

BENEFITS & COMPENSATION INTERNATIONAL

**TOTAL REMUNERATION AND
PENSION INVESTMENT**



Disability and Life Benefits in Germany

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For some time now, investment funds in Germany have been used to back up book reserves (*Direktzusagen*). Moreover, German employee pension investment funds (*Pensionsfonds*), which are no longer restricted by life annuity insurance tariffs when pensions are in payment, are establishing themselves in the market as a pension provider. Considering these developments, the question arises as to whether such types of financing and pension provision adequately meet all benefit objectives.

This article will focus on separate, employer-financed occupational pension provision for disability and survivors, i.e. risk provision.* Anglo-American employers operating in Germany generally require risk provision, often with high-level benefits. They automatically assume that risk provision cannot be financed via investment funds but only via insurance due to the fact that risk provision is triggered by an event (loss) that is less likely than the individual reaching retirement age. The German Federal Administrative Court has established in its rulings the difference between investment and insurance in Germany. If, in the case of an unpredictable event (loss), certain benefits are given as compensation; if the accepted risk is spread across a large group of individuals who are subject to the same risk; and if the acceptance of that risk is based on a calculation that rests on the law of large numbers, then it is an insurance matter and not a question of investment. In addition, this article will consider foreign employers who are providing occupational risk cover for employees in their branches/subsidiaries in Germany.† It will try to give an overview of the predominant practices and associated legal questions such as the applicable national law – the employee pension law *Betriebsrentengesetz (BetrAVG)* – and insolvency protection.

THE OCCUPATIONAL BENEFIT CONTRACT

In order to provide security when a foreign employer is setting up and arranging a plan, the applicable law under German legislation for international private companies has to be identified. Such a contract falls under the

conflict rule in labour law (labour statute) since disability and survivors' benefits are based on the employer–employee relationship. It is considered to be part of the remuneration system and therefore part of the contract of employment. While labour statute permits the employer to choose the law that will apply to the contract between the employer and the employee, it also includes an abuse clause. The choice of law must not deprive the employee of the statutory protection that would have applied had the parties not chosen that particular law. If no law is chosen, the labour statute rules that the contract is subject to the law of the state in which the employee usually carries out his/her contractual duties.

The employer is required to qualify as a legal entity and to conduct proceedings in its name. In this context, it should be mentioned that the legal scope of the employer with a registered office abroad and with a branch/subsidiary in Germany falls under the law of the state in which the main establishment is registered (individual statute). Branches/subsidiaries of foreign companies in Germany that do not qualify as legal entities under German law but do so under the law of the country of their permanent registered office therefore have to be recognized in Germany.

Thus, foreign employers would be well advised to make clear whether it is the principal office or the branch that is making the commitment to occupational pension provision and whether the latter qualifies as a legal entity.

* Accidental death and dismemberment insurance does not fall under life assurance in Germany and therefore is not covered in this article.

† This article does not cover worldwide corporate commitments.

RISK PROVISION UNDER THE BetrAVG

As already mentioned, employers in the Anglo-American world pursue the tradition of committing themselves to providing their employees with disability benefits and survivors' pensions separately. To meet this objective satisfactorily for both sides via the *BetrAVG*, it is especially important to define the possible benefit objectives and types of benefit, the measurement basis, benefit structures and the method of implementation. Once these have been decided, the liability of the employer is determined.

Benefit Objectives and Types of Benefit

The *BetrAVG* provides for disability and survivors' benefits. The term 'disability' comprises every possible physical inability of the employee to pursue his/her occupation. At this point it is worth mentioning that, due to contractual freedom, the amount of benefit and length of payment period can be stipulated in the plan rules. Survivors' benefits can be described as the employer's commitment to the employee to pay benefits in the event of his/her death to the appointed surviving dependants. The Federal Ministry of Finance (*BMF**) restricts the definition of surviving dependants and recognizes for preferential tax treatment only benefits payable in the following cases:

- widowers,
- divorced spouses,
- cohabiting partners (*nichteheliche Lebensgemeinschaft*),
- civil unions (*eingetragene Lebenspartnerschaft*),
- same-sex unions (*gleichgeschlechtliche Lebenspartnerschaft*), and
- children who are eligible for child benefit (*Kindergeld-Kinder*).

