CASES

SETTING-OFF OF LOSSES

The Decision in the Goldstein Ltd. Case (1990) 14 P.D.E. 424

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Introduction

The Israeli Income Tax Ordinance is quite generous in allowing the setting-off of losses from “trade” against taxable income in the same tax year. Under sec. 28 a taxpayer, who incurred a loss from a “trade”, may set off the loss against any taxable income, irrespective of the source from which the income was derived, provided that the income in question was taxable during the very same year. As far as the carrying forward of losses is concerned, sec. 28 is less generous. It allows the carrying forward of losses from trade indefinitely, but only against income from a “trade”, though not necessarily the same trade which resulted in the loss. Thus, a taxpayer, who incurred a loss from a trade in one year, should first set off the loss against other income in the same year. The remaining loss, if any, may be carried forward to future years, provided that the taxpayer is still engaged in a “trade”, any trade. He will not be allowed to carry forward his loss in order to set it off against any future income which is derived from a source of income other than trade, e.g., employment income, rent, interest or dividend. The carrying backwards of losses is disallowed altogether.

In the case discussed here, Assessing Officer v. Goldstein Ltd., the taxpayer company, which was engaged in the business of construction and metal, claimed to set off a loss in 1981 against income derived in 1982 from a management fee, which it received from a related company. The Income Tax Revenue disallowed the setting-off of the loss, maintaining that the income against which it was sought to be set-off, could

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1 1 L.S.I.[N.V.] 145.
not be properly classified as an income from “trade”, under sec. 2(1), but rather as an income from gains or profits arising from any other source which is not included in subsections (1) to (9) of sec. 2 (sec. 2(10)).

The Court decided in favour of the taxpayer, holding that, on the merits, the taxpayer’s income from management fees should not be classified as income from sec. 2(10) but as income from “trade”; hence the loss could be set off against that income, even though the income was received in a subsequent year.

The Tax Revenue also put up an alternative argument. Given that the taxpayer’s income was not classified under sec. 2(10), it was nevertheless not income from “trade”, but, at best, income from “an adventure in the nature of trade”. Therefore, the taxpayer should not be allowed to set off the loss against such income, since sec. 28 limited the right to set off of losses from “trade” to subsequent incomes from “trade”, implying the exclusion of income derived from an “adventure in the nature of trade”.

This argument, as well, was not accepted by the Court, which held that “the term ‘trade’ in sec. 28(1) and 28(b) includes ‘an adventure in the nature of trade’, which is, by definition, a certain type of ‘trade’.” Admittedly, the Court’s statement is an obiter dictum. However, it deserves attention, not only because of the practical effects it may have, but also because it further demonstrates the readiness of the Court to depart from the rule of literal interpretation, and to adopt “purposive interpretation”, even where such interpretation finds little support, if at all, in the wording of the law.

**Legislative History of sec. 2(1) and sec. 28**

The phrase, “transaction or adventure in the nature of trade”, was first introduced into the Income Tax Ordinance in 1947. Until 1947 the Income Tax Ordinance of 1941 used to impose tax, under sec. 5(1)(a) (today sec. 2(1)), on “gains or profits from any trade, business, profession or vocation . . .” (emphasis added). Correspondingly, sec. 13 (today sec. 28), which deals with the right to set off losses, referred to “a loss incurred . . . in any trade, business, profession or vocation, which if it had been profit would have been assessable under the Ordinance” (emphasis added). In 1947, the phrase, “transaction or adventure in the nature of
trade” was added to sec. 2(1). No similar phrase however, was added to sec. 13 [today sec. 28] which deals with losses. The object of introducing the phrase “transaction or adventure in the nature of trade” was to make it clear that isolated profits, of a “trading” and not of a capital nature, are liable to tax. This was in conformity with British law, where the word “trade” is defined in sec. 237 of the Finance Act of 1918.

It should be noted that, unlike the British legislation, the said phrase was not included in the definition of “trade” but as an addition to sec. 5(1) [today sec. 2(1)]. In fact there was no definition of “trade” in the Income Tax Ordinance of 1947. As far as “transactions in the nature of trade” are concerned, there is no explanation on record why the legislative technique used in the 1947 amendment differed from the technique used in sec. 237 of the British Finance Act of 1918.

However, it should also be stressed that generally speaking, the right to set off losses under the Ordinance followed methods similar to those adopted by the British law, but at least in one instance, the right to set off was deliberately more limited in the Income Tax Ordinance in Palestine than in the British law. Thus, originally, under sec. 14 of the Income Tax Ordinance, 1941, the right to carry losses forward was limited to six years; furthermore, unlike the British income tax law, in no case would such a set-off be allowed to such an extent that the tax payable for any year would be reduced to less than one half of the amount payable had the set-off not been allowed.

