EUROPEAN ACTUARIAL **EURACS** CONSULTANCY SERVICES

Pensions in Germany

Several decisions and decrees concerning old-age provision have introduced a profound change into the German old-age-provision system since the turn of the century. Especially the Pension Provisions Act (*Altersvermögensgesetz AVmG*) of 2001 continued by means of the Sustainability Act (*Nachhaltigkeitsgesetz*) in the year 2004 (*Rentenversicherung-Nachhaltigkeitsgesetz*) combined, among others, with readjusting the taxation of pension provision expenses and retirement income. Most recently (in 2007) the Retirement Age Law (RV-Altersgrenzenanpassungsgesetz) was passed.

These pension reforms aim at partially substituting the pay-as-you-go financed social security pensions by capital financed private provision and company pensions. The employees' scope of asset-based benefit measures was also broadened by the Pension Reform 2001. Since 2001, various options are available, both, via individual private measures as well as via deferred compensation within the context of company benefits.Further, the step-by-step transition to complete deferred taxation (EET) of social security pensions demands additional provision efforts by the employees.

The employees' enforceable right to company pension provision via deferred compensation had and still has a huge impact on the extension of company benefit arrangements generally. In 2006 (latest figures available) about 65 % of all employees were members of company benefit plans. This is an increase of 28,8 % compared to 2001 (52 %).

A distinction of German company pensions practice still is that circa 35 % of employees and nearly 58 % of total assets set aside for pensions purposes, are book-reserved. This distinguishes Germany from most other European countries and is expected to change due to recently introduced new options to pre-financing company benefits, emphasising asset accumulating vehicles. The pension funds introduced 2002 become more important since the regulation is less restrictive.

Members of the "Chamber" professions, e.g. lawyers, doctors, surgeons, are not covered by the social security system. There is a long-standing tradition to cover their overall benefit needs by so called professional pension funds (*Berufsständische Versorgungswerke*).

I Social Security Pensions

The social security pension height is earnings-related, but limited by the social security contribution ceiling (*Beitragsbemessungsgrenze BBG*) - EUR 64,800 p. a. from and beginning on 1/1/2009. Employer and employee share costs (19.9 % of present salary) equally. At present, new pensioners' social security pensions level to about 35 % to 40 % of each individual gross salary, capped by the *BBG*, on retirement after a fulfilled working life. Social security pensions are paid on reduced working capacity, on old age, and, restricted by deduction of earned salaries, on death to the surviving spouse as a partially means-tested spouse's pension.

Under a law aiming to adjust the minimum pensionable age in line with demographic change and to place the statutory pension insurance systems on a sounder financial basis (the RV-Altersgrenzenanpassungs-gesetz), the normal age for a standard pension in Germany is to be gradually increased from 65 to 67 between 2012 and 2029; the minimum ages for other pensions are to increase accordingly. The law doesl not only have an impact in the context of the statutory pension insurance system but also on occupational pensions and the above mentioned professional pension funds.

II Company Pension Plans

Up to now, company benefits have been an important but principally voluntary extra company benefit provided - and in most cases also financed in total or mostly - by the employing company. Each employer has been free to decide on whether or not, to which extent, and via which funding vehicle to provide company benefits.

The Pension Reform 2001 and the relating Pension Provisions Act (*AVmG*) have introduced important new aspects and options. Since 1/1/2002, each employee covered by the social security pension system has a claim to deferred compensation (*Anspruch auf Entgeltumwandlung*) whether the employer already finances a company benefit scheme by "real" employer contributions or not. So, any employee may ask - even force - his employer to use a part of his future compensation to provide for a suitable company benefit arrangement. This, now confronts all German companies with company benefits. All the following funding alternatives can be used, however, they enjoy different tax-relief rates. Many companies offer deferred-compensation schemes via industry-wide plans. Particularly, the new funding vehicle, the pension funds (*Pensionsfonds*) (see below), was intended to help realising the employees' new entitlement to company benefits via deferred compensation and thus to bridge the social security pensions gap.

Of course, any given company benefit promise - whether financed by deferred compensation or "traditionally" by "real" employer contributions - has to satisfy a comprehensive set of relating laws and jurisdiction. The Company Pensions Act (*Betriebsrentengesetz BetrAVG*) is of particular importance, concerning labour law and fiscal background as well as regulations on insolvency coverage. Some details see below.

In previous years, company pension commitments were usually final-salary orientated and designed. Also fixed-amount commitments existed. Companies orientated to civil service institutions traditionally provided total-retirement-earnings systems (*Gesamtversorgungssysteme)* granting provision-heights directly influenced by social security pensions. Those traditionally designed pension promises are still existing, at least for protective reasons and are closed for new entries. To date, however, more and more contribution-related, costorientated pension commitments come into focus.

