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Consolidate Global Hedge, Supreme Court Says

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COUNTRY DIGEST

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Consolidate Global Hedge, Supreme Court Says

The Dutch Supreme Court on April 10 issued an important decision clarifying how Dutch corporate income tax payers[1] should deal with the valuation of different positions held under a so-called global hedge fund.[2]

The Supreme Court held that the different instruments of a global hedge fund should be valued collectively if they are sufficiently connected and if on the balance sheet date, the price risk is greatly limited (the Court mentioned a range of 80 percent to 125 percent).

Background

In the Netherlands, the taxable profit of a corporate income tax payer must be determined in accordance with the principles of sound business practice (*goed koopmansgebruik*). Two fundamental principles that form part of this standard are the reality principle (*realiteitsbeginsel*) and the principle of prudence (*voorzichtigheidsbeginsel*). Regarding the valuation of assets and liabilities, these principles generally imply that gains should be recognized only if they are actually realized, while losses can generally be taken into account before they are actually realized.

This asymmetric timing (early recognition of a loss, late recognition of a gain) can have significant consequences for hedges. The strictest application of the principle of prudence on the separate hedging positions could, for instance, lead to a hidden loss being taken into account while the hidden gain on the hedge is postponed only to be taken into account upon realization; this could lead to a timing advantage for the taxpayer. The Supreme Court dealt with this issue on January 23, 2004, in a case that involved a specific receivable for which the currency risk was hedged by a specific debt.[3] The Supreme Court held that it would not be in accordance with sound business practice to take a currency loss into account if that currency loss is compensated by a currency gain (in the same amount) on the corresponding currency position of a specific hedge. In other words, if there is a specific hedge, the taxpayer should value the hedging positions as a whole instead of separately. The question remained to what extent this thinking should apply to global hedges. The April 10 Supreme Court decision addresses this issue.

Facts of the Case

The taxpayer in the case was a Dutch fiscal unity for corporate income tax purposes and part of an international group engaged in processing and trading agricultural products and food. One of the companies in the fiscal unity (B BV) operated production facilities in the Netherlands that continually processed cacao beans into semifinished products (cacao mass, cacao butter, and cacao powder). B BV purchased approximately 90 percent of the cacao beans it needed for production purposes by means of forward purchasing contracts and sold the semifinished products almost entirely by means of forward sales contracts. Because the forward sales were concluded with, on average, a far longer term than the forward purchases (the cacao beans of the required quality could not be purchased long before their harvest time), B BV had a structural net short position in cacao beans. To reduce the price risks concerning related to this net short position, B BV used publicly traded cacao bean futures. The forward sales, forward purchases, and futures were entered into in pound sterling and various other currencies. B BV used currency derivatives to hedge its currency risks.

To monitor its price risks, B BV recorded its flat-priced position (in metric tons of cacao beans) consolidating its forward sales, forward purchases, and futures

[1]The Supreme Court's decision also applies to individual taxpayers that fall under the profit from a business enterprise regime of the Dutch Personal Income Tax Act 2001 (*Wet op de Inkomstenbelasting 2001*).

[2]The decision also clarifies the application of a specific valuation principle for inventories that is accepted for Dutch corporate income tax purposes (the so-called *ijzerenvoorraadstelsel*).

[3]Dutch Supreme Court, Jan. 23, 2004, no. 37 893, BNB 2004/214.

for individual future months as well as its cumulative position for a number (over 12) of months. The cumulative position trended toward zero; the position per individual month did not. Directives within the international group and B BV's financial statements contained statements underpinning the aim to hedge price and currency risks as much as possible.

When determining its taxable profit, B BV took the position that the unrealized gains on the forward sales, forward purchases, and futures did not have to be recognized until such gains were actually realized, while unrealized losses were taken into account immediately, decreasing B BV's taxable profit. The tax inspector disagreed, arguing that all positions were interlinked and should therefore be valued together, meaning that an unrealized loss could be taken into account only to the extent that it would exceed the unrealized gains.

The Amsterdam Court of Appeals agreed with the tax inspector, deciding that in view of the directive regarding B BV and its financial statements and administration (flat-priced position), it should be concluded that B BV structurally aimed to globally hedge its price and currency risks and that, at least over a longer period, B BV seemed to succeed in hedging these risks. The court ruled that under those circumstances, it would be completely artificial and contrary to sound business practice (reality principle) to split the valuation of the parts of the global hedge. B BV appealed the decision.

The Supreme Court's Decision

The Supreme Court considered whether different positions of a global hedge should be valued together. Regarding the price risk on cacao, it ruled that if there is a connection between the forward sales on the one hand and the forward purchases and futures or the presence of a technical inventory on the other hand and if on the balance sheet date, this price risk is greatly limited, sound business practice (reality principle) implies that the valuation of such forward sales, forward purchases, futures, and technical inventory should be interconnected. For such a connected valuation, an unrealized loss on certain positions can be taken into account only to the extent that there is a cumulative unrealized loss on all the positions that have to be valued in connection with each other.

Whether there is a connection should, according to the Supreme Court, be assessed based on the circumstances of the case. It is, inter alia, important what the nature of the contracts and the existing risks are and whether the intention is to hedge a risk. The latter may be inferred from the administration, financial statements, or goals of the business enterprise.

The Court held that a price risk is greatly limited if at the balance sheet date, the fluctuations of the value of the cacao, which is included in the various positions, are expected to fall within a range of 80 percent to 125 percent. Data regarding past value fluctuations of the positions and the nature of the hedging contracts can be used when applying this test.

The Supreme Court further held that these rules also apply to the currency risks related to the forward sales, forward purchases, and future contracts and the currency derivative contracts entered into for purposes of hedging these risks.

Final Remarks

With its decision, the Supreme Court has essentially extended the scope of its 2004 decision regarding specific hedges to global hedges. An interconnected valuation may be required for both types of hedges. If so, unrealized losses on certain positions can be taken into account only to the extent that there is an overall unrealized loss (an overall realized profit, in principle, does not have to be recognized).

Interestingly, the specific range of 80 percent to 125 percent seems to be based on international financial reporting standards, under which the same range is used to determine whether a hedge is effective. The Supreme Court's use of this range seems to have been based on practical reasons and seems to comply with the simplicity principle that also forms part of sound business practice. It also provides a clear-cut boundary that may be very helpful to taxpayers. ◆

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