

## Canadian Taxation of Foreign Exchange Gains and Losses

by Steve Suarez and Byron Beswick

Reprinted from *Tax Notes Int'l*, January 12, 2009, p. 157

# PRACTITIONERS' CORNER

## Canadian Taxation of Foreign Exchange Gains and Losses

by Steve Suarez and Byron Beswick

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The authors wish to thank their colleague Tim Hughes for his comments and suggestions on a draft of this article.

Recent turmoil in international credit markets and general economic uncertainty have had a dramatic effect on the relative values of global currencies. The Canadian dollar in particular has experienced wild fluctuations over the past two years, showing both surprising strength and, more recently, sharp declines. The Canadian dollar rose from US \$0.84 in February 2007 to US \$1.09 in November 2007, only to fall to US \$0.77 by late October 2008 (and within 10 days of hitting that recent low, the Canadian dollar had moved back to US \$0.87). This unprecedented foreign exchange (F/X) volatility has heightened the potential for, and magnitude of, F/X gains and losses, which can have significant tax consequences.

This article provides an overview of F/X issues under Canada's income tax law, including the characterization, recognition, and calculation of F/X gains and losses. This article does not discuss all Canadian income tax rules that are potentially relevant in computing F/X gains and losses in all circumstances and in particular does not address the following:<sup>1</sup>

- **The Canadian functional currency election.** Although the general rule is that a taxpayer's Cana-

dian tax results must be reported in Canadian dollars, some corporations resident in Canada may elect to report their tax results in a currency other than the Canadian dollar if, among other things, that other currency is the primary currency in which the taxpayer keeps its books and records for financial reporting purposes.<sup>2</sup>

- **F/X gains and losses of a foreign affiliate of a Canadian taxpayer.** The characterization, recognition, and computation of a foreign affiliate's F/X gains and losses may differ from the rules discussed in this article, depending on, for example, whether the gains and losses relate to excluded or nonexcluded property.<sup>3</sup> Also, an F/X gain or loss

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purposes may differ from their treatment for income tax purposes. Other topics not addressed include F/X issues regarding tax-deferred rollovers and stop-loss rules under the Income Tax Act (Canada).

<sup>2</sup>See section 261 of the ITA; see also *Tax Notes Int'l*, Nov. 10, 2008, p. 459, *Doc 2008-23127*, or *2008 WTD 212-1*; and *Doc 2008-23114* or *2008 WTD 212-17*. Section 261 is subject to draft amendments.

<sup>3</sup>A foreign affiliate of a taxpayer resident in Canada is defined in subsection 95(1) of the ITA generally as a non-Canadian resident corporation at least 10 percent of the shares of any class of which is owned (directly or indirectly) by the Canadian taxpayer or the taxpayer and persons related to the taxpayer. Excluded property is defined in subsection 95(1) of the ITA as

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<sup>1</sup>This article also does not address the characterization, recognition, or calculation of F/X gains and losses under Canadian generally accepted accounting principles or other financial reporting rules. The treatment of F/X gains and losses for accounting

of a foreign affiliate may be deemed nil when the Canadian taxpayer has a qualifying interest in the foreign affiliate or the foreign affiliate is a controlled foreign affiliate of the Canadian taxpayer.<sup>4</sup>

Rules for the characterization and recognition of an F/X gain or loss of a financial institution may also differ from the rules discussed in this article in some circumstances. For example, an F/X gain or loss on an asset that is a mark-to-market property or a specified debt obligation of a financial institution is generally characterized as being fully includable in or deductible from income (and not on account of capital) and is realized annually on an accrual basis regardless of whether there has been a disposition of the relevant property.<sup>5</sup>

### I. Characterization

Under Canadian income tax law, gains or losses on "income account" are fully included or deducted in computing taxable income. In contrast, only 50 percent of gains on "capital account" (net of losses on capital account) are included in computing taxable income, and losses on capital account can be deducted only against capital gains. The income/capital characterization of F/X gains and losses is therefore important for Canadian income tax purposes.<sup>6</sup>

The income or capital characterization of an F/X gain or loss is normally determined by reference to the

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property that is used or held by a foreign affiliate principally for the purpose of gaining or producing income from an active business carried on by the affiliate, as well as certain other property related to the earning of income from an active business.

