Hogan Lovells

Workplace pensions in Germany: what you need to know

July 2019

Pension briefing

KEY POINTS

- In Germany, paying contributions to the statutory (state) social security pension is compulsory for most employees and their employers (for details please see the box below).
- In addition many companies, in particular large and international enterprises, choose to offer employer-financed (second tier) workplace pension schemes to help attract and retain staff.
- Workplace pension arrangements may be set up using one of five different pension vehicles. Details of each type of vehicle are set out in this note.
- Since 2002, employers must enable their staff to make employee contributions to a workplace pension scheme through salary sacrifice (*Entgeltumwandlung*), at the employee's request. Salary sacrifice to a workplace pension arrangement has tax advantages for the employee.
- Under all types of workplace pension arrangement (except for new "pure DC" arrangements – please see below), the employer remains ultimately liable for any shortfall in the funding of the benefits, even where the arrangement is nominally "contribution based".
- New legislation, the Occupational Pensions Strengthening Act (*Betriebsrentenstärkungsgesetz*)(BRSG) came into force on 1 January 2018. The BRSG is focussed on the following areas:
  - enabling the establishment of "pure" defined contribution (DC) arrangements, subject to certain conditions;
  - a new requirement for employers to contribute to a pension arrangement for their employees, where the employee converts (sacrifices) salary to make pension contributions;
  - allowing "auto-enrolment" into an employer's salary sacrifice arrangement, with the employee having a right to opt out; and
  - increasing participation in workplace pension schemes, especially among lower paid workers.

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This note is divided into three sections.

- An overview of German pension arrangements
- Reforms under the Occupational Pensions Strengthening Act (BRSG)
- Pension issues to consider when acquiring a German company or business

I. GERMAN PENSIONS: OVERVIEW

Employer liability

Traditionally, most workplace pension schemes in Germany are defined benefit (DB) plans. In recent years, contribution-based pension schemes have become more popular (please see the Glossary: DB and DC benefits below).

A key feature of both DB and contribution-based workplace plans is that the employer remains ultimately liable for the payment of benefits, even where an external pension arrangement is used. Some employers have been reluctant to establish workplace pension arrangements for their staff, because of concerns about liability.

Until now, there have been no "pure" defined contribution (DC) plans in Germany. On 1 January 2018, the BRSG brought in a legal framework for the establishment of pure DC plans. For more details, please see below.

Social security (state) pensions in Germany (*gesetzliche Rentenversicherung GRV)*

- State pensions are earnings-related, to a maximum of the social security pension contribution ceiling. In 2019 this ceiling is €6,700 per month in former West Germany and €6,150 per month in former East Germany.
- The state pension is an unfunded, pay as you go arrangement, with contributions from today's employers and employees paying the pensions of today's

pensioners.

- The right to a German state pension arises after three years of working and paying contributions (with credit given for certain other periods, such as incapacity or caring for children). Thirty-five contribution years are needed to be entitled to a full pension at state pension age.
- Contributions are 18.6% of employees' gross salary (up to the contribution ceiling), with the employer and employee each paying half of the contribution. The aggregate contribution rate will increase to 20% by 2025.
- State pension age is currently around 65 years seven months and will increase gradually to 67 by 2029.
- The state pension may be taken before or after state pension age, with a corresponding reduction or enhancement for early or late payment.
- Spouse's pensions are payable after the member's death.
- Civil servants and members of professions (such as lawyers and doctors) are excluded from membership of the state pension. Instead, they may be members of a pension fund for professionals (*Berufsständische Versorgungswerke).*

Typical benefits from workplace pensions

Benefits are usually taken as a lifetime pension, although some more recent arrangements may also allow payment of lump sums or payment in instalments (drawdown). If benefits are taken other than as a lifetime pension, the employer is released from ongoing liability for benefit payments.

Benefits from new pure DC arrangements may only be taken as a lifetime pension.

Survivors' pensions, including children's pensions, are commonly payable on death before and after retirement.