Bowing to the employers' pressure the Legislator has implemented these pension commitments in the Company Pensions Act. However, still unlawful are defined-contribution plans according to the Anglo-Saxon scheme, leaving the employee with the investment risk.

Usually the contributions employers are willing to provide annually level to a percentage of the actual salary and vary from company to company. It is appropriate and widespread to design two-tier formulas with different contribution rates for salaries up to or exceeding the social security contribution ceiling (*BBG*). Often contribution rates for salary slices up to the *BBG* are in a range of 2 % to 4 % of these salary parts, for salary slices exceeding the *BBG* the contribution rate is three times as high as the base percentage rate.

For a **typical German benefits scheme**

– today normal retirement age is 65 for cohorts born until 1946, stepwise increased to 67 (for cohorts born after 1963) for males and females, but plans must offer early retirement at least in line with the early retirement thresholds in the social security pension scheme.
– disability pensions have been granted under the same conditions valid for the social security pension scheme (on an accrued or sometimes even projected basis). Because preconditions to be fulfilled and the level of disability pensions to be drawn from the social security system have been changed considerably, a real need has risen to revise the relating provisions in company benefit schemes resulting in actualisation up to date.

– dependants' benefits like spouse's and orphan's pensions, pre- and post-retirement. In the past, a 60 % spouse's pension was the rule. New plans tend to 55 % in accordance with the new percentage granted to younger insured in social security pension system since the Pension Reform 2001. A recent decision ot The Court of Justice of the European Communities implies that the dependants' benefits have to be extended on to registered equalsex-partnership pensions.

II.1 Funding Alternatives

Companies may choose between **various funding alternatives** for their company benefit scheme. These means principally are also applicable to a deferred-compensation scheme (see above):

II.1.1 Direktzusage (direct pension promise)

Direktzusage (direct pension promise) with company-internal accumulation of book-reserves, possibly coupled with full or partial reinsurance of benefit liabilities or a pension trust sometimes by using a so called contractual trust arrangement (CTA). Employee contributions only via deferred compensation. Employee and dependants enjoy a legal title to benefits promised.

II.1.2 Unterstützungskasse (support fund)

Unterstützungskasse (support fund, established as a legal entity separate from the employing company, possibly combined with full or partial reinsurance of benefit liabilities; employee contributions only via deferred compensation). Provides no legal title, but the employing company has to fulfil the pension promise, if the support fund has no or only insufficient means.

II.1.3 Direktversicherung (Direct insurance)

Direktversicherung (Direct insurance). The employing company is the policy holder and pays contributions, employee contributions possible, not only as deferred compensation but also out of after-tax income, the employee (and his dependants) are beneficiaries.

II.1.4 Pensionskasse

Pensionskasse, established as separate legal entity, traditionally as the legal form of a mutual society, nowadays, the stock company is preferred, providing a legal title to benefits for employees and dependants and, like the insurance companies, being subject to the strict supervision of the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) (former German Insurance Supervisory Authority BAV). Employee contributions are possible, not only out of deferred compensation but also out of after-tax income.

II.1.5 Pensionsfonds

Pensionsfonds, only possible from and beginning on 1/1/2002, established as a separate legal entity as the legal form of a stock company or a mutual society, providing employee and dependants with a legal title to benefits promised. As direct insurance and Pensionskasse subject to supervision by BaFin though not considered an insurance company. Because a Pensionsfond also has the characteristics of an investment fund there are less restrictive investment options, e.g. quota of shares not limited to 35 % (as applies to Pensionskassen). Employee contributions are possible via deferred compensation or out of after tax income. In 2005, the legal framework for Pensionsfonds has been relieved. This amendment takes the burden from the pension fund to give a guarantee on the pension benefits. The consequence is that the employers' financial effort is lower than granting an insurance-like pension benefit. The assets needed approximately level to the target value according to international accounting principles (DBO / PBO). Therefore the Pensionsfonds were forecasted to be increasingly used for outsourcing of book-reserved company schemes in internationally oriented groups. Until 2008, only 27 Pensionsfonds have been set up. They make up only about 0.3 % of the total assets set aside for pension purposes. In 2007 the situation brightened for the Pensionsfonds when major German companies set up new Pensionsfonds and transferred significant amounts into these new funds.

II.2 Important Legal Rulings

– **vesting**, introduced already in 1974 by the *BetrAVG*, but more generous conditions apply since 1/1/2001: now pension-plan benefits become legally non-forfeitable after completion of age 30 and 5 years plan participation (in the past completion of age 35 and 10 years plan participation or 12 years of service with a three-year plan participation). For pension promises after 31st of December 2008 the minimum age was lowered from 30 to 25 years. Benefits arising from deferred compensation arrangements are immediately non-forfeitable. Transitional arrangements apply to promises given before and excluding 1/1/2002. Lump-sum compensation on leaving the company is principally unlawful and possible only in case of very small vested claims or on current pensions first paid before 1/1/2005.

