemed IRA and the qualified plan in separate trusts.[48]

3. Using Depository Institution Accounts as a Vehicle for Rainy Day Savings

Overview

An alternative to rainy day accounts housed within a 401(k) plan is to locate the accounts at a bank or credit union. In certain situations, an account could be accessed with a payroll card or other type of stored value card issued by a depository institution or a similar provider. Using a depository institution has certain advantages over other approaches, but it also has unique drawbacks.

Depository institution accounts. The major advantage of using a depository institution for rainy day accounts is that, rather than repurposing a savings vehicle designed to hold and invest long-term savings (i.e., the 401(k) plan), the accounts are managed by entities designed to deal with short-term savings and near-instant liquidity.[49] Banks and credit unions have literally hundreds of years of experience in dealing with just this type of account. Providing rainy day accounts using banks and credit unions removes most of the complexities associated with rainy day account compliance with retirement plan qualification and ERISA rules, including anti-discrimination tests and the QDIA provisions for 401(k) automatic enrollment.

On the other hand, using a depository institution for rainy day accounts would create challenges in coordinating two different regulatory structures that have very different requirements. An example of coordination that would raise administrative, regulatory, and legal challenges would be an arrangement that imposes a maximum limit on the rainy day savings account and redirects to the 401(k) any additional contributions that would otherwise exceed that limit.

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[48] Treas. Regs. section 1.408(q)-1(g).

[49] Another variation would be for employers to arrange to offer their employees stand-alone Roth IRAs (instead of stand-alone depository accounts or deemed, sidecar Roth IRAs associated with a 401(k) plan). This paper does not explore that alternative, but most of its advantages and drawbacks are evident from the discussion here.

In addition, depository institution accounts would be subject to a number of different regulatory requirements and disclosure rules that differ from those applicable to retirement savings plans.[50] For instance, depository institution regulations are not well suited to deal with automatic enrollment, and account owners cannot defer taxation on earnings and employer contributions. Further, the fee structures of the two approaches are very different. While banks tend to charge certain transaction and account maintenance fees, often monthly and credit unions, as non-profit cooperatives, tend to have fewer and lower fees than banks, 401(k) accounts tend to deduct fees from earnings, usually on a quarterly basis. Fees could also be a problem if a stored value or payroll card is used for the rainy day account. These cards can charge individuals fees that are excessive in amount and frequency, as discussed below, although those fees are often set after negotiations between the employer and the depository institution.

More generally, a bank or credit union account (or a payroll card) could be used to promote rainy day savings for employees without regard to whether they are eligible to participate in a 401(k) or other retirement savings plan. For employees who do not participate in a 401(k), rainy day savings does not serve the additional purpose of potentially reducing 401(k) leakage by focusing short-term withdrawals in a separate and distinct emergency savings account that could have the effect of more clearly segregating and therefore better protecting the long-term savings in the regular retirement plan accounts. However, for employees who do not participate in a 401(k), a special rainy day savings account can still serve the basic objective of promoting short-term savings (instead of immediate consumption) by setting aside and earmarking certain funds for emergencies.

[50] In addition to specific regulations mentioned in the following paragraphs, depository institutions are subject to anti-money laundering regulations as well as regulations dealing with the enforcement of sanctions against foreign governments and individuals. Institutions are responsible for any transactions that flow through them, and must monitor those transactions. In addition, banks and credit unions are required to provide certain disclosures before an account is opened under both the Truth in Savings Act and the Electronic Funds Transfer Act, as applicable. Other regulations also apply.

Depository institution-based rainy day accounts can offer the security of federal deposit insurance. This protection is likely to address any investment questions for the employer, provided that an FDIC or NCUSIF insured institution is chosen and the employer ensures that fees are comparatively low. 401(k) plans and IRAs can offer comparable security only for rainy day savings balances invested in bank deposits . On the other hand, federally insured deposits tend to pay minimal, if any, interest regardless of where these funds are deposited, and employers choosing such a rainy day account structure may be subjected to questions about why they did not choose a structure with higher earnings.

If a depository institution is used for rainy day accounts, we envision that contributions would go into a savings account rather than a transaction (i.e., checking) account. Alternatively, depending on the population being served, as discussed below, stored value cards could be an alternative to savings accounts. A key complication could be a requirement that employees be allowed to designate an existing bank or credit union account rather than using an account at an institution designated by the employer. The federal Electronic Fund Transfer Act[51] provides that, in the case of direct deposit, employees either must be allowed to designate their own account rather than one the employer chooses, or must be offered an alternative form of payment such as a paper check if the money goes into an account designated by the employer. These requirements could be applied to rainy day accounts as well. Some states also have laws, which might apply here, prohibiting employers from choosing banks for employees.

