Docket: 2003-3262(IT)G

BETWEEN:

KRUGER INCORPORATED,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Before: The Honourable Justice Gerald J. Rip

Appearances:

Counsel for the Appellant:	Louis Tassé Roger Taylor Marie-Claude Marcil
Counsel for the Respondent:	Josée Tremblay

AMENDMENT TO REASONS FOR JUDGMENT

Pursuant to Rule 172 of the *Tax Court of Canada Rules* (*General Procedure*), these amended reasons for judgment are issued in substitution to the reasons for judgment issued on May 26, 2015.

Upon paragraphs [9] and [10] having been inadvertently inverted;

The reasons for judgment issued on May 26, 2015 are therefore amended so that former paragraph [10] now reads as paragraph [9], and former paragraph [9] now reads as paragraph [10], as per the attached amended reasons for judgment.

Signed at Ottawa, Canada, this 10th day of June 2015.

"Gerald J. Rip"

Rip J.

Citation: 2015 TCC 119
Date: 2015**0610**
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AMENDED REASONS FOR JUDGMENT

Rip J.

Executive Summary

The main issue in this appeal is whether, in computing income for the year, Kruger can mark to market foreign exchange option contracts at the end of its fiscal year. The Crown's position is that foreign exchange contracts are to be valued only when realized. Expert evidence agree that for financial reporting purposes, mark to market is the appropriate method of valuing such options. The *Income Tax Act* ("*ITA*" or "*Act*") requires financial institutions, as defined, to mark to market what it defines as "mark to market property". Foreign exchange option contracts are not included in the definition of such property (section 142.2 of the *ITA*).

Nevertheless, for ease of administration of the *ITA*, the Canada Revenue Agency ("CRA") has taken upon itself to permit financial institutions to mark to market such option contracts. It also permits some regulated businesses that are not defined as "financial institutions" to mark to market property.

Kruger is not a financial institution and does not carry on a regulated business. However, it is one of the larger participants in the Canadian market. It values its foreign exchange option contracts on a mark to market basis for both tax and financial reporting. The mark to market values used by Kruger were the values it adopted from its co-contractors, various banks, the values of which may vary from bank to bank. The CRA did not allow the appellant to mark to market value its foreign exchange option contracts as at the end of its 1998 taxation year.

A taxpayer is to value its property on a consistent basis. Mark to market valuation may create income in one year and a loss in another year. A taxpayer is to include an amount in income for the year or deduct an amount in computing income for the year only if required or permitted by the *ITA*. Mark to market valuation should be applied only in the limited circumstances where it is sanctioned by the *ITA,* by section 142.2 and section 1801 of the *Income Tax Regulations* ("*ITR*").

Kruger's alternative argument was that it was in the business of both writing and purchasing foreign exchange option contracts and that the contracts were inventory. Kruger did carry on such a business. However, the foreign exchange option contracts it wrote were liabilities and not inventory. The contracts it purchased were inventory and may be valued accordingly.

INTRODUCTION

[1] The principal subject matter of this appeal from the income tax assessment for 1998 of Kruger Incorporated ("Kruger") is whether, in computing income for the year, foreign exchange option contracts should be valued mark to market at the end of the appellant's taxation year, as claimed by Kruger, or when finally realized, as assessed. Appellant's alternative submission is that in 1998 it carried on a business in which the contracts are property that is inventory and in computing its income from its business for 1998 the contracts are to be valued as such in accordance with subsections 10(1) and 248(1) of the *Act* and section 1801 of the *ITR*. In effect, mark to marketing the contracts and valuing them as inventory in accordance with section 1801 of the *ITR* would have the same result.

DEFINITIONS

[2] These reasons refer to several foreign exchange option contract terms[1] which are summarized in the following paragraphs:

a) A "Derivative" is a contract between two or more parties whose price is dependent upon or derived from, one or more "underlying assets" or factors. Its value is determined by fluctuations in the price of the underlying asset or factor.

b) A "European option" is an option that may be exercised only on its expiry date. Kruger entered into European Options which constituted the bulk of the foreign currency market.

c) The "Holder" or "Purchaser" of a "call" option wants the price of the foreign currency to increase above the strike price; the

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[1] These terms were summarized or defined by Mr. Richard Poirier, Ms. Patricia O'Malley, C.P.A. C.A. and Professor Peter Klein, expert witnesses at the hearing of the appeal.

holder or purchaser of a "put" option wants to price the currency to decrease to be less than the strike price.

d) The "Intrinsic Value" of a derivative contract is the difference between the current price of the derivative and the strike price, i.e. the gain that would be made if the option expired based on current conditions, also known as the amount by which the option is "in the money". Only "in the money" options have an intrinsic value. If the strike price of a call option is above the current price of the underlying asset, the call option is "out of the money". An option is "in the money" when the strike price is below the underlying asset's price because the holder could exercise the call option by paying the strike price and profiting on the balance. Put options are the exact opposite; it is "out of the money" when the strike price is below the current market price of the underlying asset and "in the money" when the strike price is above the current price.

e) "Mark to market" method of accounting is an accrual method of accounting by which both parties to the option, the option holder/purchaser and the option writer/issuer, recognize and value the option at its market value as at the date of the balance sheet, in this appeal, December 31, 1998, and recognize any changes in market value from the beginning to the end of the period as a gain or loss in the income statement. It is relevant for tax purposes when an option entered into in one taxation year expires in a subsequent taxation year. When a liquid security is traded in an open market, the mark to market value is easy to determine by reference to its most recently traded price. When there is no open market or exchange, the mark to market value is calculated in accordance with various pricing models.

f) A "Market Maker" is a person, usually a bank, who participates in transactions to facilitate the desire of clients to purchase or write options.

g) An "Option contract" is a derivative contract by which one party, the writer or issuer, sells (or issues) the contract to another party (the option holder or purchaser) for the payment of a premium. Under the contract the purchaser may have the right, but not the obligation to buy or sell the underlying asset, in the examples at bar, foreign currency, at a fixed price (the "strike" or "exercise price") on a specific date or during a specified period of time ("expiration" or "exercise" date).

h) "Over the counter" or "OTC" market refers to privately negotiated option contracts between the principals to the contracts, in the appeal at bar, between Kruger and its individual counterparty banks.

i) The "Premium" is the consideration or price paid for the option. The holder (or purchaser) of an option cannot lose more than the premium the holder paid for the contract, no matter what happens with the value of the foreign currency. The potential profit to the holder is unlimited in theory; the value of the foreign currency can increase based on the market. If the value of the foreign currency is less than the strike price, the holder would let the option expire. On the other hand the writer (or issuer) of an option cannot gain or profit more than the premium already received in value, the writer must absorb the increase. A premium has two components, "intrinsic value" and "time value".

j) "Realization" for accounting purposes is similar to cash basis accounting, as opposed to mark to market accounting which is an accrual method of accounting. In the realization method of accounting, a transaction is recognized as complete when an entity has a claim to be paid in cash or an obligation to pay cash. The realized value is certain and not subject to any estimate of value.

k) The "Strike Price" or "Exercise Price" is a fixed exchange rate in the contract at which the option may be exercised; i.e., that the purchaser of the option must pay the writer (or issuer) to exercise the "call" option to acquire the underlying asset, the foreign currency in this appeal, or the amount that the holder (or purchaser) will receive from the writer (or issuer) on the exercise of a "put" option to sell the foreign currency. The "Pay off" represents the value that flows from the writer to the owner of an option if and when exercised. European style options can only be exercised at the maturity date of the option at which date the "Pay off", if positive, is realized.

l) An option's "Time Value" is the difference between its market value and its intrinsic value.

m) The "Underlying Asset" in the options referred to in these reasons is foreign currency, primarily, if not wholly, United States dollars.

n) "Volatility" is the variation in price of an underlying asset during a specified period, the fluctuation in value of the underlying asset during the term of the option. It is a variable in option pricing formulas showing the extent to which the price of the underlying asset may fluctuate between the date the option is valued and its expiration date.

ISSUES

[3] After all is said and done, the principal issue in this appeal is whether Kruger, for purposes of computing its income or loss for the year under the *Act*, may value its foreign currency option contracts at the end of its financial year on a mark to market accounting method[2]. All of the options in issue were entered into Kruger's 1998 taxation year and were to be exercised in its 1999 taxation year. In the event it cannot value its derivative properties on the mark to market basis, then the appellant argues that the derivative properties were inventory, thus permitting Kruger to value the contracts, in accordance with section 10 of the *Act* in computing income for 1998 at the lower of their costs or fair market values, whichever is lower, or in accordance with section 1801 of the *ITR*, their fair market value.

[4] In filing its income tax return for its taxation year ending on December 31, 1998, Kruger claimed losses aggregating $91,104,379 from a business of trading in

2 In its Fresh as Amended Notice of Appeal the appellant stated that it traded in forward exchange contracts and currency options. The evidence, including the reports of experts, was directed almost wholly to foreign exchange currency option contracts as did the respondent's reply.

derivatives, applying subsection 9(2) of the *Act*[3]. The position of the Minister of National Revenue ("Minister") is that the amount of $91,104,959 was not deductible in computing Kruger's income for 1998, but the amount of $18,696,881 which Kruger had included in computing its income as the amortized portion of the net of premium income and premium expenses regarding the foreign exchange option contracts are to be excluded in computing its income for 1998, with the result that the appellant's income for 1998 was thereby increased by the net amount of $72,407,498, the difference between $91,104,379 and $18,696,881[4]. The Minister also included the amount of $91,104,379[5] in Kruger's taxable capital for purposes of the large corporations tax: subsection 181.2(3) in Part 1.3 of the *Act*. The appellant opposes such inclusion in its taxable capital.

[5] The Minister also says that Kruger was not carrying on a business of trading in derivatives and the derivatives were not inventory of the appellant[6]. The Minister considered the losses to be "merely a reserve or contingent amount", the deduction of which is prohibited by section 9 and paragraph 18(1)(*e*) of the *Act*. For income tax purposes Kruger is required to calculate its gains or losses from the derivative contracts on the realization method. Apparently, the purported fair market values of the contracts were less than their costs at year end. Therefore, if the contracts are inventory, they would be valued at fair market value, potentially producing the same result to income as valuing the contracts mark to market.

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3 Kruger participated in its derivative trading with a wholly owned subsidiary, Corner Brook Pulp and Paper Limited, and approximately 75 per cent of losses were allocated to Kruger and 25 per cent to Corner Brook. The actual losses claimed for 1998 on derivative contract trading were $122,099,337, that is, $91,104,379 by Kruger and $30,994,959 by Corner Brook.

