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# Income Tax Folio S5-F4-C1, Income Tax Reporting Currency

## Series 5: International and Residency

### Folio 4: Foreign Currency

#### Chapter 1: Income Tax Reporting Currency

## Summary

Section 261 contains the general rule that amounts determined for the purposes of the *Income Tax Act* are to be determined in Canadian currency. It also provides the mechanism by which amounts expressed in a foreign currency are to be converted to Canadian currency. Section 261 also contains rules that allow corporations that meet certain requirements to elect out of the Canadian currency requirement. Under these rules, an electing corporation is permitted to determine amounts for the purposes of the Act in one of five foreign currencies, where that currency is the corporation's functional currency.

In addition to a description of the general rule requiring the use of Canadian currency, this Chapter discusses:

- the criteria that must be met in order for a corporation to be eligible to make a functional currency election;
- the application of the Act to a functional currency tax reporter;
- the rules regarding how a corporation transitions into the functional currency regime;
- the revocation of a functional currency election; and
- the anti-avoidance rules that could apply to related party transactions entered into by, or with, a functional currency tax reporter.

The Canada Revenue Agency (CRA) issues income tax folios to provide a summary of technical interpretations and positions regarding certain provisions contained in income tax law. Due to their technical nature, folios are used primarily by tax specialists and other individuals who have an interest in tax matters. While each paragraph in a chapter of a folio may relate to provisions of the law in force at the time it was written (see the Application section) the information provided is not a substitute for the law. The reader should, therefore, consider the Chapter's information in light of the relevant provisions of the law in force for the particular tax year being considered.

The CRA may have published additional guidance and detailed filing instructions on matters discussed in this Chapter. See the CRA's Forms and publications web page for this information and other topics that may be of interest.

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## Discussion and interpretation

### Defined terms for all income tax reporting currencies

#### Canadian tax results

**1.1** The term **Canadian tax results** is central to a discussion of income tax reporting currency as it is those results which are subject to either the Canadian currency requirement or the functional currency elective regime. The Canadian tax results of a taxpayer for a tax year are defined in subsection 261(1) as:

- the amount of the income, taxable income or taxable income earned in Canada of the taxpayer for the tax year;
- the amount of tax or other amount payable under the Act by the taxpayer in respect of the tax year;
- the amount of tax or other amount refundable under the Act to the taxpayer in respect of the tax year; and
- any amount that is relevant in determining any of the amounts described above.

**1.2** Specifically excluded from Canadian tax results are any amounts that are payable, or amounts that are refundable in respect of amounts payable, on behalf of another person and that arise from the taxpayer's obligation to withhold and remit either:

- source deductions under subsection 153(1); or
- deductions from payments to non-residents under section 215.

### Relevant spot rate

**1.3** In a number of its provisions, section 261 requires that amounts relevant to the determination of a taxpayer's Canadian tax results be converted to Canadian dollars. Similarly, if the taxpayer is a functional currency tax reporter, amounts must be converted to the taxpayer's elected functional currency. In general, these provisions require that this conversion be made using the relevant spot rate for the day on which the relevant amount arises. The **relevant spot rate** for a particular day is defined in subsection 261(1).

**1.4** For a particular day after February 28, 2017, the relevant spot rate is to be used to convert an amount from one currency to another, where one of the currencies is Canadian currency is the rate quoted by the Bank of Canada on that day. If the Bank of Canada ordinarily quotes such a rate, but no rate is quoted for that particular day, then the closest preceding day for which such a rate is quoted should be used. If the particular day, or closest preceding day, of conversion is before March 1, 2017, the Bank of Canada noon rate should be used.

**1.5** In cases where neither of the currencies involved in the conversion is Canadian currency, the relevant spot rate is derived by reference to the Bank of Canada rates to exchange Canadian currency for each of those currencies.

**1.6** In certain situations, taxpayers are allowed to use an exchange rate other than the rate described in ¶1.4 and 1.5. In this regard, the CRA will generally accept, as the relevant spot rate for a particular day, a rate quoted by a source other than the Bank of Canada if it is:

- widely available
- verifiable
- published by an independent provider on an ongoing basis
- recognized by the market
- used in accordance with well-accepted business principles
- used for the preparation of the taxpayer's financial statements
- used consistently from year to year by the taxpayer.

Each of the above conditions must be met in order for such a rate to be accepted. Examples of other sources of acceptable foreign exchange rates include Bloomberg L.P., Thomson Reuters Corporation and OANDA Corporation.

**1.6.1** For practical reasons, the CRA may also accept the use of an average of exchange rates over a period of time in order to convert certain income items. If exchange rates fluctuate significantly, the use of the average exchange rate for a period will not generally be accepted. Note that a taxpayer transitioning in or out of income tax reporting using an elected functional currency must use the Bank of Canada rate as described in ¶1.4 and 1.5 in converting the amounts required by subsections 261(7) or 261(12) and related provisions.

### Tax reporting currency

**1.7** The expression **tax reporting currency**, defined in subsection 261(1), identifies the currency in which a taxpayer reports its Canadian tax results. This could be Canadian dollars or, for functional currency tax reporters, their elected functional currency. The term is mainly relevant in the application of the specific anti-avoidance rules in subsections 261(18) to (21). It is noted here simply to point out that those anti-avoidance rules can have an impact on both Canadian currency tax reporters and functional currency tax reporters.

