

Hiring Staff

Dezan Shira & Associates

Hiring staff is one of the first key decisions a company will come across. Before a company decides to employ significant numbers in China it should take into account all the issues introduced in this chapter. It may be acceptable, or even sensible, to hire a few employees without investing money in developing rulebooks, policies, and complex salary structures, but as a company grows it needs to protect its interests and define employment relationships in a clear manner.

This chapter discusses some options available to companies, introduces a few concepts unique to China, explains the requirements of the social insurance system as they relate to employers, and covers some other critical points that should be addressed.

2.1 Contract Types

One of the first questions a manager will wish to consider when hiring staff is whether or not the company should offer a direct labor contract for a particular position.

When hiring in China, there are a number of points to take into account:

1. The nature of the job.
2. Is the position likely to be a permanent one?
3. What kind of responsibilities will the employee have within the organization?
4. The effect on the motivation and sense of belonging of the employee.
5. Whether or not the company is able to employ people directly in China.

The first four points will be considered by employers all over the world. If the role is expected to be a permanent one carrying a large degree of responsibility, then the employer will generally look to hire the employee directly. If the role is transitory or “non-core,” then an employer will often look to second an employee from an agency, or outsource the role completely. These issues are equally relevant in



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Establishing and Running a Business in China

This guide discusses foreign investment structures in terms of suitability and feasibility by business goal, documentation, and procedure for setup, and need-to-know points for analyzing and ensuring legal compliance. This includes pre-investment considerations, foreign-invested commercial enterprises, representative offices, wholly foreign-owned enterprises, joint ventures, mergers & acquisitions, making changes to an investment, and legal due diligence.

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China. The key point for the company will be how to accommodate the employment relationship within the Chinese Labor Contract Law.

In China there are four types of permissible employment relationships that can be entered into between a private company and an individual:

- (i) Job contract.
- (ii) Part-time contract.
- (iii) Fixed-term labor contract.
- (iv) Open-term labor contract.

In addition to these four types of contracts, which are all entered into directly between the employee and the employer, the following options are also available:

- (v) Dispatch of staff (secondment).
- (vi) Outsourcing.

When can an employee be hired directly?

In principle, any company located anywhere in the world may employ a Chinese person to physically work in China. However, unless the employment contract is entered into via an invested entity on the Chinese mainland it will not be regulated by relevant Chinese legislation.¹ The company will not be able to make mandatory benefit contributions to the employee in China or deduct individual income tax before paying salary to the employee.

Note that foreign companies that have established a representative office (RO) in China do not have the ability to hire staff directly. Instead, Chinese staff must be seconded from an agency that will take the title of official employer. Foreign staff working for ROs should have an employment relationship with the parent company abroad, and any disputes should be settled under the laws of that country.

The reason for restricting the right of an RO to employ staff is quite simple; it is not a capitalized legal entity in China. An employee must have the right to claim against their employer, and an RO will not be a suitable entity to claim against. By forcing ROs to employ staff through an agency (which is a capitalized legal entity in China), the interests of the employee are protected.

1 Article 2 of the Labor Law of the People's Republic of China implemented on January 1, 1995.

(i) *Job contract*

In China it is possible to enter into an employment contract that allows a company to hire a person to implement a specific project. Once the project is completed, the employment relationship naturally comes to an end. The company should pay compensation in accordance with guidelines in the Labor Contract Law to the employee at this time.¹

This type of contract is sometimes used for seasonal jobs where the scope of work can be defined very clearly. However, in most situations defining such a contract can be a challenge. How does one adequately define the completion of a project? What to do if the project is not completed for some reason? How should employees be compensated in such circumstances?

Unlike a contract with another company for provision of services to complete a project, the job contract forms an employer–employee relationship. As such, when there is a dispute the court will tend to protect the interests of the employee to a greater extent than those of the employer. In addition, no probation period is allowed for such a job contract.² These considerations, combined with the difficulty of defining an appropriate contract scope, deter most employers from entering into job contracts with employees.

(ii) *Part-time contract*

The application of this type of contract is quite restricted in China. The main conditions are the following:

- The employee may not work for more than 4 h a day.
- The employee may not work for more than 24 h per week.
- No probation period allowed.
- Payment must be made to the employee at least every 15 days.³

For these reasons, the part-time contract is used by employers only in limited circumstances. Such a contract could be appropriate for an office cleaner, or some other role where the tasks can be completed within a relatively short period of time each day.

Please note that part-time workers should be paid at least the minimum hourly wage

(iii) *Fixed-term contract*

The vast majority of employees hired in the private sector in China are given fixed-term contracts. Generally the contracts are for full-time

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¹ Article 22 of the Implementation Rules for the Labor Contract Law implemented on September 18, 2008.

² Article 19 of the Labor Contract Law implemented on January 1, 2008.

³ Articles 68, 70, and 72 of the Labor Contract Law implemented on January 1, 2008.

positions (although they do not have to be). The key point to consider for employers is what length of contract to offer each staff member.

A fixed-term contract can be of any length.⁴ However, the length of fixed-term contract offered to an employee has a major effect on the subsequent employer–employee relationship:

- A fixed-term contract can only be renewed once. On the occasion of the second renewal the contract effectively becomes an open-term contract.⁵
- The length of the fixed-term contract will determine the maximum length of the probation period that the company can offer to the employee.⁶

Maximum probation periods by contract period	
Contract period	Maximum probation period
Less than 3 months	None
3 months to 1 year	1 month
Over 1 year, less than 3 years	2 months
3+ years (or open-term contract)	6 months

In cases where a company is acquired by another investor, the new owner is not able to insist that existing employees go through another period of probation.³⁵ Similarly, a new probation period cannot be enforced if the employee is promoted or moved to another position within the organization.

What are the benefits and risks of a probation period in an employment contract?

During a probation period, employers can pay 80 % of the full salary as stipulated in the employment contract (no lower than minimum wage benchmark) and more easily terminate employees than under fixed-term contracts.

In contrast, an employee still within their probation period can resign from the company after giving just 3 days’ notice. Employers may want to consider this point if they offer employees a particularly long probation period (for instance, 6 months). It is not advisable to give a large amount of responsibility to an employee who is able to resign at such short notice.

⁴ Article 13 of Labor Contract Law implemented on January 1, 2008.
⁵ Article 14 of Labor Contract Law implemented on January 1, 2008.
⁶ Article 19 of Labor Contract Law implemented on January 1, 2008.

