Comité mixte sur la fiscalité
de l'Association du Barreau canadien
et de l'Institut Canadien des Comptables Agréés

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Le 19 janvier 2012

Monsieur Brian Ernewein
Directeur général, Division de la législation de l'impôt,
Direction de la politique de l'impôt
Ministère des Finances
L'Esplanade, tour Est, étage
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Objet : Règles concernant la monnaie fonctionnelle

Monsieur,

Les nouvelles règles concernant la monnaie fonctionnelle énoncées dans l'article 261 de la *Loi de l'impôt sur le revenu* (Canada) ont été accueillies favorablement et ont généralement bien fonctionné. Toutefois, des membres de la communauté fiscale, forts de leurs quelques années d'expérience en matière d'application de ces règles, ont relevé un certain nombre de problèmes. Vous trouverez ci-joint notre mémoire qui aborde ces problèmes et qui contient des recommandations pour des modifications. Nous serions heureux de collaborer avec le ministère des Finances afin de trouver des solutions appropriées aux problèmes soulevés.

Nous désirons souligner les contributions de K. A. Siobhan Monaghan de Davies Ward Phillips & Vineberg S.E.N.C.R.L., s.r.l., de Tony Ancimer de Deloitte s.r.l. et de Heather O'Hagan de KPMG s.r.l./ S.E.N.C.R.L. en ce qui concerne l'analyse et la préparation du présent mémoire.

Nous vous remercions de l'attention que vous porterez à ce mémoire et nous espérons que nos commentaires vous seront utiles. Nous serions heureux de vous rencontrer pour en discuter et pour répondre aux questions que vous pourriez avoir.

Veuillez agréer, Monsieur, l'expression de nos sentiments distingués.

D. Bruce Ball
Président, Comité sur la fiscalité
Institut Canadien des Comptables Agréés

Darcy D. Moch
Président, Section du droit fiscal
Association du Barreau canadien

Submission of the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants regarding the Functional Currency Rules

The Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants is pleased to provide you with this written submission on the functional currency rules contained in section 261 of the *Income Tax Act* (Canada) (the "**Act**"). Unless otherwise indicated, references to subsections, paragraphs, etc., are to provisions of the Act.

A. Time Limits for Filing Election or Revocation:

To be effective, an election to report Canadian tax results in a functional currency must be filed no later than six months before the end of the taxation year for which the election is to be effective: paragraph 261(3)(b). Similarly, a notice of revocation of such an election must be filed no later than six months before the beginning of the taxation year to which the revocation is to apply: subsection 261(4).

The first rule presents significant difficulty in the context of a new corporation, formed, for example, for purposes of making an acquisition (a "Bidco"). Typically, a Bidco will be formed shortly before the acquisition and, if amalgamated with the target, may not have a six month year end. Similarly, both rules present challenges if the taxation year of the corporation is unexpectedly shortened, most notably by virtue of an acquisition of control.[1]

To illustrate, assume Parent is a US multinational corporation with three Canadian subsidiaries, Sub 1, Sub 2 and Sub 3, all of which have a calendar taxation year. All three subsidiaries qualify to make the functional currency election to report their Canadian tax results in US dollars and file the election on June 1, 2011 to be effective for the taxation year commencing January 1, 2011. On September 20, 2011, there is an acquisition of control of Parent resulting in the taxation years of each of Sub 1, Sub 2 and Sub 3 ending on September 19, 2011. Because the election was filed less than six months before that date, it is not effective for the taxation year commencing January 1, 2011, as intended by each of the subsidiaries. Rather, it will be effective for the taxation year commencing September 20, 2011.[2] The rules contemplate that an election can be made with full knowledge of the exchange rate that will be relevant for purposes of converting various amounts from the Canadian currency to the functional currency. Permitting the election to be filed less than six months before the end of the taxation year to which it is to apply would not affect that feature of the rules.

In contrast, if Sub 1, Sub 2 and Sub 3 had filed the election to convert to a functional currency in a prior year, for example effective January 1, 2008, but subsequently determined to revoke the election effective for their 2012 taxation years and filed the revocation on June 1, 2011, the revocation would be effective for each taxation year that commences more than six months after the filing. In this case, the acquisition of control and consequential year-end do not automatically change the time at which the revocation becomes effective. That is, notwithstanding the unanticipated September 19, 2011 intervening taxation year-end, the revocation may be effective

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[1] Taxation years may also be shortened as a result of a corporation becoming or ceasing to be a financial institution or a Canadian-controlled private corporation, or as a result of an amalgamation with one or more other corporations.

[2] Indeed, the election once filed cannot be effectively revoked unless the revocation is filed at least six months before the taxation year to which it will apply.

