

AUDIT
TAX
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Tax morality under threat again?

The concept of tax morality has often been under discussion and fiercely debated. There are those who say there is no such thing as tax morality and that tax is simply a necessary evil, part of the invisible social contract between citizen and State and that taxes have to be paid to maintain the State. There are others that say paying tax is a moral obligation over and above the invisible social contract, and that this is what drives people to pay their taxes.

One sees this philosophy in the latest South African Revenue Service (SARS) advertisements where the message seems to be clear that paying tax is the right thing to do and helps South Africa and its people to develop. But ironically, it is often the State itself that places tax morality, whatever one's view of it is, under threat. Tax morality works both ways; citizens will pay their taxes as long as the State has a legitimate government that properly collects, manages and spends the taxes.

“...citizens may well take fiscal action when their hard earned taxes are being wasted, stolen or mismanaged.”

In the dark days of pre-1994 politics in South Africa, there was a question mark around the legitimacy of the Apartheid government and consequently a definite spike in tax schemes and structures aimed not only at tax avoidance but also tax evasion. The argument is that an immoral and illegitimate government cannot rely on tax morality and therefore citizens were busying themselves with highly sophisticated and ingenious ways not to pay their taxes.

The question is whether tax morality or citizens' willingness to pay their taxes is once again under threat. The problem is the ability of government to stick to their end of the bargain. Without politicising the issues, on a purely factual analysis of the government's end of the bargain, the scorecard does not look too good.

Crime is, even by government's admission, out of control. Service delivery is at an all-time low, infrastructure such as sewage, in particular, and water purification is collapsing; the delivery of proper medical care is under

severe pressure; the police force is seen to be ineffective and often corrupt; state spending often appears to go unchecked; roads are in their worst state in the last thirty years; South Africa's productivity is at its lowest level in years, and our labour laws are not conducive to a competitive environment. Government's wastage on ill advised projects and corrupt tender processes are shocking to say the least, and many departments such as internal affairs are criticised not only by frustrated citizens but foreign governments as well. Service delivery to the poor and needy often seems to be neglected in favour of less important projects, and so the list continues.

The suggestion is not that the government is illegitimate but as we've seen at local or municipal level, citizens may well take fiscal action when their hard earned taxes are being wasted, stolen or mismanaged. Unfortunately, this government has one of the worst track records to date.

The question is whether the inability of government to stick to their end of the bargain will lead to a resurgence of arrangements, schemes and non-disclosures aimed at avoiding or even evading taxes. No government can expect its citizens to pay properly and on time when the delivery side is shrouded in mismanagement, theft and corruption. The sense is that government has brought us dangerously close to a position where tax morality is severely under pressure and unless we can return to a state of good governance, citizens will employ all kinds of methods to divert their tax payments elsewhere.



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SARS audits zero-rating VAT on sales of fixed property.

SARS is increasingly auditing taxpayers who have zero-rated the sale of a fixed property in terms of the zero-rating provision, section 11(1)(e) of the Value-Added Tax Act.

Of particular concern is that SARS is actively seeking arguments to unravel the application of section 11(1)(e) of the Act, in what appears to be an attempt to increase collections through the mechanism of penalties and interest. SARS is not attacking the formal procedures required for the application of the section, but rather the underlying requirement that there was a sale of a 'going concern'.

The fact that the source documents provide for a zero-rating of Value-Added Tax (VAT) as a sale of a 'going concern' or that the correct documentation was submitted to SARS appears to be irrelevant to the tax man.

In brief, section 11(1)(e) of the Act allows for the sale of a fixed property to be zero-rated if the income-earning activity of the property is transferred at the time of the sale. If this is done, the transaction is regarded as a sale of a going concern. Ordinarily this is a question of fact and will depend on the particular circumstances.

For example where a block of flats is sold, the leasing activity ie the tenants, must be disposed of together with the property in order to constitute the transfer of an income-earning activity.

Failure to transfer this income-earning activity will result in a simple sale of an asset which, for a vendor, would attract VAT at the standard rate.

SARS is now investigating whether taxpayers have

indeed transferred this required income-earning activity at the time of the sale. The incorrect application of section 11(1)(e) will often lead to the transaction attracting VAT in addition to penalties and interest from the date of the original sale.

The current budget deficit and increased pressure on SARS to increase revenue collection, make it more likely that SARS may discover incorrect applications of section 11(1)(e).