<sup>4</sup>A qualifying interest is defined in paragraph 95(2)(m) of the ITA generally as the ownership of at least 10 percent of the affiliate's shares (votes and value). A controlled foreign affiliate of a taxpayer resident in Canada is defined in subsection 95(1) of the ITA generally as a foreign affiliate that is controlled by the taxpayer (or that would be controlled by the taxpayer if the taxpayer owned the shares of the foreign affiliate held by persons with whom the taxpayer does not deal at arm's length and specific other persons).

<sup>5</sup>Mark-to-market property and a specified debt obligation are defined in subsection 142.2(1) of the ITA and by reference to regulations 9001(2), 9002, and 9004 of the Income Tax Regulations. Mark-to-market property includes most shares of a corporation held by the financial institution unless the financial institution has a "significant interest" in the corporation. Specified debt obligations include most debt held by the financial institution unless the financial institution is related to, does not deal at arm's length with, or has a significant interest in the debt issuer.

<sup>6</sup>Under Canadian income tax law, capital property (which for purposes of this discussion includes depreciable property) is property acquired for producing income from holding or using the property (for example, buildings, equipment, and securities (when the taxpayer is not in the business of buying and selling securities)). Property held on income account (noncapital property) is generally property held to make a profit on reselling the property (for example, inventory). The same property can be either capital or noncapital property depending on its use (for

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character of the underlying transaction, asset, or liability to which the F/X gain or loss relates.<sup>7</sup> For example, an F/X gain arising from the disposition of a capital property will prima facie be a capital gain. An F/X gain or loss is characterized from the perspective of the taxpayer realizing the gain or loss, such that symmetry of tax treatment between both parties to a transaction may, but need not, occur regarding an F/X fluctuation. For example, a creditor's F/X gain on the repayment of a loan may be characterized as being on income account when the creditor is in the business of making loans, whereas the debtor's F/X loss on repayment of the same loan may be characterized as being on account of capital if the debtor used the loan proceeds to acquire a capital asset.

### A. Assets

F/X gains and losses relating to the sale of goods or services in the course of carrying on a taxpayer's business, such as gains or losses on the collection of accounts receivable, on the sale of inventory, or on bank deposits used in the taxpayer's day-to-day business activities, are generally characterized as being on income account.<sup>8</sup> F/X gains and losses on the sale of capital property will normally be characterized as capital gains and losses.

### B. Liabilities

The characterization of F/X gains and losses on liabilities (for example, borrowings) depends on the characterization of the underlying liabilities, which for borrowed money generally depends on the use of the borrowed funds.<sup>9</sup> An F/X gain or loss on debt relating

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example, land acquired to build a production facility is normally capital property, while land acquired for resale is usually non-capital property).

<sup>7</sup>*Shell Canada Ltd. v. R.*, [1999] 4 C.T.C. 313, 99 D.T.C. 5669 (S.C.C.). Characterizing an F/X gain or loss by reference to the underlying transaction, asset, or liability also reflects the long-standing approach of the Canada Revenue Agency — see, e.g., CRA Document 9427166 (Sept. 18, 1995) and Interpretation Bulletin IT-95R, "Foreign Exchange Gains and Losses" (Dec. 16, 1980) (IT-95R). CRA documents 2006-0215491C6 (Dec. 21, 2006) and 2002-0160807 (Apr. 16, 2003) discuss the status of IT-95R, which the CRA has recognized was issued before a number of important Canadian cases relating to F/X and therefore does not reflect current CRA policy in some respects.

<sup>8</sup>The same treatment is applied to an isolated transaction that is generally in the nature of a business (for example, a transaction that is undertaken for a profit-making purpose, sometimes referred to as "an adventure in the nature of trade"), even if the transaction is not part of a business regularly carried on by the taxpayer.

<sup>9</sup>However, the Supreme Court of Canada in *Gifford v. R.*, [2004] 2 C.T.C. 1, 2004 D.T.C. 6120, stated that the character of a borrowing is determined not by the use of the funds borrowed but by the nature of the funds to the borrower when received. The scope of this holding is not clear, nor is it clear the extent to which this characterization approach deviates from the generally

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to purchases in the ordinary course of a taxpayer's business operations (for example, accounts payable) is generally characterized as being on income account.<sup>10</sup> An F/X gain or loss on debt incurred to acquire a capital asset is normally characterized as being on account of capital.

