

# S&S

PENSION CONSULTANCY



## Global Expat Pensions

CHINA EDITION

## Focus on your Results

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We provide independent pension consultancy for the (inter)national business market. Our challenge is to optimize your pension results.

## Affinity for expats

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Expats have a uniquely challenging business and private life. As we appreciate their drive and competitiveness, we have affinity for expats. It is our challenge to optimize their pension interests from day one.

## Expats require customization

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Each expat has a special situation and personal preferences. Business and personal circumstances can change in time. Therefore only customization can provide the required optimal international (risk) coverages, cost control and flexibility.

Standard financial products might seem practical. However, they tend to be (extremely) expensive, not flexible and not providing customized coverage.

## Expats in China

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China has the world's second largest economy and the largest trading power. In 2014, *Fortune's* Global 500 list of the world's largest corporations included 95 Chinese companies. Five of the world's ten largest public companies were Chinese.

This has attracted many U.S., German, British and Dutch expats. Therefore we will now focus on frequent pension related issues of especially Dutch expats in China.



## International versus local contract

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The first distinction to be made is the difference between an international and local contract.

In case of an international contract from for example a Dutch Holding company, rather strict Dutch civil and fiscal pension law is applicable. Whereas a local Chinese contract is dictated by entirely different and much more decentralized Chinese pension law

## Chinese legislation

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The People's Republic of China is ruled by the Communist Party of China and endorses a socialist market economy. The political system is partially decentralized. Regional leaders possess a certain amount of autonomy. Central legislation is not always equally implemented on regional level. Which is relevant for the exact legal and fiscal position of expats who fall within the realm of Chinese jurisdiction.

# Chinese Personal Income Tax

## Chinese tax law on taxable income

<i>Taxpayer status</i>	<i>Taxable income</i>
Living in China less than 90 days (183 days in case of a tax treaty)	<ul style="list-style-type: none"> <li>- Income sourced within China</li> <li>- Income paid and borne by an overseas employer is exempt</li> </ul>
Living in China more than 90 days (183 days in case of a tax treaty) but less than one year	<ul style="list-style-type: none"> <li>- Income sourced within China</li> <li>- Income sourced outside of China is not subject to IIT, unless the taxpayer is a director/senior manager of a Chinese domestic enterprise</li> </ul>
Living between 1-5 years in China	<ul style="list-style-type: none"> <li>- Income sourced within China</li> <li>- Income sourced outside of China where the income is paid by a Chinese enterprise or individual</li> </ul>
Living more than 5 years in China	<ul style="list-style-type: none"> <li>- Income sourced within and outside of China as of the sixth year onwards for every full year spent in China</li> </ul>



## Chinese tax rates

China has a personal income tax rate with the following progression:

<i>Monthly taxable income (RMB)</i>	<i>Tax rate</i>
<1.500	3%
1.500 < 4.500	10%
4.500 < 9.000	20%
9.000 < 35.000	25%
35.000 < 55.000	30%
55.000 < 80.000	35%
> 80.000	45%

## Tax treaty

In order to avoid double taxation, China has tax relief treaties and agreements with 101 countries. Among others with the Netherlands, U.K. and U.S.

In 2014 a new tax treaty and a protocol between China and the Netherlands entered into force. It applies to income received by residents of either State as of January 1, 2015. It regards national and local personal income tax issues in order to prevent double taxation.

We will now summarize the for Dutch expats in group context most relevant parts of the treaty.

### *Residency*

The expat is according to the treaty in general tax resident of China and liable to its taxation, if the expat has his residence or place of management in China. In case this would result in double taxation, the country which scores the highest on applicable 'home base/centre of vital interest/habitual abode/nationality' is entitled to tax.



### *Income from employment*

The expat who resides in China will be taxed in China. To the extent that work has been performed in the Netherlands, the latter may tax these wages.

However, the expat will only be taxed in China regarding work done in the Netherlands if

- 1) the expat does not reside in the Netherlands for more than 183 days in a fiscal year and
- 2) the related wages are not paid on behalf of an employer who resides in the Netherlands and
- 3) the related wages are not borne by a permanent establishment or fixed base of the employer in the Netherlands.

### *Tax relief*

When an expat resides in China and he also pays Dutch taxes regarding his Dutch wages, these taxes may be credited against the Chinese tax imposed on the expat. The credit shall not exceed the amount of Chinese tax on that income computed according to Chinese tax law.