Therefore, it's important to comply strictly with both the procedural and the substantive requirements of section 11(1)(e) when selling a fixed property as a going concern.

Furthermore, we recommend that clients review any historic sales and ensure that there was indeed an income-earning activity transferred at the time of the sale. It is our experience that where a tax payer has made a bona fide error, SARS will tend to be lenient if full disclosure of incorrect tax treatments of this nature are made.



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Mazars House, Century City, Cape Town

Mazars on the move

- Mazars Cape Town moved into new premises on 6 April. Mazars House, located in Century City, is centrally located and offers a great working environment, conducive to quality of lifestyle, both professionally and personally.
- On 1 June, Mazars Durban relocated to new offices at Mazars House, 197 North Ridge Road, Morningside. *"The move benefits staff and clients alike; clients have designated secure undercover parking with direct access to our 5th floor offices. In addition to a state-of-the-art training facility, we also have a penthouse/roof area with panoramic views over Durban which is ideal for staff and client functions,"* says Dave Bates, Mazars Durban Managing Partner.

We look forward to welcoming you to our new offices – Ed.



Islamic financing – adaptation of the Income Tax Act.

The draft Taxation Laws Amendment Bill tabled on 10 May 2010 incorporates proposed amendments dealing with the tax (and VAT and transfer duty) consequences of various forms of Islamic financing.

Islamic financing implies financial services, transactions and agreements which comply with the precepts of Shar'ia or Islamic law.

The key Shar'ia principles bearing upon Islamic financing can be summarised as follows:

- charging interest (riba) is prohibited
- there is an obligation of transparency, and each party must disclose all material facts bearing on the transaction
- while interest is prohibited, the sharing of risk (and profits and losses) is permissible
- financial transactions must be coupled to a real underlying economic transaction – such as the purchase of a home or business assets.

The offering of Shar'ia-compliant products by banks is still something of a novelty. The more common products on offer include the following:

- Mudurabah: a form of deposit where clients invest with the bank which, in turn invests their deposits in Shar'ia-compliant enterprises or products. The profits are shared in a predetermined ratio between the bank and its clients. Clients bear the risk of a loss on the investments and the bank earns management fees, and bears the risk of operational losses arising from the administration of the arrangement.
- Murabaha is a form of asset financing. The bank purchases the asset, and pays the provider. The asset is resold to the client by the bank at a mark-up and the client pays the bank in instalments. The bank's margin on the transaction is calculated by reference to the interest that would have been raised on a conventional transaction.
- diminishing Musharaka is a form of partnership commonly used in the context of project financing. The client and the bank jointly purchase project assets. The bank's share in the assets is divided into units, and the units are progressively

purchased by the client. For as long as the bank retains ownership of the units, the client pays the bank rent on the unsold units. The rent will diminish as ownership of the units passes to the client.

Shar'ia products from a tax perspective

It is a trite tax principle that transactions should be analysed in accordance with their substance rather than their form.

In the draft Taxation Laws Amendment Bill tabled on 10 May this year, the principle of 'substance over form' has been adopted as the basis for the analysis and regulation of Shar'ia-based financial transactions. In terms of this approach, an amount will (for tax purposes) be taken to be interest if it replaces interest under conventional transactions.

The explanatory memorandum accompanying the draft bill gives examples illustrating how and when components of a transaction will be treated as interest.

Application of substance over form to Mudurabah

Any profit derived by the client in consequence of the investment in the deposit account will, for tax purposes, be taken to be interest.

The substance principle and Murabaha

As explained, Murabaha transactions involve the acquisition of assets by the bank, and their resale (at a mark-up) to the client. The bank's margin on the resale of the asset to the client will, for income tax purposes, be treated as interest. For VAT purposes, the client will be taken to have purchased the asset directly from the supplier, at the price imposed by the supplier (the purchase of the asset by the bank, and its resale to the client, will accordingly be ignored for VAT purposes).

A similar approach – a deemed direct acquisition of the property by the client, without intermediation by the bank – will also be applied for transfer duty purposes. Transfer duty will accordingly be levied only on the original purchase price, and not upon the mark-up imposed by the bank.

The substance principle and diminishing Musharaka

As previously explained, diminishing Musharaka turns around a joint purchase of assets by the client and the bank. The bank's units (ownership interests) in the assets are leased to the client, pending the progressive purchase of the units by the client. The rent paid on the bank's units will, for income tax purposes, be taken to be interest.