Glossary and translation of key terms

Some key German terms are commonly translated into more than one English equivalent. To aid understanding, some of these terms and their various translations are set out below.

The English terms used in this note are highlighted.

***Betriebsrentenstärkungsgesetz*: (BRSG)**; Occupational Pensions Strengthening Act; Occupational Pensions Reform Act; Occupational Pensions Enforcement Act.

***Entgeltumwandlung*: salary sacrifice**; deferred compensation; salary conversion.

***Pensionskasse*: pension fund society**; staff pension fund.

***Pensionssicherungsverein*: Mutual Pension Protection Association (MPPA)**; Company Pension Protection Fund; (the German equivalent of the UK's Pension Protection Fund).

Vesting periods

From 1 January 2018, pension rights must vest after reaching age 21 and having three years' service.

Where employees contribute via salary sacrifice, the right to benefits vests immediately (only in respect of employee sacrificed contributions).

Shorter (or no) vesting periods may be agreed by contract.

Rights under a new pure DC arrangement (please see BRSG reform: "pure" DC plans below) must vest immediately.

Pension increases

In general, pensions in payment must be increased by either:

- an increase every three years in line with the consumer price index, subject to an upper limit of the net increase in the pay of comparable workers; or
- an annual increase in advance of at least 1%.

Revaluation of deferred pension rights

From 1 January 2018, pension rights of employees who leave pensionable service must be revalued to give some protection against inflation. This obligation will be met if one of the following applies:

- the pension rights are expressed as an entitlement to a specified sum (for example, payment of 2,000 Euros per month from age 65), without provision for inflation protection in deferment (in practice, the amount promised may be higher to reflect the expected reduction in buying power when the benefit comes into payment);
- the pension rights guarantee a rate of interest that also applies to deferred benefits; or
- the pension rights are held in a fund secured by a pension fund, a pension scheme or a direct insurance policy and the investment returns are credited to deferred benefits (with the former employee receiving the benefit provided by the fund including investment returns or, if higher, a minimum benefit guaranteed by the employer).

If none of these apply, the value of the deferred pension rights must be revalued:

- by 1 percent per year;
- in line with the pension rights or net salaries of comparable workers who are still in pensionable service with the employer;
- in line with increases to the retirement benefits currently paid to beneficiaries of the employer's pension arrangement; or
- in line with the consumer prices index for Germany.

Glossary: DB and DC benefits

Defined benefit (DB): the pension payable to the employee is defined by reference to a formula, with the employer ultimately responsible for making good any shortfall.

Defined contribution ("pure DC"): pension scheme benefits are based on a commitment by the employer to make contributions at a specified rate (for example, 5% of salary) to a fund that is invested on the employee's behalf. The employer does not retain any risk relating to the level of benefits ultimately received by the former employee; this will depend on the level of contributions made and the investment performance of the fund.

In the UK, schemes providing DC benefits are also known as "money purchase" arrangements.

Contribution-based benefits: employers and/or employees pay contributions at a specified rate (often a percentage of salary up to the social security contribution ceiling; plus a higher percentage of salary above this ceiling). The level of benefits paid is determined by a formula relating to the level of contributions. If the contributions paid are insufficient to pay the specified level of benefits, the shortfall must be made good – with the ultimate funding liability falling on the employer.

In Germany, this type of arrangement is referred to as being "defined contribution". (In the UK, this benefit structure would be a form of defined benefit.)

PENSION VEHICLES FOR WORKPLACE PENSIONS

There are five different pension vehicles (*Durchführungswege*) available to employers:

- book reserve schemes (*Direktzusage*);
- direct insurance (*Direktversicherung*);
- pension fund societies (*Pensionskassen*);
- pension funds (*Pensionsfonds*); and
- support funds (*Unterstützungskassen*).

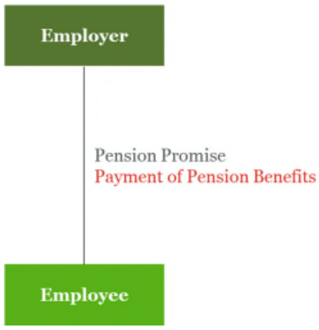
New legislation (the BRSG) enables the establishment of pure DC pension vehicles, as discussed below.

