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November 28, 2008

Mr. Brian Ernewein
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Dear Brian:

Proposed Revisions to 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 amendments (“the Proposals”) to section 261 of the *Income Tax Act* (the “Act”). The Proposals were first announced in a News Release issued on June 27, 2008 and released on November 10, 2008.

PwC views the thrust of the Proposals as being positive and is appreciative of the efforts made by the Department of Finance to simplify the existing rules and address issues raised by PwC in our submission to the Department of Finance dated December 14, 2007 and in our meeting with Finance and officials from the Canada Revenue Agency (“CRA”) on May 7, 2008.

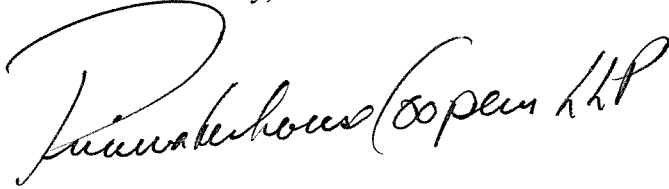
We appreciate the opportunity to make this submission and are prepared to discuss it with you and/or your officials at your/their convenience. Please contact Wally Conway at 416-365-2710 or Liam Fitzgerald at 416-869-2601 if you have any questions.

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Yours sincerely,



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Leader
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Submission of PricewaterhouseCoopers LLP on Proposed Revisions to Section 261 – Rules Relating to Functional Currency Reporting

A. Introduction

This submission comments on several matters relating to the Proposals to amend section 261 of the Act. That section requires a taxpayer to use the Canadian dollar in determining the taxpayer's *Canadian tax results*.¹ It also permits a qualifying taxpayer to elect to determine its Canadian tax results using the taxpayer's *functional currency*.

B. Eligibility Criteria for Taxpayers

Overview of Amended Eligibility Criteria

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 are set out in subsection 261(3), as amended by the Proposals. The amended requirements can be summarized as follows:

- The taxpayer must, throughout the particular taxation year, be a corporation resident in Canada that is not an investment corporation, a mortgage investment corporation or a mutual fund corporation.
- The taxpayer must elect in prescribed form and manner on or before the day that is six months before the end of the first taxation year of the taxpayer in which the taxpayer would like to compute its Canadian tax results using its functional currency.
- The taxpayer must have a functional currency throughout that first taxation year.
- The taxpayer has not previously filed a functional currency election.
- The taxpayer has not filed a revocation of the election.

The definition of *functional currency* in subsection 261(1) is also being amended under the Proposals. A currency will be a functional currency of the taxpayer where, throughout the taxation year, the currency is:

¹ In this submission, all words or terms written in italics are defined in the proposed amendments to subsection 261(1).

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- a *qualifying currency*, and
- the primary currency in which the taxpayer maintains its records and books of account for financial reporting purposes.

A *qualifying currency* is defined to mean the currencies of the United States of America, the European Monetary Union, the United Kingdom and Australia. Australia was added as part of the Proposals.

PwC Commentary: General Comments on Amendments Proposed in Respect of Eligibility Criteria

The Proposals will significantly improve the operation of section 261. This is particularly true of the amendments made in respect of the definition of *functional currency*.

However, in our view, some issues still need to be addressed.

PwC Commentary: Primary Currency Requirement

Taxpayers that wish to determine their Canadian tax results in a functional currency must establish compliance with the above eligibility criteria. The amended version of the definition of functional currency requires that the currency be the primary currency in which the taxpayer maintains its records and books of account for financial reporting purposes. 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 Proposals, these examples do not consider other more complex scenarios. For instance, an example discusses a situation where a corporation records its transactions in one currency, and then translates those transactions on an aggregated basis to its functional currency for financial reporting purposes. In that scenario, the explanatory notes indicate that the first currency would be considered the corporation’s primary currency for the purpose of the functional currency election.

We believe that this conclusion is overly simplistic. Many corporations use sophisticated general ledger systems that have the capability of recording transactions in multiple currencies (e.g., both Canadian and U.S. dollars). Such general ledger systems allow corporations to produce financial reports for a number of purposes in both currencies. Therefore, assuming the U.S. dollar was 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

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the position that its primary currency is the U.S. dollar, regardless of the fact that Canadian dollar entries are made into the general ledger.

