

Tax Memo

Functional Currency Tax Reporting: Proposed Amendments and Extended Deadline

On November 10, 2008, the Department of Finance (Finance) released draft legislation amending section 261 of the *Income Tax Act* (the Act) (the legislative proposals), which provides new tax calculating currency rules that taxpayers must use when determining their Canadian tax results. The draft legislation implements proposals announced by the Minister of Finance in a June 27, 2008 news release. This *Tax Memo* discusses these and other changes to section 261.

For more information on section 261, see our earlier *Tax Memos* on this topic:

- Functional Currency Election: Proposed Revisions and Extended Deadline (July 9, 2008); and
- Functional Currency Proposed Election (November 12, 2007)

Background

Section 261 was enacted to provide new tax calculating currency rules that taxpayers must use when determining their Canadian tax results. These rules establish the general requirement for a taxpayer to use the Canadian dollar as its tax calculating currency, and permit the use of the taxpayer's functional currency as its tax calculating currency if the taxpayer qualifies for, and makes, a functional currency election. Generally, the rules in section 261 apply in respect of taxation years that begin after December 13, 2007.

Further Extension of Election Due Date

The June 2008 proposals originally extended the filing deadline to October 31, 2008, for any election required to be filed before that date. On October 29, 2008, the Minister of Finance announced a further extension to December 15, 2008.

Qualifying to Make a Functional Currency Election

The draft legislation eases the requirements for a corporation to become (and remain) a functional currency reporter. The legislative proposals amend the definition of "functional currency" to require that the currency be the primary currency in which the taxpayer maintains its books and records of account for financial reporting purposes. The legislative proposals do not define "primary currency," "books and records of account" or "financial reporting purposes," but the explanatory notes do provide some guidance, at least with respect to the term "primary currency".

The explanatory notes highlight the situation in which a corporation carries on two distinct businesses within one entity, with the books and records of each business being maintained in a different functional currency. In this case, to determine which currency is the primary currency, the taxpayer must establish which business is the more significant.

In another example, a corporation maintains its books and records in one currency, but those amounts are converted on an aggregated basis to another currency for financial reporting purposes. The notes indicate that the "primary currency" of the corporation will be the first currency. This example may cause confusion for taxpayers who run a general ledger in two

or more currencies. If transactions are entered in the general ledger in Canadian dollars, but a U.S.-dollar financial report can be produced from such general ledger, it would appear that Finance views the Canadian dollar as the primary currency. This appears unduly restrictive.

The legislative proposals also make the Australian dollar a “qualifying currency,” joining the U.S. dollar, the Euro and the British pound.

Revocation of Functional Currency Election

The legislative proposals allow a corporation that is a functional currency reporter to revoke its election, deleting the requirement that a taxpayer have a functional currency for taxation years subsequent to its initial functional currency year. A revocation can be filed on any day in a functional currency year and will be effective for each taxation year that begins on or after six months after that day. Because a taxpayer cannot file a revocation in its first functional currency year, this rule requires taxpayers to be functional currency reporters for at least two years.

Finally, the date for filing a functional currency election has been changed from the filing due date for a corporation’s previous taxation year (or current taxation year, if it is a newly formed corporation), to six months before the end of a corporation’s first functional currency year. Therefore, a corporation that has a taxation year of less than six months must wait until the following year to elect.

Transition Rules

For the purposes of the conversion of a taxpayer’s tax attributes to the elected functional currency, consistent with the June 2008 proposals, the Minister of Finance has proposed to replace the 12-month average exchange rate for the last Canadian currency year with the spot exchange rate at the end of the corporation’s last Canadian currency year. An exception to this general rule allows taxpayers that filed a functional currency election before June 27, 2008, to elect to use the 12-month average exchange rate as a transition rate.

Reversion Rules

The legislative proposals provide a method of reversion that mirrors the transitional rules for converting into a functional currency. Specifically, a functional currency reporter reverting to reporting in Canadian dollars will

convert its tax attributes to Canadian dollars using the spot exchange rate on the last day of its last functional currency year. Similarly, for debts denominated in a currency other than the corporation’s functional currency, any accrued gain or loss will be crystallized and realized as the debt is repaid.

Partnerships

The legislative proposals provide that, if the corporation is a member of a partnership after its last Canadian currency year, the proposals apply to the partnership to allow the corporation to compute its Canadian tax results.

In effect, the rules attribute to the partnership the same functional currency as the partner and therefore allow the partner to calculate the partnership results in its elected functional currency. It appears that if a partnership has one member that has elected a functional currency and another that has not elected, or has elected another functional currency, the partnership will be required to compute its income multiple times, depending on how many different functional currencies have been elected by its members.

The Canada Revenue Agency (CRA) has also provided guidance that, in determining a taxpayer’s primary currency, regard can be had to the books and records of any partnership of which it is a member.

Amounts of Tax Payable

Under existing section 261, amounts payable to CRA from a functional currency reporter and amounts payable from CRA to a functional currency reporter are to be made in Canadian currency. Because all of a functional currency reporter’s tax amounts, including its tax payable, are maintained in its functional currency, it was necessary to provide a mechanism for converting these amounts to Canadian dollars for determining payments to or from the CRA.

With respect to taxes that are, or would be, payable in a functional currency year of a corporation, under the legislative proposals, those amounts are to be converted to Canadian dollars using the spot exchange rate on the taxpayer’s balance due date for that particular functional currency year.

Interestingly, using the balance due date as the relevant rate appears to mean that taxpayers would be unable to pay their taxes on an earlier date, because they would not know the relevant exchange rate before that time.

The legislative proposals also provide rules for installment payments, which attempt to ensure that an appropriate amount of Canadian dollars is remitted by a functional currency reporter for each installment and that a functional currency reporter is “insulated from exchange risk” in respect of its installment payments.