(iv) *Open-term contract*

An open-term contract is one that effectively guarantees an employee job security until retirement age, unless some exceptional circumstances affect the company or the individual. It can be quite difficult to terminate an employee who possesses an open-term contract.

When will an employer be required to offer an employee an open-term contract?

An employee who has been working continuously for the same employer for 10 years, or who has had their fixed-term employment contract renewed twice since the Labor Contract Law came into force in 2008 is deemed to hold an “open-term” contract.

An employee who has worked continuously for the same employer for a full year but has not concluded a written labor contract is also deemed to hold an “open-term” contract¹. If the company does not conclude open-term contracts to employees in these circumstances, the company is required to pay double the amount of the original labor remuneration to the employee on a monthly basis commencing from the date when it fails to conclude the open-term contract.²

¹ Article 14 of Labor Contract Law implemented on January 1, 2008.

² Article 82 of Labor Contract Law of the People's Republic of China implemented on January 1, 2008.

(v) *Dispatch contract (secondment)*

A dispatch contract (secondment) describes the situation in which an agency dispatches an employee to work at another organization. In China, the market for staff dispatch services is a very large and lucrative one including many organizations using the name “FESCO,” which stands for Foreign Enterprise Service Company.

Representative offices must recruit their Chinese employees through dispatch contracts, and dispatch agents can also be quite useful for other foreign-invested entities on occasion.

While a FESCO will not take liability for financial compensation—this will be quite clear in the initial agreement—in the case of a labor dispute (on issues such as performance, termination of the labor contract, salary payments, social insurances payment, training, labor protection, etc.), the FESCO can get involved in the negotiation, arbitration, and/or litigation. Many of these companies are state-owned and some of them have a strong legal team (especially for employment issues) and are familiar with local arbitration and litigation process. FESCO's involvement in labor disputes can sometimes help to achieve a resolution.

2 “In the case of a labor dispute, the FESCO can get involved in the negotiation, arbitration, and/or litigation.”

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In addition, FESCOs can also be useful for foreign-invested entities during the pre-incorporation period, during which preparation work often requires the assistance of Chinese employees. A foreign-invested entity cannot establish a legal contract under Chinese Labor Law with a Chinese individual before the entity obtains its business license. Some FESCOs (not all) will agree to hire the Chinese employee and dispatch them to the foreign-invested entity that is still under the process of incorporation, generally on the condition of a 3–4 month cash deposit of all salary and social insurance payments.

Labor Contract Law stipulates that workers dispatched from a FESCO should generally assume temporary, substitute, or auxiliary positions. In the past, this directive has often been ignored and FESCOs have been used to hire a wide variety of Chinese workers upon the client's request. However, recently drafted legislation regarding the obligation of employers to directly employ core staff has brought extra risk to companies employing a large portion of their employees through agencies, and many companies are now reconsidering their approach to hiring in light of this new regulation.

Article 66 of the Amendment to the Labor Contract Law of the People's Republic of China (Draft) is amended to read as follows: “labor dispatch shall exclusively apply to provisional, auxiliary or substitutive positions...a provisional position offered by the employer refers to a position that exists for no longer than 6 months; an auxiliary position offered by the employer refers to a position which is orientated to providing services to the positions of the primary business of the employer; a substitutive position refers to a position that is held by a labor dispatch worker on a substitutive basis during the time when the employee of the employer that originally holds the position is unable to hold the position because the employee is undergoing full-time training or on vacation.”

One thing to keep in mind about FESCOs is that, according to Labor Contract Law, they can only offer fixed-term contracts for at least 2 years. An employer may still terminate the employment relationship with the Chinese employees, following the stipulations of Labor Contract Law and the agreement signed with FESCO.

According to legislation available as of July 2012, it is unclear whether an employee that is working under an agency contract will have the opportunity to achieve an open-term contract with the company after expiration of two fixed-term contracts. Options beyond a fixed-term contract include a service agreement or part-time arrangement based on relevant Chinese laws and regulations, which can be terminated more easily.

Furthermore, some FESCOs also carry out other services such as executive search work (headhunting) on behalf of their clients, which could create a conflict of interest between payroll clients (who supply confidential personal and salary information) and headhunting clients (for whom the knowledge of such confidential data is valuable)

(vi) *Outsourcing*

Tasks that are most commonly outsourced are those that require specific specialist skills, a high degree of confidentiality, or those that have a clear scope but incur major consequences when they are wrongly implemented. Good examples of such tasks are accounting, tax filing, HR administration, and payroll processing work. Most small- and medium-sized companies will choose to completely outsource some or all of these functions, whereas some large companies will set up a separate entity to manage such “back-office” tasks on behalf of all the other entities in the region.

An outsourcing contract is fundamentally different from a secondment contract in several different ways:

- Responsibility for the behavior of the employee carrying out the task is maintained by the company contracted for the outsourcing.
- The role is often not a full-time one, and most of the work does not have to be completed on-site (working off-site improves the level of confidentiality). As the company does not need to hire a full-time internal resource for the role, outsourcing can often be a money-saving solution.
- The outsourcing company retains the right to use whichever resources it feels are best for each project. This ensures continuity in service provision.
- Often such tasks will use some special software which is licensed by the company contracted for the outsourcing. The company requesting the services does not need to pay for software licenses or development work.

The outsourcing solution works well for back-office tasks that are not industry specific. As outsourcers become more efficient, there is a growing trend for companies to use such services instead of relying on internal staff for functions unrelated to their fundamental business.

Beyond a labor contract, what additional agreements may be necessary?

Additional agreements, such as a confidentiality agreement or non-competition agreement, may be signed at the same time as the labor contract. Confidentiality agreements, which normally cover corporate secrets, may include terms relating to ownership of patents for inventions created by employees. A non-competition agreement, which aims to prevent an employee from working for a competitor after terminating the labor contract is usually used only for senior positions and can be signed for a

maximum period of 2 years. Companies are obligated to continue paying a proportion of the employee's salary after his/her departure from the company in order to maintain the effectiveness of the non-competition agreement.

Will the Real FESCO Please Stand Up?

Many foreign-invested companies and representative offices in China have a contract in place with a FESCO (Foreign Enterprise Service Company) for labor dispatch, payroll, and/or additional services for Chinese employees.

A large proportion of managers at such companies assume that FESCO is a single organization, but in fact it is a generic term used by dozens of local HR companies around the country. There are often multiple competing “FESCO” organizations in each city; some subsidiaries or affiliates of companies in another part of the country, some partially state-owned and some 100 % privately owned.

