TROUTMAN SANDERS ADVISORY

China Alert

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Foreigners caught by China's New Social Security Law

China recently passed a new social security law which, together with proposed implementing regulations, could require all foreign employees working in China to participate in China's social security system. This will add significant costs and complexity to every company in China that employs foreign staff.

This China Alert outlines the new law and summarizes the main changes it will bring to China's social security regime and to employers.

Overview of the New Law

After 16 years of debate and several redrafts, the PRC Social Insurance Law 社会保险法 (the "New Law") was enacted by the Standing Committee of the National People's Congress on 28 October 2010 and will take effect on July 1, 2011.

The New Law regulates China's five basic social security schemes: basic pension, basic medical insurance, unemployment insurance, work-related injury insurance and maternity insurance. It is the first comprehensive law in China consolidating and regulating these schemes and associated administrative issues, such as collection of premiums, management of funds and supervision of the schemes. China's housing fund scheme for Chinese nationals will continue to be governed under separate regulations.

Under China's existing social security regime, provisions regarding the five basic social security schemes have been governed by a hodge-podge of national and local regulations and policies which has resulted in inconsistent enforcement, misappropriation and inadequate protection for employees in many locales.

The New Law covers all employers within China and all full-time and part-time employees as well as self-employed individuals, including migrant workers and foreigners, working in the PRC. Employees from Hong Kong, Macau and Taiwan are also covered. Participation is mandatory for all full-time and part-time employees but employers are only liable to pay premiums for all five schemes in respect of full-time staff.

Continuity

The New Law will reform and modernize China's social security regime but for most PRC citizens, the basic principles, including the breakdown of contributions and employee entitlements under the new regime will not change significantly. As far as Chinese nationals are concerned, the main changes will mainly be on the administrative side.

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In China, employees contribute a bit more than 10% of their gross monthly income towards basic pension, basic medical insurance and unemployment insurance and employers also contribute. Employers alone contribute to maternity and work-related injury insurances schemes, an arrangement that will continue under the New Law.

The amount of premiums paid by employees and employers will also remain the same since the Chinese government has opted against unifying contribution rates for now. Contributions will continue to be calculated as a percentage of employee salaries up to specified maximums (ie: capped at three times the local average monthly wage). For example, regardless of an employee's actual salary, the maximum annual employer contribution per employee in Beijing will be Rmb49,150 and Rmb51,900 for employees working in Shanghai. Employees will continue to pay no more than Rmb15,915 in Beijing and no more than Rmb15,430 in Shanghai. The combined annual premiums for staff earning more than Rmb11,000-12,500 per month will continue to be approximately U.S.$10,000.

Key Changes

The New Law introduces a host of new provisions to China's social security regime including the following:

- *Greater portability of entitlements.*
- *Flexible medical insurance payment arrangements.*
- *A reduction in risk and costs to employers for work-related injuries.*
- *Flexibility for contributing to basic pension insurance even after employees reach retirement age.*
- *Stricter and wider liability for non-compliance.*
- *Significantly enhanced collection methods.*
- *Mandatory participation by foreign employees.*

By far, the last change appears to be the most controversial feature of the new regime. Provisions within the New Law stipulate that foreign employees will participate in China's social security regime but provide no details. However, draft regulations circulated earlier this month for public comment and subsequent statements by officials make it clear that China's Central Government intends coverage to be mandatory for all foreign staff working in China.

According to the *Interim Measures on Participation of Foreign Nationals Working in China in Social Insurance* 在中国境内就业的外国人参加社会保险暂行办法 (the "Interim Measures"), all foreign employees including those from Hong Kong, Macau and Taiwan working in China are required to participate in all five basic social security schemes. Under the Interim Measures, only foreign nationals whose countries have already executed bilateral or multilateral social security treaties with China will be exempt from participation provided they can prove that they are continuing to make contributions in their home countries. At the moment, only Germany and South Korea have signed such treaties with China.

Concerns

HR managers are understandably concerned about the proposed new arrangements. First and foremost, the attendant costs of the new regime are an unwelcome burden. Foreign investors are still reeling from steep escalations of payroll costs that resulted from the 2008 PRC Labor Contract Law as well as last year's imposition of education and urban maintenance and construction taxes.

The additional costs of providing coverage for migrant workers alone will be a huge burden for many employers. If the Interim Measures are passed into law, social security contributions for foreign staff – who typically earn above the local cap (approximately Rmb11,000-12,500 per month) – will entail a huge additional cost for many employers. Those costs will be roughly **U.S.$10,000/year** for every employee earning in excess of the local cap. Most of this will be borne by employers. Employers will also bear the administrative expense of complying with the new registration requirements and complexity under the new regime.

Secondly, there are misgivings about the expected standard of benefits provided under China's social security scheme relative to the cost. China's social security schemes are regarded as decrepit even by Chinese standards. Quality medical insurance, pension plans and maternity care can be and frequently are obtained in the private sector for less than the premiums paid to China's social security scheme. Whilst the Interim Measures enable employees to 'cash out' their own contributions to the basic pension scheme and medical scheme when they leave China or draw them as pensions when they retire after 15 years, it remains to be seen how many foreign employees will claim pension benefits in China.

Neither foreign employees nor their employers will be able to recover any employer contributions to any of the schemes and, assuming that the basic pension scheme will operate the same for foreign employees as for local staff, foreign employees will not be entitled to any interest or other appreciation on the premiums they pay. Employers regard these contributions as just another form of tax.

Thirdly, the New Law leaves a great many questions unanswered and HR managers are concerned that as detailed rules and local regulations are promulgated over the coming months, additional compliance hurdles and costs will be added.

In light of these concerns, the European Chamber of Commerce and American Chamber of Commerce have both recently urged the Central Government to reconsider making foreign employee participation compulsory for now.

Conclusion

It is too early to say how employers will respond to China's new social security regime. Given the heavy penalties for non-compliance, most will take the necessary steps to ensure that they do not fall afoul of the new regime.

For many employers, the new social security regime will entail significant costs as contributions are made for migrant workers, and possibly foreign staff, for the first time. This, at a time when labor costs have continued to escalate, is exceptionally bad timing. The additional cost pressure will provide fresh impetus to replacing foreign staff with local personnel and foregoing operations which cannot be staffed with local personnel.

The manner in which the PRC government has chosen to introduce the new regime is confusing. The new registration and other administrative requirements imposed by the New Law are clear enough but there has still been no official confirmation when foreign staff will need to participate in the new regime. An official confirmation is likely to be issued in the coming weeks and if participation is mandatory, it will probably be retroactive to July 1. Until a decision is made, employers are under no legal obligation to make contributions for foreign staff or demand that the staff themselves contribute to China's social security schemes.

A decision confirming mandatory participation by foreign staff, if it comes, will hardly be welcome news to most foreign staff or their employers. For employers that are already providing private coverage medical and pension coverage to their foreign staff, mandatory participation will result in duplication of costs. Only Korean and German nationals who continue their social security contributions at home will be entitled to opt out of the new arrangements while they work in China.

The New Law comes into force on July 1. Employers should assess their existing payroll arrangements for migrant and foreign staff, if they have not already done so, and make changes for all new, part-time and migrant staff effective July 1. They should also review any existing private benefits being provided for staff and decide whether or not to these are to be renewed. Employers and self-employed individuals would be well-advised to continue monitoring regulatory updates relating to social security schemes from both national and local levels in the coming months, to ensure that regardless of the new changes, they remain in compliance.