ACCELERATE PENSION FUNDING AND DE-RISKING AHEAD OF TAX REFORM: A LESS TAXING EXERCISE

By Rohit Mathur, Peter Kahn and Nida Ozair

In Summary

Corporate plan sponsors continue to grapple with the risks and rising costs associated with managing and maintaining their pension plans. Plan funded status, currently estimated at 84%,[1] has been extremely volatile, increasing primarily due to strong equity performance amid continued low interest rates. Additionally, PBGC premiums have increased significantly—the variable rate premium rising from 3.4% today to at least 4.1% by 2019—and are a drain for underfunded plan sponsors. With the possibility of corporate tax reform on the horizon, plan sponsors may have a unique opportunity now to reduce PBGC expenses by accelerating funding and to deduct plan contributions at the current higher tax rate, resulting in a low risk, positive net present value (NPV) outcome. Further, by de-risking now, whether through enhanced LDI interest rate strategies[2] or transferring risk, sponsors can avoid risk and potential costs associated with maintaining a plan.

Key Tax Reform Proposals

Implementing a comprehensive tax reform package is a complex and time consuming exercise that will involve debate and negotiations among the White House, and the Democrats and Republicans in Congress on (i) the corporate statutory tax rate, and (ii) key elements of reform, including the elimination of specific tax deductions. There are considerable similarities between the House GOP's Tax Reform Blueprint ("GOP Blueprint")[3] and the high-level White House proposal;[4] and three important elements, if enacted, could significantly impact pension plan sponsors.

1. Lower Corporate Tax Rate

The corporate tax rate could be reduced, possibly to 15% (White House) or 20% (GOP Blueprint) from the current 35%.

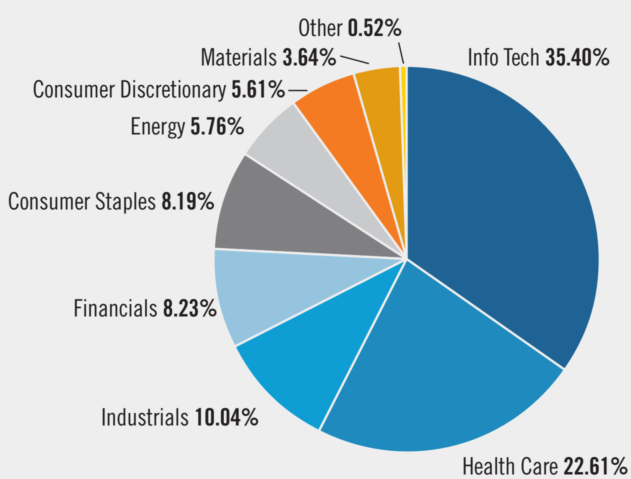
2. Repatriation of Overseas Earnings

It is estimated $3 trillion of accumulated foreign earnings is being held overseas; around $1.2 trillion to $1.4 trillion of which is held in cash or cash equivalents.[5] Both proposals contain a one-time tax on accumulated deferred earnings via a deemed repatriation, with the GOP Blueprint proposing a rate of 8.75%.[6] Both proposals also suggest a move to a territorial tax system that exempts the foreign business earnings of U.S. companies from U.S. taxes.

3. Limiting or Eliminating the Interest Expense Deduction

The GOP Blueprint proposes to limit or possibly eliminate the tax deductibility of interest expense, though interest expense on existing loans and debt may be grandfathered. To balance the impact on companies losing this tax benefit, and to stimulate capital investment, the GOP Blueprint will allow companies to immediately expense capital expenditures.

Overseas cash by sector[5]



Carpe Diem! Fund Pension Plans Before Tax Reform Implementation

Sponsors accelerating plan contributions ahead of tax reform should generate a significant positive NPV outcome versus making contributions after the implementation of tax reform. Plan sponsors may be able to take advantage of the current market conditions and higher corporate tax rate to improve funded status today while also reducing the costs of maintaining a pension plan. By funding the plan today, sponsors can avoid rising PBGC variable rate premiums paid on the funding deficit. Further, under the current tax code, sponsors' contributions made to pension plans are tax deductible at the 35% corporate tax rate. In the future, a lower corporate tax rate would reduce the value of qualified plan contribution tax deductions (i.e., benefit) that sponsors receive for funding pension plans.

