

**LRA INCOME TAX PUBLIC RULING****PR02/ITAX/2012**

Subject	:	TAX TREATMENT OF TERMINAL BENEFITS
Act	:	Income Tax Act 1993 (as amended)
Sections	:	3, 18, 32, 95, 99 and 156
Date	:	November 2012

1. Background and Introduction

The Income Tax (Amendment) Act No. 11 of 2012 (hereinafter referred to as “the Amendment Act”) introduces exemption from income tax of terminal benefits received from employment. For the purposes of this Public Ruling, employment has the meaning in section 3 of the Income Tax Act 1993 (as amended and hereinafter referred to as “the Act”). In terms of that particular section “employment” means –

- (a) the position of an individual in the employ of another person; or
- (b) a directorship of a company; or
- (c) a position entitling the holder to a fixed or ascertainable remuneration; or
- (d) a public office.

Thus, in terms of the definition, the exemption does not apply to any other forms of engagement, for example, self-employed individuals.

The Amendment Act changes the current tax treatment of the following main types of lump sum employment payments – **contract gratuities, gratuities from permanent and pensionable positions/jobs, and severance payments** in two main ways –

- (i) it brings some tax concession by exempting a certain amount of the lump sum,
- (ii) it provides the same tax treatment for the taxation of lump sum employment benefits. Prior to the amendment, contract gratuities, gratuities from permanent and pensionable positions and severance pay were taxed differently, and this created inequity in the tax system.



2. Purpose

The purpose of this Ruling is –

- (a) to introduce the new section 32 dealing with exemption of terminal benefits,
- (b) to provide guidance on how the Amendment Act is applied in practice,
- (c) to indicate typical examples of items of income and taxpayers that are excluded from the exemption, and
- (d) to show the relationship between the new section 32 and the existing section 99.

TIP!!!

In interpreting and applying the new law it is important to bear in mind three main objects for which the law was put in place –

- (I) the need to encourage self-employment and economic participation of formerly employed persons,
- (ii) the need to provide some form of “social security” for employed persons once they leave employment or are in the process of retiring. This is brought about by the exemption itself, and
- (iii) the need to minimize abuse while at the same time protecting the tax base/net through capping or limiting the exemption and exclusions available.

3. The Law

The core of the 2012 Amendment Act is contained in section 2 that reads –

“Terminal benefits shall be exempt from income tax: Provided they do not exceed 25% of basic salary earned during the period of employment.”

Terminal benefits are explained in section 1 to mean three main items of income –

- gratuity,
- severance payment, and
- superannuation fund payment.



3.1 Which Taxpayers are Covered?

As can be seen from the law and its objects, the Amendment Act exemption applies generally to –

- (a) employees,
- (b) holders of public offices which include offices in both the central and local governments (including all institutions thereof).

3.2 Which Taxpayers are Not Covered?

The exemption does not apply to taxpayers that are not taxed under sections 18 and 156 (read together with the related regulations) of the Act. Specifically the exemption does not apply to –

- (a) sole traders,
- (b) partners in a partnership unless such partners are salaried partners and taxable under sections 18 and 156 of the Act.
- (c) members in an association, a mutual club or similar organisations,
- (d) self-employed or independent contractors,
- (e) trustees, and
- (f) members of a board of directors whose income is derived only from the board sittings.

3.3 Which Items of Income are Excluded?

As the law indicates, the following are two conditions that must be met for income to qualify for the exemption –

- (a) it must be a gratuity, a severance payment or a superannuation fund payment,
- (b) the basis for its calculation must be the **basic salary earned**.

The following are examples of items of income that do not fall within the scope of the exemption –

- accumulated leave days pay (including any unused sick leave),



- overtime and bonus payments,
- passage (travel allowance) granted to an employee at the start or end of employment,
- amounts received as compensation for unfair or wrongful dismissal,
- amounts received as compensation for restrictive covenants, for example, for requesting a former employee not to be employed by another employer or undertaking private business, and
- all other work related benefits.

NOTE

It must be noted that while the foregoing are not relevant for purposes of calculating the exemption threshold, they nonetheless, remain taxable amounts arising from employment.

Example 1: Application of the 25% Cap/Limit

The table below shows examples of three taxpayers who each received M100 000 as salary during their periods of employment. Taxpayer 2 also earned some business income while Taxpayer 3 received two types of gratuities, from the employer and from a pension fund at retirement. In all the three cases, the exempt amount is only limited to a maximum of 25% of the basic salary.