Book reserve schemes (*Direktzusage*)

Key features:

- currently, the most common pension form of workplace pension in Germany;
- usually provide DB benefits, with the employer undertaking to pay certain benefits upon retirement, death or invalidity;
- employees and survivors have a direct claim for benefits against the employer;
- pension liabilities do not have to be funded (and are often not funded);
- the employer must build up book reserves in respect of the pension liabilities in its company balance sheet, using generally accepted accounting standards;
- some employers choose to fully or partially insure their liabilities to pay future pensions and may offset the insurance against balance sheet reserves, provided certain conditions are met;
- pensions in payment, and premiums for insurance, are deductible against the employer's taxable profits;

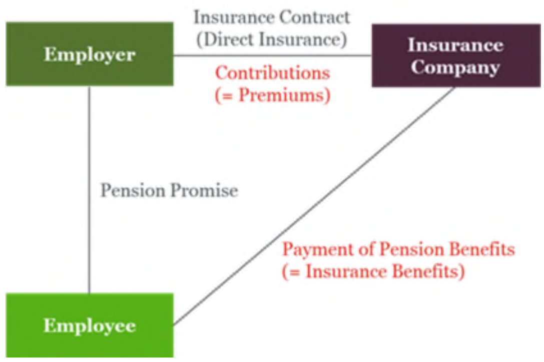
Some large employers choose to establish a pension trust company and to outsource pension obligations to the trustee under a contractual trust arrangement (CTA). A CTA has the effect of removing pension liabilities from the employer's balance sheet, although the employer retains the ultimate responsibility for paying benefits if funds in the CTA are insufficient. Funds in a CTA are not subject to investment restrictions, meaning that higher equity-based investment returns may be targeted.



Direct insurance (*Direktversicherung*)

Key features:

- the simplest vehicle to administer and most employers' choice for new pension arrangements;
- broadly, involves a group life insurance contract taken out by the employer, under which the employer takes out an individual policy in respect of each employee;
- employees may contribute through salary sacrifice or out of taxed income;
- benefits funded by taxed contributions are only taxed in payment on the interest element;
- the employee's claim for benefits is against the insurance company;
- the employer remains contingently liable if the insurance fails (although, as providers of direct insurance are subject to the stringent funding requirements of the Solvency II Directive, as implemented by German law, the risk of failure is remote).



Pension fund society (*Pensionskasse*)

Key features:

- independent legal entity, separate from the employer;
- may provide workplace pensions for one or more employers;
- employees may contribute through salary sacrifice or out of taxed income;
- benefits funded by taxed contributions are only taxed in payment on the interest element;

- employees and surviving dependants have a legal claim against the society, although the employer remains contingently liable for payment of the promised benefits;
- subject to the same tax treatment as direct insurance;
- formerly, the preferred vehicle for contribution-based plans;
- currently, less popular for new arrangements than direct insurance, as many employers prefer taking out a policy with a major insurer to making arrangements with a small pension fund society.

Pension funds (*Pensionsfonds*)

Key features:

- introduced in 2002;
- independent legal entity, separate from the employer;
- may provide workplace pensions for one or more employers;
- employees may contribute through salary sacrifice or out of taxed income;
- benefits funded by taxed contributions are only taxed in payment on the interest element;
- employees and surviving dependants have a legal claim against the pension fund for the benefits promised;
- more flexible investment is possible, as pension funds are not subject to the laws regulating insurance;
- pension funds are not required to provide guarantees on pensions in payment, provided that the employer agrees to pay future contributions to offset any underfunding.