4 Kruger amortized an amount of $18,696,881 as the net amount of premiums to December 31, 1998 and determined that an amount of $32,883,453 was left to be amortized in the future.

5 The parties agree that whether the $91,104,379 be included in Kruger's capital for purposes of Part 1.3 will depend on whether the amount was a loss or an expense, as Kruger claims, or a reserve or contingent amount for which a deduction is prohibited by paragraph 18(1)(*e*) of the *Act*.

6 The fact that the appellant was reporting income (or loss) on income account and this was accepted by the Crown seems to contradict its position that Kruger’s activity in foreign exchange option contracts was not a business.

PLEADINGS

[6] The parties agree that Kruger entered into foreign exchange option contract transactions as a speculator to profit from the sale or purchase of such options, anticipating, rightly or wrongly, on how foreign exchange rates would move in the future. The parties also agree that Kruger reported its income and losses from trading in foreign option contracts on income account.

[7] In her pleadings, at paragraph 20(4) of her Further Fresh Reply to the Notice of Appeal, the respondent referred to the appellant amortizing a portion of the net of premium income and premium expenses, $18,696,881, regarding the option contracts and as a result, the appellant's income was thereby increased by $72,407,498, the aggregate being $91,104,379[7].

[8] The respondent submitted that the mark to market values recorded by Kruger were not in accordance with mark to market valuations since it amortized the premium paid. Respondent's counsel referred to this as a "hybrid" method which created inaccuracies in computing income. Appellant's counsel submitted that the respondent's allegation that Kruger did not properly apply mark to market accounting was not pleaded and ought to be rejected.

[9] **The respondent led evidence that the mark to market method requires that any premium on options should not be amortized over the life of the option but, rather, should be entered in the computation of income when paid and received. The appellant states that the respondent did not question the appellant's method of amortization in its pleadings and is therefore not permitted to raise the issue at trial.**

[10] **The respondent did question the appropriateness of amortizing a premium in mark to market accounting. The purpose of pleadings is to inform the other party of one's position, not to take the other party by surprise. I do not believe the allegation in subparagraph 20(4) is sufficient to inform the**

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[7] 20(4) "… that the said amount of $91,104,379 was not deductible in computing the Appellant's income for the 1998 taxation year, but that the amount of $18,696,881, which the Appellant had included in computing its income for that year as the amortized portion of the net of premium income and premium expenses regarding the said foreign currency option contracts fell to be excluded in computing the Appellant's income for that year, with the result that the Appellant's income for that year was thereby increased by the net amount of $72,407,498."

appellant that the very foundation of its method of valuing its option contracts was being challenged. Accordingly, I did not consider this submission.

<u>EVIDENCE</u>

<u>Kruger's activities</u>

[11] Mr. George Bunze, Vice-chair and Director of Kruger as well as Chair of its Audit Committee, testified on the appellant's behalf. Kruger is a private corporation although one of its subsidiaries offers shares to the public. Its core business is the manufacturing of newsprint and coated paper products and tissue paper which, during the period 1997 to 2004, Kruger sold as to 80 per cent to the United States and the balance to the United Kingdom and South America. Canada is not one of its significant markets. Kruger is the third largest newsprint company in North America. Kruger also operates a lumber business selling to the U.S. market.

[12] Consolidated sales by Kruger and its subsidiaries, Mr. Bunze testified, were "around $2,500,000,000" during the period 1997 to 2004. The sales by the appellant itself were "about a billion dollars". Accounts receivable of Kruger and its subsidiaries are "around the $175,000,000 to $200,000,000 at any point in time". Mr. Bunze estimated that 75 per cent of the receivables are in U.S. dollars.

[13] In the 1980s, recognizing its exposure to foreign currencies, Kruger started to purchase and sell foreign currency option contracts, principally United States dollars, on its own behalf and on behalf of a wholly-owned subsidiary, Corner Brook Pulp and Paper Limited. At times when newsprint prices were rapidly declining, Kruger participated in hedging commodities but this was not done on a regular basis, according to Mr. Bunze.

[14] Kruger started trading in foreign currency contracts by hiring a trader to help make "more sophisticated" trades and maximize profits. Later Kruger was employing a group of four experienced and knowledgeable full-time traders to trade derivatives on its behalf. Kruger's volume in dollars of purchases of derivate products, Mr. Bunze stated, placed Kruger in the top three or four non banking enterprises in Québec, after the Caisse de Dépôt and Hydro Québec. For the purpose of managing credit risk, Mr. Bunze said, Kruger in 1998 dealt with both Schedule "A" Canadian banks, led by the Bank of Montreal, Royal Bank, TD Bank and Banque Nationale, as well as Schedule "B" banks, foreign based banks, such as Citibank, Société Générale, Deutsch Bank, NatWest Bank and J.P. Morgan Bank.

[15] In 1992 or 1993, Kruger hired Richard Bradley, a former chief trader for the Toronto Dominion Bank in London, a person Mr. Bunze described as "a very sophisticated and knowledgeable individual involved in all aspects of foreign currency … and we built on that …".

[16] Mr. Bradley's mandate, Mr. Bunze explained, originated from meetings with Mr. Bunze and Mr. Lloyd Johns, who in 1998 was Assistant Treasurer of Kruger and at time of trial was Director, Taxation and Insurance for Kruger. Mr. Johns was also a witness in this appeal The meetings would review "whatever intelligence [Mr. Bradley] would bring to the table … through his own network" and determine the position Kruger would wish to take on currency exposure at the time. Mr. Bradley did not have a "blank cheque" to trade as he wanted, but he acted within parameters and recommendations that were discussed. Mr. Bunze described the trader's livelihood depending on his or her access to other traders and Mr. Bradley had such access. Mr. Bradley, Mr. Bunze declared, "knew how to make sure that we maximize our credit strength and also our contracts".

[17] As years went by Kruger increased what Mr. Bunze called its "trading treasury group" by hiring "some bond traders, some commodity hedge type traders for products like newsprint and lumber". Kruger also established a "backroom" to handle the trading style of Mr. Bradley. The "backroom" also supported Kruger's pension fund investments. In short, Mr. Bunze described it as "a many investment institutional trading floor".

[18] Mr. Bunze described the object of the trading team was "to mirror a sophisticated trading flow on a miniature scale …" with the "same sort of structure" as the trading flow of the Toronto Dominion Bank, "an open office concept where the traders were all exchanging information flow and so forth". The objective, he said, was "to generate and produce profits on an individual profit centre basis" for Kruger and with this purpose Kruger both bought and sold foreign option currency contracts.

[19] The person ultimately responsible at Kruger for the administration and control of the trading group during the period 1997 to 2004 was Mr. Bunze. The "ultimate decision maker" was the CEO and Chairman of Kruger, Mr. Kruger.

[20] Kruger's relationship with the banks was important, Mr. Bunze stated. He recollected that about 30 financial institutions were supporting Kruger directly through actual credit facilities, loan facilities or project financing. Mr. Johns

testified that one of the reasons Kruger dealt with a multitude of banks was to expand Kruger's credit risk and get competitive prices.

[21] Kruger had contracts and credit agreements with individual banks as well as with bank syndicates. These contracts, Mr. Brunze explained, had specific covenants and restrictions as to what Kruger could do with the proceeds. A typical credit arrangement would include an actual term loan or a credit facility or a "revolver" that permitted Kruger to "borrow up and down" but with a limit to the maximum it could borrow not only with that bank but with others, as well.

[22] The bank syndicates dealing with Kruger required Kruger to report to the lead lender — Mr. Bunze believed this was the Bank of Montréal at the time — all of the foreign exchange contracts it entered into and outstanding "on a quarterly basis derived on the basis of mark to market and based on the individual institutions confirming in writing that the mark to market values were calculated by them", that is, each bank would have to confirm the actual mark to market value of the contracts it had with Kruger.

[23] Mr. Bunze recalled that the accounting profession had prepared drafts on how to treat financial investments in the financial statements and "somewhere in '97 we were notified by Price Waterhouse … we will have to start reporting in '98 and onwards the financial trading that we were doing as it's not hedging on a mark to market basis … " Mr. Bunze agreed with respondent's counsel that the purpose of this requirement was for the consortium of banks to follow the credit risk of Kruger.

[24] Kruger's financial statements for 1998 and subsequent years state and reflect that derivative financial instruments were held for trading purposes. Kruger's trades, Mr. Bunze stated on cross-examination, allowed the trader to "actually speculate and take … any side of the transaction they deemed fit", both writing options and purchasing options, always dealing with banks.

[25] Mr. Johns corroborated much of Mr. Bunze's evidence. When he joined Kruger in 1982, Kruger "already" had a currency trader. By 1998 Kruger had four traders including Mr. Bradley as well as three bond and security traders. Only Mr. Bradley traded in currency.

[26] Mr. Johns managed and supervised Kruger's treasury back office approving and authorizing daily transfers and monthly treasury reports which would

summarize the various transactions. The "back office" included a person responsible for day to day banking, including preparation of daily bank reports, a person working in the money market and a third person dealing in the foreign currency market. Mr. Johns prepared the quarterly officer certificate for loan agreements and ensured that all the debt repayments and debt rollovers were performed. He was also responsible for Canadian corporate tax for Kruger and its major subsidiaries.

[27] The following is Mr. Johns' description of how the "back office" functioned:

> … a trader would produce a trade ticket and that trade ticket would go to the Back Office and the Back Office would then verbally confirm all the trade details with the counterparty. Should they agree, then the Back Office would input it into the Treasury System, and the Treasury System would then produce a trade ticket number that couldn't be altered or deleted and it's a – it was a unique number and the Back Office would put that on the trade ticket and that's how we accounted for all the trades.
>
> The Back Office would then prepare a monthly summary that would go to myself and Accounting of all the opened transactions, closed transactions and outstanding transactions for the month.

[28] Kruger's financial results from its derivative trading activities were kept separate from the financial results of its manufacturing activities, according to Mr. Johns. The results of these two activities were kept in separate ledger books, each having its own separate General Ledger.

[29] Appellant's counsel directed Mr. Johns to a statement by Mr. Richard Poirier, an expert witness, that the currency option contracts could be closed prior to maturity. Mr. Johns recalled that "very few" would have closed prior to maturity in 1998 because of the "drastic changes" in the Canadian dollar. Management had decided "to roll these over".