A variation to this example is where a corporation, whose functional currency and financial reporting currency is the U.S. dollar, for historic reasons maintains a Canadian dollar general ledger (a reason could be the probative cost of implementing a multi-currency general ledger system). In order to produce financial reports in U.S. dollars, such corporation may use a reporting package that converts the general ledger information into U.S. dollars. In assessing what the primary currency of this corporation is, consideration should not be limited to the Canadian dollar general ledger, but should include the reporting package which is an integral part of the corporation's books and records of account. This is particularly the case if no financial reports are issued by the taxpayer in Canadian dollars, except for financial statements currently used to support the preparation of the corporation's Canadian tax returns.

The above two examples demonstrate that in assessing a corporation's functional currency, if attention is focused on the currency in which the corporation issues its financial reports to its shareholders, rather than on the primary currency determination, the functional currency assessment would be substantially simplified. The use of the term "primary currency" creates doubt for corporations whose initial accounting entries are necessarily made in the Canadian dollar, but who otherwise use the U.S. dollar for all financial reports, or corporations who have multi-currency general ledgers.

PwC Recommendation #1

Add a rule that will deem or clarify the primary currency to be, in circumstances where the records and books of a taxpayer are maintained in more than one currency, the currency used by the taxpayer in preparing its financial statements, or would be used if financial statements were required to be prepared by the taxpayer, in accordance with generally accepted accounting principles ("GAAP"). For this purpose, it may be necessary to retain the definition of GAAP in existing subsection 261(1).

PwC Commentary: Time to File an Election

Under the 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. In the case of a newly incorporated company, this may not be possible. For example, consider a company incorporated on September 1 with a year-end of December 31. To elect to report in its functional currency, the corporation will need to have elected by June 30 of that year, a full two months before its

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incorporation date. There appears to be no policy basis for excluding such a corporation from electing for its first taxation year.

PwC Recommendation #2

Provide a rule that would permit a newly formed corporation that would otherwise qualify to make an election under proposed subsection 261(3) to make the election on or before the corporation's filing due date for its first taxation year.

C. Application to Entities Other Than Corporations

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

Currently, only certain corporations resident in Canada can qualify to elect under proposed subsection 261(3) to use a foreign currency as its tax calculating currency. As a matter of equity, consideration should be considered to extending this right to other taxpayers such as income trusts and non-resident corporations.

PwC Recommendation #3

We recommend that proposed paragraph 261(3)(a) be amended to include non-resident corporations to which section 115 applies and trusts that carry on business in Canada.

PwC Commentary: Business activities in a partnership

Where a corporation is a member of a partnership and that corporation has made a functional currency election, the Proposals treat the partnership as a separate taxpayer that has made a functional currency election. This is a welcomed change.

However, the proposed rules may not operate as intended. For example, the last functional year of the partnership could end in a *reversionary year* of the corporation. As well, it is not clear 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 would seem appropriate that, in determining the eligibility of a taxpayer that is a member of a partnership to make an election under proposed subsection 261(3), 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.

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PwC Recommendation #4

We recommend that the rules in proposed subsection 261(6) be modified to ensure that the last functional currency year of the partnership ends in the last functional currency year of the taxpayer. We also recommend that, for the purpose of proposed subsection 261(3) and the definition of *functional currency*, a taxpayer that is a member of a partnership 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 for the relevant year.

D. Transition Rules

PwC Commentary: Conversion of debts denominated in currency other than the Canadian dollar or the elected functional currency

The proposed amendments to section 261 provide for the use of the *relevant spot rate* on the last day of a taxpayer's last *Canadian currency year* to convert the Canadian dollar amount of the taxpayer's tax attributes to amounts expressed in the taxpayer's elected functional currency.

Special rules apply with respect to debt obligations. Under existing subparagraph 261(5)(h)(iii) the principal amount of a debt denominated in a third currency (i.e., a currency other than the Canadian dollar or the elected functional currency) is converted to the taxpayer's functional currency by taking the principal amount of the debt determined in that third currency and converting that amount to the functional currency at the average rate for the twelve month period ending on the last day of the taxpayer's last Canadian currency year. Our understanding was that the conversion of the third currency to the elected functional currency was to ensure that no gain or loss would arise on a future settlement or assignment of the debt, except to the extent of fluctuations in the relative values of the third currency and the elected functional currency occurring after the commencement of the taxpayer's first functional currency year. It was necessary to do this because the gain or loss accruing up until that time would, under existing subsection 261(6), be crystallized and deemed to be a gain or loss of the taxpayer as the debt was paid off.

In contrast to existing section 261, 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 could give rise to inappropriate results.

