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Kruger Incorporated v. Canada: What To Make of the Realization Principle

Kruger Incorporated v. Canada (2016 FCA 186) was an appeal from the decision of Rip J (2015 TCC 119), which stemmed from a reassessment of Kruger's 1998 taxation year by the minister on the basis that the realization principle applied to determine, pursuant to section 9 of the Act, income and loss from dealing in foreign exchange options entered into during that year and to be exercised in the following year. The minister denied business losses that Kruger had claimed using the mark-to-market accounting method in computing its income from such options. The minister also removed the income that arose from having "deferred and amortized" the premiums paid and received over the term to maturity of the relevant options.

Kruger was an established manufacturer of newsprint and other paper products, which were sold mostly to customers in the United States. In order to reduce its exposure to foreign currencies, primarily the US dollar, Kruger began selling (writing) and purchasing foreign currency options in the 1980s. Gradually, it developed considerable expertise in dealing with these options and began to generate profits from this activity "on an individual profit centre basis." The TCC held that Kruger carried on a business of speculating on foreign exchange currency options that was separate from its manufacturing business.

The primary issue in the appeal was whether Rip J had erred in his conclusion regarding the computation of Kruger's income from dealing with such options pursuant to section 9.

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Rip J held that absent an authorizing statutory provision (and there was none in this case), the general principle of taxation that neither profits nor losses are recognized under the Act until they are realized applied (the realization principle). However, he had indicated that using the mark-to-market method to compute income from this activity was consistent with both Canadian and US GAAP.

The secondary issue was whether the TCC had further erred in holding that the purchased foreign exchange options were inventory so that they could be valued under subsection 10(1) while simultaneously holding that written foreign exchange options were not inventory and therefore could not be valued pursuant to subsection 10(1).

The FCA reviewed case law considered by the TCC, including *Canadian General Electric Company v. MNR* (1961 CanLII 85 (SCC)) (*CGE*); *Friedberg v. Canada* (1993 CanLII 41 (SCC)); *Canderel Ltd. v. Canada* (1998 CanLII 846 (SCC)); *Friesen v. Canada* (1995 CanLII 62 (SCC)); and *Ikea Ltd. v. Canada* (1998 CanLII 848 (SCC)), and rejected Rip J's conclusion regarding the realization principle.

Specifically, the FCA stated that the decisions in *Canderel* and *Ikea* support the proposition that "the realization principle can give way to other methods of computing income pursuant to section 9 of the Act where these can be shown to provide a more accurate picture of the taxpayer's income for the year."

The FCA also found that the SCC in *CGE* had reached a similar conclusion. In *CGE*, the minister's position that the application of the realization principle was mandatory with respect to certain foreign exchange profits generated from promissory notes in the appellant's core business was rejected and the appellant was allowed to report its income on an accrual basis. The FCA held that *CGE* directly contradicted the TCC's conclusion regarding the realization principle.

The FCA also rejected Rip J's view that decisions in *Friedberg* and *Friesen* supported his holding in relation to the realization principle. In *Friedberg*, a case dealing with whether trading losses involving gold futures could be recognized in the year of realization or whether income from that source had to be accrued over the years during which the gold futures had been held, the SCC had confirmed Friedberg's entitlement to report his losses on a realization basis.

In *Friesen*, the narrow issue was whether a taxpayer who engaged in an adventure in the nature of trade could consider land held for resale as inventory and use subsection 10(1) to write down its value.

The FCA found that there was no authority for the TCC's proposition that the realization principle applies to the exclusion of the mark-to-market method unless the Act provides otherwise. Therefore, the FCA held that the mark-to-market

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method could not be excluded as an acceptable method for computing income pursuant to section 9.

The FCA then held that Kruger had made a prima facie case that the mark-to-market method provided an accurate picture of Kruger's income under the Act and that the Crown had not discharged its onus of demonstrating that realization provided a better picture of Kruger's income.

Kruger had argued in the alternative that its foreign exchange options were inventory and thus subject to the mandatory writedown pursuant to subsection 10(1) and regulation 1801. Because inventory treatment was mandatory, the FCA felt compelled to address this issue.

Subsection 248(1) defines "inventory" as "a description of property the cost or value of which is relevant in computing . . . income from a business." On that basis, the TCC held that the options purchased by Kruger were inventory because they conferred a right and therefore constituted property. The written options were held not to be inventory because they gave rise only to a liability; therefore, they could not constitute property and consequently could not constitute inventory.

The FCA held that *Friesen* stood for the proposition that in order for property to constitute inventory it must meet two conditions. First, its cost or value must be relevant in computing business income for a year. Second, the property must be held for sale. Because the evidence indicated that none of the options to which Kruger was a party at the close of its 1998 taxation year were held for sale, the FCA held that the purchased options were not inventory. The FCA also held that the written options were not property, inventory, or capital property.

The FCA, having concluded that the options held by Kruger were neither inventory nor capital property, then held that although the Act is premised on the existence of two broad classes of property, it imposes no limit on the types of property (or liabilities) that must be recognized to provide an accurate picture of income under section 9. The FCA allowed the appeals and referred the reassessment back to the minister for reconsideration on the basis that Kruger was entitled to compute its income derived from its foreign exchange option contracts in accordance with the mark-to-market accounting method.

This case is noteworthy for three reasons. (1) It makes clear that there is no general overarching realization principle with respect to the computation of income for the purposes of section 9; (2) it confirms that a taxpayer is entitled to select a method of computing income other than the realization principle if it provides a more accurate picture of income; and (3) it creates a class of property under the Act that is neither inventory nor capital property.

Of note are the proposed 2016 budget amendments relating to property that is financial derivative instruments (including option agreements). The amendments would deem such property not to be inventory and deny a deduction for the reduction in value unless the property is disposed of. (See proposed subsection 10(15) and proposed paragraph 18(1)(x), respectively, in sections 20(1) and 21(1) of *Legislative Proposals Relating to Income Tax, Sales Tax and Excise Duties* and *Explanatory Notes Relating to the Income Tax Act, Excise Tax Act, Excise Act, 2001 and Related Legislation* released by the Department of Finance on July 29, 2016.)

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Editor's note: Brian Arnold has also discussed the Kruger case in "Federal Court of Appeal Overturns Tax Court Decision in Kruger," The Arnold Report *(September 19, 2016) at www.ctf.ca.*