

Tax Memo

Functional Currency Election: Proposed Revisions and Extended Deadline

On June 27, 2008, the Department of Finance issued a news release proposing measures to ease tax compliance for Canadian corporations that report earnings in a foreign currency. The changes will:

- extend the deadline to elect functional currency tax reporting to October 31, 2008; and
- make several technical changes to the functional currency reporting rules.

The proposals are intended to address some (but not all) of the deficiencies in the functional currency tax reporting rules. Many of these deficiencies were brought to the attention of the Department of Finance and the Canada Revenue Agency in detailed submissions by PricewaterhouseCoopers. The proposals should provide more certainty to taxpayers regarding whether a particular taxpayer is eligible to elect to use the functional currency regime.

Given the extended filing deadline and technical changes, taxpayers should assess whether filing the functional currency reporting election is beneficial. Please contact your PricewaterhouseCoopers adviser or any of the individuals listed on page 4 of this *Tax Memo* for help with this complex determination.

Background

Bill C-28¹ added new section 261 to the *Income Tax Act* 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. For more information, see our *Tax Memo*, "Functional Currency: Proposed Election" at www.pwc.com/ca/taxmemo.

Extension of Election Due Date

As mentioned, 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 the corporation files the required election on or before its filing due date for its 2007 taxation year (i.e., 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.

1. Bill C-28 – *An Act to Implement Certain Provisions of the Budget Tabled in Parliament on March 19, 2007 and to Implement Certain Provisions of the Economic Statement Tabled in Parliament on October 30, 2007*, received royal assent on December 14, 2007.

Proposed Revisions to the Definitions and Rules of Application

While the news release did not include draft legislation, it did provide a summary of the proposals. The following proposed modifications to existing section 261 will be of most significance to taxpayers.

1. Definitions “functional currency” and “qualifying currency”

The Department of Finance proposes to modify the definition of the term “functional currency” to eliminate the existing requirement to demonstrate that the currency (other than the Canadian dollar) chosen by the taxpayer to be the taxpayer’s tax functional currency for a particular taxation year was the currency that was used:

- “more often than any other currency” in the taxpayer’s principal business activities in that year; and
- in the corporation’s “consolidated financial statements” and “legal entity financial statements” for the particular taxation year that were prepared in accordance with generally accepted accounting principles.

These conditions will be replaced by a requirement to demonstrate that the currency chosen by the taxpayer to be its tax functional currency is the “primary currency in which the corporation maintains its books and records of account for financial reporting purposes.” This proposed change attempts to address:

- the interpretative issues arising out of the requirement to show that a currency is used “more often than any other currency” in the taxpayer’s principal business activities; and
- the practical issue that otherwise eligible corporations may not prepare consolidated financial statements.

Until the draft legislation is released, it will not be clear what is meant by “primary currency,” “books and records” and “financial reporting purposes.” However, we expect that if a corporation has a general ledger or equivalent that is maintained in, for example, the U.S. dollar, and that general ledger is used as the basis for that corporation’s financial reports, or those of its parent, the corporation will likely qualify to make the election. If this interpretation is correct, the proposed amendment likely will significantly expand the range of corporations that can make the election, including to holding companies.

The proposals also add the Australian dollar to the list of currencies that are defined to be a “qualifying currency,”

which is currently limited to the U.S. dollar, the British pound and the Euro.

2. Transition rules

The Department of Finance proposes to make significant modifications to the rules dealing with the transition to a tax functional currency.

Under the transition rules in existing section 261, Canadian-dollar amounts of tax attributes (such as assets and undeducted tax pools) are converted to amounts expressed in the taxpayer’s functional currency using a transitional exchange rate, which is a 12-month average exchange rate determined at the end of the last Canadian currency year of the taxpayer. Accordingly, the accrued foreign exchange gains and losses are imbedded in the functional currency amount of the tax attributes.

In respect of debt obligations issued in the taxpayer’s functional currency, the accrued foreign exchange gain or loss is determined in Canadian dollars by assuming the debt was settled at the end of the taxpayer’s last Canadian currency year using the spot rate of exchange at the end of that year. The Canadian-dollar amount of the accrued gain or loss in respect of the debt is then converted to the taxpayer’s functional currency using the transitional exchange rate. That locked-in gain or loss is included in the taxpayer’s Canadian tax results as the debt is repaid or settled. Similarly, taxpayers that have debt denominated in currencies other than the Canadian dollar and their functional currency must determine their foreign exchange gains or losses in respect of those debts, using the spot exchange rate, in the same manner as described above for functional currency denominated debts.

The use of the spot rate of exchange to determine the Canadian-dollar amount of accrued gains and losses in respect of debt obligations means that these gains and losses will not equal the accrued gains and losses determined in respect of assets and expenditures purchased and made with the proceeds from the debt, which are translated to the elected functional currency using the transitional exchange rate.

In response to this lack of symmetry, the Department of Finance proposes to replace the transitional exchange rate with the exchange (or spot) rate at the end of the last Canadian currency year. It is unclear why this method was chosen. 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. The proposed transition rules will cause exchange rate fluctuations to have more influence on a taxpayer's decision to make the election.

3. Reversion rules

A taxpayer that has made a valid functional currency election but no longer meets the requirements of section 261 (e.g., the elected currency is no longer a functional currency) will automatically revert to the Canadian dollar. On reversion, the Canadian-dollar amount of tax attributes is determined by:

- using the Canadian-dollar amount of tax attributes arising or claimed in a Canadian currency year preceding the initial functional currency year; and
- converting functional currency amounts of tax attributes arising or claimed in a particular functional currency year commencing after the last Canadian currency year to Canadian-dollar amounts using the reversionary exchange rate (the 12-month average rate determined at the end of the particular functional currency year).