The English term “FESCO” is a generic one, indicating nothing more than the type of service provided by the company. Because of the widely held misconception that FESCO is one company, the “brand” is a powerful marketing tool, and the term is often casually used to refer to companies providing similar services.

There are a couple of other large players in this market providing similar services to FESCO, but using a different brand. One is called CIIC (China International Intellectech Corporation—Chinese name 中国国际技术智力合作公司). CIIC is a state-owned organization based in Beijing and has subsidiaries, affiliates, or branches around the country. In this sense it has a larger network than any of the various FESCOs.

The other large player is known in English as China Star (Chinese name 中国四达国际经济技术合作公司). Headquartered in Beijing, it also has branches in Shanghai, Shenzhen, and Guangzhou.

It is important that foreign investors realize that FESCO is not a single organization and that organizations by other names can offer the same services. Many general managers operate under the misconception that their organization (especially if it is a representative office) has no negotiating power with FESCOs, and simply accept the quoted price they provide without question.

2.2 Designing a Labor Contract

Once a conclusion has been reached concerning the issue of what kind of contract the company wishes to enter into for a particular role (direct employment, secondment or outsourcing), the next step will be the drafting of the contract. Normally, employment agencies and outsourcing companies will have their own template for the services they provide, but the company will need to design a labor contract template for its directly hired staff. As the majority of employees are employed on fixed-term labor contracts we will concentrate on this type of contract in our explanation below.

The first condition that should be met when employing Chinese employees is for a written labor contract to be completed within one month of the commencement of the employment relationship. If this condition is not observed, under the terms of the Labor Contract Law an employee may claim double salary for each of the months worked without a written labor contract after the first month.⁷ If the situation persists for a period of more than one year, the company is deemed to have provided the employee with an open-term contract.⁸

Secondly, when employing Chinese employees the contract should be drafted in the Chinese language. It is acceptable to include an English translation along with the Chinese text, but note that the Chinese version will take priority in case of any dispute. Therefore, it is advisable that contracts are either drafted in Chinese using a legally trained professional before translating into English, or drafted in English and then translated into Chinese by a legally trained professional.

Every local Labor Bureau has a template for a standard labor contract, but it is in Chinese only. It is possible to use this template for all the contracts you enter into, however, we would not recommend this in every circumstance. A template designed with specific corporate requirements will offer more protection. We would suggest combining a standard template with a labor contract used in other countries where your company has large operations.

This document should be shown to a professional trained in Chinese Labor Law to add, remove, or amend clauses as necessary. Certain clauses inserted into a draft labor contract may be inadmissible under Chinese law. Including such clauses in the final version of a labor contract will only provide a false sense of security to the employer; in the event of a dispute, any such clauses will be deemed illegal by the court.



FOR MORE INFORMATION

International Related Party Transactions

In this issue of China Briefing, we turn once again to the issue of international transactions, specifically those between related parties.

Including:

- Service Agreements for HQ and Subsidiaries.
- A Briefing Overview of China's Transfer Pricing Obligations.
- Cross-border RMB Pilot Settlement Project.
- Q&A: How do royalty remittances work?

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⁷ Article 82 of the Labor Contract Law implemented on January 1, 2008.

⁸ Article 14 of the Labor Contract Law implemented on January 1, 2008.

What information should be included in any labor contract? The following is mandatory⁹:

1. Name of the company, address, name of the legal representative or a senior manager.
2. The name of the employee together with a valid address and identification number.
3. Commencement date and duration of the contract.
4. A description of the job and the location where it is to be implemented.
5. Working hours, vacation provided, and length and frequency of break times.
6. Salary details.
7. Indication that the employer will contribute social insurance for the employee.
8. Labor protection, labor conditions, and protection from occupational hazards.

How much annual leave must be given?

The required minimum amount of annual leave in China (in addition to at least one rest day per week and the public holidays) is 5 days. This requirement only commences once the employee has worked for one continuous year.¹ Therefore, it is not mandatory for the company to provide any annual leave to the employee in the first year of their employment if the employee has not worked in any other company for more than a year prior to joining.

In practice, the vast majority of foreign invested companies realize that their employees are more productive when allowed periodic breaks. Although annual leave periods are generally shorter than in the west, most employees working at foreign invested companies receive 15–25 days of annual leave per year.

1 Article 3, Rules on Employees' Paid Time Off, State Council, implemented on January 1, 2008.

There may be some other mandatory requirements depending on the location of the company entering into the labor contract. If important mandatory items are not adequately addressed in the labor contract, there is a possibility that the contract may be deemed by the authorities to represent an open-term contract.

⁹ *Article 17 of the Labor Contract Law implemented on January 1, 2008.*

There are a number of other clauses that may be beneficial to insert into certain contract templates. Examples are:

- Non-competition clauses.
- Confidentiality clauses.
- Allowances and benefits (particularly for foreign employees).
- Length of probationary period.
- Stock options.

We also recommend that some reference be made to the company rulebook in the employment contract. This makes a clear association between the signing of the employment contract by the employee and their observation of the company rules.

In certain cities, once the template has been drafted it should be taken to the local Labor Bureau for verification. If you fail to do this, the validity of some of the clauses may be challenged by your employees in the event of a dispute arising from the implementation of such a contract. Note that the approval should be renewed by the Labor Bureau every time an amendment is made to the template.

Finally, the contract should be chopped clearly using the Chinese entity's company chop (and of course signed by the employee) before it is considered to be valid. Similar attention should be paid to safeguarding of labor contracts. Not only do such contracts contain confidential information, it could also be costly for the company if the contracts were lost or stolen.

When does a written labor contract need to be completed by?

According to the Labor Contract Law, an employer must ensure that it has completed a written labor contract with every staff member within 1 month of the employee commencing work.¹

This is important because if such a contract is not in place by the end of the first month the employee shall have the right to claim double salary for the period in which the company remains out of compliance with this regulation. Therefore, if the company does not fulfill this obligation with an employee until the end of the third month of their employment it shall be liable to pay 2 months of additional salary to that employee.

If the company neglects to complete such a contract after the employee has worked for one whole year, not only can the employee claim double salary for the previous 11 months, they can also claim an open-term contract from the employer.² This will mean that the employer loses the ability to terminate the contract of the employee at the end of the fixed-term contract.

