Money to burn

TIM KEOGH WONDERS WHY SO MANY COMPANIES ARE MISSING OUT ON CORPORATE PENSION TAX BREAKS.

Executive summary

- The £76bn pension deficit of the FTSE 350 could be re-financed on a more tax-efficient basis.
- The tax advantages of higher scheme funding are becoming apparent.
- Companies need to explore the tax play on deficits and the tax play on equity investments.
- A minority of companies are introducing ‘salary sacrifice schemes’.
- Companies pass up many opportunities for gaining tax relief on their schemes.

Twenty years ago, companies enthusiastically set up bigger and better defined benefit pension schemes for their employees, driven partly by tax incentives for both parties. A lot has changed since then, not least the seemingly exponential growth in cost of delivering these schemes. Against this background, it is surprising that companies continue to pass up so many opportunities for gaining tax relief on their schemes. For example:

- FTSE 350 companies continue to have a combined pension deficit of £76bn, although most of this could be refinanced outside the pension scheme on a more tax-efficient basis.
- These companies continue to invest more than £200bn in equities, although the government moved the tax goalposts towards bonds more than eight years ago.
- Employers are demanding ever larger employee contributions as a condition of continued scheme membership, but are happy to pay 12.8% National Insurance on these contributions, rather than

NOW BOTH UK AND INTERNATIONAL GAAP ARE FORCING EMPLOYERS TO RECOGNISE DEFICITS AS COMPANY DEBT.

avoiding them by agreeing to fund the scheme in full in return for lower salary.

While most companies have replaced their defined benefit schemes with defined contribution arrangements for new recruits, the existing assets and liabilities will continue to grow for many years and therefore remain a key issue.

PAYING OFF DEFICITS Treasurers and finance directors faced with a pension deficit have traditionally tried to minimise pension scheme contributions by encouraging the use of optimistic investment return assumptions and spreading any cash commitment over the longest credible period. Trustees would set out to get as much money in the fund as quickly as possible. Generally, a compromise would be reached in the middle.

This was a rational response to an environment where pension liabilities, as shown in company accounts, were opaque to say the least. But now both UK and international Generally Accepted Accounting Principles (GAAP) are forcing employers to recognise deficits as company debt, and consequently investors have started to adjust for pensions when valuing a company.

At the same time, the tax advantages of higher scheme funding are becoming apparent, especially where funds are invested in bonds. Surprisingly to many, it can often make sense for a creditworthy company to borrow money to invest in a pension scheme, banking its tax relief on the interest paid and keeping trustees and employees happy.

Marks & Spencer made the headlines in 2004 when they issued £400m of corporate debt to raise funds for their pension scheme. While relatively few employers have so explicitly connected paying off their deficit with new debt issue, significant inroads have been made into reducing deficits in many companies by making changes to the overall capital structure.

In 2004, a quarter of FTSE 100 companies paid extra contributions into their schemes which exceeded the regular cost of benefit accrual, indicating a serious effort to pay off their deficits. Strikingly, the other three quarters paid practically no extra contributions even though their deficits were no smaller. Clearly, there were divergent views at work here.

THE TAX PLAY ON DEFICITS The immediate benefit of making a substantial pension scheme payment is the up-front corporation tax relief. But this is mainly a timing issue – the tax relief crystallises what would otherwise be a deferred tax asset but it does not produce any extra relief.

The real gain comes from the fact that interest charges on corporate debt can be offset against taxes, whereas pension investment benefits from a tax shelter. As a result there is a net gain to companies at the expense of the Chancellor. The gain is typically around 1% of the pension contribution for each year the money is invested in the pension scheme, provided the investment is in bonds (see *Box 1*). In the example there is an annual gain of £105,000 for shareholders in Company B by bringing forward a payment of £10m by a year, i.e. 1.05% of the sum involved.

As always, care is needed and the tax benefits cannot be taken for granted. For instance, tax relief may have to be spread on 'special' pension contributions which can reduce their attractiveness. But this

Box 1. Tax play on deficits

Company A – pension deficit maintained		Company B – pension deficit funded up front	
Deficit at start of year	£10m	Deficit at start of year	£10m
Contribution deferred to year-end		Tax relief at 30%	£3m
Discount rate for liabilities	5%	Funds borrowed	£7m
Contribution required at year-end	£10.5m	Repayment at year-end inc interest at 5%	£7.35m
Tax relief at 30%	£3.15m	Tax relief on interest at 30%	£0.105m
Net cost at year-end	£ 7.35m	Net cost at year-end	£7.245m

can be managed. Obviously, sufficient profits which are otherwise taxable are needed to claim the relief.

