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401(k) Plans

Thank You, Department of Labor, for Changing 5500 Participant Count Methodology

As of 1/1/2023, only participants with account balances will be counted when determining whether an independent audit must be attached to Form 5500, thus changing audit requirements for a number of qualified plans—particularly those with Cash or Deferred Arrangements (401(k), 403(b), and 457(b) plans) and creating financial relief. This is an important planning tool for these plans going forward.

BY MICHELLE MURPHY

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When I accidentally fell into working in the retirement plan industry, as many of us have done, I knew nothing about retirement plans. I worked as temporary help in a bank, assisting with the preparation of trust statements for qualified retirement plans, as well as the accompanying Schedule P for those plans. We typed the Schedule P on a typewriter and prayed it was error-free, because we did not have the newest IBM Selectric (that is, the one with the self-correction tape). All we had at the time were Liquid Paper (white cover-up ink in a bottle with a brush, for those under 40) or little white films with which you backspaced and typed over the error, so the film transferred white over the typo, allowing you to re-type the correct letters. That was 1982.

Things change! The Schedule P reported the Trust Identification number of the plan and was phased

out with the 2006 Form 5500. Computer programs have obviously changed considerably since that time, and we no longer type manual corrections for accrued income on trust statements or manually type Forms 5500 for hundreds of plans. Electronic filing of Form 5500 has been required since 2009 (2023 will be the fifteenth year!) and the forms continue to have been tweaked ever since I began working in that bank as a temporary employee.

Something else happened in the 1980s. The 401(k) plan became a vehicle for employee saving, where it had never been part of the retirement world previously. In the early 1980s, people were just figuring out what it might look like to allow employees to save pre-tax through a profit-sharing plan. At the time, the most innovative wealth management groups and banks were offering multiple managed funds and allowing employees to choose among them, sometimes quarterly. The administration team then had to figure out how to get that money allocated properly and quickly and reinvested in the newly elected fund before it was time to allow the employees to change their elections again. The Errors and Omissions insurance frequently had to help out someone who was slower than was favorable for the employees when the market turned before daily valuation was available.

But technology changed and software changed. The use of mutual funds and recordkeepers allowed the industry to move to daily valuation platforms to take care of those portions of shares of mutual funds into which individuals in 401(k) plans directed investments. And, as technology allowed to occur as if it were magic, the industry focused again, and more complex plan contribution designs can be administered in an easier and more cost-effective manner. We even have been relieved of the drudgery of typing or printing participant statements onto preprinted statement paper.

As advanced capabilities with databases and software came about and pension specialists were no longer relying on 12-key calculators to work through multitudes of employees' allocations, we developed cross-tested plan formulas and cash balance plans and things changed again. We moved from traditional defined benefit and profit-sharing plans, where essentially every person who was eligible to participate in a plan received a contribution and therefore had an account balance, to an industry where a majority of new retirement plan arrangements started with a 401(k) plan, a type of plan where employees were eligible to participate but might elect not to. Employees could say no. And, with a trend towards matching contributions rather than across-the-board profit-sharing allocations, if the participant said no and chose not to put their own money into the plan, the employer could say no to them as well. If there was no employee contribution, then there was no employer matching contribution, and thus no account balance. Traditional contributions might be layered on as an employer had means or the business saw profits, perhaps adding a type of non-elective contribution on top of employees' contributions, rather than starting with employer contributions from day one of the plan design.

Who Is a Participant of the Plan?

Through all of this historical change in qualified plan design, the Form 5500 changed in bits and pieces, adding schedules and removing them. I believe there was even talk about bringing back the Schedule P again, but one thing that never changed was the expectation that anyone who was eligible to participate in the plan would have an account balance, even if it was zero. One of the most frequently asked questions I have received during my career as related to the Form 5500 has nothing to do with the balances reported or the questions, but has to do with the number of participants reported on the Form 5500 and usually is something like: Why are you reporting 50 participants in the plan when there are only 15 people with accounts?

Through the 2022 reporting year, the Department of Labor instructions for the Form 5500 have been that the number of participants reported at the beginning of the year includes anyone who is eligible to participate in the plan, plus any inactive employees with a balance. This frequently meant that we were counting employees with no account balances, particularly in plans that permitted employee contributions only or where the only employer contributions were matching contributions. Consequently, we receive the types of questions discussed above from clients, wondering where the number of participants came from.

Audit Requirements

Where this methodology for counting employees has been particularly difficult is when the employee base is large enough to trigger an audit. The Form 5500 instructions also state that the line that includes the participant count as of the beginning of the year is what controls whether the plan requires an audit for that particular reporting year. For a new plan

with 100 participants or more, an audited financial report performed by a qualified independent accountant will be required. If it is an existing plan and in prior years has been under the 100-participant mark, there may be some wiggle room to wait until the plan exceeds 120 participants. It is really important then to the employer who hovers around the 100-employee mark to determine whether it will need to spend in the neighborhood of $10,000 on an audit. Counting participants with no account balances has required thousands of employers to have audits who would not otherwise.

Some big news released with the 2023 Form 5500 instructions is that, effective for plan years beginning January 1, 2023, or later, the Form 5500 will contain a new line that reports the number of participants *with account balances* and that count will be what is used to determine whether an independent audit is required to be attached to the Form 5500! This is a monumental change for some employers! While this column is dedicated to 401(k) plans, we must recognize the change is equally significant for 403(b) plans, which are required through universal availability rules to make all employees (with some exceptions) eligible upon hire, and frequently have low participation due to the demographics of the plan sponsors.

I have a client who hit the audit mark two years ago with just over 120 employees eligible plus terminated employees with account balances. We assisted in getting everyone paid out that was possible, and yet the client was in acquisition mode and knew they would have more employees who would be eligible. But only about 50 employees participated. It is a safe-harbor matching plan, and, while enrollment is actively pursued, employees just do not take advantage of the plan, which is typical of their industry. They contemplated terminating the plan due to the cost of the audit, but determined they would press on. It was with great delight that I was able to give them the good news that 2022 would be the last year they would have the additional expense to their plan (at least, until they had at least 100 people actually contributing to the plan).

By making this simple change in methodology, the Department of Labor has caught up with the change from traditional pension and profit sharing to 401(k) only plans and made the reporting easier for employers to understand. It will especially benefit smaller employers using simplified retirement plan designs to offer their employees the opportunity to save, and particularly as long-term part-time employees begin to enter plans in 2024. As so many other incentives, such as tax credits, have been created with SECURE 2.0 in an effort to provide employers some relief to the cost of plan administration and setup, this concurrent Form 5500 change will save employers money and give them more incentive to make plans available to all employees, without penalizing them if employees fail to take the opportunity to participate. I personally have several clients delighted to save those audit fees going forward.

Thank you Department of Labor for making this long-awaited change! ■

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