THE EXCELLENT FIDUCIARY

Payroll Is a Fiduciary's Trojan Horse

*Ronald E. Hagan**

Changes in the enforcement focus of the Internal Revenue Service and the U.S. Department of Labor place payroll operations high on the list of fiduciary functions that employers must monitor with great care. The financial penalties and reputational harm caused by payroll failures can be costly and damaging to enterprises that sponsor 401(k) and 403(b) retirement plans.

PAYROLL OPERATIONS CAN CONCEAL FIDUCIARY DEFICIENCIES

Like the hollow wooden Trojan horse in Greek mythology that concealed an invading force, payroll can secretly undermine the compliance efforts of every organization that sponsors an ERISA qualified retirement plan. The point at which a retirement plan and a payroll system intersect is a breeding ground for the most common violations of fiduciary duty. And they can be the most unwieldy to fix. While the IRS offers a pathway for correcting errors, it also insists that effective practices and procedures to prevent compliance problems is a basic requirement to be eligible to use its self-correction program.

The IRS reviews correction requests by first assigning an agent to a correction submission. The revenue agent's protocol requires that he or she evaluates the plan's internal controls to determine whether to perform a focused or expanded audit. In addition, if the agent finds additional plan errors, the strength of internal controls is a factor in the negotiation of the sanction amount. IRS agents make every effort to ensure that a plan seeking self-correction of payroll related operational errors has internal controls in place when the audit concludes.

A survey of retirement plan audits and voluntary correction submissions to the IRS reveals that employers often do not have the needed internal controls in place or controls exist that aren't administered properly. Plan size makes no difference.

INTERNAL CONTROLS BASICS

The Internal Control Integrated Framework published by The Committee of Sponsoring Organizations ("COSO") is the recognized standard for establishing internal controls.

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COSO defines internal control as:

> a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:
>
> - Effectiveness and efficiency of operations;
> - Reliability of financial reporting; and
> - Compliance with applicable laws and objectives.

The first objective deals with the employer's achievement of basic business objectives. The second refers to the reliability of financial information (both internal and external) that is used by decision makers. The third deals with the steps needed in order to comply with laws, regulations, and policies such as those found in ERISA and the Internal Revenue Code.

Internal controls are policies and procedures designed to help detect and prevent errors. Strong internal controls covering fiduciary functions like payroll are important to provide a reasonable level of assurance that an ERISA plan is operating properly.

FIVE COMPONENTS OF INTERNAL CONTROL

Under the COSO model a system of internal controls is a process that is made up of five interrelated components. All are applicable to employers of any size or type, but employers can apply them in different ways. The five components are aimed at achieving one or more of the objectives listed above. The five components are:

1. **Control Environment**

   The control environment is the "tone" of the organization and is the foundation for all fiduciary behavior. The "tone at the top" is a term that is used to define management's leadership and commitment towards openness, honesty, integrity, and ethical behavior.

2. **Risk Assessment**

   This component deals with an enterprise's ability to set clear operating goals and objectives, identify risks that could impede achievement of those objectives, and to reduce exposure to those risks to acceptable levels.

3. **Control Activities**

   These are objectives and steps that have been put in place to ensure that management's directives are carried out. This is the component that most people consider when they think of "internal controls."

4. **Information and Communication**

   This component concerns the way in which information is communicated throughout the plan operations community including both internal fiduciaries and third party service providers.

5. **Monitoring**

   All internal control systems and processes change over time. Some controls continue to evolve. Some may lose effectiveness, however, because they are no longer performed, are not consistently applied, or are applied incorrectly. Because of this, controls must be monitored. This is typically done in two ways, on an ongoing basis and on a periodic basis. Ongoing monitoring is typically done during regular operations. Separate monitoring is typically performed through self-assessments or by third-party risk management experts.

CASE STUDIES OF PAYROLL RELATED INTERNAL CONTROL FAILURES

Payroll errors of any kind cost an organization money, whether directly or indirectly. Often, the cost is at least two-

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fold, because the mistake itself has a financial penalty independent of the time and money required to correct it.

During our operations assessment engagements that span several years, we've noted the frequent occurrence of six payroll operations deficiencies that trigger fiduciary duty violations that require major corrective action.

