Sidestepping the Pitfalls of Plan Administration

BY ILENE H. FERENCZY AND FRANCES-ANN MORAN

It is impossible to draw a complete roadmap to what it takes for a plan and a TPA firm to run perfectly. However, acknowledging and addressing the pitfalls in this article can give both the plan sponsor and the service provider an edge on having a good result.

Ilene H. Ferenczy is a partner in the employee benefits practice group at the Atlanta law firm of Powell, Goldstein, Frazer & Murphy LLP. She is the author of *Employee Benefits in Mergers and Acquisitions*, an Aspen Publication.

Frances-Ann Moran is an attorney in the employee benefits practice group at the Atlanta law firm of Powell, Goldstein, Frazer & Murphy LLP.

Much like the movie career of Ginger Rogers, maneuvering through the administration of a qualified plan can seem like performing a professionally choreographed dance number in high heels and backwards. But unlike the carefully polished dance floor that Ginger Rogers seemed to float across, qualified plan service providers may feel that their dance floor often is filled with ruts. By recognizing many of the typical pitfalls administrators face, one may deftly sidestep those same ruts that once succeeded in spoiling the dance.

There are two very common types of pitfalls that third party plan administrators (TPAs) face: pitfalls in the actual hands-on administration of the plan and pitfalls in the management of an administrative services company. It is not possible to provide a full treatise on each of the subjects we discuss, but it is all information that most TPAs already know—at least, in their hearts. The goal of this article is to highlight several of these pitfalls and provide suggestions for ways in which to avoid them.

Pitfalls in the Hands-On Administration of Retirement Plans

Pitfall #1: Coverage Errors

Notwithstanding the fact that Code Section 410(b) coverage rules have been with us a long time, it is common to see errors in the analysis of plan coverage. These errors take several forms.

Failure to Include All Companies in the "Employer." Coverage testing must include the entire controlled group and affiliated service group. It is common, particularly with a plan sponsor that has acquired several companies, for different plans of the group to be handled by different TPAs. In that case, the TPAs may be applying the coverage rules only to the entity they handle, and ignoring—often inadvertently—the other controlled or affiliated service group members.

Failure to Include All Nonexcludable Employees in the Coverage Testing. The coverage testing must include all employees except those that are specifically "excluded" under the Code. Excluded employees include only those who are nonresident aliens, subject to collective bargaining (assuming that benefits were the subject of good faith bargaining), or terminated with less than 500 hours. Furthermore, leased employees (as defined in Code Section 414(n)) must be part of the coverage testing, and it is not permissible to exclude them from coverage unless the testing is passed.

It is important to note for this purpose that if a profit sharing portion of a plan is a design-based safe

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harbor, someone who receives only the top heavy minimum contribution for that year is *not* considered to be "benefiting." [Treas. Reg. § 1.401(a)(4)-2(b)(4)(vi)(D)(3)]

Improper Application of the M&A Transition Rule. Code Section 410(b)(6) and the related regulations provide a transition rule for meeting coverage when a company is acquired. This rule permits a plan to operate during a grace period as it is currently written, even if those operations would customarily fail coverage testing when the newly acquired entity is considered. That grace period runs from the date the acquisition occurs until the last day of the plan year following the year of the acquisition. (The grace period rules also apply to dispositions that would cause the plan to fail coverage.)

Practitioners commonly misinterpret the grace period rule as permitting a plan to exclude acquired employees who would enter if the plan's terms were applied. That is incorrect. The plan must not violate its own terms. If employees are to be excluded from participation, the plan document must provide that they may not participate. Amendments after the acquisition are not permitted to change coverage, or else the grace period evaporates. Therefore, any amendment to change the covered group under the plan must be adopted before the transaction closes.

Misuse of QSLOBs. In our experience, qualified separate lines of business (QSLOBs) under Code Section 414(r) are used very rarely, and it is even more rare that the rules governing QSLOBs are applied properly. If a QSLOB structure is used, every employee in the company must be assigned to one of the separate lines of business. Each line of business must meet the Code and regulations' requirements. A filing is needed with the IRS, advising it that QSLOBs are to be used.

