PENSION TRENDS
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Retirement Plan Documents Aren't Chiseled in Stone

Potential clients of ours who are owners of small-ish businesses are sometimes hesitant to "pull the trigger" on adopting a new retirement plan, due to uncertainties about the future of their business. They'll ask, "Business was good this year, and I'd love to be able to take a big tax-deductible contribution, but what if things dry up next year?"

That's a legitimate question, and it's prudent to exercise caution when adopting a new plan, especially if it's a defined benefit (DB) plan (including cash balance plans). And while the IRS discourages frequent amendments to retirement plan documents, those documents aren't chiseled in stone. They can (and should) be reviewed each year to ensure that the plan continues to best fit the needs of the business.

Common Types of Amendments

A DB plan can generally be amended to effectively increase the acceptable funding range for a given year. For example, under the current terms of the plan document, a plan sponsor may be allowed to contribute any amount between $0 and $80,000 for 2026, with the lower end of that range representing the minimum required contribution and the upper end being the maximum deductible contribution. If instead the plan sponsor wanted to contribute (and deduct) $150,000 for 2026, that could potentially be accomplished via a plan amendment, so long as the amendment is signed by the time 2026 taxes are filed (including extensions).

On the flip side, a DB plan can generally be amended to effectively decrease the acceptable funding range for a given year; the only catch here is that the amendment would need to be signed before any plan participants earn a benefit for the year. Most often, a benefit is earned once the participant is considered to have worked 1,000 hours for the year (typically, by May 31).

Similar amendments to increase or decrease profit sharing contribution levels in a 401k-type plan may also be utilized, although those plans tend to have significant contribution flexibility even without an amendment.

Plan amendments can also be used to address operational and/or demographic issues. For example, DB plans have minimum participation requirements. If those requirements are not met in a given year, the plan can (and should) be amended to allow more employees to participate. Depending on the timing of the amendment, it may need to be done in conjunction with the IRS's Voluntary Correction Program (VCP).

Finally, an amendment may formally terminate the plan, which allows participants to take a distribution of their benefit. The termination process can be long and involved, especially if there are non-owner participants in the plan. It's important to note that there are frequently government filings and/or contributions due after the official plan termination date.

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IRS Guidance

The IRS generally wants qualified retirement plans to be "permanent in nature", but actual guidance in this area is sparse, save for certain phrases in ERISA and comments at professional meetings. In the pension plan community, it's generally accepted that if an employer sets up a retirement plan with the intent of having it in place at least 3-5 years, then the permanency requirement will be met. But it's truly the intent that matters here. If an employer sets up a plan and something unexpected happens the following year (e.g. – significant downturn in business, death of the business owner, etc.), the plan can be terminated without running afoul of the plan permanence rule. In the event of audit, the auditor would look at the facts and circumstances to determine whether the plan was originally set up simply to shelter one year's windfall income from taxes (which is generally frowned upon).

Also, a plan can potentially be designed to allow for, but not require, contributions after the first plan year. For example, we could design a DB plan to allow for a $150,000 contribution in the first year, with no anticipated minimum required contributions in subsequent years. The plan sponsor could make that contribution in the first year, contribute nothing in the next two years, and then terminate the plan after a total of three years. This appears to be acceptable in the eyes of the IRS.

Abuses and Penalties

While plan amendments allow for a fair amount of flexibility, they should ideally be used sparingly. Again, the IRS generally wants these plans to be "permanent in nature", in that they deliver benefits consistent with the sponsor's long-term business objectives. Plan audits, while relatively rare, can sometimes uncover patterns of "abusive" amendments.

For example, let's say a business partnership sets up a cash balance plan effective January 1, 2026. They make contributions to the plan in late 2026, and then terminate the plan effective December 31, allowing the partners to roll those contributions into IRAs. The partnership then sets up a "new" cash balance plan effective January 1, 2027, makes contributions, and again terminates on December 31.

Upon audit, the IRS would likely say that this is effectively an impermissible work-around allowing partners to contribute much more to their IRAs than would otherwise be allowed. In that case, they could potentially deem the plans as a cash or deferred arrangement (CODA), invalidating the tax deductions that were taken and generally making things very ugly.

Key Takeaway

If you're an owner of a small business and have been reluctant to adopt a retirement plan because of perceived contribution requirements and restrictions, contact an actuary at IAI for a free analysis to see what may be possible.

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