January 1, 2012 as intended, provided each of the subsidiaries chooses December 31, 2011 as its first post-acquisition of control year end.[3]

Recommendation

We recommend that paragraph 261(3)(b) be amended to provide that an election to report Canadian tax results in a functional currency is effective if filed no later than 60 days after the commencement of the taxation year for which the election is to be effective. Taxpayers will continue to have full knowledge of the relevant foreign exchange rate that should be used to convert their opening Canadian dollar assets and liabilities into the relevant functional currency. However, such an amendment will also accommodate most circumstances in which there is a short taxation year.

We note that the election filing due date was changed by the November 10, 2008 amendments from a date following, to a date six months preceding, the commencement of the taxation year to which it is to apply, although the explanatory notes do not explain why the previous approach was abandoned in favour of the current rule. One possible reason is that the Department did not want a taxpayer to have perfect knowledge of the exchange rate that would apply throughout a taxation year. Under our recommendation, for a taxation year of less than two months, this could be a possibility. However, we do not believe that many taxpayers would create taxation years of less than two months simply to take advantage of the functional currency rules. Taxation years of such short duration typically occur in new corporations that need to align their year-end with that of a corporate group, or because of an acquisition of control. Any short taxation year created as a consequence of tax-motivated transactions with the goal of abusing the functional currency rules should be addressed through an anti-avoidance measure.

While at the time the election is filed, the taxpayer will have full knowledge of the foreign exchange impact up to that time. However, this is not different from the current rules since, under those rules, a valid election may be made up to six months after the commencement of the taxation year.[4] Under both the current rules and the change recommended here, a taxpayer is required to maintain the elected functional currency for an extended period and, consequently, the foreign exchange impact over this period of time to the taxpayer is unknown. Thus, it would be difficult for a taxpayer to inappropriately utilize the functional currency rules to achieve a tax benefit.

B. Amalgamations

1. <u>All Predecessors Have Common Functional Currency</u>:

If two or more corporations amalgamate, notwithstanding that all predecessors have filed an election pursuant to paragraph 261(3)(b) to report Canadian tax results in a common functional

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[3] If they do not, the revocation will be effective for the first taxation year commencing after November 1, 2011.

[4] An election must be filed at least six months prior to the end of the taxation year, such that for a 12-month taxation year, the election may be filed up to six months after the commencement of the taxation year.

currency, the corporation formed on the amalgamation nonetheless must file a separate election and that election must be filed by the amalgamated corporation at least six months prior to its first taxation year-end. The requirement to have the amalgamated corporation file in this circumstance does not appear to serve any real purpose while raising the compliance burden on the amalgamated corporation, the possibility of a filing being missed with potentially significant adverse tax consequences, and, under current rules, the possibility that the amalgamated corporation would be unable to file an effective election if the amalgamated corporation's first taxation year is shorter than six months. Indeed, it would appear consistent with the policy of subsection 261(18) that the amalgamated corporation be required to remain on that common currency unless it files an effective revocation**.**

For a revocation to apply to such an amalgamated corporation, each of the predecessors would have had to have filed an effective revocation six months before the amalgamation. If they do so, that revocation should be effective for the amalgamated corporation.

Recommendation

We recommend that section 261 be amended to provide that where all predecessors to an amalgamation have previously filed an effective functional currency election to report Canadian tax results in the same qualifying currency and the election is in place for the taxation year ending immediately before the amalgamation, the amalgamated corporation be deemed to have filed an election pursuant to subsection 261(3) , within the time frame outlined in paragraph 161(3)(b), to report its Canadian tax results in that qualifying currency.

We further recommend that section 261 be amended to provide that where predecessors have filed a revocation of such an election at least six months before the start of the first taxation year of the amalgamated corporation, that revocation apply to the amalgamated corporation for its first taxation year.

2. <u>Predecessors and Amalgamated Corporation Have Different Reporting Currencies:</u>

If a predecessor to a corporation formed by an amalgamation has, in the taxation year ending immediately before the amalgamation, a different tax reporting currency than the corporation formed by the amalgamation, the predecessor must recompute its Canadian tax results for the taxation year ending immediately before the amalgamation. The ramifications of this rule depend on the relevant circumstances.

(a) Amalgamated Corporation Wishes to make Functional Currency Election

If both predecessors report Canadian tax results in Canadian dollars but the amalgamated corporation wishes to report in US dollars, each predecessor must recompute its income for its last taxation year using the US dollar. In this respect, the amalgamated corporation is at a disadvantage from other corporations. It is not apparent why a corporation formed by an amalgamation should not be able to elect to report its Canadian tax results in a qualifying currency from its first taxation year without affecting the rules applicable to the predecessors.

(b) Predecessors Themselves not on a Common Currency

Unless all of the predecessors to an amalgamation are on a common currency, a recomputation by one or more predecessors is inevitable. If one predecessor reports Canadian tax results in Canadian dollars, but the other reports in US dollars, regardless of which of the two currencies the amalgamated corporation wishes to report in, one predecessor will be required to recompute its Canadian tax results for its last taxation year. It is not clear what policy objective is achieved by this provision.

