Why You Should Avoid Using Your Payroll Provider as Your 401(k) Provider

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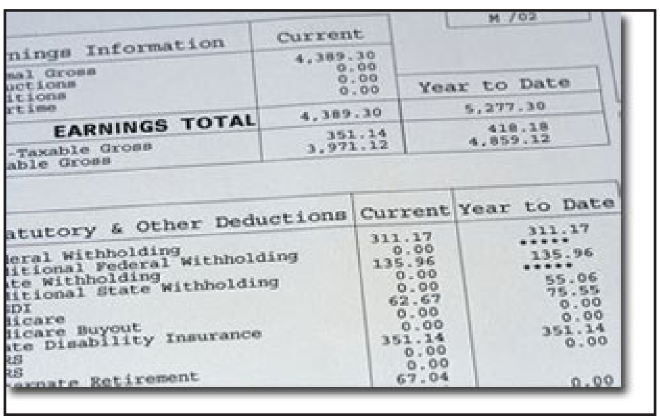
In the business world, it is often common that corporations add different product lines or a brand extension as a natural outgrowth of their business. Pepsico added Frito-Lay, Tropicana, Quaker Oats, and YUM Brands (since sold off) to their business lineup since they saw it as a fit with the soda business. Amazon.com, the Internet superstore started out selling books, then added music and video, and then added everything under the sun because they thought that they could handle the fulfillment of all these product lines at a better selection and price than a brick and mortar store. However, there are times when adding different product lines or industries or brand extensions to an existing business isn't a good idea because it either offers no synergy or because the business making the addition is ill equipped to handle it. Ben-Gay Aspirin, Smith and Wesson mountain bikes, and Lifesavers Soda are some business and brand extensions that might have looked good on paper, but fizzled out. Another idea that looks good on paper to retirement plan sponsors (but not to retirement plan experts) is third party administration of retirement plans being handled by payroll providers.



Many third party administration (TPA) firms add different lines of business that are connected with retirement plan administration such as offering investment advisory services, insurance, and legal document services. While we can debate whether what is known as producing TPAs are a good idea, there is a natural nexus between these services and the administration of retirement plans. Like Smith and Wesson bikes and guns, there is no connection between payroll services and retirement plan administration. While the two top payroll providers in the country advertise their TPA services as being seamless because it is integrated with their payroll services, the only thing that payroll has to do with 401(k) administration is the fact that the salary deferral contributions are deducted from employees' paychecks. There is more to 401(k) plan administration than payroll deductions.

The top payroll providers have been successful in the amount of plans that they administer as a TPA and they will gladly tell potential clients that they are a couple of the top TPA firms in the country. As we know in life, just because something is popular doesn't mean that it's any good. A little look behind the numbers suggest 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.

Payroll provider TPAs have a lot of 401(k) plans to administer because most plan sponsors don't understand what a TPA does. Retirement plans must abide by highly technical rules set forth by the Internal Revenue Code and ERISA. They must go through complicated testing for participation and contributions to avoid discrimination in favor of highly compensated employees. In addition they have reporting requirements such as 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 its 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 capital gains. Since retirement plans have so many moving parts, plan sponsors need to find good TPAs who make very few errors in plan administration. Errors in the administration of their retirement plan can lead to penalties on an audit by the Internal Revenue Service or Department of Labor or in extreme circumstances, plan disqualification. This is why plan sponsors should carefully select who their TPA is and not just pick their payroll provider because it's the easy thing to do.

As discussed before, the deduction of employee salary deferral contributions from payroll is such a tiny part of 401(k) plan administration. While errors in the processing of payroll for 401(k) salary deferral contributions can occur, they are less likely to happen because payroll is computerized and automated. Plan discrimination testing is not automated. While it does require payroll reports that are computerized, 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 date of hire, their date of birth, hours of service, and date of termination (if they have left employment). In addition, the data request form will also ask the plan sponsor on what its ownership is, whether they are related to any other entities (through ownership or affiliated service) as well as identifying who the officers are. Since plan administration is so dependent on the data request form, the information in that form must be correct in order for the discrimination testing to be correct. Since many of the questions asked on a data request form can be highly technical and above the heads of many plan sponsors, a good TPA will do a lot of hand holding with their clients in order to make sure that the data that they received from them is correct. Payroll providers do no hand holding and expect plan sponsors to fill out a data request form whether they know what is being asked of them or not. The problem is that if the plan sponsor does fill in the data incorrectly, many times the payroll provider TPA will run the test using the faulty data, which leads to faulty testing results. Proficient TPAs will look at the faulty data and contact the plan sponsor to verify the data.

To illustrate the point of the lack of hand holding for payroll provider TPA data requests, I once reviewed a plan that was using one of these payroll providers. One of the most important discrimination tests for a 401(k) plan is the top heavy test. A plan is top-heavy if at the end of the year, the total account value of key employees exceeds 60% of the total account value of all employees in the plan. A key employee is either an officer making over $160,000, or a 5% owner (with no salary requirement), or a 1% owner making over $160,000. So this TPA asked their client to identify their key employees. This plan sponsor had no idea of what a key employee was for qualified plan purposes, they thought it meant an employee that was key to the running of the business. So the plan sponsor selected all of their employees as key employees including those non-owner employees making $30,000. Of course, the plan failed that top heavy test (which was an error) since everyone was selected as a key employee. A good TPA would have spotted the error and asked the plan sponsor to verify who was really a key employee and who was not after reviewing it next to the ownership and corporate information that they provided. When it comes to payroll provider TPA, there is too much garbage data collected that lead to garbage results. A TPA that is more focused on administration would correct garbage data, leading to correct results.

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 gets 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 because from experience, the team approach leads to a lot of dropped balls.

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 will not likely discuss the merits of new comparability, floor-offset arrangements, or cash balance plans. I have has 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.

Too many plan sponsors that utilize the payroll provider TPAs tend not to have a financial advisor, which is dangerous for any 401(k) plan that is participant directed. While payroll provider TPAs are more than happy 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 nor are they responsible for picking mutual funds that pay a lot of revenue sharing back to themselves. In 2010, in the case of Zhang v. Paychex in Federal Court in Western New York, the court threw out a class action case against Paychex that claimed they breached their fiduciary duty because their agreements with plan sponsors specifically stated that Paychex was not a fiduciary. So while a financial representative from a payroll provider TPA may suggest what mutual funds to select, they are not considered as giving advice, they are not a fiduciary, so they are not legally culpable for their fund lineup suggestions. This leaves the plan sponsor and the other fiduciaries being exposed to liability.

Payroll providers provide a necessary function at an affordable price. I have yet to be swayed that they can do the same job as a 401(k) TPA. While some small 401(k) plans that offer a safe harbor contribution (thus eliminating most discrimination testing requirements) may be a good fit for payroll provider TPAs, I loathe recommending them because of the constant problems that I have seen is their administration of 401(k) plans and a lack of attention to details in that pursuit. While the idea of using a payroll provider as your 401(k) TPA looks good on paper, it is my experience that it has not been good in practice.

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