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December 14, 2007

Mr. Brian Ernewein
General Director – Legislation
Tax Policy Branch
Department of Finance
140 O'Connor Street
Ottawa, ON K1A 0G5

Dear Brian:

Proposed Section 261 - Rules Relating to Functional Currency Reporting

PricewaterhouseCoopers LLP (“PwC”) is pleased to present our comments on and to request certain modifications to the proposed rules in new section 261 of the Income Tax Act (“the Act”). The proposed rules were first included in the Draft Legislative Proposals and Explanatory Notes released on October 2, 2007 and were subsequently included in the Notice of Ways and Means Motion dated November 13, 2007 and Bill C-28.

We apologize for submitting this letter after the requested submission date. The delay was caused by our desire to present as complete analysis as possible given the complexity inherent in the proposed rules and to provide you with suggested revised wording.

PwC believe that the proposed functional currency reporting rules is an important and welcome initiative, which can have significant benefits for Canadian corporations. However, corporations will need to carefully consider the implications of applying these rules.

The primary objective of our modifications is to provide more certainty with respect to the application of the rules and to increase the efficiency and effectiveness of the tax system. As well, our modifications would provide for more symmetrical measurement of foreign exchange gains and losses under the rules and increase their fairness.

We request that you provide confirmation that our recommendations will be made to the Minister of Finance to modify these rules in the event Bill C-28 receive royal assent before the

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Department can consider our proposed modifications. An early announcement with respect to these matters is also requested.

We are sure you appreciate the need of taxpayers for the clarity and certainty with respect to these matters. Without such clarity and certainty, the tax rules as proposed will not serve the very corporations that the rules were intended to serve. This would not be consistent with the government's stated objective to deliver what was promised and the government's goal of increasing the effectiveness and fairness of the tax system would be poorly served.

As always, PricewaterhouseCoopers appreciates the opportunity of being able to discuss all aspects of proposed tax legislation with you. When you have had sufficient time to consider our submission, we will be happy to meet with you and members of your Department to discuss our concerns and our proposed modifications.

Yours sincerely,



Nick Pantaleo, FCA
Leader, Canadian National Technical Services

cc Gerard Lalonde, Department of Finance
Bob Hamilton, Department of Finance

Submission of PricewaterhouseCoopers LLP on Proposed Rules to Implement Functional Currency Reporting – New Section 261

A. Introduction

This submission comments on several matters relating to the proposals to amend the Act to permit a Canadian corporation to elect to determine its Canadian tax results in the corporation's *functional currency*.¹ This submission is not intended to be exhaustive.

B. Eligibility Criteria for Taxpayers

Overview of Eligibility Criteria

Proposed subsection 261(3) sets out the requirements that must be met by a taxpayer before the taxpayer can qualify to compute its Canadian tax results, for a particular taxation year, using a *functional currency* rather than the Canadian dollar. The requirements can be summarized as follows:

- The taxpayer must, throughout the particular taxation year, be a corporation that is resident in Canada.
- There is a *functional currency* of the taxpayer for the particular taxation year.
- Where the taxation year of the taxpayer immediately preceding the particular taxation year was a *functional currency year* of the taxpayer, the *functional currency* for the taxpayer for that immediately preceding taxation year and the particular taxation year must be the same.
- Where the taxation year of the taxpayer immediately preceding the particular taxation year of the taxpayer was a *Canadian currency year* of the taxpayer, no taxation year of the taxpayer preceding the particular taxation year was a *functional currency year* of the taxpayer.
- The taxpayer must elect in prescribed form and manner on or before the filing due date for the *last Canadian currency year* of the taxpayer to be a *functional currency* reporter for the *initial functional currency year* of the taxpayer and all subsequent taxation years of the taxpayer.

A currency (other than the Canadian dollar) will be the *functional currency* of the taxpayer for the particular taxation year if all of the following conditions are met:

¹ In this letter, all words or terms in *italics* are defined in proposed subsection 261(1).

- The currency is a *qualifying currency*.
- The currency is, “more often than any other currency”, used in the conduct of the taxpayer’s principal business activities in the particular taxation year.
- The currency 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* and in the taxpayer’s *legal entity financial statements* for the particular taxation year.

A *qualifying currency* is defined to mean each of the currencies of the United States of America, the European Monetary Union and the United Kingdom. Currencies of countries may also be prescribed to be qualifying currencies.

The *consolidated financial statements* of the taxpayer for the particular taxation year is defined to mean the financial statements for that year of the taxpayer prepared in accordance with *generally accepted accounting principles*.