[30] Kruger both issued and acquired option contracts with the banks but not at the same level, according to Mr. Johns. "We would have sold more then we would have bought … in 1998, I think it was close to four to one" and that at all relevant times Kruger's books would have about three times more written or sold contracts than bought options. The reason for the sales was that management believed the Canadian dollar was grossly undervalued and that the value would be coming back

and that it would be a good time to sell options within the year, the "bad ones, we would roll them over."

[31] In 1999, Mr. Johns explained, the options would have been rolled over because they were at a loss, or "under water". In 1998 the Canadian dollar (to the U.S. dollar) fell from 1.40 to 1.5750, a historical loss, said Mr. Johns. In 1999, the Canadian currency strengthened to 1.44.

[32] Mr. Johns stated that Kruger's sold options had "an intrinsic value, worth nothing". But because the options had staggering maturity dates over the year-end past the year, the options had time value, not just an intrinsic value, he stated. He estimated the time value to be "anywhere from 16 to 20 million" even if the intrinsic value was nil. And, therefore, management decided to roll these options over but hoping the dollar would strengthen in the shorter term.

[33] The financial statements for 1999 show a decrease in the notional and adjusted fair value of the written options, the latter amounts decreasing substantially due to the improvement in the exchange rate, according to Mr. Johns. He stated that Kruger continued to believe that if the Canadian dollar was "way under valued … that eventually would get back" to normal. Currency rates in 1998 were "unheard of" and the dollar fluctuation was very volatile. Management was of the view that the loss contracts be rolled over until currency rates "would come back down, which, in fact, did happen".

[34] Mr. Johns confirmed that the market values applied by Kruger were the mark to market values from its counterparty banks. He stated that Kruger did not have the ability or capability at that time to value mark to market and by Kruger adopting individual bank values, the individual banks could not dispute the values.

[35] During the years subsequent to 1998 Kruger continued entering into both written and purchased option contracts until 2004 when there was a significant decrease in the number of both option contracts. According to Mr. Johns, the Canadian dollar in 2004 was trading at $1.35 and continuing to decrease. A "lot of the so-called options expired worthless and in August of 2004 we basically closed out a lot of our positions" before maturity.

[36] Kruger received mark to market values from the banks on a quarterly basis and used them for officers' certificates for the banks and for the audited financial statements until it leased a system that was "basically" used by the Laurentian Bank, called "Super Derivatives". (The date when Kruger started using Super

Derivatives is not in evidence.) Super Derivatives, said Mr. Johns, essentially monitors every transaction on the market in real time. It permitted Kruger itself to value mark to market. However, for year-end purposes, Kruger used the counterparties' mark to market values "to be consistent and to make sure that there was a third party mark to market … to alleviate any requirement by anybody that we were falsifying our mark to market …"

[37] Mr. Johns declared that there was no attempt on Kruger's part to match the option contracts with its receivables.

Kruger carried on a business

[38] I find that Kruger carried on a business of speculating on foreign exchange currency options that was separate from its manufacturing business. It was a leading trader in such options in Québec. It entered into a large number of contracts and the amounts of the contracts were substantial. Kruger created a facility and hired experienced personnel to operate the business in a manner similar to that undertaken by sophisticated traders in foreign exchange options. Decisions to write or purchase was carried out in a businesslike manner. The parties agreed that Kruger was a speculator when acquiring or writing options and was not hedging its receivables or payables from its principal business. Kruger reported its income and loss from the option contracts on revenue account. Kruger's speculation in foreign exchange options, by writing more options than it would purchase, Prof. Klein, an expert witness for the respondent, opined, carried significant risk but also chances for large profits. This was all part of a business entreprise undertaken by Kruger to earn income separate and apart from its manufacturing business.

MARK TO MARKET V. REALIZATION

[39] In addition to Messrs. Bunze and Johns, there was an additional lay witness for the appellant, Mr. Douglas Watson, a CRA official. There were also four witnesses who were qualified to testify as experts in their field of endeavour, Mr. Richard Poirier and Mlle Chantal Leclerc, CPA.CA for the appellant and Professor Peter Klein and Ms. Patricia O'Malley, CPA.CA for the respondent.

Options market evidence

[40] At time of trial Mr. Poirier, who was qualified as an expert on the operation of foreign currency option markets, carried on his own business but in previous

years was director general of several foreign currency funds operated by the Banque Nationale du Canada and was also a trader in foreign currency markets. He described himself as a "mainteneur de marché", a market maker. Kruger was a client of Mr. Poirier when it dealt with the Banque Nationale du Canada.

[41] Professor Peter Klein, a Professor of Finance at the Beedie School of Business at Simon Fraser University in Burnaby, B.C., testified as an expert on derivative instruments, in particular foreign currency contracts, from a financial perspective. Professor Klein has a Ph.D. (Finance) degree from the University of Toronto and LL.B. and M.B.A. (Joint Program) degrees from the University of Western Ontario. He is a Certified Financial Analyst, amongst other designations. During the period 1984 to 1992 he worked at C.I.B.C./Wood Gundy Inc. at several positions, including Chief Trader, Capital Markets in London, which included derivative trading. He has written extensively and has delivered academic papers and speeches on option valuation and the effect of credit risks on options. He has been the recipient of research grants and teaching awards in financial matters.

[42] Both Mr. Poirier and Professor Klein described and explained the nature of, and market for, foreign currency option contracts, how they are purchased and sold, how they are exercised, how a gain or loss is calculated, etc. Several strategies in trading option contracts were also described. The options Kruger entered into were European style options. Kruger's option transactions were "over the counter" puts and calls on U.S. and Canadian foreign exchange rates. Since Kruger wrote many more options than it purchased, it was exposed it to the risk of being forced to make large pay offs, according to Professor Klein.

[43] Mr. Poirier described the foreign currency option market as a large market and the most liquid of all option markets, that it is possible to close a position at any moment during the term of an option. Professor Klein agreed that the size of the primary market for OTC currency options is considerable when transactions by all market participants are considered. But he cautioned that "overall market size should not be confused with liquidity available to any single market participant". A European option, Prof. Klein explained, can be settled[8] in several ways: by cash or physical delivery of a forward contract of equal value or by "rolling the option" into a new option. Professor Klein stated that markets for settling prior to expiry or for rolling the option are illiquid because they consist of a single participant who is the party on the other side of the original contract and the party wishing to settle

[8] The settlement is also referred to as a "buy out", "close-out", "tear up" or "termination".

before the expiry date has little negotiating power. Ms. O'Malley agreed that because it may not be possible to dispose of a contract in the OTC market, it is possible to close a contract before expiry through negotiation with the other party, in particular when the subject matter of the contract is "deep liquid and active like the market for major currencies". Instead of closing the original contract, “the contract can be rolled over.”

[44] Professor Klein testified that prior to a party agreeing with a bank to enter into a relationship to trade foreign exchange option contracts, the party and the bank would put into place a ISDA Master Agreement [9] to regulate their relationship. Kruger was a party to an ISDA Master Agreement with each of its counterparty banks. A ISDA Master Agreement, Prof. Klein explained, allows the parties to trade options in an efficient way by agreeing orally to each option contract and then following up with a written confirmation of the trade. An ISDA Master Agreement governs most OTC options, including the OTC options by Kruger and its counterparties.

[45] An ISDA Master Agreement, Prof. Klein stated, does allow European options to be transferred before Expiry Date provided the non transferring party consents to the transfer. He added that the requirement for such consent is "well known" by writers and buyers of OTC options.

[46] According to Prof. Klein, Kruger entered into options that generally represented "unique property" because of their specific terms and because of Kruger's credit risk as a writer.

[47] Mr. Bunze described the various banks who were Kruger's counterparties. Mr. Poirier explained that the banks always consider the credit of a customer to be a risk and is a factor in the bid/offer spread with the client. Professor Klein stated that the credit of the customer is an input into the bank's pricing model. Banks, Mr. Poirier stated, used the same pricing models to determine the value of options during the term of a contract. Professor Klein does not agree. He testified banks disagree on mark to market value because their respective pricing models may

[9] An ISDA Master Agreement is a standard agreement written by the International Swap Dealers Association Inc. to govern OTC derivative contracts. These agreements refer to Schedules added by the parties and the Schedules may include definitions of terms in the Master Agreement, tax representations, addresses for services governing law of the particular Master Agreement, etc. Most Agreements presented at trial include Schedules but several do not.

differ. Evidence also established that these models were not identical. In valuing a derivative or counterpart on a mark to market basis, Kruger adopted the model used by the bank that was its counterparty for the particular derivative. The values of contracts with different banks for the same amount and on identical terms may vary depending on the input variables in the particular bank's model. Several examples were discussed at trial.

[48] An example used by Prof. Klein were identical options owned by Morgan Guaranty Bank and the Bank of Nova Scotia. Both were written by Kruger. Each contract was written on May 13, 1998 for US$ 10,000,000 with an exercise price of 1.46 exercisable on May 13, 1999. The Bank of Nova Scotia valued its option at $797,736 while Morgan Guaranty valued its option at $612,200, both as at December 31, 1998, a difference of over 20 per cent. Professor Klein stated that on May 13, 1998, when the Canadian-US exchange rate was 1.443, the market value of the option was CAD$ 125,500, approximately. On December 31, 1998 the exchange rate increased to 1.5305, roughly 6 per cent, yet Kruger recorded the mark to market value on that date at CAD$ 612,000, four times larger than the value of the option when it was written. Then, during the final half of 1999, the U.S. dollar weakened approximately 5 per cent to 1.405, a change sufficient to reduce the actual Pay Off on May 13 1999 to CAD$ 5,000, a 99 per cent decline in the five months between December 31, 1998 and May 13, 1999. The mark to market values are, Prof. Klein concluded, very sensitive to changes in the input variables in estimating value.

[49] Professor Klein compared several other pairs of options by different banks having similar trade dates, amounts, rates and expiry dates and found that there were differences in December 31, 1998 values based on the particular banks' valuation models, ranging from 29 per cent to − .03 per cent[10].

[50] In Professor Klein's view, Kruger's mark to market valuations at the end of 1998 were not based on a market or a traded price, "they represented theoretical estimates determined by sophisticated pricing models where market values of other securities were used to determine some of the input variables." The bank's pricing models are "very mathematical and rely on highly idealized assumptions" with respect to how securities markets operate. Mark to market values are unreliable.

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[10] In one comparison the Expiry dates differed by one day, which Prof. Klein did not believe was significant in calculating values.

