

Functional Currency: Proposed Election

On October 2, 2007, Canada's federal government released legislative proposals to enact certain tax measures first announced in its 2006 budget.

Proposed subsection 261(2) confirms that, for all taxation years, the amount of income, taxable income, and taxes payable by a taxpayer under the *Income Tax Act* (the Act) are to be determined in Canadian dollars. However, proposed subsections 261(3) and (4) will permit certain corporations resident in Canada to elect to determine their Canadian tax amounts in the corporation's "functional currency." The election will be available for taxation years that begin on or after the date the proposal receives royal assent.

For qualifying corporations, electing to report their Canadian tax results in their functional currency likely will require a significant amount of accounting analysis and some detailed calculations. However, the election could prove highly beneficial if a substantial portion of their business transactions are carried out in a currency other than the Canadian dollar.

The Current Law

Although the Act currently is silent on the point, it is generally accepted that all amounts that are relevant to the computation of tax under the Act must be in Canadian dollars. For Canadian corporations that conduct business operations and report financial results to shareholders in a foreign currency, this requirement could create unfavourable results.

For example, suppose a Canadian mining company's functional currency for financial statement purposes is the U.S. dollar, reflecting the fact that its business operations are conducted primarily in U.S. dollars. If the company borrows funds in U.S. dollars, any change in the value of that currency relative to the Canadian dollar would give rise to a foreign exchange gain or loss for Canadian tax purposes and a resulting Canadian tax cost or benefit that would have to be reported for financial statement purposes, notwithstanding that the statements would report no foreign exchange gain or loss. This could significantly distort the corporation's operating results and its effective tax rate.

Background to the Proposal

Certain corporations that are required to prepare their financial statements using their functional currency approached the federal government to obtain the right to determine their Canadian tax results using their functional currency for financial statement purposes, rather than the Canadian dollar.

In their view, the requirement to report Canadian tax results using the Canadian dollar distorted the measurement of their income for tax purposes because the foreign exchange gains and losses that were attributable to the changes in the relative values of the two currencies resulted only from the requirement to compute Canadian tax results using

the Canadian dollar. The foreign exchange gains and losses did not reflect the transactions undertaken by the corporations in the normal course of their business activities and distorted their financial results as reflected in their financial statements. The corporations maintained that these distorted financial results affected their international competitiveness.

The federal government was sympathetic to these arguments and drafted section 261 in response.

Overview of the proposals

Proposed subsection 261(2) mandates that:

- all amounts determined under the Act are to be determined in Canadian dollars; and
- any amount expressed in a foreign currency should be converted to Canadian dollars using the noon exchange rate quoted by the Bank of Canada for the day the amount first arose.

Alternatively, qualifying Canadian corporations can elect (in prescribed form) to compute Canadian tax results for a particular taxation year using their functional currency for the particular taxation year. To qualify, the functional currency of the corporation (currently limited to the British pound, the Euro and the U.S. dollar) must be used:

- “more often than” any other currency (including the Canadian dollar) in the conduct of the corporation’s principal business activities in the year to which the election relates; and
- in the corporation’s consolidated financial statements (if required) and its legal-entity financial statements, prepared in accordance with generally accepted accounting principles.

A corporation that makes a functional currency election, but ceases to qualify as a functional currency reporter because it no longer has a functional currency as defined in section 261, must revert to determining its Canadian tax results using Canadian dollars. It can never again make the election.

Transition

In its first functional currency year, an electing corporation will have to translate its Canadian dollar tax attributes into the functional currency. The proposed rules provide that the amount of most tax attributes, determined in Canadian dollars at the end of the immediately preceding year (the last Canadian currency year), must be translated to the corporation’s functional currency using the 12-month

average exchange rate for the last Canadian currency year (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, unrealized foreign exchange gains and losses in respect of debt obligations of the electing corporation, issued in the corporation’s functional currency and outstanding immediately before the first functional currency year, are translated using the exchange rate immediately before the end of the last Canadian currency year, under the assumption that the debt was settled at that time. The unrealized foreign exchange gain or loss, 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 to the corporation’s income as the debt obligation is repaid or settled.

Example

The following is an example of the operation of the transitional rules:

Canco transacts predominantly in U.S. dollars, which is also its functional currency. Canco qualifies for, and makes, an election under new section 261 to determine its Canadian tax results using the U.S. dollar for its 2008 and subsequent taxation years.

In 2007, Canco issued a debt for US\$500 million and used the borrowed funds to acquire a capital asset for US\$500 million. Canco sells the capital asset in 2008 for US\$600 million, using the proceeds of sale to repay the debt in full.

