CA 4243/08

Assessment Officer - Dan Region

v.

Vered Peri

The Supreme Court sitting as the Court of Civil Appeals

[30 April 2009]

Before Deputy President E. Rivlin, and Justices M. Naor, E. Arbel, E. Rubinstein, E. Hayut

Appeal of the judgment of the Tel-Aviv District Court (Judge A. Magen) of 3 April 2008 in Tax App. 1213/04.

Facts: The respondent (the counter-appellant) is the mother of two children, and a lawyer in private practice. The respondent requested to deduct from her taxable income expenditures for her children's pre-school and day care, as well as payments for afternoon day care for her daughter after she began attending elementary school. The respondent did not request a tax deduction for clubs that the children participated in during the afternoon, nor for day camps during the vacation summer months when the day care center was closed. The respondent argued that had her two children not been looked after in these frameworks, she could not have continued to work as a lawyer in private practice. The appellant refused to allow the deduction of the disputed expenses, and the issue was brought before the District Court. The District Court granted the respondent's appeal in part, ruling that the part of the expenses incurred for her children's care should be allowed as a deduction from income This is an appeal against its decision.

Held: In denying the appeal, Deputy President E. Rivlin (Justices M. Naor, E. Arbel, E. Rubinstein and E. Hayut concurring) held that in the absence of a statutory provision specifically addressing the possibility of deducting childcare expenses, the question of whether such an expense is deductible must be examined in accordance with s. 17 of the Income Tax Ordinance, similar to the examination of other expenses for which there is no special arrangement. The purpose that guides the interpretative

task is the purpose of the provisions of s. 17 itself, i.e., the obligation to pay true tax. Charging tax for an amount that does not reflect a person's real income cannot be defined as "income tax". If an assessee is not permitted to deduct an expense incurred in the production of his income, it is tantamount to "over taxation", because the income taken into account for purposes of determining his tax liability is higher than his real income.

Standard accounting practices mandate a direct connection between the expense and the production of items of income. They also require reliable measurement of the expense. They do not require that the expense "arise from the natural course and structure" of the income producing source. This leads to the conclusion that there must be a real, direct connection between the expense and the production of income as a condition for allowing the deduction of the expense. The "incidentality test" is an auxiliary test which is not exclusive, and particular expenses may be permitted for deduction even they does not "arise from the natural course and structure" of the income producing source, if the expenses bears a real, direct connection to the production of income. The childcare expense bears a real, direct connection to the production of income. It is expended to enable the parent to produce income. Placing the children under supervision is a necessity, the absence of which renders the parent unable to produce income.

Where a mixed expense may be separated into its components, the part constituting an expense in the production of income will be permitted for deduction and the assessee bears burden of proof for identifying the income producing portion and if proved to the required degree, the relative part that should be regarded as an income producing expense should be allowed as a deduction

With respect to the question of whether the ruling was prospective or retrospective, Deputy President Rivlin ruled that the change in the manner in which tax is collected affects the protected interest of reliance on the part of the tax collector and, hence with the exception of the present case, the ruling of this case should only be applied prospectively. Justice Naor on the other hand opined that since the question raised was a new one, it could not be said that any previous law had been changed and hence there doctrine of protecting an interest of reliance did not apply,. On the other hand there were numerous assesses who have an interest in retrospective application. Given that the case cuts both ways it is preferable that no rulinhould be made at this stage on the question of the date from which the ruling should apply, and it should be left open. pending independent examination.

Israeli Supreme Court cases cited:

[1] CA 284/66 *Kopilovitz v. Assessment Officer for Large Factories, Tel – Aviv,* [1966] IsrSC 20 (4) 716

[2] CA 190/61 *Borek v. Assessment Officer* [1961] IsrSC 15, 1801.

[3] CA 165/82 *Kibbutz Hatzor v. Assessment Clerk, Rehovot* [1985], IsrSC 39 (2) 70

[4] CA 1527/97 *Interbuilding Construction Company v. Assessment Clerk T.A-1* [1999] IsrSC 53 (1) 699

[5] *CA* 4271/00 *M.L. Investments and Development v. Director of Appreciation Tax* [2003] IsrSC 57 (2) 953

[6] CA 141/54 *Wolf –Bloch v. Jerusalem District Assessment Clerk* [1956] IsrSC 10, 441

[7] CA 358/82 *Alco Ltd. v. Assessment Clerk for Large Factories* [1985] IsrSC 39(3) 316

[8] CA 735/86 *Zvi Ben Shachar Seeds Ltd. v. Assessment Clerk Tel-Aviv 3,* [1989] IsrSC 43 (4) 45.

[9] CA 580/65 *E. Ben-Ezer and Sons Ltd v. Assessment Officer for Large Factories* [1966] IsrSC 20(2) 179 [10] *CA 35/67 Shtadlan v. Tel-Aviv Assessment Officer 4* [1967] IsrSC 21(1) 455

[11] TaxApp (T.A) 22/67 *Eliyahu v. Tel-Aviv Assessment Officer 1* (1999) (unreported)

[12] TaxApp 45/97 *Levav v. Assessment Officer* (1999) (unreported)

[13] CA 2082/92 *Shacham v. Assessment Officer Tel-Aviv 2* (1994) (unreported)

[14] TaxApp (Tel-Aviv) 97/85 *Peretz Ettinger Ltd v. Assessment Officer Tel Aviv 1* [1988] IsrTax 16, 227

[15] *A-75-77;* TaxApp 539/03 *Agbaria Maarof Abd el-Kadr v. Assessment Officer Hadera* (2007) (unreported).

[16] CA 280/99 *Kima v. Assessment Officer Dan Region* [2000] IsrSC 54 (5) 529.

[17] CA 30/73 *Roth v. Haifa Assessment Officer* [1973] IsrSC 27 (2) 701.

[18] LCA 8925/04 *Solel Boneh Construction and Infrastructures Ltd v. Estate of Alhamid* [2006] (not yet reported)

[19] CA 350/05 *Jerusalem Assessment Officer v. Bank Yahav* ((not yet reported)

[20] *LaborApp (Jer) 2456/03 Bahat v. State of Israel* (not yet reported)

[21] CA 1761/02 *Antiquities Authority v. Mifalei Tahanot Ltd*. (2006) (not yet reported)

[22] HCJ 2390/96 *Karsic v. State of Israel* [2001] IsrSC 55 (2) 625

Israeli Labor Court Cases Cited.

ITA (Tel-Aviv) 97/85 Peretz Ettinger Ltd v. Assessment Officer Tel Aviv 1 *[* .

Foreign Cases Cited:

[ ] *Smith v. Commissioner of Internal Revenue*, 40 B.T.A., 1038, 1939 WL83

Israeli Law cited:

Income Tax Ordinance, ss. 17, 31

Income Tax Regulations (Deduction of Car Expenses), 5755-1995

Income Tax Regulations (Deduction of Certain Expenses), 5732-1972

Capacity and Guardianship Law, 5722-1962, ss. 14,15,17

Penal Law, 5737-1977, ss. 34G, 34H, 34H(2), 34V(2), 361, 362

For the Appellant: K. Attila, Y. Verba-Zelinger

For the Respondent: Y. Shekel, L. Gilboa-Akko

JUDGMENT

Deputy President E. Rivlin

Is a person's expenditure for childcare while at work deductible as an expense incurred in the production of income,? This is the legal question before us. Apparently, the existing law offers us one, and only one, answer.

The facts

1. The respondent (the counter-appellant) is the mother of two children, and a lawyer in private practice. She and her life partner – the father of the children - are jointly raising their children. During the tax years under appeal – 1999-2001 – the respondent requested to deduct expenditures for her children's pre-school and day care from her taxable income. The respondent's daughter Maya was born in 1994, and her son Guy was born in 1997. The respondent sought to deduct pre-school payments for Guy for the years in dispute. She also sought to deduct pre-school payments for Maya up to July 2000, and payments for afternoon day-care after Maya began attending elementary school that year. The respondent did not request a tax deduction for clubs that the children participated in during the afternoon, nor for day camps during the vacation summer months when the day care center was closed. The respondent declared that had her two children not been looked after in these frameworks until the afternoon hours, she could not have continued to work as a lawyer in private practice. The appellant refused to allow the deduction of the disputed expenses, and the issue was brought before the District Court. This is an appeal against its decision.

The Israel Bar Association requested to join the appeal proceeding as amicus curiae. We see no need to grant that request, inasmuch as the Bar Association has no unique interest in the questions in dispute, despite the fact that the respondent is an lawyer by profession and occupation. Nonetheless, the written position of the Bar Association, and its oral statements were all before us when we wrote our opinion.

The District Court judgment

2. The District Court granted the respondent's appeal in part, ruling that the part of the expenses incurred for her children's care should be allowed as a deduction from income, in accordance with certain rules that it specified. The court ruled that the parental obligation to care for children is established both by law and natural imperative. The District Court stated that "evidently the parties do not dispute that placing the [respondent's] children in supervisory frameworks was a necessity, without which she would not have been able to maximize income". The District Court therefore ruled:

> 'The basic assumption is that each of the individual spouses is entitled to realize his professional ambitions, his right to realize his desire to work in his occupation and to produce income for himself and his family members. The entrustment of children requiring adult supervision, including by dint of law, enables the parents to go to work and do their work. As distinct from food and medicines, as claimed by the respondent, the children would not have been under another person's supervision for the aforementioned times and for the aforementioned number of days per year, had the spouses not been busy in the production of income... in that sense, this not an expense which "is absolutely private"…'

Nonetheless, the District Court noted that the child's presence in the various supervisory frameworks also contributes to the child's development and education. The contribution stems from the very fact of children spending time with toddlers their own age, from spending time in the presence of non-parental adult figures, and from educational and enrichment activities. This has been ruled a "benefit" that accrues to the parents from the very fact of their children being in the different supervisory frameworks. Regarding this point, the District Court accepted the respondent's claim that "were it not for the need to spend long hours at work, both she and her children would benefit from spending as much time as possible with one another, and certainly for a period of time in excess of the time required for their education, development, imparting of knowledge, etc." That benefit, according to the District Court, "would also have accrued from spending a few hours during a smaller number of days...especially for toddlers". In this context, the District Court noted that "it is undisputed that the company of children in the day-care center, and the activity there, replace entertaining friends at home, or participating in clubs, but this could be accomplished through other, more limited means than spending no insignificant number of hours every day outside the house, in the school."

The District Court therefore ruled that the total payments made for supervision should be classified in accordance with two categories of payments. The first reflects payments that should be ascribed to "enrichment"

activities, while the other should be ascribed to “supervision" costs. Only the latter should be permitted for deduction as an expense in the production of income:

> ‘First of all, supervision expenses that are not enrichment expenses are not expended by reason of personal or individual taste. The assessee is forced to make these payments in order to be able to produce his income. It is, however, clear that having been compelled to do so, he will choose supervision in accordance with his own taste, which is where the personal preferences play a role. Were it not for the need to purchase supervisory services for the children, in order to provide for personal needs, he would choose different, more limited frameworks. To be clear: the need arises initially in order to facilitate the production of income, and only after that are the personal considerations factored in, relating to the best interests of the child, the appropriate framework etc. This is not comparable with the *direct* purchase of enrichment services, such as hobby clubs, private lessons, or other enrichment programs.’

3. The District Court distinguished between expenses for "direct enrichment" and expenses for "indirect enrichment". It therefore ruled that there is no basis for permitting payments made for all categories of enrichment, however, the mechanism for identifying the costs is different. Expenses incurred for "direct enrichment" include payment for education, clubs and other clearly enriching activities. The court ruled that the central element of "direct enrichment" is the granting of lasting benefits to the child, whereas the supervisory component in this particular context is secondary to the main component - education and enrichment. If a certain payment can be identified as intended for an activity classified as "direct enrichment" - it will not be permitted as a deduction. On the other hand, "indirect enrichment", as defined by the District Court, is that enrichment from which children derive from frameworks that are primarily the supervisory. In this context, the

court ruled that expenses imputable to supervision should be separated from expenses attributable to indirect enrichment. The District Court noted that:

> 'In this computerized, documented era, in which all activities can be monitored and reconstructed, assuming the existence of economic and other models that allow it, it would seem that the aspiration for an accurate assessment requires that where an assessee can prove that a certain expense should be attributed, under s. 17 of the Ordinance, to the production of his income, and that component can be quantified as a part of the total in a manner that distinguishes it from the portion that does not serve for the production of income, that portion should be permitted for deduction.'