The types of benefit are not restricted by the *BetrAVG*. The specific provision in the event of disability and death therefore has to be determined according to the employer's objectives and the benefits are typically set at a predetermined level whether it be a defined benefit pension, a lump-sum payment or a combination of the two.

Benefit Structures

Based on current practice, disability/death benefits can best be provided under German law through a defined benefit structure (*Leistungszusage*) that commits the employer to a specific benefit level and at the same time grants the employee a legal entitlement to this.

Neither of the other two structures under the *BetrAVG* – defined contribution (*beitragsorientierte Leistungszusage*) and defined contribution with guaranteed minimum benefits (*Beitragszusage mit Mindestleistung*) – achieves the employer's objectives.

The employer's commitment under the *beitragsorientierte Leistungszusage* refers only to the financing and payment method, not to a specific benefit level. The benefit level itself can only be determined via a conversion method applied to the defined contribution payments.[†] In contrast to the *Leistungszusage*, the benefit level can only be precisely determined in the event of *actual* disability or death because it depends on the contributions made.

The *Beitragszusage mit Mindestleistung* guarantees an amount made up of the contributions paid and potential surplus insofar as these have not been used to cover biometric risks[‡]. From this method of benefit determination it is apparent that this structure is more typical of old-age provision than risk provision. As in the case of the *beitragsorientierte Leistungszusage*, the employer does not commit himself to a specific benefit level.

Eligible Methods of Implementation

Neither the *Pensionsfonds* nor the employee pension insurance fund (*Pensionskasse*) offers separate occupational risk provision. The discussion will therefore be focused on *Direktzusagen*, direct insurance (*Direktversicherung*) and the support fund (*Unterstützungskasse*).

Direktzusagen and Rückdeckungsversicherung

Direktzusagen still represent the most popular method of pension provision in Germany. This could be due to the fact that no third party is involved, which allows the employer extensive autonomy in respect of his benefit arrangements under the *BetrAVG*.

For *Direktzusagen* covering risk provision only, stand-alone disability insurance and life assurance are eligible as employee pension liability insurance (*Rückdeckungsversicherung*) in Germany. Since, according to Anglo-American tradition, the duration of the benefits (pensions and lump-sum payments) is limited to employees reaching retirement age, the only suitable alternatives are temporary disability insurance and life assurance.

Disability insurance, which guarantees a specific benefit level, can be calculated as term risk insurance (*n-jährige Risikoversicherung*). This comprises level premiums insofar as the allocated surplus is not set off against the premium. Term risk insurance accumulates no actuarial reserves for old-age benefits. Due to the premium calculation, premium reserves are only built up as actuarial reserves, which are available in cases of policy surrender.

To realistically reflect risk during a working lifetime, annual renewable risk insurance (*einjährig laufende Risikoversicherungen*) can be recommended. The premiums of annual renewable risk insurance increase every year while the benefit level remains the same. This increase in premiums is due to the fact that every single year premiums are newly calculated on the basis of the relevant 'entry age' at that time. In contrast to term risk insurance, annual renewable risk insurance does not regularly participate in the allocation of surplus due to the realistic reflection of risk. Moreover, annual renewable risk insurance does not create actuarial reserves, nor does it regularly accumulate premium reserves. While employers prefer to apply term insurance for individual provision, annual renewable risk insurance is preferred for group contracts, especially for groups of low average age. As far as the premium calculation is

* Bundesministerium der Finanzen

† As an eligible conversion method for the purposes of risk provision, actuarial methods can reasonably be used.

‡ death and disability

concerned, this applies to term life assurance and annual renewable life assurance.

Since the Anglo-American style focuses on provision during working life, disability insurance policies providing disability annuity benefits for old age and life assurance policies providing annuity benefits for surviving dependants are not common.

If the insured benefits exceed a certain level, the insurer in Germany takes out reinsurance since he does not want to accept the whole risk. The reinsurer only covers the risk to the extent laid down by the *BMF* and the Federal Supreme Tax Court concerning adequate risk provision. The risk assessment procedures impose a huge administrative burden on the insurer as well as on the reinsurer and this might trigger off risk mark-ups or exclusion clauses based on financial and medical evidence. As a result, if the insurer accepts the risk, the employer would be well advised to include a proviso that taking on the benefit liability is subject to the individual risk being insurable.

