Foreign Exchange Issues in International Taxation: Branch Report – Canada

Summary and conclusions

The Canadian statutory rules do not have a comprehensive regime for the treatment of foreign exchange fluctuations. Case law and the administrative practices of the Canada Revenue Agency are important in dealing with foreign exchange issues. In the 1986 Report (Canada) on this subject, it was observed that there is uncertainty in this area. Since that time, considerable developments have taken place which may be attributed to a greater awareness of foreign exchange issues in global business operations. There have been a number of specific statutory amendments and significant developments in the case law. In addition, many administrative positions and comments have been published. There has also been much scholarship which has been published. While foreign exchange remains a difficult area with continuing uncertainty, these developments have provided much needed assistance.

While accounting principles may provide some guidance in determining the tax treatment of foreign exchange gains and losses, these principles are not determinative for income tax purposes. The case law adopts the approach that the determination of profit is a question of law. Accounting principles are considered to be a part of well accepted business principles, which are interpretative aids and not rules of law. Recent case law in the foreign exchange area has not followed the accounting treatment for income tax purposes.

In considering the recognition principles applicable to foreign exchange fluctuations, the threshold question is whether the foreign exchange gain or loss is on income or capital account. This determination is generally based on the character of the underlying transaction, asset or liability to which the foreign exchange gain or loss relates. This has been confirmed in recent case law. If the gain or loss is on income account, the approach now taken is to permit the adoption of any method not inconsistent with the statutory rules, case law principles and well-accepted business principles, and the goal is to obtain an accurate picture of profit for the year.

Foreign exchange gains and losses on capital account are recognized on a realization basis. This is in accordance with the statutory scheme, and there are a number of administrative positions which provide guidance as to whether a realization has occurred in specific circumstances. It may not always be clear, however, as to whether a taxpayer has made a gain or sustained a loss on capital

account in respect of foreign exchange fluctuations. This is highlighted in a number of examples reviewed in the Report.

One of the most significant developments in Canada is the recent enactment of a rule which permits functional currency tax reporting. For taxation years beginning after December 31, 2007, taxpayers may elect into a "functional currency" regime that permits the adoption of a foreign currency in certain circumstances. The rules are complex, and a number of proposed changes have already been announced. The provisions also include a rule providing that the "Canadian tax results" of a taxpayer are otherwise to be determined using Canadian currency. This rule is applicable for all taxations years. While in the past there has been some case law and commentary as to the basis for this position, the point is now dealt with by statute. Further, the statutory provision requires that currency conversions to Canadian currency are to be made based on the rate of exchange (or such other acceptable rate) on the day on which the foreign currency amount first arose. There is some uncertainty as to the implications of this change for certain administrative positions and statutory provisions, as well as comments in the case law. These issues are referred to in the Report.

A number of typical transactions are reviewed based on the foregoing principles, administrative practices and case law. As regards financing, an important development was the enactment of a provision which limits interest deductibility in respect of weak currency borrowings as a result of a decision of the Supreme Court of Canada. Also, there was a recent case which held that a foreign currency loss on the repayment of a debt obligation could not be claimed as a deduction on the basis that it was a discount on the issuance of the obligation.

There have been some developments in the treatment of foreign currency hedging. There is some judicial authority for treating the hedge as a separate transaction from the underlying transaction to which the hedge relates. It also seems clear that the characterization of any gain or loss on the hedge as being on income or capital account depends on the underlying liability, transaction or asset, although issues of the required linkage remain. On the issue of timing with respect to recognition, there is some uncertainty as to the use of the mark-to-market method where a gain or loss on a hedge is on income account, although the administrative position appears to be that this method in some cases may still be acceptable. Finally, with regard to swaps, there have been consistent administrative statements which permit the matching of foreign currency gains or losses on the swap with the offsetting gains or losses on the underlying transaction.

There have been a number of statutory changes and proposed changes dealing with foreign exchange effects in connection with measuring the income of foreign affiliates. These include specific currency rules and provisions relating to hedging.

Previous studies referring to the question of whether tax treaties should deal with foreign exchange issues have concluded that this is not necessary. These matters were generally viewed as domestic issues, and problems of double taxation were thought to be resolved through competent authority negotiation. It is suggested, however, that there may well be a need for an updated study on the problems of foreign exchange and tax treaties. An important issue is profit allocation to permanent establishments. It is noted, however, that a considerable difficulty is the extent of uncertainties in the domestic treatment of foreign exchange effects.