The District Court observed that the supervision and enrichment costs can be quantified based on the data collected by organizations that run day care centers, such as Wizo and Na'amat. The District Court also noted that the day care centers managed by these organizations "can also serve as a point of reference for the reasonability of an expense". In this context the District Court noted that the question of the reasonability of the expense as prescribed by section 30 of the Ordinance was not adjudicated in the appeal before it. The District Court further stressed that supervisory expenses not incurred for the purpose of parents going to work could not be deducted.

4. Equipped with these determinations, the District Court proceeded to classify the expenses that the responded sought to deduct. The court ruled that payment to a babysitter or a care-giver in the home was payment for supervision, and was fully deductible, subject to the principle of the reasonability of the expense. Regarding the after-school center where the respondent's daughter spent the afternoon , the District Court ruled that the expense was primarily for purposes of supervision. As such two thirds of it should be permitted for deduction (while the other third "takes into account the personal benefit, including the meal"). As for the payments to the pre-school (where the children also received lunch), the District Court ruled that one half of the sum would be regarded as an expense for indirect enrichment

and personal components such as food, and would not be permitted for deduction. The [other] half of the payments, which the District Court attributed to supervision expenses, would be deductible. The District Court further ruled that where separate payment was made for the children's meals, two thirds of the payment would be regarded as an expense for supervision.

5. The District Court rejected the appellant's claim that, at the very most, the claimed expense merely prepared the ground for generating income, but was not an expense "in the production of income", as required under s.17 of the Ordinance. The District Court distinguished childcare expenses from expenses for the purchasing of food and medicines, arguing that food and medicines are required at all events, even where a person does not generate income. The court was also of the opinion that in the case at hand one could not draw an analogy from case law that determined that travel expenses to a workplace were not a permitted deduction, and that in the case at hand, the expenses also met the test that they serve their purpose at the time the income is created. When the respondent is at work - it ruled – "she is only able to earn her income by virtue of the fact that her children are under supervision." The District Court held that childcare expenses for the children are connected to the creation of income, and are *incidental* to the creation of income, because had the children not been under supervision, the respondent would not have been able to produce income. It therefore held that the expenses were not just "a preliminary condition for her to go out to work", but rather that the expenses were required “for every hour during which she makes money". The court further ruled that if expenses intended to increase the yield of workers at the place of work were permitted for deduction, then "the supervision of the children must at least be considered as increasing output from a situation in which the parents *are unable* or limited in their capacity to produce income, to a situation where, for as long as the children are under supervision, they can operate at an increased output for the sake of producing their income."

6. Finally, the District Court dismissed the appellant's claim that the credit points given to the working mother (in conjunction with child allowances) constitute an exhaustive arrangement, and that the deduction of expenses in addition to that arrangement constitutes a double benefit. The court ruled that this claim was only raised by the appellant in summations, and that it

constituted an impermissible broadening of the scope of the dispute. On the merits, the District Court ruled that absent an explicit statutory provision, there were no grounds for denying permission to deduct an expense that fell within the ambit of s. 17. Furthermore, the District Court opined that credit points and child allowances are arrangements that serve an extra-fiscal purpose that is external to that of the Ordinance, . The court held that this result held true even when taking into consideration the fact that, over the years, various Knesset Members had made explicit proposals, which were not accepted, to recognize the deduction of child-care expenses related to their parents' work. It ruled that this legislative history does not impugn the fundamental principle whereby an expense incurred in the creation of income is a permitted deduction.

This judgment is the subject of the appeal before us

The Appellant's claims

7. The appellant brought an arsenal of claims contesting the permission to deduct supervisory expenses of children while their parents are at their place of work. The appellant's view is that "the expense will only be recognized for deduction if it is an integral part of the natural structure of the business and constitutes part of the business process itself" (hereinafter: the "incidentality test"). The appellant claims that the "if not for" test that served the District Court (in other words: if not for the payment of childcare expenses for the children, the respondent would not have been capable of producing income) is not the accepted test in case-law. The appellant claims that the appropriate test is the incidentality test, and the requirement that there be a close, tight and direct connection between the expense and the income. The appellant therefore claims that childcare expenses do not satisfy the conditions of this test, given that at the most it can be considered only a "preliminary condition" for earning income, and is not an integral part of the process of producing income. This expense does not bear the close, tight and direct connection required for purposes of deduction. The District Court's judgment, according to the appellant, blurs the boundaries between business and non-business expenses, and between revenue expenditure and capital expenditure, which likewise bear a connection to the production of income. The appellant further claims that permitting the deduction of an expense that

is neither directly nor tightly connected requires explicit grounding in a statutory provision (such as the provisions of ss. 17 (11) - 17 (13)).

Even were it to be held that childcare expenses involve a business component, the appellant claims that this does not mean that these expenses should be permitted, given that they are mixed expenses, and the business component of is not clearly discernible. The appellant refers to the District Court's rulings concerning the personal benefit to the children from merely being in the supervisory framework. Its view is that if the expense is determined as being a mixed one, then its components are inseparable because "each and every act of supervision…..benefits the child and the parent whose child is learning and developing at a time he can also work". The appellant opines that given the respondent's failure to provide a clear and accurate basis for differentiating between the private and business components, the expense should not be permitted "based on guesswork and all manner of calculations". In its view, where the components of a "mixed" expense cannot be determined precisely, an explicit provision is necessary, such as the regulations enacted by the Minister of Finance under section 31 of the Ordinance concerning the deduction of expenses for maintaining a car (see: Income Tax Regulations) (Deduction of Car Expenses), 5755-1995, telephone expenses, refreshments at the place of business location, and clothing expenses (see: Income Tax Regulations) (Deduction of Certain Expenses), 5732-1972). On the merits, the appellant claims that there is no basis for the determination that the total amount of expenses to be ascribed to indirect enrichment expenses is lower than the amount of expenses to be ascribed to supervision.

The appellant argues that the matter at hand is comparable to that of expenses for traveling to work - meaning that if it has been determined that the latter are not permitted for deduction, then *a fortiori* this must be the conclusion regarding childcare expenses.

8. The appellant claims that its position is also supported by the legislative history, which shows that childcare costs are not deductible, and that the current legislative arrangement with respect to credit points and allowances is exhaustive. The appellant noted that prior to the passage of Amendment No. 22 to the Ordinance (in 1975), the Income Tax Ordinance contained a specific arrangement by which child care expenses could be deducted up to

prescribed ceilings. The appellant stresses that this arrangement was replaced by the arrangement based on credit points and allowance points. It refers to the Explanatory Notes to Amendment No. 22 which indicate that the credit was given to working mothers as "an additional incentive for married women to go out to work". It also cites the report published by the Tax Reform Committee concerning the Recommendations for Changing Direct Tax – 5735-1975 (hereinafter: Ben Shachar Report), which states that the credits system was preferred, *inter alia* by reason of its simplicity. Based on all these, the appellant argues that, *ab initio*, the legislature viewed childcare expenses as private expenses, because from the very outset the deduction was specifically permitted by virtue of a specific section. The arrangement adopted in 1975 is thus unique and exhaustive, and replaces the deduction of childcare expenses. The appellant maintains that granting the credit and allowance points to a woman constitutes "partial recognition" of childcare expenses. It claims that there can be no deduction of an expense that already confers credit. The appellant bases this claim on judgments given in regard to National Insurance payments. The appellant argues that recognition of the expense as a deduction would constitute a double benefit, which was not the legislature's intention. The appellant also pointed out the various legislative proposals made over last decade, with respect to childcare expenses, which were ultimately rejected by the legislature. It argues that the failure of these numerous attempts to grant a tax deduction for childcare expenses also supports the conclusion that these expenses are not deductible.

9. The appellant further argues that the District Court's judgment "ignores its expected economic implications", and that "it does not achieve its aims and even impairs the efficiency of resource allocation in the economy". According to the appellant, the financial cost of the judgment amounts to three billion shekels a year, and as such substantially affects the entire state budget. The appellant repeated these claims in writing in its supplementary pleadings on 22 December 2008. The thrust of the argument that the director general of the Finance Ministry intended to bring to our attention concerning a number of economic matters, was set out in the notice that was submitted on the appellant's behalf on 7 January 2009. In that, notice the appellant claims that the current economic crisis is liable to cause a significant reduction in tax collection, and that the dimensions of the additional burden on the public coffers are still unclear. The appellant stated that covering the

budgetary costs of the judgment will probably necessitate a raise in taxes – "a step which is regressive and inevitably harms the weaker sectors". The appellant also maintains that permitting the deduction of childcare costs constitutes a deviation from the policy of "broadening the tax base, cancellation of sectorial exemptions, and lowering of tax rates – a policy intended to "create the possibility of economic growth in the economy, while constructing a simple, transparent, and fair tax system thay projects certainty while emphasizing the reduction of tax rates". The appellant raises the fear of a "slippery slope": permitting the deduction of childcare expenses may compel the deduction of additional expenses only remotely connected to production of income, such as commuting expenses, rent paid by the assessee for purposes of his work, clothing expenses, food expenses, etc.

10. The appellant believes that it is for the legislature to decide upon the manner by which women should be encouraged to go to work. It claims that the legislature, and not the court, should decide matters that have significant, broad implications. The appellant also stated that the State of Israel operates a "governmental assistance network in all matters related to child care". In the framework of the arrangements established for that purpose, it cites the credit points given to working women for each child; subsidies for day care centers; negative income tax; child allowances, and a compulsory education system. The appellant claims that permitting the deduction of childcare expenses will mainly benefit the wealthy, and economically secure sectors of the population, among which the proportion of working women is already high. This – it argues – would yield a regressive result. Recognizing childcare costs as tax deductible is inefficient in the appellant's view, because it increases the friction between the citizen and the tax authorities, and because it necessitates extensive resources. Permitting the deduction of childcare expenses will result in a significant broadening of the scope of reporting, because numerous assessees who do not currently file tax returns will begin to file them in order to obtain the tax deduction. These expenses are not recorded on the books, which makes tracking and verification difficult. The appellant believes that the deduction cannot be made through the employers, because that would require conducting an assessment. The end result will be an increase in the costs of abiding the law for assessees, and an increase in the administrative costs of the tax authorities.

The Respondents Arguments

11. The respondent maintains that chilcare costs are permitted deductions under the opening clause of s. 17 of the Ordinance. The respondent notes that under the provisions of this section, the expenses incurred in the creation of particular income can be deducted from that income. Where the legislative intention is not to permit the deduction of certain expenses –the respondent argues – they are explicitly disallowed under the Ordinance and its associated regulations. According to the respondent, childcare expenses fall within the scope of s. 17 of the Ordinance, in accordance with the accepted tests for recognizing expenses. The respondent argues that the expenses are all related to maintaining the existing situation, and bear a concrete connection to the relevant income yielding activity. As such, they relate to income and fulfill the incidentality test.

The respondent further stresses that childcare expenses are not private expenditures comparable to food and medicine. They also differ from travel expenses. They are expended exclusively by reason of going to work. They are expended in order to enable the production of income, and would not otherwise have been spent. As far as "mixed" expenses – which combine a business expense with a personal expense – are concerned, the respondent argues that the components must be distinguished so that only the appropriate part be permitted as a deduction.

