

GOVERNMENT NOTICE NO. 35 OF 1994

**Explanatory Memorandum to the Income Tax (Amendment) Bill 1994
Introduced into the National Assembly on 10th March 1994**

**(Circulated by the Authority of the Minister for Finance and
Economic Planning, The Hon. Selometsi Baholo)**

OUTLINE

The purpose of this Bill is to amend the Income Tax Order 1993 to correct a number of technical deficiencies in the operation of that Order identified since its enactment in early 1993 and also to make some minor policy changes.

The Income Tax Order 1993 has been in operation since April 1993 and a number of minor problems with the operation of that Order have been identified by the Department of Income Tax and through consultation with those affected by the Order. In addition, a number of minor shortcomings in the Order have been identified during double taxation treaty negotiations with the United Kingdom and South Africa. The main object of the Bill is to correct those problems.

NOTES ON CLAUSES

Clause 1. Short Title

Section 1 provides that the Act may be cited as the Income Tax (Amendment) Act, 1993 (hereinafter it is referred to as the "Amending Law"). It amends the Income Tax Order, 1993 ("the Principal Law") in several substantive respects and corrects some technical deficiencies.

Clause 2. Commencement

Section 2(1) of the Amending Law provides that the Amending Law comes into operation on the date on which it is published in the Gazette. Section 2(2) provides that the amendments in sections 7, 11, 12, 13, 15 and 16 of the Amending Law are deemed to have come into operation on 1 April 1993, being the date the Principal Law came into operation.

Clause 3. Title of Principal Law

Section 3 of the Amending Law amends the title of the Principal Law by changing "Order" to "Act". The section also changes references in the Principal Law from Order to Act. This amendment applies from the date the Amending Law is published in the Gazette.

Clause 4. Rate of Income Tax for Non-Residents

This section repeals the existing section 12 and replaces it with a new section. Under the previous provision people who live in South Africa and either work or operate a business in Lesotho are taxed in the same manner as Lesotho residents. However, a new double taxation agreement with South Africa is presently being negotiated and pursuant to that agreement such persons will be classified as residents of South Africa only. The result would be that those people would be entitled to be taxed at the non-resident rate of tax which is 25%. This produces an unsatisfactory result as South Africa does not tax the foreign source income of its residents.

This section therefore replaces the old section 12 of the Principal Law with a section that provides that people who reside in South Africa and are employed or engaged in business or trade full-time in Lesotho are subject to the rates of tax prescribed in the second schedule. This will ensure that those people do not gain a tax advantage over Lesotho residents.

Under section 2 of the Amending Law, the amendments in section 4 apply from the date the Amending Law is published in the Gazette.

Clause 5. Repeal of Existing Section 32

This section repeals the existing exemption under section 32 and substitutes a new exemption for severance payments.

(a) Exemption under Other laws

Current Law

Section 32 of the Principal Law exempts income exempted under any other law from income tax.

Summary of amendment

Section 5 of the Amending Law repeals the exemption for income exempted under any other law.

Explanation of amendment

The purpose of the existing section 32 was to avoid an argument that the Principal Law (being a later law) overrode the exemption from income tax granted to the King and Regent of Lesotho under the **Office of King Order, 1990**. As the King and Regent of Lesotho is now exempt under the Constitution, it is no longer necessary to include the existing section 32 in the Principal Law.

The repeal of the existing section 32 reflects the general policy that all exemptions from income tax are to be granted in the Principal Law and not in any other law.

(b) Severance payments

Current Law

A severance payment made on termination of employment is employment income under section 18 of the Principal Law is included in gross income under section 17.

Summary of amendment

Section 5 substitutes a new section 32 which exempts the first M1,500 of a payment made under section 79 of the Labour Code Order 1992 from income tax.

Explanation of amendment

Severance payments are designed to compensate an employee for lost wages resulting from retrenchment. Under section 79 of the Labour Code Order, an employer is required to make a severance payment equal to two weeks pay for every completed year of continuous service with an employer. General payments are made to low-paid workers, and therefore, the average amount of the payment is small (perhaps M1,000 — M2,000).

