



BDO Seidman, LLP
Accountants and Consultants

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Subject:

Imperial Oil Case Ruling Regarding Canadian Foreign Exchange Losses

International Tax Alert

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Issue:

As held by the Supreme Court of Canada, business losses incurred from the foreign exchange component of financing activities are not deductible from a corporation's current income for taxation purposes.

Affecting:

U.S. corporations and their shareholders engaged in cross-border borrowings with Canada.

Background:

In 1989, Imperial Oil issued debentures in U.S. dollars and later redeemed a portion of those debentures in 1999. During that time, the U.S. dollar had appreciated against the Canadian dollar and a loss upon redemption was suffered which represented the original discount and the foreign exchange loss. Imperial Oil took the position that it was entitled to deduct from income at least 75 percent, if not the entire loss, and any non-deductible portion would by default be a capital loss. The Minister of National Revenue ruled that the loss was predominantly a capital loss and not deductible. The Tax Court of Canada upheld this assessment. The Federal Court of Appeals allowed a deduction of 75 percent of the foreign exchange loss, but refused any further deduction.

Similarly, in 1989, Inco issued debentures in U.S. dollars at a discount, later redeeming a portion of them in 2000. In computing its income for 2000, Inco deducted a foreign exchange loss allegedly resulting from the purchase of the 1989 debentures. The Minister of National Revenue disallowed the deduction. The Tax Court of Canada affirmed. The Federal Court of Appeals set aside the decision and remanded the matter back to the Minister for reassessment in light of the ruling in Imperial Oil.

Details:

On October 20, 2006 the Supreme Court of Canada issued its ruling in the cases of Imperial Oil Ltd. v. Canada and Inco Ltd. v. Canada. A 4-3 split ruling upheld an appeal by the Canada Revenue Agency by reversing a 2004 ruling by the Federal Court of Appeal that allowed major Canadian corporations (Imperial Oil Ltd. and Inco Ltd.) to deduct 75 percent of foreign exchange losses they incurred from income, while requiring them to claim the remainder as a capital loss.

According to the Court, Section 20(1)(f) of the Income Tax Act was never intended to apply to foreign exchange losses, which is what Imperial Oil and Inco had relied on for their claims for deductions.

More importantly, the Supreme Court's ruling clarifies the treatment of withholding tax exemptions on medium term arm's length financings (also known as "5-year money" or a "5/25 loan"). In order to qualify, no more than 25 percent of the principal amount of the financing could be repayable within the first five years of the term. There was uncertainty on non-Canadian dollar denominated debt as to how you could ensure that no more than 25 percent came due if the definition of "amount" was converted into Canadian dollars. This was clarified by the Court that the assessment may be made in the foreign denominated debt so as not to have any uncertainty of the 25 percent threshold.

Planning Opportunities:

U.S. taxpayers may want to consider using Canadian dollars to denominate loans from a U.S. parent to a Canadian subsidiary in order to manage any currency risk in the United States. This can be done separately or in conjunction with other risk management opportunities (i.e. hedging).

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