CA 6726/05
and Cross-Appeal

Hydrola Ltd.

v.

Income Tax Assessor Tel Aviv 1

The Supreme Court sitting as the Court of Civil Appeals

[5 June 2008]

Before Justices E. Rubinstein, E. Hayut, Y. Elon

Appeal and Cross-Appeal of the decision of the Tel Aviv District Court (Judge Bracha Ofir-Tom) on May 31 2005 in ITA 1068/00.

Israeli Legislation cited:

Bank of Israel Law, 5714-1954.

Court Regulations (Appeals Regarding Income Tax) 5739-1978, r. 10(b).

Currency Supervision and Trade with Enemy States Law.

Income Tax Ordinance ss. 17, 30-33, 32(12)-(13), 145(a)(2)(b), 152(b), 170.

National Insurance Law [Consolidated Version], 5728-1968, s. 179.

Penal Law, 5737-1977, ss. 7(b), 34, 290.

Wireless Telegraph Ordinance [New Version] 5732-1972.

American legislation cited:

15 U.S.C §§ 78m, 78dd-1 (1988).

Foreign Corrupt Practices Act (FCPA), 15 U.S.C §§ 78m, 78dd-1, 78dd-2, 78ff (1977).

H.R. REP. No. 640, 95th Cong., 1st Sess. (1977).

Internal Revenue Code, 26 U.S.C § 162(c)(1) (1958).

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Loi de finances rectificative pour 1997 (Amending Law on Finances for 1997), Law No. 97-1239 of Dec. 29, 1997, J. O no. 302 Dec. 30, 1997, p. 19101; Code général des impost, article 39, 2 bis.

International conventions cited:

Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (Nov. 21 1997, 37 I. L. M 1 (1997).

United Nations Convention Against Corruption, Articles 12(4), 15 and 16.

Swiss legislation cited:

Bundesgesetz über die direkte Bundessteuer (DBG), (Law on Direct Federal Tax), 642.11 RS, Dec. 14 1990, Abs. 27, 59 (1990).

Bundesgesetz über die Harmonisierung der direkten Steuern der Kantone und Gemeinden (StHG), (Law on the Harmonization of Direct Tax), Dec. 14 1990, Abs. 10, 25 (1990).

Israeli Supreme Court cases cited:

[1] FH 22/61 *HaOleh Loan Fund, Mutual Society Ltd. and HaPoel HaMizrahi Credit Fund, Mutual Society Ltd. v. Tax Assessor for Large Enterprises, Tel Aviv* [1963] IsrSC 17, 533.

[2] CA 507-508/59 *Credit Fund v. Loan Fund* [1961] IsrSC 15, 2213.

[3] CA 380/75 *Pardes Cooperative Association of Citrus Growers Ltd. v. Tax Assessor for Large Enterprises* [1976] IsrSC 30(2) 312.

[4] CA 438/90 *Tax Assessor Haifa v. Hed HaKrayot Ltd* [1997] IsrSC 41(5) 668.

[5] CA 661/88 *Haimov v. Hamid et al.* [2000] IsrSC 44(1) 75, 84.

[6] HCJ 693/91 *Efrat v. Population Registry Commissioner at the Ministry of the Interior* [1993] IsrSC 47(1) 749, 779.

[7] CrimA 2521/03 *Sirkis v. State of Israel* [2003] IsrSC 57(6) 337, 346.

[8] CA 294/94 *Jewish Burial Society v. Kestenbaum* [1992] IsrSC 46(2) 464, 534.

[9] CA 5258/98 *A. v. B.* [2004] IsrSC 58(6), 209, 222.

[10] CrimA 7646/07 *Cohen v. State of Israel* (2007) (unreported).

[11] LCA 8253/99 *A. v. B.* [2003] IsrSC 58(2) 213, 228.

[12] HCJ 5413/07 *Anon. v. State of Israel* (2007) (unreported).

[13] CA 522/63 *Beit Zakai Ltd. v. Tax Assessor* [1964] IsrSC 18(2) 548, 551.

[14] CA 6416/01 *Benvenisti v. Official Receiver* [2003] IsrSC 57(4) 197, 206.
[15] CA 3498/94 *A. v. B.* [1996] IsrSC 50(3) 133, 153.
[16] CA 578/75 *Ben-Tal v. Ben-Tal* [1976] IsrSC 31(1) 57.
[17] FCrimH 2980/04 *Evico v. State of Israel* (2003) (unreported).
[18] CrimA 163/82 *Moshe David v. State of Israel* [1983] IsrSC 37(1) 622.
[19] HCJ 4562/94 *Abu Daka v. Lod Military Court* [1994] IsrSC 48(4) 742, 748.
[20] CrimA 2597/04 *Roitman v. State of Israel* (20040 (unreported).
[21] LCA 1436/90 *Giora Arad, Investment Management and Services Co. Ltd. v. Director of Value Added Tax* [1992] IsrSC 46(5) 101.
[22] CrimA 8573/96 *Mercado v. State of Israel* [1997] IsrSC 51(5) 481.
[23] LCrimA 5905/98 *Ronen v. State of Israel* [1999] IsrSC 53(1) 728.
[24] CrimA 733/07 *Cohen v. State of Israel* (2007) (unreported).
[25] CSA 1/77 *Klein v. State of Israel* [1977] IsrSC 31(2) 164.
[26] CrimA 5046/93 *State of Israel v. Hochman* [1996] IsrSC 50(1) 2.
[27] HCJ 368/76 *Gozlan v. Beit Shemesh Local Council* [1976] IsrSC 31(1), 505.
[28] CA 6585/95 *M.G.U.R. v. Municipality of Nesher* [1996] IsrSC 50(4) 206.
[29] FH 22/82 *Beit Jules Ltd. v. Raviv Moshe and Assoc. Ltd.* [1989] IsrSC 43(1) 441.
[30] CrimA 7068/06 *State of Israel v. Ariel Electrical Engineering Traffic Lights and Maintenance Ltd*. (2006) (unreported).
[31] CrimA 71/83 *Flatto-Sharon v. State of Israel* [1984] IsrSC 38(2) 757.
[32] CrimA 355/88 *Levi v. State of Israel* [1989] IsrSC 43(3), 221.
[33] CrimA 389/72 *Zokaim v. State of Israel* [1973] IsrSC 27(2) 487.
[34] CrimA 341/73 *State of Israel v. Vita* [1973] IsrSC 27(2) 610.
[35] CrimA 126/76 *State of Israel v. Shefer* [1976] IsrSC 30(3) 466.
[36] CA 101/74 *Hiram Landau Road Construction and Development Works Ltd. v. Water Sources Development (Foreign Countries) Ltd* [1976] IsrSC 30(3) 661.
[37] CrimA 4596/05 *Rosenstein v. State of Israel* (2005) (unreported).
[38] LCA 10231/04 *Traum v. Gaidamak* (2004) (unreported).
[39] CrimA 4722/92 *Markowitz v. State of Israel* [1993] IsrSC 47(2) 45.
[40] CA 1527/97 *Interbuilding Construction Company Ltd. v. Tax Assessor Tel Aviv 1* [1999] IsrSC 53(1) 699.
[41] CA 4030/03 *Granot Enterprises – Central Agricultural Cooperative Ltd. v. Tax Assessor for Large Enterprises* (2003) (unreported).
[42] CA 900/01 *Keles v. Tax Assessor Tel Aviv 4* [2003] IsrSC 57(3) 750.

[43] CrimA 256/97 *Lachman v. State of Israel* (1997) (unreported).

[44] CA 486/01 *Hoter-Yishai v. Tax Assessor Tel Aviv 4* [2004] IsrSC 58(5) 326.

[45] CA 1124/03 *Ganei Ofer Construction and Investment Ltd. v. Tax Assessor Tel Aviv 1* [2005] IsrSC 59(5) 313.

[46] CA 435/65 *Nagid, Trustee Businesses Ltd. v. Income Tax Commissioner* [1966] IsrSC 20(3) 287.

[47] CA 647/79 *Ivun v. Tax Assessor for Special Collections* [1981] IsrSC 35(4) 645.

[48] CA 274/84 *Shapiro and Shweitzer v. Income Tax Assessor Tel Aviv 2* [1987] Taxes 2/a, 53.

[49] CA 734/89 *Pikanti Food Industries Ltd. v. Tax Assessor Gush Dan* [1992] Taxes 6/f, 77.

[50] CA 21/60 *Levtov v. Tax Assessor Haifa* [1960] IsrSC 14, 1606.

[51] CA 506/71 *Hafetz v. Tax Assessor Haifa* [1972] IsrSC 27(1) 212.

[52] CA 5709/95 *Ben-Shlomo v. Director of VAT Jerusalem* [1998] IsrSC 52(4) 241.

[53] LCA 3476/04 *Siman-Tov v. Gad* (2004) (unreported).

Israeli District Court Cases Cited:

[54] ITA (Jer) 54/84 *El-Arabiya Hotels Ltd. v. Tax Assessor Jerusalem* [1987] Taxes 6/a, 63.

[55] ITA (Haifa) 13/82 *Frumkin v. Tax Assessor* [1982] DC 5743(A) 410.

[56] ITA (TA) 98/84 *Frankel v. Tax Assessor Tel Aviv 1* [1985] DC 5745(C) 332.

[57] ITA (Haifa) 40/95 *Vered Recycling v. Tax Assessor Haifa* [1996] Taxes J/3 172.

[58] ITA (TA) 1143/01 *Miller v. Tax Assessor Tel Aviv 3* [2006] Taxes K/2, 122.

[59] ITA 5019/97 *D. & D. Zra'im Ltd. v. Tax Assessor Haifa* [2000] Taxes O/1, 131.

[60] ITA 140/89 *Dar v. Tax Assessor Haifa* [1999] Taxes 4/D 116.

[61] ITA 1015/03 *Company Ltd. v. Tax Assessor Netanya* (January 30, 2008).

[62] OM (Jer) 2212/03 *Gad v. Siman-Tov* 920030(unreported).

United States Cases Cited:

[63] *Textile Mills Corp. v. Commissioner*, 314 U.S. 326 (1941).

[64] *Lilly v. Commissioner*, 343 U.S. 90 (1952).

[65] *Camarano v. United States*, 358 U.S. 498 (1959).

[66] *Bob Jones University v. United States, Goldsboro Christian Schools, Inc. v. United States* 103 S. Ct. 2017 (1983).
[67] *S.E.C. v. Lockheed Aircraft Corp*., 1976 WL 779 (D. D. C. 1976).

Jewish Law sources cited:

[68] Babylonian Talmud, *Ketubot* 17a.
[69] *Song of Songs Rabba* 5:2.
[70] Mishnah *Hallah*, 2:7.
[71] Exodus 23:8.
[72] Deuteronomy 16:19.
[73] *Shulhan Arukh, Hoshen Mishpat* 9:1.
[74] R. Zvi Hirsch Eisenstadt, *Pithei Tshuva* (*Hoshen Mishpat* 34:27).
[75] R. Haim Yosef David Azulai, *Birkei Yosef* (*Hoshen Mishpat* 9:10).
[76] R. Yehiel Michel HaLevi Epstein, *Arukh Hashulhan* (*Hoshen Mishpat* 9: 1).
[77] Babylonian Talmud, *Ketubot* 105b.
[78] Isaiah 1:23.
[79] Ezekiel 22:12.
[80] Babylonian Talmud, *Sotah* 47b.
[81] *Midrash Tanhuma* (Warsaw Edition, *Toldot*, 8).
[82] Book of Kings II 7:3.
[83] Babylonian Talmud, *Sanhedrin* 107b.
[84] Babylonian Talmud, *Bava Kama* 35a.

JUDGMENT

Justice E. Rubinstein

1. This is an appeal and counter-appeal against the judgment of the Tel Aviv-Jaffa District Court (Judge Bracha Ofir-Tom) of May 31, 2005 in ITA 1068/00, in which the appellant's appeal regarding its income tax assessment for the years 1992-1996 was partially allowed. The appeals are based on the appellant's claim that the sums of money that it transferred to its agents outside Israel were expended to generate its income and the respondent must allow them to be deducted as expenses; the respondent argues, *inter alia*, that some of the expenses were illegal, in that they were for bribe payments.