### **'Voluntary' implementation of homeland rates**

Some foreign based companies implement on a non governmental bases and therefore voluntarily the homeland tax rate. Besides the probably higher rates and withholding, it is advisable to beforehand look at all pension implications.

# Chinese Social Security Coverage

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## Mandatory participation expats

National legislation obligates expats residing in China to participate in the social security system as of 2011. This within 30 days after receiving their work permit. As only Korea and Germany have a social security treaty with China, Dutch expats fall within the realm of the mandatory participation. This regards 5 coverages: pension, medical care, work related injury, unemployment and maternity insurance.

## Local differences

It is typical for China that the mandatory participation is not implemented in all regions equally. Depending on which region it regards, employers seem to decide if they sign up their expats for participation. It is estimated that 35% of all expats residing in China are participating.

## Amount of premium

The amount of premium is different for each region as regional rules might differ and substantially increase the premium. In general the annual expat premium amounts to 11% of the pre tax wages with a certain maximum. The premium exposure of the employer is estimated at 35%.

## Pension annuity or refunds

The public pension system is divided into an urban and rural system. The described public pensions refer to the urban system as most Dutch expat reside in the city. For Dutch expats residing in the rural environment it is relevant that the rural pension system is voluntary, very basic and differs substantially in each region. Operational matters are left to the local government.

It appears not to be easy for an expat who has left China to receive a pension annuity. Among other demands he has to be at least 60 years old and has to have participated during at least 15 years. Neither seems it easy to get a refund of paid premium when the expat leaves China.



## Participation not always recommendable

Of the five coverages one has to pay for, the expat probably only uses medical care and work related injury. As Chinese medical care is not always up to western standards and as medical bills incurred outside of China are not covered, most expats come with insurance from home.

Regarding pensions for most expats it is not possible to claim their pension back at the end of their residence. Unemployment insurance is pointless because if the expat is fired, he loses his visa and has to leave the country. Furthermore it is not always clear if a participating expat who relocates within China can effectuate his existing coverage in another region.

Many companies find it therefore not worthwhile taking local social security for their expats.

### **Sanctioning of non compliance**

It is often stated that Chinese government does not uphold this law and that there are no sanctions in case of non compliance. It seems advisable to check regional rules on this issue. Beijing for example does have substantial penalties for both employer and expat in case of non compliance.

### **Desired coverage**

Expats have to decide what kind and amount of coverage they prefer for their family regarding in general disability, passing away prematurely and old age risks.

### **Voluntary continuation of homeland coverage**

In several home countries it is possible to voluntarily continue the domestic coverage while working abroad as expat. It is advisable to carefully compare the offered coverage with the required premium.

### **Voluntary continuation of Dutch homeland coverage**

Dutch expats have in general three separate possibilities:

A) During maximum 10 years expats can insure coverage for governmental old age and next of kin pension at the SVB. The coverage has to be requested within 12 months at the end of the previously existing mandatory coverage.



B) During maximum 5 years the expat can insure himself for governmental disability and unemployment coverage at the UWV. Required is that the expat has a Dutch employer and requests the coverage within 13 weeks after the ending of his previously existing mandatory coverage.

As disability coverage is not possible as there is no social security agreement between Holland and China, Dutch expats in China can only opt for the unemployment coverage.

C) In case an expat in general is seconded for maximum 2 years by a Dutch employer, he can apply by means of a A1/E 101 Declaration for total Dutch social security coverage at the SVB.

This regards i.e. not only old age and next of kin pension coverage but also disability and unemployment coverage. A requirement is that the expat previously was insured by Dutch social security.

As China has no social security agreement with Holland, this option is not possible for Dutch expats in China.

## Private insurance coverage

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Another option is to provide for the desired coverage by private insurance. In this respect the following issues are relevant:

- Starting this coverage while still living in the homeland might save 50% premium.
- Participating in a collective coverage facilitated by the employer might save premium.
- Regarding the next of kin and disability coverage do you prefer capital or annuity?
- Is annual indexation of the coverage to keep up with inflation required?
- Determine your wishes regarding capital and/or risk based coverage.
- Check possibly existing corporate coverage for only being valid in case of accidents.
- Substantial annual bonuses might reduce your required future coverage and costs.

## Pensions in local contract

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### Legal basis

Dutch expats with a Chinese contract fall within the realm of the Chinese pension system.



*Chinese calligraphy for learning*

In 1997 the division of public, corporate and private pensions was introduced. As the funding of the public pensions is increasingly difficult, it is for the corporate and individual sector to help fill the cap. In 2004 the Enterprise Annuity Law for the voluntary occupational pension system was introduced. It provided a legal basis for government advocated voluntary corporate pensions.

