tax notes international
Volume 68, Number 3 ■ October 15, 2012

(C) Tax Analysts 2012. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Company Can Deduct Currency Exchange Losses, Court Rules

by Anton Louwinger

Reprinted from *Tax Notes Int'l*, October 15, 2012, p. 268

taxanalysts® The experts' experts.℠

COUNTRY DIGEST

(C) Tax Analysts 2012. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Company Can Deduct Currency Exchange Losses, Court Rules

The lower court of Arnhem on October 4 held (AWB 11/3335) that a taxpayer may deduct losses incurred from currency forward contracts it had entered into to hedge the currency exchange risks associated with an upcoming acquisition denominated in a foreign currency.

Facts

A Dutch company (DutchCo) entered into a purchase agreement concerning the acquisition of an artificial grass production facility. This acquisition would be carried out through a Dubai-based LLC (LLC) that was set up specifically for the purpose of this acquisition. The purchase price that LLC would have to pay for the factory amounted to $178 million. LLC would need to obtain these funds from DutchCo.

In order to avoid exposure to a currency risk (euro versus dollar), DutchCo entered into several currency forward contracts with two banks. Under such a contract, a party either buys or sells an asset at a specified future time at a price agreed upon today (the forward price). Subsequently, DutchCo entered into several currency swap agreements that were rolled over several times. About two months after the asset purchase agreement was signed, the transaction actually closed and the assets, including the factory, were delivered to LLC.

At that moment, DutchCo acquired $179 million against payment of some €124 million. DutchCo used $178 million to make a capital contribution of $163 million and a loan of $15 million to LLC. The funds were used by LLC to settle the purchase price. Ultimately, the various currency contracts resulted in a loss for DutchCo of about €2 million, being the difference between the originally agreed forward price and the spot price at the time of the transaction.

Issue

DutchCo held that the losses incurred from the currency transactions were tax-deductible costs. The Dutch tax authorities on the other hand argued that because of the connection between the currency hedging contracts and the subsequent capital contribution to LLC, the loss should be considered part of the cost price of the shares in LLC that constituted a qualifying participation for the participation exemption.

Decision

The court had to decide whether the currency hedging transactions and DutchCo's capital contribution to LLC were so closely linked that they needed to be considered as forming a single transaction.

The court referred to a judgment of the Supreme Court of April 11, 2003 (No. 37 611). In that judgment, the Supreme Court agreed with the decision of the High Court of Amsterdam that the connection between a taxpayer's obtaining of funds in the form of a capital contribution to and a loan obtained by that taxpayer, and its use of those funds two days later to acquire a qualifying participation was not so close that the transactions should be treated as one single transaction. Consequently, the gain realized from the currency exchange fluctuations that occurred in the two-day period could not be treated as part of the cost price of the qualifying participation and should be included in the taxpayer's taxable profits.

The lower court of Arnhem held that the transactions entered into by DutchCo were not closely enough linked to treat as one single transaction (or set of transactions). One of the factors the court deemed relevant was that the upcoming capital contribution by DutchCo to LLC had not been contractually agreed when the currency hedging contracts were entered into by DutchCo. Consequently, the tax treatment of the results realized from each separate transaction was to be determined independently. The losses that DutchCo incurred from the currency hedging transactions could therefore be deducted.

Comments

If the transactions had been structured slightly differently, the outcome of the case would likely have been different.

If DutchCo had agreed on an unconditional capital contribution to LLC at the time the purchase contract

for the factory was entered into, a liability would have appeared in DutchCo's tax balance sheet, which was capable of being hedged. It follows from case law that different assets and liabilities of a taxpayer should be valued collectively if they are sufficiently connected and if the price risk is greatly limited. The Supreme Court held that a price risk is greatly limited if the effectiveness of the hedge falls within a range of 80 to 125 percent (a criterion which seems to be based on international financial reporting standards). If structured properly, a currency hedging transaction should satisfy this ''effectiveness test.''

This time, the absence of an effective link was to the taxpayer's benefit. However, currency fluctuations are difficult to predict, and taxpayers may want to avoid being exposed to a Dutch tax liability from this kind of currency exchange fluctuation. ◆

♦ *Anton Louwinger, tax adviser, Hogan Lovells International LLP, Amsterdam*

(C) Tax Analysts 2012. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.