While we recognize that rules are needed for translating a predecessor's balances (such as those referred to in subsection 261(7)) to the same functional currency as that of the amalgamated corporation, this could be achieved simply by converting those balances based on the relevant spot rate on the last day of the predecessor's taxation year ending immediately before the amalgamation without requiring the predecessor to recompute its Canadian tax results for the entire year. Under such a rule, an amalgamated corporation that reports in a currency other than Canadian currency would be in the same position with respect to amounts carried over from the predecessor as would be the case for any other corporation that elects to report its Canadian tax results in a functional currency: that is, the rate applicable immediately before that taxation year begins.

Where an amalgamated corporation reports in Canadian currency but one of the predecessors did not, the predecessor is required to treat its last taxation year as a reversionary year. Pursuant to subsections 261(7) and (12), the amounts referred to in subsection 261(7) are to be converted to Canadian currency using the spot rate on the last day of the predecessor's taxation year preceding the taxation year ending with the amalgamation. This rate will be known. In a reversionary year that arises otherwise than as a result of an amalgamation, the amounts referred to in subsection 261(7) are converted using the spot rate at the end of the last functional currency year which, at the time the revocation is filed, is not known. Thus, in the context of an amalgamation, converting those amounts based on the relevant spot rate on the last day of the predecessor's taxation year preceding the taxation year ending with the amalgamation would be a departure from the principle applicable to a reversionary year that arises otherwise than from an amalgamation. However, in any circumstance in which at least one predecessor has a different functional currency than one or more predecessors, the rule mandates a recomputation of income by at least one predecessor.

While we recognize that amalgamations should not be used to avoid the basic principles of the rules, we believe that the rules should not be penal simply because there has been an amalgamation. Attempts to misuse the rules should be addressed through an anti-avoidance measure. In this connection, we observe that subsection 261(18) may apply to an amalgamation by virtue of subsection 261(19).

Recommendation

We recommend that subsection 261(17) be amended to provide that, in the circumstances described therein, subsections 261(7) and (8) apply to any amounts carried over to the amalgamated corporation from a predecessor that has a different tax reporting currency than the amalgamated corporation on the basis of the relevant spot rate at the end of the predecessor's

last taxation year and that the tax results of the predecessors for their last taxation year not be recomputed.

We recognize that this principle is perhaps more difficult to apply in the context of a winding-up to which subsection 88(1) applies: there is no deemed year-end, the assets may be distributed over a period of time, and there may be a time lag between the commencement of the winding-up and its completion. Thus, we are suggesting that subsection 261(16) remain unchanged in this respect.

3. <u>Sequential Amalgamations</u>:

There appears to be a technical problem with subsection 261(17) where a predecessor corporation was itself formed by an amalgamation. The problem perhaps can be best illustrated by example.

Assume Amalco is formed on January 1, 2011 by the amalgamation of Aco (which reports its Canadian tax results in US dollars), BCo (which has never made a functional currency election) and CCo (which reports its Canadian tax results in US dollars). BCo was itself formed by the amalgamation on January 1, 2010 of Sub1 and Sub2, neither of which had made a functional currency election. Sub 2 was formed by the amalgamation on January 1, 2009 of SubX and SubY. Amalco will report its Canadian tax results in US dollars. Each of the corporations has a calendar taxation year.

Under subsection 261(17), subsection 261(5) is deemed to apply to BCo for its taxation year ending December 31, 2010 and BCo is deemed to have as its elected functional currency US dollars. As a result, subsection 261(17) applies to Sub 1 and Sub 2: they are predecessors to the amalgamation forming BCo, which, for its taxation year commencing January 1, 2010 has a different tax reporting currency (US dollars) than its predecessors. As a result, subsection 261(5) is deemed to apply to Sub 1 and Sub 2 for their 2009 taxation years and each is deemed to have, as its elected function currency, US dollars in such taxation years. For similar reasons, subsection 261(17) applies to SubX and SubY in their 2008 taxation years.

Subsection 261(16) does not have this problem because a determination of whether the parent and subsidiary have different tax reporting currencies is made without reference to subsection 261(16) itself:

> If…the parent and the subsidiary…***would, in the absence of this subsection***, have different tax reporting currencies at the commencement time…

While subsection 261(17) incorporates paragraphs 261(16)(a) and (b), it does not incorporate the preamble, where the relevant language is found. However, where subsection 216(17) applies to a subsidiary that was formed by an amalgamation and is wound up into its parent, a similar problem can arise. Again an example illustrates the point.

Assume that Subsidiary, wholly-owned by Parent, was formed on January 1, 2010 by the amalgamation of Corp 1 and Corp 2. None of Corp 1, Corp 2 or Subsidiary made a functional currency election and thus each has reported their Canadian tax results in Canadian dollars.

