

Taxation of Foreign Exchange Options - Sas Ansari

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Kruger Incorporated v The Queen, [2016 FCA 186](#)

At issue in this appeal was whether foreign exchange options are subject to market-to-market accounting for recognition of profits and losses and whether they are inventory that can give rise to losses at the year-end based on their value.

The TCC held ([2015 TCC 119](#)) that the options were not subject to market-to-market accounting. However, Chief Justice Rip (as he then was) held that the options were inventory.

The FCA held:

- The realization principle is not overarching in that an exception needs to be provided by the ITA - Section 9 only requires that the method chosen be one that accurately reflects income for the year;
- Inventory must be property that is held for sale; and
- The ITA contains more than two types of property - capital and inventory - with purchased options being an example of the third type.

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FACTS

The taxpayer manufactured paper products. About 80% of the taxpayer's receivables were in USD. In order to reduce exposure to foreign currency fluctuations it purchased and sold foreign currency option contracts and began to produce profits from this activity on an "individual profit center basis", growing to be an industry leader in terms of volume in dealing with derivative products.

For the purchaser, the upside is unlimited while the downside is limited by the premium paid. For the issuer, the downside is unlimited while the upside is limited to the premium charged. In 1997 it began to use market-to-market accounting for financial reporting purposes in relation to the options activities. Market-to-market accounting:

is an accrual method of accounting whereby both the writer and the purchaser value the

option at market as at balance sheet date [...] and recognize any change in the market value as a gain or loss for the period [...]. For that purpose, the premium reflects the value of the option at inception, positive in the case of the purchaser and negative for the writer

All or almost all of the taxpayer's options were "European" and "over the counter" - may only be exercised on their expiry and traded privately - could be transferred before expiry with the consent of the counter party, and could be closed off by entering into offsetting positions. At the end of the year, it claimed losses on the basis of the difference between the value of the option at the beginning of the year compared to the end, and it also deferred the premium paid until the maturity date of the option.

The Minister took the position that market-to-market accounting was not an option for the taxpayer and losses and income, including premiums, are only reportable on close of the option - realization basis.

The Tax Court held that the [ITA](#), other than sections 142.2 to 142.5, and [Regulations](#) 1801, do not allow for market-to-market accounting and that the taxpayer was not helped by the administrative policy of the CRA allowing financial institutions to use this method for options. Absent a legislative provision permitting the taxpayer to deviate from the realization principle, foreign exchange options had to be valued at historical cost such that gains/losses cannot be recognized until the option was disposed of or expired.

The Tax Court, however, held that the taxpayer was in the business of buying and selling contracts and, on the basis of the definition of "inventory" in 248(1) not requiring the property to be held for sale, found the options to be inventory. This was only for options purchased as they conferred a "right" which falls within the definition of "property" in 248(1) but not the options written as they give rise to a liability.

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ANALYSIS

Market to market accounting

The FCA stated the analysis by stating that the question of law - the calculation of income and loss from a business pursuant to ITA 9(1) and (2) - is reviewed on a standard of corrected. This requires the court to understand the exact nature of the taxpayer's business. Despite realisation being at the core of Canada's income tax system, where it can be shown that another method provides a more accurate picture of the taxpayer's income for the year, that

other method can be used by the taxpayer to determine its income or loss under ITA s 9(1) and (2) (para 59) - *Canadian General Electric Co. v. M.N.R.*, [\[1962\] S.C.R. 3](#). There is no need for the ITA to provide an exception to realization for a different method to be available to the taxpayer (para 65). The realization principle can be departed from where it provides a better picture of the taxpayer's income for the year (para 66). Realization is not an overarching principle (para 66).

The FCA concluded, at paragraph 70:

As was stated in *Candereel*, "the goal of the legal test of 'profit' should be to determine which method of accounting best depicts the reality of the financial situation of the ... taxpayer" (*Candereel*, para. 44). This coincides with the goal which mark [sic] to market accounting seeks to achieve on the facts of this case i.e.: recognizing income or losses based on the amount which can be realized by dealers in derivatives at the balance sheet by *inter alia* entering into an offsetting contract [...]. As it is otherwise undisputed that this method is consistent with well accepted business principles, GAAP and international accounting, I am satisfied that the appellant has made a *prima facie* demonstration that mark [sic] to market accounting provides an accurate reflection of its income.

Unless the crown can show that its preferred method shows a better picture of income for the taxpayer than the taxpayer's preferred method, the taxpayer can use its accounting method (para 71).

Contracts as inventory

Are contracts inventory of the taxpayer, losses on which can be recognized pursuant to ITA s 10(1) and 1801 of the Regulations? The inventory adjustment is mandatory.

Subsection 10(1) requires that a taxpayer who carries on business must value inventory on hand at the end of the taxation year at the lower of cost or fair market value. If the FMV is less than cost, the loss is recognized that year.

Inventory is defined in subsection 248(1) of the ITA as meaning "a description of property the cost or value of which is relevant in computing ... income from a business..". The ITA deviates from GAPP and allows intangible property to be treated as inventory - *M.N.R. v. Curlett*, [\[1967\] S.C.R. 280](#); *Dobienco v. M.N.R.*, [\[1966\] S.C.R. 95](#); *CDSL Canada Limited et al. v. The Queen*, [2008 FCA 400](#). The ITA also recognizes explicitly at the work in progress of a professional is "for greater certainty" inventory - ITA s 10(5). Also , only rights can be property such that liabilities cannot be property - *Tip Top Tailors Limited v. M.N.R.*, [\[1957\] S.C.R. 703](#).

The FCA also held that in order for property to be inventory, it must be held for sale (para 87). The SCC in *Friesen v. Canada*, [\[1995\] 3 S.C.R. 103](#), at para 23, said:

“inventory” in the [Act] is consistent with the ordinary meaning of the word. In the normal sense, inventory is property which a business holds for sale and this term applies to that property both in the year of sale and in years where the property remains as yet unsold by a business.

Purchased options are neither inventory nor capital property, but rather are a different type of property (para 100). Written options are not property. The FCA stated, by reference to *Canderel Ltd. v. Canada*, [\[1998\] 1 S.C.R. 147](#):

As noted earlier, the purchased options are property under the Act but they are neither capital property nor inventory. In contrast, the written options escape all three labels since they only embody the obligation to deliver funds in the future. Yet, the evolving value of both instruments is relevant in determining the appellant’s income under the Act. In short, although the Act is premised on the existence of two broad classes of property, it imposes no limit on the types of property or indeed liabilities that can impact on the computation of income and which must be recognized for that purpose since the goal pursuant to section 9 of the Act is to provide an accurate picture of that income.

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