Stopping the Losses: The Application of Stop-Loss Rules to Transactions Involving Foreign Affiliates

Jim Samuel*

PRÉCIS
Le présent article propose une vue d’ensemble approfondie des règles sur la minimisation des pertes qui revêtent un intérêt particulier dans les situations d’opérations transfrontalières et de sociétés étrangères affiliées. L’auteur passe en revue certaines opérations de façon à illustrer les différents problèmes, anomalies et écueils éventuels qui peuvent se présenter par suite de l’interaction des règles sur la minimisation des pertes avec le régime des sociétés étrangères affiliées. Il se penche également sur certains aspects du nouveau régime de la monnaie fonctionnelle de l’article 261, lequel peut être utilisé dans certains cas pour faciliter la gestion du risque de change d’un groupe multinational. Ainsi ce régime peut limiter l’exposition à l’impôt du Canada pouvant être prélevé par l’application de la règle sur la minimisation des pertes sur les opérations qui mettent en cause des sociétés étrangères affiliées.

ABSTRACT
The purpose of this article is to provide a consolidated overview of stop-loss rules that are of particular relevance in the cross-border and foreign affiliate contexts. The author reviews selected transactions to illustrate the various issues, anomalies, and potential traps that can arise as a result of the interaction of the stop-loss rules with the foreign affiliate regime. He also reviews certain aspects of the new functional currency regime in section 261, which may be used to help manage the foreign exchange risk of a multinational group in some cases and thus limit the Canadian tax exposure that might arise from the application of the stop-loss rules to transactions involving foreign affiliates.

KEYWORDS: FOREIGN AFFILIATES ■ LOSSES ■ STOP-LOSS RULES ■ FOREIGN EXCHANGE ■ FOREIGN ACCRUAL PROPERTY INCOME ■ SURPLUS

* Of KPMG LLP, Calgary (e-mail: jjsamuel@kpmg.ca). I am grateful for the assistance of Allison Eng of KPMG LLP, Calgary with the preparation of this article. Any errors remain my responsibility.
INTRODUCTION

It is not unusual for a resident of Canada to engage in transactions with one or more of its foreign affiliates.¹ Such transactions may include a disposition of shares or indebtedness of a foreign affiliate as part of a corporate reorganization or otherwise, and the making of foreign-currency denominated loans between the Canadian resident and its foreign affiliate.

Such transactions may result in a loss, some or all of which may relate to fluctuations in foreign exchange rates. In a Canadian domestic context, the benefit of recognizing a loss otherwise arising in respect of a transaction is obvious: the loss may be used to offset income or, in the case of a capital loss, to shelter a capital gain.

From a Canadian tax perspective, potential advantages may also arise from losses recognized by foreign affiliates. For example, a foreign accrual property loss² (FAPL)

---

¹ In general terms, a non-resident corporation is a foreign affiliate of a Canadian-resident taxpayer if the taxpayer’s equity percentage in the corporation is not less than 1 percent and the total equity percentage in the corporation owned by the taxpayer and each person related to the taxpayer is not less than 10 percent. See the definition of “foreign affiliate” in subsection 95(1) of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”) and the regulations thereto. Unless otherwise stated, statutory references in this article are to the Act.

² The term “foreign accrual property loss” is a reference to element F of the definition of “foreign accrual property income” in subsection 95(1), and is computed in accordance with regulation 5903. In general, a FAPL is the amount by which the deductible elements D and E in the definition of “foreign accrual property income” in subsection 95(1) for a particular taxation year in respect of a taxpayer exceeds the taxable elements A, B, and C for that year (that is, the extent to which an affiliate’s deductible losses for a year exceed the amount of FAPI otherwise realized by the affiliate during the year). Recent draft legislation proposes to amend regulation 5903 by, among other things, defining and modifying the FAPL computation: Canada, Department of Finance, Legislative Proposals Relating to the Income Tax Act, the Air Travellers Security Charge Act, the Excise Act, 2001 and the Excise Tax Act (Ottawa: Department of
realized by a foreign affiliate can be used to shelter its foreign accrual property income\(^3\) (FAPI) that would otherwise potentially be subject to Canadian income tax, either (1) on an accrual basis,\(^4\) in a situation where the foreign affiliate is also a controlled foreign affiliate\(^5\) of a taxpayer resident in Canada at the end of a particular taxation year, or (2) upon the future repatriation of such FAPI in the form of a taxable surplus dividend, in the case where the affiliate is a non-controlled foreign affiliate of a corporation resident in Canada.\(^6\)

---

3 Defined in subsection 95(1). FAPI of a foreign affiliate includes, among other things, “income from property” as defined in subsection 95(1) (for example, dividends, interest, rents, royalties, etc., depending on the facts and circumstances) and business income that is deemed under subsection 95(2) to be income from a business other than an active business.

4 In computing taxable income for a particular taxation year, a taxpayer resident in Canada is required under subsection 91(1) to include its participating percentage of the FAPI earned by each of its controlled foreign affiliates. Under existing regulation 5903(1), an unused FAPL in respect of a particular taxation year may be carried forward to offset, or reduce, the affiliate’s FAPI in respect of the taxpayer for the five subsequent taxation years. Under proposed regulation 5903(1) in the August 2010 draft legislation, an unused FAPL for a particular taxation year may be carried back 3 taxation years and forward 20 taxation years, subject to transitional rules.

5 As defined in subsection 95(1), a “controlled foreign affiliate” of a taxpayer resident in Canada is a foreign affiliate of the taxpayer that is, at that time, controlled by the taxpayer. A controlled foreign affiliate also includes a foreign affiliate of the taxpayer that would, at that time, be controlled by the taxpayer if the taxpayer owned (in addition to the shares of the affiliate owned by the taxpayer) all of the shares of the affiliate owned by (1) persons who do not deal at arm’s length with the taxpayer; (2) persons in any set of four or fewer persons (each of whom is referred to as a “relevant Canadian shareholder”) who are residents of Canada and with whom the taxpayer deals at arm’s length; and (3) persons who do not deal at arm’s length with any relevant Canadian shareholder. Transitional provisions in the Budget and Economic Statement Implementation Act, 2007, SC 2007, c. 35, set out different versions of the definition of “controlled foreign affiliate” that apply to taxation years beginning after 1995 and before February 27, 2004. The August 2010 draft legislation includes amendments to correct certain errors in these transitional provisions.

6 In general, a corporation resident in Canada is required to maintain “exempt surplus,” “taxable surplus,” and “underlying foreign tax” pools of its foreign affiliate (herein collectively referred to as “surplus pools”). These pools, which are computed in accordance with part LIX of the regulations, are potentially relevant in characterizing any distribution made by a foreign affiliate to the corporation for the purposes of claiming a deduction under subsection 113(1). By virtue of the election in section 93, surplus pools are also relevant in determining the Canadian tax consequences that arise on a disposition of foreign affiliate shares. Section 93 effectively permits, in certain circumstances, all or a portion of a taxable capital gain otherwise realized by a Canadian corporation (or in certain cases, a partnership) on a disposition of the shares of a foreign affiliate to be converted into a dividend (that is potentially eligible for an offsetting deduction under section 113).
The recognition of a loss by a foreign affiliate generally causes a reduction in the affiliate’s surplus pools in respect of its Canadian-resident parent corporation.\(^7\) Depending on the facts, a cost or disadvantage may arise from recognizing a loss because such a loss may ultimately limit the ability of the corporation to receive dividends from the affiliate that are deductible under subsection 113(1) of the Income Tax Act in computing the corporation’s taxable income.

To the extent that a loss arises to either a foreign affiliate or its Canadian-resident shareholder, the loss, whether wholly or partially attributable to foreign exchange fluctuations, may be suspended, or even permanently denied, under one or more of the stop-loss provisions of the Act.

The stop-loss rules have been discussed in varying detail in other articles and papers.\(^8\) Accordingly, a detailed analysis of the rules, and the purpose behind them, will not be undertaken here. Instead, the focus of this article is to provide a consolidated overview of stop-loss rules that are of particular relevance in the cross-border and foreign affiliate contexts. None of the previous articles and papers provide such an overview. Moreover, the potential application of the stop-loss rules in those contexts tends to be overlooked by virtue of their being dispersed throughout the Act.

Building on the basic concepts discussed by other authors, the article starts with a comprehensive summary of stop-loss rules that are potentially relevant in the cross-border and foreign affiliate contexts. This part of the discussion considers the relationship of the stop-loss rules to the computation of a foreign affiliate’s FAPI and surplus pools. Next, the discussion touches on some of the not so obvious stop-loss-related considerations that are associated with the new functional currency regime in section 261. This regime may be used in certain circumstances to help manage the foreign exchange risk of a multinational group and thus limit the Canadian tax exposure that might otherwise arise from the application of the stop-loss rules to transactions involving foreign affiliates. Finally, certain stop-loss rules are applied to selected transactions for the purposes of (1) illustrating the various issues, anomalies, and potential traps that can arise as a result of the interaction of the stop-loss rules with the foreign affiliate regime; and (2) considering whether a different result could arise if a functional currency election has been made.

---

7 See supra note 6.

SUMMARY OF THE STOP-LOSS RULES

Background

Stop-loss rules are sprinkled throughout the Act, and are included in, for example, sections 13, 40, 69, 93, and 112. Conceptually, the stop-loss rules are intended to suspend or permanently deny the recognition of a loss in situations where the legislators believe that current recognition is not appropriate from a tax policy perspective. The purpose of the stop-loss rules for foreign affiliates is generally similar, even though the recognition of losses by foreign affiliates does not always erode the Canadian tax base.