Support fund (*Unterstützungskasse*)

Key features:

- an independent legal entity, separate from the employer that will pay pension benefits to the beneficiaries upon maturity;
- often used to provide pensions for executives, managers or directors, because the threshold for tax free contributions is higher than for other funded arrangements;
- can also be used to provide pensions for an employer's entire workforce;
- legally, the employee's claim is against the employer, not the fund (although, in practice, the fund will often pay the benefits);
- employee contributions can be made only by salary sacrifice;
- no specific investment restrictions, although investment must not be contrary to the fund's purposes in its articles of association;
- benefits are often funded by reinsurance, with the support fund passing contributions on to the reinsurer;
- the employer remains ultimately liable for paying benefits if the support fund is insufficiently funded.

SALARY SACRIFICE (DEFERRED COMPENSATION)

Since 2002, employees within the social security pension system can require their employer to allow the employee to sacrifice salary and to pay the sacrificed salary to a "deferred compensation" arrangement.

Employees may sacrifice up to 4% of the social security pension contribution ceiling (please see the box on social security pensions above).

Deferred compensation may be arranged through:

- direct insurance;
- a pension fund society; or
- a pension fund.

The employer may decide the form of pension arrangement to use. Where the employer does not already have a workplace pension arrangement, an employee may require the employer to take out direct insurance to receive the employee's sacrificed salary.

PROTECTION ON EMPLOYER INSOLVENCY

The Mutual Pension Protection Association (MPPA) (*Pensionssicherungsverein*) provides protection on the employer's insolvency for pension benefits from:

- direct promise (book reserve) arrangements;
- pension funds;
- support funds; and
- direct insurance (only in certain circumstances)

Pension fund societies are not covered.

The MPPA is funded by contributions from employers which have chosen protected pension arrangements for their employees.

The MPPA only protects employees who have met the statutory vesting requirements (please see the paragraph on Vesting periods above).

Providers of direct insurance or a pension fund society are not usually required to give insolvency protection, and so their members do not benefit from MPPA protection. However, these arrangements are subject to insurance regulation and the employees have a direct claim against the insurer or the pension fund society.

Which benefits are covered?

As explained above, where an external pension arrangement is insufficiently funded to pay the benefits promised, the employer is liable to pay top-up benefits to its former employees to offset the reduction in pensions from the external provider.

In a case involving the MPPA currently before the Court of Justice of the EU (*Pensionssicherungsverein v Bauer*), the Court has been asked to decide whether those top-up benefits are protected under EU law if the employer becomes insolvent.

II. REFORMS UNDER THE OCCUPATIONAL PENSIONS STRENGTHENING ACT (BRSG)

BRSG REFORM: COMPULSORY EMPLOYER CONTRIBUTIONS

When does the contribution requirement apply?

The BRSG contains a new requirement for employers to contribute to their employees' pension arrangement where certain conditions are met:

- the employee is sacrificing salary into a direct insurance arrangement, pension fund society or pension fund; and
- the employee's salary sacrifice results in the employer paying lower social security contributions (because social security contributions are not payable on the sacrificed salary).

How much must the employer contribute?

Employer contributions must equal at least 15% of the employee's sacrificed amount, subject to an upper cap of the employer's saving on social security contributions.

Where an employee's post-sacrifice salary exceeds the social security contribution ceiling (please see the box on social security pensions above), there will be no social security saving for the employer. Employers may nevertheless choose to pay voluntary contributions in respect of these higher paid employees.

When is the contribution requirement in force?

Compulsory employer contributions must be paid from 1 January 2019, in respect of salary sacrifice arrangements set up on or after this date.

Where a salary sacrifice arrangement pre-dates 1 January 2019, compulsory employer contributions must be paid from 1 January 2020.

Interaction with voluntary arrangements

An employer who already contributes more to its employees' pension arrangements should decide whether its future voluntary contributions will be in addition to the new statutory employer's contribution. Alternatively, it may decide to keep the overall level of employer contributions the same, by reducing its voluntary contributions to reflect the compulsory contribution. Negotiation with employees or trade unions may be required.

BRSG REFORM: "PURE" DC PLANS

At the heart of the BRSG is the aim of allowing employers to support workplace pensions for their employees through contributions to a "pure" DC plan, without incurring ongoing contingent liability to fund a particular benefit promise.