Background

2. (1) The appellant, Hydrola Ltd., engaged in various business activities in the states of the Former Soviet Union, primarily Russia; these activities included the sale of medical equipment and food products. *Inter alia*, the appellant was active there throughout the 1990s, after the Soviet Union was dismantled in 1991. Those were years of crisis and dramatic change in those states, due to the change of the political and economic regime; this historical background, it is claimed, is very relevant to our case and to the appellant's mode of operation there.

(2) The appellant conducted its business through dealings with local agents; the nature of these dealings is described in the appellant's statements of appeal and appendices, and in the testimony of the witnesses for the appellant, including the agents themselves, in the District Court. The appellant transferred significant sums of money to the agents, which were used both to pay the salaries of the agents themselves and for other purposes, including the transfer of sums of money to local bodies in order to promote the success of the deals, the exact significance of which we will address below. Due to the economic situation and the state of the banking system in the former Soviet states, so it is claimed, the agents opened bank accounts in Israeli banks in Israel, and some of them also gave the appellant's managers powers of attorney to act as they saw fit. The payments designated for those agents were transferred to those accounts.

(3) It will be noted, that for some of the payments to the agents, made prior to 1996, the respondent – at the appellant's request – granted an exemption from deduction of tax at source, in accordance with s. 170 of the Income Tax Ordinance (hereinafter: "the Ordinance"), and we will address this below. The appellant also received permission from the Bank of Israel to send these sums abroad. The turning point came towards the end of 1996, when the respondent made the granting of a requested exemption – relating to a sum of $50,000 designated for one of the agents (Isaac Lipkin) –

conditional on the presentation of an invoice for the aforesaid sum and an authorization from the income tax authorities in the agent's country. The documents were not produced, and the respondent refused to grant the requested exemption. In 1997 it also denied an application for an exemption relating to a commission totaling $140,000 that the appellant was to pay to Cura Consulting Ltd. (hereinafter: "Cura") because the documents requested by the respondent relating to the transaction were not produced, and due to its suspicion that the connection between Cura and the appellant was not a genuine business connection. Following the denial of these exemptions, the appellant did not transfer the aforementioned sums to Lipkin and Cura, and in subsequent years the appellant's payments to its agents in this manner ceased altogether (at least in 1997-1998 – as shown by the financial statements that the appellant submitted to the respondent).

3. The appellant subsequently requested that the aforementioned payments from the years 1992-1996 be recognized as expenses incurred in the generation of income. The respondent refused the appellant's request, and issued it with an assessment notice for those years in accordance with s. 145(a)(2)(b) of the Ordinance. In the explanation of the assessment, dated December 28, 1998, the reasons for not allowing deduction of the payments were given as follows:

> '(1) In the reports I did not allow the payments [to be considered expenses] because you did not provide the proper documentation proving that they were incurred in generating income.
>
> (2) Alternatively, the 'commission' payments [quotation marks in original – E.R.] were illegal expenses that cannot be allowed.'

The appellant's objections to the tax assessment were rejected, and another assessment notice was issued, in accordance with section 152(b) of the Ordinance, which repeated the original assessment. Hence the appeal to the District Court.

The Deliberations in the District Court and the Judgment

4. (1) In its presentation of evidence before the District Court, the appellant's complex dealings and its business connections with its various agents were addressed down to the minutest detail. A recounting of all the details is not necessary here; as noted by the court in its judgment, the appellant's manner of conducting its business in Russia, as emerges from the testimony, was questionable (p. 25 of the judgment). Of all that was said there, we will mention only a few details that are relevant to the appeal. The appellant claims that the evidence it produced shows that payments were transferred to seven agents (excluding Lipkin and Cura: ultimately there was no claim that payments were made to these two). Four of these agents

testified before the Court. The testimony of the appellant's employees and its agents revealed that the appellant transferred large sums to its agents, which were designated, *inter alia*, to cover the costs of maintaining the equipment that was allegedly sold, and to pay the commissions of the agents themselves (i.e. their fees), at low rates relative to the large sums transferred. Most of the money, it seems, was transferred by these agents to various bodies, for what was defined as "transaction promotion" commissions, to which we will return later.

(2) It should be noted that the other three agents were not summoned to testify. The Court denied the appellant's request to admit their depositions in place of testimony, due to the absence of any possibility of submitting them to cross-examination.

(3) In its judgment, the Court first ruled on the question of the burden of proof, which arose during the hearings. It ruled that with regard to recognition of expenses as deductible, the onus was on the appellant *a priori*, and that normally, relevant documentation and paperwork are required in order to fulfill this evidentiary requirement. Nevertheless, the court ruled that under the special circumstances that prevailed in the business environment in which the appellant was operating during that period, other forms of evidence were acceptable:

> 'When dealing with a unique situation that is out of the ordinary, such as the one that prevailed in the business environment in which the appellant was operating in our case – a fact that has not been denied by the respondent – the appellant's claim regarding its inability to produce the evidence required under normal circumstances must be taken seriously. The aforementioned difficulty, which has led to a lack of evidence, was sufficient, in my opinion, to justify allowing the requested expenses to be deducted, providing that these were proven by means of other forms of evidence, such as testimony before the court by trustworthy witnesses, whose credibility has not been called into question...
>
> In our case, I heard about the extraordinary circumstances under which the appellant dealt with its clients in Russia from the Company's director.... Those agents who appeared in Court also described it, and their testimony painted the same picture of chaos and confusion to which the director referred' (at pp. 16-17).

(4) The Court therefore accepted the appellant's appeal in a partial fashion, based on the testimony of the four agents who testified before it. As noted, the agents testified regarding the significant sums of money that the

appellant transferred to them – even though their testimony was not totally consistent with the appellant's reports – but the Court recognized only that portion of the money that was used, according to their testimony, to pay their fees. It was ruled that only these sums were proportionate to the value of the reported transactions, and that they (and they alone) were clearly used to generate the appellant's income. Regarding the rest of the money, it was ruled that it was not proven that it had been expended in order to generate income, and therefore it should not be allowed. Furthermore, regarding the appellant's other agents who had not appeared to testify (and whose depositions were not admitted, as noted), it was ruled that the expenses claimed in their regard had not been proven and should not be allowed. The appellant's claim that their expenses should be allowed in light of the four testimonies that were heard, which indicated a recurring pattern or method of payment, was rejected.

(5) The expenses that the District Court recognized as allowable for deduction represented only a small fraction of what the appellant had requested.

(6) The court also addressed the question of the legality of the aforementioned expenses, and determined that some of the money had been used, according to the appellant's director and the witnesses, to pay bribes (p. 28 of the judgment). Nevertheless, the court did not rule unequivocally on the question of recognition of expenses of questionable legality, referring to case-law whereby, on the one hand, expenses incurred in the context of breaking the law will not as a rule be recognized as deductible, whereas on the other hand, deduction of expenses of this kind will be allowed in certain circumstances. It was determined that in all events, in our case the bribery issue had not been sufficiently elucidated. This is a complex case involving an alleged violation of a foreign law; and nothing has been proven in this regard, and the Tax Assessor is not required to concern himself with its enforcement. We will return to this later, too.

The parties' claims

5. (1) An appeal and cross-appeal were filed on the District Court's judgment. The appellant contends that the court erred in allowing the appeal only in relation to the commission payments that according to the agents' testimony, they had received as fees, arguing that the respondent should have allowed deduction of all of the commission expenses declared, particularly since it issued exemptions from deduction of tax at source in their regard. It is claimed that based on these authorizations, the appellant was entitled to assume that the payments would constitute recognized expenses, and that non-recognition constitutes a retroactive retraction, which causes disproportionate damage to the appellant's property. It is further claimed that

the respondent lacks the tools to make a sound assessment of the appellant's income with regard to its expenditures in Russia.

(2) It also argues, from the procedural aspect, against the court's decision not to admit the depositions of the three agents who did not appear to testify before it. According to the appellant, the provisions of r. 10(b) of the Court Regulations (Appeals on Matters of Income Tax) 5739-1978 (hereinafter: "the Regulations"), make admission of the depositions obligatory, since they were submitted as evidence to the respondent at its request. It is further argued, in this regard, that the court should also have accepted the appellant's claims because the agents' testimonies and the depositions proved the payment of the commissions as a *"modus operandi"*.

(3) The cross-appellant, i.e. the respondent to the appeal (for the sake of convenience, hereinafter referred to as "the respondent"), claims that the District Court erred when it recognized the commission payments to a limited extent, as noted above. It claims, *on the evidentiary level*, that regarding all of the payments, including those payments that were determined to have been incurred for the agents' fees, the appellant has neither demonstrated nor proved that they were incurred only to generate income. This, in the respondent's opinion, is due to the lack of adequate documentation regarding the business relationships between the appellant and its agents and regarding the payments it made. It contends that the arguments regarding the inability to produce documentation due to the prevailing circumstances in Russia should be rejected in view of the arrival of the appellant's agents in Israel during the said period, and that the allegedly abnormally high commissions – both in relation to the value of the transactions reported and in relation to the agents' testimonies – are an indication of the evidentiary problem with accepting the appellant's claims.

(4) The respondent further argues, *on the normative plane*, that even if the appellant satisfied the burden of proof standard, there would be no reason to recognize its expenses – including the agents' fees – due to their illegal nature. It claims that there is a clear evidentiary basis for determining that the payments were bribe money. It is further argued that according to case-law and academic opinions, *illegal* expenses may not be deducted – and certainly not if they are tainted by criminality, as in the present case, according to the respondent. In this regard, the respondent cites the United Nations Convention Against Corruption (hereinafter: "the Convention Against Corruption"), although its signing post-dates the relevant period. Still, the respondent claims that it elucidates the legal situation that prevailed even prior to its signing.

(5) The appellant responded to this last point by claiming that the payments were commissions to its agents in Russia and not bribe money, and

that in any case, the bribery allegations have not been proven. It also claims that even if it was proven that the payments were bribes, they are still not an illegal expenditure, since paying a bribe in Russia does not constitute a crime in Israel, and it has not been proven that under the circumstances it was even a crime in Russia, certainly not during the period relevant to the appeal.

Deliberations

6. We will first address the appellant's position that the respondent should have allowed deduction of the full amounts as expenses. The respondent, as noted, based his decision not to allow deduction of the expenses on two alternative reasons: the *evidentiary* reason – the failure to properly prove the expenses; and the *normative* reason – the illegality of the expenses. The lower Court partially accepted the respondent's position for the evidentiary reason, and did not issue a clear ruling on the normative question, notwithstanding its determination that the expenses were used to pay bribes. I will say at the outset that as far as I am concerned, the appellant's arguments should not be accepted and I am of the opinion that the evidentiary reason alone is sufficient to uphold the respondent's position that the expenses claimed by the appellant should not be allowed as deductions, since they have not been properly proven. However, I think that the outcome would be the same based on the illegality issue as well; due to its significance, I will elaborate this point below.

The nature and purpose of the commissions that the appellant transferred to its agents

7. (1) To dispel any doubts, we shall describe the nature, character and purpose of the payments made by the appellant to its agents before discussing the issue at hand. As noted, the District Court determined that these were, at least in part, bribe payments, even though their exact nature was not fully clarified. The said nature of the payments is evinced directly, and even explicitly, by the testimony before the Court. It is clear that the payments involved bribery of officials, sometimes senior ones, who by virtue of their positions were involved in transactions with the appellant – despite the attempt by some of the witnesses to present the nature of the transactions as "providing a discount." For example, in the cross-examination of the witness Josef Garbuz, who acted as an agent for the appellant in a transaction for the sale of medical equipment to Poliklinika (a clinic of the Russian Foreign Ministry), he said as follows:

> '$313,000 was the price according to the contract, and after the contract was drawn up, a discount of $52,400 was obtained... What I suggest is not to call it a discount but rather a brokerage fee, but according to the contract I retained $10,000...
>
> Q. The $52,400 was a brokerage fee or a discount?

A. A brokerage fee. Commission. I received a brokerage fee of $52,400.

Q. What was the discount you obtained?

A. As far as I understand it, the 42,000 that I forwarded to Poliklinika was the discount I obtained. Correct, previously I defined the NIS 52,000 [error in original - E.R.] as a brokerage fee, it could be that these are the accepted terms in Russia and therefore they are not precise' (p. 61 of the protocol).

The witness does not specify to which individuals the "discount" or "brokerage fee" was forwarded. The testimony of the witness Svetlana Koznitzova sheds light on the matter:

'During those years there were many offers from all the states that came to us to supply products, whoever had money and wanted to buy products wanted assurance that they would get something too.