[51] Professor Klein stated that there are a number of models banks may choose to price a foreign currency option and the result will depend on which model is chosen and, as stated above, leads to bank disagreements on mark to market value. The weakness in the mark to market method, Professor Klein declared, is that the list of input variables to the models themselves as well the "estimation" methods for the input variables can differ, causing further uncertainty as to the best estimate of risk to market value. Different banks can value as at different times of the day for example. The mark to market value is very sensitive to small changes in the input variables and are poor estimates of the value of the option that is ultimately realized. Banks caution that they do not represent the value at which options could be terminated. The difference between a mark to market value for an OTC option on its realized value and expiry date of the option, Professor Klein stated, is very large. The only clear value for Kruger options, in Professor Klein's opinion, was realized value that was determined by payment on the expiry date of the option.

[52] Professor Klein did not agree that Kruger's activities were similar to those of banks notwithstanding Ms. Leclerc's evidence that banks also speculate in foreign options. He stated that a bank facilitates trades for its clients, to facilitate demand and supply of options from these clients. Kruger is one such client and Kruger's position "consisted primarily of well-known speculative trades". However, there was evidence that banks do speculate at times.

<u>Accounting experts</u>

[53] Ms. Leclerc is Senior Manager and Partner, Assurance and Advisory Services at Deloitte & Touche. She is also leader of the firm's Montréal complex accounting group and a Financial Instruments National Subject Matter Expert at Deloitte dealing with hedging and derivative matters. She has worked at Deloitte's San Francisco's office as a member of the firm's U.S. Financial Investment Specialist Group. At time of trial, Ms. Leclerc was the Deloitte representative in the Office of the Superintendent of Financial Institutions, Auditor Deposit Taking Institutions Committee and during 2003 to 2007 was on the Canadian Institute of Chartered Accountants Financial Investments Implementation Committee.

[54] Ms. Leclerc was engaged by the appellant's counsel to report on the application of Canadian generally accepted accounting principles ("Canadian GAAP") to the transactions in issue for the period January 1, 1998 to December 31, 1999 inclusive.

[55] Ms. O'Malley was a partner with the national office of KPMG in 1999 when she left the partnership to become the first full-time Chair of the Canadian Accounting Standards Board ("CASB") which was authorized by the Canadian Institute of Chartered Accountants ("CICA") to set accounting standards that are applied as GAAP for chartered accountants. The CICA Handbook, she testified, is the product of the work of the CASB.

[56] Ms. O'Malley also served as Vice-chair of the CASB and as a member of the emerging issues Committee of the CICA which dealt with the interpretation of standards. Gradually, she said, she developed a specialty in accounting standards for financial instruments. In the late 1990s she represented the CASB as part of the Canadian delegation to the Joint Working Group on Financial Instruments, later becoming the International Accounting Standards Board, an "international consortium working to develop an accounting standard with respect to financial instruments", including derivatives.

[57] Both Ms. Leclerc and Ms. O'Malley reviewed literature and guidance on the application of Canadian GAAP. They agreed that Canadian GAPP's preferred basis of accounting for foreign exchange option contracts in 1998 was the mark to market method, that the option contracts be measured on the balance sheet at their fair market value and, Ms. O'Malley wrote, recognize changes in the fair value of income in the period of the change.

[58] Ms. Leclerc and Ms. O'Malley also reviewed principles of US GAAP as they applied to derivative financial instruments, including options. These included specific to derivative financial instruments, including options, found in standards published by the United States Financial Accounting Standards Board ("FASB") for the relevant time. Ms. Leclerc wrote that the FASB was "one of the most dominant standard setters in the world" at the time and its approved financial statements concepts were highly aligned with those of the CICA. Upon review of several FASB statements (FAS 133, FAS 80, 52) and other studies she concluded that the U.S. standards "indicate that the most relevant and decision-useful accounting policy for non-hedging option contracts was fair value (or market value) where changes in fair values, whether hedged or unrealized, were recorded through income".

[59] In her report Ms. Leclerc writes that not only financial institutions but non-financial institutions as well who traded in foreign currency option contracts in 1998 applied mark to market valuation for accounting purposes. Attached to her

report was an appendix confirming Mr. Poirier's claim that Canadian chartered banks speculated on foreign currency option contracts.

[60] Ms. Leclerc referred to a text by Ross M. Skinner[11] for the view that "it is hard to avoid a conclusion that speculative activity is best portrayed by valuing speculative option positions at market, regardless of the manner in which other assets and liabilities are reported" and it makes no difference whether the options are puts or sales (p. 284). Ms. Leclerc stated Mr. Skinner had identified three possible measurement basis for purchased options held for speculative purpose: cost basis, the lower of cost and market basis for purchased option (or highter of cost or market for written options) and market value basis.

[61] Ms. O'Malley agreed that the FAS 133 required that "all derivative financial instruments (including forwards and options) to be recognized in the financial statements at fair value when the contract is entered into and at each financial reporting date thereafter, with any change in value recognized in income in the period of the change". A rationale for the FASB's requirement is that "fair value is the most relevant measure for financial instruments and the only relevant measure for derivative instruments".

[62] Among the reasons Ms. O'Malley lists for the conclusion that fair value is the appropriate measurement for derivatives are:

> (a) Fair values of financial instruments show the market's assessment of the present value of the net future cash flows directly or indirectly embodied in them, discounted to reflect both current interest rates and the market's assessment of the risk that the cash flows will not occur. Information about fair market value better enables investors, creditors, and other users to assess an entity's performance.
>
> …
>
> (c) Fair value measurement is practical for most financial assets and liabilities. Fair value measurements can be observed in markets or estimated by reference to markets for similar instruments. If market information is not available, fair value can be estimated using other measurement techniques, such as discounted cash flow analysis and option pricing models.

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[11] "Accounting Standards in Evolution", 1987, Holt, Rinehart and Winston of Canada, Limited,.

[63] Ms. O'Malley also referred to an International Accounting Standard 39, issued in March 1999 [12] (effective for fiscal years commencing on or after January 1, 2001) to the effect that all derivatives were to be measured at fair value at each financial reporting date with the change in value recognized in income in the period. Ms. O'Malley explained that when the derivative is not actively traded but its value is derived from a commonly used technique and the inputs to that technique are all derived from active markets, that value is also appropriately referred to as a market value.

[64] As far as Kruger's foreign currency options are concerned, Ms. O'Malley wrote that the option pricing models:

> … are well established as valuation techniques and all the major inputs needed for those models can be observed in active markets. In addition, Kruger had the ability to check on the reliability of the quotes it was given as the cost to close its contracts by obtaining quotes from more than one of its counterparties. Thus, Kruger's implementation of a fair value accounting policy for its option contracts is also equivalent to the mark to market method.

This does not appear to coincide with Professor Klein’s view.

[65] Ms. O'Malley also referred to Mr. Skinner to explain that the goal of financial accounting is not necessarily the same as for tax accounting[13]. He noted that the objective of financial statements is to provide information to the users of the statements that will be useful to them in making decisions. Primary users of financial statements are investors, including potential investors, and creditors who do not have internal access to an entity's information. Creditors and investors are interested in the entity's ability to earn income and to generate cash flows in the future. Creditors want to make sure that they will not lose money if things are going badly; investors will do well if the entity does well and lose if the entity is doing poorly. The investor wants to know what his or her portfolio is worth at a given time so as to decide to buy, sell or hold onto the investment or if one is a potential creditor, to consider possible terms of a loan. The financial information of the entity provided as financial statements as at a particular date gives a picture of the entity's health at that date so as to make a decision.

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12 International Accounting Standards Board.

13 *Op. cit*.

[66] The difference in mark to market and realization methods of value is simply one of timing. Ms. O'Malley described four different methods of valuing options that could be applied in calculating income on option contracts for accounting purposes: realization and three methods of accrual accounting that are premium amortization, loss accrual method and the mark to market method.

[67] The premium amortization method would reflect changes in the time value of the premium paid and received; the premium could be amortized into income "in some systematic way" over the term. The loss accrued method requires the writer/owner to recognize, fully or partially, the potential loss on a contract that was in the money. This method would normally be combined with the premium amortization method since it would not be realistic to recognize a loss without also recognizing at least a portion of the premium received to assume the risk.

[68] The choice of method affected only the timing of the recognition of the income and losses. In the realization method, for example, Kruger would have no loss or income in 1998, the income would be realized in 1999. The premium amortization method would reflect income in 1998 and a loss in 1999. The loss accrued and mark to market methods both reflect losses in 1998 and income in 1999. But in all cases, Ms. O'Malley concluded, the income was the same amount over entire period from inception of the first contract to final expiry of the contract. The loss or gain in any one year depends on the choice of accounting method.

CRA witness

[69] The appellant called upon Mr. Douglas Watson, a CRA officer, to testify how the CRA administered sections 142.2 to 142.5 of the *Act*. Mr. Watson has worked for the CRA for 30 years. During the period 2000 to 2012 he was a Financial Product Specialist, advising CRA auditors "how to audit and analyze situations involving financial products, primarily derivative transactions and the applicable tax principles that would apply". At time of trial, he was manager of the Corporate Financing Section in the Rulings Division. Mr. Watson was not comfortable testifying.

[70] Mr. Watson recalled that in the early 1990's the term "mark to market" was "a very broad term … someone was trying to estimate the value of something, maybe the value of what it could be sold for or discharged at". However, in 1997

fair value accounting was introduced in Canada and the term mark to market became more specific, a term meaning one method of estimating fair value[14].

[71] Mr. Watson agreed with appellant's counsel that the valuation of a derivative financial instrument is based on existing market prices, among other things. However, he said, this is not the situation where there are no public market prices, in over the counter transactions, for example. Where banks are concerned, a bank will use its own pricing model. Like Prof. Klein, Mr. Watson did not agree with the appellant that all banks use the same pricing model.

[72] Mr. Watson declared that he is "aware of the fact that [CRA] bank auditors have challenged the banks on the output of certain … of their pricing models." Discussions took place with the parties and were "resolved without ever having to go to court". He insisted "our auditors do not accept the output of the pricing models at face value, they do some audit work to satisfy themselves that there are reasonable values for purposes of the Income Tax Act".

[73] With respect to taxpayers that are not financial institutions or investment dealers, Mr. Watson stated that pricing is done on a realization value. In principle, the CRA has allowed the mark to market method relied on by the banks as an acceptable method of computing income for tax purposes.

