Dutch Supreme Court Clarifies Position on Tax Treatment of Hedging Transactions

by Anton Louwinger

Full Text Published by taxanalysts®

The Dutch Supreme Court on March 21 issued its ruling in a case[1] that concerned the Dutch corporate income tax treatment of a market maker. The issue at stake was how the principles of sound business practice should be applied to various hedging transactions entered into by the market maker.

Introduction

The principles of sound business practice govern the allocation of the total profit made by a corporate taxpayer during the existence of the company to its respective financial years. The concept of sound business practice has been developed in case law and is subject to constant changes triggered by developments in society. Important elements of the concept that should be observed when selecting and implementing an accounting method for Dutch tax purposes are:

- the reality principle -- the profits are to be determined in a realistic manner, which means that:
  - the profit for a given year is to be determined with regard to the costs and benefits associated with that year;
  - the real facts, and not necessarily the legal or other structures that are applied, constitute the basis for determining the profits; and
  - the taxpayer should not doubt what is certain and vice versa;
- the prudence principle -- unrealized losses may be recognized and unrealized profits may be ignored; and
- the principle of simplicity -- the accounting method used must be manageable in view of the applicable circumstances.

The March 21 case concerned the application of the reality principle in combination with the prudence principle to determine the extent to which losses regarding specific assets -- both unrealized and realized -- can be recognized for Dutch tax purposes if they are matched by unrealized gains regarding other specific assets.

[1] Case ECLI:NL:HR:2014:635.

Facts

As a market maker, the taxpayer assumed and maintained positions in derivatives and underlying assets, particularly options and shares. Also, the taxpayer undertook arbitrage activities and tried to generate additional profits through hedging activities.

The taxpayer aimed to fully hedge the risks to which it was exposed in connection with its positions by means of delta hedging. For that purpose, the taxpayer engaged in transactions involving other options of the same funds, purchased and sold underlying securities, and created synthetic equivalents. These equivalents hedged the risks in a similar, but not identical, manner to shares.

The risk of price movement is reflected in the so-called delta. Also, there are risks reflected in the "other Greeks," -- namely, the vega (volatility), theta (passage of time), gamma (mutation delta), and rho (interest). Further, the taxpayer was exposed to risks regarding dividends as well as liquidity. The taxpayer's goal was also to control those risks as much as possible. When the price of a fund changes, the delta changes, which causes the taxpayer to rebalance its positions in order to achieve a delta-neutral position.

In its financial statements, the market maker stated the derivatives and shares at fair market value, whereas for Dutch corporate income tax purposes, the long positions were stated at the lower of the historical cost price or FMV, and the short positions were stated at the higher of the amount of the option premium/share price received or FMV. This resulted in the recognition of losses in a given year that should not be suffered during the lifetime of the business because of compensating profits on other transactions.

Leaving aside a dispute over the Dutch tax authorities' ability to terminate an advance tax ruling, the issue, in the tax authorities' view, was that in light of the taxpayer's business strategy of full risk mitigation, the reality principle is not observed when transactions are economically linked, but the tax treatment of the transactions is nevertheless determined on an isolated basis.

Decision

The Supreme Court started by confirming its previous case law, in which it had ruled that an asset can be stated at cost and that a possible increase in value of that asset must be recognized for Dutch tax purposes only at the moment the increase is realized in a transfer of that asset to another party. At the same time, according to good business practice, if the FMV is less than the cost price, a taxpayer is allowed to apply that lower value.

If, however, connected valuation with other assets or liabilities is required, such a downward revaluation is allowed only to the extent that the aggregate value of the connected assets or liabilities is less than the combined cost. The Court previously ruled (ECLI:NL:HR:2009:AZ7364) that a connected valuation of assets or liabilities is required if there is a highly effective hedge. This is the case if, at the balance sheet date, it is anticipated that the value fluctuations of specific assets or liabilities will most certainly correlate within a range of 80 to 125 percent (the high efficiency test). (Prior coverage .)

The Court added that this approach also applies to listed securities. This means that securities that are subject to this connected valuation cannot be stated below their combined market value. This is in line with the Court's decision of November 16, 2007 (ECLI:NL:HR:2007:AZ7371), which concerned the tax treatment of a writer of a call option over shares that it also owned.

However, deviating from previous decisions, the Court held in its March 21 ruling that sound business practice requires connected valuation for all assets or liabilities whose value is directly linked with that of shares. In those cases, the high efficiency test is no longer relevant. According to the Court, that test remains relevant for assets or liabilities that concern a group of (different) shares. For purposes of the high efficiency test, it is irrelevant that the market maker applied a policy of delta hedging and that the assets and liabilities were stated at FMV in its financial statements, the Court held.

It also held that if it is a taxpayer's continuous goal to minimize exchange risks for a set of securities (which may include liabilities) through hedging, that is not in line with the principles of sound business practice if: 1) a loss realized by that taxpayer on some (but not all) assets or liabilities belonging to a set of assets and liabilities that is subject to connected valuation is taken into account for Dutch tax purposes; while 2) the FMV of the remaining assets and liabilities exceeds the cost price of the total assets and liabilities for which connected valuation was required (including those that are transferred).

According to the Supreme Court, in such a case, the realized loss cannot be taken into account but needs to be added to the cost price of the remaining securities. It can then be taken into account only if a loss is ultimately suffered on the entire set of securities.

Conclusion

This decision sheds additional light on the boundaries of the reality principle.

For securities, connected valuation is obligatory if the valuation fluctuations are directly linked to those of a set of identical shares. In other cases, the high efficiency test remains relevant.

The Supreme Court has also made clear that for a connected valuation of a set of securities, only an overall loss can be taken into account for Dutch tax purposes, and not a loss suffered on the sale of a portion of those securities if, at that time, the FMV of the set of securities exceeds the combined cost price.

In that respect, the Court considered it important that the taxpayer continuously attempted to minimize its exchange risks through hedging. It remains to be seen whether the Court will rule differently in the absence of such a goal.

Additional case law will provide clarity on whether the Supreme Court will also drop the high efficiency test for assets other than shares.

Anton Louwinger, tax partner, Hogan Lovells International LLP, Amsterdam