C.A. 141/54

LILY WOLFF-BLOCH AND ANOTHER

v.

JERUSALEM DISTRICT ASSESSING OFFICER

In the Supreme Court sitting as a Court of Civil Appeal
[March 6, 1956]
Before Cheshin D.P., Sussman J., and Witkon J.

Income Tax - Income Tax Ordinance - Expenses incurred in production of income - Dentist - Period of study abroad - Expenses of - Whether for purpose of preserving existing asset.

The appellant, a dentist who had travelled to the U.S.A., and had spent 10 weeks there studying the latest developments in her profession, claimed the expenses so incurred by her as a deduction for purposes of income tax on the ground that they were incurred "in the production of income." The Assessing Officer refused to allow the deduction and this decision was upheld by the District Court.

Held, allowing an appeal (Cheshin D.P. dissenting), that the expenditure incurred by the appellant was incurred for the purpose of preserving "an existing asset" and could properly be deducted.

Palestine case referred to:

(1) *Income Tax Appeal* 11/45; *Mendel Scharf v. Assessing Officer, Jerusalem,* (1946), 13 *P.L.R.* 89.

Israel case referred to:

(2) *Income Tax Appeal* 1/49, *Tel Aviv; A.B. v. Tel Aviv Assessing Officer,* (1950/52), 7 P.M. 79.

English cases referred to:

(3) *Simpson v. Tate;* [1925] 2 *K.B.* 214.
(4) *Lomax (Inspector of Taxes) v. Newton;* [1953] 2 *All E.R.* 801.
(5) *Mitchell (Inspector of Taxes) v. B.W. Noble, Ltd,;* [1927] 1 *K.B.* 719.
(6) *Spofforth and Prince v. Golder (Inspector of Taxes);* [1945] 1 *All E.R.* 363.

American cases referred to:

(7) *Coughlin* v. *Commissioner of Inland Revenue;* 203 F. 2d. 307.
(8) *Welch v. Helvering;* (1933) 290 U.S. 111, 54 *S.Ct.* 8.

Dori for the appellants.
Shimron for the respondent.

WITKON J: This is an income tax appeal. The appellant, a dentist by profession, travelled abroad for further study, and the question is whether she may deduct the expenses of her journey from her income for the purposes of calculating her tax. The facts are undisputed. The appellant practises in a special branch of dentistry called orthodontics, and in that profession she serves in the capacity of director of the orthodontic department of the Strauss Health Center in Jerusalem as well as in her private clinic. In 1951, she spent some two-and-a-half months in the United States for the purpose of further study, and her expenses were expenses she incurred for this purpose only. The expert witness, Dr. Levin-Epstein, gave evidence - and I emphasize this - that further study of that kind is not available in Israel, and that a person of professional status such as the appellant is obliged to go abroad from time to time to study new methods and to observe for himself the progress of scientific knowledge and techniques, if he wishes to maintain his standard as an expert in his field. In actual fact, the witness was not prepared to affirm that but for that journey the appellant's earnings would be expected to drop or to dwindle. But he did confirm (if his confirmation were necessary) that the professional standard determines the size of the fee - meaning that even if the doctor does not maintain his standard on material grounds alone, his standard nevertheless innuences the extent of his earnings.

The Assessing Officer did not allow the deduction of this expense and the District Court confirmed his decision. The question is not of the easiest. As is well known, capital expenditure cannot be deducted from income, while income expenses alone, that is expenses incurred by the tax-payer in the course of producing his income, may be so deducted. The law distinguishes between the source of income and the income itself, that is to say, between the process of producing and its capital framework and structure. The rule is that expenses, relating to the production of income, laid out in that same process may be deducted, whereas expenses relating to the capital structure of the earnings may not be deducted. Here, however, we must make a reservation and distinguish between two kinds of expenses relating to capital: those intended to create or improve a capital asset, and those intended only to preserve an existing asset. Expenses of the second sort may also be income expenses, with a recognised place among the remaining current expenses in a profit-and-loss account which the earner has incurred in the process of producing his income. For the notion "income" includes the idea that in the course of producing the fruits, the capital shall remain untouched and preserved in its entirety. Whoever examines the list of expenses in section 11(1) of the Income Tax Ordinance, will discover that the majority are expenses relating to capital assests, such as interest, rent, repairs and depreciation; nevertheless they may be deducted, since they are not directed to the production of a capital asset or its improvement but to its preservation only. This is true not only of corporeal capital Assets; expenses laid out for the purpose of preserving incorporeal assets, such as goodwill, are deductible.