Q. Who were the 'they' who were involved in the story?

A. Whoever had control of the money wanted to get a piece of the payment...

Everyone - one wanted to get 10%, one 5% or 15% of the payment. There were many like that.... There was one deal between that factory [Kronichev Space Center - E.R.] and Muchinik [one of the directors of Hydrola - E.R.], and Levdiev [Deputy-Director of the Factory - E.R.] asked me if I would receive his share in the amount of $62,000, so that it would be as if I received this amount, and he would give me 10% of the amount.

Q. Why didn't he contact Hydrola directly?

A. He didn't want to be exposed' (p. 69 of the protocol).

Later in her testimony, she said, *inter alia*:

'The commissions are for the customers. The thing is that it is not private individuals who are ordering. The customers are institutions. These are people who represent the customers. The customers ordered and the people representing them received commissions.

Q. That [payment of] $122,000 went to those customers who represented the institutions, whoever they were ….

A. Yes. The Director-General of the Geological Association called on the phone, can you supply some equipment to the

> northern areas, I will make an order of $150,000 but $10,000 is for me' (p. 73).

The testimony of the agent Yaakov Lutzky was similar: "I would give a certain amount of money, so that they would... trust me, at the moment that we would do this deal" (p. 21 of the protocol). It was even more pronounced in the testimony of the agent Vladimir Friedman, who presented the matter without painting it as a "discount" or a "brokerage fee" and without "embellishment and dressing-up" (as referred to in the Babylonian Talmud *Ketubot* [68] 17A):

> 'Why do you pay more – in order to get authorization for that equipment I need to pay a bribe to every official at every level.... In answer to the Court's question – are you paying a bribe – what, is bribery a bad word? It's a way of saying thank you for signing the authorization. I gave bribes to dozens of people. And not just me...' (p. 29).

(2) Thus, the payments that were transferred to the appellant's agents and recorded in its books as expenses for "'agents' commissions outside Israel," did not serve only as fees for the agents for their brokerage of the transactions. In actuality, these fees were a relatively small component of the payments; a significant part of it was handed over to public servants in order to guarantee them a private profit from transactions with the public institution in which they worked. It is inconceivable that the appellant's management was not aware of this, even if it turned a blind eye to the destination of the money and the conduct of its agents. This is evident from the testimony of one of the appellant's directors, Mr. Shimon Muchnik:

> 'Some of the money was spent for bribing people in Russia but I didn't know who or what. I could only guess. We determine the amount that we need to send to Russia before we sign the contract' (p. 45 of the protocol).
>
> 'There were discussions [with the respondent – E.R.] about commissions for the agents, but commissions to the agents were not just commissions to the agents, technically they were recorded as commissions to the agents, part of it was the commissions to the agents and part of it was money that was refunded in accordance with earlier agreements based on the Income Tax Authority's consent to give us authorizations for these payments...
>
> To the best of my knowledge, Freidkes [the appellant's accountant – E.R.] concluded this with the Income Tax Authority in the first case that arose. That it would be termed 'commission to agent outside Israel' even though it also

> referred to other components. I did not have to go into these components. During the conversations and communications between us, they explained to us where the money was going so that we would not think that all the money was for commissions. I also did not care where the money was going' (pp. 43-44).

Moreover, Muchnik's lack of knowledge did not prevent him from advising others on how to successfully navigate the business maze that then prevailed in Russia. One of the witnesses on behalf of the appellant was Mr. Aryeh Carosh, a director of a different company that was involved in similar deals. In his testimony, he too claimed that "the main concern of all the officials was what they personally would earn from the deal, including the acquisition clerks" (p. 34 of the protocol). He also stated that he enlisted Muchnik's help to "seal the deal," as he put it, and that he acted in accordance with the instructions he received from the appellant (*ibid*.).

The deductibility of illegal expenses

8. (1) 'Normally, it can be said that a problem relating to expenses that have their source in illegal activities is not necessarily within the bounds of tax law. Two contradictory principles collide in such a case. One demands an accurate determination of income, without taking considerations of law and ethics into account, and the other is based on considerations of "setting the world aright" (public policy). This latter principle – which is usually the decisive one – recoils from recognizing and authorizing expenses incurred through illegal activities, in order that crime not pay' (Alfred Witkon and Yaakov Neeman, *Laws of Taxation - Income, Inheritance and Betterment Taxe*s (Fourth Edition, 5729), at p. 157 (hereinafter: Witkon and Neeman)).

(2) S. 17 of the Income Tax Ordinance (hereinafter: "the Ordinance"), which governs the issue of deductibility of expenses, states that "in order to determine a person's income, deductions will be made... for expenses that were incurred entirely for the generation of his income during the fiscal year, and for this purpose alone." Ss. 30-33 of the Ordinance (part D of chap. 2) contain several provisions restricting and limiting the deduction of expenses. Included among them, in s. 32, is a long list of expenses that will not be allowed. Expenses involving a violation of the law, or resulting therefrom, are not included in this list. However, according to the case-law, deductions for expenses incurred while violating the law may be prohibited.

9. (1) The issue of deductibility of expenses involving a violation of the law has been addressed over the years by Israeli courts as *obiter dicta*, in

several cases relating to legitimate expenses stemming from illegal activities, e.g. financial sanctions and legal costs. In the nature of things, cases in which recognition of tax deductibility is sought for payments involving a violation of the law cross the threshold of the courtroom quite rarely. One of these rare cases in which the question of deducting expenses made illegally was addressed in Israel in ITA (Jer.) 54/84 *El-Arabiya Hotels Ltd. v. Tax Assessor Jerusalem* [54], at p. 63. Judge Prof. Bazak said as follows in that case:

> 'It can be assumed that the problem with recognizing illegal expenses is more theoretical than practical. Usually someone making illegal payments will be in no hurry to admit this in an official document for fear that this will lead to criminal prosecution for his involvement in those activities.... Another reason that the problem of illegal expenses is a theoretical issue is that in general, it will be difficult for the assessee to adequately prove that he did indeed make the illegal expenditure. After all, the party who received the payment will not confirm this in writing or orally, for fear of the law. For these reasons, it would seem, there are so few precedents on the subject' (at pp. 69-70).

(2) In FH 22/61 *HaOleh Loan Fund, Mutual Society Ltd. and HaPoel HaMizrahi Credit Fund, Mutual Society Ltd. v. Tax Assessor for Large Enterprises, Tel Aviv* [1], at p. 533, the Court addressed the possibility of recognizing, for tax purposes, a payment that the appellant was liable to pay to the Bank of Israel for contravening the instructions of the Governor of the Bank of Israel under the Bank of Israel Law, 5714-1954. Justice Berinson (in a majority opinion) noted in his conclusion:

> 'For reasons related to the public welfare, we cannot allow an income tax deduction for an expense incurred while breaking the law, or which is liable to undermine policy stemming from the law of the State or from a legitimate action of the government regarding a matter of public importance' (at p. 551).

It will be mentioned that in that case, Justice Witkon's (minority) opinion was that a punitive function should not be attributed to the relevant section of the Bank of Israel Law (at p. 549); this was also his approach in the previous incarnation of the case, in CA 507-508/59 *Credit Fund v. Loan Fund* [2], at pp. 2213, 2217. Justice Dr. Witkon reiterated the majority court ruling that he originally disputed in CA 380/75 *Pardes Cooperative Association of Citrus Growers Ltd. v. Tax Assessor for Large Enterprises* [3], at pp. 616-617. (That case dealt with the deduction of legal costs for a transaction involving illegality; however, the primary reason for not

allowing the expenses was that they were not interest payments and were not made in the regular and normal course of business.)

(3) In *El-Arabiya Hotels Ltd. v. Tax Assessor Jerusalem* [54], as we have said, payments which were illegal in themselves were addressed – i.e. loan repayments paid to Jordanian banks, in violation of the provisions of the Currency Supervision and Trade with Enemy States Law. Following a review of the cited laws, Justice Bazak stated:

> 'The problem is not a simple one and it should not be assumed that it has a simple, unequivocal and comprehensive solution, since the matter is extremely dependent on the circumstances of the case. I would say that the rule is that it all depends on the nature and the degree of severity of the illegality involved.... There are illegal expenses that could never be allowed, such as bribing a public servant or payments to burglars and thieves. On the other hand, there is no reason not to recognize some illegal expenses, such as grossly-inflated rent payments, etc. This is the case regarding payments made in violation of the laws controlling foreign currency, as in the present matter. No hard and fast rules can be set. It very much depends on the circumstances of the case' (at pp. 69-70).

(4) This issue has subsequently been addressed once more, again incidentally, in CA 438/90 *Tax Assessor Haifa v. Hed HaKrayot Ltd.* [4], at p. 668. The issue in that case was not illegal payments *per se*; rather, Justice E. Goldberg mentioned, *inter alia*, the law regarding the non-deductibility of expenses that are contrary to public policy, and noted the relationship between this law and the partial arrangements found in the Ordinance, in ss. 32(12) and 32(13) (the prohibition on deducting sums financing or assisting sea-based transmissions, as defined in the Wireless Telegraph Ordinance [New Version] 5732-1972, and the prohibition on deducting payments paid as fines and linkage differentials in accordance with s. 179 of the National Insurance Law [Consolidated Version], 5728-1968, respectively). In light of the circumstances in which these amendments were enacted, Justice Goldberg concluded that they did not constitute a negative arrangement (for a different opinion, cf: Amnon Rafael and Yaron Mehulal, *Income Tax – Volume One* (3rd edition, 1995) at p. 429 (hereinafter: Rafael)). He said:

> 'Is there a basis in the law for economic logic being overruled by public policy? There is no general provision in the Ordinance that permits taking public policy into account when determining an assessee's taxable income. Instead, there are several partial arrangements found in the law that restrict the deduction of an expense due to the said considerations.... The

> preliminary question is: are the partial arrangements in the Ordinance exhaustive of the tax authorities' competence to take considerations of public policy into account in determining a person's taxable income? According to case-law, considerations of public policy are appropriate considerations in the tax assessment process, and the deduction of an expense may be prohibited for their sake. For example in FH 22/61 *HaOleh Loan Fund v. Tax Assessor* [1] … the provisions of s. 32(12) and s. 32(13) of the Ordinance should not be viewed as exhaustive of considerations that the tax assessor is entitled to take into account when determining a tax-payer's taxable income... Public policy is a relevant consideration for the process of determining the taxable income of an assessee...' (at pp. 712-713).

10. (1) If so, the principle of public policy ("public welfare" as Justice Berinson calls it in *HaOleh Loan Fund v. Tax Assessor for Large Enterprises* case [1], or "setting the world aright" as Witkon and Neeman call it) is a relevant consideration when determining taxable income, and it stands in opposition to recognition of expenses for tax deduction purposes (see also Nitsa Uretzky, *Illegal Income and Expenses in Taxation Law* (1990) at pp. 13-18, 57-59 (hereinafter: Uretzky); Aharon Namdar, *Taxation Law [Income Taxes] - Income Tax, Company Tax and Capital Gains Tax* (Part A, 1993) at pp. 35, 229 (hereinafter: Namdar)). The term "public policy" has been defined in our judgments on more than one occasion:

> 'Public policy' signifies the primary and essential values, interests and principles that a given society at a given time wishes to uphold, preserve and develop... public policy reflects the elemental foundations of the social contract... (*per* President Shamgar in CA 661/88 *Haimov v. Hamid et al.* [5], at pp. 75, 84).... Public policy is a central tool through which the legal system safeguards the essence of its values against various loci of power that wish to create legal norms or pursue physical activities that contradict these values. This is a tool through which the "proper functioning of the judicial institutions essential to society" is maintained (I. Englard, "The Status of Religious Law in Israeli Law (Part 3)" *Mishpatim* 4 (5732-33) at pp. 31, 57; HCJ 693/91 *Efrat v. Population Registry Commissioner at the Ministry of the Interior* [6], at pp. 749, 779, per Justice Barak).