A further complication is the Know-Your-Customer rules designed to prevent bank accounts from being used for criminal or terrorist activities. In general, these rules require banks and credit unions to establish the identity of the account owner prior to opening the account (with certain exceptions for employer-sponsored ERISA plans). This would seem to rule out automatic enrollment into a rainy day account outside of a plan although

[51] 15 USC 1693 et seq.

there is a potential way to avoid this complication if the bank or credit union permits deposits to come only through the employer, as discussed below. Thus, while housing a rainy day account in a bank or credit union is logical, many key questions must be answered first.

Stored value payroll cards

Certain segments of the workforce, especially the approximately 27 percent who are unbanked or underbanked, could benefit from a payroll deduction rainy day savings account deposited on a payroll card (Federal Deposit Insurance Corporation 2016). A payroll card is a general purpose stored value card on which an employer directly deposits all or part of an employee's wages instead of paying earnings by check or direct deposit to a personal bank account. An employee can use a payroll card to retrieve his or her entire wage in a lump sum at an ATM or, like a typical debit card, to pay bills and conduct everyday transactions. (Unlike most debit cards, though, the prepaid payroll card is not associated with a bank account.) Municipalities, industries, and even the federal government are turning to electronic payment methods like payroll cards to reduce payroll processing costs and deliver pay and benefits in a timely and secure manner that does not require employees to incur check cashing fees or to visit a bank to cash a check.[52]

A major advantage of hosting a rainy day fund on a payroll card is that the employer would be relieved of the administrative and financial burden of managing the account. Stored value card issuers, which include some of the major credit cards companies, are typically in the business of managing pooled accounts with frequent transactions and thousands of subaccounts.[53] Stored value cards can accommodate

[52] Examples of products and educational campaigns to encourage the public to use direct deposit and split deposit include Split to Save, sponsored by the Electronic Payments Association, America Saves, and ePayResources to encourage workers to use direct deposit and split deposit; Go Direct, sponsored by the U.S. Treasury Department; and for government benefits); and the Edge Discover prepaid card promoted by the National Restaurant Association.

[53] More than a third of payroll cards have more than 50 purchases over the life of the card (Wilshusen et al. 2012). As discussed earlier, some state laws prohibit employers from paying employees with a payroll card unless the employer first offers the employee a choice or obtains the employee's written consent.

subaccounts (sometimes referred to as "set-aside" accounts) that reserve funds for particular purposes, such as an emergency savings account separate from a general transaction account.

Payroll cards may also offer an appropriate balance of liquidity and withdrawal restrictions that a traditional bank account does not. Employees can spend or withdraw only the money that is loaded onto the card. Moreover, in addition to the ability to segregate funds in set- aside accounts, cards can impose further limits on the amount that can be spent or withdrawn from the card, or reloaded onto the card, in a single month, day, or other time frame.

Rainy day set-aside accounts on payroll cards could be used to impose further withdrawal restrictions. Cardholders with such separate accounts could be required to register the card and log on or call the card issuer in order to move funds from their rainy day set-aside account to their transaction account. Such a hurdle does not appear to dampen the usage rate of other prepaid cards with built-in savings "wallets," such as the Savings Vault in Walmart's Moneycard, issued by Greendot.[54] Even employees who elect to deposit most of their wages into their personal bank account or receive them in the form of a check could use a separate payroll card to hold only emergency funds. This would accentuate separate mental accounting, make it harder to overspend and help people stick to their financial plans.[55] The degree to which labeling and marketing a payroll card for emergencies can reduce the tendency to use it for everyday transactions deserves further study.

Payroll cards are not a perfect solution to the emergency savings issue. First and foremost, employers cannot require that employees be paid on a payroll card.[56] Employers must offer employees at least one alternative, which could be to receive their pay through direct deposit into their personal bank account or via check. However, employees who

[54] See a description of the Walmart Moneycard at https://buildcommonwealth.org/work/prize-savings.

[56] 12 CFR 205 Electronic Fund Transfers

decide to receive their wages through an alternate method could still be offered a rainy day account on a payroll card.

Payroll cards have also come under scrutiny for lack of transparency regarding fees and accessibility of funds. Since payroll cards are common in industries that employ large numbers of low-wage workers, like retail and food service, there are concerns that ATM and transaction fees to access wages from the cards could disproportionately harm those who can least afford to pay them. However, new disclosure requirements in recently issued regulations by the Consumer Financial Protection Bureau (2017) are designed to improve consumers' understanding of card fees. Finally, employees without reliable internet access may be at a disadvantage when it comes to managing their payroll card accounts and monitoring deposits and withdrawals.

