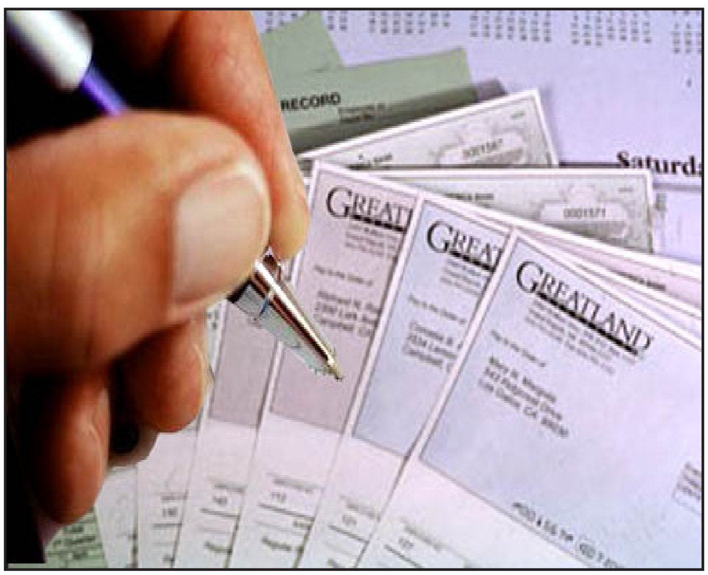
Why You Shouldn't Hire Your Payroll Company To Run Your 401(k) Plan

By Ary Rosenbaum, Esq.

In "The Outlaw Josey Wales" Josey, played by Clint Eastwood approaches a man in a bar and asks if he is a bounty hunter (there to kill Josey). The bounty hunter replies that a man has to do something for a living and Josey replies that "dying ain't much of a living, boy."

I have been an ERISA attorney for 12 years and I am always asked by people I meet whether I give financial advice as an advisor and/or whether I do plan administration as a third party record keeper. I tell these people that I do neither, that I stick to what I know as an ERISA attorney. While people may say that being a financial advisor and/or record keeper may be a nice segue from being an ERISA attorney, I believe that these expert positions are so vastly differently that I couldn't effectively wear more than one hat. I follow a major rule in business; I stick to what I know.



Too often in the retirement plan industry, we have people that claim to be experts that are really hacks in disguise. Too often, inferior work is done. The retirement plan industry is such a highly specialized field; it's the amateurs that make it extremely difficult for the expert to clean up the mess. While people may have to work as third party plan administrators for a living, being incompetent ain't much of a living.

In the 401(k) world, the two largest payroll providers in the country feel that retirement plan administration is a natural segue from doing payroll. I respectfully disagree. Providing payroll service is an automated, computerized system that is dependent on getting the correct tax rates from the Federal, State, and Local Government. As long as the employer provides the weekly payroll, the numbers should be consistent.

If mistakes are made on payroll, most can easily be rectified without having to consult with attorneys, the Internal Revenue Service, and the Department of Labor. When I was taxed as a New York City resident when I happened to live in Long Island, the extra tax paid was eventually refunded when I filed a New York State tax return.

Retirement plans are highly structured tax exempt entities. They must continuously abide by the Internal Revenue Code, ERISA, Department of Treasury regulations, Department of Labor regulations, and the terms of its plan document. Errors in retirement plans can happen during contribution deposits, trade processing, determination of eligibility and vesting, discrimination testing, and the preparation of Form 5500. Retirement plans, especially 401(k) plans have so many moving parts, that an error that requires correction and reporting to the proper governmental authority can occur on a daily basis. Some errors may result in plan disqualification where prior employer deductions for plan contributions are disallowed and plan participants must immediately report their retirement plan contributions as income. This is why plan sponsors should carefully select who their third party administrator (TPA) will be.

Except for the withholding of salary deferrals, 401(k) plan administration has nothing to do with payroll. 401(k) plan administration is a highly specialized field, dependent on getting correct data from the Plan sponsor and making the correct calculations on the administrator side. Bad data will always get a bad testing result. So a large portion of what a 401(k) administrator might have to do is to check whether the data being provided by the client is error free.