Note here that the employment relationship is deemed to have started from the first day the employee works at the company, not from the date of signature of the contract. So as long as

the employee can prove that they have physically been working for the company for over a month prior to signing an employment contract this will be sufficient to make a successful claim against the company. Of course, the simplest piece of evidence proving this will be the receipt of salary.

Therefore employers should not expect their employees to chase them for signing written labor contracts or open-term contracts—it could potentially be in their interests not to sign, especially in the event of a future dispute with the company. The company must take the initiative to ensure such contracts are signed promptly. A system should be put in place so that there is no possibility for any employee to be overlooked. One effective safety mechanism would be to only release salary to employees once written labor contracts are put in place. As salary is generally paid once per month, this would incentivize the employee to sign while ensuring the employer remains in compliance.

1 Article 10 of the Labor Contract Law implemented on January 1, 2008.

2 Article 14 and Article 82 of the Labor Contract Law implemented on January 1, 2008.

What should be done at labor contract renewal, promotion or transfer?

Upon renewal of a labor contract, a labor contract renewal form should be filled out. It could include the following details:

- Name of employee, position, commencement, and expiry date of labor contract.
- A self-evaluation by the employee of their performance.
- An evaluation by the supervisor of the employee's performance.
- The period covered by the renewal.
- The document should be signed and stamped by employee, supervisor, and HR department.

When the employee receives a promotion or a transfer, it is normally not necessary to rewrite the employment contract. More commonly, the change is registered using a promotion or internal transfer form. This form will usually show the date, previous title, and new title. Normally, it will not include any information about new salary details, and the company will reserve the right to place the employee back in the original position if they do not prove

suitable during the evaluation period. This way, the company does not incur any immediate liability to guarantee a promoted employee a higher wage if it is discovered they are not suited to the position.

2.3 Structuring a Salary Package

Structure of the salary package payable for each position in a company should be given careful consideration. Certain employees need to be incentivized, while other roles require a more fixed form of salary. Furthermore, the employer should consider the amount of IIT that will be payable by the employee. This is particularly important if the company offers a “net” salary package to its employees.

Base Salary and Bonus

The first component is base salary—a fixed amount that is guaranteed to be paid to the employee by the company. The initial base salary should be clearly stated in the labor contract.

It is also possible to include some one-off payments—many companies make a 13th month salary payment around Chinese New Year time. Please note that if this information is included in the labor contract the company is legally obligated to pay it.

An alternative option would be to pay this amount in the form of an annual bonus. It could be explained to staff that although the company will generally pay this amount under normal business circumstances; there is no obligation for the company to pay the bonus if corporate performance is below expectations. Under such conditions there is no need to include it in the labor contract.

Other bonuses can also be paid to staff at various points during the year. From a taxation perspective it is more efficient to combine bonus payments so that they are paid during the same month because in China employees are allowed to use a special tax treatment once a year to reduce their IIT burden.

Payment of annual bonus versus quarterly bonus		
An employee was transferred from the U.S. HQ to a China subsidiary. In 2011, he stayed in China for 365 days and was paid a monthly salary of RMB110,000		
	Quarterly Bonus Payment	Annual Bonus Payment
IIT	Quarterly bonus = RMB50,000 per quarter $IIT = RMB50,000 \times 45 \% \times 3 \text{ months} + (RMB50,000 \times 10 \% - RMB105) = RMB72,395$ This is because for three of the four quarters the bonus must be treated as additional salary	Annual bonus = RMB200,000 $IIT = (RMB200,000 \times 25 \% - RMB1005) = RMB48,995$
IIT savings	$RMB72,395 - RMB48,995 = RMB23,400$	

Allowances

The Chinese Tax Bureau allows foreign staff (including those from Hong Kong, Macau, and Taiwan) to deduct certain “allowances” before calculating the tax burden on their monthly salary.¹⁰ There are two prerequisites to this:

1. In the employment contract (and sometimes also in a board resolution depending on the location of the company) there should be a clear reference to the amount being paid to the employee under the title of each specific allowance.
2. Each month the employee should produce evidence to show the company that this money was indeed spent on the services described in the contract; this is done using the ubiquitous “fapiao,” or official invoice, that should be received whenever an official monetary transaction is completed in China (in some cities, the name of the company must be clearly written on the fapiao for it to be permitted as a deduction).

Let us look at the deductions that are allowable one-by-one:

(a) Meal allowance

Foreign employees are allowed to deduct a certain amount that they spend on meals each month from their taxable income. Most of the fapiaos submitted should be issued by restaurants; although for some portion of the allowance fapiaos issued by supermarkets may also be accepted. Please note that the fapiao should state that the product purchased was “meals” or “food.”

(b) Housing allowance

The amount spent on rental of an apartment may also be deducted. However, please be aware that in China a private landlord will often be reluctant to issue an official fapiao because in order to obtain one, he/she must pay approximately 17 % of the rental amount received to the Tax Bureau. If a fapiao is requested the landlord will likely charge a large premium on top of the originally negotiated rental amount. Foreign employees that require a fapiao should negotiate this with the landlord before signing the rental contract. Fapiao issuance should be clearly mentioned in the agreement. Foreign employees living in a serviced residence will not have this problem—the residence will be managed by a company that can issue a fapiao.

(c) Laundry allowance

This is fairly self-explanatory—an allowance for the dry cleaning of clothes, etc.

10 Clarifications of the State Tax Bureau on Several Issues on Foreign Individual Income Tax, implemented on April 9, 1997.

(d) Children's education allowance

Some of the cost of a foreign employee's education expense for the studying of Chinese language or relating to the education of their children can be deducted. Note that the education must be received here in China, and as with the other allowances above, a fapiao must be received.

(e) Home visit allowance

Each year a foreign employee is allowed to deduct the cost of one or two return flights back to their home country (usually the cost of a ticket up to business class may be permitted). Note that flights to other destinations are normally not accepted. Cost of hotels and other expenses are also not accepted as this is considered a home visit allowance, not a vacation allowance.

One key point is how much of a foreign employee's salary can be allocated to allowances. This is something that is not clearly defined by the law, which stipulates that the allowances should be "reasonable."¹¹ In practice, many companies adopt a proportion of 30 % of the total salary of the foreign employee and classify this portion as allowances. There is always the possibility that the tax office will challenge the company on this issue, so we recommend that the proportion of allowance should be set at or below this level.

Mandatory Benefits (Social Insurance)

The next portion of the salary package is social insurance, often referred to in China as mandatory benefit. Contributions are made by both the employee and employer. The employee's portion is deducted from their gross salary. The proportions and maximum contributions made by employer and employee vary depending on where the business is located.