For example, if a foreign affiliate of a Canadian-resident taxpayer undertakes an intragroup (that is, a related-party) transaction that generates a FAPL, the Canadian tax base may be eroded because the FAPL may be used to offset FAPI that would otherwise be included in the Canadian taxpayer’s income. On the other hand, if a foreign affiliate of a Canadian-resident corporation recognizes a loss on the disposition of an excluded property,9 such a loss does not constitute a FAPL and only decreases the foreign affiliate’s surplus pools.10 To the extent that such a loss is included in the foreign affiliate’s exempt surplus, it reduces the amount of exempt surplus that is otherwise available for distribution by the affiliate to its Canadian corporate shareholder as an exempt surplus dividend.11 If such a loss were currently recognized, the Canadian tax base would not be eroded; however, depending on the facts, one or more of the stop-loss rules could still apply.

Types of Stop-Loss Rules

Most stop-loss rules can be categorized into one of two groups, described below. Losses arising from transactions involving foreign affiliates could be included in either of these categories.

---

9 The term “excluded property” is defined in subsection 95(1) and in general includes property of a foreign affiliate that is used or held by the affiliate principally for the purpose of gaining or producing income from an active business carried on by it. Shares of a foreign affiliate will constitute excluded property if all or substantially all (typically interpreted by the Canada Revenue Agency [CRA] to be 90 percent or more) of the fair market value of the property owned by the affiliate constitutes excluded property. Also, a loan receivable held by a foreign affiliate should qualify as excluded property if all or substantially all of the income from the receivable is (would be if there were income from the property) income from an active business. In this article, the term “non-excluded property” refers to any property that is not excluded property.

10 See element E of the definition of “foreign accrual property income” in subsection 95(1) and the definitions of “exempt loss,” “net loss,” and “taxable loss” in regulation 5907(1). Exempt loss and taxable loss reduce a foreign affiliate’s exempt surplus and taxable surplus pool balances, respectively.

11 Although an exempt surplus dividend received by a Canadian-resident corporation from its foreign affiliate is included in computing the corporation’s taxable income, the corporation is entitled to claim an offsetting deduction under paragraph 113(1)(a).
The first group of rules denies immediate recognition of the loss, and potentially defers recognition to some future time (although in some cases such deferral could become permanent), either to the taxpayer that initiated the offending transaction or to certain related or affiliated persons. Under these rules, the loss may be either suspended or added to the tax basis of assets that continue to be held. Examples of these stop-loss rules, some of which are discussed in more detail later in this article, include paragraph 40(2)(e.1), subparagraph 40(2)(g)(i), and subsections 40(3.4), 40(3.6), and 93(4). Certain other provisions have the same effect, by forcing the transaction to proceed at tax basis even when there is an accrued but unrealized loss. An example of such a provision is subsection 85.1(3).

The second group includes rules that permanently deny all or a portion of a loss otherwise arising from a transaction under certain conditions. In these circumstances, the loss is denied whether or not the transaction involves a related or affiliated person. This group of stop-loss rules includes subparagraph 40(2)(g)(ii) and subsections 93(2) and 112(3).

**Application of Stop-Loss Rules to Foreign Exchange Losses**

Transactions involving foreign affiliates often have foreign exchange consequences. In the context of Canada’s stop-loss rules, the following considerations are relevant:

- If a loss arises to a taxpayer on a disposition of a capital property and the loss is not solely attributable to foreign-currency fluctuations, the more common practice is that the loss is determined under subsection 39(1) with no distinction made between the portions that relate to foreign exchange and the economic loss. However, whether there could be a bifurcation (with the economic gain being computed under subsection 39(1) and any foreign exchange gain or loss being computed under subsection 39(2)) does not appear to be settled.

---

12 Subsection 251(1) is relevant in determining whether persons are considered to be dealing with each other at arm’s length. The term “affiliated persons” is defined in subsection 251.1(1).

13 Note, however, that the stop-loss rule in paragraph 40(2)(e.2) does not belong in either of the categories of rules described here.

14 This article only discusses the potential application of stop-loss rules to foreign exchange losses that are on account of capital within the meaning of subsection 39(1). However, the Act contains certain stop-loss provisions (for example, subsections 13(21.2) and 14(12)) that may apply to losses realized on dispositions of depreciable property and eligible capital property amongst affiliated persons. Other stop-loss provisions, including subsection 93(2), apply where a loss is realized, whether on account of income or on account of capital.

15 Consider, for example, paragraph 261(2)(a); CRA document no. 2007-0242441C6, October 5, 2007; Gaynor v. The Queen, 91 DTC 5288 (FCA); and Rezvankhah v. R, [2003] 1 CTC 2473 (TCC); and a Department of Finance comfort letter dated February 12, 2001 regarding subsection 93(2).
and is the subject of some debate. Assuming that there is no bifurcation, any applicable stop-loss rules are then applied to the loss so computed.

- To the extent that a loss arising on a disposition of property is solely attributable to foreign-currency fluctuations—for example, where a taxpayer disposes of a foreign-currency denominated, non-interest-bearing note—it is uncertain whether the loss should be computed under subsection 39(1) or 39(2). The longstanding position of the Canada Revenue Agency (CRA) appears to be that such a loss should be computed under subsection 39(2). Moreover, where a stop-loss rule deems a loss to be nil, it seems that the CRA’s view is that subsection 39(2) does not apply because the taxpayer is no longer considered to have sustained (and thus cannot recognize) a loss.

The CRA’s view has been debated by commentators, from two perspectives. First, it is not clear whether subsection 39(2) applies to gains and losses arising on a disposition of capital property. In other words, does subsection 39(2) apply only to capital gains and losses arising on the settlement of liabilities? Second, assuming that subsection 39(2) is applicable to a gain or loss arising on a disposition of capital property, it has been questioned whether a loss so determined is subject to the stop-loss rules, on the basis that subsection 39(2) only deems the taxpayer to have disposed of foreign currency and that such a disposition is not made to any particular person. This article does not seek to resolve the debate but instead assumes that the stop-loss rules apply to a loss on a disposition of property, whether or not the loss is solely attributable to foreign-currency fluctuations.

- It is not entirely clear when, or if, the stop-loss rules are applicable to dispositions of foreign currency (or, more generally, a loss sustained under subsection 39(2)). Unless a contrary intention is evident, money constitutes “property” for the purposes of the Act. As a result, it seems possible that the stop-loss

---

16 As a practical matter, there is unlikely to be a difference in many situations even if there is a bifurcation. For some interesting commentary regarding the debate over whether there could potentially be a bifurcation of a foreign exchange gain or loss from the overall economic gain or loss on a disposition of property, see Lincoln Schreiner and Wallace Conway, “Foreign Currency Management: Some Observations & Recent Developments,” in 2008 British Columbia Tax Conference (Toronto: Canadian Tax Foundation, 2008), tab 10, at 9-10; Kopstein and Pantry, supra note 8, at 27:24-25; and David G. Broadhurst, “Foreign Exchange Planning,” in Tax Planning for Canada-US and International Transactions, 1993 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1994), 8:1-27, at 8:23-24.

17 This position was recently reiterated in CRA document no. 2008-0280111I7, January 6, 2009.


19 See, for example, Schreiner and Conway, supra note 16, at 9-10; Kopstein and Pantry, supra note 8, at 27:27; and Broadhurst, supra note 16, at 8:23.

20 See Kopstein and Pantry, supra note 8, at 27:27.

21 Paragraph (b) of the definition of “property” in subsection 248(1).
rules could be applicable if foreign currency is disposed of in a manner such that the taxpayer (or its foreign affiliate) has sustained a loss. For example, if a taxpayer, or its foreign affiliate, realizes a capital loss on withdrawing funds from a foreign-currency bank account to make a payment (dividend, loan repayment, etc.) to an affiliated person, a literal interpretation of the stop-loss rules in subsections 40(3.3) and (3.4) (or subparagraph 40(2)(g)(i), in the case where the taxpayer is an individual) could result in the denial or suspension of the capital loss if the foreign-currency bank account (or even that of an affiliated person) is replenished with more cash within the 30-day period preceding or following the particular withdrawal.

The CRA’s view regarding the application of the stop-loss rules to dispositions of foreign currency is not entirely clear. For example, in one technical interpretation, the CRA took the position that foreign currency did not constitute property for the purposes of the aforementioned stop-loss rules in a situation where a foreign affiliate withdrew funds from a bank account. However, in a more recent technical interpretation that did not involve a foreign affiliate, the CRA seemed to imply, but did not necessarily conclude, that the stop-loss rules could apply to a disposition of foreign currency.

- Provided that a foreign-currency denominated debt instrument is not repaid with another debt instrument, and subject to the comments immediately above regarding foreign currency, it seems that the stop-loss rules generally should not apply (to either the lender or the borrower) on the instrument’s full or partial repayment because an affiliated person should not be considered to have acquired the indebtedness (or an identical property) within 30 days of repayment.