## Canadian currency tax reporting

**1.8** Subsection 261(2) requires that taxpayers determine their Canadian tax results in Canadian currency. Accordingly, amounts expressed in a currency other than the Canadian dollar must be converted to Canadian dollars using the relevant spot rate for the particular day on which the amounts arise, if they are relevant in computing the taxpayer's Canadian tax results. However, there are some exceptions to this rule. The most significant of these exceptions is where a taxpayer has made a valid functional currency election. Other exceptions are in respect of specific provisions dealing with debts denominated in a foreign currency, as set out in subsections 20(14.2) and 79(7) and paragraphs 80(2)(k) and 142.7(8)(b). Finally, as described in ¶1.6 and 1.6.1, the definition of **relevant spot rate** gives the CRA discretion to accept an alternate exchange rate in respect of subsection 261(2) conversions, provided certain conditions are met.

## Functional currency tax reporting

### Defined terms for functional currency tax reporting

**1.9** In addition to the expressions **Canadian tax results**, **relevant spot rate** and **tax reporting currency**, subsection 261(1) contains definitions relevant only to functional currency tax reporters. These terms are listed below, and are linked to the paragraph in which the meaning of the particular term is explained.

Canadian currency year;

Elected functional currency;

Functional currency;

Functional currency year;

Pre-reversion debt;

Pre-transition debt;

Qualifying currency; and

Reversionary year.

### The functional currency election

**1.10** In order for a taxpayer to report its income in its functional currency for a particular tax year, it must satisfy the following requirements, set out at subsection 261(3):

- a. throughout the tax year, the taxpayer must be a corporation resident in Canada that is not an investment corporation, a mortgage investment corporation or a mutual fund corporation;
- b. the taxpayer must elect by filing Form T1296, Election, or Revocation of an Election, to Report in a Functional Currency on or before the day that is 60 days after the first day of the particular tax year;
- c. the taxpayer must have a functional currency, as that expression is defined in the Act, for its intended first functional currency year;
- d. the taxpayer must not have previously filed another functional currency election; and

e. a revocation cannot apply to the particular tax year.

**1.11** The currency chosen in the election is defined in subsection 261(1) as the taxpayer's **elected functional currency**. A taxpayer need not make an election every year as the language of the requirement described at ¶1.10(b) is such that, for example, the second functional currency year of the taxpayer would also be covered by an election made within the first 61 days of the taxpayer's first functional currency year.

**1.12** Once a taxpayer has elected to use a particular foreign currency as its functional currency, the requirement described at ¶1.10(d) prevents the taxpayer from subsequently changing to a different foreign currency. This condition also prevents a taxpayer that has revoked a prior functional currency election from filing a new functional currency election.

**1.13** The **functional currency** of a taxpayer for a tax year is defined at subsection 261(1) as the currency of a country other than Canada if that currency is, throughout the tax year:

- a **qualifying currency**; and
- the primary currency in which the taxpayer maintains its records and books of account for financial reporting purposes.

The requirement to have a functional currency need only be met for the first tax year to which the taxpayer intends the functional currency rules to apply.

**1.14** The currencies that are included in the **qualifying currency** definition in subsection 261(1) are the U.S. dollar, the Euro, the British pound, the Japanese yen, and the Australian dollar. Although provision is also made for additional currencies to be prescribed by Regulation, there are currently no such prescribed currencies.

### Primary currency of books and records

**1.15** As noted at ¶1.13, in order for a currency to be a taxpayer's functional currency for a tax year, the foreign currency must be the primary currency in which the taxpayer maintains its books and records of account for financial reporting purposes throughout the particular tax year. Whether a currency is a taxpayer's primary currency for financial reporting purposes is a question of fact. In general, the primary currency condition will be met where that currency is its functional currency for financial accounting purposes. In contrast, where a taxpayer's functional currency for financial accounting purposes is Canadian dollars, the taxpayer will not have a functional currency for income tax purposes simply by maintaining records and books of account in a qualifying foreign currency.

**1.16** In some instances, a corporation may carry on two distinct lines of business which have different currencies for financial reporting purposes. In such a case, the corporation may still make a valid election to determine its Canadian tax results (from all activities) in a particular foreign currency if that currency is the functional currency of its most significant business.

**1.17** It is possible to maintain shareholder resolutions in a currency other than the taxpayer's elected functional currency without affecting the validity of the taxpayer's functional currency election. However, any amounts reflected in such resolutions that are not denominated in the taxpayer's elected functional currency but are relevant to the determination of the taxpayer's Canadian tax results must be converted into the taxpayer's elected functional currency for the purpose of determining those Canadian tax results.

### Determining Canadian tax results in an elected functional currency

**1.18** If a taxpayer makes a valid functional currency election, paragraph 261(5)(a) requires that the taxpayer's Canadian tax results be computed in their elected functional currency. Each tax year of a taxpayer to which subsection 261(5) applies is defined under subsection 261(1) as a **functional currency year** of the taxpayer.

**1.19** Paragraph 261(5)(c) provides that amounts expressed in a currency other than the taxpayer's elected functional currency must be converted to that currency using the relevant spot rate for the particular day on which the amounts arise, if they are relevant in computing the taxpayer's Canadian tax results. This rule is subject to the specific provisions dealing with debts denominated in a foreign currency, as set out in subsections 20(14.2) and 79(7) and paragraphs 80(2)(k) and 142.7(8)(b). It is also subject to the rules in paragraph 261(9)(b) in respect of pre-transition debts, and subsection 261(15) in respect of amounts carried back. The definition of **relevant spot rate** gives the CRA discretion to accept an alternate exchange rate in respect of paragraph 261(5)(c) conversions – but not for the other conversions required as a consequence of making a functional currency election or a revocation of an election.

**1.20** Subsection 261(5) also contains a number of additional rules for determining the Canadian tax results of a functional currency tax reporter. More specifically:

- paragraph 261(5)(b) provides that, unless the context otherwise requires, each reference in the Act and the Regulations to an amount (other than in respect of a penalty or fine) described as a particular number of Canadian dollars is to be read as a reference to that amount expressed in the taxpayer's elected functional currency using the relevant spot rate for the first day of the tax year for which the amount is relevant; and
- paragraphs 261(5)(d) to (h) provide special rules for a number of provisions of the Act and the Regulations that substitute references to the taxpayer's elected functional currency in the place of references to Canadian currency, and substitute references to the relevant spot rate in the place of references to the Bank of Canada exchange rate.