Parent made an election effective for its taxation year commencing January 1, 2008 to use the US dollar as its elected functional currency. On September 30, 2010, the winding-up of Subsidiary into Parent commenced. Pursuant to subsection 216(16), subsection 261(5) applies to Subsidiary for its taxation year commencing January 1, 2010 and it is deemed to have elected US dollars as its functional currency for that year, its first taxation year. As a result, subsection 216(17) applies to Corp 1 and Corp 2: they are predecessors to the amalgamation to form Subsidiary and they have, in their last taxation years, a functional currency (Canadian) that differs from the functional currency of Subsidiary in its taxation year immediately following the amalgamation (US dollars by virtue of the application of subsection 216(16)).

Recommendation

We recommend that subsection 261(17) be amended, effective from the date it became effective, to provide as follows:

> If a predecessor corporation and the new corporation, in respect of an amalgamation within the meaning of subsection 87(1), would, in the absence of this subsection or subsection 216(16), have different tax reporting currencies for their last and first taxation years, respectively, paragraphs….

With that amendment, subsection 261(17) should not apply to Sub 1 and Sub 2 because, but for the application of subsection 261(17) to BCo, BCo and its predecessors would not have different tax reporting currencies. Similarly, subsection 261(17) would not apply to Corp 1 or Corp 2 because, but for the application of subsection 261(16) to Subsidiary, Subsidiary and its predecessors would not have different tax reporting currencies.

C. Application of Functional Currency Rules to Partnerships and Foreign Affiliates

Partnerships and foreign affiliates cannot elect to have the functional currency rules apply since only corporations resident in Canada can make such an election: paragraph 261(3)(a). However, subsection 261(6) applies the functional currency rules to partnerships in respect of a partner to which the functional currency rules apply. In addition, subsection 261(6.1) applies the functional currency rules in computing the foreign accrual property income ("FAPI") of a foreign affiliate in respect of a Canadian shareholder to which the functional currency rules apply.

Generally speaking, the partnership or foreign affiliate computes its Canadian tax results (or FAPI in the case of a foreign affiliate) as though it had made a functional currency election for its first fiscal/taxation period that ends on or after the Canadian corporate partner/shareholder's first functional currency year. As part of this, the transitional rules as outlined in subsection 261(7) apply to the partnership or foreign affiliate at the end of the preceding taxation year.

The following illustrates the tax consequences of applying subsection 261(6.1) where the shares of a foreign affiliate are transferred within a related Canadian group of companies.

Canco, a Canadian resident corporation, owns 100% of the shares of a US-resident foreign affiliate ("FA"). Both Canco and FA have a December 31 taxation year. Canco made an election pursuant to 261(3) to have US dollars as its functional currency commencing in its 2010 taxation year.

Pursuant to subsection 261(6.1), FA must compute its FAPI for its 2010 and later taxation years using US dollars as its functional currency. In addition, the transitional rules in subsections 261(7) through (10) would apply to FA on December 31, 2009. As a result, the cost base to FA of all of its FAPI-generating assets (and the amount of liabilities relevant to FAPI computations) would have to be recomputed (*i.e.,* their historical Canadian dollar amounts would have to be converted to US dollars using the relevant spot rate on December 31, 2009). This would create a new US dollar cost base for FAPI-generating assets (and new US dollar amounts for the relevant liabilities). On their future settlement or disposition, gains and losses may arise because of the new US dollar amounts.

Assume that in 2011, as part of a reorganization of the corporate group, Canco transferred all of the FA shares to a wholly-owned subsidiary of Canco, Cansub, which also made a functional currency election to use US dollars for its 2010 taxation year (*i.e.,* the same taxation year as Canco). In respect of Cansub, pursuant to paragraph 261(6)(a), FA's first functional currency year is now its 2011 taxation year because that is the first taxation year where FA is a foreign affiliate of Cansub, notwithstanding that FA was a foreign affiliate of Canco at all times. As such, FA's last Canadian currency year is now its 2010 taxation year and, therefore, the transitional rules in subsection 261(7) must be applied. There is no provision that takes into account the fact that Cansub was already using a US dollar functional currency in respect of a related Canadian corporation prior to the time the transitional rules apply in respect of Cansub.

As a result, FA will now have to recompute its opening cost base for its FAPI-generating assets (and the amount of its liabilities relevant to the FAPI computation) using the relevant spot rate on December 31, 2010. However, it is not clear how this computation should be done because FA already has US dollar cost base and liability amounts computed in US dollars, albeit computed at a different relevant spot rate, for Canadian tax purposes.

The above-noted tax result is obviously anomalous and not consistent with the objectives of the functional currency rules. The same results can occur in respect of partnerships, except the results would be more dramatic and pronounced since the transitional rules would apply to all items, not just FAPI items as is the case with foreign affiliates.

Recommendation

We recommend that paragraphs 261(6)(a) and 261(6.1)(a) be amended to reference any partner/shareholder that was related to the particular taxpayer, where the rules previously applied to that partner or shareholder.