12. The respondent requests that we reject the appellant's argument that the solution to the economic ramifications of going to work is to be found in the credit points granted for dependent children. She argues that this is a social benefit intended to enable the assessee to enjoy a higher disposable income when she has dependent children. Credit points are intended to preserve financial resources for the assessee's "private" expenses. According to the respondent, they are entirely unrelated to childcare expenses, which are deductible to ensure the payment of true tax on the assessee's business activity. The respondent argues that this deduction satisfies both the test of preservation of the productivity of an asset intended to produce income, and the "incidentality test" – in other words, it is an expense related to the process of producing income.

13. The respondent argues that the appellant's claims pertaining to the financial, budgetary and national economic ramifications of the lower court's

ruling cannot alter the proper interpretation of the Ordinance's provisions. It is her position that once it is determined that the Ordinance's provisions permit the deduction of childcare expenses, the appellant can no longer challenge the implementation of those provisions. The provisions can only be amended by legislation. Furthermore, the respondent claims that the forecasts regarding the grave consequences of the judgment are unfounded. The is no real fear of an increase in tax in the wake of the judgment, and even were there to be a tax increase, it would not necessarily be regressive. The respondent maintains that the appellant's claim that the judgment is not exhaustive should prompt the appellant to enact supplementary regulations. The respondent also seeks to minimize the appellant's concerns regarding the "retroactive" effect of the ruling, inasmuch as expenses that were not reported as a caregivers' wages, and for which taxes were not withheld, would not be deductible. This would be the case for various other reasons, such as a lack of appropriate documentation, or due to prescription.

We have decided to dismiss the appeal, subject to the following specification.

Deduction of childcare expenses - General

14. The dispute grounding the appeal that we decide raises a number of issues. The first is whether an expense for childcare can be defined as "an expense in the production of income". The second pertains to the question of characterizing an expense as a "mixed expense". The third concerns whether the arrangement for allowances and credit points, to which the appellant refers, is exclusive and exhaustive, such that no additional expense can be deducted. Finally, there is the question of whether the law applies prospectively or retroactively. We will examine these questions in order.

Childcare expenses – An expense incurred in the production of income

15. In the absence of a statutory provision specifically addressing the possibility of deducting childcare expenses, the question of whether such an expense is deductible must be examined in accordance with s. 17 of the Ordinance, similar to the examination of other expenses for which there is no special arrangement. The opening section of s.17 of the Ordinance states:

> 'In ascertaining the chargeable income of any person, all disbursements and expenses that person incurred during the tax year wholly and exclusively *in the production of his income* shall be deducted – unless the deduction is limited or disallowed under section 31 [emphasis added – E.R.].

As noted by the District Court, "the parties do not dispute that the placement of the (respondent's) children in a supervisory framework is a necessity in the absence of which she would not be able to maximize income". The parent's duty to provide supervision for their young children is not just an imperative of nature; it is also legally prescribed (see: Capacity and Guardianship Law, 5722-1962, ss. 14,15,17; Penal Law, 5737-1977, ss. 361,362). It is not disputed that had the respondent not gone out to work, her children would not have required particular supervisory frameworks, such as after-school day care , and that at least some of the respondent's expense would have been saved. Needless to say, herein lies the fundamental and substantive, albeit not the only, difference between supervisory expenses for children and expenses for food and medicine. Whereas the latter are expended irrespective of whether a person works, the former are not required where a person does not work, and tends to his children himself (see A. Likhovsky, "Gender Categories and Status in the Laws of Income Tax", *24 Tel-Aviv U. Law Review* 205 (2000)).

16. The appellant is of the opinion that it is not sufficient that an expense serve to produce income in order to permit its deduction, but that it must also be incidental to the production of income, in other words - involved in it. The test of incidentality was defined by Justice A. Witkon in CA 284/66 *Kopilovitz v. Assessment Officer for Large Factories, Tel –Aviv*, [1], at p. 718, in the following manner:

> 'The test of "incidentality" means viewing the source of income – in this case the employer-employee connection – in an organic sense, and asking whether the said

> expense arises from the natural course and structure of the source. To be deductible, it can be regular or irregular, but it cannot be an expense that is external to the nature and framework of the income. The difficulty of applying this test was already noted in the well-known *Strong v. Woodifield* case: "Many cases might be put near the line, and no degree of ingenuity can frame a formula so precise and comprehensive as to solve at sight all the cases that may arise".'

This test was adopted into Israeli Law from English Law, where it served as an old, well-established rule. This Court has implement the rule even where it lead to problematic results. For example, we may cite the dispute that emerged in CA 190/61 *Borek v. Assessment Officer* [2], at p. 1801. That case discussed whether to permit the deduction of travel and food expenses of the appellant, who was the employee of two separate employers, and was required to travel by shared taxi from one place of work to the other. The Supreme Court affirmed the ruling of the District Court, which rejected the assessee's claims:

> 'The aforesaid is legally well-founded, and *correctly reflects the long-established rule*, even though criticism has been leveled at the narrowness of the test, from time to time. See the incisive comments of the Royal Commission on the taxation of profits and income (1955) Cmd. 9474, secs. 238-241), but this is the law….it is true that such a person too is "forced" to incur travel or food expenses "in the production" of his income that stems from his second source of income. This, however, is not the decisive test set forth in s. 11 (1) of the Income Tax Ordinance, 1947. We must ask ourselves whether the assessee incurred the expense "in the production" of his income, and that question can only be answered in the negative…

> As such, and not without misgivings, we must reject the appeal' [emphasis added - E.R].

In our case, as mentioned, the District Court viewed childcare expenses as satisfying the conditions of the incidentality text. The court ruled that childcare costs are incidental to the production of the income, because had the children not been under supervision, the respondent would not have been able to produce income at all. As such, it ruled that the expenses are not just "an initial condition" for going to work, but are also required "hour-by-hour in the course of producing income". The District Court added that just as expenses intended to increase the productivity of workers at their workplace are deductible, "so too, supervision of children at least raises productivity from a situation in which parents *are unable* to produce income, or in which their capacity to do so is limited, to a situation in which, for as long as the children are supervised, they can operate with increased productivity in the production of income" and the expense should therefore be a permitted deduction.

The "Incidentiality" test

17. My view is that even were we to accept the appellant's claim that the expense under discussion does not fulfill the conditions of the *traditional* incidentality text, and that it does not "arise from the natural course and structure" of the income producing source, it would not necessarily disallow the expense as a deduction. The character and the status of the incidentialy text must be examined in light of current rules of interpretation, and in keeping with the purpose of s. 17 of the Ordinance. The test is, indeed, based opon a century-old rule, but its vintage does not *per se* justify a deviation from the currently accepted rules of interpretation (see: CA 165/82 *Kibbutz Hatzor v. Assessment Officer Rehovot* [3], at p. 70). The interpretative question concerns the proper construction of the term "*expenses …in the production of income*". These words do admit of a number of interpretative possibilities. "Production of income" is a process that is not always clearly delineated. For example, one could argue that only expenses that are located directly on "the production line" of the income – if the productive unit is compared to a factory – would be defined as "expenses … in the production

of income". This is a narrow interpretation of the term "production of income". On the other hand, the production process could be viewed as including not only the "production line", but also additional components necessary for production purposes, and which serve the need of producing income.

The purpose, which guides the interpretative task, is the purpose of the provisions of s. 17 itself, i.e., the obligation to pay true tax (see: CA 1527/97 *Interbuilding Construction Company v. Assessment Officer T.A-1* [4] at p. 699). In other words, the taxation of the assessee's *real income*, which is the income after deduction of the expenses incurred in order to produce it (and *cf*: : CA 4271/00 *M.L. Investments and Development v. Director of Land Appreciation Tax* [5], at p. 959. Charging tax for an amount that does not reflect a person's real income cannot be defined as "income tax". If an assessee is not permitted to deduct an expense incurred in the production of his income, it is tantamount to "over taxation", because the income taken into account for purposes of determining his tax liabililty is higher than his real income (see: Yoram Margaliot, "Fictitious Regressiveness in Family Taxation," 2 *Maazaney Mishpat* 358 (2002)). The legislature is entitled to deviate from this fundamental principle, and determine that a particular expense, incurred in the production of income, is not deductible, but in view of the aforementioned purpose, this must be done explicitly. The aforementioned purpose indicates that nothing compels the conclusion that only an expense "which arises from the natural course and structure of the source" will be a recognized expense, if there are other expenses that are incurred exclusively in the production of income. By the same token, deduction of an expense is not permitted when the deduction would create a situation in which the assessee's income for tax purposes would be less than his real income. For example, consumer expenses of the assessee (which may, occasionally, bear some connection to the production of income), as well as expenses which are only indirectly and remotely connected to the production of income. Taxation of the true income is the purpose, and the incidentiality test is meant only to serve that purpose.

For our purposes, we can seek some guidance from accounting practices, which provide that "recognized expenses in a profit and loss report – where there is a reduction in future economic benefits related to a reduction in the

asset or an increased undertaking *which admits of reliable measurement"*; and also: "recognized expenses in the profit and loss report based on the *direct connection* between the costs incurred by the entity and the production of particular items of income (see ss. 94 and 95 of the "Conceptual Framework for Preparing and Presenting Financial Reports" of the Israeli Accounting Standards Board (2005), [emphases added - E.R.]. These rules mandate a direct connection between the expense and the production of items of income. They also require reliable measurement of the expense. They do not require that the expense "arise from the natural course and structure" of the income producing source.

18. All of this leads to the conclusion that there must be a *real, direct* connection between the expense and the production of income as a condition for allowing the deduction of the expense. The borders of the production process lie beyond the "production line", and their precise delineation is in accordance with the concrete circumstances and the aforementioned purpose. The emphasis is not on the location where the expense is incurred – in the "factory" or external to it. This distinction loses its importance in an era in which the boundaries between the "factory" and the "house" have become blurred. As indicated by s. 17 of the Ordinance, the requirement is that the expense be incurred *exclusively in order to produce income.* An expense that a person would have made even had he not produced the income will not, so it would seem, be permitted (see examples above regarding medicines and food). In other words, the incidentality test should be (only) an auxiliary test for the identification of revenue expenditures in the production of income. Other expenses, too, proved by the assessee as bearing a real and direct connection to the production of income, and which were expended exclusively for the production of income, may be permitted for deduction.

Intermediary Cases and the Accepted Test

19. As stated in *Kopilovitz v. Assessment Officer* [1]: "Many cases might be put near the line, and no degree of ingenuity can frame a formula so precise and comprehensive as to solve at sight all the cases that may arise". Indeed, certain expenses are categorically incurred in "the production of income" and expenses that are not categorically "the production of income"; there is also a variety of intermediary cases. There can be no doubt that in

terms of certainty of the law, the legislature would do well by clarifying the law in these latter cases. In the absence of clarification by the legislature, the court is required to decide, and this indeed has occurred more than once in the past. The rulings in those cases indicate that the *ab initio* the test of incidentality deviated from its original borders. A few examples will demonstrate this.

In terms of the prevailing law, a number of expenses are permitted as deductions even though they are not really incidental to the production of income. An example of this is the permitted deduction of study expenses, which are considered as "preserving what already exists". Thus in CA 141/54 *Wolf –Bloch v. Jerusalem District Assessment Officer* [6], Justices A. Witkon and Y. Sussman ruled, in opposition to the dissenting opinion of Deputy President S.Z. Cheshin, that the overseas travel expenses of the appellant – a dentist by profession – to a professional training seminar should be permitted. The reason was that these expenses could be defined as "preserving what already exists" in the sense of maintaining the doctor's professional level. Justice Witkon noted that:

> 'I have already commented that if the expenditure was made in relation to a capital asset, but not for the purpose of its production or improvement, but rather in order to maintain it – *within the framework of activities that are organically a part of the income* – then there are grounds for permitting the deduction of that kind of expense. In my view, the question is ultimately whether the purpose of the expense was to create a new product, or to improve an existing product, or whether its purpose was to maintain the asset in its current condition' [emphasis added – E.R.].

