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New Section 261: The Tax Calculating Currency Rules

by Wallace G. Conway and Liam Fitzgerald

PricewaterhouseCoopers LLP

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New section 261 of the *Income Tax Act* implements the 2006 federal budget proposal to introduce calculating currency rules for determining the Canadian tax results of a taxpayer. Under the new rules, a taxpayer is required to determine Canadian tax results using the Canadian dollar as the calculating currency. When the taxpayer undertakes transactions in a foreign currency, the amount of the transaction is converted to Canadian dollars using specified exchange rates. Foreign exchange gains and losses accruing to the time of conversion are included in net income for tax purposes as the assets and tax attributes are used for tax purposes, or as the liabilities are settled or extinguished.

This article provides an overview of how the rules in section 261 operate; including some of the deficiencies of the rules, suggestions for improvements and identification of benefits that the rules might provide to taxpayers. The authors also comment on the proposed amendments to section 261 that were announced in a news release issued by the Department of Finance on June 27, 2008 and issued as draft legislation on November 10, 2008.

Wallace G. Conway wallace.g.conway@ca.pwc.com

Liam Fitzgerald liam.m.fitzgerald@ca.pwc.com

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NEW SECTION 261: THE TAX CALCULATING CURRENCY RULES

*Wallace G. Conway and Liam Fitzgerald***

New section 261 of the Income Tax Act implements the 2006 federal budget proposal to introduce calculating currency rules for determining the Canadian tax results of a taxpayer. Under the new rules, a taxpayer is required to determine its Canadian tax results using the Canadian dollar as the calculating currency. When the taxpayer undertakes transactions in a foreign currency, the foreign currency amount of the transaction is converted to Canadian dollars using specified exchange rates.

In certain circumstances, new section 261 also permits Canadian-resident corporations to elect to use a foreign functional currency as the Canadian tax calculating currency. All transactions undertaken by the electing corporation in a currency other than the elected currency (including Canadian dollar transactions) are to be converted to the elected currency using specified exchange rates.

To make a functional currency election, a Canadian-resident corporation must establish (among other things) that it has a foreign "functional currency" (as that term is defined). On making the election, the electing corporation will use the foreign functional currency in determining its Canadian tax results for the initial functional currency year and all subsequent taxation years.

Under the transitional rules in new section 261, an electing corporation must convert the Canadian-dollar amount of its assets, liabilities, and other tax attributes to foreign functional currency amounts. Foreign exchange gains and losses accruing to the time of conversion are included in net income for tax purposes as the assets and tax attributes are utilized for tax purposes, or as the liabilities are settled or extinguished. Following the transition, application rules apply to the electing corporation for each functional currency year in determining its Canadian tax results. If the electing corporation reverts to using the Canadian dollar as its tax calculating currency, reversion rules apply to convert the foreign functional currency amount of its assets, liabilities, and other tax attributes to Canadian-dollar amounts.

The authors provide an overview of how the rules in section 261 operate; they comment on some of the deficiencies of the rules, suggest improvements, and identify

* Of PricewaterhouseCoopers LLP, Vancouver.

** Of PricewaterhouseCoopers LLP, Toronto. The authors would like to thank Kevin Chan and Jeffrey Johns of PricewaterhouseCoopers LLP for their comments on earlier drafts of this article.

benefits that the rules might provide to taxpayers. The authors also comment on the proposed amendments to section 261 that were announced in a news release issued by the Department of Finance on June 27, 2008 and issued as draft legislation on November 10, 2008.

KEYWORDS: TAX ACCOUNTING ■ TAXES ■ CALCULATING CURRENCY ■ FUNCTIONAL CURRENCY

CONTENTS

Introduction 959
The Previous Law 960
Overview of New Section 261 961
  The Canadian-Dollar Requirement 961
  The Functional Currency Election 961
  Interpretive Issues 963
    The "More Often Than Any Other Currency" Criterion 963
    The "Consolidated Financial Statements" Criterion 964
  Proposed Amendments 966
    Extension of the Election Due Date 966
    Amendment of the "Functional Currency" and "Qualifying Currency" Definitions 966
    Partnerships 967
    Anti-Avoidance Rule 968
The Transition to a Functional Currency 969
  Defined Terms 970
  Conversion of Assets and Other Tax Attributes 970
  Conversion of Debt Obligations 971
    Proposed Amendments 973
  Tax Payments and Refunds 974
    Proposed Amendments 975
  Determining Canadian Tax Results Using a Functional Currency 976
    Proposed Amendments 977
Reverting to the Canadian Dollar 977
  Defined Terms 977
  Conversion of Assets and Other Tax Attributes 977
  Conversion of Debt Obligations 978
    Proposed Amendments 980
  Carryover of Tax Attributes 981
    Proposed Amendments 983
Corporate Mergers and Business Transfers 983
  Winding Up 984
  Amalgamations 984
  Business Transfers 985
  Deficiencies in the Corporate Merger and Business Transfer Rules 986
  Proposed Amendments 986
  Anti-Avoidance Rule 987
Conclusion 988

INTRODUCTION

In 2006, certain Canadian corporations approached the Department of Finance seeking relief from the requirement to use the Canadian dollar as their calculating currency for Canadian tax purposes. The corporations presented two compelling arguments for providing relief from this universal requirement to use a Canadian-dollar tax calculating currency ("the Canadian-dollar requirement"). Those arguments concerned income measurement and international competitiveness.

First, the corporations argued that in order to measure their Canadian tax results properly, they should be permitted to use their accounting functional currency rather than the Canadian dollar, because to do so would eliminate the distorting effects of foreign exchange gains and losses that arose solely out of the requirement to compute their Canadian tax results in Canadian dollars. In the corporations' view, the only foreign exchange gains and losses that should affect their Canadian tax results were those that arose out of the risks that they assumed when they decided to transact in a currency other than their accounting functional currency.

Second, the corporations identified situations in which their international competitiveness was put at risk because of the Canadian-dollar requirement. In their view the tax effect of foreign exchange gains and losses that arose out of that requirement had to be eliminated if they were to compete on an equal footing with foreign competitors. Because of the Canadian-dollar requirement, they argued, their Canadian taxable income was improperly measured; consequently, their competitors obtained a relative tax benefit because they were not taxed on such gains and losses. The corporations also argued that from an accounting perspective, the current and future income taxes that were attributable to these foreign exchange gains and losses adversely affected their effective tax rate, earnings per share, and other financial performance metrics, thereby affecting their access to capital markets relative to their competitors.

Department of Finance officials found merit in the corporations' arguments and recommended that their requests be accommodated. The new rules in section 261 of the Income Tax Act[1] are consistent with the government's general policy objective of making Canada's tax system fairer, more competitive, and more efficient. As well, because it was likely that challenges would be made in respect of the Canadian-dollar requirement (see the discussion below), the Department of Finance may have concluded that it would be prudent for the government to enact new section 261.

In short, new section 261 enacts the Canadian-dollar requirement; it establishes the criteria that a Canadian-resident corporation must meet before it can elect to use its foreign functional currency as its Canadian tax calculating currency; and it provides application rules that electing corporations must follow in determining their Canadian tax results.

1 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

In this article, we examine how the enacted rules operate, comment on some of the deficiencies of the rules, suggest improvements, and identify the benefits that the rules may offer to taxpayers. We also provide an overview of the proposed amendments to section 261 outlined by the Department of Finance in a news release dated June 27, 2008 ("the finance minister's news release"),[2] which was issued as draft legislation on November 10, 2008 ("the legislative proposals").[3]

THE PREVIOUS LAW

Before the enactment of section 261, it was generally accepted that taxpayers computed their Canadian tax results using the Canadian dollar as their calculating currency, although the Act was silent on the point. Generally, taxpayers complied with the Canadian-dollar requirement, and converted all foreign currency amounts relevant to the computation of Canadian tax results into Canadian dollars.

The Supreme Court of Canada majority in *Imperial/Inco*[4] indicated that there might be cases in which no conversion to Canadian dollars was required. In the lower courts, both parties to the case had agreed, as had the Federal Court of Appeal, that *Gaynor v. MNR*[5] stood for the proposition that each element of a statutory formula in the Act must be converted into Canadian dollars in order to determine the amount that could be deducted pursuant to the particular provision. However, LeBel J in the Supreme Court said, "In my opinion, *Gaynor* does not support the proposition that all elements of a statutory formula must be converted into their Canadian dollar value at the relevant time. The implications of *Gaynor* are narrower than that."[6]

LeBel J's reasoning strongly suggests that if there was no actual conversion of currency, no gain or loss would arise for tax purposes. This suggestion runs contrary to the previously held view that even without a conversion, the requirement to translate amounts into Canadian dollars at the exchange rate at the time of the transaction would mean that a gain or loss could be realized. This was made clear by LeBel J when he expressly said, "It was rightly held in *Pattison* that without a conversion of currency, the mere repayment of the principal—the very thing that was borrowed—cannot yield a profit or a loss."[7]

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2 Canada, Department of Finance, "Government of Canada Eases Tax Compliance Burden for Internationally-Engaged Canadian Businesses," *News Release* 2008-048, June 27, 2008.