D. Anti-Avoidance Rules: Subsections 261(20) and (21)

The anti-avoidance rules in subsections 261(20) and (21) generally apply where a transaction is undertaken between a taxpayer and a related corporation, and the two parties have different tax reporting currencies. Where the taxpayer incurs a loss in respect of the transaction that results from the difference in the two tax reporting currencies, that loss will effectively be denied.

The Explanatory Notes released with these provisions state that the purpose of this rule is to protect against abuses of the functional currency reporting regime as illustrated by the example

in the Notes: Parentco, a Canadian dollar reporter, and Subco, a US dollar reporter, enter into a loan arrangement whereby Parentco loans Subco Cdn$1 million. On the repayment of the loan, Parentco has no foreign exchange gain or loss as its receivable is denominated in Canadian dollars. However, Subco incurs a loss on the repayment due to the increase in the US dollar relative to the Canadian dollar over the period that the loan was outstanding. The loss incurred by Subco will be denied because of the rules in subsections 261(20) and (21). The same result would have occurred had the loan been denominated in US dollars, and Parentco incurred a loss on its repayment. This example, and the policy behind the introduction of the anti-avoidance rule, make sense from a tax policy perspective. Both taxpayers in this case are Canadian corporations, and both have the ability to make the functional currency election if the applicable criteria are met.

However, there are situations where the denial of a foreign exchange loss, as contemplated by this anti-avoidance rule, goes beyond the intended scope of the provision to deny losses in circumstances where it is inappropriate to do so. Two such situations are outlined below.

1. <u>Transactions between related parties where both foreign exchange gains and losses are realized</u>

(a) Back-to-back loans

In the example in the Notes, there is no indication as to where Parentco obtained the funds that it in turn loaned to Subco. In many cases, a parent corporation will borrow from a bank in US dollars, and will on-loan those funds to its subsidiary in US dollars. In the absence of the anti-avoidance rule, the parent would be effectively hedged on its foreign exchange exposure as it would have both a receivable and a payable denominated in US dollars. However, because of the anti-avoidance rule, any foreign exchange loss that the parent incurs on such a receivable from a subsidiary will be denied, even though it will also have a foreign exchange gain on its third party payable. If the parent instead incurred a loss on the third party debt but a gain on the repayment by the subsidiary, the loss will not be denied and would be available to offset the related gain. From a policy perspective, there is no reason why the tax results to the parent should differ depending on whether there is a gain or a loss on its related party debt with Subco.

(b) Commodity and swap transactions

In some cases, the fact that one of the related companies has made the functional currency election has no bearing on the computation of the foreign exchange gain or loss related to a specific transaction. The gain or loss simply arises as a result of the nature of the transaction itself, such as with commodity or swap transactions.

Cross-currency swaps and other types of hedging arrangements are generally entered into by Canadian corporations in order to hedge foreign exchange exposure on assets, liabilities, or income streams or expenses denominated in a currency other than their functional currency. These arrangements can be entered into with third parties, or with related corporations. Regardless of the currency in which a corporation's Canadian tax results are computed, both parties will report an amount under the settlement of the cross-currency swap or hedge – one will report a loss and the other will report income or a gain.

If the swap or hedge is entered into with a third party, any loss incurred by the Canadian corporation that has made a functional currency election will not be denied. In contrast, if the swap or hedge is entered into between a Canadian corporation that has elected into the functional currency regime and a related corporation that has not, the anti-avoidance provisions would apply to deny any loss incurred by either company because the loss relates to the fluctuation in value between the Canadian dollar and the tax reporting currency of the related Canadian corporation. However, this transaction should not be considered an abuse of the functional currency reporting regime because both parties will report the appropriate gain and loss.

(c) Other arrangements

There are other types of arrangements which may, indirectly and in part, be impacted by the fluctuation in value of two currencies. For example, a price hedging arrangement based on a precious metal, such as gold, may be entered into by related parties (one of which reports its Canadian tax results in US currency and the other in Canadian currency). A gain and loss will be reported by the parties on the hedging arrangement based on the change in the price of gold. However, part of the fluctuation in the price of gold may arise from fluctuations in the value of the US currency in the global marketplace. Moreover, because the price of gold is typically quoted in US dollars, the Canadian dollar equivalent of the price of gold will change as a result of any change in the value of the US currency relative to the Canadian currency. Consequently, a portion of the loss may reasonably be attributable to the fluctuation in the value of the Canadian currency and the US currency and therefore would be denied. As with the prior example, this transaction should not be considered an abuse of the functional currency reporting regime.

Recommendation

We recommend that the anti-avoidance rules in subsections 261(20) and (21) be amended to permit the realization of a loss, or a reduction in income, that is attributable to a fluctuation in currency:

(i) in situations where the taxpayer or a related taxpayer realizes an offsetting foreign exchange gain; and

(ii) where that loss or reduction in income is not attributable to the fact that one of the related parties has made a functional currency election.