IMPACT ON FINANCING COSTS AND CREDITWORTHINESS Of course, there is an extra cost arising from the spread the company will pay over the risk-free return the pension scheme trustees can obtain on the extra funding. But, from 2006, pension schemes must pay a levy to the Pension Protection Fund (PPF) broadly linked to the size of their deficit and the credit rating of the scheme sponsor. Much of this borrowing spread can be offset by the saving in levy.

Pension liabilities rank behind some other types of borrowing. Paying contributions into a scheme puts this money beyond other creditors, potentially to their detriment, so this might lead to a credit rating downgrade. But not always – the rating agencies viewed Marks & Spencer's 'borrow to fund' strategy as 'broadly neutral', accepting the rationale that the transaction represented a refinancing of existing debt (the pension deficit), not additional indebtedness.

Reducing a deficit will also provide additional security for members and increase confidence that a company will continue to support its scheme. This enhances the economic value of the benefit to employees. New legislation has strengthened trustees' roles and introduces serious scrutiny from the new Pensions Regulator. Accelerating funding plans reduces the potential for interference from the Regulator, especially in corporate transactions, and helps allay trustee concerns.

TAX PLAY ON EQUITY INVESTMENTS Most pension schemes are invested predominately in UK and overseas equities on the premise that expected outperformance over alternatives can make a big dent in deficits even if it cannot eliminate them. The overall allocation to equities has changed little following the turmoil of the last few years.

But for shareholders, this rationale may not be entirely logical. For most companies, the equity investment is effectively a company asset which extends and diversifies the operating business. Leaving aside whether equity investment is a core competency of the company or whether the shareholders could do better investing directly, if this equity asset were swapped into bonds the business could arguably afford to gear up and return capital to shareholders without changing the underlying risks and capital costs.

A reason for doing this would be to access the tax shield associated with increased borrowing. Of course this depends on the capital markets adjusting for the riskiness of a company's pension investment policy. It is questionable whether this adjustment happens now, but it seems only a matter of time.

Even without such adjustments, investing in equities is often less efficient due to the additional investment fees and loss of valuable executives' time in managing a highly leveraged investment portfolio on the side as a trustee.

FOR MOST COMPANIES, THE EQUITY INVESTMENT IS EFFECTIVELY A COMPANY ASSET WHICH EXTENDS AND DIVERSIFIES THE OPERATING BUSINESS.

Box 2. National Insurance mitigation

Consider Employee A earning £50,000 and paying 7% from this salary towards a pension, and Employee B earning £46,500 and paying nothing towards the same pension. Which is the better deal? On the face of it they are the same – Employee A pays £3,500 out of gross earnings to give a net figure of £46,500; they both end up with the same pension.

But Employee B is ahead overall because earnings for NI purposes are reduced – the marginal rate is 1% so the saving is £35. However, the employer saves 12.8%, i.e. £448 or almost 1% of total salary. One per cent of salary is a useful saving, especially as the chances of being challenged by the taxman are pretty low – 100% employer-funded schemes are already common and accepted.

MEMBER CONTRIBUTIONS – NATIONAL INSURANCE MITIGATION A minority of companies – BT is the highest-profile example – have now started to introduce 'salary sacrifice' schemes to exploit inconsistencies in the NI treatment of pension contributions between employer and employee. Put simply, employers do not have to pay NI if they contribute directly to a scheme, but they do have to pay it on earnings which are then used by employees to contribute to the same scheme (see *Box 2*). The savings can be significant, given the higher levels of employee contributions we are now seeing, and can be particularly worthwhile for high earners.

There are a number of administrative wrinkles which need to be ironed out, and some more complex implications for the lower paid. But these arrangements can be a useful addition to the NI mitigation armoury.

Salary sacrifice is an even more attractive proposition for additional contributions, which we may see more of with the relaxation of the contribution limits in April 2006. If the £3,500 contribution in the example is being paid by an employee as a top-up, £483 of NI can be saved by restructuring the arrangement as a salary reduction. If this can be arranged on a large scale, it should more than cover the costs involved.

ATTRACTIVE OPTIONS In both corporate and personal finance, no action should be taken purely for the tax breaks. The non-tax consequences have to be weighed up, along with the sustainability of the tax advantages under consideration. But there are opportunities in pensions that more employers could take advantage of, and the downsides are usually more limited than many believe.

In particular, re-financing a substantial part of a pension deficit with other types of debt represents an attractive option for creditworthy companies. This option is at least worth a thought given the seemingly inexorable rise in cash demands from schemes.

Tim Keogh is Worldwide Partner at Mercer Human Resource Consulting.
tim.keogh@mercer.com
www.mercerHR.com