- Subsection 95(2) provides special rules regarding the computation of a foreign affiliate’s FAPI and capital gain or loss. In this regard, paragraphs 95(2)(f.12) to (f.15) set forth the rules for determining the currency in which to compute any FAPI or capital gain or loss of the affiliate. Generally, any capital gain or loss arising on a disposition of excluded property is computed using the foreign affiliate’s calculating currency. In contrast, assuming that the taxpayer has

---

24 If a debt were wholly or partially settled by a debtor through the issuance of another debt, the lender’s capital loss could be suspended under paragraph 40(2)(e.2).
25 See, for example, CRA document no. 9222575, January 12, 1993, which discusses the potential application of the stop-loss rules to a lender, and CRA document no. 9818605, November 26, 1998, which discusses the application of the rules to a borrower.
26 Subparagraph 95(2)(f.12)(i). Also see paragraph 95(2)(f.15), which is a reading rule for applying subsection 39(2) in the context of a disposition of excluded property by a foreign affiliate. By virtue of a carve-out rule in paragraph 95(2)(f.13), subparagraph 95(2)(f.12)(i) does not apply to the extent that any gain or loss arising on a disposition of excluded property is deemed to be FAPI under element B of that definition.
not made a functional currency election pursuant to section 261 (discussed below), any capital gain or loss (or income or loss) arising on a disposition of non-excluded property by a controlled foreign affiliate of the taxpayer is computed using the Canadian dollar.\textsuperscript{27} Where a capital gain or loss must be computed in Canadian currency, the amount of the gain or loss is converted from Canadian currency into the currency of the affiliate’s surplus pools, using the exchange rate prevailing on the date of disposition of the property.\textsuperscript{28}

\begin{itemize}
  \item On an acquisition of control, a corporation resident in Canada must recognize any accrued capital losses, including those on account of foreign exchange, in respect of property owned by it at that time.\textsuperscript{29} The corporation may also elect to recognize an accrued capital gain to offset a capital loss that was triggered on the acquisition of control.\textsuperscript{30} Recently enacted subsection 111(12) provides a similar treatment for any accrued foreign exchange gain or loss in respect of foreign-currency denominated debt that is owed by the corporation at the time of the acquisition of control. Such a foreign exchange gain or loss is computed under subsection 40(11). These acquisition-of-control provisions potentially apply to a Canadian-resident corporation and its investment in a foreign affiliate (as well as the corporation’s foreign-currency denominated indebtedness).\textsuperscript{31}
\end{itemize}

**Stop-Loss Rules and the Foreign Affiliate Regime**

The Act contains numerous stop-loss rules that potentially apply to transactions involving foreign affiliates. These rules range from the general stop-loss provisions in section 40 of the Act to rules that are specific to investments in foreign affiliates.

\textsuperscript{27} Paragraph 95(2)(f.14). If a taxpayer has made a section 261 functional currency election, for the purposes of computing the FAPI of a foreign affiliate in respect of the taxpayer, subsection 261(6.1) effectively deems the affiliate to have also made the election. In such a situation, paragraph 261(5)(h) generally modifies the computation rules in subsection 95(2) such that the affiliate must apply that subsection by reference to the elected functional currency (as opposed to Canadian currency).

\textsuperscript{28} Regulation 5907(5).

\textsuperscript{29} Subsection 111(4).

\textsuperscript{30} Ibid.

\textsuperscript{31} Under the foreign affiliate proposals in the August 2010 draft legislation, the exempt surplus of a top-tier foreign affiliate of the Canadian-resident corporation may be reduced on an acquisition of control of the corporation. Generally, if the sum of the foreign affiliate’s “tax-free surplus balance” and the adjusted cost base of the foreign affiliate’s shares held by the corporation exceeds the fair market value of the affiliate’s shares, under proposed regulations 5905(5.2) and (5.3), the affiliate’s exempt surplus is adjusted downward on the acquisition of control by an amount equal to the excess. The proposals include an ordering rule that ensures that any adjustment to the corporation’s adjusted cost base of its shares of the foreign affiliate under subsection 111(4) is reflected in the adjusted cost base of such shares for the purposes of this calculation.
The general stop-loss rules potentially apply not only to dispositions by a taxpayer resident in Canada, but also, in some cases, to capital losses arising on dispositions by a foreign affiliate of a Canadian-resident taxpayer.

Except as otherwise provided in subdivision (i) of the Act and except to the extent that the context otherwise requires, paragraph 95(2)(f) deems a foreign affiliate of a taxpayer to be at all times resident in Canada for purposes of computing, in respect of the taxpayer, the foreign affiliate’s FAPI and any gain or loss arising on the disposition of capital property, whether or not such property is excluded property at the time of disposition. As a result, the principles associated with the computation, and timing of recognition, of a foreign affiliate’s capital gain or loss, including the general stop-loss rules in section 40, are relevant in computing the affiliate’s FAPI and/or surplus pools. It should, however, be noted that it appears that the Department of Finance has considered making the general stop-loss rules inapplicable to dispositions of property by foreign affiliates, except in very limited situations. Whether the department is still considering such a measure is uncertain.

The potential application of the stop-loss rules is often relevant in transactions involving debts owing to or from foreign affiliates or shares of foreign affiliates.

**Dispositions of Debt of a Foreign Affiliate**

A number of stop-loss rules could apply to intragroup advances made to or by a foreign affiliate of a Canadian-resident taxpayer. A few of these stop-loss rules are reviewed in more detail later in this article through various examples.

Stop-loss rules that are potentially applicable to intragroup advances include the following:

1. Paragraph 40(2)(e.1) could deem a loss to be nil where a person (the creditor) owns an obligation of a related person (the debtor) and the person disposes of the debt to another person that is related to each of the creditor and the debtor. This loss is generally added to the transferee’s adjusted cost base of

---

32 The phrase “except to the extent that the context otherwise requires” was added to paragraph 95(2)(f) by Bill C-10, An Act To Implement Certain Provisions of the Budget Tabled in Parliament on January 27, 2009 and Related Fiscal Measures, SC 2009, c. 2; royal assent March 12, 2009. Why this phrase was added is uncertain, but it seems intended to provide some subjectivity in the application of paragraph 95(2)(f) to the extent that a clearly inappropriate result would otherwise arise in the context of the foreign affiliate legislation if the affiliate were deemed to be a resident of Canada.

33 Subject to certain exceptions, taxable capital gains and allowable capital losses from dispositions of non-excluded property are included in computing the FAPI of a foreign affiliate.

34 Regulation 5907(5).

the acquired obligation. However, to the extent that the transferee is a foreign affiliate, and as made evident through an example later in this article, it is unclear whether such a loss would be added to the affiliate’s adjusted cost base of the acquired obligation.

2. Paragraph 40(2)(e.2) applies to deny a loss where a taxpayer (the creditor) realizes a loss on the settlement or extinguishment of a commercial obligation issued by a person (the debtor) and that settlement or extinguishment is effected through the issuance by that same person of another commercial obligation. The denied loss is generally added to the taxpayer’s adjusted cost base of the new obligation that was received on the exchange.

3. Subparagraph 40(2)(g)(ii) permanently denies a loss from the disposition of a debt (or other right to receive an amount) unless the debt was acquired by the taxpayer (the creditor) for the purpose of gaining or producing income from a business or property or as consideration for the disposition of capital property to an arm’s-length person.

4. Subject to the potential application of proposed paragraphs 95(2)(h) as described in point 5, the suspended loss rule in subsection 40(3.4) may apply to a disposition of a debt by a taxpayer (the creditor) where such debt (or property that is considered to be identical to such debt) is acquired by the taxpayer or an affiliated person within 30 days before or after the disposition (“the period”) and is held by the taxpayer or the affiliated person at the end of the period.

5. Draft legislation issued in February 2004 includes a stop-loss rule that is targeted at certain types of dispositions by a foreign affiliate. In general, it appears that the intention of proposed paragraphs 95(2)(h) to (h.5) is to suspend the recognition by a foreign affiliate of a Canadian-resident taxpayer of a FAPL that would otherwise arise on certain intragroup dispositions of non-excluded property involving a specified purchaser. These rules prevent such a loss from being used to shelter any FAPI earned by the affiliate.

---

36 Paragraph 53(1)(f.1) or (f.11).
37 Paragraph 53(1)(f.12).
38 Proposed subparagraph 95(2)(h.1)(v).
39 In determining whether property is identical, consideration must be given to subsections 40(3.5) and 248(12). The latter provision deems a bond, debenture, bill, or similar obligation issued by a debtor to be identical to another obligation issued by the same debtor if both obligations are identical in respect of all rights, except for the principal amount.
40 Canada, Department of Finance, Legislative Proposals and Draft Regulations Relating to Income Tax (Ottawa: Department of Finance, February 2004) (herein referred to as “the February 2004 draft legislation”).
41 The term “specified purchaser” in respect of a taxpayer resident in Canada is defined in subsection 95(1) and includes, but is not limited to, (1) the particular taxpayer; (2) an entity resident in Canada with which the particular taxpayer does not deal at arm’s length; and (3) a foreign affiliate of an entity described in (1) or (2).
If the proposed provisions are applicable, any loss otherwise realized is effectively suspended (that is, no FAPL or surplus is recognized)\textsuperscript{42} until a release event occurs.\textsuperscript{43} A release event generally occurs at the time of a triggering disposition of the property by a specified purchaser or the time at which the specified purchaser (which holds the property at the particular time) ceases to be a specified purchaser of the Canadian-resident corporation (other than by way of a specified discontinuance).\textsuperscript{44}

6. Although subparagraph 95(2)(g)(i) is generally intended to be relieving in nature, it can also function as a stop-loss rule that deems to be nil any income earned, loss incurred, or capital gain or loss realized by a controlled foreign affiliate of a taxpayer (or a foreign affiliate of a taxpayer in which the taxpayer has a qualifying interest\textsuperscript{45} throughout the taxation year) if such income, loss, or capital gain or loss is

a. caused by a fluctuation in the value of the currency of a country other than Canada relative to the value of the Canadian currency,\textsuperscript{46} and

b. earned, incurred, or realized in reference to a debt obligation that was owing

i. by the particular affiliate to another foreign affiliate of the taxpayer in which the taxpayer has a qualifying interest throughout the year (referred to as the “qualified foreign affiliate” for the purposes of paragraph 95(2)(g)), or

ii. to the particular affiliate by a qualified foreign affiliate.\textsuperscript{47}

In other words, subparagraph 95(2)(g)(i) deems any foreign exchange gain or loss realized by a foreign affiliate in respect of a qualifying debt obligation to be nil if such gain or loss is due to foreign exchange fluctuations computed vis-à-vis the Canadian dollar. Because a foreign affiliate is typically required to

\textsuperscript{42} See, for example, regulation 5907(5).