While the gain and loss need not be realized by the same taxpayer, it should be tied to a transaction or arrangement in place between two related corporations. If the fluctuation in currency would have produced a loss in respect of a transaction without regard to whether a functional currency election has been made, there should be no restriction on claiming the loss.

2. <u>Determination of "accrual period" for calculating gains and losses</u>

The rules in subsections 261(20) and (21) rely on the determination of the "accrual period," that is, the period over which the income, gain or loss accrued. This period will necessarily depend on the nature of the transaction in question. For example, assume that Canco 1, a Canadian dollar

taxpayer, has made a US$12 million loan to Canco 2, a related taxpayer who previously made a functional currency election to use US dollars. The loan must be repaid by Canco 2 within three years.

The foreign exchange results of the repayment will vary depending on the applicable accrual period.

If Canco 2 must repay the loan at the end of the three-year term, the accrual period will be January 1, 2011 to December 31, 2013. Assuming the exchange rates below, Canco 1's resulting loss will be denied because of the rules in subsections 261(20) and (21).

Applicable date	Foreign exchange rate	Loan balance US$	Loan balance Cdn$	F/X gain or loss
January 1, 2011	$1 US = $1 Cdn	$12 million	$12 million	
December 31, 2013	$1 US = $0.95 Cdn	$12 million	$11.4 million	($0.6 million)

If instead Canco 2 must repay the loan in three installments of US$4 million at the end of each of the three years, there will be three accrual periods: January 1, 2011 to December 31, 2011 for the first repayment; January 1, 2011 to December 31, 2012 for the second repayment; and January 1, 2011 to December 31, 2013 for the third repayment. Assuming the exchange rates below, Canco 1's resulting losses in 2012 and 2013 will be denied because of the rules in subsections 261(20) and (21).

Applicable date	Foreign exchange rate	Loan balance US$	Loan balance Cdn$	F/X gain or loss
January 1, 2011	$1 US = $1 Cdn	$4 million	$4 million	
December 31, 2011	$1 US = $1.06 Cdn	$4 million	$4.24 million	$0.24 million
January 1, 2011	$1 US = $1 Cdn	$4 million	$4 million	
December 31, 2012	$1 US = $0.99 Cdn	$4 million	$3.96 million	($0.04 million)
January 1, 2011	$1 US = $1 Cdn	$4 million	$4 million	
December 31, 2013	$1 US = $0.95 Cdn	$4 million	$3.8 million	($0.2 million)

However, Canco 1 will be required to pay tax on the resulting foreign exchange gain in 2011, notwithstanding that it has losses in the following years relating to the same loan transaction. Canco 1 should have the ability to use the losses incurred in the second and third years to offset the gain that is realized in the first year.

Recommendation

We recommend that the anti-avoidance rule in subsections 261(20) and (21) be amended to allow the realization and use of a loss that is attributable to a fluctuation in currency, in situations where a taxpayer realizes an offsetting foreign exchange gain in relation to the same transaction.

3. Transactions between Canadian corporations and related non-resident corporations:

"Tax reporting currency" for a taxation year is the currency in which the taxpayer's "Canadian tax results" for a taxation year are to be determined. A non-resident corporation may not have any Canadian tax results in a particular taxation year. When dealing with transactions between a Canadian functional currency corporation and a related non-resident corporation, it is often difficult to determine whether the non-resident has a "tax reporting currency" for purposes of the rules in subsections 261(20) and (21). Furthermore, and as noted above, these provisions are meant to address the situation in which a foreign exchange loss is reported by a taxpayer in respect of a transaction with a related corporation, and no foreign exchange gain is reported by that related corporation because it has a different functional currency than the taxpayer. However, where the related corporation is a non-resident corporation not otherwise subject to Part I tax, there is no avoidance of Canadian tax on the gain and thus there is no abuse of the functional currency rules.

As an example, assume a non-resident parent company (NRCo) based in Europe makes a loan in Euros to its Canadian subsidiary (Cansub) which has elected the US dollar as its functional currency. If Cansub realizes a loss on the repayment of the Euro loan to NRCo, the loss may be denied if (a) NRCo and Cansub are related at the time that the loan is made, (b) they are considered to have different tax reporting currencies during the period that the loan is outstanding (assuming for this purpose that NRCo has a tax reporting currency other than the US dollar), and (c) the loss arose because of the fluctuation in value between the US dollar and the Euro.

In this example, Cansub has experienced a true foreign exchange loss. That is, Cansub may have realized a loss even if it was not a functional currency corporation (based on the fluctuation in value between the Canadian dollar and the Euro). This loss should not be denied because its realization is unrelated to Cansub's filing of a functional currency election. Moreover, because NRCo would not have otherwise been liable to Canadian tax in relation to foreign exchange fluctuations on the loan, there is no abuse of the functional currency rules.