Table 1: Examples of 25% Maximum Limit

Item	Taxpayer 1	Taxpayer 2	Taxpayer 3
Salary	M100 000	M100 000	M100 000
Business Income	0	50 000	0
Gratuity Paid by Employer	25 000	30 000	20 000
Gratuity from Pension Fund	0	0	20 000
Exempt Terminal Benefit (25%)	25 000	25 000	25 000
Taxable Terminal Benefit	0	5 000	15 000

Example 2: Lump Sums Exempted or Taxable

Mrs Happy Ending received an award from the Lesotho Labour Court. The Court ruled in her favour that her former employer, Big Company Ltd, must pay her



M385 000 as a separation settlement broken down as follows –

- severance pay of 2 weeks' monthly salary of M10 000 for each of the 5 years worked,
- lump sum equivalent to three years' salary in lieu of what she would have earned had her contract not been unfairly terminated.

Question: How much of the M385 000 terminal benefit is exempt from tax?

Answer

- Severance payment in terms of the law = half the monthly salary x number of years worked = $(M10\ 000\ \text{pm}/2) \times 5\ \text{years} = \underline{\mathbf{M25\ 000}}$.
- Lump sum in lieu of unfair dismissal = $M10\ 000\ \text{pm} \times 12\ \text{m/y} \times 3\ \text{years} = \underline{\mathbf{M360\ 000}}$.
- Of the M385 000, the **M360 000** lump sum is not a gratuity, a superannuation fund payment or severance payment. It is compensation for unfair dismissal; it represents a salary and as such is not exempt, but taxable at the marginal rates. The **M25 000** is severance payment and the whole amount is exempt because it is less than 25% of salary earned over the five years.

3.4 In What Order are Lump Sums Exempted?

As the previous examples illustrate, employees can be entitled to different lump sums at the time of termination of their contracts, that is, different combinations of lump sums exist;

- employer gratuity and severance pay,
- pension fund gratuity and severance pay, and
- employer gratuity and pension fund gratuity.

Indeed, in principle, one can be entitled to employer gratuity, pension fund gratuity and severance pay. The example below shows the ordering that should be followed in determining exemptions limitations where combinations exist.



Example 3: Ordering of Lump Sums

Ms Mamello Mosebetsi has been working for over thirty (30) years and the following details are applicable to her on retirement.

- Total employment basic salary = M2 800 000
- Severance pay due = M360 000
- Pension fund gratuity = M804 000

Question: How should the two lump sums be treated?

Answer

Step 1: Maximum amount exempt = $25\% \times \text{M}2\,800\,000 = \text{M}700\,000$

Step 2: Lump sum payable = $\text{M}360\,000 + \text{M}804\,000 = \text{M}1\,164\,000$

Step 3: Taxable lump sum = $\text{M}1\,164\,000 - \text{M}700\,000 = \text{M}464\,000$

Step 4: Order of exemption: 1st severance pay then gratuity

Exempt severance pay = M360 000

Exempt gratuity = $\text{M}700\,000 - 360\,000 = \text{M}340\,000$

Step 5: Taxable gratuity = $\text{M}804\,000 - \text{M}340\,000 = \text{M}464\,000$

Step 6: Tax on the taxable gratuity = $25\% \times \text{M}464\,000 = \text{M}116\,000$

Note

Severance pay is exempted first by virtue of the repeal of the previous section 32, under which severance pay was taxed. The other lump sums are taxable under both the new section 32 and section 18 and/or 99

4. Special Cases

4.1 Amounts Used as Basis for Calculation of Terminal Benefits

In practice employers use different amounts for purposes of calculating gratuities at the end of employment terms –

- some employers base gratuity calculations on actual salaries paid,
- some employers use the average of some years of the total employment period, and
- other employers use the current /exit salaries as the basis.



Table 2 below illustrates the different outcomes based on the three possibilities.

Example 4: Table 2: Use of Different Amounts for Calculating Terminal Benefits

Year	Employer 1	Employer 2	Employer 3
1	M120 000	M120 000	M120 000
2	M132 000	M132 000	M132 000
3	M145 200	M145 200	M145 200
Total Salary	M397 200	M397 200	M397 200
25% Gratuity Payable	M99 300	M103 950	M145 200

Note that;

Employer 1 uses the actual salary paid, (M397 200), as the basis for the 25% gratuity,

Employer 2 uses last two years' average, $((M132\ 000 + 145\ 200) / 2) \times 3$, as the basis, and

Employer 3 uses the current/exit salary, $(M145\ 200 \times 3)$, as the basis.

Question: How much gratuity is exempt in each case?

Answer:

Employer 1: the entire gratuity, **M99 300**, is exempt.

Employer 2: of the gratuity, **M99 300** is exempt and the difference, **M4 650**, is taxable.

