

Issue Snapshot - Definitely Determinable Benefits

This snapshot examines the principles for determining whether cash balance formulas satisfy the “definitely determinable” benefit rule by precluding employer discretion and whether a cash balance formula satisfies the definitely determinable requirement of Treas. Reg. Section 1.401-1(b) if the compensation measure for designated participants is based on a limited time period (e.g., a particular month), a designated bonus (e.g., a “special bonus”) or pay over a designated threshold (e.g., “excess compensation”).

IRC Section and Treas. Regulation

Treas. Reg. Section 1.401-1(b)(1)(i)

Resources (Court Cases, Chief Counsel Advice, Revenue Rulings, Internal Resources)

Rev. Rul. 74-385, 1974-2 C.B. 130

Analysis

“A pension plan within the meaning of section 401(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement. Retirement benefits generally are measured by, and based on, such factors as years of service and compensation received by the employees.” Section 1.401-1(b)(1)(i), Income Tax Regs. If, “in the case of a defined benefit pension plan, the benefits on behalf of each participant are determined in accordance with a stipulated formula that is not subject to the discretion of the employer, the requirements of” Section 1.401-1(b)(1)(i) are satisfied. Rev. Rul. 74-385, 1974-2 C.B. 130.

In particular, benefits in a cash balance pension plan are based on a notional account balance consisting of components for hypothetical allocation credits, usually based on compensation (i.e. pay credits), as well as interest credits. Some cash balance plans use a formula based on a portion of an employee’s compensation (e.g. special bonus, compensation for a certain month, or compensation in excess of a certain amount) multiplied by a set factor (e.g. 5 or 10). These formulas are definitely determinable unless the terms of the plan allow the employer to manipulate pensionable earnings (pay credits). The employer’s inherent ability

to determine an employee's annual Form W-2 compensation and other forms of compensation outside of the plan terms doesn't cause a benefit formula to fail to be definitely determinable.

Therefore, a cash balance plan formula based on partial compensation, such as a special bonus or compensation for a specific month (e.g., March), is definitely determinable regardless of the employer's inherent ability to determine an employee's "special bonus" or "March pay" outside the terms of the plan. Similarly, a cash balance plan that bases the hypothetical allocation on a multiplier of compensation that exceeds a specified dollar amount is also definitely determinable unless the plan's terms afford the employer discretion to determine the compensation used for the plan's benefit formula. As long as the plan terms identify a "stipulated formula" that is not subject to the employer's discretion, the benefits are definitely determinable.

On the other hand, if the terms of the plan specifically allow the employer to vary the employee's compensation used in the benefit formula (e.g., an employee's annual compensation less an amount designated by the employer"), the plan would violate the definitely determinable rule.

The following three examples may be helpful in deciding whether a cash balance allocation formula is definitely determinable:

Example 1

A cash balance plan document provides:

The pay credit for Category 1 Participants is equal to ten (10) times the Participant's Special Bonus. The plan document provides that the amount of the "special bonus" is included in the participant's total annual compensation and specifically provides the employer with discretion to select the amount that will be used to determine the pay credit.

Since the "special bonus" is determined by the exercise of employer discretion based on the terms of the plan document, the benefit formula is not definitely determinable. If the employer did not have discretion under the plan terms to determine the amount of the special bonus, the plan formula would be definitely determinable.

Example 2

A cash balance plan document provides:

The hypothetical allocation for each participant is determined under the following schedule:

- Owners - 10 times the amount of compensation paid to the owner for the month of March
- All others - 3 percent of compensation.

The terms of the plan provide that the employer "has the discretion to determine" the March compensation of each owner.

Since the plan terms specifically give the employer discretion to determine March compensation, the plan's benefit formula is not definitely determinable. However, if the plan defines an owner's March compensation as Form W-2 compensation (or some other ascertainable amount) for March, the plan formula is definitely determinable even if the employer can control the amount of compensation paid to the owner in March outside the terms of the plan.

Example 3

A cash balance plan document provides:

The President and Vice-President's Unit Cash Balance Benefit shall be ten (10) times Excess Salary. Excess Salary is defined as "IRC Section 414(s) compensation in excess of \$200,000." The plan defines IRC Section 414(s) compensation as "total compensation less bonuses." The plan terms state that the employer will designate the portion of a participant's compensation that is salary and the portion that is a bonus.

The plan benefit formula is not definitely determinable because the plan terms allow the employer to designate the portion of total Section 414(s) compensation that is salary and the portion that is bonus. However, if the plan terms do not afford the employer any discretion to allocate a participant's compensation between salary and bonus, the plan benefit formula would be definitely determinable.

Issue Indicators or Audit Tips

Definitely determinable benefits should be addressed as part of the determination letter process since it is a qualification in form issue. It also may be addressed on examination if the relevant plan language was not previously reviewed as part of a determination letter application. Whether benefits are definitely determinable is not an operational qualification issue.

However, employer discretion that is not expressly stated in the plan document, and that leads to the manipulation of compensation, may result in operational disqualifying defects. If a Specialist reviewing a plan in the determination letter process has a concern about the employer's ability to manipulate compensation for the benefit formula, the Specialist might consider a referral to Examination (subject to management approval).