Some employers choose to enroll their employees in additional pension plans or other types of wealth accumulation plans. This is legal, but please note that only the mandatory benefits specified in the IIT laws can be deducted before calculation of IIT.¹²

Defining Net Salary

Normally "net" is defined as the amount employees receive into their pocket each month after payment of IIT and the employee's portion of social insurance. It is more commonly offered to blue-collar workers who may not understand the details of the Chinese social insurance or IIT systems.

¹¹ Article 1 of the Clarifications of the State Tax Bureau on Several Issues on Foreign Individual Income Tax, implemented on April 9, 1997.

¹² Article 25 of the Implementation Rules for the Individual Income Tax Law implemented on March 1, 2008.

Misunderstandings between managers and employees over the definition of “net” salary are commonplace. If your company intends to offer such packages to employees we suggest the HR Department draws up a clear example to explain to each employee how their salary package will be structured, and to show them how much money they will be able to take home every month.

The total of the base salary, allowances, bonuses, non-mandatory pension plans, and the employer’s portion of social insurance contribution are added together to form the total compensation and benefits (C&B) amount.

Example: Total expenses, Net salary, and IIT by Social Insurance Contribution Payment Party		
A company pays an employee a monthly salary of RMB10,000 per month. The company’s social insurance contribution is 39 % of the employee’s monthly salary, which the employee’s contribution is 21 %		
	Company pays only social insurance contributions required of the company	Company pays social insurance contributions required by both company and employee
Gross salary for the employee	$\text{RMB}10,000 \times (1 - 21\%) = \text{RMB}7,900$	RMB10,000
IIT for the employee	$(\text{RMB}7,900 - \text{RMB}3,500) \times 10\% - \text{RMB}105 = \text{RMB}335$	$(\text{RMB}10,000 - \text{RMB}3,500) \times 20\% - \text{RMB}555 = \text{RMB}745$
Net salary for the employee	$\text{RMB}10,000 - \text{RMB}100 - \text{RMB}335 = \text{RMB}7,565$	$\text{RMB}10,000 - \text{RMB}745 = \text{RMB}9,255$
Total expenses for the employer	$\text{RMB}10,000 + (\text{RMB}10,000 \times 39\%) = \text{RMB}13,900$	$\text{RMB}10,000 + (\text{RMB}10,000 \times (39\% + 21\%)) = \text{RMB}16,000$

2.4 Mandatory Benefits (Social Insurance)

Social security in China is a complex topic because it is organized on a regional level. The formal social security system only covers urban workers, and partially covers rural workers who have come to the cities to work (the so-called “floating population”).

In this section we will introduce the various components of the Chinese social security system, some examples of contributions that need to be made by employees and employers in various cities, and the conditions under which employees can make claims.

China’s Social Security System is made up of five different kinds of insurance, plus one mandatory housing fund. The insurances are as follows:

Pension

Pensions for workers in China are financed by contributions from both the employee and the employer. The portion contributed by the employer is normally higher than the portion contributed by the employee. As a general rule the employer’s contribution is usually between 10–22 % of monthly salary. The employee will usually contribute around 8 %.

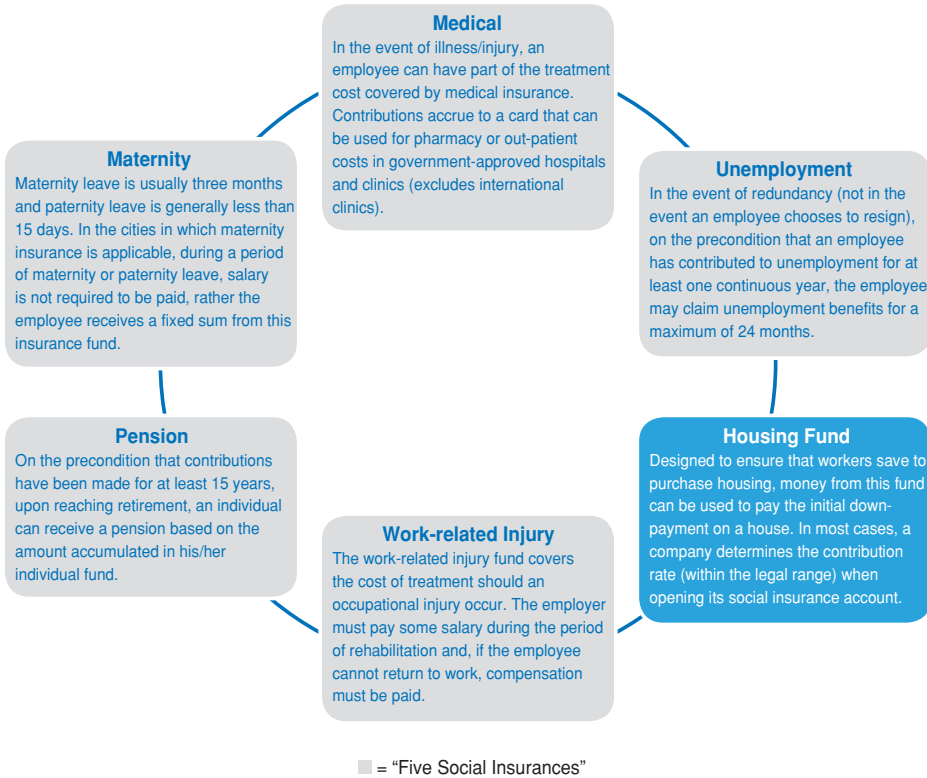


FOR MORE INFORMATION
*China’s Social Insurance System
presented by Adam Livermore*

Through an introduction to the five different types of Social Security in China, Adam Livermore illuminates the current regulations, benefits, and consequences of China’s Social Security System. The five types of Social Security include: pension, medical insurance, unemployment insurance, work-related injury insurance, and maternity insurance.

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Mandatory Benefit Types



Pension contributions made by the employees go directly into their “personal” pension accounts. The contributions made by the company go into a “social” account.¹³ The overall amount of pension that an individual can draw is based on the overall level of contributions over their working career. Once the personal account is empty, the individual’s pension will be 100 % funded from the social account. In the event that the individual dies before the amount in the personal account is used up, the balance remaining in this account may be inherited by relatives.¹⁴

It is not possible for individuals in China to draw a pension unless they have made contributions for a minimum of 15 consecutive years.¹⁵ Even if an individual loses their job it will still be necessary for them to maintain social security contributions, at least at the minimum level stipulated by

¹³ Article 4 of the Decisions of State Council on Establishing a Unified Basic Pension System for Employees Working in Enterprises implemented on July 16, 1997.