For the purpose of this example, we assume the following exchange rates:

- at the time the debt was issued and the asset was acquired the exchange rate was CAN\$1 : US\$0.80;
- the 12-month average exchange rate (the transitional exchange rate) for 2007 (the last Canadian currency year) was CAN\$1 : US\$0.95; and
- as of December 31, 2007, the exchange rate was CAN\$1 : US\$1.

In Canco’s initial functional currency year (2008), the U.S. dollar adjusted cost base of the capital asset is determined as:

$$\frac{\text{US\$500 million}}{0.80} \times 0.95 = \text{US\$593.75 million}$$

The unrealized foreign exchange loss of US\$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:

	US\$ millions
Sale proceeds	\$600 .00
Less: Cost base	\$593 .75
Capital gain	\$6 .25

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:

$$\frac{\text{US\$500 million}}{0.80} - \frac{\text{US\$500 million}}{1.00} = \text{CAN\$125 million}$$

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

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 (US\$93.75 million) and the foreign exchange gain calculated in respect of the debt (US\$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.

Post-Transition

For each functional currency year, all amounts that are relevant to the computation of tax under the Act must be determined using the corporation's functional currency. Any amount expressed in a currency other than the corporation's functional currency (including Canadian dollar transactions) must be converted using the noon

exchange rate quoted by the Bank of Canada for the day the amount arose.

PwC Observes

For many Canadian corporations that have a functional currency for financial statement purposes other than the Canadian dollar, the functional currency election will be welcome. Corporations that make the election will be able to align their financial reporting (often conducted in U.S. dollars) with their tax reporting. However, certain interpretative issues ought to be resolved before the Department of Finance finalizes this legislative proposal. For example:

- The concept of "more often than" with respect to the use of a foreign currency:** No guidance has been provided on how to interpret this phrase or whether it will preclude certain corporations that have a functional currency for financial statements purposes other than Canadian dollars, from making the election. In particular, what transactions or activities of the corporation should be taken into consideration in making this determination and are all transactions to be given the same weight? While the apparent intention is to limit the number of corporations that may qualify for the election, it is not clear why determining a corporation's functional currency under generally accepted accounting principles is not sufficient.
- Financial statements:** It is also unclear whether the election would be available to a Canadian corporation that otherwise qualifies for the election, but does not prepare consolidated financial statements. An example would be a bottom-tier Canadian subsidiary of a corporate group. This appears not to be the intention. The requirement should be clarified so that a corporation seeking to make an election need only use the elected functional currency in its financial statements (consolidated or legal-entity), assuming those statements are issued to its shareholders and prepared in accordance with generally accepted accounting principles.

Further, the prescribed translation rules may not correspond to the translation rules corporations use to prepare financial statements under generally accepted accounting principles. If the translation rules are different, the proposed legislation implies that the financial statements must be re-translated for Canadian tax purposes. However, the Canada Revenue Agency has scope for accepting the

translation method adopted by the corporation for financial statement purposes, which one hopes it would do if the statements were prepared in accordance with generally accepted accounting principles.

- **Lack of symmetry on transition:** As illustrated in the example above, the transition rules lack symmetry between the translation of debt obligations and the translation of other tax attributes into the elected functional currency. This may also affect corporations that, for example, have internally hedged their foreign currency exposure. The lack of symmetry may cause the hedge to become uneconomical from a tax perspective, even though it may continue to be effective for financial reporting purposes. Again, this result appears to be unintended. To achieve symmetry, the same translation rate should be used for all asset and liability balances.
- **Taxation of accrued currency gains and losses:** For tax attributes other than debt obligations, proposed section 261 does not specify how the locked-in gain or loss occurring on transition is to be included in the corporation's income for tax purposes after transition. Presumably, general tax principles will be relied upon to determine when the locked-in gain or loss is included in income. For example, a locked-in gain in respect of inventory would generally be recognized when the relevant inventory is sold.

In addition, the transitional rules will result in Canadian corporations creating temporary differences in respect of each item translated to the elected functional currency. These temporary differences will equate to the locked-in gain or loss occurring on transition. This will cause concern for corporations that have to determine what temporary differences arise in their first functional currency year, and when the temporary differences reverse, in order to accurately measure future taxes for financial reporting purposes.

Next Steps

Canadian corporations operating in the mining, energy and other resource industries are the obvious beneficiaries of the functional currency election, because the commodity markets within which they operate are conducted mostly in U.S. dollars. However, Canadian corporations in any sector that carry out a substantial portion of their transactions in a currency other than the Canadian dollar should evaluate carefully whether making the election would be beneficial. The decision will be based on whether:

- they are eligible to make the election; and
- the transitional rules make the election beneficial.

It is hoped that interpretative issues surrounding the proposed rules will be resolved so that Canadian corporations can make informed choices regarding the election.

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