



Dealing with the New Functional Currency Rules

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Overview of the presentation

- Introduction and context
- The rules:
 - Conditions to qualify
 - Ongoing impact
 - Transition rules
 - Special circumstances
 - Anti-avoidance rules
- Impact on other tax planning strategies

The functional currency rules and why

- For those entities that are non-Canadian dollar functional, determine all Canadian tax results using the elected functional currency
- Why?
 - Ease compliance
 - More representative financial reporting

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A simple example

	US\$	C\$
Operating Income	20	24
Foreign exchange gain	n/a	14
	20	38
Book to tax differences	<u>10</u>	<u>12</u>
Taxable income	<u>30</u>	<u>50</u>
Taxes	<u>12.5</u>	<u>15</u>
Effective tax rate	<u>41%</u>	<u>30%</u>

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Where are we?

- High degree of volatility/uncertainty:
 - A period of unprecedented changes in FX rates
 - Increased significance of FX to business and taxes
- Will the functional currency rules help?
 - Help with the “big picture” issues
 - Transaction-specific issues remain
 - Struggle with the implementation and details of a new series of rules

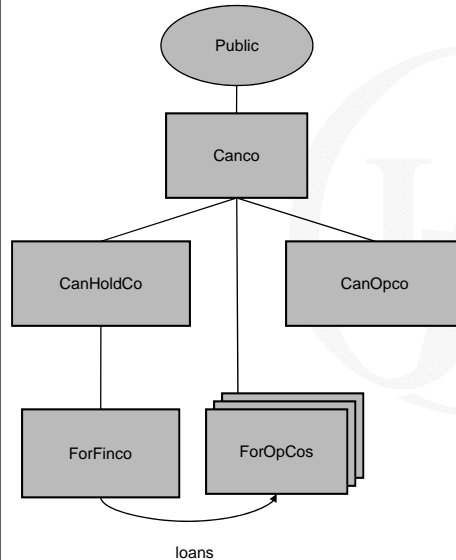
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Dealing with the new rules

- Process for deciding whether to elect
 - Can a taxpayer elect?
 - Should a taxpayer elect?
- The known vs. the unknown

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Case study – basic facts



- Canadian based public company
- Canadian operations in separate subsidiary (CanOpco)
- Foreign operations largely held in foreign subsidiaries (ForOpCos)
- Much of the treasury and financing activities carried on in a foreign corporation (ForFinco)
- Canco reports in US\$'s and is US\$ functional on a consolidated basis for GAAP purposes

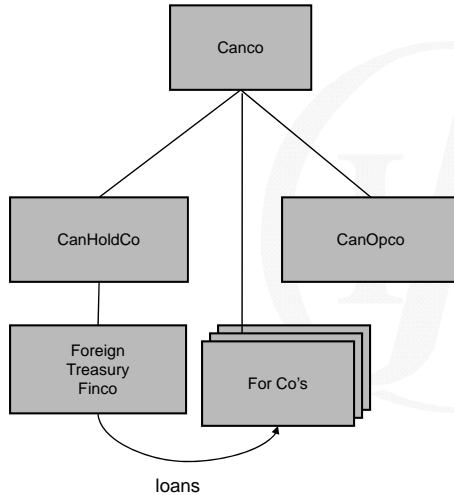
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Conditions to qualify

- Conditions outlined in 261(3):
 - Canadian-resident corporation
 - File timely election
 - Qualifying currency (US\$, €, Australian\$, £)
 - Maintain records and books of account for financial reporting purposes

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Conditions to qualify (cont'd)



Issues:

1. Relevance of functional currency under GAAP?
2. What impacts the GAAP conclusion for US\$ functional currency?
3. Under what conditions will CanHoldCo be US\$ functional for GAAP?

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Ongoing impact

- 261(5): “Canadian tax results” are to be determined using the taxpayer’s elected functional currency
- 261(3)(c): Convert all relevant amounts into the elected functional currency using the relevant spot rate
- “Canadian tax results”: some questions
 - GST receivable/payable and payroll taxes
 - Tax refund on loss carry back
 - Borrowed money

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Transition rules

- Rules applicable to convert C\$ attributes
 - Timing of election such that it is difficult to know whether economically beneficial or detrimental
- 261(3): Converting tax attributes
 - Use relevant spot rate on last day of last C\$ functional year
 - Cost, UCC, reserves, PUC, “any other amount”