¹⁴ Ibid.

¹⁵ Article 5 of the Decisions of State Council on Establishing a Unified Basic Pension System for Employees working in Enterprises implemented on July 16, 1997.

the authorities. In China the statutory retirement age for men is 60; for white-collar female workers 55; and for blue-collar female workers 50.¹⁶

Unemployment Insurance

In most large cities contributions are made by both the employee and the employer to this fund. The employer contribution can be as high as 2 % of the individual's monthly salary. If an individual becomes unemployed this insurance will pay a fixed amount every month on the condition that contributions have been made on behalf of the employee for a continuous one-year period prior to the application. It will not be related to the amount of money paid by the individual or the company into the fund.¹⁷ Individuals may claim unemployment benefits for a maximum period of 24 months.¹⁸

Medical Insurance

Both employer and employee contribute to this fund. Proportions vary considerably between cities, but generally the company will be expected to contribute between 5–12 % of the employee's monthly salary, while the employee will contribute around 2 %.

In the event an individual falls ill, they will go to the hospital and receive treatment. Usually, just a base charge will have to be paid to the hospital up front by the individual, and the rest of the treatment expense should be received by the hospital from the insurance scheme. The precise portion covered by insurance can depend on the type of sickness or injury.

Each individual covered by medical insurance is issued with a "medical treatment card" and every month a small amount of money is added to the balance in this card. Carriers of this card can make purchases from pharmacies or pay for treatment at hospitals if the balance on the card is sufficient.

Occupational injury Insurance

Contributions to this fund are made by the employer. Usually, the premium is between 0.5–3 % of the monthly salary of the employee, depending on what kind of work is being carried out by the employee.

In the event a worker experiences an injury at work, the employer will collect evidence of the incident and send it to the insurance company. Assuming everything is in order, the insurance company will reimburse

¹⁶ Reply of Ministry of Labor on the Definition of Statutory Retirement Age for Employees working in Enterprises implemented on May 11, 2001.

¹⁷ Article 19 of Beijing Unemployment Insurance Regulations (No. 38 Order issued by Beijing Municipal Government implemented on November 1, 1999.

¹⁸ Article 17 of Beijing Unemployment Insurance Regulations (No. 38 Order issued by Beijing Municipal Government implemented on November 1, 1999.

the employer for the cost of the treatment. The company will remain liable for paying salary to the employee during the period of rehabilitation.¹⁹

Please note that if you have an employee who has a serious injury at work, the company can be liable for all the costs of treatment if the insurance premium has not been paid up-to-date. For this reason it is best to ensure that your new hires are registered with the Social Insurance Bureau and contributions are made promptly.

Maternity Insurance

Usually, only the employer makes a contribution of 0.5–1 %. Under this system a female employee generally takes around 4 months of maternity leave during the period prior to and after the birth of her first child, depending on the location of the employee, age and other factors.²⁰ During this period the insurance will cover the cost of her salary. The calculation of her salary will be based on the contributions made by the individual and the company over the past year, although recent legislation in certain cities has linked the amount of the payout to the average salary paid to employees in the company (rather than the earnings of the individual employee). A fixed amount toward the cost of the childbirth will also be paid out.²¹

As an associated point, the company may not terminate the contract of the employee from point of pregnancy until the baby reaches one year of age.²² If another employee has been hired for the position in the interim period then this person must also be retained at least until the end of the period of that employee's fixed-term contract. If this is not possible then compensation should be paid to the employee in line with the Labor Contract Law.

Housing Fund

Housing fund, although in the strictest sense not a kind of social welfare, is generally included within the scope of social security, because the contributions are mandatory and come from both the employer and the employee (apart from in some special areas like Shenzhen, where the employee does not need to make a contribution).

As its name suggests, the housing fund is designed to ensure that workers save some money in order to purchase a house or an apartment. The employer will usually have to contribute between 7 and 20 % of the employee's salary. In many cities, the employee matches this contribution with an equal contribution of their own, although certain cities have different policies.

¹⁹ Article 31 of *Beijing Occupational Injury Insurance Clauses implemented on January 1, 2004*.

²⁰ Article 14 of *Beijing Enterprise Employee Maternity Insurance Regulations implemented on July 1, 2005*.

²¹ *Ibid.*

²² Article 42 of the *Labor Contract Law implemented on January 1, 2008*.

2 “In Shanghai, social insurance inspections are random. The bureau will call a company a few days prior to the inspection so that all paperwork can be put in order. A company might undergo such an inspection once a year or once every 2–3 years, it’s hard to know.”

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It is possible in many cities to make housing fund contributions in excess of 300 % of the local social average salary to employees. The limit is generally 500 %, although some cities do not set a limit at all. The portion over 300 % will be deemed to be taxable income of the employee. The key point for employers to note is that if you hire employees earning a salary of higher than 300 % of the local social average salary you should make sure to clarify in the offer letter that both employee and employer contributions will be limited by this cap. This can avoid potential problems in the future if the employee claims that higher contributions should be made.

When the employee wishes to purchase a house, the money in the housing fund can be used to pay the initial down-payment on the house, and it can also be used to subsequently pay back the loan to the bank. Furthermore, by producing evidence that funds have been accumulated in an individual’s housing fund the bank may provide a lower rate of interest on the loan. Upon retirement any remaining balance in the housing fund account can be withdrawn and used for any purpose by the individual.²³

Contribution Calculations

Monthly contributions to the social security system are determined from a base figure. In most cities it is calculated as follows²⁴:

Social security base = Previous year’s total income/12.

For new hires, the starting salary may be used as the social security base during the first year. Note that the base figure for social security contributions is capped at 300 % of the social average salary for the location in which the employee pays social security.²⁵ Therefore, any employees earning more than this amount will actually pay a smaller percentage of their salary in social security contributions (employers will also have a smaller percentage burden).

The maximum base figures will generally be updated once per year for all employees. This usually happens in May. Sometimes the government will also adjust the percentages to be contributed by employee and company at this time. Note that although the maximum base figures will usually be updated during the middle of the year, the calculation of each individual employee’s base will be made based on their average salary during the period from January to December of the previous year.²⁶

Participation by Foreign Employees

The inclusion of foreigners into China’s social insurance system was formally indicated when the new Social Insurance Law was promulgated in October 2010. However, it was not until September 2011 that

²³ Article 24 of the Regulation on the Administration of Housing Funds implemented on April 3, 1994 (and revised on March 24, 2002).