**1.21** It is important to note that it is only the Canadian tax results of the taxpayer electing into the functional currency regime that are within the scope of the functional currency rules. To the extent that certain tax attributes of the electing taxpayer are relevant in determining the Canadian tax results of other taxpayers, those attributes have to be determined in Canadian dollars. This might be the case, for example, where the paid-up capital of an electing taxpayer is relevant in determining the amount of a deemed dividend to its shareholder.

### Conversion to the functional currency regime

**1.22** Each tax year of a taxpayer in the period before its first functional currency year is defined as a **Canadian currency year**. A taxpayer that has Canadian currency years and then decides to convert to the functional currency regime may have losses and other amounts arising in those Canadian currency years that could be relevant in computing its Canadian tax results in a functional currency year. Subsection 261(7) provides that these carried-forward amounts are to be converted from Canadian dollars to the taxpayer's elected functional currency using the relevant spot rate for the last day of the taxpayer's last Canadian currency year. Note that for these conversions the definition of **relevant spot rate** does not allow for any CRA discretion to accept a rate other than the Bank of Canada rate.

**1.23** Specifically, the amounts to be converted under subsection 261(7) are:

- any amounts that were determined for a Canadian currency year and that are, or are relevant to determining, amounts that may be deducted in the particular functional currency year under:
  - subsection 37(1) (scientific research and experimental development expenditures) or 66(4) (foreign exploration and development expenses);

- variable F or F.1 in the definition **foreign accrual property income** in subsection 95(1) (foreign accrual property losses and foreign accrual capital losses);
- section 110.1 (donations) or 111 (non-capital and net capital losses); or
- subsection 126(2) (foreign tax credits), 127(5) (investment tax credits), 129(1) (dividend refunds), 181.1(4) (deduction for surtax) or 190.1(3) (deduction from capital tax);
- the cost to the taxpayer of each property acquired in a Canadian currency year and, in the case of capital properties, any additions to, and deductions from, the taxpayer's adjusted cost base of those capital properties that are made in a Canadian currency year;
- any additions to, or deductions from, in respect of Canadian currency years, any of:
  - the undepreciated capital cost of depreciable property;
  - cumulative eligible capital (for functional currency years prior to 2017); and
  - the cumulative amounts of the various resource expenses (that is, Canadian explorations expenses, Canadian development expenses, foreign resource expenses, or Canadian oil and gas property expenses);
- any reserves deducted or claimed by the taxpayer for its last Canadian currency year;
- any outlays or expenses referred to in subsection 18(9) (prepaid expenses) that were made or incurred by the taxpayer in respect of a Canadian currency year, along with any amounts deducted in respect of those outlays or expenses in computing the income of the taxpayer for a Canadian currency year;
- additions to, and deductions from, the taxpayer's paid-up capital in respect of a class of shares of its capital stock, in Canadian currency years; and
- any other amount determined under the provisions of the Act in, or in respect of, a Canadian currency year of the taxpayer that is relevant in determining the Canadian tax results of the taxpayer for a functional currency year, except for amounts referred to in subsection 261(6) (partnerships), subsection 261(6.1) (foreign affiliates) and subsection 261(8) (pre-transition debts).

## Pre-transition debts

**1.24** Subsections 261(8) to (10) provide rules applicable to debt obligations of a taxpayer that are issued in a Canadian currency year and that remain outstanding in a functional currency year. These debts are defined in subsection 261(1) as **pre-transition debts**. Note that subsection 248(26) clarifies that an amount that a debtor becomes liable to pay (other than interest) as consideration for any property acquired by, or services rendered to, the debtor is considered to be an obligation issued by the debtor with a principal amount equal to the amount of the liability. In addition, there is no provision in section 261 that allows for the netting of amounts payable to, and receivable from, another taxpayer.

## Conversion of pre-transition debts to an elected functional currency

**1.25** Subsection 261(8) provides rules to determine, at any time in a functional currency year of a taxpayer, the issuance amount and the principal amount in respect of their pre-transition debts that are denominated in a currency other than the taxpayer's elected functional currency, as at the beginning of the taxpayer's first functional currency year. Such amounts are to be determined by converting them from the currency in which the debts are denominated to the taxpayer's elected functional currency using the relevant spot rate for the last day of the taxpayer's last Canadian currency year.

**1.26** Subsection 261(9) provides a rule that applies for the purpose of determining a taxpayer's income, gain or loss in a functional currency year that is attributable to a fluctuation in the value of a currency. The rule also applies for the purposes of paragraph 80(2)(k) (debt forgiveness). For these purposes, each pre-transition debt denominated in a currency other than the taxpayer's elected functional currency is deemed to have been issued immediately before the taxpayer's first functional currency year. Accordingly, fluctuations in the value of the currency in which the debt is denominated relative to the taxpayer's elected functional currency that occur in Canadian currency years will be disregarded. However, any exchange rate fluctuations vis-à-vis the Canadian dollar that occur in Canadian currency years in respect of those debts are accounted for in subsection 261(10).

**1.27** As no conversion is necessary in respect of pre-transition debts that are denominated in a taxpayer's elected functional currency, subsections 261(8) and (9) do not apply to those debts.