(2) This is straightforward. It should, however, be borne in mind that public policy is itself a broad concept, a "meta-principle, an overarching

consideration" (CrimA 2521/03 *Sirkis v. State of Israel* [7], at pp. 337, 346, *per* (then) Justice M. Cheshin) and there are those who call this concept a "legal safety-valve" (CA 294/94 *Jewish Burial Society v. Kestenbaum* [8], at pp. 464, 534), *per* (then) Justice Barak). This concept embraces various considerations as well as the balance between them – "in determining the scope of 'public policy' there must be an internal balancing between conflicting values and interests" (CA 5258/98 *A. v. B.* [9], at pp. 209, 222, *per* President Barak, and the other references cited there). Obviously, these are cases that public integrity, in a state purporting to be moral, cannot tolerate (see, by analogy, the issue of money laundering in the explanatory notes to the Prohibition Against Money Laundering Bill, 5769-1999 at pp. 420, 423; see also CrimA 7646/07 *Cohen v. State of Israel* [10]). Public policy is the "principle that reflects the fundamental social credo of the judicial system" (President Barak in LCA 8253/99 *A. v. B.* [11], at pp. 213, 228; cited in HCJ 5413/07 *A. v. State of Israel* [12]). Therefore, in my humble opinion, in any discussion regarding illegal expenses, an examination of any claims that are incompatible with the principles mentioned above is required.

11. (1) One of the central considerations in considering the deductibility of illegal expenses is the concern that permitting these kinds of deductions makes a mockery of the law. This point was already made in the above-cited words of Justice Berinson in *HaOleh Loan Fund v. Tax Assessor for Large Enterprises* [1], as well as in the words of Justice Goldberg in *Tax Assessor Haifa v. Hed HaKrayot Ltd.* [4]:

> 'The concern is for conflicting trends in the two bodies of law and the conveying of a mixed message to the tax-paying public, whereby from the perspective of criminal law, the tax-payer's conduct is reprehensible and should be penalized, whereas 'the expenses incurred' in committing the crime are recognized under taxation law. In her book [cited above – E.R.], N. Uretzky discussed this, writing (on p. 58) that "[a]llowing the deduction of an expense stemming from business activities that are premeditated and preplanned, and that knowingly violated the law, undermines the legal and moral foundation upon which the legal system is founded"' (at p. 715; see also Rafael, at p. 427; see also CA 522/63 *Beit Zakai Ltd. v. Tax Assessor* [13], at pp. 548, 551, *per* Justice Witkon).

This consideration is extremely weighty, and it combines with the meta-principle of safeguarding the rule of law, which is also based in public policy: "Public policy includes, *inter alia*, the importance of safeguarding the rule of law (both formal and substantive). Therefore, safeguarding public

policy also means upholding the law and its provisions and deterring criminal activity and law-breaking" (CA 6416/01 *Benvenisti v. Official Receiver* [14], at p. 197, 206, *per* (then) Justice Barak). Certainly, non-recognition of the deductibility of illegal expenses does not mean that the taxation laws serve as tools for penalization or deterrence; rather they protect such tools – which are designed to protect serious public interests enshrined in other bodies of law – from neutralization, or at least impotence due to exploitation by criminals by means of the taxation laws. This is also a matter of common sense. I will add that I agree with Dr. Uretzky's narrower definition, which she quoted from Justice Goldberg, and I do not count myself among the more lenient in this matter. We would do better to express our reservations about the opposite stance, lest we fall victim to the perils of a slippery slope. A tiny chink in the proverbial armor could gradually widen until "wagons and coaches could enter through it" (*Song of Songs Rabba* [69] 5:2). I will add here that by their very essence, the "judicial genes," the DNA in every fiber of the judge – the hidden, internal compass of conscience within him/her – demand that a judge refrain from giving his/her seal of approval, be it explicit or implicit, to any illegal activity or to the benefit therefrom.

(2) Another consideration, deeply enmeshed in the first one, is the public policy principle that "crime must not pay" (based on the Mishnah, *Hallah* [70] 2:7; CA 3498/94 *A. v. B.* [15] at pp. 133, 153, *per* Justice Dorner; *Benvenisti v. Official Receiver* [14], at p. 206). The essence of this principle is that one who breaks the law should not enjoy his ill-gotten gains – and permitting the deduction of an illegal expense would allow a law-breaker to reap the rewards of his illegal act (see Witkon and Neeman, at p. 157; *Beit Zakai Ltd. v. Tax Assessor* [13], at p. 551; on this principle in Jewish law in relation to property matters, see Eliav Shochetmann, *Ma'aseh Haba Ba'avera* (1981), at pp. 250-254).

(3) Other considerations that may be taken into account relate to the specific character of the illegal activities in the particular case. We will address this, in relation to our case, below.

(4) Indeed, opposed to all of these considerations stands a basic principle of taxation law, i.e. accurate assessment. There are those who claim that the non-deduction of illegal expenses violates this principle; the violation is more serious in light of the law that illegal income will be taxed – in spite of its illegality. As well the economic illogic of this tax and the principle of accurate assessment, there are those who would claim that taxation laws should not be used as a method of penalization additional to the penal code, and that in any case the deterrent power of taxation laws is limited in its effect (see *Tax Assessor Haifa v. Hed HaKrayot Ltd.* [4], at p.

715, *per* Justice Goldberg; Uretzky, at pp. 58-59; 64-65; Namdar, at p. 229; Rafael, at pp. 427-430).

(5) I will note at this point that in my opinion, those considerations designed to maintain the values of the law and to preserve the incorruptibility of the government authority should prevail over the concern for appearing to collaborate or indirectly "authorize" illegal activities. I see no legal or moral problem with the fact that illegal income is taxed while illegal expenses are not recognized as deductible. Moreover, while it is true that the tax authorities deal with collection, and that is their main role, they are also an integral part of the wider spectrum of governmental authorities. As far as I'm concerned there is no particular reason why they should wash their hands of imposing sanctions, where appropriate, against those who act illegally, within the framework of the tax system. This is consistent with an approach that does not cast the entire burden onto the criminal law system, but rather complements it.

12. (1) In the real world we find various categories of expenses related to illegal activities, regarding which deductions are sought. One such category includes payments the very making of which is illegal. Clear-cut examples of these are bribe payments, money paid to a hired assassin in order to "increase business profits" or a payment to finance burglary or theft from a competitor; however, there are also less clear-cut examples, such as payments made in violation of the provisions of the currency control laws (see *El-Arabiya Hotels Ltd. v. Tax Assessor Jerusalem* [54]). The second category includes expenses for legitimate payments incurred as a result of illegal activities, e.g. monetary sanctions such as fines and compensation, and court costs. In the nature of things, this category finds its way into the courtroom more often, and has been discussed relatively often (*HaOleh Loan Fund v. Tax Assessor for Large Enterprises* [1]; *Tax Assessor Haifa v. Hed HaKrayot Ltd*. [4]; and also ITA (Haifa) 13/82 *Frumkin v. Tax Assessor* [55], at pp. 410, 418-419, *per* Justice Dr. Bein; ITA (TA) 98/84 *Frankel v. Tax Assessor Tel Aviv 1*[56], at p. 332, *per* Justice Pilpel; ITA (Haifa) 40/95 *Vered Recycling v. Tax Assessor Haifa* [57], at pp. 172, 177-181, *per* Justice Dr. Bein; ITA (TA) 1143/01 *Miller v. Tax Assessor Tel Aviv 3* [58] p. 122, *per* Justice Altuvia). The third category includes "illegitimate expenses" – those that are incompatible with public policy, even though they themselves do not contravene the provisions of any law. There is a variety of examples of this: repayment of a loan at a usurious rate of interest in violation of the law (see *Beit Zakai Ltd. v. Tax Assessor* [13]); expenses incurred in creating an illegal contract (see *Pardes v. Tax Assessor* [3]); legitimate expenses incurred by an illegal enterprise, such as an unregistered gambling establishment; commercial bribe payments (see CA 578/75 *Ben-Tal v. Ben-Tal* [16], at p. 57) and others, as far as the tax-payer's imagination stretches

(see other examples from US case law: *Textile Mills Corp. v. Commissioner*, 314 U.S. 326 [63]; *Lilly v. Commissioner*, 343 U.S. 90 [64]; *Camarano v. United States*, 358 U.S. 498 [65]; *Bob Jones University v. United States, Goldsboro Christian Schools, Inc. v. United States* 103 S. Ct. 2017 [66]).

(2) Even if the question of deductibility of expenses related to illegal activities is considered for each case on its merits and in direct relation to the nature of the illegal activities in the particular case, it is still only natural that insofar as the first category of expenses is concerned, the above-mentioned considerations militating against recognition for tax purposes will obviously carry significant weight. In these cases, which involve a *direct* monetary outlay for activities that the legislature has prohibited, as far as I am concerned the answer is clear, in accordance with a value-based judicial policy. Moreover, even though cases that fall into the second or third categories are widely disputed, my tendency in their regard is similar, and I think that in these types of cases the burden of persuasion borne by the assessee seeking the deduction is very heavy (see Uretzky, pp. 15-18, 89-94, 103; Namdar, at pp. 321-322; Rafael, pp. 430-435; Boaz Barzilai, "The Income Tax Authority – A Way of Collecting Taxes or a Tool for Regulating Public Conduct: A Review of the Issue and its Development based on the *Hed HaKrayot* Judgment" *Missim* XII/1, p. 65a (1998); Lior Neuman and Ofir Kaplan, "The Deductibility of Legal Defense Costs in Criminal Law" *Missim* XVIII/3, at p. 1a (2004); "Deduction of Business Expenses: Illegality and Public Policy", 54 *Harv. L. Rev.* 852 (1940-1); Donald H. Gordon, "The Public Policy Limitation on Deductions from Gross Income: A Conceptual Analysis", *43 Ind. L. J.* 406 (1967-8); Cathryn V. Deal, "Reining in the Unruly Horse: The Public Policy Test for Disallowing Tax Deductions", 9 *Vt. L. Rev*. 11 (1984).

The deductibility of illegal expenses incurred outside Israel

13. (1) The question of the deduction of illegal expenses incurred outside Israel adds further weight and complexity to the issue currently under discussion, since for the purposes of the necessary balancing between the two bodies of law – penal law and taxation law (and I have already indicated which way the scales are tipped in my opinion) – the question of how to relate to the law in the foreign state must be considered (see Uretzky, at p. 142).

(2) Regarding this issue, counsel for the appellant claimed that it had not been proven that the payments made by the agents were bribes, and even if they were bribes – it was not proven that paying bribes is a crime in Russia (referring to the words of Vice-President Cheshin in FCrimH 2980/04 *Evico v. State of Israel* [17], at para. 3). Counsel for the appellant claimed that at the very most, it could be said that these activities contradict public policy;

but – so he claims – why should Israeli public policy be concerned with Russian public policy, since [the two states] do not share the same "values, interests, and central and essential principles, which a given society at a given time seeks to establish, to maintain and to develop" (*Efrat v. Population Registry Commissioner* [6], at p. 779), and in any case, "the content of public policy varies in different societies" (*per* President Barak in the abovementioned *A. v. B.* [9], at p. 222). This claim, captivating though it may be, holds no charm for me.

Expenses relating to illegal activities conducted outside Israel could fit into each of the three categories reviewed above, and could be examined within the framework of each. Indeed one could encounter difficulties in relation to the non-deductibility of expenses incurred in a legal and legitimate manner in country A, due to public policy in country B. In this case, however, we are dealing with a situation that falls within the first category, that of expenses which in themselves constitute a violation of the law, even though they were incurred outside Israel, as I will explain below. Furthermore, there are matters of public policy that are universal, in principle if not in practice, and bribery – a biblical prohibition that is also part of the cultural heritage of the Russian nation – is included among them.

(3) On the other hand, neither should we be overly impressed by the argument of counsel for the respondent in his summation, that this is a case of an extraterritorial crime (see the definition of "extraterritorial crime" in section 7(b) of the Penal Law, 5737-1977), and that Israel's extraterritorial jurisdiction applies, by virtue of s. 15 of the Penal Law – and therefore the said payments may not be deducted. It seems to me that in the response summations, counsel for the respondent abandoned this argument, or at least expressed some reservations. In any case, I am doubtful whether there are grounds for this position. First of all, the question of whether as a rule, there can be an extraterritorial application of Israeli law with regard to the acts in the present case is a serious one, particularly in light of the nature of the crime – bribery – which includes a patently local connection in the definition of a "public servant" (see ss. 34 and 290 of the Penal Law; see in this context S. Z. Feller, *Principles of Penal Laws* (Vol. 1, 5747-1987) at pp. 216-217 and pp. 291-292). Secondly, statements are one thing and actions another: my doubts also stem from practical considerations in that I am doubtful whether we will actually see indictments of this kind filed any time soon. And thirdly, another important question relates to the treatment of the legality of expenses incurred outside Israel, for the purposes of the question of tax deductibility, when they constitute extraterritorial crimes by virtue of extraterritorial application. However, I think that there is no need to address these questions, since the illegality of the expenses becomes clear by another way, as will now be explained.