Employer 3: of the gratuity, **M99 300** is exempt and the difference, **M45 900** is taxable.

NOTE

While in actual fact Employers 2 and 3 did not pay gratuities based on the actual salaries earned during the period for a variety of reasons, some of which could be justifiable, it is good taxation principle not to allow the whole amounts in both cases for two main reasons –



- (i) *to prevent abuse thereby protecting the tax base, and*
- (ii) *to bring about equity in the tax system.*

4.2 Treatment of Terminal Benefits Related Returns/Interest

4.2.1 Returns from Complying Superannuation (Pension & Provident) Funds

As and when employers and employees contribute to complying superannuation funds, those funds whose rules have been approved by the Commissioner General as meeting the tax law requirements, the contributions are invested to earn some returns. Furthermore, it should be recalled that it is Government policy to encourage long term savings by granting a tax deduction at the time the contributions are made, but such tax free returns are subject to the limitations of the Amendment Act. When employees retire or leave employment and consequently the pension schemes, the individual shares in the pension funds are normally split into two components; ***lump sum gratuity*** and another portion that goes towards ***purchasing periodic payments***, for example, monthly pensions.

Question: How should the lump sum, consisting of both the actual contributions and the returns/interest on the contributions be treated for tax purposes?

Answer:

The actual contributions and the related returns/interest are exempt from income tax, but as already indicated, the exempt amount cannot be more than 25% of the basic salary earned during the period.

Example 5: Treatment of Terminal Benefits from Pension and Similar Funds

Mr Bokamoso has been employed by Good Employer (Pty) Ltd for the past twenty (20) years. His remuneration consisted of a fixed salary of M10 000 per month and a commission which depended on the business he brought to Good Employer.



During the years, both him and the employer each contributed 15% of the basic salary towards his pension. Over and above this, he also contributed M200 per month from his after tax income and this was with the same pension scheme. On retirement he is entitled to $\frac{1}{3}$ of his share in the fund as a lump sum gratuity. The remaining $\frac{2}{3}$ is to be used to buy him a monthly pension. His total share in the fund is estimated at M921 600.

Question: What are the tax implications for Mr Bokamoso?

Suggested Steps

Step 1: Calculate the maximum terminal benefit to be exempt under the law.

Step 2: Calculate the terminal benefit that is payable under the employment contract.

Step 3: Apportion and cap the contract terminal benefit between:

- self-provide portion,
- excessive contribution, and
- exempt amount.

Step 4: Calculate the tax on the taxable terminal benefit.

Answer:

Step 1: Maximum exemption limit = $(M10\ 000\ pm \times 12\ m/yr \times 20\ yrs) \times 25\% =$
M600 000.

Step 2: Terminal benefit payable under the contract = $\frac{1}{3} \times M921\ 600 =$ M307 200.

Note that not all of this terminal benefit is exempt even though it is less than the maximum amount allowed under the law. This is because it includes amounts related to self-provided pension fund and excessive contribution to the pension fund. As such it must be apportioned.

Step 3: Apportionment of terminal benefit payable under the contract:

- Self-provided portion = $(M200/M3\ 200) \times M307\ 200 = M19\ 200$
- Excessive contribution portion = $(M1\ 000/M3\ 200) \times M307\ 200 =$
M96 000



- Exempt amount = M307 200 – (M19 200 + M96 000) = **M192 000**

Step 4: Tax on taxable terminal benefit = (terminal benefit payable under the contract – exempt terminal benefit) x standard rate of tax.

Hence (M307 200 – M192 00) x 25% = 25% x **M115 200** = **M28 800.**

4.2.2 Taxation of Rolled Over Benefits

Section 99 of the Act allows that terminal benefits can be rolled-over or paid into a complying pension or provident fund without tax being paid at the time of roll-over. Thus, an employee may decide not to “cash (in)” the terminal benefits but transfer such into a complying pension or provident fund. When the person ultimately “cashes (in)” from the pension fund the exemption provided by the new section 32 must be applied.

Example 6: Taxation of Rolled-over Benefits

Ms Matjato is employed in a parastatal, Letamo Authority, as a Legal Officer and her contract is for five (5) years with a starting salary of M16 000 per month. For each year, an increase of M1 000 per month is to be made at the beginning.

Letamo Authority has a provident fund for its employees into which it contributes 10%, with the employees also contributing the same amount. Matjato's contract expires at the end of 2014 after which she will go into private practice for ten (10) years. She intends to invest all her estimated M264 000 proceeds from the employer provident fund into a self-provided superannuation fund, but will not be making any further contributions.