\textsuperscript{43} Proposed paragraph 95(2)(h.2).

\textsuperscript{44} The February 2004 draft legislation also contained a set of gain suspension rules. Proposed paragraphs 95(2)(c.1) to (c.6) and 95(2)(f.3) to (f.9) generally apply to certain intragroup dispositions of excluded property by a foreign affiliate. If applicable, any income or gain otherwise realized is effectively suspended (that is, no exempt surplus is recognized) until a release event occurs. Notably, none of these provisions apply to suspend the recognition of a loss otherwise arising on a disposition of excluded property by a foreign affiliate.

\textsuperscript{45} As defined in paragraph 95(2)(m).

\textsuperscript{46} If, however, a taxpayer has made a functional currency election in section 261, for the purposes of computing the FAPI of a foreign affiliate in respect of the taxpayer, the affiliate is effectively deemed under subsection 261(6.1) to have also made the election. In such a situation, paragraph 261(5)(h) modifies the calculating currency of the foreign affiliate in paragraph 95(2)(g) such that the affiliate must determine the application of that paragraph by reference to the elected functional currency.

\textsuperscript{47} Also see the related provisions in paragraphs 95(2)(g.01) to (g.03).
compute its FAPI by reference to the Canadian dollar,\(^{48}\) subparagraph 95(2)(g)(i) is most often relevant in the computation of FAPI. For example, this might be the case where debt is either

i. owing to the affiliate from the qualified foreign affiliate and the debt obligation does not constitute excluded property, or

ii. owing from the affiliate to the qualified foreign affiliate and the affiliate has not used, at all times, all or substantially all of the funds to acquire excluded property or to carry on an active business as required under paragraph 95(2)(i).

Even so, it is still possible, though uncommon, that subparagraph 95(2)(g)(i) could apply in non-FAPI situations, thereby affecting the amounts that are otherwise included in the affiliate’s exempt surplus. For example, subparagraph 95(2)(g)(i) could be applicable in the following situation. A foreign affiliate that computes its surplus pools in US dollars\(^{49}\) lends funds in Canadian dollars on a non-interest-bearing basis to its wholly owned subsidiary (that is, a qualified foreign affiliate). The loan is held on account of capital by the lending affiliate and each of the lending affiliate and the qualified foreign affiliate is a resident of, and only carries on business in, a designated treaty country.\(^{50}\) The qualified foreign affiliate’s use of the borrowed funds is such that any interest that would have been paid or payable on the loan to the lending affiliate, had the loan been interest bearing, would have been eligible for recharacterization as active business income under subparagraph 95(2)(a)(ii). Between the date on which the loan is made and the date on which it is settled, the Canadian dollar depreciates relative to the US currency. In these circumstances, since the loan would likely constitute excluded property\(^{51}\) to the lending affiliate, the affiliate would seemingly include in its exempt surplus a foreign exchange loss on settlement of the Canadian dollar denominated debt that is determined by reference to the US dollar.\(^{52}\) However, since the loan is denominated in Canadian dollars, the interaction of paragraph 95(2)(g) and regulation 5907(5) should deem the foreign exchange loss otherwise realized by the lending affiliate to be nil.\(^{53}\)

---

\(^{48}\) Paragraph 95(2)(f.14). However, if a taxpayer has made a functional currency election in section 261, for the purposes of computing the FAPI of a foreign affiliate in respect of the taxpayer, the affiliate is effectively deemed under subsection 261(6.1) to have also made the election. In such a situation, paragraph 261(5)(b) modifies the reference to Canadian currency in paragraph 95(2)(f.14) such that the affiliate must compute its FAPI by reference to the elected functional currency.

\(^{49}\) Regulation 5907(6).

\(^{50}\) As defined in regulation 5907(11).

\(^{51}\) Paragraph (c) of the definition of “excluded property” in subsection 95(1).

\(^{52}\) Paragraph 95(2)(f.12) and regulation 5907(5).

\(^{53}\) See, for example, CRA document no. 1999-0009615, August 16, 2000.
Dispositions of Foreign Affiliate Shares

A number of stop-loss rules potentially apply to dispositions of shares of a foreign affiliate by a corporation resident in Canada or by another of its foreign affiliates.\(^{54}\) Again, some of these stop-loss rules are reviewed in more detail later in this article through various examples.

Some more commonly encountered stop-loss rules in the context of dispositions of the shares of foreign affiliates include the following:

1. If the shares of a foreign affiliate are disposed of by the transferor to an affiliated person, the suspended loss rule in subsection 40(3.4) may apply (subject to the potential application of proposed paragraph 95(2)(h) as described above).
2. Subsection 40(3.6) generally applies if a taxpayer (or a foreign affiliate transferor) disposes of shares of a foreign affiliate to the particular foreign affiliate (for example, by redemption) and the parties are affiliated with each other immediately after the disposition. If applicable, any loss otherwise realized by the taxpayer is deemed to be nil and is added to the taxpayer’s adjusted cost base of the shares, if any, that the taxpayer owns of the foreign affiliate immediately after the disposition. If the taxpayer does not own any shares of the foreign affiliate immediately after the transfer, such loss effectively disappears.\(^{55}\)
3. Subsection 93(2) is similar to subsection 112(3), which applies in a Canadian domestic context. Under subsection 93(2), any capital loss realized by a Canadian-resident corporation (or, in certain circumstances, a foreign affiliate of such a corporation)\(^{56}\) on the disposition of a foreign affiliate share is reduced by the total amount of all “exempt dividends” received before that time from the affiliate by the particular corporation, a corporation related to the particular corporation, another foreign affiliate of the particular corporation, or a foreign affiliate of a corporation that is related to the particular corporation.\(^{57}\)

\(^{54}\) For purposes of computing the surplus pools of a foreign affiliate, regulations 5907(2)(j) and 5907(3.1) potentially act as stop-loss rules in certain circumstances, although neither of these provisions typically applies to a disposition of foreign affiliate shares.

\(^{55}\) See, for example, CRA document no. 1999-0010805, February 21, 2000.

\(^{56}\) Subsection 93(2) also applies if a foreign affiliate of a Canadian-resident corporation disposes of a share of the capital stock of another foreign affiliate of the corporation where the share does not constitute excluded property at the time of disposition.

\(^{57}\) Similar rules in subsections 93(2.1) to (2.3) may apply where a corporation resident in Canada owns shares of a foreign affiliate through a partnership. These rules are potentially applicable if the corporation (1) has a loss from the disposition of an interest in a partnership, or has an allowable capital loss from a disposition by the partnership of the shares of a foreign affiliate of the corporation (or a disposition by the partnership of an interest in another partnership that
An exempt dividend\(^\text{58}\) includes any exempt or taxable surplus dividend received by a Canadian-resident corporation from the foreign affiliate, to the extent of the amount of such dividend that is not taxable in Canada because it is deductible under paragraph 113(1)(a), (b), or (c). An exempt dividend also includes a dividend received by a particular foreign affiliate of a Canadian-resident corporation from another foreign affiliate of the corporation to the extent that the portion of such dividend that is not prescribed to have been paid out of the other affiliate’s pre-acquisition surplus exceeds any income or profits tax paid by the particular affiliate (or a partnership of which the particular affiliate was a partner) on the receipt.\(^\text{59}\)

4. Subsection 93(4) is a stop-loss rule that may apply where subsection 40(3.4) does not.\(^\text{60}\) This subsection potentially applies if

a. a Canadian-resident taxpayer (or a foreign affiliate of the taxpayer) has acquired shares of a foreign affiliate on the disposition of the shares of another foreign affiliate of the taxpayer; and

b. the taxpayer otherwise realizes a loss on disposing of the other affiliate’s shares.

If subsection 93(4) is applicable, any capital loss otherwise recognized by the taxpayer (or foreign affiliate) in respect of the disposition is deemed to be nil and is added to the adjusted cost base of the acquired foreign affiliate shares. This provision is presumably intended to apply to certain “downstream” transactions, where the transferor transfers shares of one foreign affiliate to another and receives shares of the transferee affiliate in exchange. However, it appears that this provision also has potential application in the context of liquidations of foreign affiliates governed by existing (or possibly proposed) subsection 88(3) of the Act.\(^\text{61}\)

5. Paragraph 95(2)(g) not only applies to foreign affiliate indebtedness but potentially also deems to be nil any income, gain, or loss otherwise arising on certain transactions involving the shares of a controlled foreign affiliate of a taxpayer

has a direct or indirect interest in the shares of a foreign affiliate of the corporation); and

(2) the corporation (and/or certain other persons, including a corporation related to the particular corporation, and a foreign affiliate of the corporation and the related corporation) received an exempt dividend from the foreign affiliate before that time.

\(^{58}\) As defined in subsection 93(3).

\(^{59}\) The foreign affiliate proposals in the August 2010 draft legislation also expand the definition of “exempt dividend” to include an amount prescribed in proposed regulation 5905(7.7).

\(^{60}\) Subsection 93(4) was, in effect, the equivalent of the domestic stop-loss provision in subsection 85(4), until the repeal of the latter provision for dispositions occurring after April 26, 1995 and its replacement, in part, by subsection 40(3.4).

