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 SECTION 261

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PRINCIPAL ISSUES: Whether the following must be reported in the taxpayer's elected functional currency: (1) Shareholders' Resolutions (2) capital dividend account and (3) Form T2054 (capital dividend election form)?

POSITION: (1) No (2) Yes (3) Yes

REASONS: See below.

September 20, 2012

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HEADQUARTERS
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2012-045307

Functional Currency Reporting

Dear Ms. Chen

This is in response to your email query of June 20, 2012 wherein you asked us to assume that the CRA is satisfied that a hypothetical Canadian resident corporation ("Canco") has met all the conditions (footnote 1) to be permitted to determine its "Canadian tax results" in a particular taxation year using its elected functional currency, rather than the Canadian dollar. In such case, you request our views on whether Canco must report the following items in its elected functional currency:

1. All of its Shareholders' Resolutions;
2. The calculation of its capital dividend account (as that term is defined in subsection 89(1)); and
3. All amounts on the capital dividend election Form T2054?

Our Comments

Canadian Tax Results

Subsection 261(5) of the Act is the main operative rule for section 261. Paragraph 261(5)(a) provides that the taxpayer's "Canadian tax results" for the particular taxation year are to be determined using the taxpayer's

elected functional currency. The "Canadian tax results (footnote 2)" of a taxpayer for a taxation year are defined as:

"(a) the amount of the income, taxable income or taxable income earned in Canada of the taxpayer for the taxation year;

(b) the amount (other than an amount payable on behalf of another person under subsection 153(1) or section 215 (footnote 3)) of tax or other amount payable under this Act by the taxpayer in respect of the taxation year;

(c) the amount (other than an amount refundable on behalf of another person in respect of amounts payable on behalf of that person under subsection 153(1) or section 215) of tax or other amount refundable under this Act to the taxpayer in respect of the taxation year; and

(d) any amount that is relevant in determining the amounts described in respect of the taxpayer under paragraphs (a) to (c)".

Since the Canadian tax results of a functional currency taxpayer are determined in the taxpayer's elected functional currency, any amount described in paragraphs (a) to (d) above will be reported on Canco's T2 return in Canco's elected functional currency (footnote 4). However, pursuant to subsection 261(11), all amounts payable by (footnote 5) (or refundable to) Canco under the Act are to be determined in Canadian dollars (footnote 6) .

Shareholders' Resolutions

Subsection 261(3) provides five conditions that must be met before a Canadian corporate taxpayer is required by subsection 261(5) to determine its "Canadian tax results", in respect of a particular year, using its elected functional currency. The condition in paragraph 261(3)(c) is that the taxpayer have a "functional currency" for the first taxation year in respect of which subsection 261(5) applies. "Functional currency" of a taxpayer for a taxation year is defined in subsection 261(1) as being a currency, other than the Canadian dollar, that is, throughout the taxation year, (a) a qualifying currency (footnote 7) and (b) the primary currency in which the taxpayer maintains its "records and books of account" for "financial reporting purposes".

You indicated that Canco made a valid election under subsection 261(3), therefore, the elected functional currency must be the primary currency in which Canco maintains its records and books of account for financial reporting purposes. It is our view that Canco's Shareholders' Resolutions can be maintained in a currency other than its elected functional currency, without affecting the validity of its functional currency election. Support for our view can be found in the Explanatory Notes to subsection 261(3) (footnote 8), which provide an example of a corporation which maintains its records and books of account for **two distinct lines of business in different currencies**. In this case, the corporation may make a valid election to determine its "Canadian tax results" from all of its activities in a particular taxation year using its elected functional currency, rather than the Canadian dollar, provided that the records and books of the corporation's **most significant business** are recorded in the functional currency for which the election is made.

However, it should be noted that any amounts reflected in the Shareholders' Resolutions that are not denominated in Canco's elected functional currency, but which are relevant to the determination of Canco's Canadian tax results, must be translated into Canco's elected functional currency for the purposes of such determination.

Capital Dividend Account and Form T2054

The capital dividend account keeps track of various tax-free surpluses accumulated by a private corporation which can be distributed as capital dividends free of Canadian Part I tax to the corporation's Canadian-resident shareholders. A corporation paying a capital dividend must file an election (footnote 9) on Form T2054 in respect of the dividend when the dividend is paid or becomes payable, although, in certain circumstances, a late-filed election file is acceptable.

If the corporation pays a capital dividend that exceeds the amount in its capital dividend account at the time the dividend is payable, the excess amount of the dividend is subject to Part III tax under subsection 184(2) of the Act. As noted above, any amount that is relevant in determining Canco's Canadian tax results (which includes any Part III tax in the event it makes a capital dividend election in excess of its capital dividend account balance) must be reported on its T2 return in its elected functional currency (footnote 10). Therefore, it is our view that Canco must maintain its capital dividend account in its elected functional currency and must report all amounts on Form T2054 in its elected functional currency. However, any Part III tax payable by Canco should be converted into Canadian dollars using the Bank of Canada noon spot rate on the due date.

Note that any capital dividend paid to a non-resident shareholder is subject to Part XIII withholding tax. The definition of "Canadian tax results" in subsection 261(1) carves out an amount payable on behalf of another person under subsection 215(1) (footnote 11); therefore, any Part XIII withholding tax must be determined in Canadian dollars.

We trust that these comments will be of assistance.

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for Division Director
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FOOTNOTES

Note to reader: Because of our system requirements, the footnotes contained in the original document are shown below instead:

- 1 These conditions are described in subsection 261(3).
- 2 As defined in subsection 261(1).
- 3 Thus, income tax withheld on the amounts described in subsection 153(1) or section 215 must be determined in Canadian dollars.

4 CRA Document No. 2009-0332771E5 dated September 15, 2009.

5 Such as taxes, installments, interest and penalties.

6 In general, such payments (including instalments) should be converted into Canadian dollars using the Bank of Canada noon spot rate on the due date.

7 "Qualifying currency" is defined as follows in subsection 261(1):

"(a) the currency of the United States of America;

(b) the currency of the European Monetary Union;

(c) the currency of the United Kingdom;

(d) the currency of Australia; and

(e) a prescribed currency."

8 In particular the Explanatory Notes state as follows:

"In many cases the "primary currency" in which a taxpayer keeps its books and records for financial reporting purposes will be easy to determine: the taxpayer will use only a single currency for financial reporting purposes. The expression "primary currency", however, also addresses two less straightforward situations. First, where a corporation first records all of its transactions in one currency and then converts those results on an aggregated basis to another currency for financial reporting purposes, it could be said that the corporation keeps its books in both currencies. The first currency would, however, ordinarily be its "primary" currency within the meaning intended here. Second, certain Canadian taxpayers may carry on two distinct businesses in one legal entity. One business may be highly integrated with that of the entity's foreign parent - perhaps mainly serving customers in the foreign parent's jurisdiction - while the other business could be a totally independent business that serves Canadian customers. In such circumstances, it is possible that the taxpayer could keep its books in two different currencies. Regard would have to be had to which business is the most significant to the taxpayer in order to determine which currency is the primary currency".

9 Under subsection 83(2).

10 See paragraphs (b) and (d) of the definition of Canadian tax results in subsection 261(1).

11 Subsection 215(1) provides that, where a resident of Canada pays or is deemed to pay an amount to a non-resident in respect of which the non-resident is liable for withholding tax under Part XIII of the Act, the payer is required to withhold the tax from the amount and remit it to the Receiver General on behalf of the non-resident.