COLLEGE OF ACCOUNTING

TAXATION | ADVANCED

Video Transcription: Important Tax Cases: CIR vs Nemojim

COLLEGE OF ACCOUNTING

The Nemojim case is one of the more advanced cases taught on tax courses, and one that often causes students some difficulty. It is an important case that confirms some foundational tax principles, and I hope that you will find that once we get our heads around the facts, it is one that we can learn a lot from.

The Nemojim case centres around the court's interpretation of the section 11(a) general deduction formula, and specifically the criterion that expenditure must be incurred in the production of income in order to be deductible. Section 23(f) supports this by emphasising that expenditure incurred in respect of exempt income is not deductible, since this falls outside the meaning of "income", as defined.

Before we get into the facts of Nemojim, let's lay the foundation with some general examples.

When a person buys shares, they either buy them to earn dividends in the future, or to sell them at a profit. If they intend to earn dividends in the future, and if the dividends will be exempt from income tax (which they normally are) the cost of the shares is not deductible. On the other hand, if their objective is to sell the shares at a profit the proceeds on disposal will form part of their gross income, so the cost of shares is deductible. We would refer to this person as a share dealer. While a share dealer may earn exempt dividends from the shares he or she holds, it is not the reason that they bought the shares, and so does not affect the deductibility of the purchase price of the share.

Back to the case of Nemojim:

Nemojim was a share dealing company that bought and sold shares, claiming a deduction for the purchase price, and including the selling price in its gross income. However, Nemojim would buy and sell specific types of shares. It would buy the shares of dormant companies with large distributable reserves. Since these companies weren't trading, the share price would equal or might even be less than the net asset value of the company. Nemojim would then declare the reserves as a dividend to itself as the shareholder. This practice is commonly referred to as "dividend stripping". Let's have a look at an example.

Assume the dormant company has total equity of R101, represented entirely by cash in the bank. As the company is not trading, the company does not have anything of value other than what is on the balance sheet, so a purchaser would be willing to buy all of the shares in issue for no more than R101.

Nemojim would buy a company like this. The company would then declare a dividend of R100 to Nemojim. Nemojim would then sell the shares in the company. Because all the reserves have been distributed, the most a new purchaser would be willing to pay would be R1. Nemojim would either break even on the entire transaction, or in the event that it had purchased the company at below its net asset value, in other words paid less than R101 for the shares (which was often the case) it would make a profit.

COLLEGE OF ACCOUNTING

There was nothing wrong with Nemojim doing what it did with these companies. What was controversial was what was reflected in it tax return. Nemojim would claim a deduction for the purchase price of the shares, since it intended to sell them in the future. It included the dividend it received in its gross income, but this dividend was exempt under section 10(1)(k). And it included the now-much-lower selling price of the shares in its gross income. The net result was an assessed loss arising from a series of transactions that had, in fact, broken even.

SARS took the position that Nemojim was not allowed the purchase price deduction it had claimed. Nemojim argued that it had correctly claimed, as a deduction, the cost of its trading stock, i.e the shares, as a deduction.

In arriving at its verdict, the court referred to the judgement in CIR v Genn & Co, where it was held that, "In deciding how the expenditure should properly be regarded the court clearly has to assess the closeness of the connection between the expenditure and the income-earning operations, having regard to both the purpose of the expenditure and to what it actually effects".

In the case of Nemojim, the court held that the shares were purchased with a dual purpose – to sell them and to earn a dividend – and this is what had in fact happened. The court therefore decided that the expenditure, i.e. the cost of the shares, had to be apportioned between these two purposes, and a deduction could only be claimed in respect of expenditure attributable to the subsequent sale.

Going back to our example, the court said that the purchase price should be multiplied by the selling price as a percentage of the selling price plus dividends to determine the allowable deduction.

Using the numbers in our simple example, this would limit the deduction to R1, which would in turn result in a taxable income of zero, which is consistent with the economic result of the underlying transaction. Remember that, if Nemojim was able to purchase the shares at a lower price, or were forced to sell the shares at a lower price, the company might have made either a profit or a loss on the transaction, and this would be reflected in the apportionment calculation too.

Our example also works on the basis that the shares were purchased and sold in the same year. Where the purchase was made in a prior year, the court said that the opening stock deduction would be limited in terms of the apportionment calculation. This would then create a situation where the closing stock figure of the prior year may not be the same as the opening stock in the year of sale.

The Nemojim case extends our understanding of the principle that we must consider the purpose of the expenditure. It establishes that where more than one purpose exists the expenditure must be apportioned between those purposes, and it is only deductible to the extent that the purpose relates to earning "income", as defined.