The legislature was perfectly aware that under such a system, the taxpayer might legitimately feel some grievance; and yet, the legislature restricted the right to set-off losses because, if the carrying forward of losses were unrestricted, the Government would be deprived for a lengthy period of a great part of its revenue from income tax.3

Only gradually has the right to set off losses been extended; a full scale right to set off losses has still not attained. Clearly, it is not by chance that certain restrictions on the right to set off losses have remained.

The position of the Tax Revenue has been that the right to set off losses was limited to losses from “trade” and could not be extended to a loss from “a transaction or adventure in the nature of trade”. The

3 See the reasons given for the system of deduction in respect of trade losses recommended in the Model Ordinance, on which sec. 14 of 1941 Ordinance is based. Cmd. 1788, p. 8, secs. 21 and 22.
decision by the District Court of Tel-Aviv, *A.B. v. Assessing Officer* supports this position. The judge in that case stated that, since sec. 28 refers to a loss from a “trade” and does not refer to a loss from “a transaction or adventure in the nature of trade”, the latter type of loss cannot be set off.

The Knesset enacted numerous laws amending the statutory provisions relating to the set off of losses. In 1952, the phrase “business or trade” was extended to include “agriculture and industry”; a series of amendments, in 1949, 1957, 1958, gradually extended the right to carry forward losses; in 1977, a new provision was added, sec. 28(8), allowing a taxpayer to set off losses from renting a building, but only against future income from the same building.

Sec. 28 was redrafted when the “new version” of the Income Tax Ordinance was issued in 1961. The “new version” also consolidated the various amendments of the Ordinance and rearranged the provisions. Since 1961, the term “trade” is defined as including “business, occupation, agriculture and industry”. The term, “vocation”, is defined as “profession and any other vocation which is not a trade”. In the “new version” sec. 5(1) is numbered 2(1); it refers to “gains and profits from any trade or vocation . . . or from a transaction or adventure in the nature of trade”. Sec. 28 of the new version (replacing sec. 13) refers to a loss “from trade or vocation” (sec. 28(a)) and the carrying forward of trading losses to future “taxable income from trade or vocation” (sec. 28(b)).

Altogether sec. 28 was amended not less than 10 times, yet none of the amendments dealt with the “transaction or adventure in the nature of trade”. The draftsman has retained that phrase as an *addition* to the terms “trade or vocation” in sec. 5(1) (sec. 2(1) in the new version) while sec. 13 (sec. 28 in the new version) continued to refer solely to “trade or vocation”, without mentioning the “transaction or adventure in the nature of trade”. Furthermore, that phrase was not added to the new definition of “trade” in sec. 1 of the new version.

The Israeli legislature could not have “overlooked” the problem of “adventure in the nature of trade” in the context of the setting-off of losses, due to the fact that it was an issue in several tax cases since January 1950, when the decision in *A.B. v. Assessing Officer* was

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4 *A.B. v. Assessing Officer*, (1952) 7 *P.M.* 79, at 84.
5 *Supra* n. 1, at 160.
6 See *supra* n. 4.
delivered. For example, in Goldberg v. Assessing Officer\textsuperscript{7} the District Court of Tel-Aviv again expressed the view that the phrase “transaction or adventure in nature of trade” is not referred to in sec. 28, hence a loss from that source cannot be set off.

There were also additional amendments, e.g., the adjustment of the rules of income tax losses to those of capital gains tax. However, the right to set off is still denied to taxpayers who sustained losses from a variety of sources, e.g., employment income, house property (except the limited right under sec. 28(8), and a very special case of citrus plantation (sec. 28 (d), (e), (f), (g)), renting of an immovable property, and the sweeping up clause of sec. 2(10). The right to set off trading losses is itself still limited; for example, there is no right to carry the loss backwards.

Analysis of the Goldstein Case

The issue in the Goldstein case is different from the one in the Goldberg case.\textsuperscript{8} Here the question was whether the taxpayer is allowed to carry forward a trading loss in order to set it off against income which allegedly did not amount to income from “trade” but, at the most, income from an “adventure in the nature of trade”. The problem of interpretation, however, was similar in both cases, i.e., does the meaning of the term “trade” in sec. 28 differ from the term “trade” in sec. 2(1), or more specifically, should the term “trade” in sec. 28 be interpreted as including an “adventure in the nature of trade?”

The Court examined secs. 2(1) and 28 of the Ordinance, and came to the conclusion that the intention of the Legislature was that the term “trade” in sec. 28 be interpreted in a different manner than the term “trade” in sec. 2(1). The term “trade” in sec. 28 should be interpreted as including “an adventure in nature of trade”. The intention of the Legislature can be inferred from the following:

1. Under secs. 28 and 2 the right of setting-off of losses is not necessarily against income from the same “trade” or “vocation”. Hence, a taxpayer who owes two businesses is not precluded from setting-off of a loss from one business against future profits from

\textsuperscript{7} Goldberg v. Assessing Officer, 3 P.D.E. 180.