For VAT purposes, the client will be taken to have acquired the assets at the outset, and directly from the supplier, at the supplier's price. A similar approach will be adopted for transfer duty purposes.

Commencement date

The commencement date of the proposed amendments is yet to be announced by the Minister.

Conclusion and perspective

The treatment of transaction amounts as 'interest' for tax purposes might be construed as offensive given the deliberate avoidance of interest under Shar'ia precepts. It should, however, be appreciated that if the amounts in question were not to be treated as interest for tax purposes, the client might be deprived of the right to

"The amendments are accordingly about extending equal rights to those who observe Shar'ia."

claim a tax deduction, even where a deduction would have been claimable pursuant to a conventional financing transaction.

For example, if you were to borrow money to acquire business assets, interest on your borrowings would be deductible. You should not be deprived of that right because, in observance of Shar'ia, you cast the transaction into a compliant form. The amendments are accordingly about extending equal rights to those who observe Shar'ia.



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JSE amends listing requirements.

The JSE Limited (JSE) has comprehensively amended their Listings Requirements, effective 1 April 2010.

These include changes to definitions, clarification of existing practices, and the introduction of a variety of new requirements for listed companies, directors, sponsors and auditors.

Certain recommendations of the 3rd King Report on Corporate Governance (King III) have been adopted by the JSE. These primarily relate to the balance of power of the board of a company, the independence of the chairman, and composition and role of the audit committee. Listed companies may apply certain transitional arrangements relating to the adoption of the King III principles.

In addition, the JSE has made extensive changes to the provisions relating to forecasts. The definition of a forecast is more encompassing and the role of the sponsor with regard to specific forecasts has been expanded. The sponsor's responsibilities have further been extended to include advising the JSE when a listed company may be in breach of any of the Listings Requirements.

The JSE has toughened their stance of some aspects of compliance, including additional censure and penalties for non-compliance with the Listings Requirements, and specifying that participation in share incentives will disqualify a director from being classified as independent.

Mazars is a JSE accredited auditor and reporting accountant.



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Kevin is accredited with the JSE as an individual auditor and reporting accountant specialist.



Disaster recovery plans crucial.

To better understand what a disaster recovery plan entails we need to briefly discuss business continuity plans. A business continuity plan is defined as a practised logistical plan that addresses the restoration of critical business processes within an acceptable time frame after the occurrence of a disaster, or disruption of business. Disaster recovery forms a part of the overall business continuity planning and is aimed specifically at the restoration of the information technology environment.

A disaster recovery plan is a combination of processes, policies and procedures that a business has put in place to ensure that any form of disaster affecting financial information and applications can be mediated in such a fashion that it would not affect the business as a whole for an undue period of time.

There are two types of disasters that tend to occur:

- **natural disasters** – these include floods, earthquakes, and other disasters that cannot be avoided and tend to occur without warning
- **man-made disasters** – these include disasters such as electrical spikes, faulty hardware and so forth that can generally be avoided and/or controlled to an extent.

Disasters require different approaches to reduce the risk they present to the business and can be addressed with different types of measures:

- **preventative measures** – for example, adequate information security
- **detective measures** – review of backup logs to ensure that backups have occurred without error
- **corrective measures** – timely restoration of business critical data after a disastrous incident.

What areas of business are at risk?

Any business is at risk when their financial information, client information, applications or general business operations are under threat or become inoperable. The more reliant a business is on electronic or technological services, the higher the risk of not being able to recover if there are no recovery measures in place.

As stipulated above, a disaster recovery plan is concerned with what a business can and will do to recover the IT operations that support the business processes as well as remain operational and not lose a substantial amount of work or information.

Why is a Disaster Recovery Plan important?

In the modern business world, most businesses have at least one technological service that they rely on for regular business use – in most instances, this would be the accounting software they use.

When access to these systems becomes limited, the rest of the business may suffer as a result. It follows that a plan to mitigate these risks or potential inoperable periods is necessary. The larger the business, the more paramount the results of an inadequate disaster recovery plan.

The impact of not having a disaster recovery plan can never fully be comprehended until after a business has suffered as a result of not having recovery measures in place.

