

Shenzhen, China
Rooms 1203-06, 12/F.
Di Wang Commercial Centre
5002 Shennan Road East
Luohu District, Shenzhen
T: +86 755 8268 4480

Shanghai, China
Room 603, 6/F., Tower B
Guangqi Culture Plaza
2899A Xietu Road
Xuhui District, Shanghai
T: +86 21 6439 4114

Beijing, China
Room 303, 3/F.
Interchina Commercial Bldg.
33 Dengshikou Street
Dongcheng District, Beijing
T: +86 10 6210 1890

Taipei, Taiwan
Room 303, 3/F.
142 Section 4
Chung Hsiao East Road
Daan District, Taipei
T: +886 2 2711 1324

Singapore
3/F., 36B
Boat Quay
Singapore 049825
T: +65 6438 0116

New York, USA
202 Canal Street
Suite 303, 3/F.
New York
NY 10013, USA
T: +1 646 850 5888

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A BRIEF INTRODUCTION ON THE CUMULATIVE WITHHOLDING METHOD FOR INDIVIDUAL INCOME TAX COMPUTATION IN CHINA

China's new Individual Income Tax law ("IIT") law came into effect on January 1, 2019. According to the new IIT law, income from wages and salaries shall be subject to the seven-bracket progressive tax rates and shall be combined on an annual basis for computation of individual income tax. Individual income tax shall be calculated based on the cumulative withholding method, withheld and prepaid on a monthly basis, and annual tax clearance shall be arranged as per the actual income during the period from March 1 to June 30 of the following year.

From January 1, 2019, individual residents can enjoy six special additional deductions, including children's education costs, continuing education costs, critical illness medical expenses, housing mortgage interest or housing rent, and elderly care expenditures, when calculating comprehensive taxable income.

Since the end of year 2018, the tax authorities have made a series of publicity and interpretation for the special additional deduction policy, and most taxpayers have had a certain understanding of the special additional deduction policy and declared and filled the deductions in January. However, the tax authorities have not carried out necessary publicity and popularization on the new cumulative withholding method. In fact, the cumulative withholding calculation method has great impact on the cash flow of both employers and employees.

1. Definition of Cumulative Withholding Method

Cumulative withholding method is an IIT computation method. As per this method, the withholding agent shall (i) deduct cumulative tax-free income, cumulative expense deductions, cumulative special deductions, cumulative special additional deductions and cumulative other deductions determined by the laws from the cumulative income from wages and salaries paid by the same company as of the current month, recognize the balance as cumulative withholding and prepayment of taxable income; then (ii) calculate cumulative tax to be withheld and prepaid, minus cumulative tax deduction and exemption and cumulative amount of tax withheld and prepaid, and recognize the balance as the tax to be withheld and prepaid for the current period, when withholding and prepaying IIT for taxpayers within one tax year.

2. Scope of Application of Cumulative Withholding Method

The withholding agent shall calculate withholding tax based on the cumulative withholding method and withhold IIT on a monthly basis when paying comprehensive income, such as wages and salaries, to individual residents.

The cumulative withholding method is only applicable to the calculation of individual income tax for individual residents who obtain income from wages and salaries. For non-resident individuals who obtain income from wages and salaries, the calculation of individual income tax shall be made on a monthly basis or on a piece-by-piece basis.

3. Computation Formula of Cumulative Withholding Method

Tax to be withheld and prepaid for the current period = (cumulative withholding and prepayment of taxable income \times withholding rate - quick deduction) - cumulative tax deduction and exemption - cumulative amount of tax withheld and prepaid

Cumulative withholding and prepayment of taxable income = cumulative income - cumulative tax-free income - cumulative expense deductions - cumulative special deductions - cumulative special additional deductions - cumulative other deductions determined by the laws

Note 1: If the tax to be withheld and prepaid for the current period is negative, tax refund shall not be applied for the time being. If the balance is still negative at the end of the tax year, taxpayers can apply for tax refund by arranging annual tax clearance for the annual comprehensive income.

