Bolton

Employee Benefits, Actuarial & Investment Consulting

Funding Strategies Under the New Tax Law

Over the last month one large U.S. employer after another has announced substantial voluntary contributions to their pension plans in 2018:

- Verizon - $3.4 billion
- 3M - $500 million
- Pfizer - $500 million
- Lockheed Martin - $5 billion
- FedEx - $1.5 billion
- Harris Corp - $300 million

What's going on?

A much-publicized provision in the Tax Cuts and Jobs Act that reduces the corporate tax rate starting in 2018 has led these employers to jump at an opportunity to recognize considerable tax savings through these significant pension funding commitments.

For plan sponsors with calendar year plans, contributions that are made through September 15, 2018 can still count as a 2017 contribution payment, which allows those companies to claim that expense as a tax deduction for 2017. Each dollar contributed that can be credited back to 2017 reduces the sponsor's 2017 taxable income. With a reduction in corporate tax rates from 35% to 21% in 2018 and later, there is a substantial tax incentive to spend that money on contributions now before the window for 2017 contributions closes. These employers are essentially pre-paying their minimum required contributions for the next few years (or longer) to get the higher tax deduction before the corporate rate drops.

It's not just the jumbo, household name plan sponsors who can benefit. All plan sponsors who are subject to the standard corporate tax rate will achieve a similar relative cost savings. For every $1,000,000 contributed that counts for the 2017 year rather than 2018 (or later), the plan sponsor will save $140,000 in federal tax. Further consider that if a plan sponsor has an underfunded plan, they are paying PBGC premiums based on the amount of underfunding. For 2018, the premium rate for unfunded liabilities is 3.8%. For each $1,000,000 of underfunding that is erased, the 2018 PBGC premiums are generally reduced by $38,000.[1] Collectively, contributing $1,000,000 now rather than waiting until after September 15, 2018 could save the plan sponsor $178,000. Over a five-year period, the PBGC premium savings amounts to roughly 20% of the unfunded liabilities that are eliminated – for a total return on the 2018 contribution of over 30%. That's ROI that should garner the attention of any CFO.

[1] Plans impacted by the variable rate cap may see a lesser reduction as a result of advanced funding.

Before making the decision to accelerate funding to leverage the change in tax rates, plan sponsors need to consider several crucial factors.

- **What is an appropriate funding target to consider?** While earning a significant tax deduction and eliminating PBGC premiums are beneficial, contributions that put the plan into an overfunded position may ultimately result in trapped surplus that costs the plan sponsor money to recover. Some obvious funding targets to consider might be:

    - Eliminating PBGC variable rate premiums
    - Eliminating benefit restrictions
    - Meeting PBGC reporting exemptions
    - Eliminating net balance sheet liability on the sponsor's financial statement

  Any of these should avoid the risk of eventual overfunding as plan's the settlement liability will exceed any of these thresholds.

- **Where will the money come from?** Sponsors wanting to make contributions at a large multiple of their usual budgeted amount may need to borrow funds either externally or from other areas of their annual operating budget.[2] Careful evaluation of the hard dollar savings of accelerated pension contributions relative to the cost of capital or borrowing will help inform the decision of whether this option is viable and an effective use of company money.

- **How will the money be invested?** Any sponsor making a large contribution should think through how they will protect their investment once it has been made. If investing the funds alongside existing assets, plan sponsors should consider how the change in funded status might affect their investment policy and target asset allocation. A large bump in funded status might allow a sponsor the opportunity to move to a less risky asset allocation without significantly increasing their annual pension expense, while reducing annual volatility on the balance sheet.

- **Should the money be used to take risk off the table entirely?** Risk reduction can occur either through investment allocation or by using the infusion of cash to settle some of their benefit obligations and transfer that risk away from the plan. Lump sum offers or the purchase of annuity contracts to settle benefit obligations can now be considered when they may not have been deemed a prudent use of plan assets at a lower funding level.

The window is open for those who wish to fund through it this year. The time to act is now. Plan sponsors who have not yet begun to consider if accelerated funding in 2018 is right for them should start having these discussion with their actuary. If you'd like assistance in evaluating what might be right for your business, please contact Ellen Kleinstuber ekleinstuber@boltonusa.com

---

[2] Borrowing to fund pension benefits is not a new idea, but increasing PBGC premiums and low interest rates have reinvigorated this funding strategy in recent years. See our recent whitepaper on borrowing to fund and the issues for plan sponsors to consider when evaluating this alternative.