The general rule for characterizing F/X gains and losses on borrowed funds may not hold when the borrowing forms part of the taxpayer's fixed working capital, or permanent capital. In that case, the F/X gain or loss is characterized as being on account of capital regardless of the use of the funds.<sup>11</sup> Whether borrowed funds form part of a taxpayer's permanent capital depends on the circumstances. Relevant considerations may include whether the draws and repayments regarding the borrowing can be linked to the taxpayer's day-to-day income-earning activities (which may indicate income treatment), and whether the taxpayer would be undercapitalized absent the borrowed funds (which may indicate capital treatment).<sup>12</sup> Although the term of a borrowing is not necessarily determinative of the issue, there may be a strong presumption that a long-term loan forms part of a taxpayer's permanent capital even if the direct use of the loan proceeds is the acquisition of current assets.<sup>13</sup>

### C. Derivatives and Hedging Transactions

An F/X gain or loss from a derivative transaction is generally characterized as being on income account unless the derivative is used to effect a hedge.<sup>14</sup> An F/X gain or loss from a derivative transaction used to effect a hedge is generally characterized as being on income or capital account, depending on the characterization of the underlying property or liability to which

understood practice for the reporting of F/X gains and losses relating to borrowings. For example, a borrowing to fund a taxpayer's working capital is characterized as being on account of capital if the borrowing is considered part of the taxpayer's "permanent capital."

<sup>10</sup>The same treatment is applied to debt used for a transaction of a type described in note 8, *supra*. See, e.g., CRA Document 9427166 (Sept. 18, 1995).

<sup>11</sup>*Shell, supra* note 7, and *Columbia Records of Canada Ltd. v. M.N.R.*, [1971] C.T.C. 839, 71 D.T.C. 5486 (F.C.T.D.). See also CRA Document 9427166 (Sept. 18, 1995).

<sup>12</sup>*Id.*

<sup>13</sup>See, e.g., *Beauchamp (Inspector of Taxes) v. F.W. Woolworth plc*, [1989] B.T.C. 233 (H.L.), cited in *Shell, supra* note 7.

<sup>14</sup>The CRA may administratively allow certain taxpayers who undertake speculative transactions (often through the use of derivatives) outside the scope of a business and without access to special (insider) information to report F/X gains and losses on the transactions either on income or capital account, provided the same method is used consistently from year to year for all such transactions: Interpretation Bulletin IT-346R, "Commodity Futures and Certain Commodities" (Nov. 20, 1978), para. 15.

the hedge relates.<sup>15</sup> For example, an F/X gain or loss on a derivative used to hedge F/X exposure on amounts arising from a taxpayer's revenue-generating business operations, such as a hedge of a taxpayer's accounts receivable, is normally characterized as being on income account. An F/X gain or loss on a derivative that is put in place to hedge F/X risk on a capital property (such as shares of a corporation held as capital property) is characterized as being on account of capital.

## Under Canadian income tax law, gains or losses on 'income account' are fully included or deducted in computing taxable income.

It is not always clear whether a transaction constitutes a hedge so that the character of any resulting F/X gain or loss arising from the transaction is determined by reference to another property or liability.<sup>16</sup> Case law suggests that for a transaction to constitute a hedge, there must be:

- an intent for the transaction to operate as a hedge of a particular item; and
- a substantial correlation in amount between the transaction and that item.<sup>17</sup>

If the primary purpose of a transaction is not to hedge F/X exposure on a property or liability, it is unlikely the transaction will be considered a hedge for income tax purposes, even if the transaction has the effect of offsetting F/X gains or losses on that property or liability.<sup>18</sup>

<sup>15</sup>*Shell, supra* note 7. See also CRA Ruling 2007-0255401R3 (2008).

<sup>16</sup>The use of hedge accounting for financial statement purposes does not necessarily mean the transaction will be considered a hedge for income tax purposes: *Saskferco Products ULC v. The Queen*, 2008 F.C.A. 297 (F.C.A.). For further discussion of the *Saskferco* case, see Glenn Ernst, "Foreign Exchange Gains and Losses in Canada: Looking Over the Hedge," *Tax Notes Int'l*, Dec. 3, 2007, p. 961, *Doc 2007-24358*, or *2007 WTD 234-8*.

<sup>17</sup>*Echo Bay Mines Ltd. v. Canada*, [1992] 2 C.T.C. 182, 92 D.T.C. 6437 (F.C.T.D.). The CRA refers to *Echo Bay Mines* and other cases in *Income Tax Technical News* No. 38 (Sept. 22, 2008) as confirming that "whether an activity constitutes hedging depends on sufficient inter-connection or integration with the underlying transaction."