\(^{61}\) For a commentary on whether the provisions of subsection 93(4) were intended to apply to a subsection 88(3) liquidation of a foreign affiliate, see Allan R. Lanthier, “Liquidations of Foreign Affiliates Under Subsection 88(3)” (1985) vol. 33, no. 2 Canadian Tax Journal 245-68, at 261-62.
(or a foreign affiliate of a taxpayer in which the taxpayer has a qualifying interest). More specifically, for the purposes of computing a foreign affiliate’s FAPI (and, generally, its surplus pools), such income, gain, or loss otherwise arising is deemed to be nil under subparagraph 95(2)(g)(ii) or (iii) if it is

a. caused by a fluctuation in the value of the currency of a country other than Canada relative to the value of the Canadian currency; and

b. earned, incurred, or realized in reference to either

   i. the redemption, cancellation, or acquisition of a share of, or reduction of the capital of, the affiliate or a qualified foreign affiliate (“the issuing corporation”) by the issuing corporation; or

   ii. the disposition to a qualified foreign affiliate of a share of another qualified foreign affiliate.

STOP-LOSS RULES AND THE FUNCTIONAL CURRENCY ELECTION

The recently enacted legislation that enables an eligible Canadian-resident corporation to make a functional currency election gives rise to some interesting interactions with the foreign affiliate regime. In certain circumstances, these interactions can also indirectly affect the application or non-application of a particular stop-loss rule.

Subsection 261(2) generally provides that the Canadian tax results (such as income, taxable income, tax payable) of a taxpayer must be determined in Canadian currency. If an amount relevant to the computation is denominated in a foreign currency, such amount must be converted into Canadian currency using the relevant spot rate for the day on which the amount arose.

The lone exception to the general rule in subsection 261(2) is applicable where an eligible taxpayer makes a functional currency election under subsection 261(3). Such taxpayer is able to compute its Canadian tax results for a particular taxation year (and each subsequent taxation year until the election is revoked, or deemed to have been revoked) using its elected currency, which must also be a qualifying currency.

62 However, if a taxpayer has made a functional currency election under section 261, for the purposes of computing the FAPI of a foreign affiliate of the taxpayer, subsection 261(6.1) effectively deems the affiliate to have also made the election. In this situation, paragraph 261(5)(h) modifies the reference to Canadian currency in paragraph 95(2)(g) such that the affiliate must determine the application of that paragraph by reference to the elected functional currency.

63 Subparagraph 95(2)(g)(ii).

64 Subparagraph 95(2)(g)(iii).

65 The amended functional currency reporting rules were enacted by SC 2009, c. 2, section 80(1), and are generally effective for taxation years ending after December 13, 2007. A discussion of the conditions associated with making the functional currency election, and the consequences arising therefrom, is beyond the scope of this article.

66 As defined in subsection 261(1).

67 Subsection 261(5). A “qualifying currency” is defined in subsection 261(1) as the US dollar, euro, British pound, Australian dollar, or a prescribed currency.
If a functional currency election is made by a corporation that has a foreign affiliate, the functional currency election effectively cascades into the foreign affiliate regime to the extent that the foreign affiliate earns FAPI. In these circumstances, a foreign affiliate is, for the purposes of computing its FAPI, effectively deemed to have also made the functional currency election, starting with the affiliate’s first taxation year that ends at least six months after the day that is six months before the end of the corporation’s first functional currency year.\(^68\) Thus, instead of computing its FAPI (including any foreign exchange gains and losses) by reference to the Canadian dollar,\(^69\) the affiliate computes its FAPI vis-à-vis the corporation’s elected functional currency.\(^70\)

Accordingly, particularly in the case of affiliates incorporated after the effective date of the election, a functional currency election may simplify the computation of, and perhaps even reduce, the FAPI of the affiliate by removing the effects of foreign exchange gains or losses that are computed by reference to the Canadian dollar. Of course, if a foreign exchange loss does not arise in the first place (for example, as a consequence of making a functional currency election), no stop-loss rule can apply. The next section of this article presents a number of examples that compare the tax consequences that may arise in situations where no foreign currency election is made and situations where the election is made.

Nevertheless, such benefits may be mitigated or even completely eliminated by virtue of other complexities or issues that can arise as a result of the election. For example, it is possible that subsection 261(21)—an anti-avoidance provision that, in effect, acts as a stop-loss rule—could apply to deny a foreign exchange loss arising on a transaction between a taxpayer and a related company where these persons have different tax reporting currencies as a result of the making of a functional currency election. Although subsection 261(21) is not a conventional stop-loss rule in some respects, it is still relevant in the context of this article because it could, as illustrated below, \textit{indirectly} deny a foreign exchange loss otherwise realized by a taxpayer in respect of an investment in its foreign affiliate. Furthermore, given that subsection 261(6.1) causes a foreign affiliate to be subject to the same functional currency computation rules as its electing Canadian parent company for the purposes of computing the affiliate’s FAPI in respect of such company, it also seems possible that the anti-avoidance rule in subsection 261(21) could apply to deny a foreign exchange loss otherwise realized by the affiliate if the requirements for the application of that rule (as set out in subsection 261(20)) are met in respect of that loss.

Subsection 261(20) states that subsection 261(21) applies in determining a taxpayer’s income, gain, or loss for a taxation year in respect of a transaction (a “specified transaction”) if three conditions are met:

\(^{68}\) Subsection 261(6.1).
\(^{69}\) Paragraph 95(2)(f.13) and subparagraph 261(5)(h)(ii).
\(^{70}\) Paragraph 261(5)(h).
1. the specified transaction was entered into, directly or indirectly, at any time by the taxpayer and a related corporation;\(^{71}\)
2. the taxpayer and the related corporation had different tax reporting currencies at any time during the period (“the accrual period”) in which the income, gain, or loss accrued; and
3. absent subsections 261(20) and (21), it would be reasonable to consider that a fluctuation at any time in the accrual period in the value of the taxpayer’s tax reporting currency relative to the value of the related corporation’s tax reporting currency
   a. increased the taxpayer’s loss in respect of the specified transaction;
   b. reduced the taxpayer’s income or gain in respect of the specified transaction; or
   c. caused the taxpayer to have a loss, instead of income or a gain, in respect of the specified transaction.

If all of these conditions are met, each fluctuation during the accrual period in the value of the taxpayer’s tax reporting currency relative to the value of the related corporation’s tax reporting currency is deemed not to have occurred for the purposes of determining the taxpayer’s income, gain, or loss from the transaction.

In the explanatory notes to Bill C-10 released on February 25, 2009, the Department of Finance provides an illustration of the potential application of subsection 261(21).\(^{72}\) In that example, a Canadian corporation (Parentco), whose functional currency is the Canadian dollar, has a wholly owned Canadian subsidiary (Subco) whose functional currency is the US dollar. During the year, Parentco loans Cdn $1 million to Subco, which is subsequently repaid. Subco, as a US dollar reporter, realizes a capital loss on repayment whereas Parentco, as a Canadian dollar reporter, does not realize a gain or loss. The Department of Finance states that Subco’s loss otherwise realized is reasonably attributable to the exchange rate fluctuation between Subco’s tax reporting currency and that of Parentco. As a result, subsection 261(21) deems the fluctuation in value not to have occurred and denies Subco’s loss. Although other currency choices are not discussed in the example, presumably a similar result could arise to the extent that Parentco had instead loaned funds in US dollars to Subco and realized a loss therefrom.

The anti-avoidance rule in subsection 261(21) potentially applies to a wide array of transactions between an electing corporation and other members of that corporation’s group. It also seems that, strictly applied, it would deny any foreign exchange loss arising from a transaction between the electing corporation and a related corporation even in the absence of an intention to abuse or misuse the functional currency

---

\(^{71}\) In determining whether a transaction involves a related corporation, the partnership lookthrough rule in subsection 261(22) is applicable.

regime. Since no similar rule denies a loss on a transaction between a non-electing corporation and its foreign affiliate, this anti-avoidance rule presents a potential disincentive for owning shares of a foreign affiliate indirectly through a Canadian-resident corporation that makes a functional currency election.

For example, assume that a wholly owned Canadian subsidiary, Cansub, of another Canadian company, Canco, elects to use the US dollar as its functional currency. Canco does not make such an election and is thus required to use the Canadian dollar to compute its Canadian tax results. Assume also that Cansub owns all of the shares of a controlled foreign affiliate, CFA, and that CFA requires additional funding for its active business. From a foreign exchange perspective, and assuming that Canco ultimately provides the funding, different consequences potentially arise depending on whether Canco funds Cansub by means of debt or equity.

If Canco funds Cansub by means of an advance, a foreign exchange exposure arises to either Canco or Cansub on settlement of the advance, depending on the currency in which the advance is denominated. The foreign exchange exposure rests with Cansub if the advance is denominated in Canadian dollars and with Canco if the advance is denominated in US dollars.

Wherever the foreign exchange exposure resides, it appears that the anti-avoidance rule in subsection 261(21) could deny any foreign exchange loss otherwise available to either Canco or Cansub in respect of the advance. Depending on the facts, it could be argued that the denial of this loss is inappropriate.

At the time that Canco makes the advance to Cansub, neither party can know or control whether it will ultimately realize a foreign exchange gain or loss upon a future repayment of the advance. In other words, the corporation with the foreign exchange exposure has an equal chance of realizing a gain as it does a loss. Notably, subsection 261(21) seems one-sided in the sense that it does not eliminate the effects of any foreign exchange gain realized by Canco or Cansub on settlement of the advance. Conceptually, depending on the facts, the potential for subsection 261(21) to deny the recognition of a foreign exchange loss may not be of significant concern to Canco or Cansub unless the loss is needed to shelter or hedge a corresponding foreign exchange gain. If, however, the loss is so required and subsection 261(21) is determined to be applicable in the circumstances, the denial of the foreign exchange loss is a potential tax cost.

