

**Date: 20081006**

**Docket: A-433-07**

**Citation: 2008 FCA 297**

**CORAM: NADON J.A.  
EVANS J.A.  
PELLETIER J.A.**

**BETWEEN:**

**SASKFERCO PRODUCTS ULC**

**Appellant**

**and**

**HER MAJESTY THE QUEEN**

**Respondent**

Heard at Toronto, Ontario, on September 16, 2008.

Judgment delivered at Ottawa, Ontario, on October 6, 2008.

**REASONS FOR JUDGMENT BY:**

**EVANS J.A.**

**CONCURRED IN BY:**

**NADON J.A.  
PELLETIER J.A.**

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**REASONS FOR JUDGMENT**

**EVANS J.A.**

**A. INTRODUCTION**

[1] For income tax purposes, foreign exchange losses or gains on the repayment of a loan denominated in a foreign currency take their character as income or capital from the nature of the loan. So, if a loan finances the construction of a capital asset, foreign exchange losses on repayments are on the borrower's capital account and cannot be used to reduce its income tax liability. See, for example, *CCLI (1994) Inc. v. The Queen*, 2007 FCA 185, 2007 D.T.C. 5372.

[2] The question to be decided in this appeal is whether the “debt principle” as the basis for characterizing a foreign currency loss or gain is displaced when an important reason for borrowing in a foreign currency is to “hedge”, or neutralise the impact of currency fluctuations on, income earned by the borrower in that currency from otherwise unrelated transactions.

[3] This is an appeal by Saskferco ULC from a decision of the Tax Court of Canada (2007 TCC 462) in which Justice Woods dismissed Saskferco’s appeal from its income tax assessments for the taxation years 1995, 1996, 1998, and 1999. In preparing its income tax returns, Saskferco had applied hedge accounting principles, whereby it booked both US dollar sales revenues (to the extent of loan repayments) and repayments of a loan denominated in US dollars at the rate of exchange prevailing when the loan was made. This effectively eliminated the impact of changes in the rates of exchange of US and Canadian dollars in the taxation years in question.

[4] In the notices of reassessment, the Minister reversed the effects of hedge accounting on the calculation of Saskferco’s tax liability by booking revenue at the exchange rates at the date of a sale and by booking loan repayments at the exchange rate when they were made. The effect was to increase Saskferco’s US dollar denominated sales revenue and to create foreign exchange losses when it made loan repayments. This result was purely the function of the direction in which the exchange rate had moved in the taxation years in question. Thus, if, instead of declining in these years against the US dollar, the Canadian dollar had appreciated, Saskferco would have shown less sales revenue, and gains on loan repayments.

[5] In addition to changing the timing of the exchange transactions, the Minister treated the gains and losses asymmetrically by attributing currency gains on sales revenue to income account, and currency losses on loan repayments to capital account.

[6] Saskferco appealed the Minister's notices of reassessment to the Tax Court of Canada. In dismissing its appeal, Justice Woods applied the principle that foreign exchange losses on loan repayments take their character from the debt. She rejected the claim that hedge accounting principles applied in this case so as to cancel out, for tax purposes, Saskferco's foreign currency losses and gains on its loan repayments and revenue from US sales respectively. Since the foreign exchange losses were on capital account they could not offset Saskferco's gains from its US sales in order to reduce its income tax liability.

[7] In its appeal to this Court, Saskferco says that, under the hedging principle, foreign exchange losses or gains take their character as income or capital from the nature of the transaction being hedged. Counsel argues that the Judge erred in law by ignoring the fact that an important reason for the loan of US\$231 million was to hedge Saskferco's US dollar income and that its foreign currency losses on the repayment of the loan were more closely linked to the loan's hedging purpose than to its financing purpose. The losses are therefore attributable to income account and are available to reduce Saskferco's "hedged" revenue from its US sales.

[8] In response, the Minister says that income tax liability is based on transactions, not overall economic reality. And, since the denomination of a loan in a foreign currency is not a transaction,

the only relevant transaction is Saskferco's borrowing to finance a capital project. Saskferco's foreign exchange losses on the loan repayments are therefore also on capital account for tax purposes.

[9] In my view, Justice Woods made no reversible error in reaching her conclusion. Accordingly, I would dismiss the appeal.

