

Tax laws bar gratuity for certain directors in Botswana

Directors are generally appointed to ensure that shareholders' interests are protected through proper management and running of corporates. Accordingly, some organisations tend to pay tribute to these hard-working directors by honouring them with gratuity payments. In this regard, it is crucial that organisations understand that the tax laws prohibit gratuity payments made to directors who are also shareholders of private companies as we will elaborate below. In this article, words importing the masculine shall be deemed to include the feminine.

Enter gratuity!

The Income Tax Act does not provide a legal definition of the term gratuity. However, the said income is generally construed to mean a payment made to an employee by an employer in recognition of long and meritorious service, above and beyond the usual wages or salary.

Since a gratuity is a compensation for employment services, it technically triggers PAYE implications in the hands of the recipient employee, in this case, the directors. Having clarified what entails a gratuity, let us now have a look at the tax treatment applicable to gratuities.

Enter tax

Gratuity payments made to any other employee are partially exempt from tax. Before the promulgation of the Income Tax Amendment Bill of 2023, gratuity receipts were or are exempt to the extent of 33.3% and only the balance would suffer tax. Upon the commencement of the said draft law, 50% of such payments would be exempt from tax, which is a move the public has warmly welcomed.

The restrictions

The Income Tax Act does not recognise a gratuity paid to working directors who are shareholders holding at least 5% shares in a private company, whom we shall refer to as participators henceforth. In fact, the Act regards a payment of a gratuity to a participator as not deductible for tax in the company's hands and also requires that such gratuity be deemed as a dividend, which attracts 10% tax. If a participator receives a gratuity of P1m, the paying company's corporate tax will increase by P220 000 (22% corporate tax) as the gratuity is not tax deductible. Furthermore, the same company is required to pay P100 000 (10% tax) as withholding tax on dividends, due to the deeming provisions of the Act.

This restriction is motivated by the fact that a director may then use gratuity payments to disguise dividend declarations and enjoy the partial tax exemption applicable to gratuities. The Act recognises that a shareholder derives dividends which are paid after corporate tax of 22%. The dividends are further taxed at 10%, which brings the effective tax rate to 29.8%, assuming all retained earnings are declared as dividends. Therefore, to avoid such higher tax, a participator may then grant themselves a gratuity and suffer lower tax as the additional 10% is avoided and also given the partial exemption of gratuities stated above.

Plan B

Well, there is a principle called Tax Planning which is the legal way of arranging one's affairs in a tax-efficient manner. This has been endorsed as legal by the Court of Appeal in the matter between Debswana Diamond Company versus BURS. Working directors who also happen to be participators may however instead opt for severance pay instead of gratuity. That severance pay is not barred by the Act and yet it enjoys the same tax exemptions applicable to a gratuity.

Well folks, we hope that was insightful. As us the two Yours Truly say goodbye, remember to religiously pay your taxes. If you want to consult, join our free Tax WhatsApp group or to know about our 9 Tax e-books, send us a text on the +267 71 81 5836. You can read more tax articles on our website, www.aupracontax.co.bw under the 'Tax articles' tab.