It could have been argued that maintaining one's professional level constitutes a condition for the continued production of income in the future, but cannot properly be viewed as an "organic" part of the income producing process. One could claim that for a dentist, the process of producing income for purposes of the incidentality test is providing medical treatment to patients, and that when a doctor engages in further studies she is not treating her patients and is not

performing any action that produces income as a direct result. The Supreme Court, *per* Justice Witkon, took a different view, finding, as stated, that professional studies abroad may be conducted "*within the framework of activities that are organically a part of the income*". This is as it should be, despite the doubt regarding whether this expense satisfies the case-law test of incidentality. There is, however, no doubt that that an expense for studies abroad intended for the purposes of maintaining one's professional level constitutes an expense in the production of income, in view of the purpose of s. 17. The expense bears a real, direct connection to the production of income, inasmuch as failure to maintain one's professional level will prevent the production of income in the future (even if not immediately); the expense is expended for the sole purpose of producing income for the person studying; it is neither a capital nor an appreciation expense (in accordance with the tests established by case law, see *Wolf –Bloch v. Jerusalem District Assessment Officer* [6] *ibid*.). The conclusion is, therefore, that in view of the goal of paying true tax, and taxation of the assessee's real income, this expense should be permitted for deduction. The Supreme Court arrived at the correct and appropriate result in accordance with the purpose of s. 17, even in a case in which it was questionable whether the expense satisfied the requirements of the incidentality test.

20. To complete the picture, it bears mention that there were cases in which it was held that even an expense incurred in order to "preserve what already exists" must satisfy the test of incidentality in order to be permitted for deduction (see: CA 358/82 *Alco Ltd v. Assessment Officer for Large Factories* [7]). The learned Amnon Raphael criticized this ruling (Income Tax, vol.1 – 291-292 (3rd ed. 1995)), writing:

> 'A revenue expenditure is generally, but not always, incidental to the process of producing income… It seems to us that it the test established under s. 17 of the Ordinance includes both revenue producing expenses and revenue expenses that are not incidental, such as expenses recognized by reason of preserving what already exists. In our view, there is no necessity that these expenses be incidental to the production of income, and their

> deduction will nonetheless be permitted […] Our opinion is, as stated, that the "incidentality test" is just one of the tests for purposes of examining whether an expenses is for the production of income or not, but not the only one.
>
> Finally, we should remember that there is no single, conclusive test in accordance with which the nature of each and every expense can be examined'

I concur with this view. I too believe, as mentioned, that the incidentality test is an auxiliary test which is not exclusive, and that particular expenses may be permitted for deduction even if not satisfying that condition, provided that they satisfy the requirements set forth above.

Naturally, this interpretative conclusion does not alter the case-law rules pertaining to the non-deductibility of capital expenditures, or those that touch upon the questions of the actual classification of expenditures as revenue or capital . The prohibition on the deduction of capital expenditures and appreciation expenditures was explicitly prescribed in the Ordinance (see the provisions of ss. 32 (3) and 32 (4) of the Ordinance). The incidentality test may serve, *inter alia*, in drawing a distinction between capital and revenue expenditures (see: Raphael, *ibid* at p. 291; A, Witkon and Y. Neeman, Tax Law, 4th ed., p. 151 (1969); CA 735/86 *Zvi Ben Shachar Seeds Ltd v. Assessment Officer Tel-Aviv* 3 [8]). However, these questions do not arise in the case before us, and we will not address them.

From the Principle to the Question in Dispute

21. We now turn to the implementation of the above in the case before us. The District Court's view was that childcare expenses satisfy the incidentality test given that they are necessary "hour by hour in the course of producing income". The court compared these expenses to expenses to improve worker productivity, concluding that if the latter were deductible, then it was appropriate that the same rule apply to the former, the absence of which precluded production altogether. It is conceded that the application of the incidentality test in this case is somewhat contrived. It is doubtful whether the expense for childcare "arise from the natural course and structure" of the

income producing source. However, this does not determine the fate of the expense. The childcare expense bears a real, direct connection to the production of income. It is expended to enable the parent to produce income. Placing the children under supervision is a necessity, the absence of which renders the parent unable to produce income, – due to the parents' natural responsibility for their children, which is also a duty imposed on them by law. To the extent that one can quantify childcare expenses, there are grounds for holding that this is an expense exclusively for the purpose of producing income. This being so, even were we to accept the appellant's claim that childcare expenses do not satisfy the incidentality test, in its narrow construction, it would not prevent our permitting the expense as a deduction as an expense "in the production of income". At the same time, and by force of the same rules, in a family unit consisting of two parents, the expense childcare would not be permitted if one of the parents were not working (and would, therefore, be capable of supervising his children), for it would not be an expense incurred "in the production of income".

Childcare costs as a mixed expense

22. In addition to the requirement that the expense be incurred in the production of income, there is also a requirement, as stated, that it be "for that purpose only". This requirement adopts the requirement of English Law that the expense must be expended "Wholly and exclusively in the production of income" (Raphael, *ibid*, p. 287). Prima facie, it could have been argued that a "mixed" expense, containing a component of revenue (expense in the production of income) and a non-revenue element, would not satisfy that requirement and would not be allowed as a deduction (see Yair Newdorf, "Mixed Expense", 22 (3) *Taxes* A-68, A-70 (2008) (Hebrew)). This however is not the case. In this context, accounting principles do not have a parallel requirement regarding the "exclusivity" of the expense. Where a certain expense comprises a component that satisfies the requirement and a component that does not, that part of the expense which satisfies the condition specified in the definition may be allowed as an expense. The deduction of that part is even an obligation in accordance with accounting principles, because the non-deduction of expenses (when they can be quantified reliably) distorts the financial results of the reporting body.

An examination of the circulars issued by the income tax authorities shows that the they, too, are of the opinion that the requirement of "exclusivity" should not be given too literal an interpretation, and that in various situations in which the expenses are mixed, an effort should be made to distinguish between the revenue component and the non-revenue component, and to permit the former for deduction (see: I.T. Circulars 17/89, 35/93, 37/93). For example, Income Tax and Appreciation Tax Circular 35/93 determined that: "it is possible that in respect of a particular asset, expenses are mixed, in the sense that some of them are intended to repair that which exists, while the other part is intended to improve the asset. In such a case, an attempt should be made to distinguish between the two components of the expenditure, so that only the first component is permitted for deduction under s. 17 (3) of the Ordinance". In Circular 17/89, rules were established for permitting the deduction of trips abroad, including the relative manner of permitting the deduction of a mixed expense of which the income production component which was the main component. Another example is the Directive to the Administration of the Tax Authority under which one third of the expense incurred in purchasing a newspaper would be permitted as a deduction, for a person whose profession or position required use of the economic information appearing in the newspaper (Newdorf, *ibid*, p. A-71).

23. The approach, which permits the assessee to extract from a mixed expense the income producing component from a mixed expense, and allows its deduction, was adopted by this Court in CA 580/65 *E. Ben-Ezer and Sons Ltd. v. Assessment Officer for Large Factories* [9]. Justice Mani ruled that travel expenses incurred for going overseas were not permitted if they included the travel expenses of the managers' family members, whose trip was not for the purpose of producing income. Justice Silberg concurred with this result, "Since those expenses also included the expenses of the wife, the husband's report did not distinguish between his expenses and those of his wife". Justice Kister concurred with this result, and did not see any need to "express an opinion on whether and to what extent it was possible to distinguish between the overall travel expenses of a number of people". In view of this reasoning, it has been claimed that this judgment too, which prohibited the deduction of a mixed expense, created an opening for the recognition of part of a mixed expense (Newdorf, *ibid*). In CA 35/67 *Shtadlan v. Tel-Aviv Assessement Officer 4* [10], Justice Mani ruled that

attorneys fees paid by an appellant to his lawyer constituted a mixed expense – both revenue and capital. All the same, this result did not lead to the dismissal of the appeal, but rather to the file being returned "to the assessment officer to determine, having given the appellant the opportunity of stating his claims and producing evidence, which part of the fees should be attributed to revenue expenditure".

Over the years, this rule has been implemented in numerous decisions. In Tax App. (T.A) 22/67 *Eliyahu v. Tel-Aviv Assessment Officer 1* [11] the District Court (*per* Judge S. Asher) accepted the recommendation of the Assessment Officer to permit 50% of the assessee's car maintenance costs as an expenditure for the production of income. In Tax App. 45/97 *Levav v. Assessment Officer* [12], the District Court (*per* Judge B. Ophir-Tom) ruled: "Although, as explained, the expense is a mixed one…. having found a reasonable way of dividing it and neutralizing the component permitted for deduction, it would be appropriate for the respondent to adopt an approach that would enable the deduction of the portion meriting deduction, as dictated by economic and tax logic". In that case, the court applied a particular method of attribution in order to distinguish between the revenue and personal components of the expense.

This approach also found support in academic writing from four decades ago. In their book (*ibid.*, at p. 137), A. Witkon and Y. Neeman note that:

> '[I]n fact, where the expenditure admits of division, such as an expense for maintenance of a car that serves both business and private purposes, it is permitted to deduct the portion appropriate to business use'

In his aforementioned article (*ibid,* p. A-72), Newdorf analyzes the significance of that example – the distinguishing of the car–maintenance expenses – noting: "Conceivably, Justice Witkon was hinting that even in mixed expenses in which the separation of the revenue component from the others is not simple, a method must be found to recognize the revenue aspect, for otherwise it is unclear why Witkon chose an example in which the separation is particularly difficult if not impossible".

24. This interpretation, which has been adopted by the courts over the years, is linguistically possible, and is consistent with the purpose of s. 17. The purpose, as stated, is to tax the true income of the assessee - accurate taxation. The question is what constitutes an "expense" that must be examined through the lens of s. 17. Where it is possible to quantify the amount spent in the production of revenue, that portion may be regarded as an "expense" to be evaluated under s. 17. The portion expended in the production of income – the "expense" – was made "for that purpose only". This portion satisfies the requirement of exclusivity, and should therefore be a permitted deduction. This is a linguistic possibility within the semantic field of sec. 17. It does not inappropriately stretch the borders of the language. This is shown by the fact that this interpretation has been applied in practice for decades, even during the period when literal interpretation reigned supreme. As mentioned, it is also the desirable interpretation in terms of the purpose of s. 17. Failure to permit the deduction of an expenditure made for the production of income leads to the assessee being taxed in excess of his real income, which is an unsuitable consequence in terms of the purpose of income taxation in general, and the provisions of s. 17, in particular.

Identifying the permitted deductible expense in a mixed expense

25. The assessee bears burden of proof for identifying the portion of a mixed expense that constitutes an expense in the production of income. Should he fail to discharge that onus, the expense will not be permitted as a deduction. (Raphael, *ibid*, p. 288; CA 2082/92 *Shacham v. Assessment Officer Tel-Aviv 2* [13]; TaxApp (Tel-Aviv) 97/85 *Peretz Ettinger Ltd v. Assessment Officer Tel Aviv 1* [14]). The burden of proof is that generally applied in civil law, and its elements are determined in accordance with the matter at hand and the concrete circumstances (see, for example, how this burden was met in *Levav v. Assessment Officer* [12].

The legislature and the delegated authority adopted various arrangements allowing the partial deduction of mixed expenses. Section 31 of the Ordinance states:

> The Minister of Finance may, with approval by the Knesset Finance Committee, make regulations – whether in general or for particular categories of assessees – *on the limitation or disallowance of the deduction of certain expenses under sections 17 to 27*, and in particular on –
>
> (1) the method of calculating or estimating expenses;
>
> (2) the amounts or rates of deductible expenses;
>
> (3) the conditions for allowing expenses;
>
> (4) the manner of proving expenses.
>
> [emphasis added - E.R.]

Section 243 of provides:

> The Minister of Finance may make regulations for the implementation of the provisions of this Ordinance, especially including regulations on –
>
> …(3) any matter on which the Ordinance authorizes him to prescribe.