Ability to use automatic enrollment

It is uncertain whether a depository institution rainy day account could use automatic enrollment. When automatic enrollment into retirement accounts was first approved by the Treasury Department in 1998, there was a possibility that it would run afoul of state anti-garnishment laws that prohibit reducing a worker's paycheck without his or her advance consent. Although this uncertainty did not deter a large portion of the plan sponsor community from adopting automatic enrollment, the Pension Protection Act of 2006 eliminated this issue for retirement accounts. However, potential concerns remain for other uses. While automatic enrollment has been used for health and certain other employee benefits other than retirement plan contributions, it is uncertain whether automatic enrollment into a depository institution rainy day account outside of a retirement or other ERISA-governed plan would violate state anti-garnishment laws.

As mentioned above, another complication to using automatic enrollment arises from federal laws designed to prevent bank and credit union accounts from being used to assist criminal or terrorist activities. The Know-Your-Customer (KYC) regulations require depository institutions to positively establish the identity of the account owner before any

account can be opened.[57] Obviously, without an exception, such a requirement would effectively rule out automatic enrollment.

However, individual banks and credit unions have some flexibility in determining what they require to meet KYC regulations. Certain depositories may allow a company with a history of business dealings to provide funds on an ongoing basis to its employees without the need to follow the normally applicable KYC regulations. The depository institution would depend on the employer to take steps to identify its regular employees through such methods as the immigration requirements under the I-9 form when a new employee is hired. At the time, the necessary documents to meet KYC requirements could be collected and a copy of them sent to the depository institution.[58] The details of the way that KYC requirements are handled depends on the individual bank or credit union, and could vary depending on its relationship to the employer.

Another method that might be acceptable to individual banks or credit unions would locate the rainy day accounts in a pooled account that the employer opened in its own name and for which it maintained legal responsibility. The employer would deposit and hold in the pooled account all the funds for the benefit of the employees participating in the rainy day account program, and would separately account for each employee's portion of the pooled funds. However, most employers would likely be deterred by the effort required to administer such an account and the potential employer liability. While these responsibilities could be handled instead through a third party that administers the account, the legal owner of the account would still be the employer unless the third party opened the pooled account.

Ability to provide liquidity

[57] Financial institutions need proof of the account owner's full name, date of birth, physical address of residence, a tax identification or Social Security number that matches the name and address, and usually a photo ID.

[58] This would be very similar to the way that banks and credit unions deal with KYC regulations in the case of auto loans originated at the dealer. In that case, the dealer checks the borrower's identification and collects copies of the necessary documents to forward to the depository making the loan.

Rainy day accounts at a depository institution should allow nearly instantaneous access to deposits in the case of an emergency, subject to certain limitations. Savings accounts are designed to allow rapid transfer of funds to a transaction account, and such moves can be initiated at a branch, through websites and phone apps, at ATMs, and over the phone, if the institution allows such transfers. However, under federal regulations, withdrawals from a savings account through certain types of transactions are limited to a certain number each month. In theory, depository institutions could also restrict access to funds in savings accounts based on account terms or major financial events, such as institution failure, but in practice, consumer savings accounts are rarely affected.

Most banks and credit unions operate branches that allow customers to withdraw cash or obtain money orders or cashier's checks from their savings account directly from the institution, with few limitations. Most of these depositories also allow direct cash withdrawal from a savings account at both their own ATMs and those operated by other networks. This requires an ATM card to be issued to access the savings account, and typically a daily maximum limit applies to cash withdrawals from ATMs. In addition, account owners can transfer money from a savings account to a checking or other account through a variety of channels. However, if the savings account is at a different depository from the saver's main checking or other account transfers could become slightly more difficult, as the funds would have to be transferred between institutions. While some transfers could be instantaneous, others could take a few days to process.

Access could be just as easy if the employer decided to use a stored value or payroll card to house the rainy day account. Stored value cards with a savings feature usually allow virtually instantaneous transfers to the card's transaction account through a phone application or a website.[59] Some even allow direct access to savings. In addition, transfers

[59] For instance, Walmart has a stored value card with a savings function that hides the savings from the transactions balance. Account holders can transfer balances through a phone app or online.

can be arranged using most of the same methods that are used with bank or credit union accounts.