The *legal-entity financial statements* of the taxpayer for the particular taxation year are the financial statements for that year that would be prepared in accordance with *generally accepted accounting principles* if those accounting principles did not require consolidation.

Generally accepted accounting principles (“GAAP”) means the accounting principles established or recommended by the Accounting Standards Board of Canada or such other accounting principles that are acceptable to the Minister.

PwC Commentary: Requirement that taxpayers be a corporation resident in Canada

In order to be eligible for the election, proposed paragraph 261(3)(a) provides that the taxpayer must be a corporation that is resident in Canada throughout the particular taxation year. This requirement unnecessarily excludes non-resident corporations that carry on business in Canada. Such non-resident corporations should be eligible to make the functional currency election, provided they satisfy the other eligibility criteria.

Further, if a Canadian resident corporation is a member of a partnership, it is unclear how the eligibility criteria will apply where the principal business activities are conducted in the partnership rather than the corporation itself.

PwC Recommendation #1

We recommend that paragraph (b) of the definition of *functional currency* be expanded to encompass the business activities of a partnership and non-resident corporations to which section 115 applies.

PwC Commentary: Interpretative uncertainties

Taxpayers that desire to determine their Canadian tax results in a *functional currency* must establish compliance with the above eligibility criteria.

However, taxpayers that would like to elect into these rules are faced with having to establish compliance with these requirements without having been provided with any guidance with respect to the criteria that will be used by the tax authorities in assessing compliance. For example, no rules of application have been provided for the purpose of identifying the particular currency that is “more often than any other currency” used in the conduct of the taxpayer’s principal business activities in the particular taxation year. The term “business activities” is also not defined in the draft legislation.

This is unsatisfactory given the seriousness of the consequences to corporations of having elected into the rules only to be found to be ineligible to make the election by the taxation authorities because they are using criteria that may not only be unknown to the corporation but also unacceptable given the policy underlying the rule. As well, corporations are, for the first year in which the rules are effective, in need of additional time to make their assessments and elect under the rules.

These difficulties and other interpretative issues are discussed more fully below.

1. Currency Usage Test – The “more often than any other currency” requirement

Establishing, with reasonable certainty, that a particular currency is, more often than not, used in the conduct of the corporation’s principal business activities is key to establishing the corporation’s eligibility to elect to be a functional currency reporter for Canadian tax purposes. Placing the onus on the corporation to defend its choice of a particular currency as the currency that is used more often than any other currency in a particular taxation year of the corporation in the corporation’s principal business activities for that particular taxation year is unsatisfactory when the legislation does not set out the criteria that is to be used in making this decision. The criteria to be used must be set out in the legislation so both the corporation and the taxation authorities can make their assessments using the same criteria and criteria that is consistent with the underlying policy of the legislation. Eligibility would then be a question of fact and evaluation based on established criteria that is known to all stakeholders.

In our view, it would be appropriate to establish criteria that reflect the indicators that are used in making such determination for accounting and financial statement purposes under the GAAP applicable to the corporation. This would be consistent with the tax policy underlying the rules. These indicators include:

- the currency in which the corporation’s current assets and liabilities are held or maintained,

- the currency in which the corporation's sales are made or investment income is earned,
- the currency with which corporation's expenses are paid or with which another currency is purchased to pay the corporation's expenses,
- the currency in which the corporation's financing debt and shares are issued or hedged with respect to foreign exchange gains or losses, and
- the currency used in the preparation of the corporation's books and records for accounting purposes.

In certain situations it would be appropriate to review transactions undertaken by related parties to determine a corporation's *functional currency*. For example, related corporations may hold assets, make sales, earn investment income or issue financing debt or shares or hedge foreign exchange risks with respect to such debt or shares on behalf of or for the benefit of the corporation. Those transactions should be considered when making any assessment in respect of the corporation.

In cases where the functional currency of the corporation can not be readily determined by reference to these indicators, management would generally be in the best position to make the *functional currency* determination since they best know the currency in which the business activities are substantially conducted. The use of these accounting indicators for determining the *functional currency* of a corporation for tax purposes has further merit from the point of view that the usage of such indicators will simplify compliance and administration because the analysis will have been made for accounting purposes and the resulting financial statements will be used in calculating the corporation's Canadian tax results.

PwC Recommendation #2

In order to provide greater certainty with respect to the application of the functional currency rules and to assist taxpayers and administrators with the compliance with, and the administration of, the rules, it is recommended that rules of application be provided.