By force of these provisions, the Minister of Finance enacted various regulations, including Income Tax Regulations (Deduction of Certain Expenses), 5732-1972, and Income Tax Regulations (Deduction of Vehicle Expenses), 5755-1995. These regulations quantify the deductible component to be allowed as an income producing expense in various mixed expenses, such as expenses for vehicle maintenance (which may serve both for the production of income and for personal use), different expenses attendant to trips abroad, bed and breakfast expenses, telephone expenses, etc. A certain difficulty may be posed by the fact that, in these regulations, "expense" is defined as "an expense permitted for deduction in accordance with ss 17- 27 and s. 30 of the Ordinance…" in accordance with the wording of s. 31 which confers the Minister of Finance with the authority to enact regulations

regarding "the limitation or disallowance of the deduction of certain expenses under sections 17 to 27". If indeed the legislature's view was that mixed expenses could never be permitted for deduction under s. 17, and inasmuch as the expenses under the Regulations must be deductible under s. 17, how is it that the Regulations permit mixed expenses? (see: Newdorf, in his aforementioned article, at pp. A-75-77; TaxApp. 539/03 *Agbaria Maarof Abd el-Kadr v. Assessment Officer Hadera* [15]. Even if there is come clumsy drafting in this collection of provisions, they shed light on the legislature's position on this matter: Where a mixed expense may be separated into its components, the part constituting an expense in the production of income will be permitted for deduction. The portion permitted for deduction was stipulated in the Regulations at a particular rate or a fixed, determined sum, which serves the interests of certainty, simplicity, and saves administrative and costs (CA 280/99 *Kima v. Assessment Officer Dan Region* [16], at p. 530). The advantages of clear, explicit determinations in the regulations are obvious, but where such determinations in secondary legislature are absent, the Court will address the matter, as we will now do.

26. The District Court held that expenses for "direct enrichment" are not permitted as deductions. The District Court defined "direct enrichment" as including "studies, compulsory studies, various clubs, and classical enrichment activities, etc". As noted by the District Court, the primary, central component of these frameworks is the education and enrichment of the children. In tax jargon, this means the granting of an "enduring advantage" to the children. As such, the expenses are of a private character, and are not allowed for deduction. Indeed, as the District Court held, even if the child is supervised while being in an enrichment framework, the supervision component is secondary to the principal component – personal enrichment – and expenses occasioned thereby will not be permitted for deduction. In that regard, the lower court was strict with the assessee, but that issue is not in dispute between the parties.

The District Court further held that the payment to a babysitter or a caregiver, at home, is given as salary for supervision, and the entire expense should be permitted for deduction, subject to the principle of the reasonability of the expense. This result is appropriate and raises no grounds for intervention. The entire expense incurred for paying a babysitter or a

care-giver while the parents are at work constitutes an "expense in the production of income" that is spent "exclusively for that purpose". Even though the children may gain lasting advantage from being supervised by a care-giver or baby sitter, this advantage is marginal and limited to the extent of not meriting any weight (all, naturally, subject to the proviso that that the caregiver does not carry out additional tasks or roles that go beyond tending the children)..

27. The question becomes more complex when it relates to supervisory frameworks that carry added value for the children, such as staying in kindergartens, after-school programs, and the like. The expense incurred by the parent in paying for the children to stay in these frameworks, is, in general terms, a mixed expense, which includes both income producing and the private expenditure. (See Margoliot, in his article, *ibid,* at p. 354). On the other hand, under no circumstances can we accept the appellant's claim that the expense is a mixed one that is indivisible. The child staying in a supervisory framework simultaneously benefits both from "indirect enrichment" and from supervision, but this is not the question. The question is whether it is possible to extract the supervision *expense* from out of the total expense. The answer to that question cannot be sweepingly negative. For the sake of simplicity, let us assume that a business venture is established in which two, separately owned companies operate. The first provides care and supervision for the children and nothing else. The other provides the children with a variety of enrichment activities, while they are under the supervision of the first company. It provides them with games, crayons for drawing, and one of the company's workers tells the children stories and plays with them. Let us assume that the parents pay each company separately for its services. In that situation, it cannot be said that the payment for supervision is unquantifiable. A similar quantification can be conducted even when the various services are all supplied to the children by the same entity. This kind of quantification is not substantively different from the methods adopted in various judgments, some of which were cited above. Such quantification may, indeed, comprise some element of arbitrariness, whether it is the result of legislation or of a judgment. Either way, if the assessee proved, to the required degree, the relative part that should be regarded as an income producing expense, that part should be allowed as a deduction.

It seems that the District Court rightly ruled that in this case it was proven that the expense was primarily for supervision, subject to the principle of the reasonability of the expense (under section 32 of the Ordinance). As noted by the District Court, expenses for a supervisory framework are made first and foremost to enable the parent to produce income. Once a parent knows that he must incur that expense, he will choose the framework according to his personal taste and preferences. In the hearing before the District Court, the question of the reasonability of the expense did not arise, and we accept the principled approach of the District Court that the various public supervision frameworks may serve as a standard for the reasonability of the expenses, at least with respect to frameworks intended for relatively older children.

Having held that expenses for the supervision of children fall within the definition of expenses for the production of income, and that, in principle, they admit of quantification and are therefore permitted as a deduction, the path is open for the legislature, the delegated authority and the Tax authorities, should they so choose, to take actions intended to clarify the rules for extracting the expense permitted as a deduction. The legislature and the delegated authority, and perhaps even the Tax authorities, will also be able to address the question of which partner should be granted the deduction. Until then, it would seem appropriate for the tax authorities to grant the deduction at equal rates against the income of each spouse. A provision of this kind not only prevents unjustified fiscal manipulations; it also dovetails precisely with the principles of fairness and equality, which we have stressed in this judgment.

The credit arrangement for working mothers – Is it comprehensive?

28. The appellant argues that the arrangement established under the Ordinance for credit and allowance points is exclusive and exhaustive, replacing the legislative arrangement that preceded it which permitted the deduction of supervision expenses for children, and was repealed. This being the case, the appellant argues that deduction of supervision expenses for children cannot be allowed in addition to the credit, in as much as "where an expense confers a credit, it cannot be deducted under section 17 of the

Ordinance (see: CA 30/73 *Roth v. Haifa Assessment Officer* [17]. This claim is unfounded.

This is the wording of section 40 before it was amended in 1975:

> (a) (1) In the calculation of the chargeable income of an individual resident of Israel, who proved to the satisfaction of the assessment clerk that during the tax year there were living children who he supported and who were not yet 20 years old, he will be permitted a deduction of 250 Lirot for the first child, 300 Lirot for the second child, 325 Lirot for the third child and 375 Lirot for each additional child.
>
> (2) An individual entitled to a deduction under paragraph (1) but who is not entitled to a deduction under section 37, will be permitted an additional deduction for the sum of 700 Lirot; this paragraph shall not apply to an individual who would have been entitled to a deduction under section 37 were it not for the provisions of section 66 (a)(2);
>
> (3) Parents living apart and for whom the child support is divided between them, shall divide the deductions under paragraphs (1) and (2) in accordance with the support expenses made by each one of the parents; where the parents were unable to agree upon the relationship of support expenses, it shall be determined by the assessment clerk

The appellant seeks to infer from this arrangement that the legislature regarded childcare expenses as non-deductible, and that an explicit provisions is required in order to permit them for deduction. An examination of this arrangement indicates that this is not the case. Prior to its amendment in 1975, s. 40 permitted the deduction of expenses for "*children's maintenance*". Today, as in the past, it is not disputed that a person's basic support, expenses for a person's sustenance, are not deductible. This is entirely unrelated to the matter under discussion. More precisely, our concern is not with *maintenance of children in general*, but rather with a specific, far more restricted issue – expenses for *supervision* of

children, - expenses made for purposes of the production of the parents' income. The cancellation of the specific arrangement that existed in the past, and which permitted the deduction of specific *private* expenses, carries no implications for permitting the deduction of expenses that were determined to be deductible under s. 17 of the Ordinance. It bears note that even the deduction under s. 40, before its amendment, was also granted for cases in which the children were not in any supervisory framework. This being so, the cancellation of that arrangement is of no relevance for the matter before us.

29. An analysis of the existing arrangement for credit and pension points yields a similar conclusion. The provision of section 40, in its current wording, reads as follows:

> '(a) An individual Israel resident is entitled to pension points for each of his children, as prescribed in section 109 of the National Insurance Law [Consolidated Version], 5728-1968; the pension points shall be paid by the National Insurance Institute under the National Insurance Law.
>
> (b) (1) If an Israel resident individual, who is the parent of a single parent family, has children who during the tax year had not yet reached age 19 and were maintained by him, but is not entitled to credit points under section 37, then, in calculating his tax, in addition to the pension points under subsection (a) in respect of the children who live with him, 1/2 credit point shall be taken into account in respect of each child in the year of its birth and in the year of its maturity, and one credit point in respect of each child beginning with the tax year after the year of its birth until the tax year before the year of its maturity; and in respect of his being the parent of a single parent family – one additional credit point only;
>
> (2) If parents live separately and the maintenance of their children is shared by them, then the parent who is not entitled to

> a credit point under paragraph (1) shall receive one credit point or part thereof, according to his share in the maintenance.
>
> (3) For purposes of this subsection:
>
> "**year of birth**" – the tax year in which the child was born;
>
> "**year of maturity**" – the tax year in which the child reached the age of eighteen.

The provision of section 66 (c)(3) states:

> The following provisions shall apply to the separate tax calculation:
>
> …. (3) only the registered spouse shall be entitled to pension points under section 40(a); the woman shall be entitled to half a credit point under section 36A, and – further against the tax due on her income from personal exertion – to credit points for her children as follows:
>
> (a) half a credit point for each of her children in the year of its birth and in the year of its maturity;
>
> (b) one credit point for each of her children beginning with the tax year after the year of its birth until the tax year before the
>
> year of its maturity;
>
> For this purpose: "**year of birth**" and "**year of maturity**" – as defined in section 40(b)(3).

It is not disputed that granting credit points constitutes an incentive for both spouses to go to work outside the household (see Margliot, in aforementioned article, at p. 336). But this is irrelevant to the case in point. The question requiring an answer for our purposes is whether the credit points arrangement is exhaustive in the sense that it bars any possibility of an assessee deducting childcare expenses. This question must be answered in

the negative. *First,* in order for an expense to be disqualified for deduction by reason of the granting of a credit, the credit must be given *for that specific expense*. Credit points are given from the year of birth until the child reaches the age of 18, i.e., even for ages at which the child does not require supervision in order for the parent to go to work. The credit points under s. 40 are also given when only one of the parents goes to work. *Second,* the legislature did not explicitly determine that granting credit points was intended to replace the deduction of childcare expenses. *Third,* an analysis of the purpose of the credit points arrangement does not lead to the conclusion that the appellant seeks to draw. Many hold the view that in imposing income tax, consideration should be given for child-raising costs that do not fall within the definition of expenses in the production of income. This point was made by Margaliot (see article, *ibid,* at pp 353-354):

> There is extensive literature treating of the need to have consideration for the general expenditure for raising children when calculating the tax burden, since it is accepted that children are not a consumer product but a part of the tax payint unit (the assessee). This means that there is a need to calculate the income of the family liable for tax having consideration for the number of children. An assesee with children should pay less tax than another assessee with the same income, but who has no children. The reason is that income tax is imposed in accordance with ability to pay and the ability of an assessee without children is greater, because he does not bear the expenses of raising children…and they should therefore be taken into consideration when determining the tax chargeable income of the assessee-parent.

The purpose revealed by the aforementioned arrangement regarding the credit points - which bears no direct relation to childcare expenses - may definitely be consistent with the imposition of income tax according to the

ability to pay, having consideration for the number of children. There is no basis for the claim that the central goal of the credit points arrangement is to replace the permitted deduction of childcare expenses incurred in the production of the parent's income.