[74] In discussing a cancelled CRA Income Tax Technical News publication,[15] Mr. Watson shared CRA's concern that taxpayers other than financial institutions use the mark to market method of accounting. An email of October 9, 2001 from Mr. Watson to colleagues at CRA discussed the difficulty CRA had in verifying the mark to market values and the concession the CRA granted to mutual fund trusts, permitting them to apply mark to market accounting:

> The opinion given in IT Technical News No. 14 applies only to mutual funds as defined in section 138 of the Act. The concern with the mark to market method is the difficulty with the verification of the value of derivatives. Mutual Fund Trusts are regulated and must provide daily market valuations for the benefit of unit holders. Therefore, they are subject to the scrutiny of these parties. In addition, the majority of their investments are in publicly traded derivatives, the value of

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[14] See footnote 15 *infra*.

[15] Income Tax Technical News #14, December 9, 1998. This document was cancelled but was being reformatted for easier online access. Its content is still valid.

> which can be verified. For these reasons, CCRA granted the concession expressed in the publication.
>
> Other taxpayers cannot use this position. Valuations prepared for shareholders may be skewed by the accounting principle of conservatism such that profitable positions are understated. Similarly, valuations prepared for tax purposes may lack consistency between profitable and unprofitable positions. At this point in time, we lack the tools to verify the valuation of derivatives. The realization method is supportable in law and, although it may present timing opportunities for taxpayers, as it is based on transactions, taxpayers can easily comply and CCRA can easily audit.

[75] The CRA permitted the Investment Funds Institute to compute income from derivative transactions by either realization method or mark to market accounting because it was satisfied that "their accounting systems were true and their methods were accurate" as well as being subject to regulations.

[76] Thus, CRA’s concern with non financial institutions using mark to market accounting was, a) except for regulated institutions, mark to market values could not be relied on as accurate, and b) CRA lacked the audit capacity to verify the accuracy of mark to market values.

[77] Mr. Watson agreed with appellant's counsel's suggestion that derivative financial instruments such as foreign currency option contracts are not mark to market property as defined by subsection 142.2(1). Banks "include these products in that section (i.e. s. 142.2) and the manner in which they file their tax returns, and (CRA) auditors do not generally dispute that."

[78] Mr. Watson acknowledged that when the Minister makes a concession to a taxpayer, it must be in accordance with the law although "we do not always necessarily apply the law as it applies to timing differences". There are circumstances he said, where the CRA will reduce the compliance burden for both parties for administrative ease. Apparently, Mr. Watson's and his employer's view is that only financial institutions and those taxpayers whose activities are "regulated" may have access to mark to market accounting in computing income for tax purposes. I am not surprised that Kruger, in particular in view of its extensive dealings in derivatives, felt odd man out.

INVENTORY

[79] The appellant's alternative position is that the foreign exchange option contracts are inventory and that in computing income from its business of speculating in such contracts it is therefore permitted to value the contracts pursuant to subsection 10(1) of the *Act* or section 1801 of the *ITR*. The Minister states that Kruger does not carry on such a business and if it does, then, in any event, the option contracts are not inventory of Kruger. I have found that Kruger does carry on a business of speculating in option contracts. The issue then is whether the contracts are inventory.

[80] Ms. Leclerc's report is silent with respect to whether foreign currency option contracts may be considered inventory in accordance with Canadian GAAP but in a question put to her, she agreed that as an accountant she would not consider a derivative property inventory. Ms. O'Malley's view is that in accordance with GAAP, inventory consists of tangible assets held for sale in the ordinary course of business. She states that foreign currency options purchased are intangible assets and that foreign currency options issued (written) are liabilities and not assets.

[81] Ms. O'Malley acknowledges that section 3030 of the CICA Handbook does not define the term "inventories" but does not contemplate inventories as being anything other than goods. CICA's *Terminology for Accountants*, 4th ed., 1992, defines inventory

> … as items of tangible property that are held for resale in the ordinary course of business or are being produced for sale, or are to be consumed directly or indirectly in the production of goods or services to be available for sale.

[82] Ms. O'Malley testified that U.S. GAAP also recognizes "inventories" to be tangible assets, "a stock of goods" held for resale in the course of business or in the process of production for such sale or are to be consumed in the production of goods for sale. The International Standards (IAS2) is similar to the U.S. definition of inventories and specifically excludes financial instruments from the score of inventories.

[83] For Canadian GAAP, Ms. O'Malley stated, foreign currency options are either financial assets or financial liabilities, not inventory. The portions of the CICA Handbook definitions pertaining to options states a financial asset is a contractual right to exchange financial instruments with another party under conditions that are potentially favourable. A contractual obligation to exchange financial instruments with another party under conditions that are potentially unfavourable is a financial liability. The overall definition of financial assets includes cash.

[84] Appellant says that it is irrelevant that derivative financial instruments were not inventories in accordance with GAAP because they were not tangible properties and because they were either financial assets or financial liabilities. All this is meaningless for tax purposes. Whether Canadian GAAP categorizes contracts as financial assets or financial liabilities does not disqualify them as inventory. The IAS definition of inventory excluded financial instruments from inventory and the reason, according to Ms. O'Malley, was that financial instruments were to be valued at fair value at the end of the year, not the lower of market and cost as required for inventory.

ANALYSIS

a) Market to market vs. realization

[85] The appellant submits that in calculating its loss of $91,104,379 for its 1998 taxation year from trading in foreign exchange contracts it applied the provisions of the *Act* as required by subsection 9(2) of the *Act*. The appellant states that in accordance with section 9 it is entitled to value its foreign exchange option contracts on the mark to market method in reporting its income or loss for the year from a business.

[86] Both expert accounting witnesses testified that GAAP recognizes mark to market as the preferred method to value derivative property at the end of a taxation year. However, I must determine if mark to market valuations employed by Kruger for its foreign exchange option contracts are consistent and appropriate for purposes of the *Act* and thus provide an accurate picture of Kruger’s income for the

year consistent with the provisions of the *Act*, case law and well accepted business principles[16].

[87] For the 1998 taxation year subsections 9(1) and (2) of the *Act* read as follows:

(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.	(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.
(2) Subject to section 31, a taxpayer's loss for a taxation year from a business or property is the amount of the taxpayer's loss, if any, for the taxation year from that source computed by applying the provisions of this Act respecting computation of income from that source with such modifications as the circumstances require.	(2) Sous réserve de l'article 31, la perte subie par un contribuable au cours d'une année d'imposition relativement à une entreprise ou à un bien est le montant de sa perte subie au cours de l'année relativement à cette entreprise ou à ce bien, calculée par l'application, avec les adaptations nécessaires, des dispositions de la présente loi afférentes au calcul du revenu tiré de cette entreprise ou de ce bien.

[88] None of the words "income", "profit" and "loss" found in section 9 is defined in the *Act*, except that subsection 9(1) assimilates income and profit. To determine a taxpayer’s loss from a business or property, subsection 9(2) requires that the loss be computed applying the provisions of the *Act* respecting the computing of income from a business or property but with modifications based on particular facts.

[89] The losses claimed by Kruger are not the result of deductions incurred by Kruger for the purpose of earning income; the purported losses result from a

16 *Canderel Ltd. v. The Queen*, [1998] 1 S.C.R. 147, [1988] D.T.C. 6100, at par. 53(g).

change in values of certain option contracts. In *M.N.R. v. Consolidated Glass Ltd.*,[17] Rand J., at p. 174, asked

> … [h]ow can profits and gains be considered to have been made in any proper sense of the words otherwise than by actual realization? This is no inventory valuation feature in relation to capital assets. That the words do not include mere appreciation in capital values is, in my opinion, beyond controversy. It is difficult if not impossible to say that where only value is being considered in which a variable inheres you can have any other than a fluctuating estimate. The word "loss" in the context means absolute and irrevocable, finality. That state of things is realized upon a sale; …

[90] In *Mountain Park Coals Ltd. v. M.N.R.*, Thorson P. opined that "… loss is the inverse of profit…"[18]

[91] In *Symes v. Canada*,[19] Iaccobucci J., writing for the majority of the Supreme Court approved the comments of Thorson P. in *Royal Trust Co. v. M.N.R.*,[20] where the latter wrote that the first approach to determine whether an expense is deductible in computing income for income tax purposes is to ascertain whether the deduction is "consistent with ordinary principles of commercial trading or well accepted principles of business and accounting practice …"[21]

[92] Earlier, in *Canadian General Electric Co. Ltd v. M.N.R.*, [22] Martland J., at p. 11, referred to *Dominion Taxicab Association v. M.N.R.*,[23] for the principle enunciated by Cartwright J. that "whether or not a sum in question constitutes profit must be determined on ordinary commercial principles unless the provisions of the *Income Tax Act* require a departure from such principles."

[93] There are several reported cases where taxpayers revalued properties at its year end for tax purposes. In *Canadian General Electric Ltd.*[24] the taxpayer

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17 [1957] S.C.R. 167.
18 [1952] Ex. C.R. 560 at. 568.
19 [1993] 4 S.C.R. 695, 722-723.
20 57 DTC 1055, 1059 (Ex.Ct.)
21 *M.N.R. v. Shofar Investment Corp.*, [1980] 1 S.C.R. 350, 355, 79 DTC 5347, 5349-50.
22 [1962] S.C.R. 3, [1961] 15 D.T.C. 1300.
23 (1954) S.C.R. 82 at p. 85. Also cited is *Lowry (Inspector of Taxes) v. Consolidated African Selection Trust Limited*, (1940) A.C. 648 at 661 per Viscount Maugham. See also *Royal Trust Co. v. M.N.R.*, 57 DTC 1055 per Thorson P. at p. 1059.
24 *Opt. cit.*

("CGE") borrowed U.S. dollars from its American parent in 1950 to acquire goods and services from U.S. suppliers. At the time the U.S. dollar was at a substantial premium over the Canadian dollar and CGE's U.S. parent made U.S. funds available to it so as to acquire its supplies. At the time each note was given, CGE set up in its books not only the liability for the fair value of the notes but also the amount of the premium necessary to pay back the notes in U.S. funds. Between 1950 and early 1952 CGE issued numerous promissory notes to its parent as evidence of its indebtedness. Soon after the U.S. dollar declined in value and CGE paid off some notes in 1951 and the balance in 1952, saving $512,847. There was no issue that the $512,847 was income to CGE. However, CGE, who reported income on an accrual basis, claimed that in order to give a true picture of its financial position it was necessary to revalue the amount of Canadian dollars necessary at the end of each year to pay off the notes. Thus, CGE apportioned the $512,847 profit as to $64,675 to 1950 and $259,820 to 1951 and $188,352 to 1952. CGE argued it always used this method in dealing with its current obligations in U.S. currency. The fisc was of the view that the $512,847 profit arose only upon actual payment of the notes and argued that $81,774, the amount paid in 1951, was taxable in 1951 and $431,073, the amount paid in 1952, was taxable in 1952.