### Repayment of pre-transition debts

**1.28** Subsection 261(10) deals with income, capital gains, losses and capital losses that accrue on pre-transition debts denominated in a currency other than Canadian dollars in the period before a taxpayer begins reporting their income in their elected functional currency. Subsection 261(10) does not cause any immediate tax consequences to the taxpayer at the time of conversion. Instead, it causes the accrued income, capital gain, loss or capital loss in respect of a particular pre-transition debt to be attributed to the taxpayer at the time a payment is made against the principal amount of the debt. The amount attributed is based on the proportion of the amount of the payment to the total principal amount of the debt at the time of transition.

**1.29** More specifically, in the case of an accrued capital gain or a gain that is on income account, paragraph 261(10)(a) deems the taxpayer to make a gain or to have income equal to the amount determined by the formula:

$$A \times B / C$$

where

**A** is the Canadian dollar amount of the gain or income that would have been determined had the entire debt been settled immediately before the end of the taxpayer's last Canadian currency year, converted to the taxpayer's elected functional currency using the relevant spot rate for that time;

**B** is the amount of the particular payment (expressed in the currency of the pre-transition debt); and

**C** is the principal amount of the pre-transition debt at the beginning of the taxpayer's first functional currency year (expressed in the currency of the pre-transition debt).

**1.30** Paragraph 261(10)(b) provides a similar rule in respect of accrued capital losses and losses on income account.

**1.31** Where subsection 261(10) deems a taxpayer to make a gain or sustain a loss (that is, where the pre-transition debt is on account of capital), subsection 39(2) then applies to deem there to be a capital gain or a capital loss, as the case may be, from the disposition of currency.

### Example 1

#### Facts:

- On July 31, 2010, Canco incurred a debt of US\$100 million (the **Loan**).
- At the time the Loan was issued, the relevant spot rate was C\$1.00 = US\$0.80. The Loan is on capital account.



- Canco's tax year end is December 31.
- For its 2015 tax year Canco makes a valid election to report its income in U.S. dollars.
- The Bank of Canada noon rate on December 31, 2014 was C\$1.00 = US\$1.00.
- On August 31, 2015, Canco makes its first payment on the principal amount of the Loan, in the amount of US\$20 million.

### Analysis:

Subsection 261(10) deems Canco to have made a gain in its 2015 tax year, as follows:

**Gain = A × B / C** where:

**A** = US\$25 million: if Canco had paid the principal amount of the Loan immediately before the end of its last Canadian currency year it would have realized a capital gain of C\$25 million (Canadian dollar equivalent at the time of issuance was \$125 million and at the time of deemed settlement was \$100 million). This amount is then converted to U.S. dollars using the Bank of Canada noon rate on the last day of Canco's last Canadian currency year - C\$25 million × C\$1.00/US\$1.00.

**B** = US\$20 million: the amount of the payment, denominated in the currency of the Loan.

**C** = US\$100 million: the principal amount of the Loan at the beginning of Canco's first functional currency year, denominated in the currency of the Loan.

Therefore, the deemed capital gain realized by Canco:

= US\$25M × US\$20M/US\$100M

= US\$5 million

**1.32** Note that subsection 261(10) also deems a taxpayer to have income, a capital gain, a loss or a capital loss where the taxpayer has reverted to reporting its income in Canadian currency and a payment is made in respect of a pre-transition debt still outstanding after the reversion. Such a debt would be both a pre-transition debt and a pre-reversion debt.

**1.32.1** If a pre-transition debt becomes a parked obligation within the meaning of subsection 39(2.02), subsection 261(10.1) will apply. In such a case, a deemed repayment of the debt may occur for the purpose of determining the taxpayer's gain under subsection 261(10). Such a deemed gain would be in addition to any deemed gain of the taxpayer under subsection 39(2.01). When applicable, subsection 261(10.1) deems the debtor to have made a payment on account of the principal amount of the debt equal to one of the following amounts:

- If the debt became a parked obligation because it was acquired by the holder of the debt, the portion of the amount paid by the holder to acquire the debt that can reasonably be considered to relate to the principal amount of the debt.
- In any other case, the portion of the fair market value of the debt that can reasonably be considered to relate to the principal amount of the debt.

Subsection 261(10.1) is deemed to have come into force on March 22, 2016. However, it does not apply to a pre-transition debt that becomes a parked obligation either on March 22, 2016, or a subsequent day before 2017, because of a written agreement entered into before March 22, 2016.

## Partnerships

**1.33** Subsection 261(6) deals with situations where a taxpayer (referred to in ¶1.33 to 1.35 as the **electing taxpayer**) that has made a functional currency election is, or becomes, a member of a partnership. Where this is the case, for the purpose of computing the electing taxpayer's Canadian tax results, section 261 subjects the partnership to the functional currency regime in a manner similar to that of the electing taxpayer, using the same elected functional currency. For these purposes, subsection 261(6) provides that the partnership's:

- first functional currency year is its first fiscal period in which the electing taxpayer is a member of the partnership and that begins after December 13, 2007 and on or after the first day of the electing taxpayer's first functional currency year;
- last Canadian currency year is its last fiscal period that ends before its first functional currency year;
- first reversionary year is its first fiscal period that begins after the electing taxpayer's last functional currency year; and
- last functional currency year is its last fiscal period that ends before its first reversionary year.

**1.34** Note that although the partnership is treated as if it had made a functional currency election itself, the application of subsection 261(6) is automatic and does not require any action on the part of the partnership. Note also that the provision applies to multi-tiered partnerships. As a result, where a partnership in which an electing taxpayer is a member is itself a member of a second partnership, that second partnership's functional currency attributes will be based on those of the first-tier partnership.

**1.35** It will not always be the case that partnership income allocated to an electing taxpayer will be computed using the functional currency regime. Similar issues can arise in reversionary situations.

### Example 2

#### Facts

A taxpayer's first functional currency year commences January 1, 2015. The taxpayer is a member of a partnership whose normal fiscal period end is October 31.

