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Understanding the Functional Currency Election

**How to save time and avoid an
administrative headache**

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If an eligible corporation resident in Canada throughout the tax year primarily keeps its books and records in a foreign currency for financial reporting purposes, they may consider electing to prepare its corporate tax return using a foreign currency as its functional currency instead of reporting in Canadian dollars.

For example, if your regular business activity is typically conducted and reported in US dollars, the corporation may elect to prepare its Canadian corporate tax return in US dollars if it meets all the eligibility requirements. This can reduce the administrative burden and time spent on foreign exchange calculations from US dollars to Canadian dollars when preparing the corporate tax return.

Who is eligible for the functional currency election?

For a taxpayer to be eligible to report income in its functional currency, all of the following criteria must be met:

1. The taxpayer must be a corporation that is resident in Canada that is not an investment corporation (defined in s.130(3) of the *Income Tax Act* ("ITA")), mortgage investment

corporation (defined in s.130.1(6) of the ITA) or mutual fund corporation (defined in s.131(8) of the ITA)¹;

2. The taxpayer must have a "functional currency" for its first taxation year to which the election applies;
3. The taxpayer has not previously filed a functional currency election;
4. The taxpayer has not revoked a previous functional currency election for the particular taxation year; and
5. The taxpayer files the functional currency election in the prescribed form within the first 61 days of the particular tax year to which the election applies.

Please note that a "functional currency" must be a "qualifying currency" and must be the primary currency in which the taxpayer maintains its books and records for financial reporting purposes.

Qualifying currencies include the US dollar, Euro, British Pound and Australian dollar. Effective for taxation years starting after 2019, Japanese Yen has been recommended to be included as a qualifying currency.

How can a taxpayer benefit from the functional currency election?

Benefits from electing to file under the functional currency include but are not limited to:

- Converting foreign currency reporting to Canadian dollars can be time consuming. Electing to report income using a functional currency can significantly reduce the time spent.
- There can be complexities to translating foreign currencies into Canadian dollars and calculating the related unrealized or realized foreign exchange gains and losses, especially with a large number

¹There are various conditions that need to be met for a corporation to be considered an investment corporation, a mortgage investment corporation, or a mutual fund corporation. As the analysis involves technical complexities, the details of these definitions are out of scope for this article. If you would like assistance in determining whether your corporation meets one of these definitions, please do not hesitate to reach out to a member of Crowe Soberman's Tax Group to assist.

of transactions. Electing to report under a functional currency could reduce any potential arithmetical errors and eliminate the need to realize foreign exchange gains and losses.

- Reporting income using a functional currency could better reflect the taxpayer's operations mirroring the financial statements more closely.

How do you file a functional currency election?

To file a functional currency election, the taxpayer must complete the prescribed Form T1296, Election, or Revocation of an Election, to Report in a Functional Currency, and file the prescribed form with the Canada Revenue Agency ("CRA") effective for the beginning of the corporation's taxation year end. Should a taxpayer elect to report in Japanese Yen, the comfort letter issued by the Department of Finance must be attached to the functional currency election as well.

Once the election is filed, there are a few additional items to consider:

- Taxpayers should ensure that the tax return correctly indicates that a functional currency is used.

- Corporate tax instalments and any outstanding balances will still need to be remitted to the CRA in Canadian dollars. The amounts payable to the CRA in Canadian dollars are determined by converting the functional currency amounts using the relevant spot rate quoted by the Bank of Canada for the day on which those amounts are due.
- Tax attributes (including losses) carried forward from Canadian currency years to a functional currency year are to be converted to Canadian dollars using the relevant spot rate for the last day of the taxpayer's last Canadian currency year.

What if a taxpayer chooses to revert to reporting in Canadian dollars?

The functional currency election may be revoked by filing the prescribed Form T1296, Election, or Revocation of an Election, to Report in a Functional Currency, with the CRA.

It should be noted that a revocation can only be made in taxation years after the taxpayer's first year using the functional currency, and the revocation is effective for taxation years that begin six months after the revocation is filed. In other

words, taxpayers are required to stay with the functional currency reporting for a minimum of two taxation years.

Once the functional currency election has been revoked, a taxpayer is required to convert tax attributes to Canadian dollars using the relevant spot rate for the last day of the taxpayer's last functional currency year. This results in double conversion of the tax attributes (i.e., first when the tax attributes are converted to its functional currency upon election, and second when the remaining unused balance would be converted back to the Canadian currency in the year the election has been evoked).

For example, if the taxpayer had non-capital losses of \$5,000 CAD at the end of its December 31, 2017, taxation year and made a functional currency effective to report in US dollars for the taxation year ending December 31, 2018, the non-capital losses carried forward from the 2017 taxation year will be converted to \$6,273 USD (\$5,000 CAD x FX rate of 1.2545). During the 2018 taxation year, \$1,500 USD of the non-capital losses were utilized, and no non-capital losses were utilized during the 2019 and 2020 taxation years. Therefore, the non-capital loss balance at the end of the December 31, 2020, taxation year is \$4,773 USD. The taxpayer then files a revocation of the functional currency election

effective January 1, 2021. As such, the non-capital losses carried forward from the 2020 taxation year will be converted to \$3,749 CAD (\$4,773 USD x FX rate of 0.7854). In other words, \$3,749 CAD of the original \$5,000 non-capital loss carried forward from the 2017 taxation year was subject to two currency conversions: first being converted to USD when the functional currency election was filed, and second being converted back to CAD when the functional currency election was revoked.

In the event that losses arise in a year after the functional currency election was revoked (i.e. a reversionary year), where reporting is done in Canadian dollars, and the taxpayer would like to carry back the losses to a year where reporting was done

in a functional currency, the loss carried back is to be converted to the functional currency using the relevant spot rate for the last day of the taxpayer's last functional currency year.

Functional currency elections might initially seem overwhelming. We're here to help.

Although there is initial administrative work to elect to report income using a functional currency, the long-term benefits of alleviating administrative burden and time spent on foreign currency conversions (as well as the elimination of potential tax impact of foreign exchange gains and losses), can outweigh the initial costs required for the election.

As there are various other intricacies and tax considerations that come with the functional currency election, we encourage you to reach out to the authors or your Crowe Soberman advisor with any questions regarding the process.

This article has been prepared for the general information of our clients. Specific professional advice should be obtained prior to the implementation of any suggestion contained in this article. Please note that this publication should not be considered a substitute for personalized tax advice related to your particular situation.

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