The premiums for term insurance and annual renewable risk insurance are calculated on the basis of the individual's risk. In contrast to this, premiums for term group risk insurance (*Risikoversicherung mit kollektiver Beitragskalkulation*) are calculated on the basis of a group's risk instead of assessing each risk individually. Due to the annual recalculation of premiums, no surplus will be allocated since risk and interest profits have already been taken into account in the premium's calculation, nor are capital reserves or premium reserves accumulated. The probability of a loss decreases for the insurer if the employer as the policyholder opts for stop-loss insurance. The higher the percentage share taken on by the employer, the lower the premiums for stop-loss insurance.

For large groups the separate settlement of accounts (*eigener Abrechnungsverband*) can be established between the insurer and the employer. For this, the insurer makes a provision for the employer on the basis of a single premium calculation. The amount of paid premium will be set off annually against the group's loss. This accounting mechanism is profitable as long as the costs of settled losses are lower than the calculated premiums.

In order to avoid an individual risk assessment (financial and medical examination), insurance can be allocated to a separate settlement of accounts via multinational pooling, which includes insurance groups from different countries. The risk assumption by the insurer who participates in the multinational pool is possible up to the free cover limit, which currently exceeds the benefit level for reinsurers in Germany.

Although the separate settlement of accounts and pooling can be used for term group insurance, common practice limits this to the pooling of risks calculated on the basis of the individual's risk.

Fiscal impact on the employer

The employer is taking on an obligation that has an uncertain due date. Under German commercial law, the employer has to enter the pension liabilities on the commercial balance sheet, which cannot be removed until the actual event of disability or death, assuming this occurs. Due to the principle of balance sheet consistency, under German tax law the pension liabilities

have to be included in the tax balance sheet as well. German tax law and the tax guidelines (*Steuerrichtlinien*) of the *BMF* set out conditions concerning what is allowable and the benefit level for the fiscal approval of pension liabilities. These conditions should be taken into consideration when setting up *Direktzusagen*.

The premiums for the *Rückdeckungsversicherung* are treated as operational expenses. The value of the claim on this insurance has to be capitalized at the level of the actuarial reserves and any allocated surplus. Term risk insurance therefore has to be capitalized with its premium reserves inclusive of guaranteed interest and allocated surplus.

Since neither annual renewable risk insurance nor term group insurance creates actuarial reserves and allocates surplus, they should not be capitalized on the balance sheet. In the case of a separate settlement of accounts – national as well as multinational – the assets have to be capitalized by those to whom they have been assigned. If the employer reports in accordance with IFRSs*, he may opt for the organizational structure of a Contractual Trust Arrangement under German law. This structure permits the removal of the assets accumulated for the pension benefits from the commercial balance sheet without employee approval. Besides potential positive effects on the balance sheet, the removal of the assets prevents their being used for other purposes and therefore serves as contractual insolvency protection for employees' benefit expectations.

In the case of separate risk provision, it should be noted that the level of liabilities for disability and surviving dependants' pensions decreases with the increasing age of the employee, in contrast to the level of liabilities for old-age benefits. As a result, each case should be carefully assessed to ascertain whether a Contractual Trust Arrangement with its associated administration and costs is reasonable.

Fiscal impact on the employee

The employer's premium payments for the *Rückdeckungsversicherung* are tax free for the employee under German tax law. Only the actual payment of benefits in the case of disability or death is considered as income from employment and it triggers off full taxation at the individual's personal rate for the employee or his/her surviving dependants.

Direktversicherung

In the case of *Direktversicherung*, the employer takes out insurance on the employee's life, and the employee or his/her surviving dependants are entitled either as revocable or as irrevocable third-party beneficiaries. Since insurance is not restricted by the *BetrAVG* to specific tariffs, all insurance tariffs approved by the Federal Financial Supervisory Authority (*BaFin*†) can be used. Thus, these tariffs for separate disability and life assurance policies can be applied. This is also the case for reinsurance and the separate settlement of accounts, both national and multinational.

* International Financial Reporting Standards
† Bundesanstalt für Finanzdienstleistungsaufsicht

Fiscal impact on the employer

The premiums for *Direktversicherung* are considered to be operating expenses and can be deducted from tax by the employer. In general, the employer has to capitalize all claims on insurers but, if the employee or his/her surviving dependants are declared as *irrevocable* third-party beneficiaries by the end of the financial year, the insurance claim should not be capitalized on the tax balance sheet. Conversely, if the employee or his/her survivors are only declared as *revocable* third-party beneficiaries, capitalization on the balance sheet is necessary.