We shall examine the present question in the light of those rules. I have no doubt that the professional standard of a doctor or member of any other liberal profession is a capital asset, and it follows that the expenditure incurred by the appellant in her journey relates to the source of her income and not to the process of producing the income. But, as stated, the question is whether that expense was directed to the production of a new capital asset or to the improvement of an existing capital asset, or whether her purpose was but to preserve the asset in its existing state. Appellant's counsel was not unaware of this problem, and he emphasized again and again in all his submissions, both in the District Court and before us, that the object of the journey was not to add to the appellant's professional standard, but to save it from falling. According to the submission of counsel for the appellant, the present case is thus distinguishable from the case of the lawyer who travelled to England and

completed his studies at the Bar: *Scharf* v. *Assessing Officer* (l), as well as from the case of the accountant who travelled to South Africa in the hope of finding new clients and expanding his earnings: *A.B.* v. *Tel Aviv Assessing Officer* (2). The expenses of those two, the lawyer and the accountant, were laid out for the purpose of improving their position. The appellant, however, went away for further study not for the purpose of improving her position, as she contends, but for the sake of preserving what exists, since if she does not succeed in bringing her professional knowledge up to date from time to time, she will ultimately lower her standards and cease to be a leader in her profession.

As stated, this case concerns an incorporeal asset. Corporeal capital assets have secured the recognition of the legislator as to their temporariness, and the law seeks in several ways to save the owner of the asset from losing his capital in the course of producing his income. One way is to allow the cost of repairs according to section 11(1)(d) of the Income Tax Ordinance. Another way is to deduct the amount of depreciation from the income, by taking into consideration the fact that the value of the asset depreciates during the period of its life on account of wear and tear. Many complain of the fact that the law does not also take into consideration the "wear of human capital" that serves as a source of income in every livelihood which derives from the physical or mental force of man. But even if the legislator had given thought to the matter, it is impossible to say that the expert knowledge and skill of a professional man are subject to wear and tear from their use, in the way that machinery wears out from use. It cannot be said that the professional standard of a person of professional status is expected to "wear out"; but it is possible that it runs the danger of "obsolescence". The law takes into consideration the obsolescence of plant and machinery that have become useless and the owners of which sell them in order to change them, and do not obtain for them a price equal to their capital price with a deduction for the amount of depreciation given them in the past. That is a loss flowing from the fact that the machine can no longer compete with more modern machinery and must be sold before its owner has taken full advantage of the annual rate of depreciation. And if a machine is liable to become obsolete as compared with more modern machines, so, too, will the expert knowledge and skill of a professional man. The knowledge and skill themselves have not been affected or become worn, but new inventions and methods have appeared to take the place of the old and have affected their value as profit-bearing assets.

If we ask in what way the law takes into consideration incorporeal capital assets, we shall see that until the amendment of the law in 1952, a deduction was allowed of a sum equal to the capital price of the old asset (less the total amount of the past depreciation and the sale price) or a sum equal to the capital price of the new asset which ever was the smaller sum. This provision, which was contained in section 11(1)(c), was repealed with the imposition of income tax on capital profits according to section 5A, and thereafter a person must seek compensation for his losses in consequence of obsolescence within the framework of the provisions of section 5A(11)(e) or 5A(12), namely, by way of set-off against a capital profit or by way of increasing the capital price of the new asset for the purposes of depreciation or for the purposes of calculating the capital profit at the time of its sale.

It is clear that the appellant cannot rely on any provision such as the provision in section 11(1)(c), first because it has been repealed, as I have said; secondly, because it was limited to certain corporeal assets; and, thirdly, because in point of fact that provision did not allow the expenditure of a sum of money on the purchase of the new asset, but the deduction of such amount of depreciation for the old asset as had not been taken advantage of as a consequence of its early sale, with the proviso that that deduction should not be greater than the price of the new asset. But I have referred here to the case of obsolescence and have spent some time on it because it shows us, in my opinion, that the loss in consequence of obsolescence is indeed a capital loss, yet nevertheless the deduction formerly allowed for it by section 11(1)(c) was charged to the profit-and-loss account, meaning that it is a burden on income revenue. The rule is that the profit-and-loss account may not be charged with a capital loss, and that includes a loss resulting from wear and tear and obsolescence; whereas the law allowed the deductions set out in section 11(1)(c) and (i) for obsolescence and for depreciation as exceptions to that rule, meaning that no deductions will be allowed outside that statutory framework.