#### Analysis

The income of the partnership for purposes of determining the income allocated to the taxpayer will not be computed using the functional currency regime until its fiscal period beginning on November 1, 2015. The taxpayer's income or loss from the partnership for the fiscal period ending October 31, 2015 would be determined in Canadian currency then, pursuant to paragraph 261(5)(c), would be converted to the electing taxpayer's elected functional currency based on the days the relevant amounts are considered to arise.

**1.36** It is also important to note that subsection 261(6) applies only for the purpose of computing the Canadian tax results of the particular member of the partnership. Therefore, where a partnership has members that have different tax reporting currencies, the partnership is required to determine the Canadian tax results for each partner using that partner's respective tax reporting currency. For information on how a partnership is to fulfil its reporting obligations in circumstances where a member is an electing taxpayer, go to T5013 Partnership Information Return filing requirements.

## Foreign affiliates

**1.37** Where a non-resident corporation is a foreign affiliate of a functional currency taxpayer, subsection 261(6.1) applies for the purpose of computing the affiliate's foreign accrual property income (FAPI) in respect of the taxpayer.

**1.38** Subsection 261(6.1) subjects the foreign affiliate, in respect of its FAPI, to the functional currency regime in a manner similar to that of the taxpayer, using the same elected functional currency. For these purposes, subsection 261(6.1) assumes that the foreign affiliate is a taxpayer whose:

- first functional currency year is its first tax year that is a tax year at any time during which it is a foreign affiliate of the taxpayer and that begins after December 13, 2007 and on or after the first day of the taxpayer's first functional currency year;
- last Canadian currency year is its last tax year that ends before its first functional currency year;
- first reversionary year is its first tax year that begins after the taxpayer's last functional currency year; and
- last functional currency year is its last tax year that ends before its first reversionary year.

**1.39** Note that, similar to where a functional currency taxpayer holds an interest in a partnership, it is possible for a taxpayer and its foreign affiliate to have different tax reporting currencies where they have different tax year-ends. It is also important to note that paragraph 261(6.1)(b) deems only the foreign affiliate's FAPI in respect of the functional currency taxpayer, along with any amount that is relevant in determining its FAPI, to be its Canadian tax results for the purposes of applying section 261.

## Revoking an election

**1.40** Subsection 261(4) allows a taxpayer to revoke its functional currency election and begin to report (or revert to reporting) its income in Canadian currency. In order to do so, a taxpayer must file Form T1296 - Election, or Revocation of an Election, to Report in a Functional Currency on a day that is in a functional currency year of the taxpayer that is not its first functional currency year. A revocation is effective for each of the taxpayer's tax years beginning on or after the day that is six months after the day the revocation is filed. This means that taxpayers are required to stay in the functional currency tax reporting regime for at least two tax years.

**1.41** A tax year to which a revocation applies is defined in subsection 261(1) as a **reversionary year** of a taxpayer. Revocation brings into application the rules of subsections 261(12) to (14), which are discussed at ¶1.42 to 1.48.

## Reversion to Canadian currency

**1.42** Where a taxpayer has revoked its functional currency election, subsection 261(12) requires the tax attributes of the taxpayer to be converted from the taxpayer's elected functional currency to Canadian currency. The conversion uses the relevant spot rate for the last day of the taxpayer's last functional currency year. Subsection 261(12) accomplishes this by providing, in part, for the application of subsection 261(7) with appropriate word substitutions.

**1.43** Note that tax attributes that originate in a Canadian currency year of the taxpayer and that are unused at the time of reversion will be subject to a double conversion. The first conversion is into the taxpayer's elected functional currency using the relevant spot rate for the last day of the taxpayer's last Canadian currency year. The second conversion is back into Canadian currency using the relevant spot rate for the last day of the taxpayer's last functional currency year.

## Pre-reversion debts

**1.44** Subsections 261(12) to (14) provide rules applicable to debt obligations of a taxpayer that are issued prior to its reversion to Canadian currency tax reporting and that remain outstanding in a reversionary year. These debts are defined in subsection 261(1) as **pre-reversion debts**.

#### **Conversion of pre-reversion debts to Canadian currency**

**1.45** Subsection 261(12), in part, determines the issuance amount and principal amount of a taxpayer's pre-reversion debts denominated in a currency other than Canadian dollars, as at the beginning of the taxpayer's first reversionary year. Subsection 261(12) accomplishes this by providing, in part, for the application of subsection 261(8) with appropriate word substitutions. The effect of these rules is to convert the issuance and principal amounts, as determined in the currency in which the debts are denominated, to Canadian currency using the relevant spot rate for the last day of the taxpayer's last functional currency year.

**1.46** Subsection 261(13) deems a taxpayer's pre-reversion debts that are denominated in a currency other than Canadian currency to be issued immediately before the taxpayer's first reversionary year. This provision applies for the purpose of determining the taxpayer's income, gain or loss in a reversionary year that is attributable to a fluctuation in the value of a currency, and for the purposes of paragraph 80(2)(k) (debt forgiveness). Subsection 261(13) is the reversion equivalent of the pre-transition debt rule in subsection 261(9).

**1.47** As no conversion is necessary in respect of pre-reversion debts that are denominated in Canadian currency, subsections 261(12) and (13) do not apply to those debts.

#### **Repayment of pre-reversion debts**

**1.48** Subsection 261(14) deals with income, capital gains, losses and capital losses that accrue on pre-reversion debts denominated in a currency other than the taxpayer's elected functional currency. It is the reversion equivalent of subsection 261(10). Subsection 261(14) does not cause any immediate tax consequences to the taxpayer at the time of reversion. Instead, it causes the accrued income, capital gain, loss or capital loss in respect of a particular pre-reversion debt to be attributed to the taxpayer at the time a payment is made against the principal amount of the debt. The amount attributed is based on the proportion of the amount of the payment to the total principal amount of the debt at the time of the reversion.