This might be the case if Canco were to borrow funds in US dollars and use such funds to make an advance (in US dollars) to Cansub. Canco could realize a foreign exchange gain on repayment of its debt but may not, by virtue of the anti-avoidance rule in subsection 261(21), be able to recognize a corresponding loss on the advance made to Cansub. This issue could be avoided by having Cansub borrow the funds

---

73 It is possible (though not entirely clear) that, by virtue of subsection 261(6.1), subsection 261(21) could also apply to deny a foreign exchange loss otherwise realized by CFA if the requirements in subsection 261(20) were met in respect of that loss. For example, this might be the case if CFA were to make a Canadian dollar, interest-bearing loan to Canco and CFA realized a foreign exchange loss (as computed vis-à-vis the US dollar) on repayment of the loan.
directly from the third party; however, an arm’s-length lender could be unwilling to lend funds directly to Cansub.

On the other hand, if Canco funds Cansub via share capital issued in Canadian dollars, could Cansub potentially realize a foreign exchange gain or loss? In this regard, there is some authority, albeit unrelated to the functional currency election, suggesting that Cansub could potentially realize a foreign exchange gain or loss on the cancellation, conversion, or redemption of its shares.

In *MacMillan Bloedel*, the taxpayer kept its financial records in Canadian dollars and issued preferred shares that were redeemable in US dollars. Because of currency fluctuations, the taxpayer paid more (in Canadian dollars) on redemption than it did on the issuance of the shares. The difference was treated by the taxpayer, and ultimately allowed by the Federal Court of Appeal, as a foreign exchange loss that was deemed to be a capital loss under subsection 39(2).

It seems that the court’s decision in *MacMillan Bloedel* could also apply, for similar reasons, to Canadian dollar preferred shares issued by a Canadian company that makes a functional currency election. To the extent that Cansub issues fixed-value, redeemable preferred shares denominated in Canadian dollars, Cansub could realize a foreign exchange gain or loss on the redemption of the shares because the redemption will result in Cansub paying more or less to Canco on redemption than it did on the shares’ issuance.

The CRA has indicated that it will apply the court’s reasoning in *MacMillan Bloedel* to a redemption of fixed-value, foreign-currency denominated preferred shares. However, the CRA seems to be reluctant to apply such reasoning in other situations. For this reason, and given the lack of other relevant jurisprudence, it is not clear whether the principles established in *MacMillan Bloedel* could apply in other situations.

For example, if instead Canco converted Cansub preferred shares into common shares, could Cansub be considered to have realized a foreign exchange gain or loss? In different circumstances, where US dollar denominated preferred shares were converted to Canadian dollar denominated preferred shares, the CRA appears to have taken the position that the Canadian corporation did not realize a loss at the time of the conversion, because the corporation transferred no property and so its patrimony of the corporation was unaffected.

To the extent that Cansub issues Canadian dollar denominated common shares to Canco, it is also uncertain whether the reasoning in *MacMillan Bloedel* could cause Cansub to have a foreign exchange gain or loss on cancelling, converting, or redeeming such shares, or returning capital in respect of them. The CRA has indicated

---

74 Any foreign exchange loss realized by Cansub would likely be subject to the loss denial rule in subsection 261(21).

75 *The Queen v. MacMillan Bloedel Limited*, 99 DTC 5454 (FCA).

76 See, for example, CRA document no. 2006-0216801I7, January 15, 2007.

that it is unclear whether the reasoning in *MacMillan Bloedel* could be extended to an acquisition of common shares because “there is no clear benchmark against which to determine whether a foreign currency gain or loss has occurred on the shares’ repurchase.”78 Nevertheless, such a position has been questioned. For example, as noted in a 2008 tax paper,

> [a]ny distributions out of retained earnings would clearly not result in a foreign exchange gain or loss. However, it is unclear why a return of capital through a redemption, through a reduction of capital, or on a winding up could not be subject to subsection 39(2). It is arguable that the benchmark referred to in the [CRA]’s comment could simply be the stated capital of the shares.79

As a result, significant uncertainty remains as to whether Cansub could potentially realize a foreign exchange gain or loss in respect of its common shares if such shares were issued in Canadian dollars. This uncertainty compounds the complexity associated with making a functional currency election.

The complexity is particularly evident when compared with the classic situation in which a corporation resident in Canada, with Canadian dollar denominated share capital, has a foreign affiliate and does not make a functional currency election. In that situation, there is typically no uncertainty as to whether either the corporation, or its foreign affiliate, could realize a foreign exchange gain or loss in respect of its shares.

For example, the foreign affiliate rules include subparagraph 95(2)(g)(ii), which is specifically intended to deal with certain situations in which a foreign affiliate might otherwise realize a foreign exchange gain or loss in respect of its shares. As noted above, for the purposes of computing a foreign affiliate’s FAPI (and, generally, its surplus pools), any income, gain, or loss otherwise arising to a foreign affiliate on certain transactions involving its shares is deemed to be nil if such income, gain, or loss otherwise arising is due to a fluctuation in the value of the currency of a country other than Canada relative to the value of the Canadian currency (or another currency if the taxpayer of the foreign affiliate has made a functional currency election) in respect of a transaction involving the redemption, cancellation, or acquisition of a share of the capital stock of, or the reduction of the capital of, the affiliate.80

**APPLICATION OF STOP-LOSS RULES TO SELECTED TRANSACTIONS INVOLVING FOREIGN AFFILIATES**

The interaction of the various stop-loss rules with the foreign affiliate regime can give rise to anomalies. Building on some of the concepts discussed earlier, this section of the article illustrates a number of these anomalies in the context of selected

---

79 Kopstein and Pantry, supra note 8, at 27:29-30.
80 Subparagraph 95(2)(g)(ii).
transactions, and considers whether a different result could arise if the foreign affiliate’s Canadian parent company made a functional currency election.

**Transfer of Intragroup Indebtedness**

Paragraph 40(2)(e.1) is an example of a provision that can provide unexpected results in a foreign affiliate context.

For example, assume that a taxable Canadian corporation, Canco, directly owns all of the shares of three controlled foreign affiliates, FA 1, FA 2, and FA 3. Assume also that FA 1 has loaned funds on an interest-bearing basis to FA 3 ("the FA 3 loan") and that FA 1 holds the FA 3 loan on account of capital. FA 1 transfers the FA 3 loan to FA 2 in exchange for fair market value consideration.

Whether or not the FA 3 loan constitutes excluded property at the time of sale, Canadian tax principles should be used to compute any capital gain or loss arising to FA 1 on the transfer. To the extent that FA 1 realized a loss on the transfer of the FA 3 loan (for example, if the FA 3 loan was sold at a discount), such a loss would seemingly be deemed to be nil under paragraph 40(2)(e.1) for the purposes of computing FA 1’s surplus pools (and FAPI, to the extent that the FA 3 loan constituted non-excluded property81 at the time of disposition).82

If FA 1 and FA 2 were instead taxable Canadian corporations, the loss otherwise realized by FA 1 would normally be added to FA 2’s adjusted cost base of the FA 3 loan under either paragraph 53(1)(f.1) or (f.11). Paragraph 53(1)(f.1) generally permits a transferee to add a loss that is denied to the transferor by paragraph 40(2)(e.1)

---

81 To the extent that the FA 3 loan constitutes non-excluded property at the time of disposition, any gain or loss arising to FA 1 should be computed by reference to the Canadian dollar. In these circumstances, paragraph 95(2)(g) could deem any gain or loss to be nil to the extent that such gain or loss is attributable to foreign exchange computed vis-à-vis the Canadian dollar. However, since the FA 3 loan bears interest, any gain or loss realized by FA 1 on disposition of the FA 3 loan is presumably attributable to both economic factors and foreign exchange. As a result, consistent with the general principles that apply in a Canadian domestic context, one interpretation is that such gain or loss should not be bifurcated into its underlying components. On the basis of this interpretation, paragraph 95(2)(g) should not apply since any gain or loss realized by FA 1 on the disposition of the FA 3 loan is not solely attributable to a foreign exchange gain or loss computed by reference to the Canadian dollar. However, if paragraph 95(2)(g) did apply in these circumstances to deem any foreign exchange gain or loss component to be nil (or potentially the entire gain or loss if the FA 3 loan were interest-free), it is unclear whether paragraph 95(2)(g) would apply before paragraph 40(2)(e.1) or vice versa. If paragraph 40(2)(e.1) applied first, it is possible that such a loss could be added to FA 2’s adjusted cost base of the FA 3 loan under paragraph 53(1)(f.11) (subject to the uncertainties described in this article). To the extent that paragraph 95(2)(g) applies first, such a basis adjustment would not exist. In this situation, it seems reasonable that the application of paragraph 95(2)(g) should precede that of paragraph 40(2)(e.1), since the former provision is more specific in this context than the latter.

82 For greater certainty, since paragraph 40(2)(e.1) applies to the loss, subsections 40(3.3) and (3.4) and subparagraph 40(2)(g)(i) should not apply, because of the exception in paragraph (e) of the definition of “superficial loss” in section 54.
to the adjusted cost base of the acquired debt if, among other things, the transferee and the transferor are both taxable Canadian corporations. Similarly, to the extent that paragraph 53(1)(f.1) does not apply, paragraph 53(1)(f.11) effectively provides that the transferee may add the denied loss to the adjusted cost base of the acquired debt as long as the transferor is resident in Canada.