Pure DC plans can only be introduced by a collective agreement (*Sozialpartnermodell*), or by a reference in a works council agreement or service agreement to a corresponding collective agreement.

Collective agreements may usually only be used by "tariff companies" (employers which have joined the relevant employer association). In an exception relating to pensions, non-tariff companies may refer to a collective agreement and may join the associated DC plan, subject to any reasonable conditions.

Pure DC arrangements may only be established using direct insurance, a pension fund society or a pension fund. They may only offer a target benefit (defined ambition): legal guarantees of a level of benefit are expressly prohibited.

Under a pure DC plan, the employer will pay contributions to the pension provider and the employee's rights under the plan will vest immediately. The pension provider will be liable to pay the employee's pension in due course and may increase or decrease pensions in payment, to reflect investment performance. The form of benefits to be paid is expected to be set out in collective agreements.

The obligation to pay an employer contribution of at least 15% of the salary sacrificed by the employee (please see Salary sacrifice above) will also apply to pure DC arrangements.

This new type of arrangement has been referred to as "pay and forget". Experience with DC arrangements in the UK might suggest that scrutiny of charges and investment allocation (including lifestyling) may be needed in future to protect members' interests. It will be interesting to see whether this role may be taken by trade unions (which are commonly more powerful in Germany than the UK), or whether a requirement for some form of "independent governance committee" may be introduced.

At the time of writing, there are no collective agreements on the use of a pure DC arrangement in force and, therefore, pure DC arrangements have yet to be established in Germany.

BRSG REFORM: AUTO-ENROLMENT

Another way in which the BRSG is intended to increase participation in workplace pension arrangements is through "auto-enrolment" into a salary sacrifice "options" arrangement. Membership of the arrangement is automatic, although employees may opt out if they wish.

Employers may only auto-enrol their employees where a collective agreement is in place. The collective agreement should extend to any employees who are not members of a trade union. Employers should consider (and may need advice on) whether the terms of a collective agreement can be applied to employees who are not ordinarily bound by collective agreements.

So far, the first auto-enrolment arrangements have been introduced by company collective agreements, although their use is not yet widespread.

BRSG REFORM: TAX CHANGES FOR FUNDED PENSIONS

Background

Most modern pension arrangements in Germany are subject to the EET (exempt, exempt, taxed) taxation model, with contributions and investment returns being largely tax free, and pensions subject to income tax in the hands of the pensioner.

Unlimited employer contributions to book reserves in relation to a direct pension promise are deductible against the employer's taxable profits. Employees are also not subject to income tax on the employer's contributions to book reserves.

Employer contributions to the social security pension (please see the box on the social security pension above) are also tax deductible.

Employer contributions and payment of expenses to funded pension arrangements are deductible against the employer's taxable profits (subject to limits – please see below).

Changes made by the BRSG

On 1 January 2018, the upper limit for tax-free contributions (the aggregate of employer and employee contributions) to a direct insurance arrangement, a pension fund society, or a pension fund increased from 4% to 8% of the social security contribution ceiling (please see the box on the social security pension above).

Where employer contributions are calculated by reference to the maximum tax free amount, the employer's contributions may have been unintentionally doubled by the change in legislation. Pension scheme rules should therefore be checked and, if necessary, amended to retain contributions at the desired level.

Pensioning breaks in employment

Since 1 January 2018, contributions can be paid tax-free for earlier calendar years in which the employer-employee relationship was suspended, for example because of a secondment, leave or a sabbatical.

Tax-free contributions in respect of previous tax years are limited to 8% of the social security contribution ceiling. Back-contributions may be paid in respect of a maximum of 10 calendar years.

Tax incentives to pension the lower paid

The BRSG introduces a tax incentive for employers to contribute to pension arrangements for low income workers (with gross monthly pay up to €2,200). Where the employer contributes between €240 to €480 per year to the worker's workplace pension, the employer is given a tax subsidy of 30% of the additional employer contribution, to a maximum of €144 per year.