3 Canada, Department of Finance, *Legislative Proposals and Explanatory Notes Relating to Functional Currency Tax Reporting* (Ottawa: Department of Finance, November 2008).

4 *The Queen v. Imperial Oil and Inco Ltd.*, 2006 DTC 6639 (SCC).

5 87 DTC 279 (TCC); aff'd. 88 DTC 6394 (FCTD); aff'd. [1991] 1 CTC 470 (FCA).

6 Supra note 4, at paragraph 52.

7 Ibid., at paragraph 55. LeBel J's endorsement of *Pattison (Inspector of Taxes) v. Midland Marine Ltd.*, [1984] 1 AC 362 (HL), was somewhat surprising. Most members of the Canadian tax community would have agreed with Binnie J, who said in his dissenting judgment, "I would add (and there seems to be no disagreement on this point as well) that Canadian tax law knows only

OVERVIEW OF NEW SECTION 261

The government enacted section 261 in light of the prospect that LeBel J's comments could form the basis for a challenge in respect of the general requirement to use the Canadian dollar as the Canadian tax calculating currency, and because of the government's general desire to respond to the concerns of the taxpayers willing to make such a challenge. Subsection 261(2) codifies the Canadian-dollar requirement in order to guard against any such challenge.

As well, the government established the criteria that must be met before a taxpayer can use a foreign currency (defined as a "functional currency" in subsection 261(1)) as the calculating currency in determining its Canadian tax results. This legislated exception to the Canadian-dollar requirement was designed to respond to the requests of Canadian-resident corporations (discussed above) to be allowed, in the appropriate circumstances, to use their accounting functional currency as their Canadian tax calculating currency.

The Canadian-Dollar Requirement

Subsection 261(2) requires that the Canadian tax results of a taxpayer for a particular taxation year be determined using Canadian dollars.[8] If a foreign currency amount is relevant in determining the taxpayer's Canadian tax results, that foreign currency amount must be converted to Canadian dollars.[9] The conversion is to be made using the relevant currency exchange rate quoted by the Bank of Canada at noon on the date on which the foreign currency amount first arose. Other currency exchange rates can be used if they are acceptable to the minister of national revenue. The Canada Revenue Agency (CRA) has yet to specify what other exchange rates would be acceptable. However, we hope that the CRA will accept the accounting methodology adopted by taxpayers in converting foreign currency amounts into Canadian dollars.

The Functional Currency Election

Subsection 261(3) is the gateway provision that prevents taxpayers without a bona fide foreign functional currency from using any currency other than the Canadian dollar as their Canadian tax calculating currency. The taxpayer must meet the criteria in subsection 261(3) for each particular taxation year in which the taxpayer elects to use its foreign functional currency as its Canadian tax calculating currency:

Canadian dollars: *Eli Lilly & Co. (Canada) Ltd. v. Minister of National Revenue*, [1955] S.C.R. 745, at p. 750. This means that for calculations required by the *Income Tax Act* an 'amount' of foreign currency must at some point be converted into Canadian dollars. The dispute between the Minister and the taxpayers, simply put, is whether this conversion should be done at the foreign exchange rate prevailing at the date of issuance of the debentures (as the Minister contends) or the foreign exchange rate at the date of redemption, when the actual cost to the taxpayer can be ascertained (as the taxpayers contend)." (*Imperial/Inco*, supra note 4, at paragraph 76.)

8 Paragraph 261(2)(a).

9 Paragraph 261(2)(b).

- Throughout the particular year, the taxpayer is a corporation (other than an investment corporation, a mortgage investment corporation, or a mutual fund corporation) resident in Canada.[10]
- The taxpayer has elected to have subsection 261(4) apply in respect of the particular taxation year (or a taxation year preceding the particular taxation year and all taxation years subsequent to that preceding taxation year), and the election has been filed in the taxpayer's income tax return for the last taxation year in which the taxpayer used the Canadian dollar as the calculating currency when determining its Canadian tax results.[11]
- The taxpayer has a currency, other than the Canadian dollar, that qualifies as a "functional currency" (see the discussion below of this defined term) for the particular taxation year.[12]
- The taxpayer's functional currency for the particular taxation year is the same as its functional currency for that taxation year immediately preceding the particular taxation year, if the taxpayer determined its Canadian tax results using a functional currency for the taxation year immediately preceding the particular taxation year.[13]
- The taxpayer did not use a functional currency as its calculating currency for a taxation year preceding the particular taxation year in determining its Canadian tax results for that preceding year, if the taxpayer determined its Canadian tax results using the Canadian dollar as the calculating currency for the taxation year immediately preceding the particular taxation year.[14]

No corporation that elects to use a foreign currency as its Canadian tax calculating currency and then reverts to using the Canadian dollar for that purpose will be able to make another functional currency election, either for the previously elected foreign currency or any other qualifying currency.

Non-resident corporations carrying on business in Canada and income trusts resident in Canada cannot elect to use their foreign functional currencies as their Canadian tax calculating currencies. The rationale for these exclusions is uncertain.

10 Paragraph 261(3)(a).

11 Paragraph 261(3)(b). If there is no immediately preceding taxation year (for example, if the functional currency year is the first year following incorporation), the election is filed with the tax return for that first functional currency year (subparagraph 261(3)(b)(ii)). Under the legislative proposals, a taxpayer must file its election in respect of its first functional currency year at least six months before the end of that year (proposed paragraph 261(3)(b)). This provision prevents a newly incorporated corporation from making a functional currency election in its first year if that year is less than six months.

12 Paragraph 261(3)(c).

13 Paragraph 261(3)(d).

14 Paragraph 261(3)(e). Under the legislative proposals, these two tests have been simplified by a requirement that a taxpayer not have filed a functional currency election (proposed paragraph 261(3)(d)) and that a revocation has not applied to the year (proposed paragraph 261(3)(e)).

Perhaps income trusts were excluded because the tax regime that applies to them was at the development stage when section 261 was drafted. Non-resident corporations may have been excluded because they are taxable only on their Canadian-source income.

A corporation that makes a functional currency election in respect of a particular taxation year must be able to demonstrate that it has a functional currency for that year. A "functional currency" is defined as a currency, other than the Canadian dollar, that meets the following criteria:[15]

- It is a "qualifying currency," which at present is limited to the currencies of the United States, the European Union, and the United Kingdom. Other currencies may be prescribed by regulation.[16]
- More often than any other currency, it is used in the conduct of the taxpayer's principal business activities in the particular taxation year.
- It is the currency in which the financial results of the taxpayer for the particular taxation year are computed in the taxpayer's "consolidated financial statements"[17] and in the taxpayer's "legal-entity financial statements"[18] for the particular taxation year. The consolidated financial statements of the taxpayer for the particular taxation year are the financial statements of the taxpayer prepared in accordance with generally accepted accounting principles (GAAP). The legal-entity financial statements of the taxpayer for the particular taxation year are the financial statements that would be prepared in accordance with GAAP if those accounting principles did not require consolidation.[19]

Interpretive Issues

The two most significant components of the functional currency definition outlined above could render the rules unusable by the very taxpayers that were intended to use them. These are the "more often than any other currency" criterion and the "consolidated financial statements" criterion.

The "More Often Than Any Other Currency" Criterion

No rules of application or criteria are provided for determining when a currency has been used more often than any other currency in the principal business activities of the corporation in the particular taxation year. As a result, a demonstration that this requirement has been met would prove to be challenging for many taxpayers.

Under the existing legislation, the taxpayer is first required to identify its principal business activities. The taxpayer is then required to establish the extent to which

15 Subsection 261(1), definition of "functional currency."

16 Ibid., definition of "qualifying currency."

17 Ibid., definition of "consolidated financial statements."

18 Ibid., definition of "legal-entity financial statements."

19 Ibid., definition of "generally accepted accounting principles."

the chosen currency was used in the conduct of those principal business activities. It is assumed that all activities of the principal business of the taxpayer will be principal business activities. It is not clear whether greater importance will be assigned to one particular activity in relation to another activity of the principal business. As well, it is not clear whether, if more than one business is carried on by a taxpayer, only the activities of the principal business will be relevant. Where a company does not carry on a business in the traditional sense of that term (for example, a company in the business of lending money or factoring receivables), it is not clear whether it has sufficient activity to constitute a business.

Further, if a Canadian-resident corporation is a member of a partnership, it is unclear how the eligibility criteria will apply if the principal business activities are conducted in the partnership rather than the corporation itself. Transactions undertaken by partnerships of which a taxpayer is a member and transactions undertaken on behalf of the taxpayer by persons related to the taxpayer should enter into the determination.

The "Consolidated Financial Statements" Criterion

If a taxpayer has not prepared consolidated financial statements, as defined, it could be difficult to establish that the taxpayer has met the requirements of the definition of "functional currency." Taxpayers may not prepare consolidated financial statements if their financial results are not consolidated with those of other entities or if they have no equity interest in other entities that require consolidation. In addition, some companies may not prepare financial statements at all—for example, a Canadian subsidiary that electronically uploads its trial balance into the reporting package of its foreign parent.

