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The Federal Court of Appeal Permits Use of Mark-To-Market Tax Accounting

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The Federal Court of Appeal has held in the *Kruger Inc. v. Canada* decision published yesterday, that Kruger Inc. was entitled to use the mark-to-market method in computing its income for federal income tax purposes. As a result, for income tax purposes it was entitled to recognize an accrued year-end loss on its book of foreign exchange option contracts.

Kruger is a manufacturer of newsprint and other paper products, but the Court found that Kruger's option trading activities – which consisted principally of writing over-the-counter foreign exchange options on the U.S. dollar but also included the purchase of option contracts – amounted to a separate business.

The Court of Appeal's conclusions rested principally on two Supreme Court of Canada decisions:

- *Canderel*, which was stated to stand for the proposition that the requirement to compute income on a realization basis (i.e., in the case of options, when they mature or are sold) "can give way to other methods of computing income pursuant to section 9...where these can be shown to provide a more accurate picture of the taxpayer's income for the year;" and
- *Canadian General Electric*, which was described as finding that a taxpayer had the *choice* of recognizing changes in the Canadian-dollar equivalent of its U.S.-dollar trade payables on an accrual rather than realization basis.

The decision also relied on key factual findings:

- the option valuations used by Kruger at year-end "were reliable;" and
- "the broad recognition of mark to market accounting for purposes of computing income from dealing in foreign exchange options, and the uncontested evidence that banks, financial institutions and mutual funds which engage in this activity report their income on this basis with the CRA's approval."

This case may indicate that a taxpayer, which has derivatives or other property or obligations acquired or incurred on income (rather than capital) account, has the option to report its gains or losses on those holdings on a mark-to-market rather than realization basis for tax purposes if, under generally-accepted accounting principles, it also prepares its financial statements on a mark-to-market basis.

However, it is not clear that the Canada Revenue Agency will accept that this is what the *Kruger* decision has established. It likely will be concerned that taxpayers would consider selectively adopting mark-to-market tax accounting whenever they sustained significant accrued losses on their derivatives book, or other trading positions that they have marked to market for accounting purposes. The CRA is also cautious about changing long-standing assessing practices except when these have been clearly found to be incorrect.

What the CRA likely will accept is that financial institutions, such as banks (which already are required to apply statutory income-tax mark-to-market rules to most of their stock and bond and equity and debt derivatives holdings) will continue to be able to use mark-to-market tax accounting for their other derivatives positions (which do not come within these statutory mark-to-market rules). These financial institutions will now be on a more secure footing than they were in the aftermath of a technical interpretation issued by the CRA in 2012, in which it indicated that it may no longer accommodate non-statutory mark-to-market tax accounting.

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