Why Plan Sponsors Should Avoid Using Their Payroll Provider as Their 401(k) TPA

By Ary Rosenbaum, Esq.

It's just natural that certain businesses will add different product lines as a national outgrowth of their business and to create a synergy. Old Spice used to be just an old Proctor & Gamble aftershave (with those nautical whistling commercials) that added deodorants and body wash to their product line and has become one of the most popular lines of male grooming products. PepsiCo added a snack company called Frito-Lay and who could forget that Amazon.com started out as just an online bookstore? 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. This article is to let you know that hiring your payroll provider as your third party administrator (TPA) is not the best idea and something you should consider avoiding.

Payroll has little to do with 401(k) plans

Many TPAs add different lines of businesses that are connected with retirement plan administration such as offering investment advisory services, insurance, and legal document services. With these producing TPAs, there is a natural nexus between these plan services and the administration of retirement plans. The fact is that 401(k) plan administration has very little to do with payroll. Other than salary deferrals and W-2 compensation, 401(k) plan administration has nothing to do with payroll. 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. Popularity doesn't mean competence. 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.

Competence of your TPA is more important than perceived ease

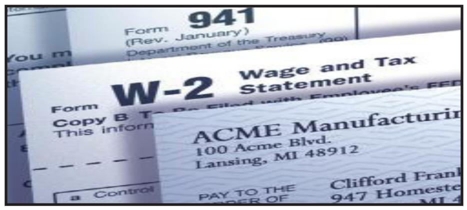
Payroll provider TPAs have a lot of 401(k) plans to administer because most plan sponsors don't understand what a TPA does. That's why payroll provider TPAs are popular, plan sponsors think they are getting a bargain by using their payroll provider as a one stop shop for payroll and retirement plan administration. The problem is that retirement plans must abide by highly technical rules set forth by the Internal Revenue Code and ERISA. 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 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.

Unlike other TPAs, payroll providers won't hold hands and expect too much from clients

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. I knew of a plan where the payroll provider TPAS asked who on their census met the definition of "key employees". Not understanding that "key employee" is a legal definition (owners, officers, etc.) other than someone who is key to your organization, the Plan Sponsor listed almost everyone as key including the people making $30,000. The payroll provider TPA then claimed the Plan was Top Heavy, which mean that the Plan Sponsor had to make a minimum contribution even though they clearly weren't. Proficient TPAs will look at the faulty data and contact the plan sponsor to verify the data. When it comes to payroll provider TPAs, 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.

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

They tend to offer plain vanilla plans, no chocolate

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 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 recently reviewed an employer who was forced by one of the payroll provider TPAs to set up a second 401(k) plan because they would not 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).

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 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. 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 being exposed to liability and holding the bag.

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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