The percentage of international corporations which operate in China and offer a pension grant is substantially lower than in fully developed markets as Europe, U.S. and Australia.

### Enterprise Annuity Law

The law created the Enterprise Annuity Funds. The already existing Legacy Funds were company funds that were managed by local social security agencies. China intends to hand management over to the private sector.

*Group pension insurance contracts and trusts* are the third and fourth possibility for employers to provide their employees with a voluntary pension scheme.

### Enterprise Annuity Fund

This voluntary fund is established as an internal or external trust. These plans use a trust model but rely on separate Enterprise Annuity specific regulations for the trust aspects. Therefore they are not equal to the (Chinese) trust in general.

The internal trustee is known as the Pension Council. It is similar to the trust system in the UK. At least one-third of trustee members should be employee representatives. The trustee is obliged to outsource administration, asset management and custody services to other institutions that are licensed to operate these businesses.

The external trustee is known as the Professional Trustee. It is executed by financial institutions with no representations requirements. The trustee is allowed to provide administrative and asset management services, but not custody.

If a company prefers an external trustee, best practices suggest the need for an internal Pension Committee to oversee the trustee and communications towards participants. The latter appears to be vital for the success of the program.

### **Enterprise Annuities**

They are voluntary occupational plans that are fully funded Defined Contribution individual accounts. Some regional regulations require asset managers to provide a certain level of returns. They can i.e. be compared to the US 401 (K) account. At pension age it generates an annuity or lump sum.



An employer who grants an enterprise annuity is obliged to pay premium. There is no mandatory own contribution for the employee. Even though own contributions quickly increase in prevalence and the majority of the pension plans have it incorporated.

Employer contributions are limited to 8,33% of employee salaries. The combined employer/employee contribution should not exceed 16,66% of the total wages. Many schemes have a flat premium percentage of 5%-7%.

An employer can only provide this corporate coverage if the corporation is already participating in the urban pension system, is financially sound and has collective bargaining mechanisms in place. Most schemes have been adopted by large state owned corporations.

The most relevant quantitative investment restrictions are:

- At least 20% of the assets have to be invested in high liquidity money market instruments such as deposits or central bank notes.
- At least 20% should be invested in government bonds.
- Maximum of 50% of assets can be invested in term/contractual deposits, government/corporate/concertable bonds and securities.



- Maximum of 30% of assets can be invested in stocks, investment-linked insurance products and equity funds.
- Investment in equities should not exceed 20%.
- In general investments can only be made in China with its low interest rate and volatile stock market.

These restrictions have lowered the potential return on investment and thus reduce an employee's potential old age pension. Due to financial market development and regulatory experience, the investment restrictions will probably be eased in the future.



## **Enterprise Annuities and Tax**

### *Premium*

Due to differences in regional rules a company with an Enterprise Annuity plan receives a tax exemption of 4%-12,5% of the wages. There is no tax benefit for employee contributions.

One of the reasons for the low degree of participation might be this small tax benefit. Many other types of investments benefit anyhow from similar tax benefits. More tax relief for both employers and employees is expected in the future.

### *Pension terms*

Investment income and pension payments are taxed according to standard tax rates. Enterprise Annuities are therefore subject to an ETT system.

## **The future of Enterprise Annuities**

The substantial differences in (tax) regulations between even urban regions hinder the implementation of the Enterprise Annuities. Mostly large Chinese companies have opted for them whereas international and smaller companies seem to be very reserved. The desired pension reforms will only succeed if national and local government succeed in much needed regulatory harmonization.

## **Group Pension Insurance**

Group pension products are offered by Chinese and international insurers. Most offered products have a Defined Contribution nature and include investment choice for participants.

Due to previous abuses of such programs as tax shelter, there are restrictions. Furthermore the tax treatment is not favourable. As with all non Enterprise Annuity models, there are no specific direct corporate tax breaks available. The regulations are clear that employees must pay income tax on the contributions when they are made. Investment income and distributions are not taxable to the employee.

The best aspects of insured pension products in China are the security and services provided by insurance companies. The insurance industry is well regulated and competitive.

## Trusts

In many countries trusts are used to implement corporate pension schemes. It provides asset independency, security for the participants and a steady framework.