\textsuperscript{8} Ibid.
the other business. Therefore, there is no reason why a loss from one business should not be set off against another business where the other business is an "adventure in the nature of trade". In substance, there is no difference between a "trade" and "an adventure in the nature of trade".

b) Allowing the setting-off of losses against income from "an adventure in the nature of trade" fits with the desirable trend of mutuality in the imposition of tax. It is neither fair nor desirable to impose tax on income from "an adventure in the nature of trade" under sec. 2(1) and yet to disallow the setting-off of a loss from "an adventure in the nature of trade" under sec. 28.

It is respectfully submitted that, considering the legislative history of secs. 2(1) and 28, as well as the definitions of "trade" and "vocation" in sec. 1, it is difficult to infer that, though the Legislature retained the phrase "transaction or adventure in nature of trade" in sec. 2(1) while omitting it in sec. 28, it still had the intention that, for the purpose of setting-off of losses, a "trade" should include "a transaction in the nature of trade". The Legislature was surely aware of the problem, certainly after the Court decisions in 1949 and 1969, and could have added that phrase to the definition of "trade" in sec. 1 if it so desired.

The author shares the view of the Court that it may be unfair to deny the taxpayer the right to set off losses from an "adventure in the nature of trade", or to set off losses from "trade" against future income from that "adventure". The question, however, remains whether the Court should base its decisions on what the law says or on what it thinks is "fair" and "desirable", or is in line with the principle of "mutuality".

Sec. 28 is not perfect. There can be no doubt about that. It may be unfair to disallow the carrying backwards of losses; it may be unfair to disallow the setting-off of losses from employment; it may also be unfair to disallow a set off of losses from sec. 2(10). Those are only a few examples of rules in which no "symmetry" is observed: one pays tax where one has profits, but one is deprived of the right to set off losses. Now that capital gains, as well, are subject to tax, the question as to what is the best system of setting-off of losses, has become even more problematic.

Once the Court bases its decisions on considerations of tax policy, the question arises what is the scope of the research into the tax policy considerations that the Court should, or has the tools to, carry out. Perhaps paradoxically, the readiness of the Court not to adhere to the
literal interpretation was approved; and yet the Court was criticized, for not going far enough in its investigation into the desirable solution of the problem of setting-off of losses. The Court was criticized for basing its decision on partial considerations of tax policy, and that some of the considerations did not reflect the attitude of Israeli law regarding setting-off of losses. It was further suggested that the Court failed to take into account the principal considerations regarding the desirable system of setting-off of losses.¹⁹

One may agree that the reasoning of the Court that the principles, if any, which guided the draftsman of the Ordinance, are not free from doubt. Indeed, it is hard to see any consistency at all in the approach of the Israeli legislature in this area. The only “principle” that emerges, is a gradual, yet careful, extension of the right to set off losses. An analysis of what is fair and desirable in the area of losses is, however, out of the scope of this note.

It is respectfully submitted, however, that the sheer controversy as to what is the right “tax policy” regarding the rules of setting-off of losses, in the present case, lends further support to the author’s view that where the meaning of a statutory provision can be inferred from the wording of the provision and its legislative history, there is no room for interpreting the provision on the basis of “tax policy” considerations.

**Summary and Conclusions**

In the decision of *Goldstein Ltd.*, the Supreme Court decided (in an *obiter dictum*, which nevertheless carries great weight) that a taxpayer is allowed to carry forward a trading loss in order to set it off against future income from “an adventure in the nature of trade”. A close examination of secs. 2(1) and 28 of the Income Tax Ordinance, and their legislative history, throws grave doubts on the correctness of the Court’s decision. Since the introduction of the phrase “transaction or adventure in the nature of trade” into the Income Tax Ordinance in 1947, the Ordinance was amended more than 100 times; at least 10 amendments

specifically dealt with losses. The Legislature did not lack opportunities
to say that concerning the setting-off of losses, “trade” includes “adven-
ture in the nature of trade”. How can the intention to bring about that
result be attributed to the Legislature, when it did not say so?

Apparently the Court based its decision mainly on “mutuality”, “fair-
ness” and “desirability” of principles of setting-off of losses. In so doing,
it appears to have been prepared to substitute considerations of tax
policy for the literal interpretation of taxing provisions. The controver-
sial observations of the Court, regarding the tax policy considerations
governing the treatment of losses, reflects one of the limitations of the
“new approach” of interpreting taxing statutes. The decision demon-
strates the hard problem how far the Courts of law should go in inves-
tigating issues of tax policy, and whether they have the tools needed to
carry out such a research. Rather than speculate on what is “fair” in tax
matters and what is the desirable “tax policy”, perhaps the safest way
may still be to give effect to the unambiguous wording of a statutory
provision, without questioning its fairness or desirability.