Severance payments are included in gross income under the current law because the "lost" wages for which they compensate are includable in gross income. The inclusion of a severance payment in gross income should not affect the tax position of many recipients as their gross income will

still be below the level of the abatements. It is recognised though, that the lump sum nature of such a payment may push the recipient into a higher tax bracket for the year of assessment in which it is received. It is further recognised that, in some cases, the severance payment may have to support the recipient for a substantial period before new employment is found. The Amending Law introduced a new exemption to provide relief from these hardships.

The exemption only applies to severance payments required to be paid under the Labour Code Order 1992 and not to voluntary payments made on retrenchment.

Application of amendments

Under section 2 of the Amending Law, the amendments in section 5 apply from the date the Amending Law is published in the Gazette.

Clause 6. Abatements

This section amends section 73 by adding a subsection (5) to provide that a non resident who lives permanently outside Lesotho but who is employed full-time in a business or trade in Lesotho qualifies for an abatement. This change is consequential upon the introduction of the new section 12 of the Principal Law by section 4 of this Amending Act.

Under section 2 of the Amending Law, the amendments in section 6 apply from the date the Amending Law is published in the Gazette.

Clause 7. Lump Sum Payments Made by a Superannuation Fund

This section amends section 99 of the Principal Law which provides for the taxation of lump sum payments made by a superannuation fund.

(a) Amendment to section 99(1)

Current law

Under section 99(1), a lump sum payment made by a complying superannuation fund is subject to a flat rate of tax of 25% of the amount of the payment. This tax is collected by withholding under section 159. The tax withheld is a final tax and the amount of the payment is not included in gross income.

Summary of amendment

Paragraph (a) of section 7 of the Amending Law amends section 99 (1) to allow a recipient of a lump sum superannuation payment to elect for the payment to be included in gross income. The effect of the election is that the superannuation payment will be added to the taxpayer's other income for the year of assessment and taxed at marginal rates.

A consequential amendment has been made to section 159(2) and the mechanics of the election is provided for in the **Income Tax Regulations, 1993**.

Explanation of amendment

The rate of withholding under the current law (25%) equivalent to

the lowest marginal rate and, therefore, the amount of tax payable will generally be less than if the payment was included in the recipient's gross income and taxed at marginal rates. There may be, however, some recipients who would have a lower tax liability on the payment if it was included in gross income particularly after taking into account the abatement. The amendment, therefore, allows those recipients to elect to include the payment in gross income rather than have it taxed at flat rate of 25%.

(b) Amendment to section 99(2)

Current Law

Under section 99(2), a lump sum payment from a complying superannuation fund ("roll-over fund") or used to purchase an annuity within 90 days of the date of the payment is exempt from income tax.

Summary of amendments

Paragraph (b) of section 7 of the Amending Order effectively makes two changes to section 99(2). For all recipients (other than expatriate taxpayers) of a lump sum payment from a complying superannuation fund, the exemption is available where the payment is rolled-over into another complying superannuation fund or used to purchase an annuity from a resident person. The change in this class of case is that an annuity must be purchased from a person resident in Lesotho.

For expatriate taxpayers, the exemption is available where the payment is rolled over into any other superannuation fund or used to purchase an annuity from any person. The change in this class of case is the removal of the requirement that the payment be rolled-over into a complying superannuation fund.

Explanation of amendments

The amendment in respect of recipients (other than expatriate taxpayers) of a lump sum payment from a complying superannuation fund relates to the use of the payment to purchase an annuity. Under the current law, the annuity may be purchased from any person wherever resident. This raises the possibility of a resident who is about to permanently leave Lesotho using his or her lump sum payment from a complying superannuation fund to purchase an annuity from a non-resident and then receiving the annuity after becoming a non-resident. As the annuity would be paid by one non-resident to another it would be outside Lesotho's jurisdiction to tax. Even if section 103(1)(k)(ii) applied to give the annuity a Lesotho-source, there would be difficulties in collecting the tax due as everything occurs outside Lesotho.

