

Budget 2008

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Changes to the IFAA

Upcoming Events

Annual General Meeting

Wednesday, the 2nd of
April 2008 at 12:00 at
the Vancouver Club.

Retirement Reception for

Bob Fairweather
Monday, the 28th of
April 2008 at the
Vancouver Club
from 4:30 to 6:00 p.m.

14th Annual Golf Tournament

Thursday, May 15, 2008
at University Golf Club
in Vancouver

Play starts at 12:00 p.m.

Please call
604-683-6626 to
register

Canada's New Functional Currency Rules

by Chris Gimpel & Kit Morissette, Deloitte & Touche LLP

In December 2007, the Income Tax Act (Canada) was amended to allow certain Canadian corporations to file their Canadian income tax returns using one of three foreign currencies, namely the US dollar, British Pound or Euro. The election to file using functional currency reporting is available for tax years starting after December 14, 2007.

Background

Canadian corporations may report income for financial statement purposes in a functional currency other than Canadian dollars. However, Canadian corporations are required to convert those financial results into Canadian dollars for income tax purposes. Such conversion often creates some undesired results for Canadian multinational corporations conducting business outside of Canada. The foreign exchange gains or losses from the currency translation often unduly distort the effective tax rates and the Canadian tax results. In addition, the restated financial results do not necessarily portray the actual business or economic realities and negatively affect the international competitiveness of these companies.

The new functional currency rules were intended to address these concerns and could potentially simplify financial reporting. However, companies need to consider the potential impact of adopting these new provisions prior to making the election to use the functional currency reporting.

General rule applicable to all taxpayers

Subsection 261(2) codifies the general rule that taxpayers report their results in Canadian currency. Any amounts that are expressed in a foreign currency must be converted to the Canadian dollar using the Bank of Canada noon rate on the day the amount first arose. The mandated conversion method could create differences where corporations use the actual, end-of-day, spot, monthly average, or any other rate for the conversion. As a result, separate conversions may be required for tax purposes.

Taxpayers should be aware that the codified Canadian currency requirement appears to be inconsistent with the current law and administrative practice. The rule appears to override the Supreme Court's *obiter* analysis in *Imperial Oil* by explicitly requiring that every amount be converted to Canadian dollars in the determination of income and taxable income. Furthermore, the rule is inconsistent with the administrative practice of the Canada Revenue Agency ("CRA") set out in Interpretation Bulletin IT-95R. The CRA's

position has been to generally permit a taxpayer to use any method to determine foreign exchange gains or losses on income transactions provided the method chosen is applied consistently. The CRA recognizes that it may not be practical to express each transaction at its prevailing rate and will accept as an alternative either a fixed or average rate. The new provisions provide the Minister with the discretion to appoint other conversion methods, but the Minister has not done so thus far.

Overview of the functional currency rules

A corporation can elect to use functional currency reporting for tax purposes if all of the following criteria are met:

- The corporation must be a Canadian resident throughout the taxation year. A permanent establishment of a foreign corporation is not eligible.
- The corporation is not an investment corporation, mortgage corporation or mutual fund corporation.
- The corporation must have a "functional currency" for the tax year and it must be applied consistently from year to year.
- An election must be made in prescribed form on or before the filing due date of the tax year prior to the taxation year of the functional currency year. Therefore, in order to apply the functional currency rules to a 2008 tax year of a company with a December 31 year-end, the election needs to be filed before June 30, 2008.
- The corporation has not reverted to Canadian currency reporting from functional currency reporting in any previous taxation years.

The "functional currency" must be the currency used more often than any other currency in the conduct of the corporation's principal business and used in determining the corporation's financial results. The current rules contemplate only US dollars, British pounds, and the Euro as qualifying currencies for functional currency reporting. However, the legislation does provide Finance the scope to

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edited by Alice Harder

Budget 2008: Changes to the *International Financial Activity Act (IFAA)*

To ensure British Columbia's economy remains competitive, B.C. introduced new measures to improve the business climate in the 2008 Budget.

Expanding the IFAA

Head Office: Management and Control Activities

As of February 20, 2008, the IFAA is amended to allow management and control functions as an eligible international financial activity. Management and control functions will be prescribed and include, for example, human resource and strategic planning services.

Short Term Financial Instruments

As of February 20, 2008, the IFAA is amended to allow non-securities corporations to trade in money market investments with a non-resident. These are generally short-term investments and include treasury bills issued by a government, commercial paper and bankers' acceptances.

Hedging Activities

Effective September 1, 2004, the IFAA is

amended to include income or loss from certain hedging transactions in determining income for non-securities corporations.

Green-Related Patents

As part of the province's climate action initiatives, effective March 1, 2008, the list of eligible life-science related patents is expanded to include patents with classifications under the International Patent Classification System related to power generation using forces of nature such as wind, solar and tidal.

Definition of "international financial business"

Effective February 20, 2008, the definition of international financial business is expanded to include a substantial British Columbia presence test. The definition of international financial business will include the following parameters:

- the corporation carries on an active business, or
- the corporation is affiliated with another corporation that carries on an active business and the corporation pays at least \$300,000 in annual salary and wages to

employees employed in the active conduct of the corporation's business and has shares of at least \$10 million related to the business.

Improving the Business Climate

Phase Out of the Corporation Capital Tax

As of April 1, 2008, the *Corporation Capital Tax Act* is amended to phase out the existing capital tax over the next three years by reducing the rates by one-third each year.

Effective April 1, 2010, financial institutions that have net paid up capital equal to or greater than \$1 billion will be subject to a minimum tax of 1 per cent of B.C. paid up capital. The minimum tax is reduced by the total of British Columbia corporate income tax payable for that year, for the seven preceding years and for the three subsequent years.

Corporate Tax Rate Reduced

The provincial general corporate income tax rate is reduced from 12 to 11 per cent effective July 1, 2008.



Functional Currency, continued

prescribe other currencies in the future.

Reap before you sow

The benefit of using functional currency reporting for tax purposes is that corporations can align their financial reporting with their tax reporting, reducing the compliance burden and removing undesirable distortions related to movements in exchange rates. Before you can reap the benefit, you need to consider the following implications of electing a functional currency:

- There are transitional rules that require the conversion of historical Canadian tax attributes using a "transitional exchange rate"—the twelve-month average rate for the last Canadian currency year. This may lead to different results for financial and tax purposes. In recent times with an appreciating Canadian dollar, these differences could be material.
- The transitional rules apply a different

treatment to the translation of debt obligations. The conversion rate differs depending on the currency in which the debt is denominated. If the debt is denominated in the corporation's functional currency, no conversion is required and the functional currency amount is used. If the debt is denominated in Canadian dollars, it will be converted using the "transitional exchange rate". For debt that is denominated in any other currency, the exchange rate on the last day of the corporation's Canadian currency year will be used. The accrued exchange gains or losses from the conversion will be deferred and amortized to future years' income as the debt's principal amount is repaid or settled. These rules create additional temporary differences that require tracking.

- The concept of "more often than any other currency" in the definition of "functional currency" is not clearly defined and is

subject to interpretation.

- The definition of "functional currency" requires that the financial results must be determined using the functional currency for both consolidated and legal-entity financial statements. It is unclear whether the election is available to a Canadian corporation (e.g., a bottom-tier Canadian subsidiary within a corporate group) that does not prepare consolidated financial statements.

Conclusion

The current legislation leaves some points open for discussion and some for improvement. The CRA or the Department of Finance will hopefully issue technical explanations in the future to clarify these concerns. In any case, the complex rules involved with the functional currency and their impact should be carefully reviewed.



Further information can be found on Deloitte's website at www.deloitte.com