<sup>18</sup>For example, in *Saskferco, supra* note 16, a taxpayer's U.S. dollar borrowing was not considered to be a hedge of its U.S. dollar revenue, even though the borrowing had that effect, because the use of the borrowed funds was to construct a plant

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A class of similar properties may be treated as one property for hedging purposes, and it is not essential that the hedge provide a complete offset of F/X fluctuations. For example, the Canada Revenue Agency stated that forward contracts entered into by a taxpayer were properly considered hedges of the taxpayer's accounts receivable, even though the forward contracts were not each linked to particular receivables and may not have provided 100 percent protection from exposure to foreign currency fluctuations.<sup>19</sup> However, it was clear that the purpose of entering into the forward contracts was to hedge a significant portion of the taxpayer's foreign currency fluctuation on the receivables.

## II. Recognition (Timing)

The time at which an F/X gain or loss is recognized and calculated for income tax reporting purposes generally depends on whether the gain or loss is characterized as being on income or capital account.

### A. Gains and Losses on Income Account

As a general principle, a taxpayer must compute business income in a manner that provides "an accurate picture of the taxpayer's profit for a given year."<sup>20</sup> The taxpayer may adopt any method that is not inconsistent with the provisions of the Income Tax Act (Canada), case law principles, developed by the courts in interpreting the ITA and "well-established business principles."<sup>21</sup> Accounting rules and principles are certainly a relevant consideration in determining what well-established business principles are. However, the determination of profit for income tax purposes is ultimately a question of law, and accounting rules cannot be substituted for, and do not determine, the legal interpretation of profit.

The ITA is silent on the timing of recognizing F/X gains and losses that are characterized as being on income account and as relating to current assets or liabilities, such as accounts receivable, accounts payable, inventory, and some short-term bank deposits. The courts have not required one particular method of recognition to be followed, generally noting only that a taxpayer must use a method that provides an accurate picture of the taxpayer's profit for the year. The CRA's administrative position appears to be that a taxpayer may recognize

that was clearly a capital asset. Thus, F/X losses on the repayment of the debt were characterized as being on account of capital, while F/X gains on the taxpayer's U.S. dollar sales revenue were characterized as being on income account.

<sup>19</sup>See CRA Document 2002-0160807 (Apr. 16, 2003) as amended by CRA Document 2003-0019667 (June 27, 2003).

<sup>20</sup>*Canderel Ltd. v. R.*, [1998] 2 C.T.C. 35, 98 D.T.C. 6100 (S.C.C.).

<sup>21</sup>*Id.* While the provisions of the ITA and case law principles must be followed, "well-established business principles," which include GAAP, are merely interpretive aids.

F/X gains or losses on current accounts either on an accrual basis (whereby inherent gains and losses on assets and liabilities not yet sold or settled are recognized and calculated as of the taxpayer's tax year-end) or on a settlement basis (whereby gains and losses are recognized and calculated only when the assets and liabilities are sold or settled).<sup>22</sup> However, the taxpayer must be consistent from year to year in the method chosen. Before *Canderel Ltd. v. R.*,<sup>23</sup> the CRA had taken the position that the method of recognition used for income tax purposes should be the same used by the taxpayer for accounting purposes.<sup>24</sup> Post-*Canderel*, this administrative position has softened, reflecting the ruling in that case that accounting principles are relevant but not determinative. It is probably more accurate today to say that the CRA will ordinarily look for consistency between accounting and income tax reporting on this issue, but that it accepts that consistency may not exist in all cases.<sup>25</sup>

Foreign exchange gains and losses on transactions that hedge a current asset or liability are generally recognized in the same manner as the gains and losses on the property or liability hedged. For example, if the taxpayer uses the accrual method to recognize an F/X gain or loss on accounts receivable at year-end, an F/X gain or loss on a hedge specifically related to those accounts receivable should also be recognized at year-end.<sup>26</sup>

### B. Gains and Losses on Capital Account

F/X gains and losses characterized as being on account of capital are recognized only at the time of disposition of the underlying capital property or settlement of the underlying capital liability.<sup>27</sup> For example,

<sup>22</sup>IT-95R.

<sup>23</sup>See *supra* note 20.