Fiscal impact on the employee

Contributions when paid by the employer as premiums for *Direktversicherung* for disability and for surviving dependants are treated as income in the hands of the employee under German tax law. As they are not considered to be tax free due to the specific tax relief on occupational pension provision, they are subject to income tax. Tax relief only covers insurance that grants annuity benefits and consists of a tax-free allowance for the allocation of contributions up to 4% p.a. of the social security ceiling (*BBG*^{*}). For the year 2006 the maximum allocation amounts to €2,520[†]. If the employee had not opted for flat-rate taxation on contributions to an occupational pension before 1 January 2005, the tax-free allowance would increase by a further €1,800 p.a.

The employer's premiums for term life assurance, annual renewable life assurance and term group life assurance with a lump-sum payment for surviving dependants are not eligible for tax relief and are therefore subject to full taxation. The payment of the lump sum to the surviving dependants, however, is tax free as long as any surplus is set off against premiums. This also applies to disability insurance with a lump-sum payment.

Support fund with *Rückdeckungsversicherung*

In the case of a support fund providing risk cover, the employer grants the employee a legal entitlement to disability or survivors' benefits. The support fund does not in itself grant the entitlement and is therefore not considered to be conducting insurance business.

The employer and the support fund enter into a contract in which they determine the extent of each party's rights and obligations, the so-called benefit plan (*Leistungsplan*).

In the case of an insured support fund, it takes out *Rückdeckungsversicherung* to finance the benefits. The contract between the employer and the support fund obliges the employer to allocate the same level of pension expenses to the support fund as the support fund pays in *Rückdeckungsversicherung* premiums.

'Term risk provision' might be implemented by the support fund but it then faces severe restrictions under German tax law. Since the benefit entitlements are limited to an employee's working lifetime, the deduction of pension expenses for the support fund is not approved as an operating expense. Deductions are only allowed if the employer is committed to paying lifetime benefits. This regulation has the effect on disability benefits that, after reaching retirement age, they have to be converted into old-age benefits. Furthermore, the benefits to be paid by the support fund must not exceed a specified level. Thus, the support fund cannot always be used for benefit payments to a group of high earners as it would lose its

existing exemption from corporation tax. The support fund is therefore not an appropriate method for implementing separate term risk provision.

Level of Vested Expectations

Depending on the selected method of implementation and the structure of benefits, the level of vested pensions will change if the employee leaves the company. If these vested expectations cannot be fulfilled via compensation (in the case of 'minor vested expectations') or be transferred by mutual agreement to the new employer, the previous employer is not discharged from his obligation.

Direct Pension Obligations and *Leistungszusagen*

In the case of a direct pension obligation structured as a *Leistungszusage*, the level of the vested expectations is determined by a pro rata measurement technique (*ratierliches Verfahren*). Thus, the level of the expectation is determined by the ratio of the maximum benefit (maximum duration of service[‡]) to actual service. This means that the employer remains liable for the settlement of the vested expectations. It is length of service that determines the level of the benefit.

As mentioned above, the predominant practice is to provide term insurance, annual renewable risk insurance and group term insurance as *Rückdeckungsversicherung*. These types of insurance accumulate only negligible premium reserves and no actuarial reserves. Moreover, surplus is not always allocated according to a realistically calculated premium. If the term insurance is paid off, there is no corresponding benefit to be paid by the insurer. The same problem occurs if the premium payment for annual renewable risk insurance and group term insurance ceases. The level of vested expectations can therefore only be financed via *Rückdeckungsversicherung* after termination of employment if the employer keeps up the premium payments. The employer's continuing premium payments can be set off against any surplus.

If group term insurance is applied, the cost of continuing premium payments for the individual's vested expectations is negligible, especially in the case of stop-loss insurance. In the case of a separate settlement of account, the overpayments of premium can be put towards the insurance renewal.

Direktversicherung* with *Leistungszusagen

Direktversicherung, structured as a *Leistungszusage*, determines the level of vested expectations using the pro rata measurement technique. At this point it is worth mentioning that the *Leistungszusage* refers only to the legal relationship between the employer and the employee and therefore has to be clearly differentiated from the legal relationship between the employer and the insurer.