In the foreign affiliate context, it appears that in certain circumstances the requirements of paragraph 53(1)(f.1) or (f.11) may never be met to permit a loss (that is denied under paragraph 40(2)(e.1) to a transferor that is a foreign affiliate of a taxpayer) to be added to the adjusted cost base of a debt acquired by another foreign affiliate of the taxpayer. In this example, it seems that FA 1’s loss may not be added (under either paragraph 53(1)(f.1) or (f.11)) to FA 2’s adjusted cost base of the FA 3 loan because FA 2 acquired the FA 3 loan from FA 1, a non-resident of Canada.\(^8\)

Assuming that neither paragraph 53(1)(f.1) nor (f.11) applies to add FA 1’s loss to FA 2’s adjusted cost base of the FA 3 loan, FA 2 could realize a gain in respect of the future settlement of the loan since FA 2’s adjusted cost base of the FA 3 loan (that is, the amount paid by FA 2 to FA 1) would be less than the loan’s face amount. To the extent that the FA 3 loan constituted excluded property at the time of repayment and FA 2 was a resident of a designated treaty country, presumably the entire gain would be included in FA 2’s exempt surplus.\(^8\) However, if the FA 3 loan did not constitute excluded property at the time of repayment, FA 2’s gain (or taxable portion of the capital gain) would constitute FAPI.

Similar results should arise even if Canco has made a functional currency election. However, if the FA 3 loan was not excluded property, subject to the potential application of paragraph 95(2)(g), the quantum of any capital gain or loss realized by FA 1 would likely be different because such gain or loss would be computed by reference to Canco’s elected qualifying currency, and not the Canadian dollar.

**Interaction of Subsections 40(3.4) and 93(2)**

In certain uncommon circumstances, both subsections 40(3.4) and 93(2) could be relevant to the same transaction in determining the amount of capital loss that may be recognized. It is unclear how these subsections would interact in such situations.

Assume that a taxable Canadian corporation, Canco, directly owns, on account of capital, all of the shares of two controlled foreign affiliates, FA 1 and FA 2. Canco

---

\(^8\) Regarding paragraphs 53(1)(f.1) and (f.11), although FA 2 is deemed under paragraph 95(2)(f) to be a resident of Canada for the purposes of computing its capital gains and losses, it is difficult to interpret paragraph 95(2)(f) to mean that FA 1 would also be considered a resident of Canada for the purposes of computing FA 2’s capital gain or loss on a future disposition of the FA 3 loan. However, if the transferor of the FA 3 loan were instead Canco, it seems that FA 2’s adjusted cost base of the FA 3 loan should be increased under paragraph 53(1)(f.11) because Canco is not a non-resident person.

\(^8\) Paragraph (a) of the definition of “exempt earnings” in regulation 5907(1) includes capital gains of an affiliate, excluding the taxable portion of such gains that arise on the disposition of certain types of property (for example, non-excluded property, interests in a partnership, and shares of a foreign affiliate). Exempt earnings are included in computing a foreign affiliate’s exempt surplus.
transfers all of the shares of FA 1 to FA 2 in exchange for a note with a face value equal to the fair market value of the FA 1 shares (“the original disposition”).\textsuperscript{85} Up to and including the time of the original disposition, FA 1 has not paid any dividends.

At some time after the original disposition, FA 1 pays an exempt surplus dividend to FA 2. Later still and after the dividend is paid, FA 2 disposes of all of the FA 1 shares to a person that is not affiliated with Canco.

Assuming that Canco realizes a capital loss on the original disposition, subsection 40(3.4) would suspend the loss because the transferee, FA 2, is affiliated with Canco. Generally, FA 2’s subsequent sale of the FA 1 shares should trigger the release of Canco’s suspended loss in the year of sale.\textsuperscript{86} In this example, the issue is whether the stop-loss rule contained in subsection 93(2) causes Canco’s capital loss, when ultimately recognized, to be reduced by the exempt surplus dividend paid by FA 1 to FA 2 after the date of the original disposition.

In concept, it seems reasonable to expect that a transaction (that is, the payment of a dividend by FA 1 to FA 2) that occurs after the date of the original disposition should be irrelevant in determining the amount of Canco’s ultimate loss in respect of the original disposition. However, a closer inspection of subsections 40(3.4) and 93(2) might suggest otherwise.

Paragraph 40(3.4)(b) sets out the time for the subsequent recognition of Canco’s suspended loss that arose on the original disposition. This suspended loss is deemed to be a loss of Canco from a disposition of the shares of FA 1 at the time that is immediately before the occurrence of certain events, including the beginning of a 30-day period throughout which neither Canco nor any person affiliated with it (including FA 2) owns the FA 1 shares (or an identical property). Accordingly, Canco is deemed to have a capital loss from the disposition of the FA 1 shares in the taxation year in which FA 2 disposes of the FA 1 shares to the unaffiliated person.

Under subsection 93(2), if Canco has a loss from the disposition by it at any time of the shares of FA 1, the amount of the loss otherwise realized is reduced by any exempt dividends received before that time by Canco or by a foreign affiliate of Canco (that is, FA 2).

Because subsection 40(3.4) effectively deems Canco to recognize the capital loss when FA 2 disposes of the FA 1 shares (rather than at the time of the original disposition), subsection 93(2) could be interpreted as providing that Canco’s capital loss (otherwise recognized under subsection 40(3.4)) is reduced by any exempt dividends paid by FA 1 before the date on which such loss is recognized, including the dividend paid by FA 1 to FA 2 after the original disposition. Despite this interpretation and the apparent lack of any administrative or legislative guidance on the interaction of subsections 40(3.4) and 93(2), it appears reasonable, for several reasons, to conclude that the capital loss ultimately recognized by Canco in respect of the

\textsuperscript{85} Since Canco receives no FA 2 shares as consideration on the transfer, subsection 85.1(3) does not apply.

\textsuperscript{86} Paragraph 40(3.4)(b).
original disposition should not be reduced (under subsection 93(2)) by any dividends paid by FA 1 after the date of the original disposition.

The first reason for such an interpretation is that as an initial step in determining the amount of the loss otherwise suspended by subsection 40(3.4) on the original disposition, it seems reasonable that subsection 93(2) should first apply. Any loss of Canco remaining after the application of subsection 93(2) would then be subject to the stop-loss rule in subsection 40(3.4).

This view seems to be supported by the fact that paragraph 40(3.4)(b) provides that the loss to be suspended is to be determined without reference to paragraph 40(2)(g) or subsection 40(3.4). By inference, it seems that other relevant provisions of the Act, such as subsection 93(2), should be taken into account in computing the amount of a capital loss before the application of subsection 40(3.4). Accordingly, since FA 1 did not pay any dividends before the original disposition, subsection 93(2) should not reduce the loss realized by Canco, but suspended under subsection 40(3.4), as a result of the original disposition. On the basis of the above rationale, it appears reasonable, and appropriate in the context of the Act read as a whole, that subsection 93(2) should not subsequently apply again to deny or reduce the suspended loss that Canco can ultimately recognize upon the occurrence of a triggering event described in subsection 40(3.4).

The second reason for the above interpretation is that, although subsection 40(3.4) suspends recognition of a capital loss, it does not change the fact that, for the purposes of the Act, Canco made a disposition of the FA 1 shares at the time of the original disposition. Instead, subsection 40(3.4) merely provides that

- Canco's loss, if any, from "the" disposition is deemed to be nil; and
- "the" amount of Canco's loss, if any, from "the" disposition is deemed to be a loss of Canco from "a" disposition of the FA 1 shares immediately before the occurrence of certain specified future events.

The implication is that the amount of the capital loss to be recognized upon the occurrence of a future triggering event should equal the amount of the loss realized by Canco at the time of the original disposition. Similarly, it seems that paragraph 40(3.4)(b) deems a disposition of the FA 1 shares by Canco to occur at the time of

---

87 This view also seems to be indirectly supported by the May 1991 Department of Finance technical notes to former subsection 85(4), which was subsequently repealed and replaced, in part, by subsection 40(3.4). These technical notes state that an "amendment to paragraph 85(4)(b) . . . is intended to ensure that this provision does not operate to override the rules in subsections 93(2) and 112(3), (3.1) and (3.2)": Canada, Department of Finance, Explanatory Notes to Legislation Relating to Income Tax (Ottawa: Department of Finance, May 1991), clause 64.

88 As defined in subsection 248(1).

89 Paragraph 40(3.4)(a).

90 Paragraph 40(3.4)(b).
the triggering event only for the purpose of releasing (or permitting recognition of) the suspended loss.

Finally, subsection 93(2) applies only where Canco has a loss from the disposition by it at any time of the shares of a foreign affiliate. Again, subsection 40(3.4) does not seem to change the fact that, for the purposes of the Act, Canco disposed of the FA 1 shares at the time of the original disposition. Since Canco arguably should not be considered to have made another disposition of the FA 1 shares upon the occurrence of a future triggering event, for the purposes of the Act, it follows that subsection 93(2) should not apply again to deny or restrict the amount of Canco’s loss otherwise released/recognized (upon the occurrence of such an event). This interpretation is consistent with the fact that if FA 2 were to realize a capital loss on its disposition of the FA 1 shares, subsection 93(2) could apply to reduce the loss by any dividends previously paid by FA 1, depending on the facts.

Again, similar results should arise if Canco has made a functional currency election. However, to the extent that Canco does not realize a loss on the disposition of the FA 1 shares because Canco uses an elected qualifying currency to compute any gain or loss on the disposition, the uncertain interplay between subsections 40(3.4) and 93(2) becomes moot.