A legislative proposal is as follows:

(19) For the purpose of the definition of "functional currency" in subsection (1), the following factors are to be considered in determining if a particular currency is used more often than any other currency by a particular corporation in a particular year in the conduct of the principal business activities of the particular corporation for the particular taxation year:

(a) the currency in which, in the normal course of carrying on its principal business activities for the particular taxation year; the particular corporation generally holds its current assets in the particular taxation year,

(b) the currency in which, in the normal course of carrying on its principal business activities for the particular taxation year, the particular corporation's sales are generally effected or its gross investment revenue is generally earned in the particular taxation year,

(c) the currency in which, in the normal course of carrying on its principal business activities for the particular taxation year, the particular corporation generally

(i) issued debt or shares in the particular taxation year for the purpose of financing its principle business activities, or

(ii) hedged the debt or shares referred to in subparagraph (i) in the particular year to reduce its foreign exchange risk in respect of the fluctuation in the value of the currency in which the debt or shares were issued relative to the value of any other currency,

(d) the currency that, in the normal course of carrying on its principal business activities for the particular taxation year, the particular corporation generally used in the particular year to

(i) purchase its assets or pay its expenses, or

(ii) purchase another currency that is used to purchase its assets or pay its expenses, and

(e) the currency that, in accordance with generally accepted accounting principles that are applicable to the particular taxation year, would be determined to be the functional currency of the particular corporation for the particular taxation year.

(20) In making the determinations under subsection (19) in respect of the particular corporation, transactions (referred to in this subsection as "compliant transactions") performed by another corporation (referred to in this subsection as the "compliant corporation") will be deemed to be transactions undertaken by the particular corporation if

(a) the compliant corporation is related to the particular corporation, and

(b) it is reasonable to conclude that the compliant transactions are performed by the compliant corporation at the direction of or with the concurrence of the particular corporation.

(21) In making the determinations under subsection (19) in respect of the particular corporation, where, in the particular taxation year, the particular corporation is a member of a partnership,

(a) the activities carried on by the partnership in a fiscal period of the partnership ending in the particular taxation year of the particular corporation are deemed to have been carried on by the particular corporation to the extent of the proportion that

(i) the particular corporation's share of the partnership income or loss for the fiscal period

is of

(ii) the partnership's income or loss for the fiscal period, and

(b) if the income or loss of the partnership for the fiscal period is nil, the proportion in paragraph (a) shall be determined as if the income of the partnership for the fiscal period was \$1,000,000.

2. Consolidated financial statements

The requirement in paragraph (c) of the proposed definition of *functional currency* requires that the elected currency be used in the taxpayer's consolidated and legal entity financial statements. This requirement, as currently drafted, appears cumulative such that if a Canadian corporation that meets all other criteria does not issue consolidated financial statements, then it appears not to be eligible to make the election.

By definition, where consolidation is not required or prepared, it would appear (but it is not clear) that the consolidated and the legal-entity statements would be the same.

There are situations where consolidated financial statements are not prepared and issued to a corporation's shareholders. For example, this could be the case where the particular corporation is closely held and /or is a lower-tier corporation and consolidated financial statements are not prepared for that corporation because there is no legal or accounting requirement to do so. In such a case, it should be sufficient for a corporation to establish that, if the legal entity financial statements of the corporation were prepared in accordance with GAAP, the currency used in preparing such statements would be the foreign currency that the corporation wishes to use as a functional currency. The satisfaction of the currency usage test using the criteria described above would validate the appropriateness of the functional currency used in the legal entity statements. Consequently, a rule could be provided that would provide that, where consolidated financial statements are not prepared by the corporation, paragraph (c) of the definition *functional currency* can be read without reference to the words "consolidated financial statements".

PwC Recommendation #3

We recommend that a rule be added to provide that where consolidated financial statements are not prepared, paragraph (c) of the definition *functional currency* can be read without reference to the words *consolidated financial statements*.

The rule could be written as follows:

Where a taxpayer has not prepared consolidated financial statements for a particular taxation year, paragraph (c) of the definition “functional currency” in subsection (1) shall, in respect of the particular taxation year, be read without reference to the words “consolidated financial statements and”.

3. **Change of functional currency**

The rules in proposed paragraph 261(3)(d) require that the *functional currency* of the taxpayer cannot change. More specifically, the rules in paragraph 261(3)(e) provide that the taxpayer can not have a *functional currency* year preceding a *Canadian currency year*.