Example 1

The following example illustrates the shortcomings described above:

1. Canco, a Canadian mining company, has a gold-mining operation in Ontario. Canco has no subsidiaries.
2. Canco sells all the gold it derives from its mining operations on the open commodity market at prices expressed in US dollars, and it is paid in US dollars.
3. Canco pays most of its Canadian operating expenses in Canadian dollars and uses its US dollars to acquire Canadian dollars to pay those expenses. Canco's fixed assets are purchased with US dollars or Canadian dollars, depending on the requirements of the vendor. When necessary, Canadian dollars are purchased with US dollars for this purpose.
4. Canco was initially capitalized with US-dollar-denominated share capital. Canco issued publicly traded US-dollar-denominated debt of US$100 million. At the time the debt was issued, the exchange rate was Cdn $1.00 = US$0.80. The Canadian-dollar historical amount of the debt is Cdn $125 million (US$100 million × 1/0.80 = Cdn $125 million).

5. The US$100 million loan proceeds were used to fund the acquisition of land that will be used as a site for a bulk terminal. At the time the land was acquired, the exchange rate was Cdn$1.00 = US$0.80. The Canadian-dollar historical cost of the land is Cdn$125 million (US$100 million × 1/0.80 = Cdn$125 million).
6. Canco maintains all its liquid assets, such as cash, in US dollars.
7. Canco prepares legal-entity US-dollar financial statements and is not required to prepare consolidated financial statements. The financial statements are prepared using the US dollar as the functional currency in accordance with GAAP.
8. In 2008, Canco sold the capital property (acquired in 2006) for proceeds of US$100 million and used the proceeds of sale to repay the US$100 million debt in full.
9. Canco elected with its 2007 Canadian tax return to adopt the US dollar as its tax functional currency for 2008.
10. The average exchange rate for the 12 months ended December 31, 2007 was Cdn$1.00 = US$0.90; as of December 31, 2007, the rate was Cdn$1.00 = US$1.00.

From a tax policy perspective, one would expect Canco to qualify for the functional currency election. Under the existing legislation, however, Canco is required to establish that the US dollar satisfies the three requirements noted above before the US dollar can be treated as Canco's functional currency.

Although the US dollar is a qualifying currency, no criteria were established for determining whether the US dollar was used more often than any other currency in the conduct of Canco's principal business activities—namely, its Ontario gold-mining operations. Because Canco has substantial Canadian-dollar transactions, there may be some doubt about whether it satisfies this second requirement. As well, Canco does not prepare consolidated financial statements.

One approach to dealing with the "more often than any other currency" issue is to establish well-known objective criteria, either as part of the rules or as guidelines issued by the CRA, so that taxpayers and CRA officials alike understand the basis on which decisions are made. As a practical matter, the criteria could be based on those used by accounting professionals in making the determination of the functional currency of the taxpayer for accounting purposes as required under GAAP.

With respect to the "consolidated financial statements" issue, the requirement to refer to the currency used in the taxpayer's consolidated financial statements (if such statements exist) is inappropriate for a number of reasons. First, legal-entity financial statements prepared in accordance with GAAP should be the only financial statements required for the determination of a taxpayer's functional currency. This is because taxpayers determine income for Canadian tax purposes using legal-entity financial statements rather than consolidated financial statements. As well, it is appropriate that separate entities in a consolidated group be allowed to make a functional currency election if they compete in foreign markets where other members of

the consolidated group do not.[20] This approach promotes the international competitiveness of Canadian business and is consistent with the policy underlying the rules. Therefore, only the entity's financial statements should be considered in the determination of whether it has a functional currency.

Proposed Amendments

The proposed amendments in the legislative proposals are intended to address some (but not all) of the deficiencies in the functional currency rules described above. The proposals should provide more certainty about whether a particular taxpayer is eligible to elect to use the functional currency regime.

Generally, the proposed amendments will have the same effective date as existing section 261—that is, they will apply to taxation years of a taxpayer commencing after December 13, 2007. However, a taxpayer that has, on or before June 27, 2008, validly made a functional currency election can choose to have the current transition rules apply.[21] As well, a taxpayer that has validly elected before June 27, 2008 will be subject to the new anti-avoidance rule in subsections 261(20) and (21) (discussed below) for its taxation years that begin after June 27, 2008.

Extension of the Election Due Date

As mentioned above, the functional currency election is available to qualifying corporations for taxation years that begin after December 13, 2007. For example, under existing section 261, a qualifying corporation with a calendar year-end can elect to use its functional currency as its qualifying currency for its 2008 taxation year and subsequent taxation years if it files the required election on or before its filing due date for its 2007 taxation year (June 30, 2008). The June 27, 2008 proposals extend to October 31, 2008 the deadline for filing an election that was required to be filed before October 31, 2008. This deadline was further extended to December 15, 2008.[22]

Amendment of the "Functional Currency" and "Qualifying Currency" Definitions

The Department of Finance proposes to modify the definition of the term "functional currency" to eliminate the two criteria that triggered the interpretive issues

20 A positive feature of these rules is that they could be made to apply to a new corporate member of a consolidated group that has been incorporated to start a new business that will compete in the international marketplace. This tax result is consistent with the tax policy underlying the adoption of the rules.

21 Paragraph 1(2)(a) of the legislative proposals. In order to make this choice, the taxpayer must make a further written election on or before the taxpayer's filing-due date for the taxation year that includes the date on which the legislative proposals receive royal assent.

22 Paragraph 1(2)(b) of the legislative proposals. This extension was first announced in a news release issued by the Department of Finance on October 29, 2008 ("Government of Canada Extends the Functional Currency Election Deadline," *News Release* 2008-084).

discussed above: the "more often than any other currency" requirement and the requirement that the financial statements (both legal-entity and consolidated) of the company be computed in the elected currency. These conditions will be replaced by a requirement to demonstrate that the currency that the taxpayer chooses as its tax functional currency is the "primary currency in which the taxpayer maintains its records and books of account for financial reporting purposes."[23] This proposed change attempts to address the issues discussed above regarding the "more often than any other currency" requirement and the requirement for consolidated financial statements.

The terms "records" and "books of account" are not defined; nor is a definition provided for the term "primary currency."

Although examples are provided in the explanatory notes to the legislative proposals, they do not consider more complex scenarios. For instance, an example discusses the situation in which a corporation records its transactions in one currency and then translates those transactions on an aggregated basis into its functional currency for financial reporting purposes. In that scenario, the explanatory notes indicate that the first currency is considered the corporation's primary currency for the purposes of the functional currency election.

This conclusion is overly simplistic. Many corporations use sophisticated general ledger systems that permit the recording of transactions in multiple currencies (such as Canadian and US dollars). Such systems allow corporations to produce financial reports for a number of purposes in both currencies. Therefore, assuming that the US dollar is the corporation's functional currency and the currency in which financial statements issued to its shareholders are prepared, such a corporation should be able to take the position that its primary currency is the US dollar, regardless of the fact that Canadian-dollar entries are made in the general ledger.

When the functional currency determination is made, attention should be focused on the currency in which a corporation issues its financial reports to its shareholders. A rule should be added to the "primary currency" test that will deem or clarify the primary currency to be, in circumstances where the records and books of account of a taxpayer are maintained in more than one currency, the currency used by the taxpayer in preparing its financial statements in accordance with GAAP.

The legislative proposals also add the Australian dollar to the list of currencies that are defined as qualifying currencies.[24]

Partnerships

When a corporation is a member of a partnership and the corporation has made a functional currency election, the legislative proposals treat the partnership as a separate taxpayer that has made a functional currency election.[25]

23 Proposed paragraph (b) of the definition of "functional currency" in subsection 261(1).

24 Proposed paragraph (d) of the definition of "qualifying currency" in subsection 261(1).

25 Proposed subsection 261(6).

It is not clear from the legislative proposals whether a taxpayer that holds a partnership interest can look to the activities of the partnership in determining the taxpayer's eligibility to make an election under proposed subsection 261(3). It seems appropriate that in determining the eligibility of a taxpayer that is a member of a partnership to make a functional currency election, the taxpayer should be treated as carrying on all the activities of the partnership to the extent of the taxpayer's participation in the income or loss of the partnership. This point has been clarified by the CRA, which expressed the view that in determining a taxpayer's primary currency, regard should be had both to the taxpayer's books and records and to the books and records of any partnership of which it is a member.[26]

Anti-Avoidance Rule

The Department of Finance has expressed a concern that existing section 261 may be open to abuse, particularly because the election is made on an individual-corporation basis. The concern appears to be that related Canadian corporations can arrange their affairs so that one corporation in the group can make a functional currency election and the group as a whole can receive an economic benefit through intercompany transactions with the electing corporation. To deal with the perceived opportunities for abuse, the legislative proposals introduce an anti-avoidance rule in proposed subsections 261(20) and (21). These provisions are intended to determine a taxpayer's income, gain, or loss for a taxation year in respect of a transaction if all of the following conditions are met:

1. the transaction was entered into (directly or indirectly) by the taxpayer and a related corporation;
2. the taxpayer and the related corporation have different tax reporting currencies at any time during the period ("the accrual period") in which the income, gain, or loss is accrued; and
3. it is reasonable to conclude that a fluctuation in the value of the taxpayer's tax reporting currency relative to the value of the related corporation's tax reporting currency in the accrual period increased the taxpayer's loss, reduced the taxpayer's gain, or caused the taxpayer to have a loss instead of a gain in respect of the transaction.