It is wise to consider investing the time and resources in performing an impact analysis to identify critical business processes if there is currently no disaster recovery plan for the enterprise. It is also advised that if a business currently has a disaster recovery plan in operation, that it should be tested on a regular basis to ensure that it is still applicable and adequately addresses the needs of the enterprise.

Finally, IT governance, which includes business continuity, is considered an integral part of corporate governance according to the King III report and should therefore be periodically, if not actively, reviewed and addressed as a business risk.



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Rand strength favours offshore investments.

Now is an opportune time to invest offshore as the strength of the rand continues to make offshore investments more attractive. Currently, our clients hold anywhere from 30% to 50% of their equity investments offshore.

The purpose of offshore diversification is not necessarily to generate superior investment returns. Those who invested in offshore shares over the past decade were disappointed with underperforming returns; over the long term, local equities have provided more than double the returns of offshore equities.

Instead, offshore diversification should be used to hedge future rand depreciation and to stabilise a portfolio by providing diversification through access to large global companies.

“Growth in foreign equities is more likely to come predominantly from rand depreciation over the next couple of years...”

Growth in foreign equities is more likely to come predominantly from rand depreciation over the next couple of years rather than from dividends and capital appreciation although we do expect a modest return from foreign equities.

But poor returns from shares should not discourage investors from participating in international markets as the rand is likely to depreciate over time and this will be the main reward for those going offshore. But, of course, it's impossible to say when this will happen. As always a well diversified portfolio with exposure to various asset classes remains the main objective and goal.

In terms of where to invest offshore, while international markets produced some positive returns in 2009, making a geographical call is proving to be challenging for investors as not all countries are out of the woods yet.

With insolvency still rife in the UK, America sitting with

huge debt and Europe plagued by sovereign defaults, the world is not such a great place for investors at the moment, although opportunities do exist albeit at lower levels than we experienced during 2009.

It's often said that offshore markets are more stable than the South African market, but looking at the events of the past three years, is this still true?

The world has developed much more appetite for emerging markets as they've proved to be less volatile and less risky than markets in some developed countries. This can obviously change very quickly if market or political problems are experienced in any one of the prominent emerging markets.

In conclusion, offshore investments should be used to help preserve capital and to position your portfolio for rand weakness – anything you achieve over and above that is a bonus.



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Beyond the GAAP

Mazars publishes an electronic monthly International Financial Reporting Standards (IFRS) newsletter, Beyond the GAAP, which details the technical aspects of IFRS and the implementation thereof.

If you would like receive a copy, please email marketing@mazars.co.za or contact Pam Warrington on (021) 818 5020. Visit www.mazars.co.za to access Beyond the GAAP.



Mazars Forensic Services celebrate Western Cape businesswomen

A gala dinner at the glamorous new Crystal Towers Hotel in Century City was the venue for the recent Regional Business Achiever Awards of the Businesswomen's Association of the Western Cape. Mazars Forensic Services took the opportunity to sponsor a table and invite high profile women from government and business to join them in celebrating and applauding the phenomenal finalists and winners in categories such as Entrepreneur, Social Entrepreneur and Corporate.



Back from left: G Bolton, NS Pandor, M Simpson, P Seane, N Hepburn
Front from left: Y Lungcuzo, Minister N Pandor, S Sekoko

'It was truly inspiring to be in the company of such remarkable and outstanding women and the fact that Mazars was able to invite and host women who are passionate about achieving high standards of excellence in every facet of their lives was very encouraging. It was certainly an event worth attending and our guests thoroughly enjoyed themselves,' said Nazreen Sekao Pandor, Senior Consultant, Mazars Forensic Services.

Among Mazars' guests were The Minister of Science and Technology, Naledi Pandor; Yvonne Lungcuzo, owner of Ibhongo Car Hire; Selina Sekoko, Human Resources Manager for Metrorail; Phumla Seane, owner of Cape Executive Parking and Cape Scaffolding and Mandy Simpson, Partner at Maurice, Phillips, Wisenberg.

What's new at Mazars...

- **Kathy Robison** has been appointed to the Mazars Global Support Unit for Technique & Innovation
- We are pleased to announce the appointment of **Marius Fenwick** as Chief Operating Officer of Mazars Financial Services (Pty) Ltd. Since joining us in 2004, Marius has contributed immensely to growth in the business and apart from giving advice to clients, he has progressively fulfilled a management role in the business.

Please send your comments/ideas to the editor
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level: hard



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