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TAX ADVANTAGES OF RETIREMENT FUNDS

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Most governments have set up schemes for the assistance of the senior citizens, generally of 60 years of age and above, belonging to a family living below the poverty line or as part of the government's social security benefits to qualitied retirees and disabled people. However, oftentimes, other priorities of the government such as education, health care and the creation of employment, amongst many others, make it impossible for most governments to provide an adequate income for the senior citizens. Governments do their best to provide for the aged with the limited resources at their disposal, but in the end the individual must, as far as possible, be encouraged to make his or her own arrangements for retirement.

Governments are continuously consulting with pension experts and members of the public on how to ensure the pensions system is future-proof and how to encourage pension saving. As an example, the government of Lesotho has introduced tax savings on contributions and tax concessions at retirement. These are incentives that should not be ignored. The discussion below explains some of the tax advantages of retirement funds that are available in Lesotho.

The income tax act allows up to 20% of retirement savings to be exempted from tax. In order to explain what this means, let's look at an example of two people who earn a monthly gross salary of M10,000. For argument's sake let's call them Thabo (aged 30) and Teboho (aged 30). To understand how this tax benefit works, let's assume that Thabo contributes 10% of his monthly income towards retirement and that Teboho contributes 0% of his monthly income. Based on the income tax act and Lesotho Revenue Authority (LRA) 2016/2017 tax table, Thabo's annual income tax will be M20,457. On the other hand, Teboho, who saves 0% for his retirement will pay an annual income tax of M24,057.

This example shows that a person who does not save for retirement pays a higher income tax. Assuming that Thabo and Teboho both started working at the age of 30 and that both of them will retire at age 65, let's find out how much Teboho could have saved if he was also contributing 10% towards retirement, just like Thabo. For the 35 years of their working career (from 30 to 65 – their

retirement age), Teboho is losing out on M126,000 (the difference between M24,057 and M20,457 multiplied by 35 years). Assuming this money (M126,000) was invested in a portfolio that earns an investment return of 6.5% (compound interest), then by the age of 65 Teboho would have missed out on M1,141,844.

Had Teboho saved for retirement, this amount (M1,141,844) could buy him a monthly pension at retirement that earns him a monthly income of M 8,000 (increasing with 5% per annum and guaranteed for life). But since he was not saving money for retirement, he will earn a state pension of less than M1,000 per month. Now let's assume that when Teboho retires, he will have to take care of three dependents – a wife and two children. The critical question is, how will he support his family with less than a 1,000 Maloti per month? Remember his family was used to a lifestyle of M10,000 before Teboho retired.
Another tax concession is enjoyed when a person obtains his retirement savings from a pension or provident fund. People normally ask whether their retirement capital or lump sum will be taxed or not. The answer to this question depends on the assessment that will be conducted by the LRA to determine whether one should be taxed or not. Here is an example:

Taxable retirement benefit

Total salary history = M500,000
25% of total salary history = M125,000
Total retirement benefit = M200,000
According to the income tax act M125,000 will be tax free. What will only be taxable is the difference between the total retirement benefit and 25% of salary history which in this case is M75,000. This amount will be taxed by 25%. This means that in this case a person will be taxed only M18,750.

Non-taxable retirement benefit

Total salary history = M500,000
25% of total salary history = M125,000
Total retirement benefit = M120,000
In this example a person's retirement benefit will not be taxable since the total retirement benefit is less than 25% of the total salary history.

In conclusion, these are the tax benefits which the government in Lesotho has made available to encourage people to increase their savings for retirement so that they can retire with enough capital to purchase annuities (monthly income at retirement). The decision is now left to each person to decide whether they want to retire with enough capital or not. The current trend in Lesotho is that most people retire with less capital and very few people can maintain their standard of living during the years of retirement. This is because most people start saving for retirement only in their 40s and 50s. In order to retire with enough capital, experts recommend that we start saving in our middle 20s or at least early 30s. Another important variable is that we should save at least a minimum of 15% of every source of income that we earn.

At Minet, we have a specialized employee benefits division that is available to help with additional information and advice on the structuring of your pension plan.

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