Tax Avoidance in Response to Funding Status of Defined Benefit Pension Plans

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ABSTRACT

We examine effect of the funding status of defined benefit (DB) pension plans on managerial incentives to avoid tax payments. We hypothesize that managers of firms with underfunded pension plans are more likely to consider tax avoidance as a less costly financing option. Underfunding of DB pension plans trigger mandatory pension contributions, higher insurance premium and also increased scrutiny by Pension Benefit Guaranty Corporation. Given that prior studies (Campbell, Dhaliwal and Schwartz, 2012) have shown that firms with higher pension deficit have higher cost of capital, we argue that firms with underfunded pension plans are more likely to employ tax avoidance as an alternative source of funds. Using a sample of U.S. firms from 1987 to 2012, we find higher pension deficit firms engage in significantly more tax avoidance. We perform additional analyses and show that pension deficit firms use less aggressive forms of tax avoidance. We find that the tax savings are associated with payment of higher mandatory contribution. The separate analyses of pension deficit and pension surplus firm-years confirm our results that the incentives for tax avoidance exist only for pension deficit subsample, and not for pension surplus. Our robustness checks include employing alternative measures of pension funding, controlling for financial constraints, applying change-in-changes, generalized method of moments, and finally propensity score matching procedure, all providing supporting evidence to our main results.

Keywords: Tax avoidance, Defined benefit pension plan, Pension deficit, Under-funded pension plan