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Consider the following example:

Facts

1. In year one, Canco issues a debt for AU\$100, with no principal payments due for three years.
2. At the time the debt is issued the exchange rates were as follows $C\$1 = AU\$1.10 = US\$0.90$ ($US\$1 = AU\1.22), meaning, for tax purposes, the amount for which the debt was issued and its principal amount were C\$90.91.
3. Canco elects to become a US\$ functional currency reporter at the beginning of year three. At the end of year two, the exchange rates are as follows: $C\$1 = AU\$1.20 = US\$0.90$ ($US\$1 = AU\1.33).

Results

Because the Canadian dollar increased in value against the Australian dollar in the period before Canco became a functional currency reporter, Canco will have a suspended gain under proposed subsection 261(10) of US\$6.82 ($C\7.58×0.90).

The amount for which the debt was issued and its principal amount will be converted to US\$ from C\$ at the spot rate to become US\$81.82. If the US\$ does not fluctuate any further against the AU\$ until the debt matures, Canco will only need US\$75 (i.e. $AU\$100 / (1.2 / 0.9)$) to repay the AU\$100 debt. The difference of US\$6.82 should not be taxable as a foreign exchange gain to Canco in its *functional currency year*, or as an amount of debt forgiven under section 80 of the Act, as it will already have been included in taxable income as a result of the application of proposed subsection 261(10).

The existence of proposed subsection 261(9) indicates that it is not Finance's intention to make any pre-transition accrued gains or losses relevant in computing a taxpayer's income other than through the application of proposed subsection 261(10). However, proposed subsection 261(8) appears to confuse this intention. In a functional currency year of a taxpayer with pre-transition debt denominated in a third currency, the application of proposed subsection 261(8) could lead to difficulties for taxpayers attempting to show the "right" amount of foreign exchange gain or loss or debt forgiven in respect of the debt to the CRA.

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Because of the application of proposed subsection 261(12), which is a “read as” rule for proposed subsection (8) with respect to the transition back to Canadian currency, the same issue could arise there.

PwC Recommendation #5

Proposed subsection 261(8) should be revised to clarify that, in respect of debts denominated in a third currency, the amounts are converted to the taxpayer’s elected functional currency in a manner that will not result in foreign exchange gains and losses accruing before the taxpayer’s first functional currency year being taxed more than once (i.e. once under proposed subsection 261(10) and again under the operation of subsection 39(2) with reference to the taxpayer’s functional currency or as a forgiven amount). Similar assurance should be provided in respect of gains accruing before the taxpayer’s first reversionary year.

E. Determination of Amounts Payable

PwC Commentary: Calculation of the instalment base of a taxpayer

Existing subsection 261(7) requires taxpayers to convert any amounts payable (determined in the taxpayer’s functional currency) into the Canadian dollar using the currency exchange rate on the day the amount was so paid or the day on which the amount first becomes payable, whichever is earlier.

The Proposals amend this requirement and 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. 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, as the currency exchange rate that is applicable to such payment will not be known until the balance due date has arrived.

PwC Recommendation #6

Subsection 261(11) should be amended to use the relevant spot rate on the day payments are made rather than the day when balances are due to allow taxpayers to make tax payments at any time.

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F. Anti-Avoidance Rules

Overview

The Proposals include two new anti-avoidance rules that are intended to guard against the misuse of the provisions of section 261.

The first of these provisions is contained in proposed subsection 261(18). Briefly, this subsection provides that the Canadian tax results of a corporation must be determined in a particular currency where all of the following conditions are met:

- Property is (directly or indirectly) transferred between the corporation and another corporation;
- 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);
- 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;
- 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; and
- The Minister directs that the Canadian tax results of the taxpayer be determined using the particular currency.

The second anti-avoidance rule is contained in proposed subsections 261(20) and (21). These provisions are intended to apply 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:

- The transaction was entered into (directly or indirectly) by the taxpayer and a related corporation;
- The taxpayer and the related corporation had different tax reporting currencies at any time during the period ("the accrual period") in which the income, gain or loss is accrued; and

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- 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 a 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 fluctuations that lead to the loss or reduction of gain not to have occurred.

PwC Commentary: Subsection (18) – One of the main purposes test

The “one of the main purposes” test is excessively restrictive and punitive. There could be a number of reasons for restructuring the affairs of a corporate group. For example, in takeover situations, a purchaser may incorporate an acquisition corporation to affect the takeover. This acquisition corporation may subsequently amalgamate with the target corporation in order to (i) match the interest expense relating to acquisition debt of the purchaser corporation and the income derived from the assets of the acquired corporation; (ii) to obtain economic and operational synergies; and (iii) to manage foreign exchange risk with respect to the acquired assets and debt. All of these are “main” purposes for the amalgamation but from a policy perspective, none of these purposes are abusive.