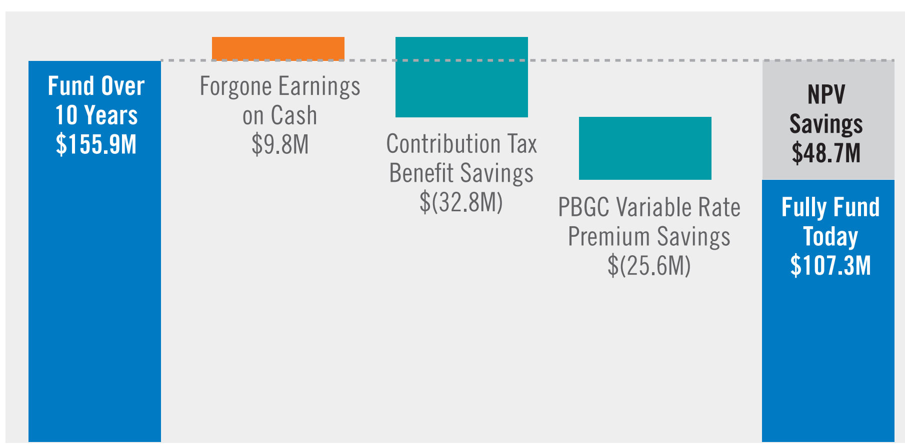
A sponsor with a $1 billion plan that is 85% funded could generate a $48.7 million NPV benefit by fully funding its plan today versus funding the plan deficit over a 10-year period. Such NPV savings are generated by eliminating variable PBGC premiums and deducting the contribution made today at a 35% tax rate. Delaying contributions to fully fund until after tax reform reduces the NPV benefit by $34.3 million. This is driven primarily by forgoing the benefit of a 20% tax difference between the current 35% corporate tax rate and the proposed 15% corporate tax rate that could be effective post-tax reform.

Sponsors may fund their pension plan contributions using existing cash; likewise, borrowing to fund may also be a viable option. In fact, an increasing number of companies, including FedEx Corp. ($1 billion), Delta Air Lines ($2 billion), DuPont ($2 billion) and Verizon ($3.4 billion), are taking advantage of low borrowing rates to issue debt to fund their plan contributions and create shareholder value.[7] Engaging in a borrow-to-fund strategy today may be more beneficial at the higher corporate tax rate and while interest expense is deductible. Plan sponsors can issue debt today and preserve the associated interest expense deduction if existing debt is grandfathered under tax reform.

Plan sponsors that expect to repatriate their overseas earnings once tax reform is implemented may consider issuing short-term debt or borrowing temporarily in the commercial paper market. Such debt will be cheaper than long-term debt, and can be paid down using cash from repatriated earnings.

NPV Benefit of Funding Today vs. Funding Over Time ($1B Plan)

Funded Status	Tax Rates	
	15%	20%
75%	$81.1	$68.1
80%	$64.9	$54.5
85%	$48.7	$40.9
90%	$32.5	$27.3
95%	$16.2	$13.6



Source: In USD millions. Prudential analysis.

Sponsors May Benefit by Accelerating Their De-risking Plans

Sponsors planning for, or currently on, a de-risking path should consider accelerating their strategies. If the corporate tax rate is significantly lowered, the reduced tax preference of corporate debt could drive companies to de-lever their capital structure. According to analysts at Citi and Bank of America, companies are likely to adjust to a lower, more optimal debt-to-equity ratio[8] under the reformed tax code due to the increased cost of debt caused by a lower tax benefit. Further, new issue activity and the supply of high quality fixed income securities is expected to decline if the interest expense deduction is eliminated and companies can repatriate overseas earnings to fund domestic operating needs.

While gradual de-levering will reduce the supply of corporate debt, demand is expected to remain strong from insurance companies and pension plans, which may result in a decrease in the yield on long duration debt. Today, sponsors can readily source long-dated corporate bonds needed to match their liabilities at a relatively lower cost, as compared to later when a smaller or shrinking bond market may drive up market prices, more so if the interest expense deduction is eliminated. Repositioning the portfolio into long-dated corporate bonds could also prove beneficial if a risk transfer transaction is executed in the future. Sponsors may be able to use the same bonds to satisfy an insurer's premium and achieve better pricing economics.