Some level of instantaneous access to a rainy day account would be valuable in an emergency, although such access could increase the risk that account owners would use the savings for non-emergency situations. Unfortunately, instantaneous access through an ATM may be too tempting for some consumers. In practice, the restrictions imposed by federal regulations on the number of certain types of withdrawals per month from savings accounts may prove to be the best way to discourage misuse of rainy day accounts. In addition, though, it may be desirable to encourage rainy day accounts to require certain interim steps before a withdrawal is made. These steps could include requiring a funds transfer through a website or other mechanism prior to a withdrawal, a mandatory delay, or some other way to limit instantaneous access. Banking regulations may limit the ability of depository institutions to use certain of these mechanisms, but a pooled or trust account that is administered by either the employer or a third party could implement them. On the other hand, in a true emergency where instantaneous access to savings is actually needed, such a feature could reduce the value of a rainy day account, especially if the delay made a crisis worse. Employers would need to weigh these considerations before deciding whether to add (or accept) such a delay in employee access to a rainy day account. A field experiment may be useful in weighing these countervailing considerations.

Tax treatment of depository institution rainy day accounts

Like other bank accounts, a rainy day account at a depository institution outside of a tax-qualified plan would not be entitled to preferential tax treatment.[60] Deposits would be made on an after-tax basis, and interest and other earnings would be taxable in the year in which they are earned. Withdrawals, whether of previous contributions or earnings, would not be taxed because the funds being withdrawn had been taxed

[60] At least in the near term, Congress is unlikely to enact legislation allowing rainy day accounts to be funded with pre-tax dollars like certain types of employee benefits (such as 401(k) plans or health savings accounts).

previously. Accordingly, there would be no tax-related need to determine how much of a given withdrawal would be treated as return of contributions versus earnings.

Ability to provide employer matching contributions

Employers wishing to do so could match employee rainy day contributions up to a specified level or otherwise help to fund a depository institution rainy day account. Employers could even seed the account with an initial deposit or series of deposits for a certain length of time while encouraging employees to contribute.

However, unlike employer matching contributions to a 401(k) plan, employer matches to a depository rainy day account would not be tax-deferred; they would be considered taxable income to the employee when made. Few if any employers would be willing to consider paying the tax on such matches for the employee. Among other things, in addition to the cost, such a "gross-up" of taxes would be challenging to administer and could set a precedent that employers would wish to avoid. Further, taxes on employer contributions that are withheld from an employee's paycheck could reduce take home pay, making such an arrangement less attractive to employees.

An employer that wished to make matching contributions to employees' depository rainy day accounts would keep those contributions separate from its matching contributions to the tax-qualified 401(k) plan. Given the different tax treatment and the very different regulatory regimes applicable to the two types of employer contributions and to the two types of employee contributions they are matching, it would seem impractical to try to integrate or otherwise interrelate the amount of the employer matching contributions to the 401(k) with any employer matching contributions to the depository account A depository rainy day account also could conceivably make it harder to satisfy the 401(k) nondiscrimination tests to the extent that the rainy day contributions had the effect of replacing or crowding out NHCEs' tax-favored employee contributions and employer matching contributions that would otherwise be made to the 401(k) plan.

Ability to encourage separate mental accounting

The differences between depository institution rainy day accounts and 401(k) plan accounts would facilitate differentiation and separation of the two types of accounts. The depository rainy day accounts would be housed at a different institution than the 401(k) accounts, with different withdrawal rules and providing a different statement from the 401(k) accounts with a different institution's name on the statement. This should clearly distinguish the rainy day accounts from the retirement accounts and could encourage savers to treat them quite differently – viewing their rainy day accounts as available for emergency withdrawals and their retirement balances as locked up for the long term.

As most consumers have some familiarity with bank accounts, they would almost immediately understand how to use their new rainy day savings account. However, this familiarity could lead to a different problem: inability to differentiate the rainy day account from their normal deposit accounts, giving rise to the risk that the rainy day account would be used for regular expenses rather than being reserved for emergencies.

If the rainy day account is established as a savings account, federal regulations[61] limit withdrawals to six transactions of certain types per month. Restricted transactions include withdrawals made through a debit card, over a telephone, or online, but not in-person withdrawals made at a bank branch or at an ATM. This restriction could be viewed as supportive of a policy of limiting use of a rainy day account for emergency savings. Another potential discourage the use of the rainy day account for other purposes would be to require withdrawals to be initiated from a separate website or phone application. For rainy day accounts that are accessed through a payroll or similar card, labeling that card prominently as an emergency card could discourage regular, routine use. Some experiments using payroll cards show preliminary evidence that a large majority of savers do not access savings to pay for consumption. However, it is likely that some unintended or suboptimal use would be a fact of life for a rainy day depository institution account.