But that does not settle the problem arising here. Deductions for depreciation and obsolescence, within the meaning of sections 11(1)(c) and 11(1)(i), are chargeable to income with which the taxpayer is able to restore to himself capital that has been reduced as a consequence of the wear to the asset, or capital that has been lost, completely or partially, as a consequence of the obsolescence of the asset before its due time. The fact is

that a person seeking such deductions cannot do so except within the existing statutory provisions. The appellant, however, did not seek such deductions, but rather, according to her contention, is entitled to deduct a certain expense that she incurred in order to maintain her professional standard. We must weigh that argument according to the rules applicable. I have already noted that if the expense was indeed incurred in connection with a capital asset, but not for the sake of producing or improving it, but for the sake of preserving it - and that within the framework of acts pertaining to revenue from the organic point of view - then there is room for allowing the deduction of that expense. In my opinion, the question is, in the end, whether the purpose of the expense was to create a new asset or to improve an existing asset or whether the purpose was to preserve an asset in its existing condition.

No clear answer is to be found in the English cases. The authorities for the most part deal with assessments under Schedule E, namely, "wage-earning" taxpayers. But it is well-known that the provision in Rule 9 applies to such assessments, and that it is so narrow that hardly any expenses are allowable save those that, if not incurred by the employee, would involve him in a breach of duty towards his employer. Accordingly, the court has not allowed even membership fees in a learned society or subscriptions to scientific periodicals: in the cases of *Simpson* v. *Tate* (3), and *Lomax v. Newton* (4), the court allowed special expenditures as a consequence of compulsory participation in conferences, but no other expenses the outlay of which was not one of the conditions of service. The Royal Commission on the Taxation of Profits and Income considered this question in its Final Report (London, June 1955, Cmd. 9474), and stated: --

> "The present form of the Rule bears hardly upon persons of professional status in another way. We do not use the word "professional" here in any precise sense: we have in mind all those persons in office or employment whose work is of such a kind that they are expected to employ in it an equipment of expert or specialised knowledge. Doctors, teachers, lawyers, scientific workers, clergymen fall into this category. Such persons require to maintain and often to increase their professional equipment of knowledge, and it must often be quite impossible to relate the expenses of so doing to any specific obligation in performing the duties of a particular period. Their

> obligation is not only to be skilled in learning but to remain skilled in learning as conditions change. The expenses of so doing are represented by subscriptions to professional and learned societies, purchases of books and magazines, attendance at conferences, travel for research, purchase of instruments, etc. Yet, under the present rule, the Revenue is forced into making what seems to us rather unreal distinctions between what an employer insists upon and what he does not, between what a person is obliged to do in the performance of his duty and what it is desirable that he should do in order to be able to perform his duty: and between current expenses of maintaining knowledge or skill for one post and capital expenses of acquiring improved knowledge or skill to qualify for another post. It is not to be wondered at that the administration of Rule 9 is attended by rather widespread dissatisfaction."

Further on, the Royal Commission suggests a relaxation of the severity of Rule 9 and to exclude from it the test of the essentiality of the expenditure from the point of view of a condition of a contract of service. The fact is that the Commission did not propose that this amendment should bring in its wake the allowing of all the expenses referred to in the above passage or that it would have the effect of wiping out all distinction between the employed and the self-employed worker. Such amendment, the Commission stated, "will not provide for the expense of 'self-improvement', except so far as such expense is fairly related to the duties of the current employment. " But it is precisely from that reservation that one is given to understand that as far as the independent person of professional status is concerned, a certain liberality is followed in allowing such expenses.

I have no doubt that in the United States, the appellant would have succeeded in her appeal. In the case of *Coughlin v. C.I.R.* (7), the United States Court of Appeals (Second Circuit) dealt with the appeal of a lawyer, an expert in taxation, who laid out lecture-fees, travelling and living expenses, while taking part in the Annual Institute on Federal Taxation which took place in New York, and who wished to deduct his expenses from his income. The appellant was a partner in a firm of lawyers in the town of Binghamton, and it was necessary that at least one of the partners be an expert in tax matters, and that he

should remain an expert and should know his way around all the changes and innovations in the law and the case-law. His partners relied upon his special expert knowledge. The case was conducted as a test case, and representatives of the New York State Bar Association and representatives of the American Medical Association also took part in it. The court decided in favour of the taxpayer. Admittedly, it was not essential that the taxpayer should bring his knowledge up to date in that field, and he would have remained a lawyer and partner in his firm without that, but he was under a moral and professional duty to maintain his expert knowledge. To quote from the judgment of the court (loc. cit. (7), at pp.309-310) :--

> "...Here the petitioner did not need a renewal of his license to practise and it may be assumed that he could have continued as a member of his firm whether or not he kept currently informed as to the law of Federal taxation. But he was morally bound to keep so informed and did so in part by means of his attendance at this session of the Institute. It was a way well adapted to fulfil his professional duty to keep sharp the tools he actually used in his going trade or business. It may be that the knowledge he thus gained incidentally increased his fund of learning in general and, in that sense, the cost of acquiring it may have been a personal expense; but we think that the immediate. Over all professional need to incur the expenses in order to perform his work with due regard to the current status of the law so overshadows the personal aspect that it is the decisive feature.
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> "(2) It serves also to distinguish these expenditures from those made to acquire a capital asset. Even if in its cultural aspect knowledge should for tax purposes be considered in the nature of a capital asset as was suggested in *Welch v. Helvering* (8), the rather evanescent character of that for which the petitioner spent his money deprives it of the sort of permanency such a concept embraces."