30. The appellant maintains that support for its construction can be found in the very fact of the non-adoption of various bills proposing the explicit recognition of childcare expenses. But that does not lead to the conclusion that the appellant seeks to draw. The question requiring this Court's decision concerns the interpretation of the existing statute law. Having concluded that a particular expense should be recognized for deduction according to our interpretation of s. 17 of the Ordinance, the existence of incomplete legislative proceedings does not change that conclusion. Obviously, if the legislature chooses to allow and expense that is currently not allowed, or to disallow a currently permitted expense, it has the ability and authority to do so by explicit legislation.

"Regressivity", equality and other issues

31. The appellant claims that the main beneficiaries of permitting the deduction of childcare expenses will be the upper, well- established social echelons, among which the rate of working women is high, in any case. In its view, this result is regressive. Making this claim requires precision. Allowing the deduction of an expense in the production of income is neither a benefit nor a sectoral subsidy. Permitting the deduction of an expense in production of income derives from the goal of income tax, which is to tax a person's real income. The fundamental principle deriving from that goal - that an expense incurred in production should be permitted - is implemented in the same manner for the rich and the poor. Regarding the alleged regressivity, there are numerous factors that may result in a tax being progressive or regressive. Hence, should it be determined that certain assessees from among a group of high-income assesses, cannot deduct part of their expenses, it would have a progressive effect. On the other hand, establishing a rule that would prevent some of the high-income assesses from deducting an expense incurred in the

production of income would be inappropriate, for it would violate the equality in the distribution of the tax burden among the group of high-income assesses. This is so because the tax burden would not be determined exclusively in accordance with the assessees' income, but rather as a factor of the manner in which they produced it (see Margaliot, in his article, p. 361). By the same token, were we to assume that the majority of those benefitting from the deduction of financing and administrating expenses are the holders of capital in the top percentile, would avoiding the deduction of such costs in that situation be an appropriate progressive step, or perhaps a discriminatory, inefficient distortion of the tax system? Alternatively, if two assessees - one with children and the other without - earn the same gross salary, and one of them is forced to pay childcare costs in the production of his salary, then obligating them to pay an identical tax, without permitting the deduction of the income-producing expense, would distort the tax system, and create wrongful inequality between the assesees. In fact, this is the question of equality relevant for our purposes – *equality in the application of the tax law, and equality in the imposition of tax on real income*, and permitting the deduction of an expense that serves in the production of income. The equal imposition of tax laws removes various distortions in decisions, which stem from over taxation. The practical result of the removal of these distortions is likely to induce women who do not to work because of the tax distortions, to go out to work. Such a result is also likely to be efficient in economic terms, because by their work these woman increase the economic product (and the state's income from taxes, even if only in the long term). Encouraging woman with children to enter the workforce need not come at the expense of other woman who enjoy a high income. If the legislature wishes to grant a subsidy or a benefit to woman who are unable to earn large salaries, the economic cost of that subsidy could be financed by a tax imposed equally to all of the high-income assessees. At all events, there is no justification for creating distortions and inequality in the high-income sector by determining that only assessees with children will bear the funding burden (by not permitting the deduction of expenses from their income).

32. The consideration of encouraging women to enter the work force is neither a guiding, nor even a secondary consideration in our conclusion. As

explained, our conclusion derives from the basic principles of tax law, and from the goal of taxing the real income of the assessee. The social goal goes beyond these principles. Recognition of the contribution of women to the labor market crosses the boundaries of income levels, and is not limited to the tax or financial advantages that they gain by reason of the balance of income over expenditure. Failure to recognize childcare expenses is a valueless - and in this case illegal - relic of the archaic division of roles between the spouses, in which the nature of things was that the female was entrusted with care giving and supervision. According to that conception, releasing the wife from that duty by hiring a care giver was regarded as a private expense that was deemed a luxury. Accordingly, in a judgment handed down in the United States one generation ago (but never overturned), the tax court maintained that child care expenses, like other aspects of family life and maintaining the household, should not be treated differently from any other private expense. It clarified its position as follows:

> 'The wife's services as custodian of the home and protector of its children are ordinarily rendered without monetary compensation. There results no taxable income from the performance of this service and the correlative expenditure is personal… Here the wife has chosen to employ others to discharge her domestic function and the services she perform are rendered outside the home' (*Smith v. Commissioner of Internal Revenue* [ ]).

The "private" duty imposed on the wife confers a private status upon the care-giving expenses.זו גם This, even if we ignore the feminization of the work. This archaic conception also leads to the question of whether it is economically "worthwhile" for the woman to go out to work, and to the proposed distinction between woman of high economic status and others. This distinction is not relevant to the question of the social recognition of childcare expenses, because such recognition is a result of the equality of the spouses with respect to the right and the duty to work. A hint of this archaic conception can also be found in our midst by the fact that credit points were only granted to the woman. The deduction, on the other hand, according to

our interpretation is bi-sexual. Abandoning the archaic conception, in our case, is consistent with the basic principles of tax law, and with the purpose of taxing the real income of both the male and the female assessee. These principles stand at the basis of the interpretation we propose for the provisions of s. 17 of the Ordinance.

We do not presume to replace the legislature or the executive branch in the creation of arrangements intended to encourage women to enter the labor market. The legislature also has the authority to determine that a particular expense which serves in the production of income will not be allowed as a deduction. However, in the absence of an explicit determination on the legislature's part, it is not possible to reach the conclusion that an expense in the creation of income cannot be deducted.

Application

33. The bottom line is that the appeal is denied. Regarding the method of deduction, if at all, and the manner of extracting the permitted expense for deduction from the overall "mixed" expenses, the legislature and the delegated authority would do well to give this matter their attention. In the absence of regulations, these topics will be treated at the level of the the assessee and the assessment officer. The deduction will be calculated using the methods used in the past with respect to mixed expenses. The assessment officer will be the one to decide the portion that should properly be deducted, and that portion which is not permitted for deduction – and in the case of disagreement, the matter will be brought before the court, as in the past. In the matter before us, the concrete questions have already been decided by the trial court, and there is no need for them to be reconsidered.

All that we have decided today is that in the absence of legislation, there is a legal duty of deduction. The legislature may decide otherwise, but as long as it does not, we have done nothing other than declare the existing law. The question remaining for our examination is the date upon which this ruling goes into effect.

34. In general, a new judicial rule operates both retrospectively and prospectively (LCA 8925/04 *Solel Boneh Construction and Infrastructures*

Ltd v Estate of Alhamid [18] (hereinafter: *Solel Boneh*). When interpreting a legislative provision, the court declares the existing law and does not create it: it declares what the law always was. Even when the court chooses prospective effect for its judgment, the accepted distinction is between the litigant who seeks to deviate from the previous law, for whom the new rule will have retroactive application, and other litigants whose matters have yet to be resolved, and in respect of whom the new rule will not apply (*ibid*, para. 7 of President Barak's judgment). This distinction provides an incentive for the litigant arguing for a change in the law.

This is not the case when the previous law is not fundamentally flawed, and it is the change in the social and cultural environment in which the court operates that catalyzes the change in the law. In cases such as these, the effect may be purely prospective (the rule would not even be applicable to the litigant who initiated the legal proceeding in order to bring about the new case law), or qualified (the ruling applies to that particular litigant). A request for prospective effect may also arise in cases in which the parties relied on the previous rule for an extended period of time and regulated their relations in reliance thereupon (see *ibid*, para. 12). The choice of non-retrospective change of the law thereby limits the harm to the reliance interest that might be caused by giving retrospective effect to a new rule. In the words of President A. Barak (*ibid*, para. 14), it prevents the need to decide between "truth" and "stability" (an expression coined by President Smoira), and it enables the attainment of both "truth" and "stability".

35. It seems that this case justifies giving today's ruling only prospective effect , starting as of the tax year beginning in the January 2010, subject to one qualification regarding its application to the parties before us. There are a number of reasons for both the choice and its qualification.

The construction given today to the provision of s. 17 brings about a practical change in the way the appellant has treated assessees for many years. The need to protect the reliance interest in this case is a powerful one. The old rule created a real, substantial reliance that precludes the retrospective application of the rule. Returning taxes collected undermines the tax collector's reliance interest (*ibid*, para. 20). In the present context, it is doubtful whether this interest can be protected by means of other legal doctrines. The proviso presented here to retrospective application would not

apply to the case of the respondent in this case. The reason for this is the general need to provide an economic incentive to the litigant, in appropriate cases, to take steps to change the existing law. The concrete reason in this particular case is that a decision was already made concerning the respondent by the trial court. As stated, as long as appropriate regulations have net been enacted, the question of how to implement the new rule will be an issue for case-by-case examination by the assessment officer, and in the absence of agreement, a subject for judicial resolution. In the matter of the respondent, this last stage has already been exhausted. The result is that, in this case, the general qualification frequently accompanying prospective application has been realized.

It should be emphasized that the criteria for distinguishing the appropriately deductible expenses from the overall "mixed expenses" were chosen in accordance with the particular circumstances of the respondent. They do not prevent other assessees, or the assessment officer, from reaching other results in appropriate circumstances.

In conclusion, the application of this judgment is prospective, but it will apply to the respondent in this case, whose claim succeeded in changing the rule.

Deputy President

Justice E. Rubinstein

A. I concur with the result reached by my colleague the Deputy President, and his elucidative reasoning. I would like to add a few comments.

B. In my view, the judgment of my colleague and that of the trial court bring the interpretation of taxation law, and for our purposes of section 17 of the Tax Ordinance (along with section 32 (1) which prohibits the deduction of home or private expenses), closer to social developments, in other words, closer to reality, and true tax can be levied only if anchored in reality.

Reality, as any socially aware person knows,is a "gradual revolution" in relation to the past, now expressed by the fact that women work outside the home. This phenomenon crosses social boundaries and is expanding, fortunately, into social circles among which women did not previously work outside the home. I stress the expression "outside the home" because work inside the home, even for women who are only homemakers - or for a man who plays the same role at home - is difficult, taxing work. The expression "a working woman" is an archaic term. Maintaining a home is no trivial matter, and the woman who is a homemaker, or a man fulfilling that role, are working in the most basic sense of the word. This reality has been partially recognized by the law in certain contexts. In any case, it is clear that the interpretation of tax law must reflect the dynamic social situation, just as the law itself must go hand in hand with social developments. Personally, with all due respect, I dispute the position expressed by the appellant that the recognition of the deduction constitutes, in and of itself, a benefit for the richer classes, and is regressive with respect to the weaker socio-economic sectors. It is clear for all to see that young couples, even from relatively well established families, where both spouses work outside the home, are forced to spend considerable sums for childcare. Indeed, in the absence of a grandmother or grandfather who has the time, or is retired, and who can voluntarily care for the children, the amount spent for that purpose constitutes a large portion of the couple's expenses, or as expressed in the immortal aphorism attributed to the late Knesset Member Abraham Hertzfeld, "All income is dedicated to expenses". Taking the bull by the horns, it is clear that without incurring these expenses, one of the spouses would not be able to work outside the home. Accordingly, it is quite obvious that childcare expenses are expenses necessary for the production of income, and the qualms regarding its regressive character can be allayed without difficulty, as also explained below.

C. Needless to say, this was not the dominant approach in the past (see, *inter alia*, Asaf Lachovsky "Categories of Gender and Status in Income Tax Law", 24 (1) *Tel-Aviv Law Journal* 205, 225 – 228 (2000), and references there (hereinafter: "Lachovsky"). The author criticizes the conception that views childcare expenses as private expenses, stating (p. 227)

> 'It seems that the real reason for the special treatment of childcare expenses is the identification of this expense as a woman's expense.'

We will return to the gender issue further on. Regarding the deduction, in the article by Dr. Yoram Margaliot, cited by my colleague, he suggested disguising childcare costs as a "mixed expense" (p. 360).