Note 2: If there is any discrepancy between the annual tax withheld and prepaid and the annual tax payable, the individual residents shall apply with the tax authorities for annual tax clearance during the period from March 1 to June 30 of the following year for tax refund or repayment.

An interpretation of the computation formula:

- (1) Cumulative expense deductions: RMB5,000/month multiplied to the number of months of employment in the tax year as of the current month
- (2) Cumulative special deductions refer to the accumulated deductible amount of the taxpayer during his/her employment in the company in the current year as of the current month according to the monthly statutory deduction standard. Special deductions include basic pension insurance, basic medical insurance, unemployment insurance and other social insurance premiums, and housing provident fund paid by individual residents in accordance with the scope and standards stipulated by the state.
- (3) Cumulative special additional deductions refer to the accumulated deductible amount of the taxpayer during his/her employment in the company in the current year as of the current month according to the declared deduction standard. Special additional deductions include six items of expenditure, including children's education costs, continuing education costs, critical illness medical expenses, housing mortgage interest or housing rent, and elderly care expenditures.

3. Computation Formula of Cumulative Withholding Method—Cont'd

An interpretation of the computation formula:--Cont'd

- (4) Cumulative other deductions determined by the law refer to the accumulated deductible amount of the taxpayer during his/her employment in the company in the current year as of the current month the monthly statutory deduction standard. Other deductions include enterprise annuities and occupational annuities paid by individual residents in accordance with the state regulations, expenditures for purchases of commercial health insurance and tax-deferred commercial pension insurance in accordance with the state regulations, and other deductible items as stipulated by the state council.
- (5) Special deductions, special additional deductions and other deductions determined by the laws shall be limited to the taxable income of individual residents in one tax year. If the deductions cannot be used up in one tax year, it shall not be carried forward to the subsequent years.
- (6) Please refer to the table below for the individual income tax rates applicable to income from wages and salaries:

Bracket	Cumulative Taxable Income (A) (RMB)	Tax Rate (%)	Quick Deduction
1	≤36,000	3	0
2	36,000<A≤144,000	10	2,520
3	144,000<A≤300,000	20	16,920
4	300,000<A≤420,000	25	31,920
5	420,000<A≤660,000	30	52,920
6	660,000<A≤960,000	35	85,920
7	>96,0000	45	181,920

4. Examples for Illustration of Cumulative Withholding Method

【Example 1】

Staff A was engaged in year 2017, whose gross salary in year 2019 is RMB11,000 per month. The expense deduction is RMB5,000 per month, the special deduction of “three insurances and one fund” is RMB1,700, the special additional deduction for housing rent is RMB1,500. No tax-free income or other tax reduction or exemption policy is applicable. Taking the first three months of year 2019 as an example, the tax to be withheld and prepaid is calculated as below:

January: $(11,000 - 5,000 - 1,700 - 1,500) \times 3\% = 84$

February: $(11,000 \times 2 - 5,000 \times 2 - 1,700 \times 2 - 1,500 \times 2) \times 3\% - 84 = 84$

March: $(11,000 \times 3 - 5,000 \times 3 - 1,700 \times 3 - 1,500 \times 3) \times 3\% - 84 - 84 = 84$

As the annual cumulative taxable income of the taxpayer A is RMB33,600, 3% of tax rate is applicable and the tax to be withheld and prepaid for each month remains the same.

4. Examples for Illustration of Cumulative Withholding Method—*Cont'd*

【Example 2】

Staff B was engaged in year 2017, whose gross salary in year 2019 is RMB40,000 per month. The expense deduction is RMB5,000 per month, the special deduction of “three insurances and one fund” is RMB6,000, the special additional deduction for children's education, housing mortgage interest and elderly care is RMB3,000. No tax-free income or other tax reduction or exemption policy is applicable. Taking the first three months of year 2019 as an example, the tax to be withheld and prepaid is calculated as below:

January: $(40,000 - 5,000 - 6,000 - 3,000) \times 3\% = 780$

February: $(40,000 \times 2 - 5,000 \times 2 - 6,000 \times 2 - 3,000 \times 2) \times 10\% - 2,520 - 780 = 1,900$

March: $(40,000 \times 3 - 5,000 \times 3 - 6,000 \times 3 - 3,000 \times 3) \times 10\% - 2,520 - 780 - 1,900 = 2,600$

The above calculation result shows that due to the cumulative taxable income as of February is RMB52,000, 10% of tax rate is applicable and the tax to be withheld and prepaid for February and March is to be increased.