It was not intended that the Principal Law could apply in this way. The amendment, therefore, confines the exemption in section 99(2) to a lump sum used to purchase an annuity from a person resident in Lesotho. This will ensure that, even if the recipient becomes a non-resident, the annuity has a Lesotho-source and the payer is a resident to whom section 110 of the Principal Law can apply. Sections 5-8 of the Principal Law provide tests for determining whether a person is a resident of Lesotho.

The amendment in respect of expatriate taxpayers receiving a lump sum payment from a complying superannuation fund relates to the roll-over of the payment into another superannuation fund. Under the current law, the exemption is only available where the payment is rolled-over into a complying superannuation fund which by definition must be a resident fund. The amendment removes the requirement that the roll-over fund be a complying superannuation fund thereby allowing the exemption where the payment is rolled-over into any superannuation fund wherever resident. The amendment is confined to expatriate taxpayers which term is defined in section 3(1) of the Principal Law.

The purpose of the amendment is to ensure that expatriate taxpayers who use a Lesotho superannuation fund are subject to the same Lesotho tax treatment as those who use a non-resident fund. It is intended in particular, that the amendment will encourage expatriate taxpayers who come to Lesotho without existing superannuation funds to use a Lesotho fund rather than a non-resident fund (such as an RSA fund).

Application of amendments

Under section 2 of the Amending Law, the amendments in section 7 apply from 1 April 1993, being the date the Principal Law came into operation.

Clause 3. Source of income

This section amends section 103 by adding a paragraph (n) to provide that income is Lesotho source income if it is taken in Lesotho under an international agreement. The reason for adding this paragraph is that double taxation agreements that Lesotho is currently negotiating will contain broader source rules for certain classes of income than currently exist in the Principal Law. To take advantage of these broader source rules it is necessary to amend section 103 so that income that is taxable in Lesotho by virtue of the provision of an international agreement is treated as Lesotho source income.

Under section 2 of the Amending Law, the amendment in section 8 applies from the date the Amending Law is published in the Gazette.

Clause 9. Withholding Tax on International Transactions

This section amends section 107 of the Principal Law which imposes withholding tax on certain Lesotho-source payments made to a non-resident.

Current law

Section 107(1) imposes withholding tax on Lesotho-source dividends, interest payments, royalties, natural resource payments, or management charges paid to a non-resident. The current rate of withholding tax is 25% of gross amount of the payment.

Under section 107(2), no withholding tax is payable on a Lesotho-source dividend paid by a Lesotho-resident company out of manufacturing income subject to the concessional rate of tax (15%) under section 10(2) of the Principal Law. As dividends are paid out of after-tax profits, the effective rate of Lesotho tax on the manufacturing profits of a Lesotho resident company distributed to a non-resident shareholder is 15%

Further, under section 107(3), the rate of withholding tax payable on a Lesotho-source royalty paid in respect of technology used in the production of manufacturing income subject to the concessional rate of tax under section 10(2) is 15%.

Interest and management charges paid to a non-resident in respect of concessionally taxed manufacturing income are subject to the full rate of withholding tax (25%). As these payments are deductible to the payer, the effective rate of Lesotho tax on manufacturing profits used to make such payments is 25%.

Summary of amendment

Section 9 of the Amending Law repeals the existing subsection (3) of section 107 and substitutes a new subsection which provides for a 15% withholding tax rate on certain interest, royalties and management charges made to a non-resident by a Lesotho resident manufacturing company.

The reduced rate of withholding tax is only available to interest, royalties and management charges that have a sufficient nexus to the derivation of manufacturing income. In the case of interest, the loan funds on which the interest is paid must have been used solely in the production of manufacturing income subject to the concessional rate of tax. In the case of royalties, the technology in respect of which the royalty has been paid must have been used solely in the production of manufacturing income subject to the concessional rate of tax. In the case of management charges, the management or administrative service to which the payment relates must have been used solely in the production of manufacturing income subject to the concessional rate of tax.