D. The learned Prof. Y. M. Edrey, in his (new) book "Introduction to the Theory of Taxation" (5769-2009), treated the subject at length, and similarly took issue with the "accepted theory" according to which study expenses, travel expenses, and childcare expenses are private expenses (pp. 221-112). In his view, this accepted view is based on "social assumptions that are no longer appropriate in a modern, egalitarian Israeli society" (p. 223), and that ignore the human capital and changing social conditions in different areas. I will not address the issues that digress from the specific matter at hand, but I will only note that regarding expenses for academic studies, the author's view is that developments in this area include the need to recognize advanced academic studies as expenses for maintaining existing economic value (p. 210 and p. 215), and that in his view, the half-credit points granted in the Income Tax Ordinance are insufficient (p. 226). I had the opportunity in the past to address the issue of studying towards an academic degree in CA 350/05 *Jerusalem Assessment Clerk v. Bank Yahav* (not yet reported) [19]. I stated there:

> '(1) Academic studies, as with any other studies, are for the person's benefit, they contribute to his values, broaden his professional and other horizons, and raise his level. However, the legislature chose to express this recognition by way of credit points, and not by way of deduction. We also learn this from the legislative developments in this area. On 10 August 2005, the Tax (Amendment No. 147) Ordinance, 5765-2005, came into force. Section 9 establishes an arrangement for credit points based on expenses for academic and education studies (the addition of ss. 40C and 40D to the Ordinance, including "half a credit point for an individual who completed studies towards a

first or second academic degree," and "half a credit point for teaching studies", respectively. Prima facie, it may be inferred that studies towards an academic degree, until that time, were not allowed as a deduction from the chargeable income of the student, and hence the amendment. Furthermore, in Amendment 151, 5766-2006, the legislature went another step down the same path, and explicitly prohibited viewing academic studies as a permitted expense, stipulating among the "matters prohibited for deduction": "educational expenses, including expenses for acquiring academic education or for acquiring a profession, and apart from expenses for professional advanced studies, which are not studies for acquiring academic education or a profession, for purposes of preserving that which exists" (see s. 32 (15)). This also appears in the explanatory notes: "It is proposed to clarify that deductions for educational expenses for the purposes of acquiring a profession or acquiring academic education are not deductible from a person's taxable income unless they were expenses for preserving that which exists that do not confer the student with a permanent advantage. As stated, this is the *existing situation*, but in order to remove all doubt, it is proposed to establish this explicitly in legislation" (Government Draft Proposals, 5766, 236, pp. 305-306 (emphasis added – E.R.).

(2) The absolute majority of the workers in the bank in this case studied, as mentioned, towards a first or second degree in business administration, and with respect to studies of anthropology or geography, for example, the bank itself agrees that the expenses are not recognized for tax purposes. The present case involves the study of business administration, which may be of benefit to the bank workers, but the academic degree as such cannot be regarded as fulfilling the required connection between itself and the function of the assessee. To be precise - this does not constitute a rejection of the "substantial test" which the court must adopt when examining

> the recognition of academic degrees as allowable expenses (see: R. Livnat, "Advanced Academic Degrees – as a Recognized Professional Studies Expense", *Taxes* 13/2 (April 1999); L. Newman, "The Parameters for Permitting the Deduction of Expenses for Academic Studies" *Taxes* 16/3 (June 2002)). The studies must be essentially connected to the assessee's professional role, but they must also focus on, and be essential to his job. Furthermore, while academic study does provide the student with tools, in the current case these extend beyond the knowledge required for discharging his role. As such, they are in a field in respect of which the fiscal legislator adopted a different approach. This point was addressed by Judge Altovia in his comments on the second degree, but they are also applicable to a first degree:
>
> "From the perspective of tax law, second degree studies are not different from studies towards a first or third degree. Second degree studies give the student, apart from the academic degree as such, academic tools, personal skills of analysis, study, research, data processing, analytical abilities, capacity for broad and focused perspective, ability to confront different and conflicting opinions, and others such life skills which cannot be enumerated, and which deviate above and beyond the particular subject being studied"(ITA (Tel_Aviv) 1122/03 *Heichal Yair v. Assessment Clerk - Gush Dan* (not yet reported).
>
> However, a broad perspective and the legislature's considerations, are separate issues. Even if we are aggrieved by this situation and hope for its change, this is the current situation.'

E. How does the issue of childcare differ from the aforementioned academic studies expenses (to which recognition should, ideally, be extended)? At least in that the legislature made his views patently and explicitly clear in regard to education, as shown above, and it has the capacity to do so, as mentioned by the Deputy President, in the matter concerning us, as well. However, as distinct from the issue of educational studies, with respect to childcare we

find ourselves in the more flexible realm of interpreting the subject of deductions, which is regulated, albeit laconically, in the Ordinance.

F. As Edrey argues concerning the subject of childcare expenses, the solution provided was that of credit points – from birth until age 19 – which is also the response of the state in the matter before us, "irrespective of whether the children require supervision or not. Furthermore, to the best of my knowledge, there has been no systematic discussion of the question of whether these credit points actually contributed to encouraging women to go to work, or whether they encouraged employers to discriminate against women and pay them a low wage" (p. 226). The author rejects the criticism levelled by the authorities against the District Court's decision, and notes, *inter alia* (p. 226), that the authorities have the ability to provide appropriate solutions:

> 'One possible example of a creative solution to the question of deduction of expenses for the care and supervision of small children can be found in the examination of the accumulated cost to the state treasury of implementing the aforementioned judgment, and a courageous decision to direct these sums for the development of a network of quality daycare centers situated near places of work; to provide a real incentive to employers to invest in daycare centers for the children of their employees, and other similar solutions. Needless to say, a serious examination of the optimal solution requires the involvement of experts from the fields of early-childhood education, sociology, and economics.

G. With all due respect, I concur with these last comments, and personally, I cannot understand the claim that recognizing the deduction would not encourage women to work - or couples to work. I have no doubt that, looked at from a broad perspective, it would provide that kind of encouragement, and to me, this appears as clear as day.

H. Indeed, initially, I was impressed by the aforementioned claim - that credit points are granted, and that the state had therefore provided an appropriate solution, and there was, therefore, no need for an additional solution relating to childcare expenses. However, closer examination reveals

that there is no correlation between the purpose served by credit points and that of the deduction, as explained by my colleague the Deputy President. Furthermore, as also noted by the District Court, the proposal for the 1975 legislative reform (the Ben Shachar Reform) stated (Draft Amendment of the Tax Ordinance (No. 22) 5735-1975, Draft Laws, 5735, 319, 320): "The credit points will replace the deduction for residence and the deduction for a woman...allowance points will replace the deductions for children, and replace the child allowance paid by the National Insurance Institute". In other words, as the trial judge pointed out, the subject was the encouragement of childbirth. I am aware that there may be a certain overlap of the deduction and the credit during certain years of child rearing, and if we are really intent upon true tax, that is inappropriate. But the challenge of regulating the matter so that the public coffer is not harmed falls to the authorities.

I. Indeed, it could be claimed that, to a certain extent, our decision turns the back the clock, at least with respect to the burden to be imposed on the tax authorities - after the tax system underwent a reform in 1975, to a regime of credit points and allowances, as distinct from deductions, and its life was made easier in this regard. My colleague the Deputy President gave a detailed description of the developments from 1975, in order to show that, in essence, our ruling does not turn the clock back. Of course, the multi-assessee dialogue with the tax clerks will certainly not be easy, and there will be additional work for tax clerks, work from which they were exempt over the years with respect to childcare. Shlomo Yitzhaki, in his article "Tax Reform 1975" (in David Glicksberg (ed.) Tax Reform, 5766-2005, p. 195, and see p. 215ff), points out that the 1975 reform was directed, *inter alia, and with special emphasis, to the streamlining of proceedings in the tax system* (see: Draft Bills, 5735, 319; Tax Reforms, *ibid*., 226ff). Our judgment thus makes it necessary for the tax system to deal with numerous new details in every file, and one needn't be an administrative genius to understand – and we state it quite frankly – that it involves a significant administrative burden. However, as noted by my colleague, even if the Jordan flows slightly backwards, the legislature , the secondary legislator and the Tax Authority have a "medicine cupboard". That is' they can

establish norms to regulate the deduction to be recognized, in order to simplify, as far as possible, the individual auditing process. This is accomplished by determining even such matters as what constitute reasonable childcare expenses, and the cost of "baby sitting", which is hardly beyond human capability. To my understanding, there are accepted market rates childcare costs, in addition to the other classifications mentioned by my colleague (and see: Margaliot, at pp. 360- 361, who suggests allowing the deduction of a certain percentage of the expense, or the setting of a ceiling , as per the practice with other items (office hospitality costs, telephone expenses) that were regulated by the establishment of presumptions). Such regulation should be done earlier than later, in order to avoid local and individual "trench wars" between the assessees and the tax authorities regarding the amount of childcare expenses permitted for deduction. Regulation of this kind would resolve issues such as the distinction between supervision expenses and "enrichment" expenses, which were dwelt upon by the District Court, and would also quell the fears of deduction "out of all proportions", which might lead to reduced taxation specifically of those who pay particularly high supervision expenses.

J. My colleague the Deputy President rightly noted that our decision is not limited to one gender, but applies to both. This is similarly a part of the conceptual-social revolution in which this judgment is rooted, which militates against identification of the woman exclusively with private activity (Lachovsky, p. 225; and see: Labor.App. (Jer) 2456/03 *Bahat v. State of Israel* [20] where a man (a lawyer in the District Attorney's Office) claimed and obtained a shortened work day, and a day-care supplement, etc.). There is no need to belabor the point that many more couples share the burden of childraising than in the past, so that the man's role in family care, with its implications for his ability to work outside of the home is, in many cases, almost equal to that of the woman, the traditional house keeper, who now goes out to work herself, even if his status is not yet entirely equal to hers, as there are also subjects that nature itself dictates (breast feeding). Perhaps the psalmist was referring to our times in writing (Psalms 102:13): "A person goeth out to his work and labor towards evening". The first verse says neither "man" nor "woman", but rather "person"[(*adam* –Heb.]. From my perspective, I think that the approach in this judgment brings it close to the spirit of the International Convention on Economic, Social and Cultural

Rights, and the Convention on the Rights of the Child, which was ratified by Israel in 1991 (and see also: Draft Bill – Basic Law: Social Rights (Draft Bills 3068, 23 Tevet, 5762-7.1.02) s. 4).

K. This last matter brings us to consideration of social rights in general. A person has a right to human dignity (Basic Law: Human Dignity and Liberty) and to freedom of occupation (Basic Law: Freedom of Occupation). A person's right to self-realization should and ought to receive expression in the *practical* possibility of fulfilling that right. Our concern here is not with lofty words but with "basic sustenance", in accordance with the simple equation that if a person is unable to go to work because the price of caring for his children (for obviously the "daily separation" from his children is in itself difficult) consumes the fruits of his labor, then that element of self-realization involved in his leaving the home will be severely impaired. (As for his social rights, see: Dafna Barak – Erez and Aeyal Gross, in *Dalia Dorner Volume* (S. Almog, D. Beinish, Y.Rotem, eds.), 5769-2009, p. 189). Tax law is an integral part of the economic-social fabric and, in my opinion, its interpretation should take these aspects into account.

