CASH ‘PENSION PLANS’: THE EXPAT’S WORST OPTION

‘Let the short term not implode the long term’

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The Author

Patrick Donders is Pension Jurist/Consultant and founder of Expat Pension Holland. He graduated from Law School and has a Pension and Post Doctorate Tax Law background. As well as an actuarial education at the Actuarial Institute.

After an internship at the Columbia Law School in New York City Patrick started his career at Arthur Andersen. During his career Patrick had several management positions at financial institutions. During his 10 years at Moore Stephens Amsterdam Patrick build the international pension consultancy practice.

Patrick has more than 20 years of experience regarding International Pension Consultancy. Both collective and expats. Patrick is passionate about quality and adding value. He is a trusted advisor of a number of especially German and Japanese Global Companies. As well as of many Expats of whom most are of Board level.

1) Expats & Pensions

As most Expats are not specialized in Global Expat Pension Optimization and as they tend to relocate on a rather regular base with their family, pensions are a sensitive topic for Expats.

Thus advisable to make sure that Expats have the optimal coverages at the lowest costs.

2) Three Pillars

Pensions are in general acquired by means of three Pillars:

- Pillar 1: State Pensions;
- Pillar 2: Workplace Pensions;
- Pillar 3: Private Pensions/Annuities.

In this article we will only focus on Workplace Pensions and stick to the essence.

3) Three kind of Pension Coverages

In general Pension Plans provide three kind of pension coverages:

- Old Age Pension;
- Next of Kin Pension;
- Disability pension.

In case it might not be feasable to have a certain coverage as ‘Pension’, it might be possible as an ‘Insurance’ due to the possibly different legal regime of the latter.

4) Expat versus Standard Pension Plan

We often see that HR tries to service Expats in the best way possible by providing the choice between;

- The standard national collective workplace pension plan;
- The special international expat workplace pension plan.

In case an Expat can choose between both options, it is advisable to carefully compare all aspects.

The Cash 'Pension Plan' option is in general not offered in National Pension Plans and only in Expat Pension Plans. Thus we will only focus on that situation.

5) Why does the Cash 'Pension Plan' exist?

Most countries have certain legal and tax requirements which have to be met in order to have the benefits of a formal Workplace Pension Plan.

The i.e. positive aspects of a Workplace Pension Plan:

- Substantial/huge income tax benefits;
- Low costs due to collective coverages;
- Complete coverages at one stop shop;
- Governmental oversight;
- The chance to if so desired acquire additional coverage and optimize tax benefits.
- No (substantial) additional advisory costs as the plan already exists.

The possible negative aspects of a Workplace Pension Plan:

- Mandatory participation;
- Own contributions (even though often tax deductible);
- Limited availability to the capital due to sometimes strict pay-out regulations;
- Due to the sometimes complexity of pensions, HR often depends on the advice of consultants, who are not always independent/capable.
- Due to many scandals in the past it is not always clear that the employee can trust the quality of an existing pension plan.

The main reason for HR Departments to offer a Cash 'Pension Plan' to Expats is:

- They prefer expats to have direct access to these funds and decide for themselves;
- They prefer not to be bothered by many kind of regulations regarding international pension plans;
- They have not received adequate advice and thus do not really understand the impact of this kind of plan.

6) The effect of a Cash 'Pension Plan'

In essence this is about the difference between (not) having income tax benefits regarding the capital build up phase*.

* Of course the non existence of Next of Kin and Disability coverage at low rates is also a relevant aspect. All the more for the employer who feels responsible and likes to make sure that in case something might happen to his employees, that there will be adequate coverage for the family.

Which is best explained by means of two examples*:

- Expat A is age 35 and has a pre tax wages of € 100.000,-;
- Expat B is age 45 and has a pre tax wages of € 250.000,-;
- We will assume a DC Pension Plan with an annual premium of 15% of the annual pre tax wages, an annual compounded return on investment of 6%, pension age 65 and no annual tax on private net capital (gains).

*To the extent that the age of the Expat is lower and the tax exposure pre pension age is higher, the effect will be even (much) more substantial. Likewise if the amount of the annual pension premium would in reality increase substantially with age.

6.1) Expat A

Regular Pension Plan with Tax Benefits

Expat A will receive between age 35 and age 65 annually € 15.000,- pension premium. At age 65 this will provide a pension capital of € 1.257.025,-.

In case Expat A buys a lifelong annual pension annuity at the current rates, the estimated pre tax annual annuity amounts to € 57.000,-. In case of a tax exposure as of pension age of 25%, the annual net pension amounts to **€ 42.750,-.**

Cash Pension Plan without Tax Benefits

Expat A will receive between age 35 and age 65 annually € 15.000,- pension premium. In case of a tax exposure of 40%, this will result in a total net capital at age 65 of € 754.215,-. And (for sake of comparison) into a net lifelong annuity of **€ 34.283,-.**

Conclusion

If we translate the mentioned difference into a net cash value as of pension age 65 at an interest rate of 2%, then the pension plan with tax benefits generates an additional net pension capital of **€ 153.000,-.**

6.2) Expat B

Regular Pension Plan with Tax Benefits

Expat B will receive between age 45 and age 65 annually € 37.500,- pension premium. At age 65 this will provide a pension capital of € 1.462.227.

In case Expat B buys a lifelong annual pension annuity, the estimated pre tax annual annuity amounts to € 66.500,-. In case of a tax exposure of 25% the annual net pension amounts to **€ 50.000,-.**

Cash Pension Plan without Tax Benefits

Expat B will receive between age 45 and age 65 annually € 37.500,- pension premium. In case of a tax exposure of 40%, this will result in a total net capital at age 65 of € 877.336,-. And (for sake of comparison) into a net lifelong annuity of **€ 40.000,-.**

Conclusion

If we translate the mentioned difference into a net cash value as of pension age 65 at an interest rate of 2%, then the pension plan with tax benefits generates an additional net pension capital of **€ 180.000,-.**

7) Conclusion & Recommendation

Due to the described huge negative impact of the not existing tax benefits for Cash 'Pension Plans', we advise companies to never offer such a plan to their Expats.

Private Pension/Annuity as (Partial) Alternative

In case companies might decide to still ofter such a plan, then we deem it advisable to see if it is possible to decrease that pension claim by also creating a Private Pension Plan with full tax benefits.

Of course the additional costs for such an individual plan would be a negative aspect. But in case the costs are of a regular level, those costs will be easily outweighted by the huge effect of the tax benefits. Which argument is especially valid in case the Expat has still a long time until pension age.

A further positive aspect of Private Pensions/Annuities might be that there is much more pay-out flexibility as compared to Workplace Pension Plans.

In case such a Private Pension/Annuity were to be used, regarding the Next of Kin and Disability Coverage it might be an option to provide by means of a Group Coverage a fine and low cost coverage.