



Saskferco Products Inc. v. The Queen: **Hedge Accounting Principles and Foreign Exchange Recognition**

The Tax Court of Canada (the "TCC") has once again shot down a taxpayer's attempt to deduct foreign exchange losses on a current basis rather than as a capital loss. In our December 2006 Tax Law Update, we reported on the Supreme Court of Canada's decision to deny Imperial Oil and Inco current deductions on foreign exchange losses under s. 20(1)(f) of the *Income Tax Act* (Canada). More recently, in *Saskferco Products Inc. v. The Queen*, the TCC rejected the taxpayer's attempt to use hedge accounting principles as a basis for offsetting U.S. dollar revenues with foreign exchange losses on U.S. dollar debt to effectively "hedge" foreign exchange fluctuations for income tax purposes.

The Facts

Saskferco is a Saskatchewan based corporation which produces and sells fertilizer. In July 1990, Saskferco raised project debt from U.S. institutional lenders in the amount of US\$231 Million through a private placement to finance the construction of a nitrogen fertilizer plant in Saskatchewan. The debt was issued in the form of a series of notes (the "Notes") denominated in U.S. dollars with maturity dates ranging from 5 to 17 years and an average interest rate of 9.59%.

For the purposes of the tax appeal, the key issue was that the debt was denominated in U.S. dollars. During the period in question, the U.S. dollar had appreciated significantly against the Canadian dollar, resulting in large foreign exchange losses realized on the repayment of the loan principal.

Beginning in 1991, Saskferco adopted hedge accounting for financial statement purposes with respect to foreign exchange fluctuations on both the principal of the Notes and a portion of its U.S. revenues. In other words, the U.S. dollar revenue was considered to provide an effective hedge against fluctuations in the U.S./Canadian exchange rate. The basis for the decision was that it was thought that Saskferco was assured of having a sufficient flow of funds in U.S. dollars from its business revenues to satisfy the principal repayments on the Notes. This accounting treatment dictated that the U.S. dollar principal Note payments and the U.S. revenues used to pay them were both translated at the July 1990 exchange rate. As a result, the financial statements did not reflect any foreign exchange fluctuations for these amounts.

Saskferco also adopted this hedge accounting approach for its income tax purposes whereby the principal repayments of the Notes and the portions of U.S. revenues used to make those repayments were translated using the July 1990 exchange rate. The overall effect of this translation was the elimination of foreign exchange losses on the principal repayment of the Notes, and a decrease in U.S. dollar sales revenues (by an equivalent amount of the Note repayment) in years where debt repayments were made.

The CRA reassessed and reversed the effects of the hedge accounting. Specifically, U.S. dollar revenues were increased by translating them at the exchange rates in effect when the revenues were earned, and capital losses were permitted for the foreign exchange losses on the principal repayment of the Notes.

Tax Court of Canada Decision

Saskferco raised two arguments in support of its position. First, it argued simply that it is appropriate to adopt the same method of foreign exchange translation for both accounting and tax purposes. Alternatively, it argued that the foreign exchange loss on the Notes should be on income account rather than capital account because the Notes were denominated in U.S. currency in order to provide a hedge against foreign exchange fluctuations in its U.S. dollar sales revenue.

(i) Translation of Revenues

Saskferco's first argument was that where a taxpayer puts in place a hedge which effectively eliminates foreign exchange exposure on sales revenue, the sales proceeds are appropriately determined by taking the hedge into account. Justice Woods had little trouble rejecting this argument based on earlier jurisprudence. She indicated that the courts had developed a fundamental principle that in computing revenue and expense denominated in a foreign currency, a taxpayer must use the foreign exchange rate in effect at the time of the transaction. She went on to write that it may be appropriate to combine the two transactions for accounting purposes, but not for income tax purposes.

(ii) Foreign Exchange Losses

Saskferco's alternative argument was that it had decided to denominate the currency of the Notes in U.S. dollars in order to provide a hedge against currency fluctuations on its U.S. dollar sales revenue. It argued that for income tax purposes a hedging instrument such as this should be characterized by the item that was being hedged. As the hedge was with respect to sales revenue, the hedging instrument itself should be treated on income account for tax purposes rather than capital account. Saskferco relied on comments made by the Supreme Court of Canada in *Shell Canada Limited v. The Queen*¹ in support of this argument.