[94] The Minister's position was that a taxable profit is not realized and does not arise by the mere revaluation in a trader's accrual of the cost of Canadian dollars, at any given time, of paying off an indebtedness payable as a foreign currency. Such a profit would be an unrealized profit. Profit, insisted the Crown, can only be realized on actual payment of the notes in 1951 and 1952.

[95] The Supreme Court held that it was proper for CGE to compute its profits, in relation to the notes, in the manner in which it did. There would be no "profit" at all in respect of the notes in 1952 save for the fact that their value had to be estimated under the accrual method of accounting in 1950 in order to determine CGE's profit for that year. Being a matter of estimate, Martland J., Cartwright and Ritchie J.J. concurring, wrote that the valuation of the liability should continue to be revised in each year thereafter until the year of actual payment[25]. The Supreme Court allowed CGE's appeal. The profit for 1952 in relation to the notes should be the amount by which, in terms of Canadian dollars, the cost of payment was reduced in that year, the difference between the estimate of the cost of payment at the beginning of 1952 and the actual cost of payment in 1952.

[25] Pp. 14-15.

[96] CGE's liability on the promissory notes was the result of it securing product from its parent for sale in its regular Canadian business operations and not part of a separate business carried on by CGE.

[97] Abbott J. dissented; he favoured the realization method. In 1952, he wrote, CGE was able to acquire for CDN$ 9,032,383, US$ 9,225,327 to discharge a liability of CND$ 9,461,455 which it had claimed and was allowed as a deduction from gross income in arriving at its profits in 1950 and 1951. It thus realized a gain of CDN$ 431,073 which on the principles laid down in several cases[26] must be taken into the computation of profit and loss for tax purposes and this exchange gain must be taken into account in 1952, the year in which it became a reality.

[98] On p. 20, Abbott J. stated:

> Particularly in the absence of a fixed exchange rate, a liability incurred by a Canadian debtor in terms of a foreign currency must always contain a contingent element and what the appellant did, in reality, in revaluing its U.S. dollar liability at the end of each fiscal period, was merely (1) to state from time to time in its balance sheet, a revised estimate of the Canadian dollar equivalent of what it owed to its parent company in U.S. dollars and (2) to write down the amount of that indebtedness as originally entered in its books and treat the resulting "gain" as a capital profit apportioned over three years. The fact that appellant used the accrual system of accounting in calculating its trading profits for each year had no relevance to this purely bookkeeping operation. No doubt the entries made by appellant in its books were proper from an accounting standpoint in order to present from time to time, as accurate a balance sheet as possible, but in my opinion they had no bearing upon the appellant's liability for income tax.

[99] The Supreme Court considered mark to market accounting in *Friedberg v. Canada*[27]. In *Friedberg*, the taxpayer relied on the lower of cost or market method in computing his income from trading in gold futures. He reported unrealized losses when they actually occurred but reported gains only when they were actually realized. The Crown assessed on the basis he ought to have valued the gold future contracts on the mark to market method, recognizing all unrealized losses and gains. The Court rejected the mark to market accounting method stating that although that method may have described better the taxpayer's income position

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[26] *Eli Lilly & Co. (Canada) Ltd. v. The Minister of National Revenue*, [1955] S.C.R. 745; *Tip Top Tailors Ltd. v. The Minister of National Revenue*, [1957] S.C.R. 703. Both these cases were referred to by Martland J. but he held that the point in issue in CGE was never considered.

[27] [1993] 4 S.C.R. 285, [1993] D.T.C. 5507.

for some other purpose, which I assume the Court meant financial purposes, the Court was not satisfied that it can describe income for income tax purposes. The Supreme Court held that the procedure used by Mr. Friedberg in reporting his income was proper.

[100] Expert evidence in *Friedberg* agreed that the lower of cost or market method was acceptable under Canadian GAAP and the Federal Court of Appeal agreed that the method used by Mr. Friedberg was "appropriate to the business" and told "the truth about the taxpayer's income."[28]

[101] I agree with appellant's counsel that the Supreme Court held that on the facts, the Crown did not demonstrate that there was any error in Mr. Friedberg's approach in computing income from his business. Counsel submitted that the Supreme Court did not close the possibility of applying mark to market accounting for income tax purposes.

[102] The principles applied to determine a taxpayer’s income or profit also determine a taxpayer’s loss. A comprehensive and critical analysis of profit computation for tax purposes is found in Justice Iaccobucci's reasons in *Canderel v. The Queen*[29]. In *Canderel* the issue was whether a tenant inducement payment is to be deducted from income entirely in the year in which it was made or is it to be amortized over the term of the lease to which it relates. The Supreme Court held that the taxpayer's income calculation, amortizing the payments, provided an accurate picture of income for the year in question and was not inconsistent with any principle of the *Act*.

[103] Iaccobucci J. wrote:

> 30 What, then, is the true nature of “profit” for tax purposes? While the concept has been variously expressed, perhaps the clearest and most concise articulation of the term is to be found in the oft-quoted decision of this Court in *M.N.R. v. Irwin*, [1964] S.C.R. 662, at p. 664, where profit in a year was taken to consist of “the difference between the receipts from the trade or business during such year ... and the expenditure laid out to earn those receipts” (emphasis in original). This definition was echoed by Jackett P. in *Associated Investors of Canada Ltd. v. M.N.R.*, [1967] 2 Ex. C.R. 96, where he stated at p. 102:

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28 *Friedberg*, 92 DTC 6031, 6036. See also *M.N.R. v. Publishers Guild of Canada Ltd.*, 57 DTC 1017 at p. 1026 per Thorson P.

29 *Canderel, op. cit*.

> Ordinary commercial principles dictate, according to the decisions, that the annual profit from a business must be ascertained by setting against the revenues from the business for the year, the expenses incurred in earning such revenues.

31 Accepting this fundamental definition, in *Symes*, supra, at pp. 722-23, the majority made the following observations about the computation of profit:

> . . . the "profit" concept in s. 9(1) is inherently a net concept which presupposes business expense deductions. It is now generally accepted that it is s. 9(1) which authorizes the deduction of business expenses; the provisions of s. 18(1) are limiting provisions only. . . .
>
> Under s. 9(1), deductibility is ordinarily considered as it was by Thorson P. in *Royal Trust*, [*Royal Trust Co. v. Minister of National Revenue*, 57 D.T.C. 1055 (Ex. Ct.)] (at p. 1059):
>
> ... the first approach to the question whether a particular disbursement or expense was deductible for income tax purpose was to ascertain whether its deduction was consistent with ordinary principles of commercial trading or <u>well accepted principles of business</u> ... <u>practice</u> ... (Emphasis added.)
>
> Thus, in a deductibility analysis, one's first recourse is to s. 9(1), a section which embodies, as the trial judge suggested, a form of "business test" for taxable profit.
>
> … it is more appropriate in considering the s. 9(1) business test to speak of "well accepted principles of business (or accounting) practice" or "well accepted principles of commercial trading".
>
> [Emphasis in original.]

32 The great difficulty which seems to have plagued the courts in the assessment of profit for income tax purposes bespeaks the need for as much clarity as possible in formulating a legal test therefor. The starting proposition, of course, must be that the determination of profit under s. 9(1) is a question of law, not of fact. Its legal determinants are two in number: first, any express provision of the *Income Tax Act* which dictates some specific treatment to be given to particular types of expenditures or receipts, including the general limitation expressed in s. 18(1)(a), and second, established rules of law resulting from judicial interpretation over the years of these various provisions.

33 Beyond these parameters, any further tools of analysis which may provide assistance in reaching a determination of profit are just that: interpretive aids, and no more. Into this category fall the "well-accepted principles of business (or

accounting) practice" which were mentioned in *Symes*, also referred to as "ordinary commercial principles" or "well-accepted principles of commercial trading", among other terms. A formal codification of these principles is to be found in the "generally accepted accounting principles" ("GAAP") developed by the accounting profession for use in the preparation of financial statements. … What must be remembered, however, is that these are non-legal tools and as such are external to the legal determination of profit, whereas the provisions of the Act and other established rules of law form its very foundation.

34 That is not to minimize the key role played by such well-accepted business principles (as I shall hereafter refer to them) in the profit-computation process. In *Friesen v. Canada*, [1995] 3 S.C.R. 103, Major J. made the following observation at para. 41:

> The *Act* does not define "profit" nor does it provide any specific rules for the computation of profit. Tax jurisprudence has established that the determination of profit under s. 9(1) is a question of law to be determined according to the business test of "well-accepted principles of business (or accounting) practice" or "well-accepted principles of commercial trading" except where these are inconsistent with the specific provisions of the *Income Tax Act*. . . .

35 I think this statement aptly describes the proper relationship between tax law and business principles. In the absence of a statutory definition of profit, it would be unwise for the law to eschew the valuable guidance offered by well-established business principles. Indeed, these principles will, more often than not, constitute the very basis of the determination of profit. However, well-accepted business principles are not rules of law and thus a given principle may not be applicable to every case. More importantly, these principles must necessarily take a subordinate position relative to the legal rules which govern.

36 The reason for this is simple: generally speaking, well-accepted business principles will have their roots in the methodology of financial accounting, which, as was expressed in *Symes*, is motivated by factors fundamentally different from taxation. Moreover, financial accounting is usually concerned with providing a comparative picture of profit from year to year, and therefore strives for methodological consistency for the benefit of the audience for whom the financial statements are prepared: shareholders, investors, lenders, regulators, etc. Tax computation, on the other hand, is solely concerned with achieving an accurate picture of income for each individual taxation year for the benefit of the taxpayer and the tax collector. Depending on the taxpayer's commercial activity during a particular year, the methodology used to calculate profit for tax purposes may be substantially different from that employed in the previous year, which in turn may be different from that which was employed the year before. Therefore, while financial accounting may, as a matter of fact, constitute an accurate determinant

of profit for some purposes, its application to the legal question of profit is inherently limited. Caution must be exercised when applying accounting principles to legal questions.

37 I do not wish to be taken, however, as minimizing the role of GAAP in the determination of profit for income tax purposes. … GAAP will generally form the very foundation of the "well-accepted business principles" applicable in computing profit. It is important, however, for the courts to avoid delegating the criteria for the legal test of profit to the accounting profession, and therefore a distinction must be maintained. That is, while GAAP may more often than not parallel the well-accepted business principles recognized by the law, there may be occasions on which they will differ, and on such occasions the latter must prevail: see, for example, *Friedberg v. Canada*, supra.