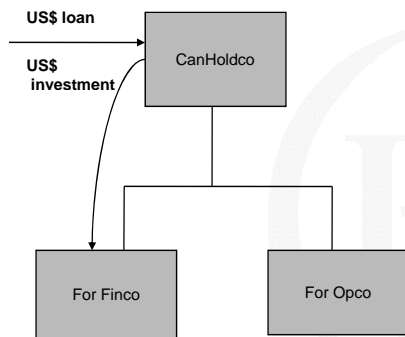
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Transition rules (cont'd)

- 261(8), (9) and (10)
 - Functional currency denominated debt
 - Lock in embedded income, gain or loss
 - No future FX exposure
 - Non-functional currency denominated debt (including C\$ debt)
 - Lock in embedded income, gain or loss
 - Future FX exposure as if debt was issued immediately prior to first functional currency year

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Transition rules (cont'd)



- CanHoldco borrowed \$1,000 in US\$ and invested US\$ in ForFinco
- Foreign exchange rate at the time of borrowing was US\$1 = C\$1.10
- Relevant spot rate for transition rules is US\$1 = C\$1.20 (i.e., US\$ has strengthened)

Liability

- Hypothetical loss = C\$1,100 – C\$1,200 = C\$100
= C\$100 ÷ 1.2 = US\$83.33

Assets

- Tax basis: C\$1,100 ÷ 1.20 = US\$916.67
- While FMV = US\$1,000
 - Embedded gain of US\$83.33

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Special circumstances

- Amounts payable under the Act [261(11)]
 - What about amounts receivable?
- Amounts carried back [261(15)]
 - FX “locked in” for any carry back
- Amalgamations and windups [261(16) & (17)]
 - Require election in order for Amalco to be non-Canadian dollar functional

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Special circumstances (cont'd)

- Foreign affiliates & partnerships [261(6) & (6.1)]
 - e.g., September 30 year end of foreign affiliate
- Reversionary rules [261(12), (13) & (14)]

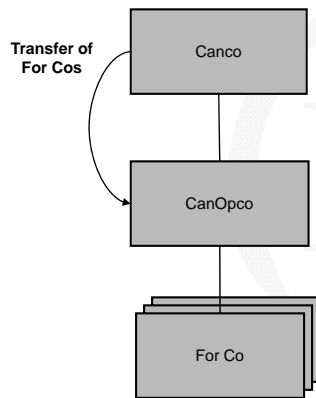
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Anti-avoidance rules

- “One sided loss” where different functional currencies [261(21)]
- Transfer of property to access functional currency rules – Minister’s discretion [261(18)]
- Transactions with partnerships [261(22)]

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Application of anti-avoidance rule



- Does this make CanOpco US\$ functional?
- Application of 261(18)?

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Impact on other strategies – 16.1 election

Facts

- CanOpco entered into US\$ denominated lease in prior year – FMV and lease payments
- Parties elected under section 16.1 to treat as “capital lease”

Original Treatment (C\$ functional)

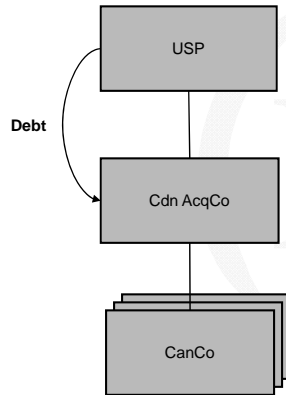
- 16.(1)(c) and (e) amounts: converted to C\$'s
- Final deemed proceeds on termination is dependent upon foreign exchange rate throughout

Treatment of US\$ Functional

- Convert 16.1(1)(c) amount into US\$'s: 261(7)(h)
- Subsequent amounts under 16.1(1)(c) determined in US\$
- Final deemed proceeds no longer subject to foreign exchange fluctuations
- Is 16.1(1)(c) amount captured by 261(9)?

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Impact on other strategies – acquisition planning



- CanCo acquired by US company September 30 via Cdn AcqCo
- Cdn AcqCo capitalized with debt and equity
- All entities to retain December 31 year-end

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Impact on other strategies – acquisition planning

Some Issues:

1. Functional currency for CanCo – September 30
2. Functional currency for Cdn AcqCo – December 31
3. Thin capitalization – first year and thereafter
4. Amalgamation of Cdn AcqCo and CanCo
5. Repayment of debt – debt forgiveness

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Summary

- Compelling need for non-Canadian dollar functional reporting
 - New rules fulfill the need but still much uncertainty
- Difficult process to decide
 - Known vs. unknown
- Broader (unforeseen) impact