Pitfall #2: Compensation Errors

Very commonly, the compensation that is used for plan purposes is incorrect. Part of the problem may be that different compensation definitions are used for different purposes in the plan—an issue that was much more pronounced in the past when Code Section 415 and Code Section 404 required different compensation analyses. Nowadays, these problems generally arise, not because there are different definitions for different purposes, but because the person or entity reporting compensation to the recordkeeper and TPA may not know what the correct definition is. What is really needed is for someone to go through the payroll report, analyze the different types of compensation that the plan sponsor pays during the plan year, and tell the responsible reporting party which ones are included for which plan purposes.

Pitfall #3: Top Heavy Errors

When the top heavy rules were first introduced as part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), no one could have expected that we would still be struggling with them 20 years later. In fact, the practical and niggling details of the top heavy rules are very complex, and the problem has been exacerbated by the fact that IRS guidance has not kept up with the changes in the law. In fact, the top heavy regulations go back to the early 1980s and are full of obsolete provisions.

Here are some suggestions relating to the problems TPAs commonly encounter:

1. Remember that deferrals by key employees are counted in the determination of whether a plan is top heavy, but deferrals by nonkeys do not count toward the top heavy minimum. As a result, many plans that are intended to be deferral-only plans fall into top heaviness, and an unexpected 3 percent employer contribution arises.

   This problem has recently gotten worse because of the legal changes occasioned by the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), which abruptly changed the look-back period for distributed account balances from five years to one in most cases. This change causes distributions to be eliminated from the top heavy fraction more quickly. This, in turn, may make a plan that was not top heavy (and was not expected to be top heavy for several years) become top heavy in a 12-month period. Because of the delay that many TPAs experience getting information from a client, it is possible that deferrals by the highly compensated employees (HCEs) in the top heavy year will have begun before the TPA can warn them that the structure of the plan has changed.
2. Remember that any nonkey employee who is a plan participant at year end must receive the top heavy minimum, regardless of hours worked.
3. Remember that plans that contain key employees must be aggregated for top heavy testing purposes. If certain nonkey employees (such as law office associates) have been placed in a separate plan to avoid aggregation and top heavy minimums, the nonkeys must be removed from that plan *before* they become officers or 1 percent or 5 percent owners, so that a key employee never participates in the

plan. There is no clear definition of what it means to participate in a plan for this purpose, but there is plenty of precedent for believing it is someone with money in the plan, even if that individual's account receives no current contributions.

Pitfall #4: Code Section 401(a)(4) Nondiscrimination Testing Errors

There are two major errors that we see in nondiscrimination testing, separate from the failure to use correct compensation. First, TPAs must remember which individuals are included in the testing. For example, once the Code Section 410(b) coverage tests have been met, only the participants in the plan (and any participants in plans that were aggregated for Section 410(b) purposes) must be included in the Section 401(a)(4) testing. The only exception to this rule is when the average benefits test is being used.

The second error that we see is the failure to recognize when something is a benefit, right, or feature for purposes of Section 401(a)(4) testing. When different groups of employees are subject to different rules or have different options under the plan, the situation is likely to invoke Section 401(a)(4) issues. Examples include when separate employee groups are eligible for different rates of matching contributions, different vesting schedules, or different investment options.

There is one more big error we see in nondiscrimination testing, this time in the 401(k) setting. Suppose an HCE participates in two different 401(k) plans during a given year. (This commonly happens when a company has two plans, each covering a different division or subsidiary, or when there is a stock acquisition during the year.) Under the Code Section 401(k) regulations, the actual deferral ratio for the HCE in each plan must equal the total deferrals in *all* 401(k) plans of the employer in which he or she participates, divided by the total compensation earned during the plan year for the employer.

Example. An HCE works for Division 1 of a company for the first six months of the calendar year and defers $6,000 to the calendar year 401(k) plan that covers the Division 1 employees. He earns $50,000 during that year as an employee in Division 1. As of July 1, the HCE is transferred to Division 2, which is covered by a different calendar year plan. He defers a further $6,000 and earns $75,000 during the second half of that year in the Division 2 plan. The actual deferral ratio for the HCE in *both* the Division 1 plan and the Division 2 plan is $12,000/$125,000 or 9.6 percent. (The problem is more complex if the plan years are different. The proposed Section 401(k) regulations specifically discuss how to handle that situation, but those regulations are not yet final. [*See* "Be Careful What You Wish For: The Proposed 401(k) Regulations Are Here!" in this issue of the *Journal of Pension Benefits.*])

Pitfall #5: Distribution Errors

There are three errors we commonly see in this category.