In such circumstances, proposed subsection 261(21) deems the fluctuation that led to the increased loss or the reduced gain not to have occurred.

Example 2

Consider the following example of a possible fact pattern to which this anti-avoidance rule applies.

26 See the response to question 7-3 of the CRA Round Table at the Sixtieth Annual Tax Conference of the Canadian Tax Foundation, Calgary, November 30-December 2, 2008.

Assume that Canco (from example 1) on-lent the $100 million US-dollar-denominated publicly traded debt to a related Canadian company, Canco 2. The loan to Canco 2 is also denominated in US dollars and is issued as a demand note. Canco 2 then uses the loan proceeds to fund the acquisition of a capital asset. In the absence of a functional currency election, Canco is effectively hedged because any foreign exchange gain or loss realized on the repayment of the publicly traded debt can be offset by the foreign exchange gain or loss realized on the repayment of the Canco 2 loan. Canco 2 will realize a foreign exchange gain or loss on the repayment.

This hedge assumes that both debts will be settled or repaid at the same time. It is likely that Canco will have to make periodic payments on its publicly traded debt that may not be able to be matched with a repayment of the Canco 2 debt if Canco 2 does not have sufficient funds to make the repayment, thus making the hedge ineffective. In order to remove this risk, Canco can make a functional currency election, adopting the US dollar as its tax functional currency. Assuming that the debts are created in a functional currency year, Canco will not realize any foreign exchange gain or loss on the repayment of the publicly traded debt or the Canco 2 loan. Because Canco 2 will not make a functional currency election (assuming that it does not qualify), it will continue to realize a foreign exchange gain or loss on the repayment of the Canco 2 loan.

If Canco 2 has an accrued foreign exchange gain in respect of the Canco 2 loan, Canco and Canco 2 may choose to leave the loan outstanding indefinitely in order to defer the realization of the foreign exchange gain. However, if Canco 2 has an accrued foreign exchange loss in respect of the Canco 2 loan, it may choose to realize that loss through the repayment of the loan and obtain a tax benefit.

It appears that the proposed anti-avoidance rule will apply to deny Canco 2 the benefit of the loss. This result is inappropriate, however, since Canco 2's foreign exchange gain or loss arises regardless of Canco's functional currency election. More specifically, if Canco 2 had borrowed directly rather than through Canco, any foreign exchange loss arising on the settlement of the debt would not be denied. To limit the application of this broad based anti-avoidance rule to such fact patterns, the proposed rule should include a purpose test to ensure that the rule applies only if the "principal purpose" of the specified transaction is to create a result described in proposed paragraph 261(20)(c).

As noted above, corporations that have validly filed their election under subsection 261(3) before June 27, 2008 will have a one-year grace period in which to deal with the uncertainty posed by the new anti-avoidance rule. Other taxpayers contemplating an election for the 2008 taxation year must contend with the uncertainty.

THE TRANSITION TO A FUNCTIONAL CURRENCY

If a taxpayer qualifies for and makes a functional currency election for a particular taxation year, the taxpayer must follow the rules in subsections 261(5) to (10) in calculating its Canadian tax results for the particular taxation year.

Defined Terms

Subsections 261(5), (6), and (10) set out the rules for establishing the functional currency amounts of the taxpayer's tax attributes for its first or initial functional currency year. The key terms in the transitional rules are as follows:

- "Canadian currency year": a taxation year in which the taxpayer uses the Canadian dollar as its calculating currency in determining its Canadian tax results for the year.
- The "last Canadian currency year": the year that ends before the beginning of the initial functional currency year.
- "Functional currency year": a taxation year of the taxpayer in which the taxpayer uses its functional currency as its calculating currency in determining its Canadian tax results for the year.
- "Initial functional currency year": a functional currency year of the taxpayer if the taxation year that ends immediately before the beginning of the functional currency year was a Canadian currency year of the taxpayer.
- "Transitional exchange rate": the average daily rate of exchange, for the 12-month period ending on the last day of the last Canadian currency year, for the exchange of the Canadian dollar for a unit of the taxpayer's functional currency for the initial functional currency year.
- "Currency exchange rate": the average daily rate of exchange, for the 12-month period ending on a particular day, for the exchange of a unit of the particular currency for a unit of the other currency.[27]

Example 1 above illustrates several of these concepts: the last Canadian currency year of Canco is 2007, and the initial functional currency year of Canco will be 2008. The transitional exchange rate of Canco is Cdn $1.00 = US $0.90.

Conversion of Assets and Other Tax Attributes

Under the transitional rules, the Canadian-dollar amounts of a taxpayer's tax attributes that arise in taxation years preceding its initial functional currency year are converted to functional currency amounts for the initial functional currency year (and each subsequent functional currency year) using either the transitional exchange rate or the appropriate currency exchange rate at the end of its last Canadian currency year.[28]

The transitional exchange rate is used to convert the Canadian-dollar amounts of the following tax attributes that arise in a Canadian currency year to amounts expressed in the taxpayer's functional currency for the initial functional currency year:

27 Subsection 261(1).

28 Subsection 261(5).

- unused deductions and credits, referred to in subsection 37(1) (scientific research and experimental development expenses), subsection 66(4) (foreign exploration and development expenses), section 110.1 (donations and gifts), section 111 (losses), subsection 126(2) (foreign tax credits), subsection 127(5) (investment tax credits), subsection 129(1) (dividend refunds to private corporations), subsection 181.1(4) (surtax deducted from capital tax), or subsection 190.1(3) (surtax deducted from capital tax);
- the cost of a property acquired before the initial functional currency year;
- adjustments required under section 53 in determining the adjusted cost base of property;
- undepreciated capital cost of depreciable property of a prescribed class, cumulative Canadian exploration expense, cumulative Canadian development expense, and similar cumulative amounts of expense pools;
- the amounts at the end of the last Canadian currency year of reserves, prepaid expenses, paid-up capital in respect of shares, and any other tax attributes relevant to determining the taxpayer's Canadian tax results for the initial and any subsequent functional currency year; and
- taxes payable under part I.

The effect of the transitional rules is to incorporate or embed the foreign exchange gains or losses that accrued to the end of the taxpayer's last Canadian currency year in the cost or adjusted cost base of assets or the amount of expenditure pools or other tax attributes. The taxpayer's Canadian tax results will be affected by the accrued foreign exchange gains and losses when those tax attributes in which the accrued foreign exchange gains or losses are embedded are used in calculating a taxpayer's Canadian taxable income. Section 261 provides no specific guidance on when this occurs, so taxpayers will often have to rely on general tax principles in making this determination.

From a tax accounting perspective, the embedded gain or loss will result in the creation of temporary differences in respect of each item translated to the elected functional currency. Therefore, to accurately measure future taxes for financial reporting purposes, taxpayers will have to determine what temporary differences arise and when those temporary differences reverse.

Conversion of Debt Obligations

The transitional rules also apply to debt obligations issued by a taxpayer in a Canadian currency year that ended before its initial functional currency year.[29] The CRA has expressed the view that "debt obligation" means any debt owing by the taxpayer and includes trade payables and advances.[30] "Debt obligation" also includes an unpaid

29 Paragraph 261(5)(h) and subsection 261(6).

30 See the response to question 7-2 of the CRA Round Table, supra note 26.

purchase price for goods and services.[31] The rules determine the amount for which the obligation was issued, the principal amount of the obligation, and any amount paid in satisfaction of the principal amount of the obligation, expressed in the taxpayer's elected functional currency, as follows:

- If the obligation is issued in the taxpayer's functional currency, the taxpayer will continue to use the foreign currency amounts determined for those years in respect of the obligation in its functional currency.
- If the obligation is issued in Canadian currency, the Canadian dollar amounts are converted to the elected functional currency using the taxpayer's transitional exchange rate.
- If the obligation is issued in another currency, the amounts expressed in the other currency are converted to the elected functional currency using the currency exchange rate on the last day of the last Canadian currency year.

The taxpayer's accrued income, loss, capital gain, or capital loss in respect of a debt obligation issued by the taxpayer in a Canadian currency year that ended before its initial functional currency year is determined to be that which would have been determined in Canadian dollars under the Act if it had settled, immediately before the end of its last Canadian currency year, the entire principal amount of the obligation. That Canadian-dollar amount of the income, loss, capital gain, or capital loss is then converted to the taxpayer's functional currency, using the transitional exchange rate. The functional currency amount of the income, loss, capital gain, or capital loss is amortized into the taxpayer's income as the debt is repaid or settled.