Upstream Loans Between Foreign Affiliates

Another illustration of how the stop-loss rules can potentially cause unexpected results in a foreign affiliate context involves certain types of intragroup loans made by a foreign affiliate.

For example, assume that a controlled foreign affiliate, FA Subco, of a Canadian-resident corporation, Canco, temporarily advances funds (“the advance”), interest-free, to its shareholder, FA Parent, another controlled foreign affiliate of the corporation. Assume also that FA Subco holds the advance on account of capital, the advance is repayable in euros, and FA Subco’s calculating currency for the purposes of computing its surplus pools is the US dollar.

While the advance is outstanding, the euro depreciates in value relative to the US dollar such that FA Subco realizes a foreign exchange loss on repayment of the advance. The treatment of FA Subco’s loss for surplus and FAPI purposes ultimately depends on FA Parent’s use of the borrowed funds.

To the extent that FA Parent used the funds to earn income from an active business carried on by it, the advance should be excluded property to FA Subco, even though it is interest-free, assuming that any interest otherwise payable in respect of the advance had it been interest bearing would have met the requirements of paragraph 95(2)(a). The capital loss realized by FA Subco on the advance repayment should not be relevant in computing FA Subco’s FAPI because such a loss should be

---

91 Within the meaning of the definition of “calculating currency” in subsection 95(1) and regulation 5907(6).

92 Paragraph (c) of the definition of “excluded property” in subsection 95(1).
considered to be in respect of excluded property. Further, since the advance does not bear interest, it appears that the loss should also be deemed to be nil, under subparagraph 40(2)(g)(ii), for the purposes of computing FA Subco’s surplus pools. This treatment seems to apply because the loss arises from the disposition of a debt that FA Subco did not acquire for the purpose of gaining or producing income from a business or property.⁹³ If the advance were instead interest bearing, subparagraph 40(2)(g)(ii) would not apply and the loss would reduce FA Subco’s surplus pools.

On the other hand, if FA Parent used the funds to earn FAPI, the advance would not be excluded property to FA Subco. As a result, any gain or loss realized by FA Subco on repayment of the advance would be relevant in computing FA Subco’s FAPI, subject to the application of a stop-loss rule. In determining the amount of any foreign exchange gain or loss to be included in computing FA Subco’s FAPI (and ultimately FA Subco’s surplus pools), such gain or loss would no longer be computed vis-à-vis the fluctuations in the exchange rate between the US dollar and the euro. Instead, any foreign exchange gain or loss arising to FA Subco on repayment of the advance should be computed by reference to changes in the exchange rate between the euro and the Canadian dollar.⁹⁴

With the recomputation of any foreign exchange gain or loss arising to FA Subco on repayment of the advance vis-à-vis the Canadian dollar, subparagraph 95(2)(g)(i) should now apply to deem any foreign exchange gain or loss to be nil for the purposes of computing FA Subco’s FAPI and surplus pools. As a result, FA Subco would have no FAPL arising in respect of the repayment of the advance to shelter its FAPI. The same result should arise even if the advance were interest bearing.

Results similar to those above should arise even if Canco had made a functional currency election, and even if the advance was not excluded property of FA Subco. In the case where the advance constituted non-excluded property, any foreign exchange gain or loss otherwise arising between the euro and the Canadian dollar would instead be computed vis-à-vis the euro and Canco’s elected qualifying currency. In any event, subparagraph 95(2)(g)(i) and paragraph 261(5)(h) should still deem any such a foreign exchange gain or loss to be nil for the purposes of computing FA Subco’s FAPI and surplus pools.

**Upstream Loans Made by Foreign Affiliates to Canadian Shareholders**

Potential issues can also arise when a controlled foreign affiliate, FA, advances funds (“the Canco advance”) to its shareholder, Canco, a taxable Canadian corporation.

---

⁹³ Regulation 5907(5), paragraph 95(2)(f), subparagraph 95(2)(f.12)(i), paragraph 95(2)(f.15), and subparagraph 40(2)(g)(ii). In considering the application of subparagraph 40(2)(g)(ii), the Federal Court of Appeal’s decision in *The Queen v. Byram*, 99 DTC 5117, likely does not apply in this fact pattern, because the upstream nature of the advance precludes FA Subco from indirectly receiving dividend income from FA Parent; that is, no nexus exists between the making of the advance by FA Subco and the potential for future income from FA Parent.

⁹⁴ Paragraph 95(2)(f.14).
Assume that FA holds the advance on account of capital and that the advance is repayable in US dollars, which is also FA’s calculating currency for the purposes of computing its surplus pools.

Because the borrower, Canco, is a resident of Canada, such an advance would not be considered excluded property of the foreign affiliate. Accordingly, any foreign exchange gain or loss arising on a repayment or disposition of the Canco advance would generally be included in computing FA’s FAPI and surplus pools.

In this regard, paragraph 95(2)(f) effectively requires the use of Canadian tax principles in determining the amount of any such gain or loss arising to FA on repayment of the Canco advance. Similarly, paragraph 95(2)(f.14) requires any capital gain or loss arising on the disposition of a non-excluded property to be computed by reference to the Canadian dollar. For the purposes of determining FA’s surplus pools, the capital gain or loss, as determined in Canadian dollars, is converted back into the affiliate’s calculating currency (that is, US dollars) using the exchange rate prevailing on the date of the disposition.

If the US dollar strengthens relative to the Canadian dollar while the Canco advance is outstanding, FA should realize a foreign exchange gain on repayment while Canco should realize a foreign exchange loss. Since one-half of the gain realized by FA would constitute FAPI (and thus taxable surplus) to FA, such amount would be currently included in computing Canco’s income under the Act. However, the foreign exchange loss realized by Canco on repayment, assuming that it is on account of capital, could not be used to offset the FAPI inclusion.

On the other hand, if the US dollar weakens relative to the Canadian dollar while the Canco advance is outstanding, the consequences to FA and Canco are reversed. FA should realize a foreign exchange loss on repayment of the Canco advance while Canco should realize a foreign exchange gain. Again, a mismatch arises because Canco’s capital gain cannot be offset by the capital loss realized by FA.

Regarding the foreign exchange loss realized by FA, one-half of the loss is potentially included in computing FA’s FAPI (or FAPL to the extent that FA has no FAPI). However, FA’s ability to claim this loss against its FAPI likely depends on whether the Canco advance bears interest.

If the Canco advance does not bear interest, such a loss seemingly should be deemed to be nil under subparagraph 40(2)(g)(ii) for the purposes of computing FA’s FAPI and surplus pools since the Canco advance arguably was not acquired by FA for the purpose of gaining or producing income from a business or property. In contrast, if the Canco advance were interest bearing, subparagraph 40(2)(g)(ii) would not apply and the loss could be used to offset any FAPI of FA.

95 None of the requirements of paragraph (a) or (c) of the definition of “excluded property” in subsection 95(1) are met.

96 Regulation 5907(5).

97 In the event that the Canco advance was interest bearing, the interest income earned by FA would constitute FAPI under general principles or paragraph 95(2)(a.3). Subject to the
The potential mismatches described above would be avoided if Canco made a US dollar functional currency election. In this case, Canco would not realize a capital gain or loss on repaying the US dollar denominated Canco advance.

Similarly, FA would no longer have a foreign exchange gain or loss on repayment that could be relevant in computing its FAPI and surplus pools, because such gain or loss would no longer be computed vis-à-vis the fluctuations in the exchange rate between the US dollar and the Canadian dollar. Instead, since the Canco advance would be repayable in US dollars and since FA must compute its FAPI in US dollars as a result of Canco’s functional currency election, no foreign exchange gain or loss would arise on repayment.

CONCLUSION
A variety of stop-loss rules potentially apply to transactions involving foreign affiliates. These rules include not only provisions that specifically target foreign affiliate investments, but also more general stop-loss rules (and in some cases, far-reaching anti-avoidance provisions) that apply for all purposes of the Act. Since these stop-loss rules are not grouped together within the Act, it can be difficult to identify whether a particular rule may apply.

When computing a foreign affiliate’s FAPI and taxable surplus, the application of the general stop-loss rules appears to produce results that are reasonably consistent with the rules’ overall objective of protecting the Canadian tax base. However, since the general stop-loss rules are intended to curb perceived abuses that are arguably not relevant in computing a foreign affiliate’s exempt surplus, these rules can give rise to anomalous results from an exempt surplus perspective.

To reduce the impact of foreign exchange gains and losses on the computation of a foreign affiliate’s FAPI, including the risk that a stop-loss rule could apply to deny or suspend the recognition of a foreign exchange loss that would otherwise be beneficial in computing such FAPI, a functional currency election could be considered by the Canadian corporate shareholder of the affiliate. Although making such an election may be beneficial from a FAPI perspective in some cases, the potential benefits should be carefully weighed against the complexities and uncertainties associated with this election.

potential application of the foreign tax credit generator rule in proposed subsection 91(4.1) (Canada, Department of Finance, 2010 Budget, Notice of Ways and Means Motion to Amend the Income Tax Act and Income Tax Regulations, March 4, 2010), any Canadian withholding tax on the interest paid by Canco to FA should be available as foreign accrual tax (and underlying foreign tax), which would reduce Canco’s net FAPI inclusion. Generally, this FAPI inclusion should be offset by Canco’s interest expense in respect of the Canco advance. As a result, provided that Canco is fully taxable in the particular year, there should generally be no cash tax leakage from the interest-bearing aspect of the Canco advance. However, in certain circumstances, the thin capitalization rules in subsection 18(4) could unexpectedly apply to deny all or a portion of Canco’s interest expense in respect of the Canco advance.