1. **Definition of Compensation**
   The ERISA plan's definition of compensation was not used correctly for all participants' deferrals and allocations.
   - Cause: Because a plan may use different definitions of compensation for different purposes, it's important to apply the proper definition for deferrals, allocations and testing. The payroll system *must follow the plan document* compensation definitions. Thus, it's critical that the plan monitor its operation to ensure that the terms of the plan are followed to determine an employee's elective deferral or other allocation.
   - Cure: Fixing the control failure required corrective contributions, reallocations, and distributions.
2. **Matching Contributions**
   Employer matching contributions weren't made to all appropriate employees.
   - Cause: The employer failed to contribute the employer matching contribution according to the plan document. The process deficiency was caused by failing to properly count hours of service or identify plan entry dates for employees. Incorrect contributions also occurred when a plan service provider failed to follow the plan document terms.
   - Cure: The plan administrator applied a reasonable correction method that put affected participants in the same position they would have been in if matching contributions were made to eligible employees in accordance with plan terms.
3. **Elective Deferrals**
   Eligible employees weren't given the opportunity to make an "elective deferral" election.
   - Cause: The employer failed to contribute the employer matching contribution according to the plan document. The shortcoming was caused by failing to properly count hours of service and to identify plan entry dates for employees.
   - Cure: The employer made a qualified nonelective contribution for the employee that compensated for the missed deferral opportunity.
4. **Participant Loans**
   Participant loans didn't conform to the requirements of the plan document and were, therefore, prohibited transactions.
   - Cause: Several outstanding loans were made to participants who did not repay their loans timely. No procedures were in place to prevent loans from being classified as prohibited transactions.
   - Cure: The deficiency

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was fixed by correcting the repayment transactions and by adding an internal control step to the payroll compliance framework.

5. **Hardship Distributions**

   Hardship distributions weren't made properly.

   - Cause: An ERISA defined contribution plan may allow employees to receive a hardship distribution because of an immediate and heavy financial need. Hardship distributions from such a plan are limited to the amount of the employee's elective deferrals. In addition to demonstrating immediate and heavy financial need, the plan must also demonstrate that a **distribution from the plan is necessary to address the need**. A distribution is not considered necessary to satisfy an immediate and heavy financial need of an employee if the employee has other resources available to meet the need, including assets of the employee's spouse and minor children. The plan's governance document did not state such.
   - Cure: The employer amended the plan retroactively to better define hardship distribution qualifications. Participants that received unauthorized distributions were required to return their hardship distribution amounts plus earnings.

6. **Timely Deposits of Deferrals**

   The employer is alone responsible for contributing the participants' deferrals to the plan trust. While the employer's payroll records verified that deferral data was released to the payroll provider efficiently and on time, the provider failed to forward process the deferrals in a timely manner. An independent payroll reconciliation assessment identified the problem.

   - Cause: DOL rules require employers deposit deferrals to the trust as soon as the employer can; however, in no event may the deposit be later than the 15th business day of the following month. The rules about the 15th business day are not a safe harbor for depositing deferrals; rather, these rules set the maximum deadline. The DOL provides a 7-business-day safe harbor rule for employee contributions to plans with fewer than 100 participants. The deficiency caused the plan to incur prohibited transaction status.
   - Cure: The employer submitted a notification of its violation to the regulators through the DOL's Voluntary Fiduciary Correction Program.

EXAMPLES OF INTERNAL CONTROL STEPS

There isn't sufficient space in this article to describe properly a full range of steps for each of the five components of a payroll internal controls framework. Listed below, however, is a list of several basic actions that should be part of a retirement plan sponsor's management of its payroll operations.

- Compare salary deferral

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election forms with the amounts deducted from employees' wages;

- Verify the types of compensation used for allocations, deferrals and testing;
- Check that plan service providers received accurate compensation and ownership records;
- Monitor annual contribution and compensation limits;
- Verify the validity of rollover contributions to the plan;
- Verify that years of service were accurately determined for eligibility and vesting;
- Verify marital status and spousal consent for plan distributions; and
- Ensure participants received required minimum distributions

CONCLUSION

Deficiencies in payroll operations trigger retirement plan compliance problems for all types of employers. Many don't even realize they have fiduciary related payroll problems or how to fix them. Avoiding fiduciary traps that are embedded in the typical payroll function requires that plan sponsors have a proven set of guidelines, which are diligently followed, and periodically checked for continued relevancy.

ERISA defined contribution plans should commission an independent assessment of their payroll operations. Implementation of any needed controls should be part of the assessment engagement.

Caution: *The annual financial audit performed by a plan's CPA won't necessarily catch all payroll deficiencies that might exist. A CPA's audit is focused primarily on financial transactions not operational processes. So, it's vital to self-test periodically all of your plan's payroll dependencies.*

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