Explanation of amendment

The effect of the amendment is to place interest and management fees paid in respect of manufacturing income on the same footing as royalties. As interest and management charges are deductible to the payer, the effective rate of tax on the manufacturing profits represented by those payments is 15%. This reduces the effective rate of tax on such profits from 25% to 15% thereby ensuring consistency with the taxation of dividends and royalties.

The main technical issue with the amendment is determining when the nexus test is satisfied particularly where the payer also carries on non-manufacturing activities. In this case, for example, loan funds used generally in the manufacturing company's business will not satisfy the nexus test as they are not solely used in producing manufacturing income. On the other hand, loan funds that have been used solely to purchase an item of manufacturing plan or that have been used solely to meet the current expenses of the manufacturing operation (such as payment of wages to manufacturing workers) will satisfy the nexus test.

Application of amendment

Under section 2 of the Amending Law, the amendment in section 9 applies from the date the Amending Law is published in the Gazette.

Clause 10. Reciprocal Assistance in the collection of tax

Section 10 of the Amending Law inserts into the Principal Law a new section 112A empowering the Commissioner to collect tax on behalf of

another country pursuant to an international agreement. The double taxation agreement currently being negotiated with South Africa contains an article allowing for the reciprocal collection of taxes. This article would be used for example if a South African taxpayer owed taxes in Lesotho and had returned to South Africa. The Commissioner could request his Southern African counterpart to collect the Lesotho taxes owing and forward these to the Commissioner. South Africa already has provision in its income tax law to allow for this. Section 102A of the Principal Law will provide that Lesotho could offer reciprocal assistance to South Africa or any other country that is a party to a similar agreement.

Under section 2 of the Amending Law, the amendments in section 10 apply from the date the Amending Law is published in the Gazette.

Clause 11. Loan Fringe Benefit

This section amends section 125 of the Principal Law which provides for a loan fringe benefit.

Current law

Section 125(1) provides that a benefit provided by an employer to an employee consisting of a loan at a rate of interest below the Central Bank of Lesotho discount rate is a loan fringe benefit. The Central Bank of Lesotho discount rate, therefore, is the benchmark interest rate for the purposes of determining whether an employer has provided a loan fringe benefit. Under section 125(2), the taxable value of a loan fringe benefit is the difference between the interest paid by the employee during the year of assessment and the interest that would have been payable if the loan had been made at the Central Bank of Lesotho discount rate.

Summary of amendment

Section 11 of the Amending Law amends the benchmark interest rate for the purposes of determining whether a loan fringe benefit has been provided and, if it has, for the purposes of calculating the taxable value of the benefit. The new benchmark interest rate is a rate equal to two-thirds of the Central Bank of Lesotho discount rate.

Explanation of amendment

The amendment is intended to use a benchmark interest rate that more accurately reflects the employer's cost of providing the benefit. There will only be a loan fringe benefit under section 125(1) if the interest rate charged to the employer is less than two-thirds of the Central Bank of Lesotho discount rate. If there is a loan fringe benefit, then the taxable value of the benefits is the difference between the interest paid by the employee and the interest that would have been paid if the interest rate was two-thirds of the Central Bank of Lesotho discount rate.

For example, if the Central Bank of Lesotho discount rate is 15%, then the benchmark interest rate for the purposes of section 125 of the Principal Law is 10%. In this example, therefore, a loan fringe benefit only arises if the loan to an employee is at an interest rate less than 10% and the taxable value of the benefit is the difference between the interest paid and the interest that would have been paid if the interest rate was 10%.

Application of amendment

Under section 2 of the Amending Law, the amendment in section 11 applies from 1 April 1993.

Clause 12. Payments by a Superannuation Fund

This section amends section 159 of the Principal Law which provides for the payment of withholding tax on lump sum or periodic superannuation payments.