Employer contributions to an existing workplace pension arrangement in respect of current employees will only qualify for the tax subsidy if the employer's contribution exceeds its contributions paid in 2016 in relation to those employees. This restriction does not apply to new hires.

III. PENSIONS ISSUES ON ACQUISITION OF A GERMAN COMPANY OR BUSINESS

PENSION RIGHTS ON SHARE SALES

If a German company ("target") is acquired, all pension liabilities in respect of its employees' past service will pass with it. In many cases, the target will retain its contractual rights and obligations with external pension providers.

If a pension arrangement is restricted to companies within a specific corporate group, the target will no longer have access to the funds in the arrangement after its sale out of the group. However, the target will still retain the liability for its employees' past service pension rights. Protection for the purchaser should be included in the sale and purchase agreement, example, through an adjustment to the purchase price.

Effects of share sales on different pension vehicles

- **Book reserve arrangements**: unfunded pension liabilities under a book reserve scheme will remain with the target. Where actuarial investigation shows that the reserves are unlikely to be sufficient, the purchaser may seek a price adjustment or other compensation from the seller.
- **Direct insurance**: the share sale is likely to have no major impact, as the target will remain the policyholder of the insurance policies in respect of its employees.
- **Pension fund society**: some pension fund societies are suffering from the current low interest rate environment and cannot pay out the full amount of pension benefits that was originally promised. In such event, the target will be liable to make good any shortfall. Thorough due diligence, including financial and actuarial scrutiny, may be required. The purchaser may seek appropriate warranties and indemnities and/or a price adjustment. Some pension fund societies are restricted to employers within a particular corporate group. Where this is the case, compensation may be needed in respect of the pension liabilities which remain with the target. It may also be possible for the pension fund society to agree to the target's continued participation after it is sold out of the corporate group.
- **Support fund**: some support funds are restricted to employers within a particular corporate group. Where this is the case, compensation may be needed in respect of the pension liabilities which remain with the target. It may also be possible for the support fund to agree to the target's continued participation after it is sold out of the corporate group.
- **Pension fund**: pension funds are uncommon in practice.

PENSION RIGHTS ON A BUSINESS TRANSFER

Business transfers are subject to requirements of the Acquired Rights Directive 2001/23/EC (the "TUPE Directive"), as implemented by German national legislation.

Employees' pension rights are fully protected on a business transfer, regardless of the form of the pension arrangement. The receiving employer becomes responsible for the transferring employees' pension rights, including rights built up in pre-transfer service. Pension obligations in respect of deferred and pensioner members remain with the transferring employer.

Transferring employees are treated as having a single period of service (important, for example, in relation to vesting rights).

Waivers of employees' pension rights are prohibited.

Effects of a business sale on different pension vehicles

- **Book reserve arrangements**: the receiving employer must honour commitments under a direct promise (book reserve) arrangement in full. The purchaser may negotiate a price adjustment or other compensation in respect of the past service rights it is acquiring. Book reserves in the transferring employer's accounts may be reduced after the transfer to reflect the decrease in its pension liabilities.
- **Direct insurance and pension funds**: policies in respect of the transferring employees should be assigned to the receiving employer.
- **Pension fund societies**: policies should be assigned to the receiving employer. Similar concerns about the funding level of policies and about the continuation of obligations with pension fund societies arise as on a share sale. In particular, an agreement may be reached for the receiving employer to become a member of the pension fund society in respect of the transferring employees. Alternatively, other compensation may be sought, such as an adjustment in the purchase price.
- **Support fund**: agreement may be reached for the receiving employer to become a member of the support fund in respect of the transferring employees. Alternatively, other compensation may be sought, such as an adjustment in the purchase price.

Transfer of pension rights after employer's insolvency

Where a business is transferred following the transferor's insolvency, liability for payment of past service benefits passes to the MPPA. The receiving employer will only be liable for future service pension benefits.

FURTHER INFORMATION

For further information, please contact one of our pension partners below.

This note is written as a general guide only. It should not be relied upon as a substitute for specific legal advice.

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