<sup>24</sup>CRA Document 9824405 (Nov. 23, 1999).

<sup>25</sup>In CRA Document 2006-0215491C6 (Dec. 21, 2006), the CRA stated, in the context of foreign currency deposits held on income account, that a truer picture of a taxpayer's income would normally be determined by following GAAP (and, in that case, by recognizing accrued F/X gains and losses as of the year-end date). However, the CRA has also acknowledged that GAAP is only one element in determining profit for tax purposes, such that a change in accounting standards would not necessarily result in a change in income tax reporting (CRA Document 2006-0178661E5, Mar. 9, 2007). *Saskferco*, *supra* note 16, is an example in which accounting and tax treatment of F/X diverged.

<sup>26</sup>See CRA Document 2002-0160807 (Apr. 16, 2003). The CRA also stated in this document that if (a) foreign funds to be purchased under a forward contract are irrevocably committed to payment of a specific debt; and (b) the forward contract can be considered an agreement relating to that specific debt, the CRA would not require the taxpayer to report the related F/X gains or losses.

<sup>27</sup>See, e.g., CRA Documents 2007-0234001E5 (Oct. 22, 2007) and 2001-0083135 (June 27, 2001).

the disposition of a share for proceeds of US \$100 (the cost of which is also US \$100) will give rise to an F/X gain or loss for Canadian tax purposes if the value of the U.S. dollar relative to the Canadian dollar has changed between the time of acquisition and the time of disposition. It is also not necessary for there to be an actual conversion of foreign currency to Canadian dollars for an F/X gain or loss to be recognized; the disposition of, for example, a share valued in a foreign currency may give rise to an F/X gain or loss even if the proceeds from that disposition are reinvested in an asset in the same or another foreign currency.

It may sometimes be difficult to determine whether there has been a disposition of an asset or a settlement of a debt for purposes of the ITA. For example, a change in the terms of a share (or a debt) may or may not result in a disposition of that share (or a settlement of that debt), depending on the magnitude of the change. The CRA has stated that nonnegotiable foreign currency term deposits, guaranteed investment certificates, and other similar deposits on capital account can be moved from one form of deposit to another without giving rise to a disposition as long as the funds continue to be viewed as on deposit and are not converted into another currency or used to purchase a negotiable instrument or some other asset.<sup>28</sup> However, F/X gains and losses are realized on negotiable investments such as notes, bonds, mortgages, and debentures when those investments mature or are otherwise disposed of (whether or not the funds are used to purchase like securities).<sup>29</sup>

Regarding debt on capital account, an F/X gain or loss is generally recognized only at the time of a realization event such as a settlement of the debt.<sup>30</sup> An F/X gain or loss is also recognized, for example, at the time of a conversion of a foreign currency deposit at maturity into another foreign currency, the assumption of a debt by another party as partial consideration for assets purchased, or the conversion of a foreign-currency-denominated debt into common shares.<sup>31</sup>

<sup>28</sup>IT-95R.

<sup>29</sup>*Id.*

<sup>30</sup>Because a disposition is defined (in subsection 248(1) of the ITA) with reference to property rather than liabilities (*i.e.*, creditors rather than debtors), a special provision is required to cause debtors to realize F/X gains or losses on repaying or otherwise settling liabilities. Subsection 39(2) applies when a taxpayer has "made a gain or sustained a loss." This provision operates to tax an F/X gain or loss when the gain or loss has been realized but there is no disposition of property.

<sup>31</sup>CRA documents 2007-0234001E5 (Oct. 22, 2007), 2007-0239291R3 (2007), 2007-0252491R3 (2007), and 2004-0085081E5 (Sept. 8, 2005). In CRA Document 2001-0083135 (June 27, 2001), the CRA confirmed its position that an F/X gain or loss can arise before funds are converted into Canadian dollars.