The amount of foreign exchange gain or loss embedded in the tax values of the taxpayer's tax attributes can differ from the amount of an accrued foreign exchange gain or loss calculated in respect of the taxpayer's debt obligations. This point is best illustrated by an example.

Example 3

On the facts in example 1, the US-dollar cost of Canco's land acquired in 2006 is US$112.5 million (Cdn$125 million × $0.90 = US$112.5 million). For the US-dollar-denominated debt, the transitional rules assume that the debt is repaid on December 31, 2007. As a result, the Canadian-dollar cost of retiring the debt is Cdn$100 million (US$100 million × 1/$1.00). The historical Canadian-dollar amount of the debt at that time is Cdn$125 million (US$100 million × 1/$0.80). If the debt is settled, Canco will have a deferred gain on the settlement of Cdn$25 million. The US-dollar amount of the deferred gain would be US$22.5 million (Cdn$25 million × $0.90 = US$22.5 million). This gain will be realized by Canco for tax purposes as the debt is settled.

31 Subsection 248(26).

The repayment of the debt by Canco in 2008 results in a capital gain of US$22.5 million (the deferred gain of US$22.5 million) that will be included in Canco's taxable capital gains for 2008. The sale of the land for proceeds of US$100 million will result in a capital loss of US$25 million (US$125 million – US$100 million = US$25 million) realized by Canco. The US$2.5 million difference between the foreign exchange loss attributed to the capital property (US$25 million) and the foreign exchange gain in respect of the debt (US$22.5 million) can be attributed to the fact that the spot rate on December 31, 2007, and not the transitional exchange rate, was used to determine the Canadian-dollar amount of the gain on the deemed settlement of the debt on December 31, 2007. To achieve symmetry, the transitional exchange rate could have been used to determine foreign exchange gains and losses on all balances of the electing taxpayer.

Proposed Amendments

Relevant Spot Rate

In response to the lack of symmetry, the legislative proposals replace the 12-month average exchange rate concept used in the definitions of "transitional exchange rate" and "currency exchange rate" (and "reversionary exchange rate," discussed below) with the term "relevant spot rate."[32] The "relevant spot rate" will be the exchange rate quoted by the Bank of Canada at noon on the day on which the relevant transaction arose.[33] Therefore, for Canco in example 1, the US-dollar cost of Canco's land acquired in 2006 will be US$125 million using the spot rate as of December 31, 2007 (Cdn$125 million × $1.00) rather than US$112.5 million using the 12-month average exchange rate for 2007. This result now matches the accrued gain on the US-dollar-denominated debt.

Although this proposed amendment resolves the symmetry issue, the use of the 12-month average exchange rate approach was a reasonable way to deal with transitions to a functional currency when the relevant exchange rates have had significant fluctuations, as was the case recently for the rate of exchange between the Canadian and US dollars. The use of the current (or spot) rate in the transitional rules will cause exchange fluctuations to have more influence on a taxpayer's decision to make the election for a particular taxation year.

Pre-Transition Debt

The legislative proposals are consistent with the treatment of debt obligations under existing section 261; however, the Department of Finance has reframed the transitional rules in respect of debt obligations by using the term "pre-transition debt," which is defined in proposed subsection 261(1) as a debt obligation issued by the taxpayer before the beginning of its first functional currency year.

32 Proposed subsection 261(7).

33 Proposed definition of "relevant spot rate" in subsection 261(1).

The one exception is in respect of debts denominated in a currency other than the Canadian dollar or the elected functional currency. Proposed subsection 261(8) appears to require the taxpayer to convert a pre-transition debt that is denominated in a third currency to the taxpayer's elected functional currency by taking the Canadian-dollar amount of the debt and applying the relevant spot rate on the last day of the taxpayer's last Canadian currency year. This method could give rise to inappropriate results. For example, assume that Canco issues a debt for Au$100, with no principal payments for three years; at the time the debt was issued, the exchange rates were Cdn$1.00 = Au$1.10 = US$0.90 (US$1.00 = Au$1.22). For Canadian tax purposes, the debt was issued for Cdn$90.91. Canco elects to have the US dollar become its tax functional currency in year 3. At the end of year 2, the exchange rates were Cdn$1.00 = Au$1.20 = US$0.90 (US$1.00 = Au$1.33).

Because the Canadian dollar increased in value against the Australian dollar in the period before Canco became a functional currency reporter, under proposed subsection 261(10) Canco has a suspended gain of US$6.82 (Cdn$7.58 × 0.90). The amount for which the debt was issued and its principal amount will be converted from Canadian dollars to US dollars at the relevant spot rate to become US$81.82. If the US dollar does not fluctuate any further against the Australian dollar until the debt matures, Canco will need only US$75 (Au$100/(1.2/0.90)) to repay Au$100 of debt. The difference of US$6.82 should not be a taxable foreign exchange gain to Canco in its functional currency year or a net forgiven amount under section 80, because it will already have been included in taxable income as a result of proposed subsection 261(10).

Proposed subsection 261(9) indicates that it is not the Department of Finance's intention to make any pre-transition gains or losses relevant in computing a taxpayer's income other than through the application of proposed subsection 261(10).[34] However, proposed subsection 261(8) appears to confuse this intention. On the repayment of the debt by Canco in a functional currency year, the foreign exchange gain could be taxable under both subsection 261(10) and subsection 39(2).

Tax Payments and Refunds

Although the taxpayer's Canadian tax results are to be determined using its functional currency as the calculating currency, tax payments or refunds are to be made to the CRA in Canadian dollars.[35]

When taxes are to be paid by the taxpayer for a taxation year, the amount of tax payment, determined in its functional currency for that year, is to be converted to Canadian dollars by using the currency exchange rate on the earlier of the day on which the amount is paid and the day on which the amount first became payable.

34 Proposed subsection 261(9) deems the debt to have been issued immediately before the taxpayer's first functional currency year for the purpose of determining the income, gain, or loss in a functional currency year.

35 Proposed subsection 261(7).

When taxes are to be refunded by the government for a taxation year, the amount of the tax refund, determined in the taxpayer's functional currency for that year, is to be converted to Canadian dollars by using the currency exchange rate on the earlier of the day on which the amount is refunded and the day on which the amount first became refundable by the government.

Proposed Amendments

The legislative proposals generally require that the relevant spot rate for the taxpayer's balance-due day be used in determining the Canadian-dollar amount of taxes that are, or would be, payable for the particular taxation year.[36] This conversion rule prevents a corporation that has made a functional currency election from making a tax payment prior to the payment's due date, since the relevant spot rate that is applicable to the payment will not be known until the balance-due date has arrived. The relevant spot rate should be that which is applicable on the date that a payment is made.

The legislative proposals also provide rules with respect to instalment payments. The rules attempt (1) to ensure that an appropriate amount in Canadian dollars is remitted by a functional currency reporter for each instalment and (2) to insulate the functional currency reporter from exchange risk in respect of instalment payments. The specific rules are as follows:

1. A corporation's first instalment base for its first functional currency year, or its second instalment base for its first or second functional currency year, is determined in Canadian dollars as if the functional currency election had never been made.
2. For instalment amounts based on a taxpayer's own estimate, the amount to be paid by the taxpayer is determined in the taxpayer's elected functional currency and converted to Canadian dollars using the relevant spot rate on the balance-due date for the payment (the day that is two months after the year-end of that year).
3. For instalment amounts based on the first instalment base, the amount is determined in the corporation's elected functional currency and converted to Canadian dollars using the balance-due date of the corporation's immediately preceding year (the day that is two months after the year-end of the immediately preceding year).
4. For instalment amounts based on the second instalment base, the amount is determined in the corporation's functional currency and converted to Canadian dollars using the balance-due date of the corporation's second preceding year (the day that is two months after the year-end of that second preceding year).

36 Proposed subsection 261(11).

5. For final tax payments, the instalments paid to date are converted to the elected functional currency by multiplying the Canadian-dollar instalments by the relevant spot rate for the date of each respective payment.

The explanatory notes to the legislative proposals provide examples of how to calculate an electing corporation's instalments.