In China the pure trust constellation is not that often thus used. Chinese trust law is not written with such plans in mind. Trusts do not receive the level of regulatory and public support that alternatives do. Due to scandals in the past, in China trusts do not radiate an aura of security. Therefore only a few trust companies in China implement pension schemes.



## Pensions in International contract

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Many expats have an employment and pension contract directed by the homeland jurisdiction. We will now focus on current pension issues of such Dutch expats in China.

### Decreased maximum Dutch pension claims

As of 2015 the maximum amount of pension earning wages regarding old age and next of kin pensions amounts to € 100.000,-. The maximum amount of pension claim is as of 2015 and based on old age pension age of 67:

#### *Defined Benefit system with final pay clause:*

Old age pension claim	: 1,657 %
Next of kin pension claim	: 1,160 %
Orphan pension claim	: 0,232 %

#### *Defined Benefit system with average pay clause:*

Old age pension claim	: 1,875 %
Next of kin pension claim	: 1,313 %
Orphan pension claim	: 0,263 %

#### *Defined Contribution system:*

These percentages are derived from the maximum Defined Benefit pension claims. They are calculated at a 3% or 4% discount rate. As of 2015 these percentages have to be listed without costs.

### **Decreased pension claim compensated correctly?**

For many expats this results in a seriously decreased pension claim. According to Dutch jurisprudence, total compensation is in order.

Has this been implemented to the right extend and in the right manner? Especially regarding Defined Benefit pension claims this is an interesting issue. It is in the interest of expats to use among other parameters the correct (future) interest rate and future period.

### **Attractive compensation possibilities**

If the existing pension scheme is attractive, it is an option to have the mentioned compensation invested in the current plan:

- In the past not totally used fiscal possibilities can i.e. still be used.
- Often the annual bonus is not included in the standard pension earning wages. In this respect however it can i.e. be included in order to calculate the maximum fiscal possibilities.



### **Net Pension**

In order to 'compensate' the end of pension claims beyond € 100.000,- pension earning wages as of 2015, the Net Pension has been introduced by the Dutch government.

In general in Holland the pension claim and pension build up are not taxed until pension age. Then the terms are taxed annually. The current own contribution of premium is according to Dutch tax law in general tax deductible.

The Net Pension option provides an additional pension claim. The annual premium is taken from the net (after tax) wages and the terms at pension age are not taxed. Tax is totally by passed. In Holland the positive aspect is that one currently does not have to pay 1,2% capital tax in Box 3 of the Dutch Individual Income Tax.

Net Pension can only be implemented by a Defined Contribution system. Participation is voluntary. As with each kind of pension premium, the wages administration of the employer takes care of the premium payment and of the withholding from the wages of the participating employee.

### **Net Annuity**

The essential difference with the Net Pension is that it is taken out of the legal pension sphere and therefore totally private. The positive effect thereof is that the strict Dutch pension legislation does not apply. A negative effect is that a medical test is legally allowed.

### **Existing expat pension claims**

Many expats have in the past already acquired substantial pension claims. Due to lack of time and expertise these claims are not always handled in the best way. For instance the annual effect of indexation deserves attention as its total effect during for example 25 years will be substantial.

Has been looked into the possibility and desirability of (inter)national transfers of value? As these issues are rather technical, professional advice seems desirable.

### **Optimal pension system**

Due to the historically low interest rates and the introduction of the Defined Contribution based new PPI system in 2011, the Dutch PPI system can be very interesting for expats.



Regarding PPI please take among other parameters the following issues into account:

- Besides low cost levels the annual return on investment is outstanding?
- Does the PPI have the by you required investment possibilities?
- Their Life Cycle propositions are well structured and one can choose between defensive/neutral/offensive?
- Regarding the possibly by you required risk coverage you can choose between several insurance options?
- It is possible to end the PPI contract on short term?

### **Consultancy for Expats/HR**

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Our expat services can be provided exclusively for expats or HR. Another approach is that we mediate between expats and HR. After we have analyzed all facts, we advise them both about all options and the most realistic solutions. This approach tends to cut costs and can be implemented swiftly.

### **International experience and network**

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We have more than 20 years of experience in international expat and collective pension consultancy. Thus we have an elaborate international network. If so desired, we can advise and act swiftly in international matters.

### **Chinese legal issues**

For expats and corporations with Chinese legal issues, we gladly refer to Mrs. Choy Yiu Chan. Mrs. Choy Yiu Chan is partner at Bonnard Lawson International Shanghai and Dutch and International lawyer with more than 10 years of experience working in the Netherlands, Hong Kong and China.

## **Contact**

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