The Crown countered that the foreign exchange losses were capital losses and were therefore only deductible against any capital gains that Saskferco may incur. The Crown relied on *Shell Canada* and *CCLI (1994) Inc. v. The Queen*² which stand for the principle that a foreign exchange gain or loss on debt takes its character as income or capital from the character of the debt. In this instance, the Notes issued by Saskferco were used to finance a production facility (a capital asset) and therefore should take on the character of capital.

Again Justice Woods rejected Saskferco's argument in fairly short order. She stated that regardless of whether there is no principled basis to not apply the hedging principle to indebtedness, such an approach would be inconsistent with judicial precedent regarding foreign exchange losses on debt instruments. Thus, the foreign exchange losses suffered by Saskferco should be treated as capital losses since they pertain to capital debt. Interestingly, Justice Woods stated one may question the theory behind *Shell* and *CCLI* approach to characterization, but that it should be followed in the interests of providing certainty.

Although not the determining factor in her reasons for rejecting Saskferco's alternative argument, Justice Woods also made some notable comments with regards to the evidence that was presented to her on this issue. Saskferco's witness had testified that the only reason that Saskferco had decided to issue the project debt in U.S. dollars was to hedge against exchange rate risk on its business revenues and that otherwise the debt would have been denominated in Canadian dollars. Justice Woods took issue with this assertion as it was inconsistent with reports prepared by Saskferco's financial advisor, Merrill Lynch, that the United States had a deeper market of potential lenders and that lower interest rates could be obtained in the United States.

In her conclusion, Justice Woods stated that it was with

considerable regret that she dismissed the appeal, due to the harsh tax consequences inflicted on Saskferco (i.e. approximately \$13.5 million income inclusion for the 4 years under appeal). However, she felt that this was a tax policy matter that should be left for Parliament to address and not the courts.

Conclusions

The result in Saskferco is not particularly surprising as the TCC decision follows well established judicial precedent. What is perhaps more surprising is that Saskferco took such an aggressive tax position in the first place. Of course, the taxation years under appeal pre-date the Supreme Court of Canada's 1998 decisions in the trilogy of *Candere/ Ltd.*, *Toronto College Park* and *Ikea Ltd.* which rejected the notion that GAAP, rather than legal tests, would be determinative in calculating profit for income tax purposes. Perhaps this impacted Saskferco's decision at the time.

This case does reveal the unsatisfactory state of affairs with respect to Canada's tax treatment of foreign exchange gains and losses when considering the realities of financing international business operations. Justice Woods has made it fairly clear that she sees a need for change in this area; however, she sees this as a matter to be dealt with by Parliament. It will be interesting to see whether Saskferco is prepared to appeal this decision and take its novel arguments to the Federal Court of Appeal (and perhaps on to the Supreme Court of Canada) and whether the appellate courts are more receptive and willing to create new judicial precedent in this important area of tax law.

This update is intended as a summary only and should not be regarded or relied upon as advice to any specific client or regarding any specific situation. If you would like further information regarding the issues discussed in this update or if you wish to discuss any aspect of this commentary, please feel free to contact:

Kevin Fritz (416) 361-2933 kfritz@wildlaw.ca
George Nehme (416) 361-4788 gnehme@wildlaw.ca

Wildeboer Dellelce LLP



Suite 800
Wildeboer Dellelce Place
365 Bay Street
Toronto, ON M5H 2V1
Phone: (416) 361-3121
Facsimile: (416) 361-1790

72 Victoria Street South
Suite 305
Kitchener, Ontario N2G 4Y9
Phone: (519) 741-8708
Facsimile: (519) 741-9576

¹ *Shell Canada Limited v. The Queen*, 99 D.T.C. 5669 (S.C.C.).

² *CCLI (1994) Inc. v. The Queen*, 2007 D.T.C. 5372 (F.C.A.).