**Litigation - Canada**

## Court rules on taxation of foreign exchange derivatives gains/losses

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In *Kruger Incorporated v The Queen*(1) the Tax Court held that the taxpayer could not value its foreign exchange options contracts on a mark-to-market basis, with the result that certain losses were not deductible by the taxpayer in a year. *Kruger* is another recent judgment of the Tax Court in the developing law on the Canadian tax treatment of financial derivative products.(2)

**Facts**

Kruger Incorporated's core business was manufacturing newsprint, paper-coated products and tissue paper. In the 1980s Kruger started trading in foreign currency contracts, activities which grew to involve more than 10 employees trading in currency, bonds and securities.

In 1997 Kruger was advised that it was required to start reporting its financial trading activities on a mark-to-market basis, which required the recognition of any change in market value in a year as an income gain or loss.

In 1998 certain of Kruger's US currency options contracts were 'under water' due to fluctuations in the Canada-US exchange rate. Accordingly, for its 1998 tax year Kruger claimed losses totalling C$91,104,379 from a business of trading in derivatives. The Canada Revenue Agency (CRA) reassessed to deny the deduction of C$91,104,379, but excluded from income the amount of C$18,696,881, which Kruger had included as the amortised portion of the net of premium income and expenses for the foreign exchange options contracts. The CRA also included the amount of C$91,104,379 in Kruger's taxable capital for the purposes of the large corporations tax (which has now been generally repealed).

Kruger appealed the reassessment on the basis that, in accordance with Section 9 of the Income Tax Act, it was entitled to value its foreign exchange options contracts using the mark-to-market method, and argued in the alternative that its foreign exchange options contracts were inventory and were to be valued at the lower of cost and fair market value under Section 10(1) of the act.

**Decision**

The court reviewed the key Canadian judicial authorities regarding the test for determining income under the act, including *Friedberg v The Queen*,(3) *Canderel Limited v The Queen*(4) and *Friesen v The Queen*.(5) The court referred to the oft-cited principles from *Canderel* that the determination of profit is a question of law and a taxpayer is free to adopt any method for determining profit that is not inconsistent with the act, case law and well-accepted business principles. Once the taxpayer has shown that it has provided an accurate picture of income, the onus shifts to the CRA to establish that the amount is not an accurate picture of profit or that another method would provide a more accurate picture.

The court noted no provisions in the act require or authorise the valuation of property on a mark-to-market basis. Further, there is an important difference between financial and tax accounting:

> "*[109] Financial accounting… is concerned with constructing a picture of profit from year to year in a consistent manner for the benefit of the audience for whom financial statements are prepared: shareholders, investors, lenders, etc… FASB views mark to market valuation for the same reasons: to better enable investors, creditors and others to assess the entity's performance...*
>
> *[110] Tax accounting normally is not overly concerned with the past; it wants a picture of income for a particular year and … the methodology used to calculate income in one year may be different from that used in an earlier year… statements for tax purposes are solely concerned with the computation of income in achieving an accurate picture of income for the particular taxation year.*"

The court noted that Sections 142.2 to 142.5 of the act require financial institutions and investment dealers to use the mark-to-market method, but these rules did not apply to Kruger. The court stated,

> "*[114] Mark to market accounting… would compel a taxpayer to include any loss or gain in value of the property at year-end in income for the year. This may be appropriate for financial statements for reasons discussed earlier. But, for income tax purposes, the taxpayer may be compelled to include an amount in income where there is no clear statutory language requiring him or her to do so. The realization principle is basic to Canadian tax law. It provides certainty of a gain or loss. Without some support of the statutory language or a compelling interpretation tool it ought not to be cast aside.*"

The court also noted a difficulty in respect of the market prices for the foreign exchange options contracts – namely, that such prices were formulated by the counterparties to the contracts (ie, Kruger's banks). The court held there was "probably inconsistency in values" depending on the pricing method used by the counterparty.

In respect of Kruger's alternative argument that the options contracts were inventory, the court determined that Kruger was carrying on a business of speculating on foreign exchange currency options that was separate from its manufacturing business. Further, the court determined that the foreign exchange options contracts were financial liabilities when such contracts were written by Kruger, and property (ie, inventory) when purchased by Kruger.

The court allowed the appeal only to permit Kruger to value its purchased foreign exchange options contracts in accordance with Section 10(1) of the act (which would have an effect similar to mark-to-market accounting in that the contracts would be valued each year at the lower of cost and fair market value). Additionally, the amount of C$91,104,379 was to be added to Kruger's taxable capital for the purposes of the large corporations tax.

*For further information on this topic please contact Timothy Fitzsimmons at Dentons Canada LLP by telephone (+1 416 863 4511) or email (timothy.fitzsimmons@dentons.com). The Dentons website can be accessed at www.dentons.com.*

**Endnotes**

(1) 2015 TCC 119.

(2) See *George Weston Limited v The Queen* 2015 TCC 42.

(3) [1993] 4 SCR 285.

(4) [1998] 1 SCR 147.

(5) [1995] 3 SCR 103.