Use Repatriated Cash to Fund Pensions

Sponsors of underfunded plans that choose a wait-and-see approach could consider using overseas cash to fund their plans once, and if, tax reform is implemented. While companies will consider several alternative uses of overseas cash—investing in the business, M&A, or return of capital through share buybacks or dividends—we believe pension funding could generate significant NPV savings from reduced PBGC premiums and prove to be an attractive use of cash.

Pension funding decisions should be made keeping the end goal of pension de-risking in mind. Improvement in funded status driven by favorable market conditions and discretionary pension contributions may enable sponsors to accelerate de-risking plans. Those who proactively manage or transfer pension risk can focus on their core business, and gain a considerable advantage over those who do not.

Borrowing to Fund Remains a Viable Option For Many Plan Sponsors

Company	Debt Issuance[(1),(2)]		Related Plan Contribution[(1)]
	Date	Amount	
DuPont Company	5/1/17	$2,000	$2,000
Verizon Communications Inc.	3/16/17	$6,500	$3,400[(3)]
Delta Air Lines	3/14/17	$2,000	$2,000
FedEx Corp.	1/6/17	$1,200	$1,000
Northrop Grumman Corp.	12/1/16	$750	$20
CSX Corp.	10/18/16	$2,200	$220
Altria Group, Inc.	9/16/16	$2,000	$500
Cox Communications, Inc.	9/13/16	$1,000	Not disclosed[(4)]
Premier Health Partners	8/31/16	$300	Not disclosed[(4)]
International Paper Co.	8/11/16	$2,300	$500
General Motors Company	2/23/16	$2,000	$2,000
International Paper Co.	5/26/15	$2,000	$750
Kimberly-Clark Corporation	2/27/15	$500	$410
Northrop Grumman Corp.	2/6/15	$600	$500
Raytheon Company	12/2/14	$600	$634[(5)]
Motorola Solutions, Inc.	8/19/14	$1,400	$1,100
Ford Motor Co.	1/8/13	$2,000	$1,200
CSX Corp.	2/28/12	$300	$275
The Kroger Co.	1/19/12	$450	$450
Raytheon Company	12/6/11	$1,000	$425
NiSource Finance Corp	11/23/11	$250	$250

In USD millions

(1) Company filings.

(2) Debt issued to fund pension contributions and/or for general corporate purposes.

(3) Contribution per company's fiscal 1Q 2017 earnings call dated April 20, 2017.

(4) Private company that does not issue public financial statements. Intended use of proceeds from Fitch rating report dated 8/10/16 and 9/8/16 for Premier Health Partners and Cox Communications, respectively.

(5) 4Q14 includes $34M required pension contributions and $600M discretionary pension contributions.

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[1] *Milliman 100 Pension Funding Index, May 2017.*

[2] *"The Hidden Cost of Mismatching Duration," PGIM Fixed Income, May 2017.*

[3] *"Tax Reform Blueprint – A Better Way," June 24, 2016, https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf, accessed May 31, 2017.*

[4] *"Briefing by Secretary of the Treasury Steven Mnuchin and Director of the National Economic Council Gary Cohn," April 26, 2017, https://www.whitehouse.gov/the-press-office/2017/04/26/briefing-secretary-treasury-steven-mnuchin-and-director-national.*

[5] *"Repatriation Update: Trapped Earnings Surpass $3 Trillion," Morgan Stanley, April 21, 2017.*

[6] *Trump's campaign proposal included a 10% tax rate on repatriated earnings. "Tax Reform that will Make America Great Again," https://assets.donaldjtrump.com/trump-tax-reform.pdf, accessed May 31, 2017.*

[7] *"Borrowing to Fund Pensions Could Enhance Shareholder Value," Prudential Retirement, May 2016. http://pensionrisk.prudential.com/insights/borrowing-to-fund-pensions.php.*

[8] *"2017 Corporate Finance Priorities," Citi, January 2017; "Corporate Tax Reform = Less Debt," Bank of America Merrill Lynch, November 28, 2016.*

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