– **the indexing of current pensions**: Par. *16 BetrAVG* and Supreme Labour Court legislation prescribes a triennial review of pensions in payment, in line with the consumer price index, limited to the increase of comparable employees' net-income as at the commencement date of pension payment. A company can avoid such increases by granting (in advance) an annual increase of at least 1 % per annum (according to law this applies only to pension promises after 1/1/1999). The 1 %-adjustment per year is compulsory for deferred-compensation arrangements.

– **insolvency coverage**: Company pension schemes effect compulsory insolvency insurance with an industry-wide pension protection funds, the *Pensions-Sicherungs-Verein VVaG (PSV)*; exceptions for employers making use of a *Pensionskasse* or direct insurance contracts, as far as not pledged. *Pensionskassen* and non-pledged direct insurances are not covered by the *PSV* as they are subject to the strict supervision of the *BaFin* former German Insurance Supervisory Authority (*BAV*) Compared to *Direktzusage* and *Unterstützungskasse* a reduction of the contributions to the PSV for *Pensionsfonds* down to 20 % is valid since 2003. Some of the responsibilities for the supervision of life insurance companies (and at least the bigger *Pensionskassen*) were passed over from the *BaFin* to a so called appointed actuary (*Verantwortlicher Aktuar*).

– **deferred compensation**: Since 2002, as introduced by the *AVmG* (see already above), each employee has the right to ask his employer for a deferred-compensation arrangement within a range up to 4 % of the actual social security contribution ceiling. Decision on funding vehicle is up to the employing company. If both parties agree support fund *(Unterstützungskasse*) or direct pension promise (*Direktzusage*) is applicable. If they cannot agree upon a funding vehicle, the employer has to offer the employee deferred compensation via direct insurance.

III Taxation

The employer's contributions/expenses to pre-finance company benefits are recognised as deductible expenses reducing the company's taxable profits. Anyhow, accepted company benefits are only those providing for at least one biometrical risk (old age, death, disability). As a rule, interest earned on accumulated benefit capital is tax-exempt. Taxation of contributions (both, "real" employer contributions and those to an employee's deferred compensation) and the resulting benefits depends on the funding method adopted, both EET and TEE are still to be found. However, in 2004 was a far-reaching tax reform concerning the taxation of oldage income derived from the social security system and company plans (*Alterseinkünftegesetz AltEinkG*). Therefore, from 2005 on, TEE is principally applicable only for a further transitional period, in the future there shall be only EET applicable on all old-age income from social security pensions as well as from company plans.

Employer contributions to company benefit systems are exempt from contributions to the social security system up to a maximum of 4 % of the *BBG*, employer contributions to the funding vehicles support fund (*Unterstützungskasse*) and direct pension promise (*Direktzusage*) are exempt from contributions to the social security system without any limit. Also contributions relating to deferred compensation enjoy tax exemption up to a maximum of 4 % of *BBG.* Since 2004, benefits are always subject to contributions to the social security system according to the *Gesetz zur Modernisierung der Krankenversicherung* (*GMG*).

III.1 Direktzusage

Tax-effective appropriations to book-reserve are calculated according to a prescribed method, see par. 6a of the Income Tax Act *(EStG)* (which may not reflect long-term cost) and, together with any pensions actually paid, are tax-deductible to the employer. Reinsurance premiums are also deductible. Employees can contribute to a book-reserve plan via deferred compensation. No maximum on tax-free appropriations, neither for that part "really" relating to the employer nor for that part relating to deferred compensation. Accruals are not taxed before benefits are paid. Benefits out of book-reserve systems payable to employees or dependants are fully taxed as ordinary income subject to certain tax-free allowances. However, since 2005 tax-free allowances are gradually reduced, life-time tax-free allowances depend on the first year of benefit payments.

III.2 Unterstützungskasse

Employer contributions to a support fund (including employee contributions via deferred compensation) are tax-deductible within pre-described limits. Unless the fund is reinsured, the contributions and fund assets are very restricted. Accruals are not taxed before benefits are paid. Benefits payable to employees or dependants are fully taxed as ordinary income subject to certain tax-free allowances. However, since 2005 tax-free allowances are gradually reduced, life-time taxfree allowances depend on the first year of benefit payments.