First, plans subject to the joint and survivor rules must provide the QJSA and QPSA notices required by Code Section 401(a)(11). It is possible to eliminate QJSA rules from profit sharing plans nowadays, but *not* with regard to transferred accounts from merged pension plans. It is not uncommon for us to see plans amended onto a new prototype, with the grandfathered pension plan rules eliminated both on paper and in practice.

Second, remember that all distribution forms, whether or not subject to QJSA, must be completed and the benefit payment made within 90 days. The rule is actually 30 to 90 days, but participants are permitted to return their distribution forms quickly and waive any remaining portion of the 30-day waiting period. (Make sure the plan and distribution forms permit such a waiver before it is used.)

Finally, if a plan provides that participants who terminate with accounts of less than $5,000 are to be cashed out, the plan is required to follow those terms and cash them out. Commonly, the recordkeeper waits for plan sponsor authorization to perform this cashout and the plan sponsor does not have the foggiest notion that there is a requirement or a need for it to authorize the plan's compliance.

Pitfall #6: Failure to Follow the Plan Document

This brings up what has become the IRS's first commandment of plan administration: "Thou Shalt Follow the Plan Document." The IRS defines a disqualifying failure as not conforming to the plan operation document's terms. If the plan says to do it, the plan administrator must do it unless such action would violate ERISA (and even then, one has to wonder what such a violative provision is doing in the plan in the first place). There are those practitioners who contend that the IRS is wrong in its interpretation of the law, and that failure to follow the plan is not grounds for disqualification. They may be right. But, then again, do YOU want to be the test case on this issue?

Pitfall #7: Other Document-Related Errors

Plans must be updated to conform to legal changes within the remedial amendment period. If they are not,

the plan is subject to disqualification. The remedial amendment period, according to the IRS, ends when the plan is terminated. Therefore, if a plan is terminated, the plan document must be updated for all legal changes.

Be sure to protect benefits that cannot be eliminated under Code Section 411(d)(6). Sometimes plan documents contain a "savings" clause that essentially provides: if anything in a prior plan is protected under Section 411(d)(6) and you do not see it in this document, it has really been preserved. (Naturally, we paraphrase.) That may get past the argument that the plan document disqualified the plan, but in our experience, if these protections are not outlined in the plan document, they probably are not part of the plan's administration.

Finally, it is possible to accidentally reawaken features that were amended out in the intervening years. This problem is likely to arise commonly during the next year or so, when there is a remedial amendment period that causes a plan sponsor to adopt a retroactive amendment. For example, suppose a plan was amended in 2001 to provide for no further contributions. The GUST amendment was then due this past September, but its effective date was commonly retroactive to 1997. In that situation, the person drafting the GUST amendment may have written the 1997 contribution formula in such a way that did not specify that it was subsequently changed in 2001. If the document is not drafted properly, it is possible that the scrivener reawakened the contribution requirement without meaning to do so.

On December 19, 2003, the IRS issued a Technical Advice Memorandum providing relief to practitioners who did not reaffirm EGTRRA elections in the restated GUST document. The IRS has agreed to presume that the plan sponsor intended the EGTRRA provisions to survive the GUST restatement.

Pitfall #8: Improper Correction of Errors

When a mistake happens in plan administration, it is important to correct the problem in an appropriate fashion. No one wants a skeleton in the closet for a future audit. The IRS has provided proper methods for correction in the Employee Plans Compliance Resolution System (EPCRS), for which the most recent procedures are in Rev. Proc. 2003-44. [2003-25 I.R.B. 1051] These correction methods should be used and, when the prescribed correction is either impractical or unavailable, the plan sponsor should take advantage of the Anonymous Submission Program to propose an alternate resolution. If self-correction is practical, do it, and document it well so that the positive actions taken by the plan sponsor can be proven if the plan is later audited.

Pitfalls in the Business of Running a Plan Administration Company

Pitfall #9: Failure to Be Properly Educated on the Law

Bringing this up in a journal article is probably like preaching to the choir. However, it is not unusual, particularly in very small administration shops, for the responsible parties to be undereducated on the law. It is also common in larger shops when the people doing the hands-on work are not trained in the law, but only in procedures. The result is that everyone applies rules that they know only anecdotally, and not because they understand what the underlying law says.

First, it is important for someone at the TPA firm to completely understand the law relating to the work that is done at the company. This burden can be spread among the several members—maybe someone is the 401(k) expert, someone else is the cross-testing guru, and someone else knows what one needs to know about plan documentation. If the staff is too small for that, then it is important to recognize when outside help is needed. Even the most expensive ERISA attorney in the country is probably affordable for a 15-minute phone call once in a while when an issue arises that is unfamiliar.