Proposed subsections 261(13) to (17) provide rules that apply when there is a winding-up to which subsection 88(1) of the Act applies or an amalgamation described by subsection 87(1) of the Act. In such cases, where the parent or the new corporation is not a functional currency reporter or the functional currency of the wound-up or predecessor corporation is not the same, the wound-up or predecessor corporation ceases to be a functional currency reporter at the end of its last taxation year ending before the year in which assets are distributed to the parent in the course of the winding-up or the year that ends immediately before the amalgamation. The parent and the new corporation are deemed to be continuations of the wound-up or predecessor corporation for the purposes of paragraph 261(e) unless the cost amount of the assets of the wound-up corporation or the predecessor corporation was less than 50% of the cost amount of the assets of the merged corporation in its first year ending after the distribution of the assets of the wound-up corporation on the winding-up or the amalgamation of the predecessor corporations.

We believe that these rules are too restrictive and do not contemplate that a corporation may have a change in its *functional currency* for reasons that could not have been contemplated at the time the election was made to become a functional currency reporter, for example, as the result of a takeover of a target corporation and a merger of the acquirer and the target corporations.

PwC Recommendation #4

We recommend that an exemption such as that provided by subsections 261(16) and (17), be extended to corporations where there has been an acquisition of control of a corporation that was a functional currency reporter. The modified rule could read as follows;

(22) Where, in the course of a series of transactions or events, a person or a group of persons (the person or group of persons is referred to in this subsection as the “controllers”) have acquired control of a corporation (referred to in this subsection as the “target”) and immediately before the acquisition of control, the target was not controlled by the controllers or by a person or a group of persons that did not deal at arm’s length with the controllers,

(a) where, as part of the series of transactions or events, the target is wound-up into a parent in a winding-up to which subsection 88(1) applied, paragraph (15)(a) shall not apply for the purpose of paragraph (3)(e) to the parent in respect of the target, and

(b) where, as part of the series of transactions or events, the target is amalgamated or merged with one or more other corporations to form a new corporation and the merger or amalgamation is described by subsection 87(1), paragraph (15)(b) shall not apply for the purpose of paragraph (3)(e) to the new corporation in respect of the target.

C. Transition Exchange Rates

Overview of Transition Rules

In its first *functional currency year*, in accordance with the rules in proposed subsection 261(5), an electing corporation will have to translate its Canadian dollar tax attributes into the elected functional currency. For most tax attributes, the proposed rules provide that the amount of these attributes, determined in Canadian dollars at the end of the immediately preceding year (the *last Canadian currency year*), must be translated using the *transitional exchange rate*, which is defined to mean the 12-month average exchange rate for the last Canadian currency year of the corporation, calculated by reference to the noon exchange rates quoted by the Bank of Canada. Accordingly, any unrealized foreign exchange gain or loss to the date of translation is effectively imbedded into the new functional currency amount of the tax attributes.

As an exception to this general translation rule, proposed paragraph 261(5)(h) provides that the outstanding principal amount of a debt issued in the corporation's functional currency at the commencement of the initial functional currency year is determined using the exchange rates applicable when the debt was issued. In accordance with proposed subsection 261(6), any unrealized foreign exchange gains and losses attributable to such debt obligations of the electing corporation are determined, immediately before the end of the last Canadian currency year, using the assumption that the debt was settled at that time (and using the foreign exchange rate that was in existence at that time). Any unrealized foreign exchange gain or loss so determined in Canadian dollars is converted to the corporation's functional currency using the 12-month average exchange rate for the last Canadian currency year and is amortized into the corporation's income as the debt obligation is repaid or settled.

PwC Commentary: Issues with transitional rules

The use of the foreign exchange rate immediately before the end of the last Canadian currency year as opposed to the transitional exchange rate means that foreign exchange gains and losses in respect of debt are measured differently to that in respect of assets. This lack of symmetry can produce adverse results.

Example

Facts

- Canco transacts predominantly in U.S. dollars, which is also its functional currency.
- Canco qualifies for, and makes, an election under proposed section 261 to determine its Canadian tax results using the U.S. dollar for its 2008 and subsequent taxation years.
- In 2007, Canco issues a debt for U.S.\$500 million and uses the borrowed funds to acquire a capital asset for U.S.\$500 million.
- Canco sold the capital asset in 2008 for U.S.\$600 million, using the proceeds of sale to repay the debt in full.
- The following exchange rates existed :
 - The exchange rate at the time the debt was issued and the asset was acquired was CDN\$1: U.S.\$0.80.
 - The 12-month average exchange rate (the transitional exchange rate) for 2007 (the last Canadian currency year) was CDN\$1: U.S.\$0.95.
 - The exchange rate as of December 31, 2007 was CDN\$1: U.S.\$1.