The rules also provide that any time an amount is deemed to be paid on account of an amount payable by the taxpayer (such as an investment tax credit), the amount is converted to Canadian currency using the exchange rate on the day that includes that time.

Carry-back Rules

Changes are also proposed to the rules in section 261 concerning situations in which tax amounts, such as capital or non-capital losses, are carried back from a functional currency year to a Canadian currency year, or from a reversionary year to a functional currency year.

Existing section 261 converts amounts carried back from a functional currency year of a corporation to a Canadian currency year by converting the relevant amounts, such as a loss incurred, using the 12-month average exchange rate of the last day of the taxation year in which the loss was incurred. The same rule applies for amounts arising in a reversionary taxation year.

The legislative proposals change the rate at which the amount to be carried back is to be converted. Instead of using an average for the year in which the amount of loss or expense arose, the spot exchange rate on the last day of the end of the corporation's last Canadian currency year (when carrying an amount back to a Canadian currency year) or last functional currency year (when carrying back to a functional currency year) is used. Similarly, if an amount is carried back from a reversionary year to a Canadian currency year, the amount must be converted to the corporation's functional currency at the spot exchange rate on the last day of its last functional currency year, then converted again to Canadian dollars by using the spot exchange rate on the last day of the corporation's last Canadian currency year.

Reorganization Rules

The draft rules significantly broaden the scenarios in which a parent (after a wind-up) or new corporation (following an amalgamation) can continue to be a functional currency reporter. Specifically, when a corporation is wound up into its parent, and one or the other is a functional currency reporter, the parent is permitted to be a functional currency reporter if:

- it is a functional currency reporter and the subsidiary is a Canadian currency reporter;
- it is a Canadian currency reporter and the subsidiary is a functional currency reporter and the parent makes a future functional currency election; or
- it is a functional currency reporter with one functional currency and the subsidiary is a functional currency reporter with another functional currency.

Similar rules are proposed in respect of amalgamations. Because these rules are so much broader than existing section 261's reorganization rules, Finance appears to have felt compelled to introduce a rule intended to prevent abuse of this generosity (discussed below).

New “Anti-avoidance” Rules

The draft legislation repeals the existing anti-avoidance rules (in subsections 261(15) to (18)) and introduces two new rules. The first is aimed at using the rules in section 261 to create foreign exchange results that do not reflect economic reality. The other (previously unannounced) rule appears concerned with ensuring that taxpayers cannot unduly avoid the requirements that allow a corporation to elect to be a functional currency reporter.

Loss Limitation Rule

The loss limitation rule was discussed in the June 2008 proposals, although, as drafted, its application is now significantly broader. This rule applies if:

- there is a transaction between a taxpayer and a related corporation, each with a different tax reporting currency; and
- a fluctuation in the two currencies in the period while the two entities had different tax reporting currencies resulted in:
 - an increase in the loss of the taxpayer in respect of the transaction; or
 - a reduction in the taxpayer's income or gain in respect of the transaction; or
 - the taxpayer's having a loss, instead of income or a gain, in respect of the transaction.

The explanatory notes provide the example of Parent (Canadian dollar reporter) making a Canadian dollar loan to Subco (U.S. dollar reporter). The Canadian dollar strengthens over the term of the loan. The foreign exchange loss that Subco would realize on the repayment of the loan would be denied under the proposed loss limitation rules. This rule also appears to be broad enough to include transactions between the taxpayer and related non-residents.

Functional Currency Qualification Rule

The functional currency qualification rule provides that the Canadian tax results of a corporation for any one or more taxation years will be determined using a particular currency if:

- property is transferred between two related corporations either:
 - in a functional currency year (or a taxation year that would be a functional currency year if the reorganization rules did not apply) of the transferor corporation, and the transferor corporation and transferee corporation have (or would have had, if the reorganization rules did not apply) different tax reporting currencies; or
 - in a reversionary year (or a taxation year that would be a reversionary year if the reorganization rules did not apply) of the transferor corporation that is not in a reversionary year of the transferee corporation; and
- one of the main purposes of the transfer is to change, or to enable the changing of, the currency in which the Canadian tax results in respect of the property, would otherwise be determined.

These rules prevent a taxpayer from avoiding the requirements of subsection 261(3) through the use of transfers of property, wind-ups or amalgamations. For example, a corporation that is a functional currency reporter could conceivably transfer all of its assets to another corporation. After the transfer, the transferee corporation could make a functional currency election electing a currency other than that of the transferor corporation. Finance might see this as attempting to circumvent the prohibition against more than one election being made by a corporation. However, if the main purpose of the transfer was for business reasons, unrelated to the tax reporting currency of the property transferred, the rule should not apply.

Notwithstanding what the rule appears to be targeting, its broad wording produces a certain amount of uncertainty as to how it would apply to certain transactions such as internal reorganizations. In a simple situation in which a Canadian corporation that has elected to be a U.S. dollar tax reporter winds-up into its Canadian parent, transferring all its assets to the parent, to ensure that the proposed anti-avoidance rule does not apply, it would have to be established that changing the tax reporting currency in respect of those assets was not one of the main purposes of the winding-up.

PwC Observes

The draft legislation appears to have fulfilled, at least in part, the Finance Minister's intention of easing compliance with the new functional currency rules. By introducing the concept of the relevant spot rate, the legislation has made it easier for corporations to evaluate whether making a functional currency election is beneficial. Further, the introduction of rules in respect of partnerships is a welcome enhancement to the existing rules.

Taxpayers may have to reevaluate their position in light of the Finance Minister's overly stringent interpretation of the term "primary currency" as well as the far-reaching proposed anti-avoidance rules.

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