Second, it is important to have access to the actual law—that is, the Code, ERISA and regulations. Many major retirement plan publication houses offer a collection that is updated once a year or so, providing the relevant sections of the Internal Revenue Code, Titles I and IV of ERISA, and the relevant proposed and final regulations. This is a worthwhile investment for all TPAs. Even if a good treatise provides the answer to a question, it is a good idea to check out the primary sources to be sure that the context and the rule are understood.

Finally, even though it takes time and costs money, it is important to expose everyone who does technical work at a TPA firm to continuing education. Webcasts and teleconferences make education opportunities possible at a reasonable cost. Education and examination programs offered by such organizations as ASPA, NIPA, and the International Foundation of Employee Benefits should be encouraged.

Pitfall #10: Failure to Train and Supervise

This problem is commonly encountered in smaller TPA companies, but may be an issue at larger firms, too. For example, suppose a TPA firm hires Sam, an experienced administrator, gives him a caseload, and never looks at his work product again until Sam leaves to take another job. At that time, the TPA discovers with dismay that the

only thing Sam did right throughout his tenure with the administration firm was to spell his name correctly when he endorsed his paychecks. (By the way, this is a true story, albeit with a little exaggeration.)

Even if the knowledge level of the staff is as it should be, everyone makes mistakes. Everyone has misconceptions on occasion. A failure to train and supervise the hands-on administrators will create undiscovered errors.

In a perfect world, a second set of eyes should look at every client's annual administration. Many firms cannot afford that or have insufficient personnel. Here are some additional ideas:

1. The less supervision a firm can afford, the more it needs strong procedures in place. Consider having an extensive checklist, under which each step must be initialed by the responsible party. If employees know that failure to complete the checklist or initialing when they did not do the work is grounds for termination, they will take this procedure seriously.
2. Consider having administrators check each other's work, rather than having a full-time quality control person. If that is impractical, consider switching staff administrators each year on every case. You may think that the inconsistency of administrators will upset your clients, but if you are consistently involving only two people with each case, your clients can get to know both people well.
3. Encourage all firm members, including the owner, to have a "what if I am not here tomorrow" attitude. Make sure to document all files well, and leave very little to institutional memory. If someone is checking another's work, the rule should be: "If I need to ask you questions, you haven't documented the file well." If a file is handled properly, someone's absence either for illness or because they quit to go somewhere else should distract very little from getting the work done.

Pitfall #11: Selling What You Can't Deliver

Someone once said, "Making a sale is better than chocolate. Making a big sale is better than sex." That person understood the tension between a company's sales force and the staff that has to perform the services that are sold.

A TPA firm cannot afford to sell what it cannot deliver. And, systems must be established to keep the sales force from bringing in business that costs the firm money in the long run or leads to unacceptable liabilities.

Here are some suggestions to avoid this problem:

1. Involve an administrator in forming sales presentations, and make sure that nothing is being proposed that cannot be done.
2. Involve an administrator in structuring fee quotes. Administrators know how long it takes to do the work, and they should provide extraordinary insight in making sure that the fee quote is sufficient (and, by the way, not outrageously high).
3. Don't kiss on the first date. Encourage sales people to tell potential clients that the first meeting is to collect information and to examine how the administration company can meet the prospect's needs. Then, go back to the office and formulate the proposal where the passion of the sale potential is not quite so hot.

Pitfall #12: Failure to Bill Properly

This problem may be decreasing somewhat in light of the change in the administration market over the past few years, but it has been historically common for TPA firms to have absolutely no idea whether they are making money or losing money from the work they perform. Flat fee administration often causes this problem. When hourly work does not translate to billing, people tend not to pay attention to the time spent on a case. Consequently, they do not know (except anecdotally) whether a case is a money maker or a money loser.

Similarly, it is common to quote fees improperly, so that the client has no reasonable expectation of what the work will cost. Consider this analogy: imagine taking your car into a service station and leaving it there to be fixed without getting an estimate. Imagine instead that you got an estimate but, when you went back to get your car, the bill was twice the amount of the estimate. These unthinkable scenarios are commonly what administration clients face from their TPAs.