[61] Regulation D

Investment issues

As contributions to this type of rainy day account would go into a bank or credit union savings account or a similar instrument, there are no significant issues with the choice of investment. Contributions would go into a pre-determined financial institution savings account that pays some level of interest. The interest is likely to be minimal, in view of the liquidity of the account and the current interest rate environment. As noted, the interest, like most deposit account interest, generally will be taxable in the year in which it is earned.

Savers wishing to earn more interest could consider using a Certificate of Deposit (CD). However, bank or credit union CDs require the funds to be on deposit for a set period of time, and early withdrawals usually result in a penalty that is often calculated as a portion of the interest the CD would have earned during its entire term. If the CD did not earn interest sufficient to cover the penalty at the time of the early withdrawal, the penalty could be deducted from the principal.

Because rainy day accounts in a bank or credit union would be covered by federal deposit insurance, balances up to the maximum deposit insurance level (generally $250,000, far in excess of a plausible rainy day savings target) should not be at risk.[62] However, this protection depends on who holds the accounts, or in the case of a payroll or stored value card, which entity issues the card. Non-depository financial institutions issue some stored value cards, and these are unlikely to be covered by federal deposit insurance. In the event that a rainy day account is housed in such an entity, depositors should be clearly and regularly notified that the FDIC and the NCUA do not insure the accounts.

[62] Interest rates could vary from quarter to quarter, but this is a very different type of volatility than would be found in a riskier type of investment.

Another factor to consider with bank or credit union rainy day accounts is the effect of fees and possible minimum balance requirements. Fees and other account requirements can vary widely among financial institutions, so it will be important to select a low-cost account with minimal restrictions. Larger banks are likely to charge as much as $5.00 a month for a savings account and to require a minimum deposit of $25.00 to open it.[63] In contrast, certain online banks have no monthly fees and have no minimum deposit for opening accounts. Similarly, most credit unions have no monthly fees, although they are required to have a $5.00 minimum balance. Almost all financial institutions charge a fee for the use of an ATM if the user is not a bank customer. In addition, fees for falling below minimum balance requirements often apply. While some depository institutions impose minimum balance fees only if the average balance in the account over a set period falls below the minimum, others impose fees if the minimum is not met every day of the month.

If a rainy day account is housed in the account owner's existing bank or credit union, it may be easier for the account holder to keep fees to a minimum, but if the employer or payroll processor selects the depository institution or the payroll card provider, it would be desirable (all other things being equal) to choose one with low fees and few other requirements. As noted earlier, fees become even more of an issue with a stored value or payroll card, as some cards charge fees for any withdrawal, for other types of transactions, and for failing to use the account within a specified period of time.

Conclusion

As discussed, we believe that automatically enrolling workers into an employer-sponsored payroll deduction "rainy day" or "emergency" savings account could be a cost-effective means of helping households accumulate liquid savings to meet possible urgent pre-retirement expenditure needs. After describing the salient features of several possible

[63] See http://rates.savingsaccounts.com/savings-and-money-market-accounts

approaches – including after-tax employee contributions within a 401(k) plan, deemed Roth IRAs associated with a 401(k), or separate rainy day savings accounts at a bank or credit union arranged by the employer – and considering in a preliminary way their main advantages and potential drawbacks, our view is that, at this early stage, each approach merits further exploration, including through workplace pilot projects and experimentation.

That said, the authors are under no illusion that most plan sponsors will jump at the chance to offer rainy day accounts to their employees. We recognize that in our voluntary private employee benefits system, many employers will be inclined to begin, and end, by asking, "What's in it for me?" Many will find ready justifications for not getting involved and for letting employees figure this out on their own: costs to employers, administrative burdens, lack of special tax incentives in the case of stand-alone bank or credit union accounts, and pervasive concern about litigation risks. But most of these are concerns that plan sponsors generally have been able to manage while choosing to sponsor retirement savings plans to compete effectively in the labor market and to promote greater workplace productivity by addressing workers' needs.

The evidence suggests a real need for short-term emergency savings. This suggests that such arrangements at the workplace could help attract and retain valuable employees. And the relatively modest accumulation required to address the need (depending on how ambitious a target is established for the rainy day savings) means that such an account could be built up in relatively short order and without undue diversion from long-term savings. In addition, as discussed, a rainy day account might even help contain some of the 401(k) leakage that occurs today. There have been signs of interest in establishing rainy day accounts among some employers, and, as in the case of other innovations, we see a path forward that begins with pilots and workplace experiments.

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