**1.49** As mentioned at ¶1.32, subsection 261(10) can also apply to debt payments made in a reversionary year of a taxpayer, to the extent the debt was outstanding at the time the taxpayer converted from Canadian currency tax reporting to functional currency tax reporting.

**1.50** As is the case with subsection 261(10), where subsection 261(14) deems a taxpayer to make a gain or sustain a loss in respect of a pre-reversion debt that is on account of capital, subsection 39(2) will then apply to deem a corresponding capital gain or capital loss from the disposition of currency.

**1.50.1** If a pre-reversion debt becomes a parked obligation under subsection 39(2.02), subsection 261(14.1) will apply. In such a case, similarly to the application of subsection 261(10.1), a repayment of the pre-reversion debt will be deemed to have occurred for the purpose of determining the taxpayer's gain under subsection 261(14). Subsection 261(14.1) is deemed to have come into force on March 22, 2016. However, it does not apply to a pre-reversion debt that becomes a parked obligation either on March 22, 2016, or a subsequent day before 2017, because of a written agreement entered into before March 22, 2016.

## Taxes payable and instalments

**1.51** Paragraph 261(5)(a) provides the general rule that the Canadian tax results of a functional currency tax reporter are to be determined in the taxpayer's elected functional currency. Although Canadian tax results include taxes and other amounts payable under the Act, subsection 261(11) overrides this rule, as well as the general conversion rule in paragraph 261(5)(c), and provides specific rules for the conversion of these amounts payable from the taxpayer's elected functional currency to Canadian dollars. This is necessary because all amounts payable under the Act must be paid in Canadian dollars.

### Calculation of taxes subject to instalments

**1.52** Where taxes payable arise under a part of the Act that requires instalment payments, that is, Parts I, VI, VI.1 and XIII.1, the conversion to Canadian currency is governed by paragraphs 261(11)(a) and (b). These paragraphs provide a mechanism by which amounts payable, as determined in the taxpayer's elected functional currency, are converted to Canadian currency. For ease of reference, in ¶1.53 and ¶1.54 these amounts are referred to as a taxpayer's **EFC taxes payable** and **CAD taxes payable**, respectively.

**1.53** Paragraph 261(11)(a) provides the rules for determining a functional currency tax reporter's instalment obligations under paragraph 157(1)(a) or 157(1.1)(a), as the case may be. Paragraph 261(11)(b) provides the rules for determining the taxpayer's remainder of tax payable, if any, under paragraph 157(1)(b) or 157(1.1)(b). Paragraphs 261(11)(a) and (b) contemplate the use by a functional currency tax reporter of any of the instalment methods described in paragraphs 157(1)(a) and 157(1.1)(a), referred to herein as the **estimated method**, the **first instalment base method** and the **second instalment base method**. In summary, paragraphs 261(11)(a) and (b) provide the following:

- instalment obligations under paragraph 261(11)(a):
  - A functional currency tax reporter's instalment obligations under the estimated method are determined by taking either 1/12 or 1/4, depending on which instalment regime they are under, of the taxpayer's estimated EFC taxes payable for the year and converting this amount to Canadian dollars using the relevant spot rate for the day on which each instalment is due.
  - The taxpayer's instalment obligations under the first instalment base method or second instalment base method are based on the taxpayer's CAD taxes payable for its previous tax year, or previous two tax years, as the case may be. For these purposes, the CAD taxes payable are the aggregate of the taxpayer's instalments payable and remainder of tax payable for the relevant base year, as determined in Canadian dollars using the rules of paragraphs 261(11)(a) and (b).
- remainder of taxes payable under paragraph 261(11)(b):
  - The computation of a functional currency tax reporter's remainder of taxes payable starts with a conversion of each of the taxpayer's Canadian dollar instalment obligations to the taxpayer's elected functional currency using the relevant spot rate for the day on which each of the instalments was due.
  - The total of the required instalments, as expressed in the taxpayer's elected functional currency, is then deducted from the taxpayer's actual EFC taxes payable for the year.
  - The difference, if any, is then converted to Canadian currency using the relevant spot rate for the taxpayer's balance-due day.

**1.54** Paragraph 261(11)(c) provides that the amount of a functional currency tax reporter's CAD taxes payable for a tax year is also used to determine other amounts, such as interest and penalties.

## Calculation of other taxes and amounts

**1.55** Subsection 261(11) also specifies other amounts that must be determined in Canadian currency, and how those amounts are to be converted. Specifically:

- Paragraph 261(11)(d) provides that amounts of tax payable, other than those covered by Parts I, VI, VI.1 and XIII.1 of the Act, are to be determined by converting those amounts from the taxpayer's elected functional currency to Canadian currency using the relevant spot rate for the day on which those amounts are due.
- Paragraph 261(11)(e) provides that if a particular amount that is determined in a taxpayer's elected functional currency is deemed to be paid at any time on account of an amount payable for a functional currency year of the taxpayer (for example, a refundable investment tax credit), the particular amount is to be converted to Canadian currency using the relevant spot rate for the day that includes that time.
- Paragraph 261(11)(f) provides that the following amounts are to be determined in the taxpayer's elected functional currency and converted to Canadian currency using the relevant spot rate for the taxpayer's balance-due day for a particular tax year:
  - amounts described in paragraph 163(1)(a) (penalties for failure to report income) in respect of the particular tax year; and
  - the amount of the taxpayer's taxable capital employed in Canada, for the purpose of applying section 235 (failure to file returns of large corporations).

