

Lower court of Arnhem rules that currency exchange losses are tax-deductible.

In a case concerning a taxpayer that entered into a series of currency forward contracts to hedge the currency exchange risks associated with an upcoming acquisition denominated in a foreign currency, the court of Arnhem ruled that losses suffered with respect to such contracts are tax-deductible.

Facts

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

In order to avoid being exposed to a currency risk (EUR versus USD), DutchCo entered into a number of currency forward contracts with two banks. Pursuant to such contract a party buys or sells (as the case may be) an asset at a specified future time at a price agreed upon today (the forward price). Subsequently DutchCo entered into a number of currency swap agreements that were rolled over several times. About 2 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 USD 179 million against payment of some EUR 124 million. DutchCo used USD 178 million to make (i) a capital contribution of USD 163 million and (ii) a loan of USD 15 million to LLC. These funds were used by LLC to settle the purchase price. Ultimately the various currency contracts resulted in a loss of about EUR 2 million for DutchCo, being the difference between the originally agreed forward price and the spot price at the time of the transaction.

Issue

DutchCo took the position that the losses suffered in respect of the currency transactions were tax-deductible costs. The Dutch tax authorities on the other hand argued that the connection between the currency hedging contracts and the subsequent capital contribution to LLC was such that the loss suffered 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 on whether the connection between the currency hedging transactions and DutchCo’s capital contribution to LLC was such that indeed these transactions need to be considered as transactions that are so closely linked that they form, objectively, a single transaction.

The court started with a reference to the judgment of the Supreme Court of 11 April 2003 (No. 37 611). In that judgment the Supreme Court agreed with the decision of the High Court of Amsterdam that the relation between the obtaining by a taxpayer of funds in the form of a capital contribution to, as well as a loan obtained by, that taxpayer and the use by that taxpayer of the relevant funds two days later to acquire a qualifying participation was not so close that these should not be treated as one single transaction. As a consequence, the gain realised as a result of currency

exchange fluctuations that occurred in the two days period could not be treated as part of the cost price of the qualifying participation and was to be included in the taxpayer's taxable profits.

In its decision of 4 October 2012 the lower court of Arnhem ruled that also the transactions entered into by DutchCo were not linked closely enough to treat these as one single (set of) transactions. One of the factors that the court deemed relevant was that the upcoming capital contribution by DutchCo to LLC had not been contractually agreed at the time the currency hedging contracts were entered into by DutchCo. As a consequence the tax treatment of the results realised in respect of each separate transaction was to be determined independently. The losses that DutchCo suffered on the currency hedging transactions could therefore be deducted.

Comment

If the transactions would have been structured slightly differently, then the outcome of the case would likely have been different. If at the time the purchase contract with respect to factory was entered into DutchCo would have agreed on an unconditional capital contribution to LLC, then a liability would have appeared in DutchCo's tax balance sheet, which was capable of being hedged. From case law it follows 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%-125% (which criterion 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, clearly the predictability of currency fluctuations is a difficult issue and taxpayers may want to avoid possibly being exposed to a Dutch tax liability with respect to this kind of currency exchange fluctuations.

Source: decision of 4 October 2012 of the lower court of Arnhem (AWB 11/3335)