Too often, I find that payroll providers who act as TPAs run retirement plans the way they run payroll. I have seen too many instances where the client provides completely wrong key and highly compensated employee information and the payroll provider TPA will run the tests with the wrong data. I remember one case when an employer did not know the definition of key employee and checked off everyone as a key employee because they were "key" to the operation of the company. So the folks making $30,000 were considered key. It was no surprise that the payroll provider TPA found the Plan to be Top Heavy even though a skilled TPA would have contacted the company about the correctness of the data.

I have had a client for the last eight years because the Plan consistently failed ADP (actual deferral percentage) and ACP (actual contribution percentage) testing for salary deferrals and matching contributions. The payroll provider TPA never bothered to explain about the benefits of 401(k) safe harbor design or that if my client would make a $7,000 qualified non-elective contribution, the owner would avoid a $10,500 ADP deferral refund. Perhaps this was because the plan was small enough that the payroll provider TPA offered a "team" approach by not allotting a dedicated administrator to that Plan. Regardless, I have always find the better TPAs to go above and beyond when it comes to correcting plan design and plan data defects. They also offer a highly experienced, dedicated plan administrator to each client because the team approach allows too many balls to be dropped and the client always wants one person in charge to talk to.

I have another client who typically has a plan error every six months with their payroll provider TPA, usually dealing with eligibility. The company had changed their eligibility requirements to immediate, but the human resources director at a subsidiary still treated the eligibility requirements as three months. If the TPA is a payroll provider shouldn't have they asked whether newly hired employees should be treated as a participants once they showed up on payroll? Payroll provider TPAs usually mention the "seamless" integration of 401(k) plan administration with payroll as a strong selling point. After discussions with many of their unhappy clients, I understand that this integration may not be as seamless as they claim. As I stated before, 401(k) plan administration has very little to do with payroll, so many errors will be able to fall through the seams.

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. The highly regarded TPAs (along with an ERISA attorney) are the firms that can take plan participant data and determine whether a 401(k) plan with a pro rata employer contribution is the right fit or whether the employer can augment retirement savings with a safe harbor or new comparability plan design, or whether the use a of a defined benefit plan like a cash balance plan should be added as well. Payroll providers tend to only administer 401(k) plans, so they will not likely discuss the merits of new comparability, floor-offset arrangements, or cash balance plans. They also tend to only offer cookie cutter 401(k) plan design through the use of prototype plan documents that may not fit all the needs of the 401(k) sponsor if they have a provision that may be outside the box that the prototype has set. A good TPA will be able to service the plan sponsor in all their retirement plan needs. A payroll provider TPA will only be able to service the plan sponsor in all their retirement plan needs, as long as all those needs can be met in a cookie cutter 401(k).

Another problem I have with the payroll provider TPA is the fact that they play a little too close to the role of a financial advisor/co-fiduciary. Many plans of these payroll provider TPAs do not have an advisor or broker to give them a level of protection for a participated directed ERISA 404(c) 401(k) plan. So while these payroll provider TPAs offer financial experts who select their menu of mutual funds and meet their clients, they do not offer any financial advice nor do they offer any co-fiduciary role.

I had a client with one of these payroll providers with $10 million in assets. While this Plan was large enough to have its own dedicated plan administrator/contact person, they had no financial advisor. I was at a meeting with the client, their payroll provider TPA administrator, and one of the TPA's financial "advisor." This advisor suggested that the Plan needed to add a small cap fund to the lineup, but he then insisted that he was not offering any advice; it was just a suggestion because he could not legally give advice. I jokingly called it a wink and a promise because while the advisor was offering a suggestion, the client could not legally rely on this suggestion.

In 2010, I cannot fathom how any TPA could offer financial suggestions from one of their advisors, knowing that these suggestions cannot be legally relied on and allowing their clients to function without the use of broker or registered investment advisor. No participant directed 401(k) plan should ever operate without the use of a broker or financial advisor and no TPA should ever take the any role where any client may think their winks on selection of mutual funds is financial advice.

Having your 401(k) plan administered by a payroll provider is like having a proctological exam performed by a pediatrician. Like a pediatrician in the area of proctology, payroll providers have a limited background and capability in administering retirement plans. Like hiring a proctologist to examine that area of trouble, it's important to hire retirement plan experts as your TPA and ERISA attorney.

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 they may be the largest 401(k) TPAs in terms of number of 401(k) plans serviced, this has less to do with their skill at administration and more with their standing as payroll providers. As we also know in business, bigger is not better.

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