5. Comparison of New and Old IIT Computation Method and the Influence of Cumulative Withholding Method

The individual income tax special additional deduction policy was implemented in China on January 1, 2019. To give you an example, Mr. Zhang, a director of a company, declared two items of special additional deduction in January. On the pay day, he found that his take-home pay for January 2019 is nearly RMB8,000 more than December 2018, and the pay advice shows that the individual income tax deducted is around RMB8,000 less than December 2018. Mr. Zhang is delighted to find that his net salary is increased, however, he also doubts how could thousands of individual income tax be saved since he only declares two items of special additional deduction? At last, he even doubts if the financial staff has miscalculated his salary.

In fact, the financial staff does not miscalculate Mr. Zhang's salary. The increase in take-home pay is indeed caused by the decrease of individual income tax. However, Mr. Zhang is also right to be sceptical about the amount of tax deduction benefits brought in by special additional deduction. The reason why take-home pay is increased is mainly because of the change of individual income tax calculation method which has changed from monthly withholding to annual cumulative withholding. The annual cumulative withholding method causes the phenomenon of "tax reduced and take-home pay increased" in the first few months. However, it is only a temporary illusion, and will be gradually evolved into "tax increased and take-home pay decreased" within a tax year.

Under the old individual income tax calculation method, tax is calculated based on the monthly salary income only. While, as per the new cumulative withholding method, tax is calculated based on the cumulative salary income in the current year. The most significant feature of the cumulative withholding method is that as the cumulative salary income increases, the corresponding tax rate will probably show an upward trend, and the individual income tax will also be higher, and the take-home pay will be gradually reduced.

5. Comparison of New and Old IIT Computation Method and the Influence of Cumulative Withholding Method—*Cont'd*

【Example 3】

The monthly salary of staff C is RMB25,000. Regardless of other deductions, under the old and new calculation method, the individual income tax calculation is as follows:

(1) Under the old individual income tax calculation method in year 2018 (Unit: RMB)

Tax Period	Salary Income	Expense Deduction	Taxable Income	Tax Rate	Quick Deduction	IIT Payable
January	25,000	5,000	20,000	20%	1,410	2,590
February	25,000	5,000	20,000	20%	1,410	2,590
March	25,000	5,000	20,000	20%	1,410	2,590
April	25,000	5,000	20,000	20%	1,410	2,590
May	25,000	5,000	20,000	20%	1,410	2,590
June	25,000	5,000	20,000	20%	1,410	2,590
July	25,000	5,000	20,000	20%	1,410	2,590
August	25,000	5,000	20,000	20%	1,410	2,590
September	25,000	5,000	20,000	20%	1,410	2,590
October	25,000	5,000	20,000	20%	1,410	2,590
November	25,000	5,000	20,000	20%	1,410	2,590
December	25,000	5,000	20,000	20%	1,410	2,590
Total						31,080

(2) Under the new cumulative withholding method implemented in year 2019 (Unit: RMB):

Tax Period	Cumulative Salary Income	Cumulative Expense Deduction	Cumulative Taxable Income	Tax Rate	Quick Deduction	Cumulative Prepaid IIT	IIT Payable for Current Period
January	25,000	5,000	20,000	3%	0		600
February	50,000	10,000	40,000	10%	2,520	600	880
March	75,000	15,000	60,000	10%	2,520	1,480	2,000
April	100,000	20,000	80,000	10%	2,520	3,480	2,000
May	125,000	25,000	100,000	10%	2,520	5,480	2,000
June	150,000	30,000	120,000	10%	2,520	7,480	2,000
July	175,000	35,000	140,000	10%	2,520	9,480	2,000
August	200,000	40,000	160,000	20%	16,920	11,480	3,600
September	225,000	45,000	180,000	20%	16,920	15,080	4,000
October	250,000	50,000	200,000	20%	16,920	19,080	4,000
November	275,000	55,000	220,000	20%	16,920	23,080	4,000
December	300,000	60,000	240,000	20%	16,920	27,080	4,000
Total							31,080