***B. FACTUAL BACKGROUND***

[10] While planning to embark on the production of nitrogen-based fertilizer, Saskferco estimated that approximately 50% of future sales would be in US markets, and that the annual revenue from total sales would be US\$100 million. The Province of Saskatchewan's potential partner in the joint venture was concerned about the exposure of the US sales revenue to currency fluctuations. If the Canadian dollar appreciated against the US dollar, the value of the Saskferco's US sales revenue would be diminished when converted into Canadian dollars, an especially important consideration since most of its operating and construction costs would be payable in Canadian dollars.

[11] On the basis of a report by its financial adviser, Saskferco financed the construction of its plant largely by issuing notes totalling US\$231 million, repayable in instalments. Denominating the loan in US dollars allowed Saskferco to take advantage of lower interest rates in the United States and to protect itself against uncertainties in its revenue from US sales as a result of currency fluctuations in the relative values of the US and Canadian dollars. US dollar revenues from

Saskferco's sales would be used to repay the notes. This matching of foreign denominated revenues against debts or other expenses in a foreign currency is known as a "natural hedge".

[12] Saskferco adopted this means of minimising the effects of currency fluctuations on its sales revenue because it had been unable to enter into contracts at a commercially viable cost for the forward purchase of US dollars, or other kinds of "derivative" contracts commonly used to provide a hedge against foreign exchange exposure on a transaction in a foreign currency.

[13] In the four taxation years in question in this appeal, years when notes were repaid, the Canadian dollar declined sharply against the US dollar. This resulted in total foreign currency losses on Saskferco's repayments of principal in these years of more than Cdn\$13 million.

[14] Saskferco was advised by its auditors that it could offset the foreign currency gains on its US sales revenues and losses on its loan repayments by using hedge accounting, if it preserved sufficient US dollars from its sales revenue to make loan repayments. Because the value of Saskferco's sales exceeded its loan repayments, the loan did not hedge its entire US revenue. The "unhedged" portion of the revenue was converted into Canadian dollars at the rate of exchange rate prevailing when it was earned.

[15] In fact, Saskferco converted the US dollar proceeds of its sales into Canadian dollars because it could earn a higher rate of interest in Canada. In order to preserve the hedge, Saskferco purchased derivative contracts at the time when the sales revenue was converted, in order to

eliminate any currency exposure between the times when the sales revenues were received and the loan repayments were made.

**C. DECISION OF THE TAX COURT**

[16] Justice Woods addressed two issues. First, Saskferco argued that the hedge accounting principles used for calculating Saskferco's sales revenue in its financial statements were equally applicable for income tax purposes. Thus, for the years that loan repayments were made, Saskferco calculated the portion of its sales revenues needed to cover the exchange losses on the loan repayments, as well as the repayments of the loan itself, in Canadian dollars at the rate of exchange when the notes were issued. Hedge accounting was said to be appropriate because it reflected the reality of Saskferco's financial position by cancelling currency losses on the loan repayments and currency gains on the sales revenue.

[17] Justice Woods rejected this argument, which she described as the "primary argument of the appellant", and held that, even if this method of accounting conformed to generally accepted accounting principles, it was not acceptable for calculating profit for the purpose of subsection 9(1) of the *Income Tax Act*, R.S.C. 1985 (5<sup>th</sup> Supp.), c. 1.

9.(1) Subject to this Part, a taxpayer's income for a taxation year from a business or property is the taxpayer's profit from that business or property for the year.

9.(1) Sous réserve des autres dispositions de la présente partie, le revenu qu'un contribuable tire d'une entreprise ou d'un bien pour une année d'imposition est le bénéfice qu'il en tire pour cette année.

[18] The Judge held that it was contrary to the principle, supported in the jurisprudence, that a taxpayer must use the rate of exchange at the time of the transaction, which, on the present facts,

was when the contracts of sale and the loan repayments were made. Saskferco does not challenge this conclusion in its appeal.

[19] Second, Justice Woods refused to apply to the facts of this case the principle that a hedging contract takes its character as income or capital from the character of the item hedged. She pointed out that, while hedge accounting principles look at the reality of a business's financial position, the *Income Tax Act* makes a fundamental distinction between income and capital.