²⁴ Article 12 of the Beijing Social Pension Regulations implemented on January 1, 2007.

²⁵ Ibid.

²⁶ Ibid.

China's Ministry of Human Resources and Social Security (MOHRSS) announced in the Interim Measures for Participation in the Social Insurance System by Foreigners Working within the Territory of China that foreigners should be included in the Chinese social insurance system starting from October 15, 2011. The Interim Measures require employers to undertake social insurance registration for foreign employees within 30 days of applying for work permits.

In December 2011, MOHRSS issued a Notice on Guiding Measures for Foreigners Working in China to Participate in the Social Insurance specifically providing guidance on the issue of foreigners' participation in China's social insurance. The Notice requires foreigners who have been working in China prior to October 15 and who meet the participation requirements to register with the MOHRSS authorities by December 31, 2011, or late payment surcharges will be applied. It also provides that foreign employees who are nationals of countries that have concluded social insurance agreements with China can be exempted from certain Chinese social security contributions in accordance with these agreements as long as they produce proof that they participate in the relevant country's social insurance within 3 months of receiving their work permits.

Subsequent to the promulgation of the above national regulations, various cities such as Beijing and Suzhou have issued local implementing rules requiring foreign employees to enroll in the social insurance scheme. However, the implementation of the scheme for foreigners remains uneven and uncertain across China.

Summary

Contributions from the employee and employer can vary considerably depending on the city in which the amounts of contribution are being made. For a company that has employees based in a number of cities around the country this means that the overall cost to the company for an employee earning RMB10,000 in one city may be quite different from someone on the same salary based in another city, although the cost in first-tier cities such as Beijing and Shanghai tend to be similar.

Companies based in large cities may find that if they employ an individual from a regional city in their head office, the employee will request to have social security paid in the city where the company is based rather than in their hometown. The reason is simple—the employee will be able to earn more money via the pension and housing fund.

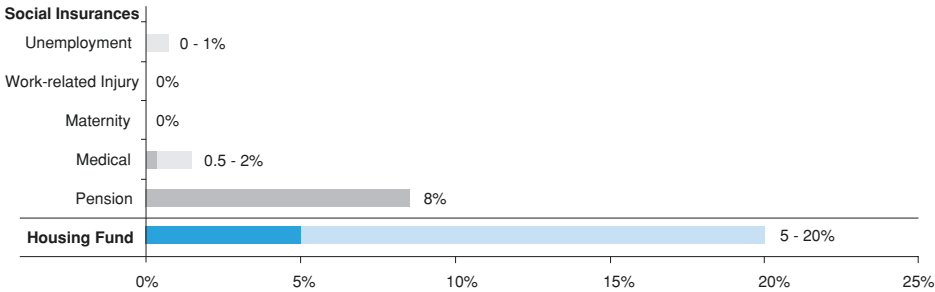
The opposite situation occurs as well. For example, if an employee is relocated from Shanghai to Shenyang the employee will likely request that social security continues to be paid in Shanghai. This is partly because the amount of pension and housing fund receivable in Shanghai will be higher. Additionally, the employee will probably consider the fact that it is unlikely the company will employ them permanently in Shenyang; there is a strong likelihood of a return to Shanghai at some point.

The social security contribution can affect the total compensation and benefits (C&B) cost quite considerably. Companies should take this variance into consideration when deciding where to locate their

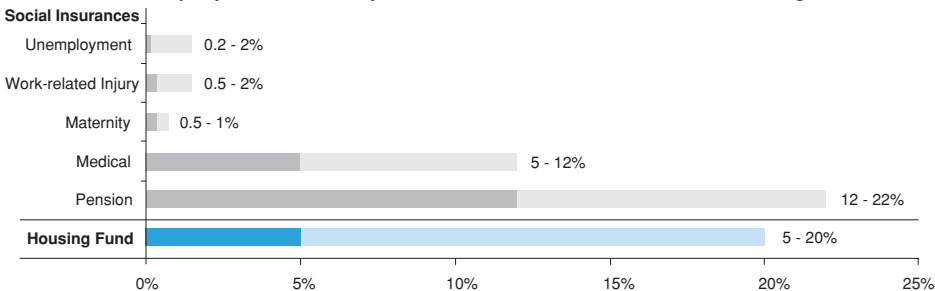
operations. You will find that even within some cities there are different percentages and bases for contribution of social welfare.

2

Employee Mandatory Benefit Minimum Contribution Ranges



Employer Mandatory Benefit Minimum Contribution Ranges



*Penalties for noncompliance can be imposed @ 183 times the outstanding liability. Interest is calculated @ 0.05% per day on the outstanding liability.

Example: Different salary, same social insurance contributions		
Two employees working in Beijing make different salaries, but because of the social insurance payment base (RMB14,016), their social insurance contributions are the same total amount		
	Employee 1	Employee 2
Monthly salary	RMB14,016	RMB20,000
Employer social insurance contribution (44.3 %)	$RMB14,016 \times 44.3 \% = RMB6,209$	$RMB14,016 \times 44.3 \% = RMB6,209$
Employee social insurance contribution (22.2 % + RMB3)	$RMB14,016 \times 22.2 \% + 3 = RMB3,115$	$RMB14,016 \times 22.2 \% + 3 = RMB3,115$

Example: Different cities, similar employer burden		
The employer burden for an employee with a monthly salary of RMB10,000 would be similar in Beijing and Shanghai despite differences in social insurance contribution rates. In Beijing, the employer's social insurance contribution is 44.3 %, while the employee's contribution is 22.2 % + RMB3. In Shanghai, the employer contribution is 44 % and the employee contribution is 18 %. The employee's monthly salary is below the social insurance base in both cities		
	Beijing	Shanghai
Social insurance base	RMB14,016	RMB12,993
Employer social insurance contribution	$RMB10,000 \times 44.3 \% = RMB4,430$	$RMB10,000 \times 44 \% = RMB4,400$
Employee social insurance contribution	$RMB10,000 \times 22.2 \% + RMB3 = RMB2,226$	$RMB10,000 \times 18 \% = RMB1,800$
Net salary paid	$= 10,000 - 2,226 - 322.4 \text{ (IIT)} = RMB7,451.6$	$= 10,000 - 1,800 - 385 \text{ (IIT)} = RMB7,815$
Total employer's burden	$= 10,000 + 4,430 = RMB14,430$	$= 10,000 + 4,400 = RMB14,400$