I agree with the ruling that was laid down in that judgment, and in my opinion it ought to serve as a guide to us. I see no need for dwelling at length on the English authorities in

connection with expenses that a person bears in order to preserve his moral standing and his good name. Such expenses were allowed in several cases (for example, *Mitchell v. Nable* (5)), and not allowed in others (for example, in *Spofforth and Prince v. Golder* (6)), because the court thought that that was an expense of a personal nature and not solely professional. In the present case, there is no fear that the expenditure, in whole or in part, is personal. In my opinion, the sole question is whether this expenditure is designed to preserve an existing asset or whether it is calculated to add to and improve it. The test is, what is the asset? If one regards the knowledge and skill of a professional person altogether as one single whole, which we previously called "professional standard", then it may be said that the expenditure is designed to preserve the asset, whereas if we break down the generality of knowledge and skill into parts and examine each one of them separately, we will find that every bit of knowledge and every new method that the appellant learnt in her journey constitutes a new asset, an addition to the existing capital. I prefer the first approach to the second. A bare asset such as "professional standard" exists as a whole, and as long as the nurturing of that asset does not exceed the bounds of preserving what exists and is not designed to provide the professional man with another standing or another standard, an expense incurred by its owner for that purpose ought not to be regarded as a capital expense.

I have not overlooked the fact that this decision is likely to present assessing officers with difficult problems. Not only must they distinguish between personal expenditure and expenses connected with a profession, but they must also examine every professional expense of the kind in question and decide on its substance from the point of view of the professional standing of the particular taxpayer before them. They must consider each case according to its circumstances. But I do not think that the problem arising here is different in nature or more difficult than the problems that assessing officers deal with in relation to other taxpayers. Whenever the expense in question is not incurred for the purpose of the production or supply of goods or services, but in connection with capital serving as a source of income, the question always arises as to what that connection is: was the money expended for the purpose of producing the asset or for the purpose of preserving it? I have no doubt that only in rare cases will the taxpayer be able to prove, as the present taxpayer has proved, that he really incurred the expenses of travelling abroad for the purpose of "further study" in the sense stated here. If the Assessing Officer, or the District Court on

appeal from him, had found as a fact that the travelling expenses were not incurred in the present case for the sake of preserving an existing asset, but for the purpose of improving it, we should not have interfered with his decision if it had been based on the evidence. The advertising expenses of a business man serve as an example of an expense which may be an income expense or a capital expense, depending on the extent of the business and the expense. The question is one of degree. In the present case, evidence was brought which supports the taxpayer's contention, and that being so, we have only to examine the legal conclusion that the court arrived at on that evidence. That conclusion appears to me to be erroneous, as I have endeavoured to explain, and for that reason I am of opinion that the appeal should be allowed, and that the assessment should be amended as prayed for in the notice of appeal.

SUSSMAN J. I agree.

CHESHIN D.P. I regret that in the circumstances of the present case I cannot recognise the fine distinction between further study for the purpose of acquiring new knowledge and further study for the purpose of maintaining a professional standard. If the appellant had contended that she had forgotten her learning, or part of her learning, and proceeded overseas in order to revive her memory, she would have been entitled to demand a deduction within the framework of section 11(1) of the Income Tax Ordinance, as if all the trouble she had gone to and all the expenses she had incurred were designed only to restore the sources of creation of her income - that is to say, her medical knowledge - to their former state. But she did not so contend and she did not do so. She travelled abroad in order to complete her professional studies, that is, to observe for herself modern developments in the branch of medicine in which she is engaged, and to gain some idea of and add to her knowledge of techniques and new methods of treatment. I do not regard that act as an effort to maintain a professional standard, like the repairs that have to be done to machinery and tools of work which serve as a means of acquiring income. It is plain from the evidence that no danger threatened the appellant's position as a dentist, and that her income would not have dropped even if she had not travelled for the purpose of further study. I do not dispute the fact that the new knowledge which the appellant gained will be of great use to her, and will even increase her earnings in the future; but the further study here was, in my opinion, capital investment, a capital expense directed to the capital

structure of the appellant's earnings, and it should be regarded as improvements, the expenses incurred in the making of which are not deductible according to section 12. For that reason, I should be disposed to dismiss the appeal.

Appeal allowed

Judgment given on March 6, 1956.