Recommendation

We recommend that the anti-avoidance rule in subsections 261(20) and (21) be clarified in respect of transactions with related non-resident corporations. The ability to claim a loss, or to reduce income, should be allowed where that loss or reduction in income is not attributable to the fact that the Canadian corporation has made a functional currency election. In other words, if the fluctuation in currency would have produced a loss in respect of a transaction without regard to whether a functional currency election has been made, there should be no restrictions on claiming it. Moreover, the anti-avoidance rules should be clarified so they do not apply to transactions with non-residents not subject to tax pursuant to Part I of the Act

4. Transactions between Canadian corporations and related Canadian entities:

In some cases, a taxpayer other than a Canadian corporation will be party to a transaction with a Canadian corporation that has made the functional currency election. For example, the taxpayer could be an individual owner-manager or a Canadian resident trust who owns the shares of the

functional currency company. In each of these cases, the taxpayer in question does not have the ability to make the functional currency election, and will generally have a different tax reporting currency from the functional currency corporation. Accordingly, any transactions between such a taxpayer and the related Canadian corporation will be caught by these rules, and any foreign exchange losses arising on the transactions will be denied.

Recommendation

We recommend that the anti-avoidance rule in subsections 261(20) and (21) be amended to limit their application to transactions between related Canadian resident corporations, so that they do not apply to other taxpayers who have no ability to make a functional currency election.

E. Administrative Matters

1. <u>Relevant Spot Rate</u>:

Relevant spot rate is defined in subsection 261(1) as the Bank of Canada noon rate for the particular day[5] with only two potential exceptions. The relevant spot rate may be another rate of exchange that is acceptable to the Minister for only two purposes:

(a) Paragraph 261(2)(b): For a taxpayer that uses Canadian currency in determining its Canadian tax results (*i.e.,* subsection 261(5) does not apply to the taxpayer), the rate used to convert non-Canadian currency amounts to Canadian currency may be other than the Bank of Canada noon rate where the rate used is acceptable to the Minister.

(b) Paragraph 261(5)(c): For a taxpayer that uses an elected functional currency in determining its Canadian tax results (*i.e.,* subsection 261(5) does apply to the taxpayer), the rate used to convert non-functional currency amounts to the functional currency may be other than the Bank of Canada noon rate where the rate used is acceptable to the Minister.

However, the rules applicable to convert Canadian currency amounts to the elected functional currency upon transitioning into the functional currency rules, as outlined in subsection 261(7), do not permit the use of any rate other than the relevant spot rate. Each amount listed in subsection 261(7) must be converted from Canadian currency to the elected functional currency using the Bank of Canada noon rate on the last day of the taxpayer's last Canadian currency year.

The ability to use an alternative rate is helpful in situations where a taxpayer's accounting system is programmed to use a rate of exchange that may differ slightly from the Bank of Canada noon rate for the particular date. For example, certain organizations, particularly those with ultimate ownership outside of Canada, may use sources other than the Bank of Canada to program their accounting systems, which, in many circumstances, apply for every company in the group on a global basis, including any Canadian corporations. In these circumstances, the requirement that a

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[5] Or the closest preceding day where there is no such rate for the particularday.

Canadian corporation use a different rate of exchange for tax purposes may create an unnecessary burden. Moreover, it may not be practical for a Canadian taxpayer to separately track foreign exchange gain and loss computations for tax purposes, in particular for large volume transactions such as trade account receivables.

If the rate of exchange for accounting purposes is the same as the Bank of Canada noon rate, then the cost amount for accounting purposes and tax purposes should be the same and no adjustment is necessary in computing the Canadian tax results when these items are settled after the transition time.

However, if the rate of exchange for accounting purposes is not the Bank of Canada noon rate, the cost amount used for tax purposes[6] will be different than the cost amount for accounting purposes and this difference will have to be tracked. In many circumstances (*e.g.,* trade accounts receivable), there may be a significant number of transactions with no reasonable way for a taxpayer to accurately perform the required calculations. The result is greater complexity in computing the Canadian tax results after the transition time. Allowing a taxpayer to use a rate of exchange other than the Bank of Canada noon rate in circumstances like these is consistent with one of the purposes of the functional currency rules, ease of administration. Presumably the Minister would accept this approach only where the rate of exchange is reasonable and used consistently by the taxpayer.

Recommendation

We recommend that the definition of relevant spot rate be modified such that the alternative of "another rate of exchange that is acceptable to the Minister" apply for purposes of subsections 261(7), (8) and (9). This provides flexibility to taxpayers but provides a safeguard because the other rate may only be used where approved by the Minister.

2. Determination of amounts payable – Subsection 261(11)

Subsection 261(11) applies for a functional currency year of a taxpayer and addresses numerous issues where amounts are owing by a taxpayer under the Act. These provisions are necessary because a taxpayer must remit any amount owing in Canadian currency notwithstanding that its Canadian tax results are determined in the elected functional currency. Generally, the rules establish how a taxpayer computes installments (in particular where the relevant year for computing the installment base is a Canadian currency year for the taxpayer) and required remittances in Canadian currency when the required payment is computed in the elected functional currency.