If an amount that is determined in a taxpayer's elected functional currency is deemed to be paid at any time on account of an amount payable for a functional currency year (such as an investment tax credit), the amount is converted to Canadian dollars using the relevant spot rate for the day that includes that time.[37]

Determining Canadian Tax Results Using a Functional Currency

If the taxpayer qualifies for and makes a functional currency election, for each functional currency year the rules in subsection 261(4) will replace the Canadian dollar with the elected functional currency as the taxpayer's tax calculating currency. The rules can be summarized as follows:

- The taxpayer determines its Canadian tax results for the particular taxation year using its functional currency for that year.
- The taxpayer converts the amounts expressed in Canadian dollars under the Act for expenditure and deduction limits into the elected functional currency using the relevant exchange rate quoted by the Bank of Canada at noon on the first day of the functional currency year.
- The taxpayer must determine its Canadian tax results using its elected functional currency as its calculating currency. If an amount that is relevant in determining the taxpayer's Canadian tax results is determined in a currency other than the elected functional currency, the taxpayer must convert that amount into a functional currency amount using the exchange rate quoted by the Bank of Canada at noon on the day that the amount arose (or such other exchange rate as is acceptable to the minister of national revenue).
- Special rules must be used for subsection 79(7), paragraph 80(2)(k), subsection 39(2), subsections 80.01(11) and 80.1(8), and the definition "foreign currency" in subsection 248(1). Essentially, references to "Canadian currency" are replaced with references to "functional currency of the taxpayer for the taxation year," and references to "currencies other than Canadian currency" are replaced with references to "currencies other than the functional currency of the taxpayer for the particular taxation year."

These currency translation rules may not correspond to the currency translation methodology used by a corporate taxpayer to prepare its financial statements under

37 Proposed paragraph 261(11)(b).

GAAP. Where there are differences, the CRA has scope for accepting the translation method adopted by the corporation in preparing its financial statements in accordance with GAAP. It is hoped that the CRA will take this course of action to reduce the complexity of applying these rules.

Proposed Amendments

The legislative proposals change the definition of "Canadian tax results" to include the amount of the taxpayer's "taxable income earned in Canada." Subsection 261(2) also applies to taxpayers that calculate their Canadian tax results using the Canadian dollar; this change clarifies the application of the rule to such taxpayers.

REVERTING TO THE CANADIAN DOLLAR

Section 261, as it is currently enacted, does not allow a taxpayer to revoke a functional currency election. However, if after making an election a taxpayer ceases to meet the requirements of subsection 261(3) in a particular taxation year (for example, if it no longer has a "functional currency"), it must revert to determining its Canadian tax results for the particular taxation year using the Canadian dollar.[38] To facilitate this reversion, all of the functional currency amounts of the assets, liabilities, and other attributes of the taxpayer must be converted into the Canadian dollar using the rules in subsections 261(8) and (9).

Defined Terms

When a taxpayer reverts to using the Canadian dollar as its tax calculating currency, the reversionary rules apply to the taxpayer for the Canadian currency year commencing after its last functional currency year.[39] The key terms used in the reversion rules are as follows:

- "Initial reversionary year": the first taxation year of the taxpayer that begins immediately after the last functional currency year.
- "Last functional currency year": a functional currency year of the taxpayer if the particular taxation year of the taxpayer beginning immediately after the end of that functional currency year is a Canadian currency year of the taxpayer.
- "Reversionary exchange rate": the average exchange rate for the 12-month period ending on the last day of a particular functional currency year of the taxpayer.[40]

Conversion of Assets and Other Tax Attributes

The reversion rules apply to any transactions that the taxpayer undertook in a taxation year that began before the start of its initial reversionary year. These rules determine

38 Subsection 261(2).

39 Subsections 261(8) and (9).

40 Subsection 261(1).

the Canadian-dollar amount of the taxpayer's tax attributes in respect of the initial reversionary year and each subsequent Canadian currency year that begins after its last functional currency year.

The general principles of the reversion rules are as follows:

- For transactions arising in a Canadian currency year of the taxpayer beginning before the initial reversionary year, use the Canadian-dollar amount of the transaction.
- For transactions arising in a functional currency year of the taxpayer beginning before the initial reversionary year, use the Canadian-dollar amount obtained by converting the functional currency amount of the transaction to a Canadian-dollar amount using the taxpayer's reversionary exchange rate for that functional currency year of the taxpayer.

The specific reversion rules in subsection 261(9) are summarized in table 1.

The taxpayer's tax payable determined in the taxpayer's functional currency for its last functional currency year is converted to Canadian-dollar amounts using the reversionary exchange rate of the taxpayer.

Conversion of Debt Obligations

For debt obligations issued by taxpayers in taxation years ending before the commencement of the initial reversionary year, the reversion rules determine the Canadian-dollar amounts in respect of the amount for which the obligation was issued, the principal amount of the obligation, any amount paid in satisfaction of the principal amount of the obligation, and the amount of any gains or losses attributable to fluctuations in the value of the Canadian dollar relative to the value of the currency in which the obligation was issued. The following rules are used by taxpayers in calculating any Canadian-dollar amounts of such debt obligations for the purpose of calculating any foreign exchange gains or losses arising in the initial reversionary year and following years:

1. For a debt obligation issued in a currency other than the Canadian dollar, the following rules apply:
   a. If the obligation was issued in a Canadian currency year, use the Canadian-dollar amount for which the obligation was issued, the principal amount of the obligation, and any amounts paid in respect of the debt obligation in a relevant Canadian currency year, while converting any amounts paid in respect of the debt obligation in a functional currency year into Canadian dollars using the reversionary exchange rate for that functional currency year.
   b. If the obligation was issued in a functional currency year, convert the functional currency amounts for which the obligation was issued and the principal amount of the obligation to Canadian dollars using the reversionary exchange rate for that functional currency year. For any payments made

TABLE 1 Subsection 261(9) Reversion Rules

<table>
<tr><th rowspan="2">Tax attribute classification</th><th colspan="2">Calculating currency year classification</th></tr>
<tr><th>Functional currency</th><th>Canadian currency</th></tr>
<tr><td>■ Capital and non-capital losses
■ Tax credits
■ Adjustments to cost base of property
■ Deductible pools of expenditures
■ Paid-up capital</td><td>Convert the functional currency amounts added or deducted to Canadian-dollar amounts using the reversionary exchange rate.</td><td rowspan="2">Use Canadian-dollar amounts added or deducted.</td></tr>
<tr><td>Cost of property</td><td>Convert the functional currency amount to Canadian dollars using the reversionary exchange rate.</td></tr>
<tr><td>Reserves</td><td>Convert the balance of the reserve on the last day of the last functional currency year to Canadian dollars using the reversionary exchange rate.</td><td>na</td></tr>
</table>

in respect of the debt obligation in a functional currency year preceding the initial reversionary year, convert the functional currency amount paid into Canadian dollars using the reversionary exchange rate for that preceding functional currency year.

c. If the obligation was issued in a taxation year preceding the initial reversionary year, for the purposes of subsection 79(7) (seizure of debt by a creditor) or paragraph 80(2)(k) (the forgiven amount of foreign currency obligations) or paragraph 142.7(8)(b) (assumption of debt on the conversion of a foreign bank affiliate to a branch), the Canadian-dollar amounts for which the obligation was issued, the principal amount of the obligation, and any amount paid in respect of the debt obligation in a Canadian currency year are calculated without taking into account the fact that a functional currency election had ever been made by the taxpayer.

2. For an obligation issued in Canadian dollars, use the Canadian-dollar amount for which the obligation was issued, the principal amount of the obligation, and the amount paid in respect of the debt obligation in the Canadian currency year preceding the initial reversionary year.

By virtue of these rules, foreign exchange gains and losses arising on the repayment or settlement of debt obligations in the initial reversionary year or following years will be calculated by reference to fluctuations in the value of the Canadian dollar relative to the value of the currency in which the obligation was issued. Such calculations will exclude the foreign exchange gains and losses (by ignoring the crystallization of such gains or losses) determined at the end of the last Canadian currency year under the transitional rules discussed above.

Example 4

To illustrate the operation of the reversion rules, assume that Canco issued US-dollar-denominated debt in 2010 of US$60 million to finance the immediate acquisition of land at a cost of US$60 million. At the time of issue and acquisition, the exchange rate was US$1.00 = Cdn$1.15. Therefore, the Canadian-dollar historical cost of both the loan and the land is Cdn$69 million (US$60 million × 1.15). Canco elected with its 2011 Canadian tax return to adopt the US dollar as its tax functional currency in 2012. The 12-month average exchange rate for 2011 is Cdn$1.11 = US$1.00, and the exchange rate as of December 31, 2011 is Cdn$1.20 = US$1.00.

On transition in 2012, the US-dollar cost of the land to Canco is US$62.1 million (Cdn$69 million/1.11). The US-dollar amount of the debt is US$60.0 million. The accrued foreign exchange loss on the debt is US$2.7 million (US$60 million × (1.20 – 1.15)/1.11).

Assume that no debt repayments were made and that the 12-month average exchange rate for 2012 is Cdn$1.00 = US$1.00. If Canco reverts to the Canadian dollar in 2013, according to the reversion rules discussed above, the Canadian-dollar cost of the land will be Cdn$69 million, which is the amount determined under subsection 261(2). For the US-dollar-denominated debt, the Canadian-dollar amount of the debt in 2013 will be the same as the Canadian-dollar amount of the debt when it was issued in 2010, or Cdn$69 million. The accrued foreign exchange loss of US$2.7 million essentially disappears.

This example demonstrates that the objective of the reversion rules is to put the taxpayer into the same position that it would have been in if it had never made a functional currency election.