[20] The Judge found that, unlike other kinds of "derivative" transactions (such as contracts for the future purchase of foreign currency and currency "swaps") entered into to hedge items on income account, Saskferco's loan was denominated in US dollars not only to hedge its foreign exchange exposure on the sales revenue, but also to reduce the cost of financing the construction of its plant by obtaining a lower rate of interest. She was not satisfied that the loan would have been denominated in Canadian dollars even if currency fluctuations had not been a consideration.

[21] In these circumstances, Justice Woods concluded that the jurisprudence establishing that foreign exchange losses on a debt take their character from that of the debt applied in this case, even though protection against currency fluctuations was "an important factor" (at para. 80) in Saskferco's decision to denominate the loan in US dollars. Accordingly, Saskferco was entitled to use losses on the loan to reduce only capital gains, not income.

[22] However, Justice Woods was not unsympathetic to the position of Saskferco, describing (at para. 87) as “harsh” the asymmetrical tax consequences of attributing foreign exchange losses on the debt to capital account, and gains to income. She also seemed to imply (at para. 80) that, if the loan had been denominated in US dollars solely to offset foreign exchange losses (that is, interest rates were not a consideration), the result would have been different. Because these observations are not integral to her decision, I do not wish to express a firm view on their correctness. I would, however, make two points.

[23] First, when the Canadian dollar appreciates against the US dollar, Saskferco’s foreign currency gains on the loan repayments will be on capital account, thus making it liable to tax at the lower rate imposed on capital gains. This, in my view, mitigates the alleged “harshness” of the effect of the tax asymmetry in the present case, whereby Saskferco must pay income tax on all foreign exchange gains on its sales revenue.

[24] Second, as for the suggestion that it would (or should) have made a difference if Saskferco had denominated the loan in US dollars solely for currency exchange reasons, I would note that, unlike other arrangements for hedging currency exposure, such as the forward purchase of foreign currency, Saskferco’s loan had an independent commercial purpose (financing the construction of the plant) that was unrelated to the contracts of sale. That Saskferco was unable to enter into a derivative contract at a commercially viable cost does not warrant treating foreign currency losses on the repayment of money borrowed to finance a capital expenditure as on income account for tax purposes.

**D. ISSUES AND ANALYSIS**

[25] Since the determination of this appeal turns on a question of law, correctness is the applicable standard of review. So much is common ground.

[26] The legal issue to be decided in this appeal is fairly narrow. Saskferco does not base its argument on the interpretation of a provision of the *Income Tax Act*. It is conceded that subsection 39(2), which deems foreign exchange losses to be on capital account, only applies if the underlying transaction in connection with which the losses were incurred is capital in nature: *Imperial Oil Ltd. v. The Queen*, 2004 FCA 361, 2004 D.T.C. 6702 at para. 16. Nor is there any judicial authority directly on point.

[27] Counsel for Saskferco says that the question at stake is one of principle: should the tax treatment of exchange losses and gains on contracts for the forward purchase of foreign currency to protect against foreign exchange exposure on other transactions on revenue account apply to the facts of this case, where hedging was an important, but not the only, reason for its US dollar denominated loan. He submits that the answer is to be found in deciding which of two competing principles is applicable here: foreign exchange gains or losses take their character as income or capital from that of the underlying loan or, when foreign exchange gains or losses arise on a hedging transaction, they take their character from that of the hedged transaction.

[28] Acknowledging that liability under the *Income Tax Act* is based on transactions, Saskferco says that the transaction in question here is its US dollar denominated loan. It concedes that the

denomination of a loan in a foreign currency is not an independent transaction: *Canadian Pacific Ltd. v. The Queen*, [2002] 3 F.C. 170, 2001 FCA 398 at para. 23 (*Canadian Pacific*). Rather, Saskferco argues that the currency of its loan is an element of the loan when viewed in its totality, and that the foreign exchange losses incurred in repaying it are more closely connected to the loan's hedging than to its financing function.

[29] Attractively as counsel put his argument, I cannot accept it. First, I do not see how one can avoid the conclusion that the relevant transaction is a loan taken to finance the construction of a capital project, the proceeds of which were in fact used for this purpose. The loan was unrelated to the US sales, except in the obvious, but irrelevant, sense that, without the plant, Saskferco would have had no fertilizer sales at all. Indeed, the foreign exchange gains on the sales revenues arose at different times from the losses on the loan: that is, the conclusion of the contracts of sale and the repayments of the loan. Sales income was entered throughout the year as it arose, while loan repayments were entered once a year.