## Amounts carried back

**1.56** Subsection 261(15) contains provisions that apply to carrybacks of losses and tax credits to tax years that are mismatched. This refers to situations in which the year the loss or credit arises (the **loss year**) is not the same type of year (a functional currency year, a Canadian currency year or a reversionary year) as the year to which the loss or credit is applied.

**1.57** Paragraph 261(15)(a) applies in situations where the loss year is a functional currency year and the taxpayer wishes to carry back some amount of those losses or credits to one or more Canadian currency years. In this case, the loss amount, as well as any amounts of that loss that are claimed in a functional currency year, must be converted to Canadian dollars using the relevant spot rate for the last day of the taxpayer's last Canadian currency year. In effect, the net unapplied amount of the loss or credit from functional currency years is converted to Canadian dollars.

**1.58** Paragraph 261(15)(b) applies where the loss year is a reversionary year and the taxpayer wishes to carry back some amount of those losses or credits to one or more functional currency years. Where this occurs, the loss amount, as well as any amounts of that loss that are claimed in a reversionary year, must be converted to the taxpayer's elected functional currency using the relevant spot rate for the last day of the taxpayer's last functional currency year. However, in determining the net unapplied amount available for carryback to functional currency years it is also necessary, in such cases, to take into account any amounts carried back to a Canadian currency year. These amounts are converted from Canadian dollars to the taxpayer's elected functional currency using the relevant spot rate for the last day of the taxpayer's last Canadian currency year.

**1.59** Finally, paragraph 261(15)(c) applies where the loss year is a reversionary year and the taxpayer wishes to carry back some amount of those losses or credits to a Canadian currency year. In this case, the taxpayer is not allowed to simply claim the unapplied Canadian dollar loss amount from the reversionary years to the Canadian currency year. Instead, two conversions are required:

- first, the Canadian dollar loss amount must be converted to the taxpayer's elected functional currency using the relevant spot rate for the last day of its last functional currency year; and
- second, that elected functional currency loss amount, as well as any amounts of that loss that are claimed in a functional currency year, must be converted to Canadian dollars using the relevant spot rate for the last day of the taxpayer's last Canadian currency year.

## Wind-ups and amalgamations

### Wind-ups

**1.60** Subsection 88(1) provides for a tax-deferred rollover of the property of a subsidiary corporation upon a wind-up of the subsidiary into its parent corporation in circumstances where the parent owns at least 90% of the issued shares of each class of the capital stock of the subsidiary and certain other conditions are met. Subsection 261(16) applies where, at the commencement of such a wind-up (the **commencement time**), the parent and the subsidiary would not otherwise have the same tax reporting currency. In effect, the provision aligns the tax reporting currency of the subsidiary with that of the parent for the purposes of the transfer of the tax attributes of the subsidiary to the parent.

**1.61** Where the subsidiary's tax reporting currency is the Canadian dollar – either because it has never elected into the functional currency regime or it has reverted to Canadian currency – the subsidiary is deemed to be a functional currency tax reporter with the same elected functional currency as its parent. This deeming rule applies for the tax year that includes the commencement time and each of its subsequent tax years, if any. As a result:

- the subsidiary's tax year that includes the commencement time will be its first functional currency year;
- the immediately preceding tax year will be its last Canadian currency year; and
- subsections 261(7) to (10) will operate to convert its Canadian currency tax attributes and its pre-transition debts into the parent's elected functional currency.

**1.62** Where the subsidiary's tax reporting currency is not the Canadian dollar, two potential scenarios exist:

1. The first scenario is where the parent is reporting in Canadian currency. In such a case the subsidiary is simply deemed to have revoked its functional currency election. This means its tax year that includes the commencement time is its first reversionary year and subsections 261(12) to (14) operate to convert its elected functional currency tax attributes and its pre-reversion debts into Canadian dollars.
2. The second scenario is where the parent is reporting in a qualifying currency other than the subsidiary's elected functional currency. Where this occurs, the subsidiary is first deemed to revoke its functional currency election, as in the first scenario. But then its first reversionary year is deemed to end immediately after it began and the subsidiary is deemed to file a new functional currency election to use the same currency as the parent's elected functional currency starting in that new year. On the latter transition, subsections 261(7) to (10) would apply to convert the tax attributes and pre-transition debt amounts from the amounts determined in Canadian currency under subsections 261(12) to (14) (on the deemed reversion to Canadian currency) into the parent's elected functional currency. This will produce the necessary alignment of tax currencies between the parent and the subsidiary.

**1.63** Subsection 261(16) is subject to the potential application of the anti-avoidance rule in subsection 261(18).

### Amalgamations

**1.64** Where certain conditions are met, subsection 87(1) provides for a tax-deferred rollover of the property acquired by the new corporation that is deemed to be formed on the amalgamation of two or more predecessor corporations. These rules are discussed in [Income Tax Folio S4-F7-C1, Amalgamations of Canadian Corporations](#). Where such an amalgamation occurs, subsection 261(17) applies to each predecessor corporation that has, in its last tax year ending on the amalgamation, a different tax reporting currency than that of the new corporation in its first tax year.

**1.65** Subsection 261(17) is designed to align the tax reporting currency of each predecessor corporation with that of the new corporation for the purposes of the transfer of the tax attributes of the predecessors to the new corporation. This alignment is achieved by reference to the rules in subsection 261(16), with appropriate word substitutions. Subsection 261(17) is subject to the potential application of the anti-avoidance rule in subsection 261(18).

**1.66** Ordinarily, the new corporation formed on an amalgamation would have to file a timely election under subsection 261(3) in order to have the functional currency regime apply. However, for amalgamations that occur after July 12, 2013, where each predecessor corporation has the same elected functional currency for its tax year ending on the amalgamation, subsection 261(17.1) deems the new corporation to have filed a timely functional currency election for its first tax year and to have the same elected functional currency as that of its predecessor corporations. This deeming rule does not apply if any predecessor corporation has filed a revocation on or before the day that is six months before the end of its last tax year.

