Williams Overman Pierce, LLP
Certified Public Accountants and Consultants

Carpe Diem! Accelerating Defined Benefit Funding to the 2017 Tax Year Can Generate Tax Savings

Last year's tax reform law has created a rare opportunity for defined benefit plan sponsors to take advantage of the tax rate difference by accelerating deductions to the year with the higher tax rate. The lowering of the corporate tax rate makes pension plan contributions for the 2017 plan year significantly cheaper on an after-tax basis than contributions for the 2018 plan year.

The Tax Cuts and Jobs Act (the Tax Act), passed in December 2017, implemented a flat corporate tax rate of 21 percent, shifting from a tiered system in which the top marginal rate for corporations was 35 percent. Even though the Tax Act also eliminated some common deductions for businesses, most corporations will face a lower effective tax rate in 2017 than in 2018. For these companies, accelerating deductions into 2017 could result in significant tax savings.

One of the more powerful opportunities to do this has to do with contributions to qualified retirement plans. A for-profit business with a December 31, 2017 tax year end and an extended income tax return can deduct contributions to its qualified retirement plan if they are made before September 15, 2018. The 14 percentage-point difference between 2017's top rate of 35 percent and 2018's rate of 21 percent can create significant savings for qualified retirement plan sponsors who act before the September extended deadline.

This accelerated funding technique is especially attractive for sponsors of defined benefit plans because the funding does not have a direct impact on the amounts of benefits owed or paid under the plan. Pre-funding of a defined benefit plan simply increased the cash set aside in the pension trust to meet the plan's future benefit obligation. It does, of course, put the cash out of reach of the business and its creditors which is a consideration when projecting the business cash flow requirement. The higher funding levels can lower variable-rate premiums owed to the Pension Benefit Guaranty Corp. (PBGC), increase the plan's projected assets, and lower future funding requirements. This approach also makes de-risking strategies more viable.

Do The Math

Accelerating defined benefit plan contributions to the 2017 plan year can create a positive ripple effect. For example, Company A in the top corporate marginal tax bracket decides to contribute an extra $1 million to its pension plan for the 2017 plan year rather than wait to make that contribution for the 2018 plan year. As a result, the company will receive an additional $140,000 in tax savings because it's able to deduct the contribution at the 35 percent rate instead of the 2018 rate of 21 percent.

Meanwhile, the PBGC—the government's insurance agency for defined benefit plans—charges two different kinds of premiums: a flat rate and a variable rate. The flat-rate premium for single employer plans is based on the number of participants in the plan. The 2017 rate is $69 per participant; it will go up to $74 in 2018. It's an annual charge, so plan sponsors simply pay this. There's no real savings in this premium, except in the case of a company that de-risks using an annuitization or lump-sum strategy, which would leave it with fewer participants in the plan.

The variable rate is set at a certain percentage for each $1,000 of unfunded vested benefits (UVBs). In 2017, plan sponsors pay 3.4 percent, or $34 per $1,000, in UVBs; this is capped at $517 per participant. The rate will go to 3.8 percent in 2018, or $38 per $1,000, in UVBs, with a cap of $523 per participant. The PBGC estimates the cost will go to $42 per $1,000 in UVBs in 2019.

Clearly, a better-funded plan will pay a lower variable rate premium. The bonus is that extra contributions will not only lower the UVB for 2017, but they will be invested and could be expected to compound in the future. Higher overall earnings can reduce prospective funding obligations.

Another potential benefit from the new law: the mandatory tax on overseas foreign earnings was lowered from 35 percent to 15.5 percent. The extra cash companies will see as a result could go directly toward many corporate objectives, including improving pension funding levels.

Before jumping to take advantage of these potential benefits, though, it's important to work with your representative to make sure overfunding doesn't occur. While excess assets can go back to an employer when the plan terminates and all benefits are paid out, such asset reversions are subject to regular taxes and hefty penalties.

Time to De-Risk?

The financial crisis of 2008 delivered a heavy blow to defined benefit plan funding levels. As a result, many companies decided to implement various de-risking strategies. Some changed the asset management approach, but others chose to reduce plan obligations by purchasing annuities or offering lump sum amounts for plan participants. With the latter two actions, plans became smaller, but more manageable in terms of ongoing costs.

Ten years later, plan sponsors have a similar opportunity to de-risk again. Plan sponsors wanting to get off the rollercoaster when dealing with liabilities, variable premiums, investment returns, interest rate assumptions, regulations, and other moving targets that deeply impact a pension plan's bottom line, might consider the various options available to reduce or eliminate risk in a company's defined benefit plan.

Insight: Consider Taking Advantage of a Rare Opportunity

While the Tax Cuts and Jobs Act didn't directly address defined benefit plans, the law's shift in the corporate tax rate, as well as the tax rate for unrepatriated foreign earnings, has presented plan sponsors unique opportunities to boost plan funding levels. Plan sponsors should work with their representative to set goals, understand risks and benefits, determine the best funding strategy, as well as to see how this strategy integrates with other employer offerings.

There are many factors to consider. While the September 15 extended deadline is still months away, it will get here sooner than you think. Much thought and planning should go into a well-executed defined benefit funding plan, so please take the time to work with your advisor to weigh the possible benefits for your company.