However, subsection 261(11) does not address the situation where an amount, such as a refund, is owing to the taxpayer under the Act. While any refund will be paid in Canadian currency, there

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[6] For certain items, like monetary assets held on income account, the foreign exchange rate used for accounting purposes is the relevant foreign exchange rate for computing Canadian tax results, particularly when the taxpayer computes foreign exchange gains and losses for tax purposes in a manner consistent with the method used for accounting purposes.

is no statutory guidance on how the Canadian currency amount is computed when the refund amount must be initially computed in the elected functional currency.

The issues are illustrated by the following examples:

Example 1:

A taxpayer has elected to use the US dollar as its functional currency and that election has been in effect for the past two taxation years. In the current taxation year the taxpayer was required to make US$100 monthly installments[7] and made total installments of US$1,200. The actual exchange rate on the date of each installment payment was C$1.00 = US$1.10. As such, the installments paid in Canadian currency totalled $1,090.

The taxpayer's final tax liability for the year is US$1,000. Consistent with paragraph 261(5)(a), the Canadian tax results (which include the amount of tax refundable under the Act) must be computed in US currency so the taxpayer has an amount refundable of US$200. The exchange rate at the time the return is assessed[8] and the refund cheque is prepared is C$1.00 = US$1.00. As such, the Canadian currency equivalent of the final tax liability is C$1,000. Based on the current legislation, it is unclear whether the amount to be refunded to the taxpayer is C$200 (that is, converting the refund of US$200 to Canadian currency using the exchange rate when the refund is prepared) or C$90 (that is, computing the refund in Canadian currency using the exchange rate at the time the refund is computed but applying the installments in Canadian currency using the exchange rate when the installments were made).

Under the first approach, the foreign exchange currency exposure rests with the tax authority and under the second approach, the foreign exchange currency exposure rests with the taxpayer. Both have an opportunity for gain or loss. Our understanding is that the Canada Revenue Agency is administering refunds in a manner consistent with this second approach.

Example 2:

A taxpayer has elected to use the US dollar as its elected functional currency and that election has been in effect for the past two taxation years. In the second preceding taxation year, the taxpayer made the following installment payments:

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7 All taxation years relevant for computing the installment base were US functional currency years.

8 In fact, it is not clear what time is the relevant time: the time the return is assessed and the refund cheque prepared, the time the return is filed, the tax return due date, the date the final tax payment for the year was due, or some other date.

		Exchange Rate	
	US$100	0.85	C$118
	US$100	0.84	C$119
	US$100	0.80	C$125
	US$100	0.80	C$125
	US$100	0.85	C$118
	US$100	0.85	C$118
	US$100	0.90	C$111
	US$100	0.92	C$109
	US$100	0.90	C$111
	US$100	0.95	C$105
	US$100	0.98	C$102
	US$100	1.00	C$100
Total	US$1,200		C$1,361

The final tax liability was US$1,000 and the relevant exchange rate was C$1.00 = US$0.80. As such, the Canadian currency equivalent of the final tax liability was C$1,250.

Example 2 further highlights the question of how to deal with partial refunds when installments are made at different foreign exchange rates. Should the refund be computed with reference to the average exchange rate for the installments made for the year, or should the refund be computed with reference to the exchange rates for the final two installments made in the year that ultimately resulted in an overpayment of tax for the year? The current legislation provides no guidance.

Example 3:

Assume the same facts as in Example 2 and that the refund issued to the taxpayer for the second preceding taxation year is $111 (that is, C$1,361 installments paid less C$1,250 tax liability). Assume income in the second preceding year was US$3,500 and the loss in the current year is US$1,400 (*i.e.,* current year loss is 40% of the total income earned in the second preceding year). The relevant exchange rate for the current year is C$1.00 = US$1.10. The taxpayer applied the full amount of the current year loss to the second preceding year to offset a portion of the income earned in that year with the result that a further refund is owing to the taxpayer.

Based on current legislation, it is unclear how the refund arising because of the loss carryback is computed. The refund in US dollars is US$400 (that is, the US$1,000 tax liability multiplied by 40% -- the loss of $1,400 divided by taxable income in the second preceding year of $3,500). Should the US$400 refund be converted to Canadian currency using the relevant exchange rate in the year of the loss (*i.e.,* US$400/1.10 = C$364); using the average exchange rate applicable at the time the tax installment payments were made in the second preceding year (*i.e.,* US$400/0.89 =

C$449); or the exchange rate applicable at the time the final tax liability for that year was computed before carrying back the loss (*i.e.,* 40% of the total tax liability of C$1,250).

Recommendation

We recommend that subsection 261(11) be amended to clarify that an amount refundable to the taxpayer should be converted from the elected functional currency to Canadian currency in a manner that is consistent with the principles applicable to the conversion of amounts payable by the taxpayer under the Act.