## Anti-avoidance

**1.67** Section 261 has two anti-avoidance rules that need to be considered for certain related party transactions. The first deals with asset transfers. The second is a rule that [denies losses](#) from certain foreign currency fluctuations.

### Asset transfers

**1.68** Subsection 261(18) is an anti-avoidance rule that gives the CRA the ability to direct that the Canadian tax results of a particular corporation for any one or more tax years be determined using a currency other than the one otherwise applicable. This rule is aimed at preventing asset transfers, whether by mergers or otherwise, between related corporations that have – or would have, in the absence of the deeming rules of [subsections 261\(16\) and \(17\)](#) – different tax reporting currencies from being used to circumvent the restrictions imposed by the functional currency rules. The rule can also apply where the transferor and transferee are both reporting in Canadian dollars but the transferor is in a reversionary year, that is, where the transferee would, in the absence of the anti-avoidance rule, be in a position to make a functional currency election while the transferor cannot.

**1.69** In order for the rule to apply, it must be reasonable to consider that one of the main purposes of a transfer of property between the corporations – or of any portion of a series of transactions or events that includes such a transfer – is to change, or to enable the changing of, the currency in which the Canadian tax results in respect of the property, or property substituted for it, for a tax year would otherwise be determined. Where this condition is met, subsection 261(18) permits the CRA to direct that either the transferor or the transferee determine its Canadian tax results for one or more of its tax years in a different currency.

## Example 3

### Facts



Canco elects to report its Canadian tax results in U.S. dollars commencing with its 2008 tax year. In 2010, it decides to revoke that election and revert to the Canadian dollar as its tax reporting currency for its 2011 and subsequent tax years. As a result of the revocation, Canco is prohibited by subsection 261(3) from making another functional currency election in the future.

### Scenario 1

Canco incorporates Cansub, and transfers all of its property to the new corporation. Cansub then elects to report its Canadian tax results in U.S. dollars.

### Scenario 2

Canco incorporates Cansub. Canco and Cansub amalgamate to form Newco. Newco then elects to report its Canadian tax results in U.S. dollars.

### Analysis

In each of these scenarios, the CRA would consider issuing a direction under subsection 261(18) that would require either Cansub or Newco, as applicable, to report its Canadian tax results in Canadian dollars.

**1.70** Subsection 261(19) ensures that the rules of subsection 261(18) apply properly in the context of an amalgamation by deeming, for the purposes of that subsection:

- the predecessor corporations to transfer their properties to the new corporation at the time that is immediately before the amalgamation (the **prior time**);
- the new corporation to exist and to be related to each predecessor corporation at the prior time; and
- the new corporation to have the same tax reporting currency at the prior time that it has at the time of the amalgamation, that is, for its first tax year.

**1.71** Subsection 261(22) applies for the purposes of subsection 261(18) to provide a look-through rule for transfers by, or to, partnerships.

### Loss denial

**1.72** Subsection 261(21) (together with its companion rule in subsection 261(20)) is an anti-avoidance rule that can apply to deny losses on certain transactions between a taxpayer and a related corporation, where the parties have different tax reporting currencies. The rule applies to deny a loss to the taxpayer where the loss can reasonably be considered to be attributable to a fluctuation in the value of the taxpayer's tax reporting currency relative to the related corporation's tax reporting currency during the period in which the loss accrues. There is no purpose test; the rule applies automatically.

## Example 4

### Facts

Parentco is a Canadian corporation that wholly owns Subco, another Canadian corporation. Parentco determines its Canadian tax results using the Canadian dollar whereas Subco's tax reporting currency is the U.S. dollar.

Parentco has made a C\$1 million loan to Subco, which is on capital account. At the time the loan was made, the rate of exchange was US\$1.00 = C\$1.25.

Subco repays the loan at a time when the rate of exchange is US\$1.00 = C\$1.20.

### Analysis

Parentco realizes no gain or loss on the repayment, as the loan was denominated in Canadian dollars, but Subco would (but for subsection 261(21)) realize a capital loss of US\$33,333  $[(1,000,000/1.25) - (1,000,000/1.20)]$ .

Subco's loss is attributable to the fluctuation in value of the U.S. dollar (its tax reporting currency) relative to the Canadian dollar (Parentco's tax reporting currency). Parentco and Subco also have different tax reporting currencies during the period in which the loss accrued. Therefore, subsection 261(21) would deem the fluctuation in currencies not to have occurred, resulting in a denial of Subco's otherwise claimable capital loss of US\$33,333.

**1.73** Subsection 261(22) applies for the purposes of subsection 261(21) (and its companion rule in subsection 261(20)) to provide a look-through rule for transfers by, or to, partnerships. It also provides that members of a partnership are deemed to be parties to the transactions entered into by the partnership.

### Forms and elections

**1.74** Form T1296 - Election, or Revocation of an Election, to Report in a Functional Currency must be filed in order for a Canadian corporation to elect to report its Canadian tax results in a functional currency. The same form must be filed in order to revoke such an election.

## Application

This updated Chapter, which may be referenced as S5-F4-C1, is effective June 27, 2024.

This Chapter was first published on September 2, 2016. The history of updates to this Chapter can be viewed in the [Chapter History](#) page.

Except as otherwise noted, all statutory references herein are references to the provisions of the *Income Tax Act*, R.S.C., 1985, c.1 (5th Supp.), as amended and all references to a Regulation are to the *Income Tax Regulations*, C.R.C. 1978, c. 945, as amended.

Links to jurisprudence are provided through CanLII.

Income tax folios are available in electronic format only.

## Reference

Section 261.

### Date modified:

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