L. It would not be superfluous here to mention that the obligation of charity in Jewish Law (for its basis, see *Shulhan Arukh, Yoreh Deah,* Laws of Charity, 247:1), which is of such singular importance (see *Midot Zedakah* of the esteemed Hasidic rabbi, Menachem Mendel Schneerson of Lubavitch, 5754) is fixed as follows (*Shuhan Arukh, Yoreh Deah, ibid,* 249:1): "if he is financially capable, he should give in accordance with the needs of the poor, and if not, he should give up to one fifth of his assets, which is the ideal performance of the commandment, and one tenth is the mediocre and less than that is mean". This commandment is known as "Tithing of Assets" The question is what constitutes the basis from which tithe (one tenth) is given and *inter alia what is recognized as an expenditure to be deducted from the profit in its calculation.* It has been ruled that the cost of a child carer hired by the woman going to work, for purposes of her work, can be deducted from her profits which are liable for tithes of assets. See *inter alia* the responsum of Rabbi Joseph Ginzburg in *Pinat Ha-Halakhah, Weekly Session (*Habad*)* 1164, 30 Nissan, 5769 (20.4.09) and references. See also the responsum of Rabbi Chaim Katz "*Tithing Assets – Offsetting Expenses"* on

the internet site of the Beth El Yeshiva, 11 Iyar 5768. See also *Ahavat Hesed* of the esteemed Rabbi Yisrael Meir Hacohen, the *Hafetz Hayyim* (ed. Rabbis D. Zicherman, and B. Zeligman, 5763, at 232): It seems that he should also have a special book, in which he records all of the profits bestowed to him by Hashem, after deduction of the expenses of his business", and in the editors note, *ibid* 20, concerning "all of the expenses that are necessary for the business", and references. The emerging picture is that Jewish law regards necessary expenses, including expenses for a caregiver, as appropriate for deduction from the basis of tithes (*ma'aser kesafim*), and the analogy to our case is clear.

M. After writing all of the above, I perused the article of Dr. Tzila Dagan "Recognized Expense" (31 (2) *Tel-Aviv Law Review* 257 (2009)). Among other things, the article addresses the subject of expenses for childcare, from the initial assumption (p. 293) that it is first necessary to establish who is the "normative assessee, through whom we can arrive at appropriate conclusions. By examining considerations of efficiency, division, community and identity, the author concludes (p. 300) that "permitting the recognition of expenses for childcare will, indeed, promote economic efficiency, and will contribute to equality between women and men". She notes however that this may have problematic distributive consequences. For example, women whose tax rate is high will receive more of a benefit than those whose tax rate is low (pp. 296-297, 300). But in her view, this effect can be moderated by a ceiling that restricts the expenses permitted for deduction, and a bonus for women who earn less than the tax threshold. The spirit of the comments is consistent with our approach. Indeed, in my view, the significance of our judgment in this case is that there is a need to achieve a new balance, which accurately reflects contemporary Israeli society, taking into account the changes in the socio-economic environment, changes that are often – though not always – for the better.

N. As stated, I concur with the opinion of my colleague the Deputy President.

Justice

Justice E. Arbel

I concur with the judgment of my colleague, the Deputy President, and with his reasoning. Indeed, as stressed by the Deputy President, the result whereby the deduction of working parents' childcare expenses are deducted from taxable income stems from, and does not deviate from the general principles of tax law. It leads to a result of true taxation, which is the central goal of tax law. At the same, it cannot be ignored that this particular decision concerning tax issues also raises other important social issues. The result reached by my colleague, the Deputy President, in my view, also achieves an important social goal that enables women to go out to work, or at least makes it easier. Should a woman wish to work, whether for economic reasons or for considerations of self-realization and development, then society should not frustrate that desire by disregarding the significant economic burden of childcare while she is at work. One cannot ignore the social reality that this economic burden is usually borne by the female member of the family, for a variety of reasons. As such, recognition of childcare expenses is a step towards a more egalitarian society (see: Tzila Dagan, "Recognized Expense", 31 (3) *Tel-Aviv Law Review* 257, 297 (2009).

On the practical level, I find it proper to mention that in my view, when both parents are at work, activities such as clubs and day camps that fall outside the usual childcare framework, may be regarded as partially deductible expenses because part of their purpose is the supervision of children while the parents are at work. It should be remembered that the hours of activity and holidays of the kindergartens and schools are not always identical to the work hours and holidays of the worker. As such, parents are often compelled to find frameworks for their children when the regular frameworks are not available. The fact that some of these frameworks also provide enrichment for the children does not prevent recognition of part of the expenses as intended for the supervision of the children, even though the rates paid for day camps or clubs may differ. Granting partial recognition will also prevent a situation in which the parents will opt for frameworks that do not provide any enrichment so that part of

the expense will be recognized for tax purposes, rather than choose frameworks that provide some enrichment but would not be recognized for tax purposes. On the other hand, in my view, consideration should also be given to additional factors, such as social interests, and considerations of the child's best interests, which presumably support encouraging parents to spend more time with their children. It may, therefore, be proper to consider the determining a limit to the number of childcare hours per day that would be recognized as an expense, for reasons of public policy. In addition, in the framework of establishing rules for this field, consideration should be given to the distributive implications as they relate to families from varying economic backgrounds, that spend varying sums on childcare (see: Dagan, p. 296). In any case, establishing guidelines for implementing of the rule laid down in this judgment is a matter for the legislature, or the delegated authority, and they would do well in regulating the matter in a clear, prompt manner in order to prevent individual disputes with assessees.

Justice M. Naor

1. I concur with the principal conclusion of my colleague the Deputy President according to which childcare expenses are permitted for deduction. I also concur with the comments of my colleague Justice Rubinstein.

2. Following an exhaustive hearing before this panel, the Director General of the Ministry of Finance requested to appear before us to present the budgetary implications of the rejection of the appeal. There was no basis for that request. If – and this is our legal conclusion – the expense is one which is permitted as a deduction, then it cannot be expected that our conclusion will change due to the budgetary implications, serious as they may be. On the day of the hearing before this Court, we proposed that the state regulate the subject of deduction of childcare expenses in regulations, but that proposal was rejected. It would seem, in the wake of this judgment, that it would be appropriate to reconsider the arrangement of the subject in primary legislation (or, at least, in secondary legislation), which will establish clearly defined criteria for childcare expenses. Legislative arrangement will

prevent the need for superfluous individual litigation for each and every assessee.

3. I will not deny that I was disturbed, not from the legal point of view but from the social point of view, by the question raised by the state concerning whether the recognition of the deduction did not constitute a benefit for the more established social classes, and regressivity with respect to the weaker socio-economic sectors. My colleague Justice Rubinstein also addressed this subject, disputing the appellant's position on this matter. Personally, I am unable to dismiss the appellant's arguments. As stated, this is a disturbing issue from the social point of view; however, the solution. cannot lie in the non-recognition of the possibility of deducting the expense, just as the burden on the state budget cannot distort the result. My colleague Justice Rubinstein cited, with approval, the comments of Prof. Edrei, who brings a possible example of a creative solution to the question of deducting childcare expenses for small children by opening a network of quality daycare centers near workplaces. I warmly endorse the proposal to examine the possibility of expanding the free education provided by the state to young children. Such a solution, if found feasible, would benefit all Israel children (and their parents), and might well broaden the circle of those who go out to work (including women), even among those in low tax brackets.

4. Regarding the date upon which our judgment takes effect, unlike my colleague the Deputy President, my view is that the matter should not be decided in the framework of this proceeding. I think that the matter should be left pending for proceedings in which arguments can be heard on the matter. According to my colleague, although we are concerned with a declaration concerning an "existing situation", there is justification for giving our judgment only prospective effect (except with respect to the respondent). The question of when a judicial ruling comes into force is a complex one that cuts both ways. While our judgment is a "revolution" in terms of actual practice, to the best of my knowledge, this judgment is the first to address and decide the question of the deduction of childcare expenses in Israel. The appellant, too, agrees that the question has not previously been addressed directly in Israel. Our judgment is, therefore, not a deviation from existing precedent (which is also permitted). Even if the assessment officers were asked to recognize these expenses and refused, until today that refusal had never been

subjected to judicial review. The "revolution" is, therefore, not in the settled law, but rather in the practice of the assessment officers. Under these circumstances, when the matter at hand "has never been ruled on in the past, it cannot be said that there is a reliance interest worthy of protection" (LCA 8925/04 *Solel Boneh Construction and Infrastructures Ltd v. Estate Ahmad Abd Alhamid* [18], para. 18) that justifies retroactive application. Furthermore, presumably, there are a substantial number of assessees who waited for a decision in the respondent's case, and thus prospective application will not only prevent the restitution claims that worry my colleague the Deputy President, but will also hurt all of those whose claims are still pending regarding open tax years, without having had any opportunity of presenting their claims on the matter. Note that regarding the latter it is certainly not a matter of "restitution of taxes that were collected, [that] harms the reliance interest of the tax collector" - an interest that was addressed by my colleague. Furthermore, even if the question of restitution of taxes arises, there may be other legal doctrines which provide us sufficient grounds for not determining prospective application (see, e.g: CA 1761/02 *Antiquities Authority v. Mifalei Tahanot Ltd* [21], para. 69). Thus, the question can go either way, but since we have not heard arguments concerning application in respect to time, I would refrain from ruling on the question, and leave it for future resolution (*cf*: HCJ 2390/96 *Karasic v. State of Israel* [22], 694 a-b). Under the circumstances, the appropriate place for resolving the question of the date of application is in future litigation, with any particular assessee, and not the current case.

Justice

Justice E. Hayut

I concur with the conclusion of my colleague the Deputy President E. Rivlin, that the appeal should be dismissed and we should uphold the ruling of the District Court, according to which s. 17 of the Tax Ordinance [New Version] should be interpreted to permit the deduction of a person's childcare expenses from his chargeable income. I also concur with his conclusion that

these expenses should also be permitted in cases of a "mixed expense", in other words, an expense that contains an additional, non-revenue component.

Regarding the effect of the new ruling, whether retrospective or prospective, my colleague feels that even if it should be applied to the appellant before us, due to the need to provide incentives for litigants in appropriate cases to take measures to change the existing law, the case at hand justifies only prospective effect for this judicial ruling (as of the tax year beginning in January 2010). The reason for his approach is:

> 'The construction given today to the provision of s. 17 brings about a practical change in the way the appellant has treated assesees for many years. The need to protect the reliance interest in this case is a powerful one. The old rule created a real, substantial reliance that precludes the retrospective application of the rule. Returning taxes collected undermines the tax collector's reliance interest :'

Justice Naor, on the other hand, feels that the decision on the issue of the ruling's effect (prospective or retrospective) should be left for another proceeding, as the question being "a complex one which cuts both ways", and because we have not heard the parties' arguments on the matter. On this issue, I concur with the view of my colleague Justice Naor. I, too, feel that the question is a complex one which should be examined in all its ramifications before we rule categorically on the judgment handed down in this appeal. I will further add that, in my view, and even though the Court has not previously addressed the issue of deduction of child-care expenses from taxable income, the criterion implemented by my colleague the Deputy President in determining that these expenses are permitted for deduction, is a new test, which is broader than the incidentality test, which prevailed until today, and which the District Court sought to implement in the current case (and I concur with the comments of my colleague, in para. 19 of his opinion, that any attempt to apply the incidentality test to this case is somewhat contrived). Indeed, as held by my colleague the Deputy President, the incidentailty test should be an auxiliary test for identifying revenue expenditures in the production of income, but not an exclusive test. In its

stead, a more sophisticated test should be endorsed, that of the *real and substantial connection* between the expenditure and the production of income (See para. 16 of the opinion of my colleague the Deputy President). In that sense, we are handing down a new ruling that replaces the old one, and this being the case, in my view, there is even more of a need for a solid, detailed basis to justify deviating from the ruling in *Solel Boneh Construction v. Estate of Ahmad Alhamid* [18], according to which the point of departure is that a new judicial ruling goes into effect retrospectively. Finally, and in order to remove all doubt, I will add that, in any case, I concur with the position of my colleague the Deputy President according to which our new ruling should be applied to the case at hand. In this context, it is not amiss to mention that it was for similar reasons that the Deputy President M. Cheshin, who was in the minority in *Solel Boneh* [18], had difficulty in finding any case in which a successful plaintiff whose case had led to a change in the existing law and the creation of a new one, would not be found worthy of enjoying the fruits of the new ruling (See *ibid*, para. 26). This approach, as stated, is acceptable to me.

For all of the above reasons, I join in the conclusion of my colleague the Deputy President, that the appeal should be dismissed.

Decided in accordance with the judgment of Deputy President E. Rivlin.

6 Iyar 5769 (30 April 2009)