38 … GAAP will surely not be determinative as to the method by which an accurate picture of profit may be obtained for taxation purposes, though it may still be useful as a guide to the various acceptable methods of computation, one of which may yield the appropriate result for taxation.

39 A good example of the relationship among the provisions of the *Act*, the principles developed in the case law, and GAAP or well-accepted business principles can be found in s. 18(9) of the *Act*, which requires the amortization of certain prepaid expenses over the periods of time to which they relate.

40 I pause here for a moment to distinguish the role of the courts in this regard from that of Parliament. Generally speaking, the courts are free, in the absence of contrary legislation or established rules of law, to assess the taxpayer's computation of income in accordance with well-accepted business principles. Obviously, this will require an assessment in each case of which of these principles apply to the particular circumstances which present themselves. However, it is not for the court to decide that one principle is paramount, or applicable to the exclusion or subordination of all others by saying that it has been elevated to the status of a rule of law which is to be applied in all situations. That is exclusively within the province of Parliament, and the willingness of Parliament to exercise this power is exemplified by s. 18(9) and by countless other codifications in the *Act* of what would otherwise likely be considered well-accepted business principles: see Symes, supra, at pp. 723-25.

…

42 Of course, this is distinct from the interpretation of such rules, such as, for example, the elucidation of the otherwise undefined concept of "profit", which is well within the jurisdiction of the courts. Such interpretive jurisprudence will fall within the category of "rules of law" which, as a matter of course, will predominate over well-accepted business principles. However, when no specific legal rule has been developed, either in the case law or under the Act, the taxpayer

will be free to calculate his or her income in accordance with well-accepted business principles, and to adopt whichever of these is appropriate in the particular circumstances, is not inconsistent with the law, and, as I shall elaborate upon below, yields an accurate picture of his profit for the year. The simple application by a court of one or another well-accepted business principle to a particular case or cases, moreover, will not ordinarily amount to the elevation of that principle to the status of a "rule of law". In general, the Minister will not be entitled to insist that one method supported by business practice and commercial principles be employed over another, equally supported method, unless, as I will develop below, the method chosen by the taxpayer fails to yield an accurate picture of his or her income for the taxation year.

(b) The Interpretive Goal: An Accurate Picture of Income

43 Having established an appropriate framework for analysis, I should now like to discuss what exactly is the question that must be answered when attempting to assess a taxpayer's profit for tax purposes. A good place to begin is with the decision of the Federal Court of Appeal in *West Kootenay*, *supra*, where MacGuigan J.A. stated at p. 745:

> The approved principle is that whichever method presents the "truer picture" of a taxpayer's revenue, which more fairly and accurately portrays income, and which "matches" revenue and expenditure, if one method does, is the one that must be followed.

44 … that 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 particular taxpayer. If this is accomplished by applying the matching principle, then so be it. On the other hand, if some other method is appropriate, is permissible under well-accepted business principles, and is not prohibited either by the *Act* or by some specific rule of law, then there is no principled basis by which the Minister should be entitled to insist that the matching principle -- or any other method, for that matter -- be employed. MacGuigan J.A. in *West Kootenay* seemed to advert to this notion at pp. 745-46, in the passage immediately following the above-quoted portion:

> The result often will not be different from what it would be using a consistency principle, but the "truer picture" or "matching approach" is not absolute in its effect, and requires a close look at the facts of a taxpayer's situation. [Emphasis added.]

…

47 … To the extent that they may be applicable to particular circumstances, well-accepted business principles are to be assessed and applied only on a case-

by-case basis, and only for the purpose of achieving an accurate picture of profit for the year in question for income tax purposes. …

…

50 It follows from all of this that in calculating his or her income for a taxation year, the taxpayer must adopt a method of computation which is not inconsistent with the *Act* or established rules of law, which is consistent with well-accepted business principles, and which will yield an accurate picture of his or her income for that year. In the simplest cases, it will not even be necessary to resort formally to the various well-accepted business principles, as the simple formula by which revenues are set against the expenditures incurred in earning them is always the basic determinant.

…

53 The outlined framework for analysis is, of course, only as useful as its application to actual cases. Turning to the facts of this case will illustrate how this principled approach to the computation of income is intended to operate. Before I do this, however, it may be both convenient and useful to summarize the principles which I have set out above:

(1) The determination of profit is a question of law.

(2) The profit of a business for a taxation year is to be determined by setting against the revenues from the business for that year the expenses incurred in earning said income: *M.N.R. v. Irwin*, *supra*, *Associated Investors*, *supra*.

(3) In seeking to ascertain profit, the goal is to obtain an accurate picture of the taxpayer's profit for the given year.

(4) In ascertaining profit, the taxpayer is free to adopt any method which is not inconsistent with

(a) the provisions of the *Income Tax Act*;

(b) established case law principles or "rules of law"; and

(c) well-accepted business principles.

(5) Well-accepted business principles, which include but are not limited to the formal codification found in GAAP, are not rules of law but interpretive aids. To the extent that they

may influence the calculation of income, they will do so only on a case-by-case basis, depending on the facts of the taxpayer's financial situation.

(6) On reassessment, once the taxpayer has shown that he has provided an accurate picture of income for the year, which is consistent with the *Act*, the case law, and well-accepted business principles, the onus shifts to the Minister to show either that the figure provided does not represent an accurate picture, or that another method of computation would provide a more accurate picture.

[104] In *Friesen v. Canada*[30], the Supreme Court of Canada considered whether a taxpayer's venture in the nature of trade was a true business allowing the taxpayer to value vacant land as inventory under subsection 10(1) of the *Act*[31]. Both Major J., at para. 45 and 46 and Iaccobucci J., at para. 105 to 108, notwithstanding they were on opposite sides, agreed that a general principle of taxation is that neither profits nor losses are recognized under the *Act* until realized except if the *Act* provides an exception to the realization principle. Iaccobucci J., in dissent, emphasized, at para. 160, that:

> … whenever the *Income Tax Act* permits deemed dispositions at fair market value without actual realizations, it does so narrowly and in a highly circumscribed manner: for example, when a taxpayer ceases to be a Canadian resident (s. 48 (now repealed)), or upon death (s. 70), or upon change of control (s. 111). Exceptions from the realization principle are thus clearly stipulated and explicitly codified, unlike the exception upon which the appellant seeks to rely. For the most part, the *Act* does not recognize "unrealized" or "paper" gains or losses: Krishna, *supra*, at pp. 278-79.

[105] Mark to market valuation is consistent with well accepted business principles and practice. GAAP's preferred basis of accounting for foreign exchange option contracts in 1998 was mark to market. International accounting also recognizes that these options be valued mark to market. However, except for sections 142.2 to 142.5 of the *Act* (and section 1801 of the *ITR*), there is no express statutory provision requiring or authorizing valuation of property on a mark to market basis.

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30 [1995] 3 S.C.R. 103, 95 DTC 5551.

31 Note that as a result of the Supreme Court decision in *Friesen*, subsection 10(1) has been amended.

[106] The provisions of section 142.2 to section 142.5 require financial institutions and investment dealers to use mark to market; there is no option. These provisions did not speak to the entitlement or lack of entitlement of any other class of taxpayer to use mark to market accounting for trading in financial instruments. Kruger submits that its entitlement to use mark to market accounting in respect of its profits and losses from foreign currency option contracts is in no way affected by the fact that it is not a financial institution.

[107] GAAP is a non-legal tool, external to the legal determination of profit. To determine whether mark to market is a proper method available to taxpayers for income tax purposes, one is bound by the provisions of the *Act* and rules of law. Any given accepted business principle may not be applicable to every case[32].

[108] Iaccobucci J. warns that caution must be exercised when applying accounting principles to legal questions[33]. The goals in determining profit and loss for financial purpose and tax purposes are not the same.

[109] Financial accounting, Iaccobucci J. states, 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. Ms. O'Malley described a statement for financial purpose as "a snapshot" of the entity at a precise moment. FASB views mark to market valuation for the same reasons: to better enable investors, creditors and others to assess the entity's performance. Mark to market value is the market's assessment of the present value of net future cash flows directly or indirectly embodied in them, discounted to reflect both current interest rates and the market's assessment of the risk of the cash flows that will not occur, as well as reflecting the current cash equivalent of the financial instrument rather than its historic cost. Any loss in a mark to market valuation is temporary; the loss is not absolute, irrevocable or final[34].

[110] Tax accounting normally is not overly concerned with the past; it wants a picture of income for a particular year and, as Iaccobucci J. writes, the methodology used to calculate income in one year may be different from that used in an earlier year. Ms. O'Malley's view is similar: statements for tax purposes are

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32 *Canderel, op. cit.*, para. 32-35, per Iaccobucci.
33 *Canderel, op. cit.*, para. 36
34 *Consolidated Glass, op. cit.*; per Rand J, see para. 89 above.

solely concerned with the computation of income in achieving an accurate picture of income for the particular taxation year.

[111] The parties agree that a foreign exchange currency option contract does not qualify as a "mark to market property" for purposes of section 142.5 of the *Act*. I agree. Notwithstanding that a foreign currency option contract is not a "mark to market property" for purposes of the section 142.2[35], Mr. Watson acknowledged that the CRA permits financial institutions to use mark to market foreign currency option contracts.

[112] The reasons of Major J. in *Friesen* are relevant to the mark to market issue, in particular his remarks on pages 129 to 130 and page 135. Subsection 10(1) of the *Act* requires a business to value its inventory at the lower of cost or market value. This principle, states Major J., is an exception to the general principle that neither profits nor losses are recognized until realized. That the business shall value its inventory at the <u>lower</u> of cost or market value means that the business will not include any value in excess of cost in calculating its income for the year. Subsection 10(1) imposes a cost value ceiling on inventory. As Major J. states on page 130:

> … the well-accepted principle of conservatism which underlies the valuation method in s. 10(1) represents not only an exception to the realization principle (in cases of loss) but also an exception to the principle of symmetry since gains are not recognized until they are realized. Thus the taxpayer who is entitled to rely on

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35 The Minister of Finance proposed legislation that eventually became sections 142.2 to 142.6 of the *Act* in his budget of 1994, S.C. 1995, S. 21, subsection 142.6(7) generally applied to dispositions that took place after October 30, 1994. Sections 142.2 to 142.6 are applicable to taxation years ending after February 22, 1994. The published Budget Supplementary Information 1994 commented as follows:

> The *Income Tax Act* does not contain specific rules dealing with the tax treatment of securities held by financial institutions, leading to uncertainty on some issues. The budget proposes to introduce several measures that will clarify this tax treatment and ensure that the income of financial institutions from securities is measured appropriately.

