

Income in Kind Begets Deduction in Kind, Supreme Court Says

by Amnon Rafael and Shlomi Lazar

Reprinted from *Tax Notes Int'l*, April 13, 2009, p. 125

COUNTRY DIGEST

Income in Kind Begets Deduction in Kind, Supreme Court Says

The Israeli Supreme Court in a March 29 decision held that income in kind requires a deduction in kind.

The case involved a nursing home. Its residents deposited with the home an interest-free dollar-linked deposit as part of the consideration for their residential rights. The deposit was amortized at 30 percent but at a rate of 2 percent per year. Hence, each year the taxpayer reported nominal income of 2 percent of the deposit. The taxpayer then claimed a deduction corresponding to the exchange differentials accruing on the unamortized deposit.

The assessing officer disagreed with the taxpayer's method of reporting its income. He therefore added to the reported income notional interest at the market rate. He denied any deduction for exchange differentials on the part of the deposit that still remained to be amortized (originally 30 percent).

The Court held that the transaction before it was in essence an exchange. In return for the waived interest, the resident paid less for his residence. Thus, had the taxpayer paid interest to the resident, it would have been returned as part of the resident's payment for the services rendered. The result would be a wash of the additional income against the in-kind deduction. Thus, adding in-kind interest income would result in nil tax.

A deduction in kind offsets income in kind when there is no reason to doubt that the values of the exchanged services are equal, the Court said. But what happens when the equality test is failed? For example, assume that the interest rate drops severely (as indeed

it has) while the payment for services rises or remains constant. The taxpayer's taxable income will increase because the deduction in kind, taken at fair market value, will exceed the low interest income in kind. In other words, the resident in this case received a better deal than the taxpayer. If the interest rate were to rise and the payment for services were to remain constant, the opposite would occur. The taxpayer would have a higher outlay than the resident's payment.

The Court's approach if taken further also allows for a change of the source of the income under a schedular tax system. Suppose rental income is subject to high taxes while income from personal efforts is subject to lower taxes. The taxpayer could, at least in theory, claim it is owed a fee for its efforts to derive the rental income. Suppose the fee were 75 percent of the rental income. The taxpayer would deduct 75 percent from the rental income (the fee deduction in kind) and report it on its return as personal exertion-in-kind income, thus enjoying the lower tax rates. In this case, the taxpayer pushes the "in-kind doctrine" a bit further than the Supreme Court by conducting an exchange with itself.

The Supreme Court denied the deductibility of exchange differentials on the part of the remaining unamortized deposit. In its view, the claim related to a contingent liability that could not be reasonably ascertained for purposes of its allowance as a deduction.

Tax planners will no doubt study this exchange doctrine to create in-kind losses that are deductible against real cash income. ♦

♦ *Amnon Rafael and Shlomi Lazar, A. Rafael & Co., Law-Offices, Tel Aviv*