The effect of these rules was to compute the Canadian-dollar amounts (the approximated amounts) of tax attributes, at the beginning of the first Canadian currency year commencing after the taxpayer's last functional currency year, that approximate the amounts that would have been determined if the taxpayer had never made a functional currency election. The use of a reversionary exchange rate, determined at the end of the taxpayer's particular functional currency year in which a functional currency amount of a tax attribute arose or a claim in respect of a tax attribute was made, to convert that functional currency amount of the tax attribute that arose or the claim made to a Canadian-dollar amount was key to calculating these approximated amounts.

Consistent with the transition rules, the proposals replace the reversionary exchange rate (a 12-month average rate of exchange) with a spot rate of exchange. Under the proposals, the reversion rules will determine the Canadian-dollar amounts of the taxpayer's tax attributes, at the beginning of the taxpayer's first Canadian currency year beginning after its last functional currency year. This is done by converting the functional currency amounts of the taxpayer's tax attributes, at the end of the taxpayer's last functional currency year, to Canadian dollars, using the spot exchange rate at the end of the taxpayer's last functional currency year. The concern with using the spot exchange rate is that when exchange rates have fluctuated, the Canadian-dollar amount of tax attributes determined in this manner will not approximate the

amounts that would have been determined if the taxpayer had never made a functional currency election.

The Department of Finance also proposes to permit a taxpayer that has made a valid functional currency election, to remain (subject to the rules dealing with business mergers and transfers) as a functional currency reporter if the taxpayer can no longer demonstrate that the elected currency still qualifies as a functional currency of the taxpayer. As well, under the proposals, the taxpayer will be able to cease to be a functional currency reporter by electing out of the functional currency rules. A taxpayer wishing to elect out of the rules for a particular year and subsequent years must file an election before the time that is six months before the end of the last functional currency year.

4. New "anti-avoidance rule"

The Department of Finance expressed concerns that existing section 261 may be open to abuse, particularly given that the election is made on an individual corporation basis. The particular concern appeared to be that related Canadian corporations could arrange their affairs so that one corporation in the group could make a functional currency election and the group as a whole could receive an economic benefit through intercompany transactions with the electing corporation.

To deal with the perceived opportunities for abuse, the proposals introduce an anti-avoidance rule that would apply when the corporation that makes a functional currency election has amounts owing to, or from (or other financial transactions with, directly or indirectly), a corporation resident in Canada that:

- is related to the taxpayer; and
- reports its Canadian tax results in a different currency from that of the electing corporation, for the related corporation's taxation year ending in the calendar year in which the taxpayer's taxation year ends.

Any loss in respect of these amounts owing, or other financial transactions, would be denied to the taxpayer or the related corporation, as the case may be, to the extent that the loss would not have been available had the two corporations reported their Canadian tax results in Canadian dollars.

It is unclear how the anti-avoidance rule will apply. Corporations that have validly filed their election under subsection 261(3) before June 27, 2008, will have a one-year grace period to deal with uncertainty posed by the new anti-avoidance rule. Other taxpayers contemplating

an election for the 2008 taxation year must contend with the uncertainty, with no prospect of electing out of the rules before the new anti-avoidance rule applies to them.

Effective Date of the Proposals

Generally, the proposed amendments will have the same effective date as existing section 261, i.e., to taxation years of a taxpayer commencing after December 13, 2007. However, a taxpayer that has, before June 27, 2008, validly made a functional currency election, can choose to have the current transition rules apply. As well, a taxpayer that has validly elected before June 27, 2008, will be subject to the new anti-avoidance rule for its taxation years that begin after June 27, 2008.

PwC Observes

The apparent intention of the June 27, 2008 proposals is to make the rules in existing section 261 easier to comply with. Whether this intention has been fulfilled will not be clear until the implementing legislation is released.

It is hoped that the federal government will allow a longer period of consultation in respect of the draft legislation than was allowed in respect of existing section 261. This would permit all stakeholders to comment on the proposals and help prevent the many deficiencies identified in respect of existing section 261 from being repeated or replaced with others.

More was expected from the proposals. For example, the treatment of transactions conducted through partnerships has not been addressed. Taxpayers that have already decided to elect, but have not filed the functional currency election, will have to re-evaluate their positions in light of the proposed amendments, because new opportunities and pitfalls may present themselves from the modified rules.

Notwithstanding the issues, section 261 is welcome. It makes Canada's tax system more efficient and fair and promotes the international competitiveness of Canadian corporations competing in the global market. With the increased certainty these proposals provide in respect of section 261, any Canadian corporation that maintains its books and records in a currency other than the Canadian dollar should consider the benefits of making a tax functional currency election.

PricewaterhouseCoopers Contacts

For further information, please contact any of the following PricewaterhouseCoopers tax advisers.

Liam Fitzgerald Mining Group Toronto	<i>liam.m.fitzgerald@ca.pwc.com</i> 416 869 2601
Wallace Conway Canada National Technical Services Toronto	<i>wallace.g.conway@ca.pwc.com</i> 416 365 2710
John Gravelle, Leader Mining Group Toronto	<i>john.gravelle@ca.pwc.com</i> 416 869 8727
Angelo Toselli, Leader Oil & Gas Tax Group Calgary	<i>angelo.f.toselli@ca.pwc.com</i> 403 509 7581

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