14. (1) The payments made by the appellant's agents outside Israel are, in my opinion, illegal expenses for the purpose of tax deduction since, as will be explained in detail, they are not legal in the country in which they were made – or at least it is so presumed as long as the appellant has not proved otherwise – and they would not have been legal had they been expended in the taxing state, i.e. Israel. In other words, they are, if you will, a case of "double illegality" (in the sense of the term "double criminality" in the area of extradition law), both in Israel and in the foreign state. You're damned if you do it in Russia, and you're damned if you do it in Israel.

(2) *Regarding the question of the hypothetical legality of the expenses in Israel*: In spite of the fact that the payments were made outside Israel, we must hypothetically examine the legality of the expense in Israel, i.e. what would be the situation had the deed taken place in Israel (see also Uretzky, at p. 142). Vice-President Cheshin called this a "transplanting of foreign events into Israeli law" (*Evico v. State of Israel* [17]). "Hypothetical criminality means that the deed would constitute a crime in the perpetrator's country of origin too, if it includes the factors that form the basis for effective criminality, *in abstracto* and *in concreto*, in the country in whose territory the crime was committed" (Feller, at pp. 219-220). Even in cases in which the expenses incurred outside Israel involved, according to the definitions of criminal law, elements that are based on a clear local connection, such as in this case, the circumstances of the deed can be substituted and examined as though they took place in Israel. Vice-President Cheshin's words in *Evico v. State of Israel* [17] are particularly apposite in this matter, and even though the statement was made in a different context, it is almost as if it were written for us:

> 'How can we carry out this transplantation into Israel of an event that took place outside Israel? Close examination will reveal that it is possible to perform this transplantation without any particular difficulty. This is the case, for example, in relation to crimes that are not "local" – floating crimes, if you will – i.e. crimes that are not, by their very nature, dependent on the place of commission of the crime.... The procedure is different in a case in which one of the components of the deed (that was committed outside Israel) is a "local component," a component characterized by a specific local context. Such, for example, is the component of the crime of bribery in Israel if the person receiving the bribe is a "public servant." This concept is defined in the Penal Law (s. 34(24)) and its nexus is specific to the State of Israel. A "public servant" in Israel is not the same as a "public servant" in the country in which the event took place (inasmuch as the concept exists in that country). The

> question that therefore arises is how to effect the transplantation in these kinds of cases, and the answer given was – and is – that we must adopt a "conceptual approach" (as *per* (then) Justice Barak in *Moshe David v. State of Israel* [18]) or one of "hypothetical criminality" (in the words of Feller). The technique for transplantation is that of a "conversion of factors", and the act of conversion will be effected by exchanging "the actual factual circumstances [that existed outside Israel] for corresponding hypothetical Israeli circumstances" (*Moshe David v. State of Israel* [18], at p. 636). In these cases of "local" circumstances we will, therefore, examine whether it is possible to transfer the circumstances that pertained in another country to corresponding, hypothetical, circumstances in Israel' (paras. 13-14, and see also *Moshe David v. State of Israel* [18], at p. 622, cited by the Vice-President; see also Feller, at pp. 213-220).

I will add that for the purposes of this examination, we should recall the process of globalization that is sweeping the world, and with it the international war on corruption that finds expression *inter alia* in the United Nations Convention against Corruption, which we shall address below. In our case there can be little doubt that the agents used the money that they received from the appellant to bribe public officials and civil servants in public institutions in Russia – who pocketed the money in exchange for closing deals with the appellant. There is no doubt that had these expenses been made in Israel, they would have constituted an act of calumny falling within the bounds of the crime of bribery.

(3) *The question of the legality of the expense in the foreign country:* This question is examined as a factual-evidentiary question. As elaborated above (para. 8), the appellant's agents themselves testified that they "gave bribes." Indeed, some of them claimed that at that time this was a common phenomenon, though this may not necessarily attest to its legality – "anyone who had control of the money wanted a share of the payment..." (as stated by the witness Koznitzova, see above). These words speak for themselves, and indicate illegality. The Russian President, upon his recent retirement, noted that the war on corruption had not made much progress, and he hoped that it would be more successful in the future. Apparently a problematic basic situation had been created in Russia whereby public servants received low salaries, which constituted an incentive to seek additional sources of income; this coincided with a period of huge spending, the opening up of profitable commercial avenues and new opportunities; in terms of corruption, this is a lethal combination. Edward Shevardnadze, who was Foreign Minister of the

Soviet Union in the 1980s before he became President of Georgia, first made his name as a crusader against corruption.

Returning to Israel: on the legal plane, the question of the status of the deed under the law of the foreign country required proof through the regular methods of the foreign law, i.e. testimony from a suitable expert (see HCJ 4562/94 *Abu Daka v. Lod Military Court* [19], at pp. 742, 748; CrimA 2597/04 *Roitman v. State of Israel* [20], paras. 69-73; Menashe Shawa "The Nature and Manner of Proving Foreign Law in Anglo-American Law and Israeli Law," *Tel Aviv U. Law J. (Iyunei Mishpat)* 3 at p. 725 (1973)). In our case, no expert witness was summoned by either party. Since the burden of proof regarding an expense incurred in generating income falls on the appellant (see LCA 1436/90 *Giora Arad, Investment Management and Services Co. Ltd. v. Director of Value Added Tax* [21], at p. 101), the appellant also bears the burden of proof of the legality of the expense: "the burden of proof encompasses both the actual performance of the act and the goal served by its performance" (ITA 5019/97 *D. and D. Zra'im Ltd. v. Tax Assessor Haifa* [59], at pp. 131, 142, *per* Deputy President Dr. Bein). In our case, allegations regarding the legality of the expenses have been raised both through the respondent's investigations and through the questioning of the appellant's witnesses in the lower Court. Certainly under these circumstances the onus was on the appellant to prove its contention that this was not an illegal expense under the foreign law, inasmuch as this is indeed its claim, via the accepted methods mentioned. Since it did not do so, the expense will be considered illegal for purposes of tax deduction.

(4) From the aforesaid it transpires that the said expenses were tainted by "double illegality" – *in concreto*, in the country in which they were incurred, and *in abstracto*, had they been incurred in Israel. In this case I am of the opinion, as noted, that these expenses are subject to the same law as expenses incurred through a violation of the law, and therefore extra weight should be assigned to the considerations denying them recognition when determining taxable income. It would appear that this outcome should not, as a rule, be different from other cases in which this kind of overlap does not exist, and of these, too, it has been said that the deductions may possibly be disallowed for reasons of public policy, although it was said that this should appear in explicit statutory provisions (and see extensively in Uretzky, at pp. 142-146). These cases must be addressed on a case-by-case basis.

On bribery and corruption in Israel and abroad

15. (1) Above we addressed questions relating to the framework for the deductibility of illegal expenses incurred outside Israel. We will now fill in this framework with the particulars of the illegal activity in the present case, i.e. the payment of bribes. The value that is protected by the law prescribing

the offense of bribery is dual-faceted (see CrimA 8573/96 *Mercado v. State of Israel* [22], at p. 481 (1997), at pp. 505-506, *per* Justice Turkel; LCrimA 5905/98 *Ronen v. State of Israel* [23], at pp. 728, 735; CrimA 733/07 *Cohen v. State of Israel* [24], *per* Justice Grunis, para. 13, and the references there; see also Mordechai Kremnitzer, "Are we Short of Crimes?" *Mishpatim*, 13 at pp. 159, 161-162 (5743-5744), hereinafter: Kremnitzer; also cf: Liat Levanon and Mordechai Kremnitzer, "How Far will the Crime of Bribery Extend – In the Aftermath of CrimA 8573/96" *Alei Mishpat* (Bikurim Volume, Booklet 2) at pp. 369, 372-375 (2000)): *first*, ensuring the proper functioning of the public administration, such that it serves the public interest and acts without bias and without foreign influences swaying governmental discretion; this includes protection of the integrity of the public administration (there are those who see this as a separate goal, see Justice Grunis in *Cohen v. State of Israel* [24]); *secondly*, preservation of the public's trust in the administrative authorities and of the prestige of the administration in the eyes of the public, as President Shamgar said:

> 'These phenomena can seriously erode the trust with which a citizen regards those who have been appointed to serve the public, it fouls the atmosphere and sows the seeds of disappointment and frustration.... Distorted standards in human relationships and the relationship between the government and the citizen emerge and grow, posing a latent danger to society as a whole' (CSA 1/77 *Klein v. State of Israel* [25], at pp. 164, 167).

In my opinion, these concerns are ultimately two sides of the same coin for a society wanting a fair system of governance that it can trust. This is evident to every intelligent and decent person.

(2) In *Ronen v. State of Israel* [23], Justice Strasbourg-Cohen commented:

> 'The act of bribery is one of the most serious crimes. It has the power to corrupt the public administrative system, and to lead it to act in ways contrary to relevant criteria, contrary to the norms worthy of a proper public administration, and contrary to the law. The act of bribery corrupts the character of public servants and damages the delicate fabric of the relationship between individuals and public servants, which is based on fairness, relevance, impartiality, equality and more. It eats away at the foundations of the societal construct; it damages the public's trust in the administration, which is a necessary basis for the existence of a proper society' (at p. 734).

President Barak summarized the dual-faceted value as follows:

'The basis of the law of bribery is the concern that receiving a gift will affect a public servant's decisions on the one hand, and the public's trust in the government authorities on the other' (CrimA 5046/93 *State of Israel v. Hochman* [26], at pp. 2, 10).

(3) In relation to bribery in commercial contexts, it seems that in most cases, including the present case, this occurs in the context of contracts with public authorities, which as a rule ought to be awarded through tenders. In such cases, the bribery adversely affects other values that the public would wish to uphold, such as efficiency and thrift in the expenditure of public funds, as well as fair competition. As is known, the mechanism of the public tender is designed to facilitate the existence and combination of two fundamental objectives – proper administration and equal and fair treatment, by ensuring fair competition and equal opportunities for all; and economic efficiency in the management of the economy and the use of public funds (see HCJ 368/76 *Gozlan v. Beit Shemesh Local Council* [27], at pp. 505, 511-512; CA 6585/95 *M.G.U.R. v. Nesher Municipality* [28], at pp. 206, 212; Gabriela Shalev, "Public Tenders since the Mandatory Tenders Law 5752-1992", *Mehkarei Mishpat* 12 at pp. 393, 396-397 (1995)). It will be mentioned that some divide the first objective into two objectives – proper administration and the maintenance of the integrity, on one hand, and the granting of equal opportunity, on the other: see Omer Dekel, *Tenders*, Vol. 1, at pp. 92-98 (2004)(hereinafter: Dekel)). It is clear that a bribe paid to secure a biased outcome of a tender impacts negatively on these objectives. We have explained the importance of proper administration above, and there is no need to say any more; in addition, however, "in the nature of things, corruption and bias also entail serious economic damage to the public and the economy in general, both immediately – due to the decreased efficiency of contractual arrangements, and in the long-term – due to the loss of trust in the system of governance" (Dekel, at p. 118; see also regarding the interface of bribery and tenders *ibid*. at pp. 197-199).

(4) The value of fair competition – which Justice Berinson defined as "integrity in commerce" (*Ben-Tal v. Ben-Tal* [16], at p. 61) – is also a public interest of great significance, and the law protects it in various ways, including through the laws of tenders (see, for example, FH 22/82 *Beit Jules Ltd. v. Raviv Moshe and Assoc. Ltd.* [29], at p. 441; see also, in a criminal context, CrimA 7068/06 *State of Israel v. Ariel Electrical Engineering Traffic Lights and Control Ltd*. [30]). In our case, even if the damage to fair competition is not one of the interests protected by the criminal prohibition against paying bribes, there is no doubt that when this kind of payment is made in a commercial context, damage to fair competition ensues as a side-effect.

