For 401(k) Errors, It Seems To Be All Payroll These Days

By Ary Rosenbaum, Esq.

In the movie Fletch, Chevy Chase played Irwin R. Fletcher ("Fletch"), an undercover newspaper reporter under the byline "Jane Doe". Fletch would use aliases to get to the bottom of the story, namely why Alan Stanwyk wanted Fletch to murder him and who was behind all the drugs on the beach. At one point, Fletch was snooping around Stanwyk's private plane and found a connection between the two mysteries while posing as a plane mechanic G. Gordon Liddy. Pretending to know a thing about airplane maintenance, he claimed it was all ball bearings these days. For a 401(k) plan sponsor, many of the problems that also seems to be getting government attention are payroll issues. It seems to take a line from Fletch, it's all payroll issues these days. This article is about the many different issues from payroll that are causing headaches for plan sponsors.

Compliance headaches and the issue of 401(k) and payroll

401(k) plans are like any complicated pieces of machinery, there are a lot of moving parts and a lot of ways that things can go wrong. While there are so many compliance issues that can occur especially dealing with compliance testing, eligibility, and the plan document, payroll is the root of many potential headaches. Unlike defined benefit plans and some other defined contribution plans, 401(k) plans are forever connected to payroll based on the fact that participant salary deferrals are taken from payroll. As a cash or deferred arrangement, a 401(k) plan has that unique integration with payroll that most other forms of retirement plans don't have. Payroll for 401(k) plans is more than just salary deferrals and that's why it's at the root of many plan problems.

The late deposit of salary deferrals

When it comes to the Department of Labor (DOL), they have been ramping up compliance on retirement plan sponsors through their compliance audits. In terms of what they are looking for, the largest focus for 401(k) plans for the last few years has been the late deposit of salary deferrals. A few years back, the DOL reinterpreted the guidelines of salary deferral deposits and opined that plan sponsors could no longer depend on the safe harbor guidelines of depositing deferrals before the 15th day of the following month. The reason that the DOL changed their viewpoint because technology has made salary deferral deposits to be done quickly and efficiently that the safe harbor was too long and generous for plan sponsors. So the DOL indicated that plan sponsors need to deposit participant salary deferrals as soon as possible. Under the new DOL viewpoint, 401(k) plan deferrals must be deposited on the earliest date the funds can reasonably be separated from the employer's general assets. For some larger companies, the DOL thinks it should be within three business days. The DOL did create a safe harbor standard for plans with fewer than 100 participants, which states that regardless of how quickly the sponsor is able to reasonably make the deposit, the DOL will treat it as timely if made within seven business days following the payroll date. Even if the plan sponsor is one day late in depositing salary deferrals, they essentially have a prohibited transaction on their hands that red flags go up and the 401(k) sponsor needs to correct it as soon as possible. The reason it creates a big red flag for 401(k) plan sponsors is that late deposit of participant deferrals and loan payments must be reported on the annual Form 5500/5500-SF filing each year until fully corrected. Plan sponsors that reporting delinquent salary deferral deposits as required are a

red flag for the DOL and, oftentimes, these filings result in follow-up correspondence from the DOL when corrections through their Voluntary Fiduciary Compliance Program haven't been completed. I will say that plan sponsor informing the government on Form 5500 that they have late salary deferral deposits (as required under penalties of perjury) are likely to be contacted by the DOL for an audit than plan sponsors who make salary deferral deposits timely. Any plan sponsor who thinks they have been late for even just one payroll should correct it through using the DOL calculator and making the application to the VFCP program. As will see throughout the article, late salary deferral deposits are just one 401(k) compliance issue dealing with payroll.

The compensation problem

In terms of fixing 401(k) issues, the most popular error is the late deposit of salary deferrals. The second biggest problem is what I call the compensation issue. What is it? It's when a 401(k) plan sponsor is using one definition of compensation for salary deferrals and employer contributions, but the plan document says something different. The best example is when a 401(k) plan sponsor doesn't want to allow participants to defer and doesn't want to make contributions on bonuses. It's a big problem when the plan document failed to exclude bonuses as compensation. 401(k) plan sponsors need to operate their plan according to the plan document's terms. So that means not only is the plan out of compliance, they will have to make corrective contributions for the missed deferral opportunity and any employer contributions associated with the bonus that should have been included as compensation. Plan sponsors need to reconcile payroll, the contributions they make, and how the plan document defined compensation and make sure there is uniformity. Otherwise, the plan sponsor is going to have unnecessary compliance errors. The problem with compensation errors is that it may only be detected many years later. I had one potential client advise me that they had a compensation problem for over 20 years where they didn't include bonuses as compensation when the plan document said they should and their third party administrator (TPA) and auditor failed to discover. Mistakes do happen, but mistakes that are identified years later are more expensive to fix than errors that are discovered immediately.

Loans and loans and loans

401(k) plan loans are an attractive need because participants can access their account balance when they need arises. The problem with loans is the compliance part of it. Loans are an exemption from the prohibited transaction rules under the Internal revenue Code. Anything that takes loans outside of the exemption makes it a prohibited transaction that makes the loan taxable and it can become a headache because essentially it means that the plan sponsor committed a prohibited transaction. While there are several parts of the exemption that when violated can turn the loan into a prohibited transaction, the main issue with payroll is that payments to the loan are made from them. The problem with payroll is when loans aren't paid for payroll as required by the Internal Code and by the loan's promissory note. Failure to pay a loan (subject to the promissory note and must have quarterly payments) will turn the loan into a deemed distribution and taxable event to the participant. This payroll snafu may happen when the participant decides they need to default the loan because they can't afford to pay for it or an error occurs that payments aren't made to the loans. The latter error usually happens when there are multiple loans of the participants and not all of them have been receiving payments, which turns one or more of these loans into a taxable event. Loans are a tremendous headache because when a default occurs, a lot of times, it's detected years later. This big compliance error should require the plan sponsor to submit the plan into a voluntary compliance program to fix the error.

One warning about payroll

Payroll is an important facet of 401(k) plans because a whole host of problems can be related to it. However, that doesn't mean that a plan sponsor should hire their payroll provider as their TPA. Most payroll providers (I usually focus on the top two national payroll providers) aren't very good as TPAs, so there is no seamless integration between payroll and TPA services that will eliminate these payroll errors that I highlighted. Plan sponsors should pick a good payroll provider and a good TPA, there is no provider out there that I know of that are great at both.

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