5. Comparison of New and Old IIT Computation Method and the Influence of Cumulative Withholding Method—*Cont'd*

【Example 4】

Mr. Zhang is a director of a company, whose monthly salary is RMB55,000. Regardless of other deductions, under the old and new calculation method, the individual income tax calculation is as follows:

(1) Under the old individual income tax calculation method in year 2018 (Unit: RMB)

Tax Period	Salary Income	Expense Deduction	Taxable Income	Tax Rate	Quick Deduction	IIT Payable
January	55,000	5,000	50,000	30%	4,410	10,590
February	55,000	5,000	50,000	30%	4,410	10,590
March	55,000	5,000	50,000	30%	4,410	10,590
April	55,000	5,000	50,000	30%	4,410	10,590
May	55,000	5,000	50,000	30%	4,410	10,590
June	55,000	5,000	50,000	30%	4,410	10,590
July	55,000	5,000	50,000	30%	4,410	10,590
August	55,000	5,000	50,000	30%	4,410	10,590
September	55,000	5,000	50,000	30%	4,410	10,590
October	55,000	5,000	50,000	30%	4,410	10,590
November	55,000	5,000	50,000	30%	4,410	10,590
December	55,000	5,000	50,000	30%	4,410	10,590
Total						127,080

(2) Under the new cumulative withholding method implemented in year 2019 (Unit: RMB):

Tax Period	Cumulative Salary Income	Cumulative Expense Deduction	Cumulative Taxable Income	Tax Rate	Quick Deduction	Cumulative Prepaid IIT	IIT Payable for Current Period
January	55,000	5,000	50,000	10%	2,520		2,480
February	110,000	10,000	100,000	10%	2,520	2,480	5,000
March	165,000	15,000	150,000	20%	16,920	7,480	5,600
April	220,000	20,000	200,000	20%	16,920	13,080	10,000
May	275,000	25,000	250,000	20%	16,920	23,080	10,000
June	330,000	30,000	300,000	20%	16,920	33,080	10,000
July	385,000	35,000	350,000	25%	31,920	43,080	12,500
August	440,000	40,000	400,000	25%	31,920	55,580	12,500
September	495,000	45,000	450,000	30%	52,920	68,080	14,000
October	550,000	50,000	500,000	30%	52,920	82,080	15,000
November	615,000	55,000	550,000	30%	52,920	97,080	15,000
December	660,000	60,000	600,000	30%	52,920	112,080	15,000
Total						127,080	

5. Comparison of New and Old IIT Computation Method and the Influence of Cumulative Withholding Method—*Cont'd*

The examples quoted in this section are relatively simply, in which the monthly gross salary of the taxpayers have been remained unchanged, only monthly expense deduction of RMB5,000 has been deducted from the wages and salaries income with no consideration of social security contribution, housing provident fund, special additional deductions and other factors. These examples are quoted to make a comparison of the increase or reduction of monthly individual income tax calculated under the two calculation methods. Under the aforesaid circumstances, the final individual income tax to be paid for the whole year shall remain the same under the two different calculation methods. However, it doesn't mean that the annual individual income tax calculated under the two methods will always remain the same and it will change if monthly income changes.

If you wish to obtain more information or assistance, please visit the official website of Kaizen CPA Limited at www.kaizencpa.com or contact us through the following and talk to our professionals:

Email: info@kaizencpa.com, enquiries@kaizencpa.com

Tel: +852 2341 1444

WhatsApp/Line/Wechat: +852 6114 9414, +86 1521 932 644

Skype: kaizencpa