16. (1) It is impossible to address this issue in the State of Israel without reference to Jewish law. In the law of Israel and the tradition of Israel, the prohibition on bribery and the negative attitude towards it are anchored in biblical law. In the Torah portion of *Mishpatim* (Laws), it is written: "And you shall take no bribe; for a bribe blinds they that have sight, and perverts the words of the righteous" (*Exodus* [71] 23:8; see also *Deuteronomy* [72] 16:19; *Shulhan Arukh, Hoshen Mishpat* [73] 9:1) Even though the biblical prohibition relates to judges, the later commentators applied it, based on the words of earlier commentators, to public officials as well. R. Zvi Hirsch Eisenstadt (Poland, 19th century), author of *Pit'hei Tshuva* [74], cites the *Pilpula Harifta* (R. Yom Tov Heller, Prague, 17th century):

> 'Another great thing is understood from the words of Rosh [R. Asher, Germany-Spain, 14th century – E.R.], that bribery is prohibited not just in the courts but also for all types of fines... And I write this to instruct those appointed by the public, even though they are not judges and have not been accepted as such, even so they should avoid accepting gifts for their decisions' (*Hoshen Mishpat* 34:27).

In other words, an official who holds a public office other than in a rabbinical court is also forbidden to accept unlawful gifts. In *Birkhei Yosef* [75], R. Haim Yosef David Azulai (known by the acronym HIDA - Israel and Italy, 18th century) noted: "Public officials, even though they are not judges in a court of law and have not been accepted as such, must still avoid accepting gifts for their decisions" (*Hoshen Mishpat* 9:10, p. 26). R. Yechiel Michel HaLevi Epstein (Russia, 19th and early 20th centuries), author of the renowned halakhic work, *Arukh Hashulhan* [76], wrote:

'It does not necessarily mean that only a judge is forbidden to accept bribes, but rather anyone who is appointed and who deals with public affairs, even if he is not a judge in a court of law, is forbidden to pervert and distort an issue due to feelings of love or hatred and certainly not by taking a bribe" (*Hoshen Mishpat* 9:1; see also in this regard R. Avraham Tzvi Scheinfeld, "Bribing a Public Servant," *Tchumin* V, at pp. 332, 333 (5744), which discusses a case with circumstances somewhat similar to ours (hereinafter: Scheinfeld); Nahum Rakover, *The Rule of Law in Israel*, at pp. 96-99 (1989 R. Itamar Warhaftig, "A Gift to an Employee from Another – His or His Employer's?" *Tchumin* XVII at pp. 293, 297-299 (5757); Eliav Shochetmann "For a Bribe Blinds the Eyes of the Wise, and Perverts the Words of the Righteous: Integrity of Judgment and Integrity of Public Administration" *Parashat Hashavua*, Aviad Cohen and Michael Wigoda, eds. (*Parashat Shoftim*, 5763, Issue No. 135) (hereinafter: Shochetman); R. Shlomo Ishon, "Gifts to a Government Official,' *Tchumin* XXVI at pp. 335,

337-338 (5766)). (2) The Talmud asks: "What is *shohad* (bribery)? *Shehu-had* (they are one)" (Babylonian Talmud, *Ketubot* [68] 105b). Rashi explains as follows: "The giver and receiver are made to have one heart." And further: "Rava said: How does bribery work? One who receives a bribe from another begins to agree with him and becomes like a part of him and no-one sees his own shortcomings." These words (even though, as stated, they were said in relation to judges) illustrate the two-fold basis of bribery – the need to prevent "closeness" between a public official and a citizen giving a bribe, both for the sake of proper administration and for the sake of the public's trust in its representatives and institutions (for more on bribery in Jewish law, see CrimA 71/83 *Flatto-Sharon v. State of Israel* [31], at pp. 757, 768-769; CrimA 355/88 *Levi v. State of Israel*, [32] at pp. 221, 230-232, *per* Justice D. Levin in both these cases; Haim Cohn, "Reflections on Integrity," *Haim Cohn - Selected Writings*, Aharon Barak and Ruth Gavison, eds., at pp. 417, 421-423 (2001), and the citations *ibid*.; Shochetmann).

17. (1) The odious practice of bribery was widespread during various periods throughout history. Bribery was prevalent in Israel both in the times of the Prophets (see for example Isaiah [77] 1:23; Ezekiel [78] 22:12), and in the times of Talmudic Sages (Babylonian Talmud *Sotah* [79] 47B), and of course in many other societies and entities. In the early days of the State of Israel, the legislature was aware of a scourge of bribery, and addressed the issue several times by expanding the definitions of the crime and increasing the penalty it carries (see the Commentary to the Penal Law Amendment Bill (Bribery and Corruption), 5711-1950, Bill 60; Commentary to the Penal Law Amendment Bill (Amendment No. 3), 5724-1964, Bill 591, 54; see also Shimon Agranat, "Developments in Criminal Law," *Iyunei Mishpat* 11 at pp. 33, 35-36 (1986); but see Kremnitzer). Over the years bribes have been accepted by public servants, in a variety of circumstances, whether due to personal need or to the desire for supplementary income (see, for example, CrimA 389/72 *Zokaim v. State of Israel* [33], at p. 487; CrimA 341/73 *State of Israel v. Vita* [34], at p. 610; CrimA 126/76 *State of Israel v. Shefer* [35] at p. 466 (hereinafter: *State of Israel v. Shefer* [35]); and many examples – most recently the aforementioned CrimA 766/07 *Cohen* [24]).

(2) The odious practice of bribery crosses geographical boundaries. Obviously, the phenomenon of bribery, as well as the need to fight it, exists in other countries besides Israel (see for example, the Commentary to the Penal Law Amendment Bill (Bribery and Corruption), 5711-1950). The more international commerce becomes in our generation, known as the "age of globalization," the more opportunities there are for bribery to become "international" in nature. It is also clear that in years gone by, even well-respected and legitimate Israeli companies used to engage in bribery in foreign countries, and they were not too ashamed to bring their cases before

the Israeli courts (see CA 101/74 *Hiram Landau Road Construction and Development Works Ltd. v. Water Sources Development (Foreign Countries) Ltd* [36], at pp. 661, 668, regarding bribes given in Uganda). In this context, which involves international economic activity and the "export" of bribes, harm is done - by the very nature of these kinds of activities - to the values of economic efficiency and fair competition, in addition to the damage to the values of integrity and public trust. Any kind of bribery is bribery and is damaging. As our Sages said: "To what can bribery be compared? To a stone. Wherever it falls – it breaks things" (*Midrash Tanchuma* [80] (*Toldot*, 8); see also *Mercado v. State of Israel* [22], at p. 592).

(3) The Hebrew poetess Rachel, in her poem "Day of Tidings," writes of the reluctance, even in troubled times, to benefit from activities that pollute the moral-ideological atmosphere. This is the poem, which was based on a biblical story in the Book of Kings II 7:3 ff. It is cited here without interpretation or reference to the background material to its composition:

'In days past the terrible foe
Laid Samaria under siege;
Four lepers brought it glad tidings
They brought it tidings of liberty.As Samaria in siege – all the land is as one
And the hunger too heavy to bear.
But I do not wish for redemption's tidings
If they come from the mouth of a leper.

A pure one will tell and a pure one redeem
And if his hand is not found to redeem –
Then it has been chosen for me to fall
In the plight of the siege
At the dawn of day of great tidings."

Even if a bribe in a particular country might be financially fruitful for Israelis, and through them for the Israeli economy – the Israeli economy should not thrive on the "fruit of the poisonous tree."

18. (1) To deal with corruption, and following legislative developments in various countries around the world, some of which we will address below, in 2003 the United Nations adopted the Convention against Corruption, some aspects of which are relevant to our case – i.e. the question of tax deduction of expenses incurred in a bribery situation. In the Preamble to the Convention, concern is expressed regarding the problems and threats that corruption poses to the stability and security of societies and democratic institutions; the Convention goes on to emphasize that international

cooperation and a comprehensive, inter-disciplinary approach are essential in order to overcome this phenomenon:

> '*The States Parties to this Convention,*
>
> *Concerned* about the seriousness of problems and threats posed by corruption to the stability and security of societies, undermining the institutions and values of democracy, ethical values and justice and jeopardizing sustainable development and the rule of law,…
>
> *Convinced* that corruption is no longer a local matter but a transnational phenomenon that affects all societies and economies, making international cooperation to prevent and control it essential,
>
> *Convinced* also that a comprehensive and multidisciplinary approach is required to prevent and combat corruption effectively…'

(2) The Convention includes many articles prescribing a variety of methods of fighting corruption within member states and outside them. Chapter III of the Convention, subtitled "Criminalization and Law Enforcement," provides, in arts. 15 and 16, that the states will act by means of legislation to criminalize activities intended to provide an undue advantage to public officials in an improper manner in order to influence their activities in their official capacity – both regarding the officials of the State itself (in art. 15) *and regarding officials of a foreign state* (or international organization, art. 16). Particularly relevant to our case is art. 12(4), which lays down provisions regarding recognition and deductibility for tax purposes:

> '4. Each State Party shall disallow the tax deductibility of expenses that constitute bribes, the latter being one of the constituent elements of the offences established in accordance with articles 15 and 16 of this Convention and, where appropriate, other expenses incurred in furtherance of corrupt conduct."

These words are clear and require no explanation.

(3) The State of Israel signed the Convention against Corruption on November 29, 2005. However, it is yet to ratify the Convention, and indeed, even its signing of the Convention was marked by problems and delays (apparently primarily due to Israeli Ministry of Defense officials – see the protocol of the meeting of the Parliamentary Commission of Inquiry on Exposing Governmental Corruption, of November 16, 2005). Moreover, Israel's signing of the Convention, and the Convention itself, post-date the

events that are the subject of this appeal. In any case, we do not need to rely on the Convention as legal grounds in this case. Rather, it serves as a compass and a road map that show us the most desirable interpretation and the appropriate judicial policy in cases such as this – desirable and appropriate today, following the signing of the Convention, as at the time relevant to the appeal, prior thereto.

19. In today's world, the massive advances in transportation and communications, the technological innovations and the resulting global "proximity" have brought about the expansion and spread of international and multi-national economic and business activity. This has major implications for various areas of law; one such consequence is the transformation of corruption from a national and local matter to an issue of broad-ranging, international significance, which needs to be treated as such, including in relation to taxation. In CrimA 4596/05 *Rosenstein v. State of Israel* [37] I had occasion to comment:

> '"The Global Village" is not just a technological concept, relating to the expanding possibilities for communication and travel, which no one can dispute; in my opinion it is also an ideological concept, even though it is still an ongoing process and there remains much that is unclear about it…. However, our case falls clearly into the category in which the law will be interpreted according to what is appropriate, which in this case is also what is effective. Globalization therefore includes questions of terrorism on one hand, and of economics on the other, besides environmental issues and many other concerns. In more than one sense, the law lags behind the new technology and it must catch up materially and ideologically.'

It transpires that these words are applicable to various matters – including the case at hand, in the context of bribing the officials of a foreign state. In LCA 10231/04 *Troim v. Gaidamak* [38], Justice Arbel stated (albeit in essentially different circumstances):

> 'The contention that bribery in Kazakhstan should not be viewed as seriously as we would view this crime in a law-abiding state, but rather as the accepted mode of business conduct, has no leg to stand on. Even if it is acceptable somewhere, this does not vindicate bribery and certainly does not lead us to the conclusion that bribery should not be viewed as a criminal act' (para. 5).

A clear and incisive approach here is inescapable. No one claims that the phenomenon of bribery does not exist in various countries. It is sometimes practically an open secret and the aforementioned Convention was initiated

for good reason. But it should not be rationalized that it has always been that way. There will be Sisyphean struggles in the future, but we must persist, and there are tools to help us in our quest.

Comparative law – expenses incurred for bribery in a foreign country from a tax perspective

20. (1) The specific phenomenon of promoting business interests in foreign countries through bribery and corruption is not a new one and, as stated above, various states have addressed it, *inter alia* in relation to the question of the deductibility of these kinds of expenses. In the USA, as early as 1958 a section in the US Internal Revenue Code was enacted prohibiting the deduction of expenses incurred through illegal payments to foreign governmental officials (Internal Revenue Code, 26 U.S.C § 162(c)(1) (1958)).

