Using A Payroll Provider As Your 401(k) TPA Is An Awful Idea

By Ary Rosenbaum, Esq.

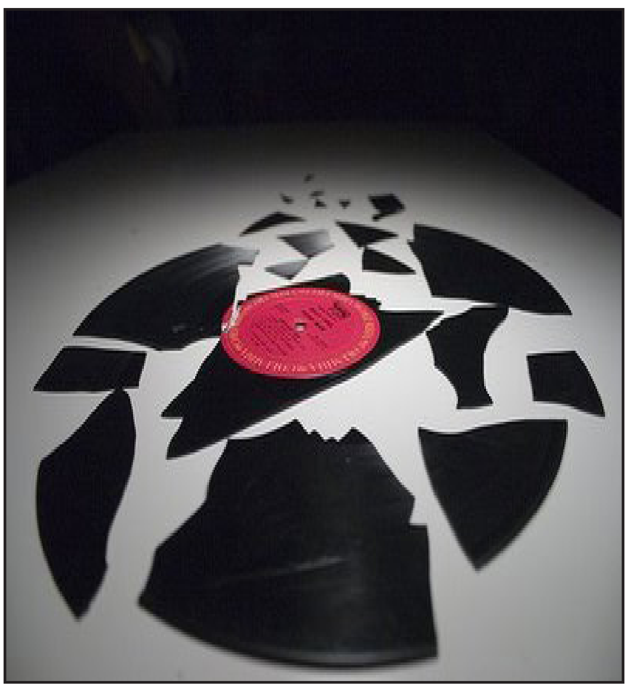
I've been a broken record for the past 8 years, I've been saying that by having the top two payroll companies (ADP and Paychex) handle a 401(k) plan's administration, a plan sponsor may have a whole host of surprises that aren't very good.

Payroll has very little to do with 401(k) plans.

Many third-party administrators (TPAs) add ancillary lines of business that are connected with retirement plan administration, such as offering investment advisory services, insurance, and plan document services. TPAs that offer investment advisory services are called producing TPAs. With these producing TPAs, there is a natural nexus between these additional plan services and the administration of retirement plans. However, 401(k) plan administration has very little to do with payroll. Other than salary deferrals and W-2 compensation, 401(k) plan administration has absolutely nothing to do with payroll.

Competence of your TPA is more important than perceived ease

Payroll provider TPAs have a lot of 401(k) plans to administer because most plan sponsors don't understand what a TPA really does. That's why payroll provider TPAs are so popular: plan sponsors think they're getting a bargain by using their payroll provider as a one-stop shop for payroll and retirement plan administration. The problem is that retirement plans must abide by highly technical rules set forth by the Internal Revenue Code and ERISA (the Employee Retirement Income Security Act of 1974). They must undergo complicated testing for participation and contributions in order to avoid discriminating in favor of highly compensated employees. In addition, they have reporting requirements such as the annual Form 5500 and Form 1099 for plan distributions to participants. They must have up-to-date plan documents and they must be administered according to the plan document's terms. In addition, if the retirement plan is a participant-directed 401(k) plan, there are deposits made from payroll to the plan's trust through electronic transfer (or by check) as well as daily trades of mutual funds or exchange-traded funds. After the trades are made, assets must be distributed to participant accounts, which also must be updated with any gains, losses, dividends, and/or capital gains. Since retirement plans have so many moving parts, plan sponsors need to find competent TPAs who are competent in plan administration. Errors in the administration of a retirement plan can lead to the imposition of penalties resulting from an audit by the Internal Revenue Service or by the United States Department of Labor. The problem is that with any TPA errors, it's the plan sponsor ultimately on the hook. This is why plan sponsors should carefully select a TPA, as opposed to just choosing their payroll provider because it looks good on paper.



Payroll Providers won't hold their clients' hands

The deduction of 401(k) salary deferrals from payroll is a small part of plan administration and while errors in the processing of payroll for salary deferral contributions can and do occur, such errors have become far less common since payroll has been computerized and automated. Unlike payroll, plan discrimination testing is not automated. While plan discrimination testing does require computerized payroll reports, it is heavily dependent on data collected from the plan sponsor. After the end of the plan year (for most 401(k) plans, it's the calendar year), the TPA will send a data request form to the plan sponsor. The data request form will ask for the census of all of the plan sponsor's employees, their dates of hire, their dates of birth, hours of service, and, for employees who have separated from service, their dates of termination. In addition, the data request form will also ask the plan sponsor to specify the ownership of the employer, whether the employer affiliated with any other entities (through ownership or affiliated service) and to identify the employer's officers. Since plan administration is so dependent on the information provided by the plan sponsor in the data request form, the information in that form must be correct in order for the discrimination testing to be accurate. Since many of the questions asked on a data request form can be highly technical, a competent TPA will work closely with their clients in order to ensure that the data provided is accurate. Payroll providers, on the other hand, routinely expect plan sponsors to independently, and without any support or guidance, complete a data request form. The problem is that if the plan sponsor provides inaccurate or incorrect information on the data request form, the payroll provider TPA will run the test using the faulty data and obtain faulty testing results. Its what I call: garbage in, garbage out and plan sponsor can't afford their compliance test results to be garbage.