Computations

- In Canco's initial functional currency year (2008), the U.S. dollar adjusted cost base of the capital asset is determined as U.S.\$593.75 million (U.S.\$500 million / .80 x 0.95 = U.S.\$593.75 million)
- The unrealized foreign exchange loss of U.S.\$93.75 million is embedded in the adjusted cost base of the capital asset.
- When the asset is sold, the capital gain, calculated in U.S. dollars, is computed as follows:

Sale proceeds	U.S.\$600.00 million
Less: Cost base	<u>(U.S.\$593.75 million)</u>
Capital gain	U.S.\$ 6.25 million

- On transition, the unrealized foreign exchange gain or loss in respect of the debt is calculated using the exchange rate applicable at December 31, 2007 (i.e., the time

immediately before the end of the last Canadian currency year). In the example, this unrealized foreign exchange gain is calculated in Canadian dollars as CDN\$125 million (U.S.\$500 million / .80 – U.S.\$500 million / 1.0 = CDN\$125 million)

- The unrealized foreign exchange gain is then converted to U.S. dollars using the 2007 average exchange rate or U.S.\$118.75 million (C\$125 million x 0.95). 50% of this unrealized foreign exchange gain will be included in Canco's taxable income in 2008, the year the debt is repaid.

Conclusion

In this example, Canco would have expected that on transition, the unrealized foreign exchange gain that accrued in respect of the debt would exactly offset the unrealized foreign exchange loss that accrued in respect of the capital asset. The difference between the foreign exchange loss embedded in the cost of the asset (U.S.\$93.75 million) and the foreign exchange gain calculated in respect of the debt (U.S.\$118.75 million) arose from the fact that the Canadian dollar unrealized foreign exchange gain in respect of the debt was not determined using the transitional exchange rate (currency exchange rate where the currency in which the debt was issued is not the functional currency).

PwC Recommendation #5

We recommend that “D” in proposed subparagraph 261(6)(a)(i) and “I” in proposed subparagraph 261(1)(a)(ii) be modified to require the unrealized foreign exchange gain or loss in respect of a debt obligation issued in the corporation's functional currency be measured using the *currency exchange rate in respect of the exchange of the Canadian dollar for the unit of the currency in which the debt was issued*. The modified wording could read as follows

Description of D in the formula in subparagraph 261(6)(a)(i)

“D is the amount (expressed in Canadian dollars), if any, that would be determined to be the taxpayer's capital gain under paragraph 39(2)(a) or income, as the case may be, if

(I) the principal amount of the debt obligation (determined in Canadian currency), immediately before the end of the last Canadian currency year of the taxpayer, had been settled by a payment by the taxpayer to the holder of the obligation of an amount equal to that outstanding principal amount at that time, and

(II) the rate of exchange for the exchange of the Canadian dollar for the unit of the currency in which the debt was issued was equal to the currency exchange rate at the end of the last Canadian currency year, and”

Description of I in the formula in subparagraph 261(6)(a)(i)

I is the amount (expressed in Canadian dollars), if any, that would be determined to be the taxpayer's capital loss under paragraph 39(2)(b) or loss, as the case may be, if

(I) the principal amount of the debt obligation (determined in Canadian currency), immediately before the end of the last Canadian currency year of the taxpayer, had been settled by a payment by the taxpayer to the holder of the obligation of an amount equal to that outstanding principal amount at that time, and

(II) the rate of exchange for the exchange of the Canadian dollar for the unit of the currency in which the debt was issued was equal to the currency exchange rate at the end of the last Canadian currency year, and

D. Effective Date of Application

There are taxpayers that may want to elect to be a functional currency reporter in the earliest possible year. However, because of the uncertainties described above, those taxpayers will not be comfortable in determining, with adequate certainty, if they qualify to make the election by the time required, which is the filing due date for their return for their taxation year ending immediately preceding that earliest possible year.

Consequently, we believe that it would be reasonable for the government to provide those taxpayers with additional time to make an election under proposed subsection 261(3).

Recommendation #6

We recommend that the election time should, for the first taxation year, be extended to the filing due date of their return for that first taxation year. This could be accomplished by altering the coming-into-force provision that enacts subsection 261(3). A legislative proposal is as follows:

Subsections 261(1) (other than the definition "Canadian tax results" and subsections 261(3) to (18), of the Act, as enacted by subsection (1)), apply in respect of taxation years that begin on or after the day on which this Act is assented to, except that, in applying subsection 261(3)(b)(i) for the first such taxation year, that subparagraph shall be read as

(i) for the taxation year in respect of which the election was made, or

In addition, because we understand it was intended for these rules to be available to taxpayers as soon as possible, if royal assent is not received until after December 31, 2007, we recommend that the coming-into-force be changed to taxation years beginning after 2007.