PwC Recommendation #7

The purpose test in subsection 261(18) should be amended so that the rule applies only where the “principle purpose” of the transfer is to change or enable the changing of the currency in which the Canadian tax results in respect of the property are determined. This change will permit bona-fide and non-abusive business transactions to take place, without causing the transaction to fall afoul of the current anti-avoidance rule in proposed subsection 261(18).

PwC Commentary: Subsections (20) & (21) – No purpose test

We understand that the rules in proposed subsections 261(20) and (21) are intended to ensure that corporations in a related group cannot obtain an economic benefit through the use of the functional currency election and intercompany transactions. While we understand Finance's concerns, the blanket application of this rule is troublesome and unnecessarily restrictive.

There are many cases where the rule will apply inappropriately. For example, it is common for a parent corporation to borrow funds to finance a subsidiary's operations. Typically, the parent will on-lend the funds to the subsidiary on a back-to-back basis. The borrowing by the parent and the subsidiary will be denominated in the same currency to manage the foreign

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exchange risk of the parent. Hence, if the parent borrows in a foreign currency and on-loans the funds to the subsidiary in the foreign currency, the foreign exchange risk would rest with the subsidiary, which is appropriate because it is the ultimate user of the borrowed funds.

If the parent is a functional currency reporter, the anti-avoidance rule in proposed subsections 261(20) and (21) would likely deny any foreign exchange loss that arises in the subsidiary on the settlement of its borrowing from the parent. This would clearly be inappropriate as the subsidiary's foreign exchange loss arises regardless of the parent's functional currency election. More specifically, if the subsidiary had borrowed directly from the third party, any foreign exchange loss arising on the settlement of that debt would not be denied. There is no policy reason for denying such loss simply because a parent company that has made a functional currency election instead borrows the funds and on-lends such funds to the subsidiary. Particularly given the current liquidity crisis, the use of the parent company as the "banker" of the group should not be impeded.

The proposed rule should have a purpose test, such as that suggested for proposed subsection 261(18). This would permit the unencumbered financing within a corporate group, while at the same time, ensuring that the functional currency election is not used inappropriately.

PwC Recommendation #8

PwC recommends that proposed subsection 261(20) be revised to add a new proposed paragraph 261(20)(d), which would provide that proposed subsection (21) will apply where the "principle purpose" of the specified transaction was to create the result described in paragraph 261(20)(c).

G. Timing of Currency Translation

Proposed paragraph 261(2)(b) provides that any amount expressed in a currency other than Canadian currency that is relevant in computing a taxpayer's Canadian tax results is to be converted to an amount expressed in Canadian currency using the relevant spot rate for the day on which the particular amount first arose. Under the definition of *relevant spot rate*, the rate is to be that of the Bank of Canada quoted at noon on that day, or another rate of exchange that is acceptable to the Minister. Our understanding is that the intention of proposed paragraph 261(2)(b) is not to force the CRA to use the Bank of Canada noon rate in all cases. It is our understanding that it is intended that taxpayers be able to use an exchange rate as long as the rate chosen produces a reasonable measurement of the taxpayer's income. For example, exchange rates allowed under generally accepted accounting principles should be considered reasonable for such purposes.

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PwC Recommendation #9

PwC recommends that this matter be clarified either in the legislation or in the explanatory notes to the legislation.

H. Miscellaneous

In our review of the proposed legislation, we came across a number of other minor issues.

PwC Commentary: Exclusion of subsection 153(1) and section 215 amounts from Canadian tax results

The definition *Canadian tax results* exclude amounts payable or refundable on behalf of another person under subsection 153(1) or section 215, such as employee and non-resident withholding taxes. That exclusion may have implications for proposed subsection 261(5).

PwC Commentary: Use of “that day” in subsection 261(4)

The second sentence in proposed subsection 261(4) references “that day”. However, the day in that sentence does not appear to be the day the term “that day” is referring to. Instead, “that day” appears to refer to the day mentioned in the previous sentence. While it is unlikely that subsection (4) could be misconstrued as a result, the provision could be more clearly worded.

PwC Commentary: Transition of Functional currency denominated debt

Proposed subsection 261(8) ignores debt issued in the functional currency of the taxpayer. The technical notes explain that such translation is not necessary. In our view, because the amount for which the debt was issued for and the principal amount of the debt are amounts determined and denominated in Canadian dollars (and only in Canadian dollars), a mechanism must be provided by which those amounts are translated, just as is the case with foreign currency denominated assets.

In our view, it would be appropriate to provide a conversion mechanism such as that which exists in the current rules.