At retirement, that is after the private practice, she can either be paid her estimated fund of M684 800 or have 1/3 of this amount as a lump sum gratuity, with the 2/3 remainder used to buy her periodic pension.

Question: What will be the tax implications at retirement under the two options Ms Matjato is considering?



Suggested Steps

Step 1: Calculate the total salary earned during the five years.

Step 2: Calculate the 25% cap provided under the new section 32.

Step 3: Calculate the terminal benefit payable at retirement under each option.

Step 4: Calculate the taxable amount under each option.

Step 5: Calculate the tax payable on taxable terminal benefits, if any.

Answer:

Step 1: Year 1 salary = M16 000 per month x 12 months = M192 000
 Year 2 salary = M17 000 per month x 12 months = M204 000
 Year 3 salary = M18 000 per month x 12 months = M216 000
 Year 4 salary = M19 000 per month x 12 months = M228 000
 Year 5 salary = M20 000 per month x 12 months = M240 000
 Total salary = M1 080 000

Step 2: 25% cap allowed by the law = 25% x M1 080 000 = M252 000

Step 3: Terminal benefit payable under each option

	<u>Option 1¹</u>	<u>Option 2²</u>
Terminal benefit =	<u>M684 800</u>	M684 800 x 1/3 (33%) = <u>M228 267</u>

	<u>Option 1</u>	<u>Option 2</u>
Step 4: Taxable terminal benefits:		
Benefit under Step 3 =	M684 800	M228 267
Benefit under Step 2 =	<u>(M252 000)</u>	<u>(M252 000)</u>
Taxable difference =	<u>M432 800</u>	<u>Mo.00³</u>

Step 5: Tax on taxable terminal benefit

Tax on terminal benefit = 25% x M432 800 = M105 950

NOTE: Tax on terminal benefits is payable only under Option 1. The monthly salary payable under Option 2 is to be taxed in the same manner as monthly salaries under the PAYE system.

¹ This is a provident fund option where the employee takes the whole amount in the fund as terminal benefit.

² This is a pension fund option where a lump sum is paid at retirement and monthly pension thereafter.

³ The exempt benefit allowed by law is more than benefit paid and as such no taxable amount.



5. Other Types of Benefits

In practice there are many other reasons and circumstances that can bring an employment contract to an end, for example, death or disability. Employers get a tax deduction when they insure their employees under different life assurance policies. The benefits derived from such instances are also subject to tax laws.

It must however be noted that for any contract gratuity to be exempt it must satisfy all the key elements/conditions of the definition of “contract gratuity”. The key elements are;

- the gratuity must be expressed as a percentage of salary,
- the basis of the gratuity must be a certain period of time of actual employment, and
- the gratuity must be paid upon expiry, termination or renewal of a written contract.

If any one of these conditions is not met then the individual is not entitled to any exemption on that type of gratuity. An example of this is where an employer pays four times annual death gratuity regardless of the actual period worked. As can be seen only one condition/element is satisfied. The other terminal benefits that are payable and meet all the above will qualify for exemption in the manner already explained in the foregoing parts of this note.

6. Effective Date

In terms of Government Gazette No. 41 of Friday 23 March 2012 the Income Tax (Amendment) Act No. 11 of 2012 is effective from 1 April 2012. In applying this effective date, the meanings of “paid” and “payment” as defined under section 3 of the Act must be taken into consideration. This therefore, means that if an employee's contract expired on or before 31 March 2012 but received the lump sum after the effective date then the exemption does not apply to such an employee.

7. Summary

- (a) Terminal benefits can take many forms and variations, but the exemption is limited to only three main types; gratuities, severance and



superannuation payments.

- (b) Employment contracts are of different types and duration. The exemption applies to each employment contract regardless of renewals, terminations or variations.
- (c) Different formulae and approaches can be used in determining the terminal benefit payable at the end of employment contracts. Care should be taken that the formulae or approaches taken are those that are in line with the Law.
- (d) The exemption provided under the amended section 32 does not replace the concession under section 99. Both sections should be read together in determining the tax on the terminal benefits.

8. Further Information

This Public Ruling does not cover all possible cases and examples. For further information or clarification please refer to the Taxpayer Services Division at the Lesotho Revenue Authority Offices (including the Advice Centres).

Disclaimer

This ruling provides the general interpretation of the legislation. It has no binding legal force and does not affect a taxpayer's right of objection and appeal to the Commissioner General, the Revenue Tribunal or the Courts of Law. This ruling shall not affect the taxpayer's right to argue for a different interpretation, where necessary, in any appeal process, as stipulated in the revenue laws.