III.3 Direct insurance

Contributions up to 4 % of *BBG*, whether "real" employer contributions or via deferred compensation (as far as the 4 % have not been exploited by the employer) are tax-free. For pension promises committed before 2005, contributions up to a maximum of EUR 2,148 per annum and on average less than EUR 1,752 per annum a flat-rate income tax of 20 % (plus church taxes plus the so called solidarity surcharge) can still be applied (transitional rule for TEE purposes). If the employee waived the application of this transitional rule, another EUR 1,800 of contributions are tax-free, if the pension promises were committed after 2004. In addition, employee contributions out of after-tax income are possible, for which subsidy tax incentives may apply. Pensions are fully taxed, if the contributions were tax-free or were subject to subsidy tax incentives. For the transition period, there exist certain tax-free allowances, which are gradually decreased depending on the commencement year of the pension payment. Lump-sum benefit arrangements harm the tax-exemption of contributions; according to the Government’s intention which was initialised by *AltEinkG* only pension payments shall be subsidised by tax-free contributions. For transitional reasons, lump-sum benefits are still tax-free only from pension promises committed before 2005 (provided, certain conditions are met). Pensions financed by contributions which were subject to taxation (individual or flat-rate tax) are taxed only on their so called interest content (*Ertragsanteil*), e.g. 18 % of a pension that falls due first at age 65. In case of need, benefits have to be split up accordingly.

III.4 Pensionskasse

Contributions up to 4 % of *BBG*, whether "real" employer contributions or via deferred compensation (as far as the 4 % have not been exploited by the employer) are tax-free. For additional contributions the flat-rate tax of 20 % can be applied in the same range as described for direct insurance, if the pension promise was committed before the year 2005 (transitional rule). If this transitional rule is not applied, another EUR 1,800 of contributions are tax-free for pension promises committed after 2004. In addition, employee contributions out of after-tax income are possible, for which subsidy tax incentives may apply. Benefits accruing from tax-free contributions or from contributions that have enjoyed subsidy tax incentives are fully taxable. For the transition period there exist certain tax-free allowances, which are gradually decreased depending on the commencement year of the pension payment. As far as contributions are taxed (by individual or flat rate) the resulting benefits are taxed only on their interest content. In case of need, benefits have to be split up accordingly. Lump-sum benefit arrangements are also harmful for tax purposes (see above).

III.5 Pensionsfonds

Contributions up to 4 % of *BBG* are tax-free ("real" employer contributions as well as those via deferred compensation - as far as the 4 % have not been exploited by the employer-). If the flatrate tax of 20 % is not applied to contributions to the vehicles *Pensionskasse* and direct insurance (see above), another EUR 1,800 of contributions are tax-free if the pension promise was committed after 2004. Beyond that, contributions via deferred compensation are taxed individually with possible subsidy tax incentives. Benefits are fully taxable as far as contributions have been tax free or have enjoyed subsidy tax incentives. For the transition period there exist certain tax-free allowances, which are gradually decreased depending on the commencement year of the pension payment. The funding vehicle *Pensionsfonds* does not allow lump-sum benefit arrangements.

III.6 "*Riester*-Benefits"

Since 1/1/2002, individual capital accumulating options are available on a private basis such as special life insurance products, special savings products, or real estate. These products also enjoy favourable tax treatment, if minimum conditions are met (contracts/products must be "certified", contributions must meet a certain minimum limit, and benefits must be principally payable as annuities). The granted subsidy tax incentives (also dependent on number of children) are limited in absolute terms. The limit was EUR 525 (2002/2003), EUR 1,050 (2004/2005) and EUR 1,575 (2006/2007) per annum. Since 2008 favourable tax treatment is limited to EUR 2.100.. Benefits paid are fully taxable, according to EET-principle. For the transition period there exist certain tax-free allowances, which are gradually decreased depending on the commencement year of the pension payment. In a first step individually taxed contributions to the funding vehicles direct insurance, *Pensionskasse,* and *Pensionsfonds* can also take advantage of these subsidy tax incentives within the same limits that apply for the private products/contracts.

III.7 "*Rürup*-" or "Base-Benefits"

Since 1/1/2005, special annuity insurance products are available on a private basis. If they fulfil certain conditions (capital coverage, benefits must be payable as annuities not before age 60, benefits must not be inheritable, are unacceptable as collateral, are non-transferable, are not sellable, and cannot be capitalised), contributions and benefits are taxed in the same way as contributions to and benefits out of the social security system: Contributions are gradually tax-free, starting with a 60 % tax exemption in 2005. The tax-free percentage increases by two percentpoints each year, so, from 2025 on they are totally tax-free within a EUR 20,000 ceiling (which has to be shared with social security contributions). The taxation of benefits depends on the first year benefits are paid. If 2005 or earlier is the first year of benefit payments, 50 % of the benefits are subject to taxation, increasing 2 per cent-points each year depending on the commencement year of pension payment until 2020. From 2021 on, this increment is reduced to one percent-point. So, pensions drawn from the year 2040 on are fully taxed. After the first year of pension payment the tax-free part of the pension is frozen as absolute tax allowance and is applied for lifetime. In extremely exceptional cases the vehicles direct insurance, *Pensionskasse*, and *Pensionsfonds* may be taxed like “Base-Benefits”.

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