The definition of “mark to market property” was subsequently replaced by S.C. 2009, ch. 2, s. 46(3), generally applicable to taxation years beginning after 2006.

> s. 10(1) is allowed to claim a business loss where the value of inventory falls but is not required to declare a business profit until the inventory is sold even if the value of the inventory rises.[36]

[113] Earlier, Professor Brian J. Arnold explained the effect upon profit for tax purposes of the three methods of inventory valuation allowed by subsection 10(1) of the *Act* and section 1801 of the *ITR*, the latter being similar to mark to market[37]. He wrote:

> … If all property in inventory is valued at cost, profit or loss will arise in respect of that inventory only if the property is sold for more or less than its original cost; fluctuations in the value of the property will not result in any profit or loss. On the other hand, if all property in inventory is valued at its fair market value, profit or loss will result if the fair market value of the property at the end of the taxation year is different from that value at the commencement of the taxation year or at the time of acquisition of the property (where the property is acquired during the year). If the property has appreciated in value at the end of the taxation year, the amount of the appreciation reduces the cost of goods sold and thereby increases income for tax purposes. Conversely, if the property has declined in value at the end of the year, the amount of the reduction is reflected in a larger cost of goods sold and smaller amount of income. Under the lower of cost and fair market value rule, if the value of property declines below its cost, the amount of the decrease in value increases the cost of goods sold and reduces the amount of income for the year. Appreciation in the value of the property does not, however, have the converse effect.

[114] Mark to market accounting, therefore, as I understand it, 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 be cast aside. This is found in sections 142.2 to 142.5; these provisions, like subsection 1801 of the *ITR*, are

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[36] *Op. cit.*, pp. 130-135. See also *Ostime v. Duple Motor Bodies, Ltd.*, [1961] 2 All E.R. 167 (H. of L.) at pp. 172-173, cited by Major J.

[37] Arnold, B.J., “Timing and Income Taxation: The Principles of Income Measurement for Tax Purposes”, Canadian Tax Paper No. 71, 1983, Canadian Tax Foundation.

exceptions to the realization principle and a departure from the general principle that assets are valued at their historical cost.

[115] The appellant can find no solace in the fact that the CRA has recognized that mark to market is an appropriate method of computing income for tax purposes in derivative financial instruments, including foreign exchange option contracts. All agree that derivative financial instruments are not "mark to market" property as defined by section 142.2. Yet the CRA has accommodated banks and others to value such contracts mark to market. The CRA has also published Technical Interpretation approving "mark to market valuation"[38]. At the end of the day, however, it falls to Parliament to enact the law, the courts to interpret the law and the CRA to enforce the law, notwithstanding CRA's administration policies.

[116] There is also a difficulty with Kruger's option contract themselves. As I view the evidence, and as Professor Klein suggests, the market prices of OTC foreign exchange option contracts are estimates, if not artificial. Kruger's contracts are European contracts and cannot be traded during the time the contract is made until it matures, except with consent of the other contracting party. Each bank formulates its own market value based on its own model applying inputs that are not necessarily used by another bank. There is no consistency or objective, it appears to me, by the banks in fixing a common fair market value for a given day (or time of day). Professor Klein described two identical contracts as to amounts and expiry dates, among other things, having a significant difference in values on December 31, 1998. This shakes my confidence as to the other market values used by Kruger, not because Kruger was trying to do something nefarious, which it was not, but because of a probable inconsistency in values depending on the different models used by Kruger's counterparties. I may have had more comfort in agreeing with Kruger's valuations if all the contracts were valued using the same models, not a variety of models used by different banks. Thus even if I found that it was appropriate for Kruger to mark to market its derivatives for income tax purposes, I would not find that the inconsistent bank values used by Kruger was properly applied in calculating its losses on derivative trading in 1998.

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[38] For example, Technical Interpretation Bulletin 9824405, dated November 23, 1999, Technical Interpretation 2000-0001327, dated April 11, 2000 and 2002-0160807, dated April 16, 2003.

INVENTORY

[117] The appellant's alternative submission is that both written and purchased foreign exchange option contracts are inventory and are to be valued as required by subsection 10(1) of the *Act*. The Crown denies their status as inventory.

[118] The appellant finds comfort in *Friesen* where the Supreme Court held that the *Act* defines two types of property, capital property, which creates a capital gain or loss on disposition, and inventory, property the cost or value of which is relevant to the computation of business income. "There are separate rules", Major J. stated, for each of capital property and inventory, "and the taxpayer should be entitled to take the benefit as well as bear the burden applicable to the category into each property falls". The parties acknowledge that the foreign exchange option contracts are not capital property. Therefore, they must be inventory, says the appellant.

[119] The respondent argues that the written foreign exchange option contracts are not inventory for two reasons: one, that they are rights and not tangible property and two, that they do not represent a right on the part of the writer but a liability and, therefore, are not property of the writer.

[120] Both Ms. Leclerc and Ms. O'Malley testified that for GAAP, inventory must be a tangible asset. A foreign exchange option contract is not inventory for accounting purposes. The respondent's expert, Ms. O'Malley, described a written foreign exchange option contract as a "financial liability" and the purchased option contract is a "financial asset", as far as accounting practice is concerned. As far as I am aware the terms "financial asset" and "financial liability" have not been considered in earlier cases.

[121] Notwithstanding GAAP, any property, taxable or intangible, may be inventory for purposes of the *Act*. The word "property" in subsection 10(1) is defined in subsection 248(1) of the *Act* (1998) and means property of any kind whatever whether real or personal or corporeal or incorporeal and includes:

a) a right of any kind whatever, a share of a chose in action,	(*a*) les droits de quelque nature qu'ils soient, les actions ou parts;

…

[122] The courts have assumed that intangibles may be inventory. In *M.N.R. v. Curlett*,[39] for example, there was no dispute that second mortgages were inventory when the mortgages earlier had been sold in the ordinary course of business. The issue was whether the profit realized on the sale of second mortgages was profit from the sale of a business as a going concern or simply a profit from the sale of the bulk of the existing inventory of second mortgages.

[123] The respondent insists that inventory only constitutes property held for sale. Subsection 248(1) of the *Act* defines inventory to mean:

> "a description of property the cost or value of which is relevant in computing a taxpayer's income from a business for a taxation year"

[124] There is no requirement that property must be held for sale to qualify as inventory. However, the cost or value of the property must be relevant in computing a taxpayer's income from a business. If property that is a foreign exchange option contract is so relevant, then it so qualifies.

[125] I have found that in 1998 Kruger carried on a business of selling and purchasing foreign exchange option contracts. What I now have to determine is whether both or one of the written contracts or purchased contracts are properties and if either or both are property, whether they are property that is inventory.

[126] The position of the appellant is that the written option contracts have both rights and obligations and are property held by Kruger, not simply the obligation contained in the contract. A written option contract contains a property right which subsists during the life of the contract and which fluctuates in value, from the amount of the premium paid down to zero, during the life of the contract. Thus a written option represents a property right to the writer as much as the purchaser's right. The value of both these rights fluctuates with the fluctuation of the values of the currencies involved relative to each other, as well as the passage of time.

[127] The purported property right of the writer is the premium, the writer's right to retain the premium that is paid by the purchaser for the contract. However, appellant's counsel states, the premium, when received, is not profit, and when paid, is not an expense; the profit or loss is only computed at maturity or settlement of the contract.

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39 [1967] S.C.R. 280. And see also *Dobieco Ltd. v. M.N.R.*, 65 DTC 5300 where the Supreme Court agreed that an interest in a joint venture was inventory.

[128] If the option contract terminates upon maturity or settlement and the contract has no value, i.e., the price the purchaser is entitled to buy foreign currency is higher than the spot price at the time, the contract is worthless. It is not until maturity or settlement, the appellant submits, that the premium belongs to the writer absolutely and, under the realization method is considered income to the writer. Until maturity, the writer has had the contracted right to retain the amount of the premium but the amount does not constitute profit from the contract or revenue from the contract.

[129] According to appellant's counsel, examples of journal entries used by both Ms. Leclerc and Ms. O'Malley, reflect the fact that the writer has a contractual right to retain the premium which subsists until the contract ends, at which time the writer's right to keep the amount of premium becomes absolute and is income or the purchaser will exercise the option to buy in which case the writer will have to purchase foreign currency at the higher spot price to fulfill its contractual obligation to sell the currency at the lower price, at which point the writer will lose all or part of the premium or have to pay an additional amount to satisfy the obligation.

[130] The eventual result, as I appreciate appellant's submission, rests until maturity or settlement. In other words, the economic effects of the option contract must wait to maturity or settlement date. The writer's obligation does not become exigible until such time. In any event, notwithstanding the accounting treatment of the premium, a premium is what the writer receives as consideration for the contract. Until maturity or settlement, the writer is liable to the purchaser; that is the essence of the foreign exchange option contracts. The accounting profession is not wrong in describing the writer's obligation as a financial liability. The writer has no proprietary interest in the contract[40].

[131] However, the purchased contracts are property owned by the purchaser. The purchaser of an option contract has acquired property to deal with as it wishes on maturity.

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40 See Friedlander, Lara, "Taxation of Corporate Finance", vol. 2, Carswell 2011, para. 8.1.4.1 where the author discusses realization and mark to market commenting that "… there are some cases where a derivative that is out-of-the-money position does not have any more rights under the derivative, but merely the obligation to deliver funds or property in the future. …" Hence, whether a written foreign exchange contract out-of-the-money can be said to be a property, as opposed to a liability, may be valued mark to market.

<u>DECISION</u>

[132] The appeal will be allowed only to permit the appellant to value its purchased foreign exchange option contracts in accordance with subsection 10(1) of the *Act*, including section 1801 of *ITR*. This assumes the values are not in dispute. The appellant is not permitted to otherwise value its foreign exchange option contracts on mark to market. The amount of $91,104,379, subject to any adjustment as a result of valuing purchased foreign option contracts as inventory, shall be included in the appellant's capital in accordance with Part I.3 of the *Act*.

[133] The parties will have 30 days, or such longer delay as approved by the Court, to make submissions in writing as to costs.

[134] **These amended reasons for judgment are issued in substitution to the reasons for judgement issued on May 26, 2015.**

Signed at Ottawa, Canada, this 10th day of June 2015.

"Gerald J. Rip"

Rip J.

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