The Best Way A 401(k) Plan Sponsor Can Avoid Headaches? Hire The Right TPA

By Ary Rosenbaum, Esq.

I've been an ERISA attorney for 23 years and I've seen a lot of 401(k) plan sponsors that have liability and compliance headaches that they could have avoided. The most important step that plan sponsors can take in avoiding needless plan errors that can cost them in the pocketbook is by hiring the right third-party administrator (TPA), no ifs, ands, or buts.

The TPAs are the most important provider you can hire

With apologies to financial advisors, other ERISA attorneys, and auditors, the fact is that the most important provider that a plan sponsor will hire a TPA. The reason is they do most of the work and most of their work if done incorrectly, is usually the reason that 401(k) plans have compliance issues that will lead to corrective contributions and possible penalties. Another reason is that poor plan design formulas by a TPA could lead to a 401(k) plan sponsor either making unnecessary contributions or leaving money on the table by not allowing the employer the opportunity to maximize contributions. A 401(k) plan is like a car, it has so many moving parts that it's difficult to determine what can and what has gone wrong. A good TPA like a good car mechanic will keep the 401(k) plan running in tip-top shape.

Yes, but the TPA doesn't do everything, especially windows

While the TPA is the most important provider that a 401(k) plan sponsor could hire, it's not the only one to hire. For example, unless they are a "producing" TPA with an affiliated asset advisory firm, they aren't responsible for the fiduciary component of the plan. If you see a good amount of the 401(k) plan litigation out there, a lot of it these days surrounds mutual fund share classes and aside from receiving revenue sharing payments, the TPA isn't involved in that. Despite what some people thought in the past, a TPA can't draft plan audits. So a TPA is only responsible for assisting in the day-to-day plan administration un- less they contractually take on other roles. Despite their work and their responsibility, a TPA isn't a fiduciary unless they decide to take it con contractually under an ERISA §3(16) setting where they assume the role of named plan administrator. While a TPA can unwittingly become a fiduciary through their acts, absent a contract, that would be the subject of litigation, and most times, the TPA has come out on top in that regard. Like a cereal that is part of a complete breakfast, utilizing a good TPA is part of a 401(k)'s prudent fiduciary process, it's not a substitute for everything that could rise to liability headaches for the plan sponsor.

The compliance part is one huge reason you need a good TPA

The fact is that most 401(k) plan sponsors have no idea what a TPA does. They understand that they need one, but they don't understand what they do. A TPA has essentially delegated the role of plan administrator even though the 401(k) plan is the plan administrator and keeps the liability that goes with it unless there is that §3(16) role in place. A TPA usually wears two hats, the role of TPA and recordkeeper. There may be a situation where there is a TPA that is affiliated with a bundled provider like a mutual fund company and another separate company serves as a recordkeeper. For our purposes, we will still discuss what a TPA does when they wear both hats. For a participant-directed 401(k) plan, the TPA is involved with the trading of mutual funds on a custodial platform based on instructions provided by plan participants. So within the 401(k) plan's trust account, the TPA creates subaccounts to properly credit each participant 401(k) account with new contributions and earnings. While there may be errors with the crediting of contributions, the bulk of the 401(k) plan's compliance headache deals with the compliance portion of the 401(k) plan. The TPA prepares the annual return Form 5500 and that's an issue when the TPA fails to properly complete one for the plan sponsor to file. While the voluntary corrective process by the Department of Labor (DOL) for

late filings is easy and fairly inexpensive, getting a letter from the DOL that the plan sponsors owe penalties over $1,000 a day for a late 5500 filing is scary and precludes the plan sponsor from using that voluntary late filing program. Even if Form 5500 is completed, there may be some errors or unfavorable answers that could generate a DOL or Internal Revenue Service (IRS) audit. I had a recent audit just because the TPA reported a contribution on a cash basis while the plan sponsor reported that contribution on that corporate tax return on an accrual basis. Since the contributions didn't match up with the difference in a year, an audit was conducted. In addition to Form 5500, a TPA is responsible for all of the compliance testing that 401(k) plans must conduct (unless they are a safe harbor 401(k) and are not tested in certain areas). Coverage, actual deferral percentage test, actual contribution percentage test, general test, and Top Heavy are just some of the testing that the TPA does. The problem with testing is that it has to be precise, so if a TPA is using bad data or misinterpreting errors, compliance issues result. The problem with compliance errors is that they are often discovered years later on an audit or when there is a change of TPA. When errors are discovered later, it's more money to correct because some corrective measures are foreclosed because of time and there is the possibility of penalties if the plan is under audit. In addition, the TPA is also responsible for the allocation of employer contributions. In addition to crediting plan participants with the salary deferral contributions they make, the TPA will also credit any profit-sharing or matching contributions to participant accounts. Many errors come as a result of a TPA misinterpreting the employer contribution formula that can lead to a whole host of headaches later down the line. So a TPA does a lot of work that could get a plan sponsor in hot water So that's why a 401(k) plan sponsor needs to find a good quality TPA that will cause fewer errors and keep the plan and the plan sponsor's wallet out of harm's way.

Using a plan design formula efficiently

Designing a contribution formula is like playing a game of chess, moves have to be thought out. Thanks to mini- mum contributions and the demographics of the company's workforce, a plan sponsor could needlessly pay contributions to rank and file employees or not be able to maximize contributions for their highly paid employees when a small minimum contribution was needed. A good TPA will design a retirement plan that fits the needs and demographics of the plan sponsor. I've seen too many plan sponsors use inferior TPAs and end up paying through the nose in corrective contributions or tax deferral refunds to highly compensated employees. I've seen too many plan sponsors pay every employee the same profit-sharing contributions when a cross-tested allocation could be used to reward highly compensated employees at a greater percentage or they could use a cash balance plan that's integrated with a safe harbor 401(k) plan. I will never forget the 401(k) plan sponsor who had to refund $10,500 of the owner's salary deferrals for a failed test when the TPA could have told her that she only had to make a $7,500 corrective contribution instead. The TPA also never bothered to tell the owner the benefits of a safe harbor 401(k) plan design, which would have eliminated the consistent failure of the actual deferral percentage test. There are too many plan sponsors with an inefficient employer contribution formula design. The right TPA is a plan formula expert that can custom a formula that is the most efficient to a specific employer. An employer doesn't have to give every employee the same per- centage in compensation if they want to reward their employees and there are corrective formulas to consider when a plan is consistently failing their compliance tests. This is why a plan sponsor needs to find the right TPA that has the expertise in designing a plan contribution formula that is the right fit for every 401(k) plan sponsor.

Cost shouldn't be the most important factor in hiring a TPA

There are many reasons why a 401(k) plan sponsor should pick a particular TPA. It could be based on experience, level of service, recommendations, and plan design needs. Cost shouldn't be the most important factor in selecting a TPA. A plan sponsor has a fiduciary duty to pay reasonable plan expenses for the services provided. That doesn't mean they have to pick the cheapest TPA. From experience, solely or mainly selecting a TPA on a cost is a bad bet. I've seen too many 401(k) plan sponsors do that and pay through the nose in trying to fix the errors caused by these cheap providers. There is nothing wrong with picking an inexpensive TPA as long as they have the level of expertise to do a competent job and keep the plan sponsor from having compliance errors to fix many years down the line. As this article suggests, a plan sponsor's best chance of eliminating potential liability and compliance headaches is hiring a good TPA. A plan sponsor has to conduct a prudent process in selecting plan sponsors; it must make sense and benefit the 401(k) plan and the plan's participants. So a plan sponsor

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