(2) In 1977 a law was enacted expressly criminalizing the payment of bribes by US companies to government officials outside the USA: the Foreign Corrupt Practices Act (FCPA), 15 U.S.C §§ 78m, 78dd-1, 78dd-2, 78ff (1977). The aforementioned § 162(c) was amended to include direct reference to the FCPA. The background to this legislation was, on the one hand, the criticism leveled against § 162(c)(1) – primarily after it was extended – due to its lack of clarity and the fact that it had become a method of penalization through the taxation system (see, for example: Christopher A. Lewis, "Penalizing Bribery of Foreign Officials Through the Tax Laws: A Case for Repealing Section 162(c)(1)" 11 *U. Mich. J. L. Reform* (1977-78)); on the other hand, an investigation by the U.S. Securities and Exchange Commission found that the incidence of bribe payments to foreign governmental officials was extremely widespread, involving hundreds of US companies and payments worth hundreds of millions of dollars (Securities and Exchange Commission (SEC) Report on Questionable and Illegal Corporate Payments and Practices, CCH Federal Securities Law Reports No. 642, pt. II (1976), quoted in: Morgan Chu & Daniel Magraw, "The Deductibility of Questionable Foreign Payments", 87 *Yale L. J.* 1091 (1977-78; hereinafter: Chu & Magraw), in note 2; see also Uretzky, at pp. 149-151). The discovery of this phenomenon resulted, *inter alia*, from the exposure of a scandal relating to the aerospace company Lockheed, where it was found that the company had paid bribes worth tens of millions of dollars to senior foreign government officials *(S.E.C. v. Lockheed Aircraft Corp*., 1976 WL 779 [67].

(3) As part of the policy considerations behind the enactment of the FCPA, it was explained that not only is bribing foreign governmental officials an unethical act that violates the moral and ideological expectations of the American public, but it also does damage to business by creating

unfair competition, sabotaging public trust in the free market system and encouraging corruption at the expense of efficiency. It was stated that such an act is contrary to American interests, both because US companies not participating in bribery are at a disadvantage, and because the reputation of all US companies is tarnished, and also because of the serious difficulties it creates for US foreign policy with friendly governments and states (H.R. Rep. No. 640, 95th Cong., 1st Sess. (1977); Chu & Magraw, pp. 1095-97).

(4) It should be noted, nonetheless, that in subsequent years the FCPA was amended and the range of payments it criminalized scaled back, so that payments intended to smooth or expedite a "routine governmental action" would not be considered illegal under the FCPA; this also applies, in a case where it is proven that payments were legal in the country in which they were expended, or constituted good faith expenditures directly related to the promotion of products and services or execution of a contract with a foreign government (15 U.S.C §§ 78m, 78dd-1 (1988)).

21. (1) In 1997, member States of the Organization for Economic Co-operation and Development (OECD) and five additional States signed the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (Nov. 21 1997, 37 I. L. M 1 (1997)). In this Convention, the signatory states committed themselves, *inter alia*, to adopt measures to criminalize the bribery of public officials, using a relatively broad definition of the said term. As part of the Convention the signatory states undertook to uphold the Recommendation of the Council of the OECD on the Tax Deductibility of Bribes to Foreign Public Officials (April 11, 1996, 35 I. L. M. 1311 (1996)).

(2) Following the signing of this Convention, in 1997 France enacted a provision in its taxation code prohibiting the deduction of payments to foreign public officials, as defined in the Convention (*Loi de finances rectificative pour 1997* (Amending Law on Finances for 1997), Law No. 97-1239 of Dec. 29, 1997, J. O no. 302 Dec. 30, 1997, p. 19101; *Code général des impost*, article 39, 2 bis).

(3) Similar provisions were also legislated in Switzerland, prohibiting tax deductions of bribes paid to Swiss or foreign public officials – whether on the federal level or the cantonal level (*Bundesgesetz über die direkte Bundessteuer* (DBG), (Law on Direct Federal Tax), 642.11 RS, Dec. 14 1990, Abs. 27, 59 (1990); *Bundesgesetz über die Harmonisierung der direkten Steuern der Kantone und Gemeinden (StHG)* (Law on the Harmonization of Direct Tax), Dec. 14 1990, Abs. 10, 25 (1990).

(4) It will be mentioned that the American FCPA was amended one further time to align its provisions with those of the OECD Convention,

which defined bribery in a broader manner than the pre-amendment US law (15 U.S.C. § 78m (1998).

Interim summation

22. (1) All the abovesaid indicates that the payments transferred by the appellant to its agents and used for bribes should not be deductible, due to the illegality of the expenses. These payments, which were intended to bribe and corrupt public officials in a foreign country, would have been illegal had they been made in Israel, and by presumption – at least – were illegal in the country in which they were made. They will therefore be considered as expenses made illegally. Recognition of these payments as tax deductible contradicts public policy. It would make crime pay. It would make this court into a partner in whitewashing a crime and rendering the law an empty vessel. This outcome, prohibiting deduction of the payments, is also inevitable in light of the protected interests that are compromised by bribery – proper public administration and public trust in the government authorities and the law. The fact that the illegal act was perpetrated outside Israel does not detract from the force of these interests. On the contrary, in the context of the development of international business activity, the damage caused by bribery extends beyond the concerns of the national and the local communal domains – it undermines proper and trustworthy administration throughout the world. An additional consideration is the concern for compromising the State of Israel's foreign relations and image (cf. CrimA 4722/92 *Markovitz v. State of Israel* [39], at pp. 45, 49-50). Moreover, this outcome is reasonable in terms of the rules of fair competition – which are particularly important in the context of international economic activity; of encouragement of economic efficiency and the saving of public funds; and of common decency.

(2) It could be claimed that this outcome puts Israeli investors active in certain locations outside Israel at a competitive disadvantage vis-à-vis investors from other states whose policies allow these deductions (regarding considerations of competition in questions of international taxation, see Tzili Dagan, *International Taxation*, at pp. 19-22, 49-66 (2004)). However, the consideration of the economic benefit to the assessee – and to the State itself, through taxation of the assessee – in no way justifies such deductions, in light of the counterbalancing list of grave concerns mentioned above. This is especially true in light of the existence of a similar legislative mechanism in other developed countries. This can also be said in relation to the principle of "exact taxation," which is liable to be compromised by the prohibition on deducting illegal expenses. As stated, in my opinion, no heed should be paid to the argument against "imposing sanctions" via taxation law, since the non-recognition of deductibility does not constitute "penalization" *per se*,

but rather a normative necessity, a natural extension and complement to policies reflected in other bodies of law. Otherwise the law would be contradicting itself: "the left hand pushes away and the right hand draws close" (Babylonian Talmud *Sanhedrin* [82] 107B).

(3) This outcome is also consistent with the purpose which underlies taxation law. Indeed, the particular purpose of the Income Tax Ordinance is exact collection of tax: "The payment of exact tax is the essence and purpose of the law" (CA 1527/97 *Interbuilding Construction Company Ltd. v. Tax Assessor Tel Aviv 1* [40], at pp. 699, 719, *per* Justice Ariel; see also CA 4030/03 *Granot Enterprises – Central Agricultural Cooperative Ltd. v. Tax Assessor for Large Enterprises* [41], *per* Justice Adiel, para. 30). At the same time, the principle of exact tax serves the need for tax collection – which in itself is a mechanism for financing government and state activities. The principle of exact taxation is intended to serve justice, by upholding the first of the four principles of the "good tax" as defined by Adam Smith – "tax must be equal and just" (see Joseph M. Edrey, "An Overall Tax Base in Israel," *Mishpatim* 12, at pp. 431, 432 (1983); see also CA 900/01 *Keles v. Tax Assessor Tel Aviv 4* [42], at pp. 750, 765-766). But what is the justice in legal recognition – in the sense of allowance – of an expense incurred through crime? Indeed, taxation laws do not exist in a vacuum. Prof. Barak explained their purpose in his article "Interpretation of Taxation Laws," *Mishpatim* 28, at pp. 425, 434-436 (1997):

> The first-order purpose is to guarantee income for the public purse. This basically covers the immediate purpose, but it is not the only purpose. Behind the immediate purpose may lie other purposes that are societal in character. *Taxation is a social instrument.* Through it, society combats phenomena that it perceives as negative. It encourages those activities that it wishes to encourage and acts as a deterrent against those activities that it wishes to prevent…. It is assumed that the purpose of the law is to aspire to normative harmony. *A tax law does not exist in a vacuum.* It is interlinked with other laws that impose similar taxation and with the entire body of taxation legislation in Israel. It should be interpreted with a view to creating internal harmony within tax legislation. This harmony is not limited to 'internal-taxation' harmony only. *The interpreter must aspire to an overall normative harmony. Therefore it is assumed that taxation laws are interlinked with the law in general*' (emphasis added).

(4) Finally I repeat that in our case I have not addressed the question of the deductibility of expenses in the case of payments that are proven to

have been made lawfully in the foreign state. As stated, the laws of various countries distinguish these kinds of cases from other cases of illegal expenses incurred on foreign soil; US law also distinguishes cases in which it was proven that the bribes were paid in order to expedite or facilitate routine governmental procedures not involving discretion (in this context see also the discussion in Uretzky, at p. 144; and by analogy see also Scheinfeld, at p. 339). In my opinion the cases are different, and the latter case, for example, justifies an interpretation that disqualifies it outright. At any rate, no claim of this kind has been made in this case (all that was claimed by the appellant was that corruption was a very widespread phenomenon in Russia in the years following the collapse of the Soviet Union, and that many believe that corruption helped Russia to survive the transition between regimes; however, the prevalence of this phenomenon does not attest to its legality (see also *State of Israel v. Shefer* [35], at pp. 470-471; *Ben-Tal v. Ben-Tal* [16], at p. 61; CrimA 256/97 *Lachman v. State of Israel* [43]).

The alternative reason – the evidentiary aspect and the question of proving the expenses

23. As will be recalled, the major reason given by the lower court for the conclusion it reached was the evidentiary aspect, i.e. the extent to which the appellant proved the expenses it claimed. Based on this aspect, and in light of the testimony of the agents, the Court decided to allow the appeal in a partial manner, in relation to those parts of the commissions paid to the agents as their salaries only, and not in relation to the full expenses that the appellant claimed. The appellant directed its arguments against this decision too, as stated; however I am of the opinion that the appeal should not be allowed on this aspect either.

24. (1) No one disputes that it was incumbent on the appellant to prove the expenses claimed. In an income tax appeal, the burden of proof is squarely on the assessee's shoulders when addressing a non-accounting dispute, even if – as the appellant claims in this case – it kept its books properly (see *Arad* [21], at pp. 107-111; CA 486/01 *Hoter-Yishai v. Tax Assessor Tel Aviv 4* [44], at p. 326; CA 1124/03 *Ganei Ofer Construction and Investment Ltd. v. Tax Assessor Tel Aviv 1* [45], at pp. 313, 323-324; see also Dan Bein, "The Burden of Persuasion and Obligation of Evidence in Taxation Laws," *Mishpat U'Mimshal* 3, at p. 277 (1995)). This is certainly the case when the assessee seeks to prove expenses incurred in generating income. In such a case the Talmudic maxim holds especially true: "He who wishes to extract [money] from his fellow is the one who must bring evidence" (Babylonian Talmud *Bava Kama*, [83] 35A; see also *Beit Zakai Ltd. v. Tax Assessor* [13], at p. 522; CA 435/65 *Nagid, Trustee Businesses*

Ltd. v. Commissioner for Income Tax [46], at p. 287; Namdar, at pp. 226-227).

(2) The appellant argues that the lower Court erred when it imposed the regular burden of proof on it, and did not consider the difficulties it encountered in producing evidence for payments made in Russia during the period in question, especially in light of the particular circumstances. This argument should be rejected. Basically the appellant is attacking the factual findings of the lower court. In this regard it should be recalled, first, that "the question of the credibility of the evidence and how much weight should be attributed to it is given over to the court of first instance, and it is not the place of the appellate court to interfere with this, except in rare cases" (CA 647/79 *Ivun v. Tax Assessor for Special Collections* [47], at p. 648, *per* Justice Bejski; see also CA 274/84 *Shapiro and Schweitzer v. Income Tax Assessor Tel Aviv 2* [48] at p. 53; CA 734/89 *Pikanti Food Industries Ltd. v. Tax Assessor Gush Dan* [49] at pp. 83-84, and the sources *ibid*). Secondly, I believe that on the merits of the case, there is no reason to interfere with the decision of the lower Court, which weighed the burden of proof borne by the appellant against the evidentiary difficulties that it faced (on this issue see and compare *D. and D. Zra'im Ltd. v. Tax Assessor Haifa* [59], at pp. 142-144). The commercial and political circumstances prevailing in Russia at that time did indeed cause evidentiary difficulties; however, at least a few of the appellant's agents visited Israel, as will be recalled, and yet insufficient documentation was presented regarding the expenses that the appellant paid to them too. Note that the Court did not disqualify all the appellant's expenses due to lack of documentation; rather, it considered the testimony of the agents who appeared before it, and on that basis it recognized the expenses in a partial manner. In the words of the Court: "If not for the existence of an abnormal situation in the locations where the appellant was operating at that time, which all agree existed, it would have had nothing to say when confronted with the respondent's claims in regard to the verification of its expenses" (p. 27 of the judgment). Therefore it cannot be said that the Court did not take the evidentiary difficulties encountered by the appellant into consideration. For this reason, too, I cannot accept the appellant's argument.