Proposed Amendments

As discussed above, the legislative proposals replace the 12-month average exchange rate concept used in the definition of "reversionary exchange rate" with the relevant spot rate for the last day of the taxpayer's last functional currency year. More specifically, proposed subsection 261(12) converts all amounts from a functional currency to the Canadian dollar, whether in respect of events occurring in a Canadian currency year or events occurring in a functional currency year, using the relevant spot rate for the last day of the taxpayer's last functional currency year.

Therefore, for Canco in example 4, the US-dollar cost of the land on transition in 2012 will be US$57.5 million ($69 million/1.20) rather than US$62.1 million. The US-dollar amounts for the debt will remain the same. Under the proposed amendments, the Canadian-dollar amounts to Canco of the debt and land in the initial reversionary year of 2013 will be converted using the exchange rate as of December 31, 2012. Therefore, instead of being put back into the position it would have been in if it had never made a functional currency election (which is achieved under the current rules), Canco will have a foreign exchange gain or loss embedded in the Canadian-dollar tax amount of its attributes. Proposed subsection 261(14) provides that this gain or loss will be included in Canco's taxable income following

reversion in the same manner as the embedded gain or loss arising under the transitional rules: it will be included in Canco's taxable income as the assets or attributes are utilized or the liabilities extinguished.

Further, the Department of Finance proposes to amend subsection 261(3) to remove the requirement in paragraph 261(3)(c) that the taxpayer continue to have a foreign currency qualify as a functional currency for all years subsequent to the initial functional currency year. Instead, if a taxpayer makes a valid functional currency election, it will continue to calculate its Canadian tax using the elected functional currency in all future taxation years unless it elects out of the functional currency regime. A revocation of a functional currency election can be filed on any day in a functional currency year (other than the taxpayer's first functional currency year) and will be effective for each taxation year that begins on or after the day that is six months after that day.[41] Taxpayers are required to stay within the functional currency regime for at least two taxation years.

Carryover of Tax Attributes

Section 261 provides rules for dealing with the carryback of capital and non-capital losses, investment tax credits, foreign tax credits, and surtax credits from a functional currency year to a Canadian currency year, and vice versa.[42] The carryback rules measure the extent to which the taxpayer's losses, credits, and expenditures are available for use when they arise in a Canadian currency year (functional currency year) of the taxpayer and claims are made in respect of those tax attributes in a functional currency year (Canadian currency year).

When a taxpayer ceases to be a functional currency reporter, the rules in paragraph 261(10)(a) determine the Canadian-dollar amount of the taxpayer's tax attributes arising in a previous taxation year that would be carried forward to the taxpayer's initial reversionary year and a subsequent Canadian currency year. The rules in paragraph 261(10)(b) determine the functional currency amount of the taxpayer's tax attributes that arose in a Canadian currency year beginning after the taxpayer's last functional currency year that can be carried over to a functional currency year.[43]

If a taxpayer does not cease to be a functional currency reporter, the rules apply to determine the Canadian-dollar amount of the tax attributes arising in a functional currency year of the taxpayer that are deductible in respect of a preceding Canadian currency year of the taxpayer. The rules, which are summarized in table 2, also apply to determine the functional currency amount of tax attributes that can be carried over between taxation years of the taxpayer that are functional currency years.

41 Proposed subsection 261(4).

42 Subsection 261(10).

43 More specifically, subparagraphs 261(10)(a)(i) and (ii) and subparagraph 261(10)(b)(iii) deal with the carryback of amounts from a Canadian currency year to a functional currency year. Subparagraphs 261(10)(a)(iii), (b)(i), and (b)(ii) deal with the carryback of amounts from a functional currency year to a Canadian currency year.

TABLE 2 Rules for the Carryover of Tax Attributes

Currency year		Currency of claim or tax attribute	Method
Of tax claim	When tax attribute arose		
For functional currency amount			
A Canadian currency year preceding the initial functional currency year		Canadian dollars	Convert to the taxpayer's functional currency. Use the appropriate currency exchange rate at the end of the functional currency year in which the attribute arose.
	A Canadian currency year ending after the functional currency year	Canadian dollars	Convert to the taxpayer's functional currency. Use the appropriate currency exchange rate at the end of the relevant Canadian currency year.
A functional currency year	A functional currency year	Taxpayer's functional currency	Use the amount, determined in the relevant functional currency year, expressed in the taxpayer's functional currency.
For Canadian-dollar amount			
A functional currency year preceding the initial reversionary year		Taxpayer's functional currency for the relevant year	Convert to an amount expressed in Canadian dollars. Use the appropriate currency exchange rate at the end of the Canadian currency year in which the attribute arose.
	A functional currency year ending after the Canadian currency year for which the calculation is being made	Taxpayer's functional currency for the relevant year	Convert to an amount expressed in Canadian dollars. Use the appropriate currency exchange rate at the end of the relevant functional currency year.
A Canadian currency year	A Canadian currency year	Canadian dollars	Use the amount, determined in the relevant Canadian currency year, expressed in Canadian dollars.

Example 5

Assume that Canco had taxable income of Cdn $5 million for the 2007 taxation year and Cdn $6 million for the 2008 taxation year, and that it elected with its 2008 Canadian tax return to adopt the US dollar as its functional currency in the 2009 taxation year. For 2009, the initial functional currency year, assume that Canco had a non-capital loss of US $8 million, which was carried back to the 2007 and 2008 taxation years. The exchange rate for December 31, 2009 was US $1.00 = Cdn $1.10.

Under the carryover rules, Canco's 2009 non-capital loss expressed in Canadian dollars is Cdn $8.8 million (US $8 million × 1.10). Canco can carry back Cdn $5 million of this loss to the 2007 taxation year and the remaining Cdn $3.8 million balance to the 2008 taxation year, leaving Cdn $2.2 million of taxable income in the 2008 taxation year.

Proposed Amendments

The legislative proposals change the rate at which the amount to be carried back is to be converted. The relevant spot rate on the last day of the last Canadian currency year (where an amount is carried back to a Canadian currency year) or the last day of the last functional currency year (where an amount is carried back to a functional currency year) is used instead of an average for the year in which the amount of the loss arose. Similarly, where an amount is carried back from a reversionary year to a Canadian currency year, the amount is converted into the taxpayer's functional currency at the relevant spot rate on the last day of its last functional currency year and then converted into Canadian dollars at the relevant spot rate on the last day of the last Canadian currency year.[44]

CORPORATE MERGERS AND BUSINESS TRANSFERS

Subsections 261(11) to (18) provide rules that apply when a taxpayer that uses a functional currency, or has used a functional currency, as its Canadian tax calculating currency participates in a corporate merger or transfers a business to another taxpayer.

In the case of corporate mergers, the rules are required to make the calculating currencies of the merging corporations the same. If the merging corporations have different calculating currencies, the rules ensure that the calculating currency of each corporation going into the merger will be the Canadian dollar.

The rules also have an anti-abuse element: they prohibit a taxpayer from circumventing the one-time election restriction. If a taxpayer reverts to using the Canadian dollar as its calculating currency, it can use only the Canadian dollar as its calculating currency for all future years.[45] This restriction was intended to guard against the changing of a calculating currency for tax arbitrage purposes. However, these rules

44 Proposed subsection 261(15).

45 Paragraph 261(3)(e).

may be overly restrictive, particularly where arm's-length takeovers of corporations are concerned.

Winding Up

The corporate merger and business transfer rules apply to a subsidiary that has been wound up into its parent in a winding up to which subsection 88(1) applies, if

1. the taxation year ("the distribution year") of the subsidiary in which
   a. property was distributed to the parent or
   b. any portion of an obligation of the subsidiary was assumed by the parent on the winding up,

   was a functional currency year of the subsidiary; and
2. in the taxation year of the parent in which
   a. property was distributed to the parent or
   b. debt of the subsidiary was assumed by the parent on the winding up,

   the parent's calculating currency was the Canadian dollar or the parent's functional currency calculating currency was not the same as that of the subsidiary.[46]

The rules provide that the last functional currency year of the subsidiary will be the last taxation year of the subsidiary ending before the beginning of the distribution year. Further, the subsidiary cannot be a functional currency reporter for a taxation year commencing after that last functional currency year.[47]

For the purposes of section 261, the parent is deemed to be the same corporation as and a continuation of the subsidiary.[48] Consequently, for the purposes of paragraph 261(3)(e), the parent will be considered to have been a taxpayer that has had a functional currency year in a preceding taxation year. This deeming rule will adversely affect the parent's eligibility to become a functional currency reporter in its own right under the requirements in subsection 261(3).

