Currency Hedging - Gains Capital or Income?

Author : admin

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George Weston Limited v The Queen, 2015 TCC 42

At issue was whether the gains realised from the dissolution of a currency hedge were on account of capital or income. The Court identified the defining characteristics of a "hedge", and stated that the nature of hedge gains or losses is linked to the nature of the underlying item the risk of which is being hedged.

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FACTS

The Appellants is a holding company parent of a number of operating subsidiaries, many of which are in the USA. In order to protect itself against fluctuations of the US dollar in relation to the Canadian dollar (the currency in which it had to reports its financial statements in), the Appellant entered into currency swaps. When the Canadian dollar rose in relation to the US, reaching parity, the swaps were terminated resulting in a gain of about 317 Million.

The Appellant took the position that this gain was on account of capital and only half included in income. The respondent took the position that the gain was on account of income and, therefore, fully included.

ANALYSIS

The Court determined that it was appropriate to admit expert evidence of a risk management person because (i) hedge is not defined in the ITA and in the context of this case it was appropriate to consider the commercial context of hedging, as "well-accepted principles of commercial trading are acceptable as guidance": *Symes v. Canada*, [1993] 4 S.C.R. 695, and (ii) expert testimony on industry practice and on accounting principles related thereto are relevant: *Echo Bay Mines Ltd. v. Canada*, [1992] 3 F.C. 707. Where a statutory definition is absent, the Courts should be careful to disregard the valuable guidance offered by well-established business principles: *Canderel Ltd. v. Canada*, [1998] 1 S.C.R. 147.

The Court moved on to **define "hedge**" and noted that the ITA does note provide a definition (other than in the context of weak currency debts in subsection 20.3(1), which provides indirect guidance). In subsection 20.3(1), hedge is a derivative that is entered into primarily to reduce risk, where the derivative is properly designated as a hedge. In *Placer Dome Canada Ltd. v.*

Ontario (Minister of Finance), [2006] 1 S.C.R. 715, the SCC characterized hedging as referring to a transaction that offsets financial risk, and a transaction is a hedge where the party to it genuinely has assets or liabilities exposed to market fluctuations, and not in an amount in excess of risk exposure (which indicated speculation).

Here the Court held that the swaps were entered into over a period and that this period was close to the transaction dates that gave rise to the need to hedge against financial risk. The court did not find a problem with a parent holding company entering into the swaps on behalf of its subsidiaries.

The Court distinguished *Tip Top Tailors Ltd. v. Minister of National Revenue*, [1957] S.C.R. 703 and *Atlantic Sugar Refineries Ltd. v. Minister of National Revenue*, [1949] S.C.R. 706, as both those cases involved earnings from derivatives linked to commodities used in the business of the taxpayer. Here, the swaps were not the purchase or sale of commodities; rather they serve to stabilize the value of foreign currency assets exposed to currency risk on the company's balance sheet (para 77). The character of the hedge gain or loss depends on the characterization of the underlying item to which the hedge relates - the risk being hedged (para 80).

It appears that the Court accepts a transaction to be a hedge where: (i) the transaction is recorded as a hedge in its financial statements for accounting and tax purposes; (ii) the transaction was not speculation ; and (iii) the amount of the hedge matches as closely as possible the amount of the financial risk being hedged against (Para 96). Further, the character of the hedge gains or losses depend on the character of the underlying item being hedged - if the risk being hedged is capital in nature, the gain or loss from the hedging transaction will also be capital in nature (absent a secondary intention) (para 97). The Court concluded, at paragraph 98:

> [98] In sum, the present case involves a situation that has not previously been brought before the courts, at least that I am aware of. The appellant made a commercial and business decision, after careful consideration, to enter into the swaps in order to protect its consolidated group equity. It knew better than anyone else the consequences of having its net investment assets exposed to the risk of currency fluctuations. The swaps are commercial derivatives designed expressly to circumvent that kind of risk. As stated by Ms. Frost, the swaps were not speculative transactions. They were designed for hedging in the financial market. Now when the risk vanished, there was no need to keep the swaps. Here, GWL was satisfied that the swaps were no longer necessary when the risk exposure of the net investment assets was reduced significantly. They therefore decided to unwind the swaps. I have concluded that the swaps were entered into to protect a capital investment, and therefore they were linked to a capital asset. Absent unacceptable risk with regard to those capital assets, the swaps had to be terminated since the reason for their existence no longer applied, and the gain or loss from unwinding the swaps should, in my view, be treated as being on capital account. The swaps were not linked in any manner to any business income per se.

The Court rejected the Crown's alternative argument that the gain was from an adventure or concern in the nature of trade, by referring to the factors that determine whether an adventure is an adventure or concern in the nature of trade in *Belcourt Properties Inc. v. The Queen*, 2014 TCC 208, and *Happy Valley Farms Ltd. v. The Queen*, [1986] 2 C.T.C. 259. Having rejected the existence of an initial and/or secondary intention to enter into a profit making scheme, the transaction failed to meet this test.

Sas Ansari, BSc BEd PC JD LLM PhD (exp) CPA In-Depth Tax 1, 2 &3

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