(3) In this context, I am also unable to accept the appellant's argument that the Court should have admitted the depositions of the three remaining agents, who did not testify, based on the provisions of reg. 10(b) of the Regulations. Indeed, in hearing an income tax appeal, the Court is not bound by the regular rules of evidence, and it may accept any evidence on which the respondent based its assessment (see also CA 21/60 *Levtov v. Tax Assessor Haifa* [50], at p. 1606; CA 506/71 *Hafetz v. Tax Assessor Haifa* [51], at pp. 212, 217; CA 5709/95 *Ben-Shlomo v. Director of VAT Jerusalem*

[52], at pp. 241, 252-254; and also Amnon Rafael, *Income Tax* – Vol. VI (Osnat Frank, ed.) at pp. 264-268 (2005)) but in our case the respondent did *not* base its assessment on these depositions. These depositions were submitted in February 1999, during a hearing held by the respondent at the appellant's instigation, and they are formulated in the most general of terms and in the same format, in a manner that led the respondent to assume that they had been prepared especially for the hearing (see the testimony of Income Tax Coordinator Tzipi Yosef of April 29, 2004, p. 84 of the protocol; I will add that this was also my impression from looking at the depositions – the submission of which was approved by a decision of the District Court of April 29, 2004, see p. 87 of the protocol). At any rate, even if the court had accepted the depositions as evidence, this would have been of no help to the appellant – since the court's recognition of the appellant's expenses was ultimately granted only in accordance with the testimony of the agents that held up in the face of cross-examination, and in any case the amounts that were recognized were not consistent with the amounts reported in their depositions.

25. The appellant's other argument relates to the fact that the respondent authorized an exemption from deduction of tax at source from the payments transferred to its agents. I cannot accept this argument, irrespective of whether it was raised in an attempt to reinforce the evidence that the payments were incurred in generating the appellant's income, or whether it was raised on the normative level. According to counsel for the appellant, authorization of the exemption constitutes a "governmental promise" to recognize the payments as expenses, and non-recognition is therefore a violation of a property right. Deduction at source is a method of tax collection for which the recipient of a payment may, in certain circumstances, be liable, and it is unrelated to the question of proving an expense in the generation of income by the payer: "Deduction at source does not, in essence, relate to the substance of the tax liability or the generation of tax liabilities – when is a person liable for tax and when is that person not liable for tax; rather it relates to the method of tax collection and the administration of taxation" (*Tax Assessor Haifa v. Hed HaKrayot Ltd*. [4], at p. 683 (regarding deduction at source by an employer), *per* Vice-President Cheshin; see also ITA 140/89 *Dar v. Tax Assessor Haifa* [60], at p. 116), and it would not be superfluous to mention s. 1.4 of Directive No. 34/93 on the issue of deduction of tax at source from payments to foreign residents, according to which: "It is hereby emphasized that an exemption from deduction of tax at the stage of deduction at source in no way determines the final status regarding the non-liability of the payment as taxable income for the payee"; *a fortiori*, in no way does it determine the status of the payment as an expense for the payer.

The cross appeal

26. The respondent cross-appealed the decision of the District Court to partially recognize payments made by the appellant – those that were destined for the agents' pockets – as expenses. At any rate, I find it difficult to accept the respondent's assertion that these payments have not been proven. As noted, this is a question of credibility and factual determinations of the District Court, and I have found no grounds to interfere with its decision, which was based on the testimony it heard. Nonetheless, I admit that I had my doubts regarding the question of legality: perhaps the full amount transferred to the agents was "tainted" and "stained" by illegality stemming from the bribery as described above. Ultimately I decided, following careful consideration of the testimony, that the payments transferred to the agents themselves, as payment for their work, should not be viewed as illegal payments. The agents, who were retired or former Russian public servants, performed many tasks for the appellant, foremost of which was the brokerage and contacts between the appellant and the organizations that constituted potential buyers — activities that are not illegitimate *per se*, especially under the particular conditions that prevailed in Russia at that time. In the words of the lower court, the agents "led him [the appellant's director – E.R.] through the commercial and fiscal maze created by Perestroika" (p. 17 of the judgment). They received their fees for this agency, which entailed costs. From the testimony it is also evident that the role of the agents did not end with brokering the transactions, but apparently also involved the installation, adaptation and maintenance of the medical equipment. See, for example, the testimony of the agent Garbuz:

> 'I knew that the clinic of the Foreign Ministry needed a particular piece of equipment, I approached the clinic and said that I know a body that can supply a suitable piece of equipment... (p. 58 of the protocol)
>
> I would monitor all the activities, I would release goods at customs, when they got held up. When they installed the equipment and there were problems in the beginning, I would help with the installation' (p. 66, see also p. 63).

A similar story emerged from the testimonies of the agent Lutzky ("What did I physically do – I had meetings in different cities… I met with the workers of the factories…" (p. 21 of the protocol)), and the agent Koznitzova ("I dealt with supply but I looked for customers. I had connections throughout the Soviet Union" (p. 74 of the protocol)); the agent Friedman testified about training and studies (pp. 30, 32)). From here we see that even though promoting the transactions through bribes was a part of the

agents' role – and perhaps even a central part – it was not the only part, and it cannot be said that their fees, which were paid by the appellant, were tainted by illegality such as to disqualify them from being recognized as expenses.

Epilogue

27. (1) The completion of the writing of this judgment coincided with the publication of the judgment of the Tel Aviv-Jaffa District Court (Judge M. Eltuvia) in ITA 1015/03 *Company Ltd. v. Tax Assessor Netanya* [61]; that case, too, addressed the question of the deduction of expenses paid as bribes outside Israel, under rather similar circumstances, and its conclusion is consistent with the aforesaid. In that case the bribe was paid directly by the company being assessed, as part of a single transaction that was larger in scope than the transactions in our case. I will not address the circumstances of that case here, but I will briefly address several of the principle-based reasons for the decision. The judgment addresses, *inter alia*, the claim of a governmental promise and damage to property due to its violation, and the use of monies by the controlling shareholder in order to give a bribe – but these questions are not relevant to our case.

(2) According to the judgment, recognition of bribes given outside Israel as an expense undermines the fundamental principles of the State of Israel and is incompatible with its obligations under the UN Charter, as well as with public policy, which is not confined to the borders of the State (citing a case of an arbitration award being revoked due to bribe payments that were made outside Israel and that constituted the factual basis for the arbitration award – OM (Jer) 2212/03 *Gad v. Siman-Tov* [62], *per* Judge Okon; LCA 3476/04 *Siman-Tov v. Gad* [53], *per* Justice Joubran). It was ruled that recognizing a bribe payment as an expense would make the Israeli public an accomplice to the crime, and that when accurate assessment and public policy clash, the latter must prevail. It was also determined that the prohibition on deducting bribe payments is designed to act as a disincentive to engaging in activities that involve giving bribes, and that it is doubtful whether bribe payments, which are antithetical to public policy, can be considered a necessary and essential expense for generating income.

(3) I humbly agree with the message of these words, as I explained above. As stated, in my opinion the recognition of expenses that were incurred to pay bribes is in general incompatible with public policy. Our case, as stated above, falls into the category of illegal expenses – the payment of which constituted an actual crime – and these should not be recognized for tax purposes for reasons of public policy. I have expressed my position that a person who chooses to spend money on bribes should

know that the legal authorities will not support these activities, even indirectly, by recognizing them as an expense.

(4) After these lines were written, the respondent requested that this judgment be appended as a reference.

28. In conclusion, I recommend that my colleagues not allow the appeal or the cross-appeal.

Justice E. Hayut

I agree with my colleague Justice E. Rubinstein that the appeal and cross-appeal should be denied, but in my opinion the fundamental question regarding the deductibility of illegal expenses (which the lower court said it addressed most perfunctorily, and even then, more than was necessary) may be left for a more opportune moment, since the appeals can be denied by simply adopting the lower court's finding and conclusions on the factual plane.

In its judgment the lower court ruled that the income tax appeal filed by the appellant should be partially allowed and that the fees the appellant paid to the four agents who worked on its behalf in Russia during the 1992-1996 fiscal years should be recognized as deductible expenses. The Court emphasized at the start of its judgment that the appeal before it "turns primarily on questions of fact and credibility," and the deliberations on these questions are indeed the main focus of the judgment. The court noted that the point of departure in this context is the well-established rule that in cases involving recognition of expenses as deductible, the burden of proof is borne by the assessee, who must present material evidence and appropriate documentation to establish his claims regarding the expenses incurred. Nevertheless, the lower court held that under special circumstances the assessee may be allowed to provide a basis for recognizing the expenses it claims "even in the absence of formal documentation… providing that in place of the documentation required to support the claims, other credible evidence is submitted, such as oral testimony from credible witnesses." In this case, the appellant claims that its activities in the states of the Soviet Union were mainly carried out via seven agents, but it did not possess formal documentation to show that these expenses were incurred as claimed, in the relevant fiscal years, as fees to the agents and as additional payments for "marketing facilitation" and "brokerage." Ultimately the appellant managed, following a not inconsiderable effort, to obtain testimony from four of the agents who worked for it during those years, and the court was prepared to recognize that these were special circumstances due to the unique situation that prevailed in the Soviet states with the advent of Perestroika. It was therefore willing to examine and rely on the testimonies of those agents who testified before it (Koznitzova, Garbuz, Lutzky, and Friedman, as well as the

testimony of Koznitzova's daughter Mrs. Dvinsky) regarding the question of the expenses, even in the absence of formal documentation for the relevant transactions. The court examined and analyzed these testimonies thoroughly and found them credible and convincing. It therefore used them as the basis for its decision to allow partial deduction of the expenses that the appellant claimed, in the amount of the fees that it paid to those agents according to their testimony (Koznitzova – $48,000; Garbuz – $10,000; Friedman – $30,000; and Lutzky – $135,000). Regarding the remainder of the expenses claimed by the appellant, including the payments which it termed "under the table" payments, the court thought that these had not been proven through any material evidence and that this was sufficient to deny the appellant's claims in their regard. In the words of the court:

> 'In our case, since there is no real proof regarding a significant portion of the expenses claimed by the appellant, there is no room to recognize these as deductible. Regarding the other portion of the expenses, those accounted for in the testimony of the agents summoned before me – i.e. Mr. Garbuz, Mr. Lutzky, Mr. Friedman, and Ms. Koznitzova – I have reached the conclusion that what I heard from them was enough to create an evidentiary basis for proving that these payments were made to them, even in the material absence of documents that should have substantiated the transactions that generated those expenses.'

These findings and conclusions of the lower Court are based, as stated, on a thorough and exhaustive evaluation of the testimonies before it and, like my colleague Justice Rubinstein, I too see no reason to interfere with them. This is also the case regarding the ruling of the lower court that in light of the special situation that prevailed in the Soviet states during the years in question, the credible testimony of the agents is sufficient in terms of evidence, insofar as it relates to the fees paid to them by the appellant for their services.

For these reasons, I concur with the position of my colleague Justice Rubinstein that both the appeal and the cross-appeal should be denied.

Justice Y. Elon

I concur with position of my colleagues Justice E. Rubinstein and Justice E. Hayut that the appeal and cross-appeal should be denied.

Like my colleague Justice Hayut, I too am of the opinion that in the matter of these appeals, the concrete factual findings of the lower court and the judicial outcome that they entail are sufficient basis for this conclusion.

The fundamental question raised by my colleague Justice Rubinstein regarding the general approach that should be adopted in relation to the deductibility of expenses that are allegedly illegal, and which were incurred by an Israeli tax-payer outside Israel, need not be decided in the context of the appeals before us. This is a complex and multi-faceted issue, which has manifold implications on many and various planes. It is possible that many aspects of this issue are a matter for statutory regulation.

In any case, I concur with the words of my colleague Justice Hayut, that a systematic investigation of this issue should be left for a more opportune occasion, when a decision on the matter is actually required.

Decided as per the judgment of Justice E. Rubinstein.

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June 5, 2008

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