Mandatory Welfare Payments in Selected Cities (October 2012)

C = Company I = Individual

1 Beijing

	C	I
Pension	20%	8%
Injury	0.5%	0%
Maternity	0.8%	0%
Unemployment	1%	0.2%
Medical	10%	2% + RMB3
Housing fund	12%	12%

2 Shanghai

	C	I
Pension	22%	8%
Injury	0.5%	0%
Maternity	0.8%	0%
Unemployment	1.7%	1%
Medical	12%	2%
Housing fund	7%	7%

3 Guangzhou

	C	I
Pension	20%	8%
Injury	0.25 - 0.75%	0%
Maternity	0.85%	0%
Unemployment	2%	1%
Medical	8% + RMB12.45	2%
Housing fund	5% - 20%	5% - 20%



4 Shenzhen

	C	I
Pension	11%	8%
Injury	0.4%	0%
Maternity	0.5%	0%
Unemployment	0.4%	0%
Medical	6.5%	2%
Housing fund	5 - 20%	5 - 20%

5 Dalian

	C	I
Pension	20%	8%
Injury	0.6 - 2%	0%
Maternity	0.8%	0%
Unemployment	2%	1%
Medical	8%	2%
Housing fund	10, 12 or 25%	10, 12 or 15%

6 Hangzhou

	C	I
Pension	14%	8%
Injury	0.4 - 1.6%	0%
Maternity	0.8%	0%
Unemployment	2%	1%
Medical	11.5%	2% + RMB4
Housing fund	12%	12%

¹ Shenzhen pension contribution by company to non-Shenzhen hukou holders is 10%, not 11%

How do hukou influence social insurance participation today?

A hukou (pronounced hoo-kou) is a kind of domestic passport for all Chinese citizens. A hukou stipulates an employee's home city/country and is either a rural hukou or an urban hukou, with the social insurance system applying only to the latter.

Previously, an employee working outside of his/her hukou area would generally not be able to participate in the mandatory fund benefits of the region of employment. If an employer wished to hire someone from outside the region of employment, the employer could pay mandatory benefit contributions through a branch office or through an employment agency (such as FESCO) in the employee's hukou area.

Since last year when the social insurance system was expanded to include even foreign employees, hukou became mostly irrelevant when determining which local Social Insurance Bureau should receive payments made on behalf of an employee. The company should pay mandatory benefits in the city in which it is based. This way, should an employee want to access medical insurance funds at a local government-approved facility, they can do so conveniently. In addition, the company is familiar with the local government bureaus and can more easily assist the employee in resolving any difficulties in accessing benefits.

Hukou still has a small influence on mandatory benefit contribution rates, as employees are divided into the categories of permanent local residents and other residents (which includes Chinese with hukou from other cities and foreigners) and rates differ for certain insurances contribution.

Certain hukou locations are viewed as being the most highly desirable (particularly Beijing and Shanghai) for reasons related to children's education, property purchases, international travel, etc. For key staff that a company wants to retain for the long term, a company can endorse an employee's application for a hukou change.

The full hukou transfer process takes about 6 months and involves several bureaus other than the Social Insurance Bureau. These bureaus include the Public Security Bureau, which must issue a new id card (shenfenzheng) for the employee before the Social Insurance Bureau will accept that employee's application to make social insurance contributions as a local permanent resident.

The transfer of previously contributed social insurance funds between cities can vary in difficulty, depending on city tiers. Transferring funds between two first-tier cities is of course the easiest, while a transfer to/from a third tier city can be more challenging.

No one can be sure what China's hukou policy will be like in 20 years, but the law says that an individual can apply for a refund or transfer of the individual portion of their social insurance contributions back to their hometown. Note that only the funds contributed by the individual can be transferred, company contributions must stay in the city in which they were made.

2.5 Creating a Company Rulebook

A company rulebook clarifies an employer's expectations and if necessary, makes it easier to demonstrate that an employee has broken a company rule and can be legally dismissed. As a guideline, we would normally suggest that any company with more than ten employees consider creating a company rulebook.

Contents of the company rulebook vary based on the industry in which the company is involved. Companies in the manufacturing industry will generally be more concerned about issues relating to promptness, length of breaks, safety of employees, etc. Those in the business process outsourcing (BPO) market will be particularly concerned about the confidentiality of their clients' information. Those in the food industry will pay most attention to hygiene.

The rulebook should be bilingual, with the Chinese version considered valid. If a company has a trade union, the terms included in the rulebook shall be agreed with the union itself. Finally, the labor contract template should include a clear reference to the rulebook. This strengthens the company's case if it needs to dismiss an employee based on rulebook infractions in the future.

1. *Is the rulebook reasonable?*

A company may devise hundreds of rules in their rulebook, making it extremely hard for the employees to keep "in compliance," and also increasing the workload of the HR division to supervise the rules. Bear in mind that if a dispute with an employee or ex-employee reaches the court, the judge may consider the size and complexity of the rulebook when deciding how much responsibility the employee should take for a particular infraction. If the judge considers that the company has set arbitrary rules in order to find reasons to dismiss employees then the employee is more likely to receive a sympathetic judgment. The employer should be prepared to explain exactly why each of the regulations should be included in the rulebook.

2. *Is the severity of each infraction described in the rulebook?*

A rulebook should differentiate between a serious breach and a minor breach when determining how many warnings a company must

give an employee before dismissing that person. Serious breaches can constitute immediate dismissal. Minor breaches are generally dealt with by issuing an official warning letter to the employee. The rulebook may stipulate that after a specified number of official warnings the employee is deemed to have committed a serious breach of the rulebook. In this way the company may gain the right to dismiss the employee without compensation, although we would like to stress that ultimately the decision on whether or not the infringements warrant dismissal could be challenged by the employee in a court.

3. *Do you have evidence that your staff have read and agreed with the terms?*

Each employee should sign a document confirming that they have received a copy of, read, and understood the rulebook. If you amend the rulebook in the future, have the employees confirm once more. Provide a draft of the amended rulebook to employees, giving them a chance to provide comments and feedback for the company's consideration (although there is no obligation to adopt any suggested adjustments). This not only improves the position of the company legally in the event of a dispute, but will ensure that employees read the rulebook more carefully.

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