Under proposed amendments to the ITA, F/X losses on debt would have to be recognized, and F/X gains on debt could be elected to be recognized, by a corporate debtor on a change of control of the debtor.<sup>32</sup> Again, the recognition of an F/X gain or loss typically does not depend on whether the borrower actually converts an amount of Canadian dollars into the foreign currency to repay the debt.<sup>33</sup>

### III. Calculation of F/X Gain or Loss

As noted above, the general rule is that amounts must be computed in Canadian dollars for Canadian tax purposes. The relevant exchange rate for conversion is the noon rate quoted by the Bank of Canada or "such other rate of exchange as is acceptable to the Minister."<sup>34</sup> An alternate rate could be acceptable if, for example, a taxpayer has many transactions in a specified period of time and wants to use an average exchange rate for that period.<sup>35</sup>

In many cases, an F/X gain or loss is recognized at the same time and has the same capital or income character as any inherent gain or loss (in foreign currency terms) on the property or liability from which

<sup>32</sup>For more information, see "Foreign Currency Denominated Debt and Acquisitions of Control in Canada," *Tax Notes Int'l*, May 12, 2008, p. 495, *Doc 2008-9260*, or *2008 WTD 95-10*.

<sup>33</sup>However, in *Imperial Oil Ltd. v. R.*, [2007] 1 C.T.C. 41, 2006 D.T.C. 6639, the Supreme Court of Canada suggested *in obiter* that when a foreign currency borrowing is repaid in the same currency as the borrowing, the repayment of principal may not yield a profit or loss. The context of the Court's comments is not clear (*e.g.*, the comments may have been related only to income transactions). The CRA is apparently maintaining its pre-*Imperial Oil* administrative position, stating (when asked about *Imperial Oil*) that:

where U.S. dollar denominated loans are repaid with newly borrowed U.S. dollars or U.S. dollars generated by the operations of the corporate group and there has been a fluctuation in the value of the U.S. dollar relative to the Canadian dollar since the time the money was borrowed, a taxpayer will be considered to have "made a gain" or "sustained a loss," for purposes of subsection 39(2), at the time of repayment of part or all of the foreign currency denominated capital debt obligation.

CRA, *Income Tax Technical News* No. 38 (Sept. 22, 2008). Nevertheless, the Court's comments have raised some uncertainty about when a taxpayer has realized an F/X gain or loss other than in the context of a disposition of property.

<sup>34</sup>Subsection 261(2) of the ITA. A taxpayer's foreign sales and expenses are generally recorded in Canadian dollars using the F/X rate in effect on the date of each sale or expense.

<sup>35</sup>The CRA expressed this view in Document 2007-0242861M4 (Aug. 8, 2007). This and other CRA administrative views regarding the use of alternate exchange rates in appropriate circumstances predate the enactment of subsection 261(2). However, the CRA confirmed orally to the authors that these administrative positions remain unchanged.

the F/X gain or loss arises. This means that in Canadian dollar terms, many F/X gains or losses will generally be subsumed within the computation of the overall gain or loss on the property. (See Example C below.) When a gain or loss is partly attributable to a gain or loss in the value of a property (expressed in terms of the foreign currency) and partly attributable to an F/X fluctuation of the foreign currency relative to the Canadian dollar, partitioning the gain or loss between the two is generally unnecessary since doing so does not affect the taxpayer's Canadian tax liability.<sup>36</sup>

An F/X gain or loss is generally computed as the difference between:

- the amount paid or received on the disposition of an asset or settlement of a liability multiplied by the exchange rate in effect on the date of disposition or settlement; and
- the original cost or amount of the asset or liability multiplied by the exchange rate in effect on the date the asset was acquired or the liability arose.<sup>37</sup>

The same approach is generally used for determining F/X gains and losses on related hedge transactions.

The main exception to this rule is for F/X gains and losses on current accounts (such as accounts receivable, accounts payable, some deposits, and inventory) when a taxpayer uses the accrual method. Such gains and losses are computed as the difference between:

- the amount accrued multiplied by the exchange rate in effect at the tax year-end (or, when the asset or liability is subsequently disposed of or settled, the amount received or paid on disposition or settlement multiplied by the rate in effect at the time of disposition or settlement); and
- the amount accrued multiplied by the exchange rate in effect on the date the asset was acquired or the liability arose (or the date of the most recent year-end accrual, if the amount remains outstanding over a tax year-end).

<sup>36</sup>This is not universally the case. For example, paragraph 95(2)(g) of the ITA deems an F/X gain or loss of a foreign affiliate of a Canadian taxpayer to be nil in some circumstances. When a foreign affiliate realizes a gain or loss that is not solely attributable to an F/X fluctuation, it is unclear how paragraph 95(2)(g) of the ITA is to be applied. It is the CRA's view that subsection 39(2) of the ITA will apply on the disposition of a capital property only if the gain or loss is solely attributable to a currency fluctuation. If the gain or loss is not solely attributable to a currency fluctuation, the general rule in subsection 39(1) of the ITA is relevant in computing the foreign exchange gain or loss: CRA Documents 2007-0242441C6 (Oct. 5, 2007), 2007-023469117 (July 23, 2007), and 2000-EM20425 (Sept. 27, 2000).