There never seems to be one person to talk to

Most TPAs offer plan sponsors a dedicated administrative representative that a plan sponsor can directly talk to, to get information. For payroll provider TPAs, only their larger plans get a dedicated representative, so they offer the team approach to most of their plans. From experience with clients with payroll provider TPAs, it is very difficult to track someone who actually physically worked on that plan. It is far easier to work with one plan contact than multiple contacts because, from experience, the team approach leads to a lot of dropped balls.

They tend to offer plain vanilla plans and that can cost an employer

The payroll provider TPAs also tend to be unsophisticated for plan design, as well as not being pro-active when a 401(k) plan has testing issues. One major component of setting up a retirement plan is to maximize retirement plan savings for the plan participants. This can be done through a proper choice of among many different plan types and plan designs. Payroll providers tend to only administer straight vanilla 401(k) plans, so they won't likely discuss the merits of new comparability, floor-offset arrangements, or cash balance plans. I have had clients that would fail their discrimination tests for years before being approached by their payroll provider TPA in considering adding a safe harbor contribution to avoid testing. I once reviewed an employer who was forced by one of the payroll provider TPAs to set up a second 401(k) plan because they hadn't handle a 401(k) plan with existing brokerage accounts, so this employer was forced to create a new plan, merge the assets from the old one into the new one, and file two Form 5500s for two plans (even though the payroll provider disclaimed any responsibility for filing a 5500 for the first plan which is now delinquent). While I understand that payroll provider TPAs now handle new comparability/cross tested plan designs, they won't handle any administration or discussion of combination plan design with a defined benefit plan or cash balance plan. So that means if a plan sponsor wants a cash balance or defined benefit plan coupled with a 401(k) plan, they have to hire another TPA.

They may offer fund lineups, but payroll provider TPAs are not fiduciaries and do not give investment advice

Too many plan sponsors that utilize the payroll provider TPAs don't have a financial advisor, which is dangerous for any 401(k) plan that is participant-directed. While payroll provider TPAs are more than willing to offer a choice of investment options on their mutual fund menus that they offer to their clients, they are not fiduciaries and so they are not liable for any losses suffered by plan participants. Payroll provider TPAs are also not responsible for picking mutual funds that pay a lot of revenue sharing back to them. While a financial representative from a payroll provider TPA may suggest what mutual funds to select, they are not considered as giving investment advice, they are not a fiduciary, and so they are not legally culpable for their fund lineup suggestions. This leaves the plan sponsor and the other fiduciaries exposed to liability and holding the bag. Another interesting bit is that the reason that payroll provider TPAs get so much business is that they will refer plans to investment advisors is one is not attached to a plan in the hopes that they can get referral business from the advisors that they refer business to.

The turnover rate for the payroll provider TPAs is high

Many financial advisors who are critical of payroll provider TPAs maintain that a payroll provider TPA's salesperson is only concerned with a sale. That's because that is all they're actually paid for and, since the turnover rate for their TPA salespeople is high, they're less likely to be around when the plan sponsors have problems with plan administration. The two top payroll providers have been successful in the number of plans that they administer as a TPA and they will gladly tell potential clients that they're a couple of the top TPA firms in the country. The payroll provider TPAs also do well with plan sponsor surveys because most plan sponsors don't know the issues with their plan until after problems are discovered. Popularity doesn't necessarily equate with competence. A look behind the numbers suggests that, while payroll provider TPAs have many clients, they have a high churn rate, which means that they gain as many plans as they lose. Good TPAs have very little turnover, suggesting that their clients stay with them because satisfied clients rarely leave.

Payroll/TPA Integration isn't so important

The two largest payroll providers will tell potential clients that integration of their payroll services with TPA services is very important since it's seamless. If it's so important, why do these payroll providers offer integration of their payroll services to their competition, some of the very large mutual fund companies who serve as bundled TPAs? Anything important in business is not something you share with your competition. In addition, competing payroll providers that don't offer TPA services offer integration with many different TPAs, so it's not so important that a plan sponsor needs a payroll provider to provide payroll and TPA services.

The Rosenbaum Law Firm P.C.

The Rosenbaum Law Firm P.C.
734 Franklin Avenue, Suite 302
Garden City, New York 11530
(516) 594-1557

http://www.therosenbaumlawfirm.com
Follow us on Twitter @rosenbaumlaw