Tax Reform Provides Another Incentive to Implement Pension Plan De-Risking Strategy

Tax reform offers another incentive for employers to consider completing a pension plan de-risking strategy in 2018. A change in the corporate tax rate will make funding pension plans sooner more appealing, which many try to do before completing a risk transfer anyway.

The Tax law approved in December 2017, lowers the corporate tax rate to 21% from 35%. Calendar Year Taxpayers will have until September 15, 2018 to make a pension contribution for the 2017 Tax Year and have that contribution be tax deductible at the 35% tax rate. The alternative is to wait and have the contribution be deductible at the lower 21% rate.

Consider the following scenario:

- Calendar Year 2017 Taxpayer has scheduled a final pension contribution of $2.0 million, to be paid on or before September 15, 2018.

- There is capacity to make an additional $7.0 million contribution, before running up against the maximum limitation for funding.

- The Company has determined that is has sufficient cash flow to make an additional $5.0 million contribution, which will generate a favorable tax benefit of $.700 million ((35%-21%) x $5.0 m).

- The Pension Plan will then use $5.0 million to purchase non-participating annuity contracts for a portion of the current retiree liability, prior to the end of 2018. This will not trigger any settlement charges for accounting purposes and will eliminate approximately $4.8 million of balance sheet liability as well as reduce future PBGC premiums and other administrative costs associated with these retirees.

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The strategy above is targeted at reducing the underfunded size of the pension that is actually debt. There is a growing view among corporate CEOs and CFOs that pension debt is a riskier form of debt than traditional debt, because pension debt carries additional volatility. Keep in mind that at the close of 2017, there was yet another drop in the discount rate used to measure pension debt for accounting purposes, resulting in increasing liabilities. During the early months of 2018, companies with calendar-year defined benefit pension plans will be reviewing their funded status, expense levels, and future contributions, realizing that not much has really changed. As such, there should be a premium placed on managing that risk and companies are weighing up this risk alongside others. This is a fact regardless of whether or not the DB pension plan is a strategic part of a Company's Total Compensation offerings.

The tax benefits may be the added incentive to make the strategy noted above even more attractive.

Please share your thoughts!

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