The deeming rule will not apply to the parent in respect of the subsidiary if the cost amount to the parent of the subsidiary's property received by the parent on the winding up is less than 50 percent of the total cost amount to the parent of all its assets at the end of its taxation year in which the property of the subsidiary was distributed to the parent on the winding up.[49]

Amalgamations

The corporate merger and business transfer rules will apply in certain circumstances to a predecessor corporation ("the specified predecessor corporation") that has been

46 Subsections 261(11) and (12).

47 Subsection 261(12).

48 Paragraph 261(15)(a).

49 Subsection 261(16).

amalgamated, in an amalgamation to which subsection 87(1) applies, with another corporation to form a single corporate entity ("the new corporation"). The rules will apply if

1. the taxation year of the specified predecessor corporation that ends immediately before the amalgamation was (but for these rules) a functional currency year; and
2. in the first taxation year of the new corporation commencing after the amalgamation, the calculating currency of the new corporation was the Canadian dollar, or the new corporation's functional currency calculating currency was not the same as that of the specified predecessor corporation.[50]

Like the rules that apply to a winding up, the corporate merger rules provide that the specified predecessor corporation's last functional currency year is the taxation year of the specified predecessor corporation that ends immediately before the commencement of the specified predecessor corporation's last taxation year. It also provides that the specified predecessor corporation cannot be a functional currency reporter for a taxation year commencing after that last functional currency year.[51]

For the purposes of section 261, the new corporation is deemed to be the same corporation as and a continuation of the specified predecessor. Consequently, for the purposes of paragraph 261(3)(e), the new corporation will be considered to have been a taxpayer that has had a functional currency year in a preceding taxation year. The new corporation's eligibility to become a functional currency reporter in its own right under the requirements set out in subsection 261(3) will be adversely affected.[52]

The deeming rule will not apply to the new corporation in respect of the specified predecessor if the total cost amount to the new corporation of property of the specified predecessor corporation that became property of the new corporation because of the amalgamation is less than 50 percent of the total cost amount to the new corporation of all its assets at the end of its first taxation year.[53]

Business Transfers

The corporate merger and business transfer rules also apply when a corporate taxpayer ("the transferor"), which used a functional currency calculating currency at any time, transfers all or substantially all of the property used in a business to another corporate taxpayer ("the transferee") that was related to the taxpayer immediately after the transfer. The rule applies if, at the end of the transferee's taxation year in which the transferor transferred the property to the transferee, more than 50 percent of the total cost amount to the transferee of all of its assets is attributable to the

50 Subsections 261(13) and (14).

51 Subsection 261(14).

52 Paragraph 261(15)(b).

53 Subsection 261(17).

property transferred to the transferee by the transferor or to property substituted for that property.[54]

The rules deem the transferee to be the same corporation as and a continuation of the transferor for the purposes of section 261. Consequently, the transferee will, for the purposes of paragraph 261(3)(e), be considered to have been a taxpayer that has had a functional currency year in a preceding taxation year. The transferee's eligibility to become a functional currency reporter in its own right under the requirements set out in subsection 261(3) will be adversely affected.

Deficiencies in the Corporate Merger and Business Transfer Rules

The anti-abuse provisions of the rules for corporate mergers and business transfers are overly restrictive. On a typical corporate takeover, a purchaser corporation will be established to acquire the shares of the target corporation. Typically, the target is merged with or wound up into the purchaser corporation for a number of tax and business reasons. In such circumstances, the merged corporation will inappropriately be precluded from using a functional currency as its calculating currency if the calculating currency of the purchaser corporation and that of the target corporation were not the same. An arm's-length takeover exception to the anti-abuse provisions should be included in the rules.

Proposed Amendments

As a part of the legislative proposals, the Department of Finance has divided the corporate merger and business transfer rules into (1) broad-based rules that relate to amalgamations and windups and (2) an anti-avoidance rule that appears to address the concern that taxpayers may use corporate mergers to avoid the requirements that allow a corporation to elect to be a functional currency reporter.

For a winding up under subsection 88(1), proposed subsection 261(16) applies where a parent and a subsidiary have different tax reporting currencies[55] at the time the winding up is commenced. If this is the case, then the following rules apply:

1. If the subsidiary's tax reporting currency is the Canadian dollar, the subsidiary is deemed to have made a functional currency election in respect of the parent's elected tax reporting currency for the year that includes the commencement time of the winding up and each subsequent year. The pre-windup year becomes the last Canadian currency year for the purpose of transition.[56]

54 Subsection 261(18).

55 "Tax reporting currency" is defined in proposed subsection 261(1) as the currency in which the taxpayer's Canadian tax results are determined for a taxation year.

56 If the commencement of the winding up is in a reversionary year of the subsidiary (that is, it has made and revoked a functional currency election), the winding up rules still apply to deem the subsidiary to have made a functional currency election on the winding up.

2. If the subsidiary's tax reporting currency is not the Canadian dollar, and
   a. the parent's tax reporting currency is the Canadian dollar, the subsidiary is deemed to revoke its functional currency election so that the taxation year that includes the commencement of the winding up is its first reversionary year. The pre-windup year will be its last functional currency year for the purpose of transition;
   b. the parent's tax reporting currency is another foreign currency, the subsidiary is deemed to revoke its functional currency election and is further deemed to have made another functional currency election in respect of the parent's elected tax reporting currency for the year that includes the commencement time of the winding up. For transition purposes, the subsidiary first reverts to the Canadian dollar and then moves to the parent's elected functional currency at the spot rate on the last day of the pre-windup year.

Analogous rules in proposed subsection 261(17) apply to amalgamations where the predecessor corporations have different tax reporting currencies.

Anti-Avoidance Rule

The anti-avoidance rule in proposed subsection 261(18) provides that the Canadian tax results of a corporation must be determined in a particular currency where all of the following conditions are met:

1. Property is (directly or indirectly) transferred between the corporation and another corporation.
2. The transferor and transferee are related at the transfer time (or become related in the course of a series of transactions or events that include the transfer of the property).
3. The transfer time is
   a. in a functional currency year of the transferor if the transferor and transferee have different tax reporting currencies, or
   b. in a reversionary year of the transferor and in a non-reversionary year of the transferee.
4. It is reasonable to conclude that one of the main purposes of the transfer, or of any portion of the series of transactions or events, is to change or enable the changing of the currency in which the Canadian tax results in respect of the property would be determined.
5. The minister directs that the Canadian tax results of the taxpayer are to be determined using the particular currency.

The purpose of this rule appears to be to prevent taxpayers from avoiding the requirements of subsection 261(3) through the use of property transfers, windups, or amalgamations. For example, if a corporation that has made a functional currency election transfers all its assets to another related corporation, and subsequent to the

transfer the transferee makes a functional currency election in a currency different from that of the transferor, the CRA could consider the transfer to be an attempt at circumventing the prohibition against making more than one functional currency election and require the transferee to continue to use the transferor's elected functional currency (or whatever currency the CRA deems appropriate) in calculating the Canadian tax results in respect of the transferred property.

The "one of the main purposes" test is excessively restrictive and punitive. There may be a number of reasons for restructuring the affairs of a corporate group. As described above, a purchaser may incorporate an acquisition corporation to effect a takeover. That acquisition corporation may subsequently amalgamate with the target corporation in order to (1) match the interest expense relating to acquisition debt of the purchaser corporation and the income derived from the assets of the acquired corporation, (2) obtain economic and operational synergies, and (3) manage foreign exchange risk with respect to the acquired assets and debt. All of these are "main purposes" of the amalgamation, but from a policy perspective none of these purposes is abusive. Therefore, there should be no reason for the rule to apply. However, if point 3 involves making a functional currency election, then the CRA may challenge the election and disregard it in reference to the property transferred on the amalgamation.

CONCLUSION

New section 261 should make Canada's tax system more internationally competitive, ease compliance, and reduce administrative complexity. The rules are consistent with the federal government's stated tax policy objective of making Canada's tax system fairer, more competitive, and more efficient.

The proposed modifications to section 261 set out in the legislative proposals correct some but not all of the deficiencies in the functional currency rules. It is hoped that the federal government will carefully consider all submissions made in respect of the legislative proposals to ensure that the deficiencies are addressed.

The primary benefits of making a functional currency election can be found in the reasons given for its adoption. Taxpayers that use accounting functional currencies other than the Canadian dollar and that qualify to make the election will be able to compute their Canadian tax results using their accounting functional currency. This will relieve them from the requirement to compute foreign exchange gains and losses attributable to the fluctuations in the value of their functional currency relative to the value of the Canadian dollar. Canadian tax results will thus reflect foreign exchange gains and losses arising out of the business risks that the taxpayer assumes when it decides to transact in a currency other than its elected functional currency. By measuring foreign exchange gains and losses in this manner, electing taxpayers will face tax burdens comparable to those of their competitors that are able to measure foreign exchange gains and losses in a similar manner.

By making the election, corporations in the resource and manufacturing sectors that conduct and finance their principal business activities in their accounting functional currency will be able to eliminate the distorting foreign exchange gains and

losses that arose simply because they were historically required to calculate their Canadian tax results using the Canadian dollar.

The functional currency election is available to existing taxpayers and new taxpayers formed to carry on new business ventures. It is appropriate that each member of a corporate group be permitted to elect its own Canadian tax calculating currency under section 261; a corporate group will thus be able to establish separate Canadian-resident corporations to compete in different regions of the world using different functional currencies, making Canada's tax system more competitive.