[30] The fact that the loan was denominated in US dollars for financing and foreign exchange reasons does not alter its essential character as borrowed money to finance a capital project: *Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622 at para. 32. Therefore, foreign currency gains or losses on its repayment are also on capital account.

[31] Second, the case principally relied upon by Saskferco as supporting its position is *Netupsky v. The Queen*, 92 D.T.C. 2282 (T.C.C.), where a taxpayer was able to claim currency exchange

losses on a loan denominated in Swiss francs, even though the proceeds of the loan, when converted into Canadian dollars, were used to refinance a rental property.

[32] *Netupsky* is distinguishable from the present case because it did not involve a hedge, and (although this is not altogether clear) the taxpayer's only purpose in borrowing in Swiss francs seems to have been to make a profit from speculating in commodities. More important, however, the basis of the Court's decision was that the taxpayer had entered into two separate transactions: the borrowing in Swiss francs, and their conversion into Canadian dollars and use for the mortgage. However, this reasoning is inconsistent with the subsequent decision of this Court in *Canadian Pacific*, holding that the denomination of a loan in a foreign currency is not a transaction separate from the borrowing. *Netupsky* thus does not materially assist *Saskferco*. To the extent that *MacMillan Bloedel Ltd. v. The Queen*, 90 D.T.C. 6219 (F.C.T.D.) was decided on the basis that a borrowing and its currency denomination constitute two transactions, its authority is also in doubt.

[33] Third, the law of taxation rests largely on a complex statutory scheme in which particularities rather than general principles normally determine outcomes. Hence, courts should approach with considerable scepticism arguments based solely on general principle, even where, as here, the *Income Tax Act* does not deal comprehensively with an issue. It is notoriously difficult for policy-makers, let alone judges, to foresee the ramifications of general principles when employed as the basis for the determination of liability to tax.

[34] Whether courts have accepted hedge accounting as a taxation principle at the level of generality urged upon us by Saskferco seems to me highly questionable. The attribution of foreign exchange gains or losses on income account for tax purposes when income transactions are hedged by derivative contracts is an inadequate basis for extending them to commercially independent transactions and thereby departing from the well-accepted principle that foreign exchange losses on the repayment of a loan take their character from that of the loan itself.

[35] Counsel argued that it would be bad public policy for the Court not to generalize hedge accounting principles and apply them to the facts of this case for tax purposes. In particular, he said, for the law of taxation to prefer some hedging transactions (derivative contracts) over others with a hedging purpose (the loan in this case) would have a distorting effect on the market, to the detriment of international trade and commerce, because a “natural hedge” would not eliminate all the uncertainties flowing from currency fluctuations. I am not in a position to assess the merits of this argument; it is more appropriately raised as a policy issue with the Department of Finance and, ultimately, with Parliament. It cannot, in my view, warrant the Court’s extension of the law respecting the tax treatment of losses and gains on hedging transactions in the manner urged by Saskferco.

[36] I would only note in this context that, tax consequences aside, the foreign exchange risks were in fact hedged as intended, albeit that, since the value of the Canadian dollar declined during the taxation years in question, foreign exchange gains on Saskferco’s sales revenues offset losses on

its loan repayments, and not *vice versa*. Tax considerations appear to have played no part in Saskferco's decision to denominate the loan in US dollars.

***E. CONCLUSIONS***

[37] For these reasons, I would dismiss the appeal with costs.

"John M. Evans"

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J.A.

**FEDERAL COURT OF APPEAL**

**NAMES OF COUNSEL AND SOLICITORS OF RECORD**

**DOCKET:** A-433-07

**APPEAL FROM AN ORDER OF THE HONOURABLE MADAM JUSTICE WOODS OF  
THE TAX COURT OF CANADA DATED AUGUST 10, 2007, FILE NO. 2004-3592 (IT) G.**

**STYLE OF CAUSE:** SASKFERCO PRODUCTS INC. v.  
HER MAJESTY THE QUEEN

**PLACE OF HEARING:** Toronto, Ontario

**DATE OF HEARING:** September 16, 2008

**REASONS FOR JUDGMENT:** Evans J.A.

**CONCURRED IN BY:** Nadon J.A.  
Pelletier J.A.

**DATED:** October 6, 2008

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