Current law

Section 159(1) of the Principal Law requires the trustee or fund manager of a superannuation fund to withhold tax from a lump sum or periodic payment made by the fund to a beneficiary as prescribed by regulations. Consistent with section 99(1), the **Income Tax Regulations, 1993** require tax at the rate of 25% of the gross amount of any lump sum payment made by a complying superannuation fund to be withheld from the payment. Under section 159(2), the tax withheld on a lump sum superannuation payment made by complying superannuation fund is a final tax and the payment is not included in the recipient's gross income.

Summary of amendment

Section 5(a) of the Amending Laws amends section 99(1) of the Principal Law to allow a taxpayer to elect to include a lump sum superannuation payment from a complying superannuation fund in gross income. Section 8 of the Amending Law amends section 159(2) to ensure that, where the recipient elects under section 99(1) for the payment to be included in gross income, the tax withheld under section 159(1) is not a final tax.

Explanation of amendment

The amendment to section 159(2) is consequent upon the amendment in paragraph (a) of section 7 of the Amending Law.

Application of amendment

Under section 2 of the Amending Law, the amendment in section 12 applies from 1 April 1993.

Clause 13. Tax Withholding Certificates

This section amends section 163 of the Principal Law which obliges a withholding agent to deliver a tax withholding certificate to a payee.

Current law

Section 163(2) sets out the time limits within which a withholding agent is required to deliver a tax withholding certificate to the payee. For employees, the certificate must be delivered within 28 days after the end of the year of assessment or within 7 days of the employee leaving the employer's employment. For all other payees, the certificate must be delivered on the date of the payment. This means that the trustee or man-

ager of a superannuation fund making pension or annuity payment must give the recipient a tax withholding certificate with every payment.

Summary of amendment

Section 13 of the Amending Order amends subsection (2) of section 163 of the Principal Law so that a tax withholding certificate must be delivered to a beneficiary in receipt of a periodic superannuation payment within 28 days after the end of the year of assessment.

Explanation of amendment

It was not intended that section 163 of the Principal Law apply in this way and, therefore, the amendment is correcting a technical deficiency.

Application of amendment

Under section 2 of the Amending Law, the amendment in section 13 applies from 1 April 1993.

Clause 14. Repeal of Section 184

This section repeals the existing penalty provision for breach of the tax clearance requirements of section 174 and replaces it with a new penalty provision. The amendment is a purely technical amendment necessitated by the form of the regulations made under section 173 (see **Income Tax Regulations, 1994**) and applies from the date the Amending Law is published in the Gazette.

Clause 15. Secrecy

This section amends section 202 of the Principal Law which provides for secrecy of tax information and documents.

Current law

Section 202(1) of the Principal Law provides that a person appointed under, or employed in the carrying out of, the Principal Law must preserve secrecy with regard to all information or documents which may come to his or her knowledge in an official capacity in the performance of duties under the Principal Law. Disclosure of information or documents is permitted under section 202(3) in certain specific instances. The terms of section 202(3) do not permit the exchange of information or documents between the Commissioner of Income Tax and other revenue departments such as Sales Tax and Customs.

Summary of amendment

Section 15 of the Amending Law amends 202(3)(a) to permit disclosure of information or documents to the Minister or to any other person for the purposes of any other fiscal law.

Explanation of amendments

The amendment is necessary to permit the exchange of information or documents between revenue departments. The amendment to section 202 ensures consistency with the **Sales Tax Act 1982**.

Application of amendment

Under section 2, the amendment in section 15 applies from 1 April 1993.

Clause 16. Regulations and Amendment of Schedules

This section amends section 212 which provides the Minister with general regulation-making power. The amendments are of a technical nature. The amendment in paragraph (a) removes the reference to "Seventh Schedule" in section 212(1)(b); and the amendment in paragraph (b) adds a new subsection (2A) to section 212 empowering the Minister to prescribe specific offences for breaches of the Regulations.

Under section 2, the amendment in section 16 applies from 1 April 1993.