<sup>37</sup>*Gaynor v. M.N.R.*, [1991] 1 C.T.C. 470, 91 D.T.C. 5288 (F.C.A.).

## Examples of Calculation of F/X Gains and Losses

The following are simple examples of the calculation of the gain or loss on the disposition of a capital property in three separate scenarios with different variations in the value of the property and foreign exchange fluctuations.

### Example A

- Cost of property: US \$100
- Proceeds of disposition: US \$90
- F/X rate on date of acquisition: US \$1.00 = C \$1.00
- F/X rate on date of disposition: US \$1.00 = C \$1.00

On these facts, a loss of C \$10 (none of which is attributable to F/X) would be computed as follows:

$$(\text{US } \$90 \times \text{C } \$1.00) - (\text{US } \$100 \times \text{C } \$1.00) = (\text{C } \$10)$$

### Example B

- Cost of property: US \$100
- Proceeds of disposition: US \$100
- F/X rate on date of acquisition: US \$1.00 = C \$1.00
- F/X rate on date of disposition: US \$1.00 = C \$1.20

On these facts, a gain of C \$20 (all of which is attributable to F/X) would be computed as follows:

$$(\text{US } \$100 \times \text{C } \$1.20) - (\text{US } \$100 \times \text{C } \$1.00) = \text{C } \$20$$

### Example C

- Cost of property: US \$100
- Proceeds of disposition: US \$90
- F/X rate on date of acquisition: US \$1.00 = C \$1.00
- F/X rate on date of disposition: US \$1.00 = C \$1.20

Under the facts, a gain of C \$8 would be computed as follows:

$$(\text{US } \$90 \times \text{C } \$1.20) - (\text{US } \$100 \times \text{C } \$1.00) = \text{C } \$8$$

In this scenario, the loss on the property in U.S. dollar terms is more than offset by the appreciation in the value of the dollar relative to the Canadian dollar.

## IV. Conclusion

In times of sustained volatility in foreign exchange, understanding the tax implications of F/X movements is particularly important for businesses and their tax advisers. A summary of the general principles for dealing with the characterization, recognition, and calculation of F/X gains and losses for Canadian income tax purposes is provided in Figure 1.

Figure 1. Summary of Principles

F/X Income/Capital Characterization	Recognition of F/X Gains and Losses	Computation of F/X Gains and Losses
<p><b>F/X Gains/Losses on Assets</b> Determined with reference to capital/income treatment of underlying property.</p> <p><b>F/X Gains/Losses on Liabilities</b> Determined with reference to capital/income treatment of underlying liability; capital treatment if relating to "permanent capital."</p> <p><b>F/X Gains/Losses on Derivatives</b> For hedges, determined with reference to capital/income treatment of property or liability being hedged; otherwise, derivatives typically on income account (CRA administrative policy allows for choice of capital/income treatment for certain speculators).</p>	<p><b>Items on Income Account</b> Taxpayer can use any method not inconsistent with case law and "well-established business principles" that produces an accurate picture of profit for the year; generally interpreted by the CRA as permitting taxpayer to choose recognition of F/X gains and losses on accrual or settlement basis, so long as consistent from year to year and method represents "truer picture" of taxpayer's income.</p> <p><b>Items on Capital Account</b> F/X gains and losses realized on disposition or settlement.</p> <p><b>Hedges</b> Determined with reference to item hedged.</p>	<p><b>Income Account Items Using Accrual Method</b> Amount accrued (in foreign currency terms) x F/X rate at year-end, minus amount accrued (in foreign currency terms) x F/X rate on date amount arose.</p> <p>On settlement, amount received or paid (in foreign currency terms) x F/X rate on date of receipt or payment, minus amount accrued (in foreign currency terms) x F/X rate on most recent date of accrual.</p> <p><b>Other Items</b> Disposition or settlement proceeds (in foreign currency terms) x F/X rate on date of disposition or settlement, minus cost of asset or amount of liability (in foreign currency terms) x F/X rate on date of acquisition or incurrence.</p> <p>In many cases F/X gain or loss will be subsumed within overall calculation of gain or loss.</p>

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