Clients should have a clear understanding of what the bill will look like ahead of time, and what services will cost extra. Many billing disputes are caused, not by the amount of the bill, but by the unreasonable expectation that the client had about what the bill would be. If the client understood, that expectation would be adjusted, and the disappointment or shock that they feel would be alleviated. In addition, TPAs' guilt over charging extra would be relieved, making it easier to bill properly for work done.

It is a good idea to keep track of time spent, even if it is not billed. This gives everyone an idea of whether the work is being performed efficiently and whether a profit is being made and adjustments in procedures are necessary.

One of our actuary acquaintances complained once that one of his clients never paid and had a large outstanding account receivable. We said, "Well, fire him. Or refuse to do further work until he pays." The actuary responded, "I can't; he gives me a lot of business." That just about sums up this pitfall.

Pitfall #13: Taking on or Failing to Fire Bad Clients

All of us have clients we don't particularly like. Sometimes the problem is one of personality; other times, it's more serious. All business people, including TPAs, must understand when a client has such severe issues that you cannot do business with them. Here are some examples:

1. Clients that consistently won't pay for the work you do (assuming that you have conquered Pitfall #12). At some point, the time you spend in collection squabbles eats up your profit (and grays your hair prematurely).
2. Clients that will not give you what you need to do your job. Everyone has clients who dawdle on sending in data. When a client makes it impossible for you to do your job, you have to get out of the relationship.
3. Clients that mistreat you or your employees. Clients who use angry profanity, sexual innuendo, or racial slurs can get you sued by your employees for creating a hostile work environment, one of the types of legally recognized harassment. Besides, you should have enough loyalty to the people who work with and for you not to subject them to this type of treatment.
4. Clients who are engaging in fiduciary breaches. When the participants sue, they will name everyone associated with the plan in the lawsuit. You may be able to get dismissed out of the lawsuit, but it will be costly, both financially and emotionally.

Pitfall #14: Failure to Limit Your Liability

It used to be that lawsuits against TPAs almost never occurred. That is not the case in the 21st century, particularly in light of the retirement-plan-related scandals of the last few years. TPAs must take necessary action to protect themselves from liability.

First and foremost, the use of engagement letters is critical. These letters can outline what services you provide, what services you specifically do not provide, and the obligations for which the client remains responsible. Statements in a TPA engagement letter that the TPA is not the ERISA Plan Administrator and that the TPA has no obligation to communicate with employees have both been the basis for a court's dismissal of lawsuits against TPAs.

Second, knowing what makes one a fiduciary is very important. The Department of Labor, in regulations, has outlined the kind of "ministerial activities" that do not produce fiduciary liability. [DOL Reg. § 2509.75-8, Q&A D-2] Every TPA should know what is clearly not a fiduciary action, what clearly is, and where the gray area lies.

Third, when a plan sponsor engages in activity that creates liability, the TPA must give the sponsor sufficient information to decide the proper course of action and must reduce those recommendations and decisions to writing. This is particularly important when the sponsor's decision is not to do things "by the book." If something goes wrong, the sponsor's memory of who did what will get fuzzy—even if the sponsor does not mean it to be. Having written proof of who took which responsibilities is critical to the TPA's survival.

And the Final Pitfall; Pitfall #15: Failure to Consult and Lead

The goal of everyone involved in plan administration—the TPA, the client, the fundholder, and the participants—is to have a well-run plan. Unfortunately, in the current marketplace, it is common for a plan sponsor to be in the dark about the complete menu of services it needs to properly run the plan and whether those service needs are being fulfilled by the companies it hires. The service providers commonly concentrate on protecting themselves from liability—but not necessarily for advising the plan sponsor of what tasks it is required to complete or when another service provider is needed.

The best run plans have a quarterback—someone who takes the bull by the horns and tells the plan sponsor what needs to be done, who is doing it, and where there are gaps that must be filled. It is not necessary for the quarterback to provide all the services that are needed; in fact, it is unlikely that he or she can. However, by helping the plan sponsor know what needs to be done and helping to get those acts accomplished, the quarterback ensures that everyone is happy in the long run.

If a service provider cannot be a quarterback, he or she would do well to encourage the plan sponsor to find someone—perhaps a lawyer or accountant—to fulfill that role.

Conclusion

It is impossible to draw a complete roadmap to what it takes for a plan and a TPA firm to run perfectly. However, acknowledging and addressing the above pitfalls can give both the plan sponsor and the service provider an edge on having a good result.