To take length of service into account, the *BetrAVG* regulates the employer's liability as to the difference between the employee's entitlement to vested benefits

* Beitragsbemessungsgrenze in der allgemeinen Rentenversicherung

† £1 = €1.48; US\$1 = €0.77 as at 5 January 2007

‡ Retirement age in Germany is generally 65.

and the employer's claim against the insurer for the insured benefit. As far as the exemption and cessation of premiums is concerned, the same applies. The employer therefore has the option of either financing the difference on his own or continuing to pay the premiums for *Direktversicherung*, even after termination of employment, in order to secure the correct level of benefit via insurance.

All the above tariffs for the *Rückdeckungsversicherung* also apply to *Direktversicherung*, including reinsurance and the separate settlement of accounts.

Direktversicherung and the Versicherungsförmige Lösung

The employer is able to replace his pro rata liability via *Direktversicherung* if the following requirements are fulfilled (the so-called *versicherungsförmige Lösung*).

First of all, the employee has to be declared an irrevocable third-party beneficiary no later than three months after termination of employment. Moreover, the claim on the insured benefit must not be assigned or loaned by the employer and no premiums may be outstanding. Due to the terms of the policy, at the latest from the start of employment with that employer, the allocated surplus must only be used to enhance the insured benefit and the employee has to be granted the option of taking over the insurance and continuing it on his/her own.

Secondly, the *versicherungsförmige Lösung* (insurance benefit solution) can be applied to term risk insurance as well as to annual renewable risk insurance but cannot be applied to group term insurance. This is due to the fact that such risk insurance policies do not specify an individual benefit and the policies therefore neither declare the employee as a revocable or irrevocable third-party beneficiary nor allow the employee's premiums to be continued by him- or herself.

Thirdly, as already mentioned, the *versicherungsförmige Lösung* requires that, due to the terms of the policy, the allocated surplus can only be used to enhance the insurance benefit. If – due to the realistically reflected risk and associated insurance tariff – insurance does not accumulate surplus, no surplus can of course be allocated. Since the wording of the *BetrAVG* does not exclude tariffs that do not allocate surplus, the application of any tariff is permitted.

Fourthly, if the employee opts to continue the *Direktversicherung* policy on his/her own, it changes into an individual life assurance policy. In this case, the level is determined by substituting the individual life assurance policy for the vested expectations.

Fifthly, if the employer opts for the *versicherungsförmige Lösung* and the employee does *not* opt to continue the policy individually after termination of employment, the level of vested expectations is either determined by the value of the paid-up insurance benefit or, if a paid-up policy is not possible due to actuarial constraints, by the

surrender value. If no surrender value exists, the insurance policy expires.

Finally, reinsurance and separate settlements of account are also possible.

Insolvency Protection for Occupational Pensions

In Germany the *PSVaG** provides compulsory insolvency protection for pension plans in the case of an employer's insolvency. Where insolvency proceedings are started in Germany, the *PSVaG* takes on the vested expectations, which are restricted to certain maximum levels. Implementation via *Direktzusagen* and *Direktversicherung* in which the employee is only declared a revocable third-party beneficiary, entails compulsory insolvency protection.

If the employer opts for a method of implementation that falls under the compulsory insolvency protection, he has to take out insurance against insolvency and, as the policyholder, he is liable for the premiums. The annual premium rate varies since it is calculated according to an adjustable contribution process and is fixed every year in line with the claims experience.

On the assumption that the employee usually carries out his/her contractual obligation at the employer's branch in Germany and that German law therefore applies, compulsory insolvency protection becomes effective depending on whether it is the main establishment or the branch that is providing the occupational pension.

If the main establishment abroad is responsible for occupational pension provision and insolvency proceedings are started against it, these proceedings are recognized in Germany and trigger off compulsory insolvency protection.

Where the branch is the responsible party, compulsory insolvency protection is triggered off if territorial or secondary insolvency proceedings are started against the branch in Germany. Where it is against the main establishment abroad that insolvency proceedings are started, these are recognized in Germany because they have universal application and therefore include the branch or the other permanent establishment. This also brings about insolvency protection.

CONCLUSION

This article has tried to demonstrate that the *BetrAVG* offers more flexibility to foreign employers than at first sight. Nonetheless, it must be emphasized that the employer would be well advised first to define the benefit objective and only then select the benefit structure and method of implementation, since both have a decisive impact on the employer's liability. Ω

* *Pensionssicherungsverein auf Gegenseitigkeit*
(Pension Guarantee Insurance Society)