

U.S. May Impose Tax and Penalties on Certain Holders of Canadian Mutual Funds and ETFs



The United States (U.S.) imposes tax on the worldwide income of U.S. citizens, U.S. residents and green card holders (collectively referred to as U.S. persons) regardless of where they live. Most U.S. persons living in Canada have annual U.S. income tax filing and reporting requirements.

One of these requirements applies to U.S. persons who hold investments in a Passive Foreign Investment Company (PFIC). For U.S. tax purposes, Canadian mutual funds and Exchange Traded Funds (ETFs), even those organized and treated as trusts for Canadian tax purposes, are generally considered to be corporations and may be subject to the U.S. PFIC regime. The PFIC rules may be punitive and could involve significant reporting requirements and costs. Therefore, for many U.S. persons living in Canada, it may not be practical to hold Canadian mutual funds or ETFs.



Overview of the PFIC rules

The PFIC rules were enacted in the U.S. *Internal Revenue Code* (IRC) to eliminate beneficial tax treatment for certain offshore investments. Under prior law, U.S. taxpayers could accumulate tax-deferred income from offshore investments and upon sale of the investment for a gain, have that gain subject to U.S. tax at the lower long-term capital gains tax rate. In general, a PFIC is a foreign corporation that meets one of two tests:

- **Income Test** — at least 75% of the corporation's gross income for the year is passive or investment-type income; or
- **Asset Test** — at least 50% of the average fair market value of its assets during the year are assets that produce or are held for the production of passive income.

Since most Canadian-based mutual funds and ETFs primarily hold investments that are passive in nature, they will generally be considered to be PFICs for U.S. tax purposes. In addition, U.S. persons in Canada that own shares of a Canadian corporation may be subject to the PFIC rules (or the U.S. Controlled Foreign Corporation rules which are beyond the scope of this article).

Reporting requirements for U.S. persons

U.S. persons who own investments in a PFIC must file Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund* on an annual basis.

U.S. taxation of PFICs

As described in more detail below, U.S. persons owning investments in a PFIC must pay tax:

- On realization events (distributions or dispositions), but under a punitive regime that includes an interest charge and the denial of any capital gains treatment (the "Default Rule");
- Annually on their share of the company's income, if they so elect and the PFIC provides them with certain information, including the information necessary to determine their respective share of the company's ordinary earnings and capital gains (a "QEF Election"); or

- On an annual mark-to-market basis (if they so elect and the stock is regularly traded on a qualified stock exchange) (a "Mark-to-Market Election").

Default Rule

In general, if a U.S. person invests in a PFIC and receives income or recognizes a gain from the disposition of such investment, the individual may face U.S. income tax consequences which generally include the following:

- "Excess distributions" (a distribution in excess of 125% of the distributions received by the U.S. investor over the last three years or their holding period, if shorter) are subject to tax at the highest marginal rate, rather than at the taxpayer's marginal rate, plus a non-deductible interest charge;
- Any gain on the sale of the investments is treated entirely as an excess distribution (therefore no capital gains tax rate applies); and
- Tax-free reorganizations of the shareholdings are generally not available.

QEF and Mark-to-Market Elections

In certain circumstances, U.S. persons that invest in PFICs may make elections to help mitigate the adverse tax consequences of the Default Rule.

1. Qualified electing fund (QEF) Election

A U.S. investor may be able to make a QEF election with respect to their PFIC investments if the PFIC agrees to make certain information available to the investor on an annual basis. Under the QEF election, the U.S. person effectively elects to include in each year's income his/her pro rata share of the PFIC's ordinary earnings and net capital gains.

If a QEF election is properly made, it can help reduce the adverse tax effects of the Default Rule on a U.S. person by allowing the investor to be taxed at long-term capital gain rates on some portion of their return from the PFIC investment and by avoiding interest charges.

Note that it may be impractical to expect the PFIC to make adequate disclosures to support a QEF election since a foreign public company with no U.S. ties

may not wish to convert their financial statements to comply with U.S. tax principles.

2. Mark-to-Market Election

U.S. persons that invest in PFICs can make a “mark-to-market” election with respect to the investment in the PFIC if the PFIC investment is regularly traded on a qualified stock exchange. In general, such an election would require the U.S. person to include any appreciation (or, to a limited extent, depreciation) in the PFIC investment over each annual period in income as ordinary income (or, to a limited extent, ordinary loss).

Exemptions from the PFIC rules

The application of the PFIC rules to Canadian mutual funds held within certain retirement accounts, such as Registered Retirement Savings Plans (RRSPs) or Registered Retirement Investment Funds (RRIFs) was unclear for many years. RRSPs and RRIFs are not tax-deferred under the *IRC* and the income generated inside these accounts technically is taxable income for U.S. tax purposes, even if the income is not currently distributed. However, if a U.S. person has a specific election or automatically qualify, RRSPs and RRIFs may receive tax-deferred status in the U.S.

The Internal Revenue Service (IRS) recently released regulations that state that the PFIC rules do not apply to PFICs held in RRSPs and RRIFs as long as the election for tax-deferred status (as noted above) has been made by the U.S. person.

In addition, the regulations provide an exemption from the PFIC reporting requirements:

1. For shareholders with PFIC assets that have an aggregate value of less than US\$25,000 (US\$50,000 if couple filing jointly); and
2. For shareholders that hold PFIC shares through another PFIC, where the value of the shareholder’s proportionate share of the upper-tier PFIC’s interest does not exceed US\$5,000.

These exceptions apply only if the PFIC shareholder has not made a QEF or mark-to-market election and has not received any excess distributions from the PFIC in the particular year.

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Example of application of PFIC rules

A U.S. person purchases a \$20,000 Canadian mutual fund in January 2015 and throughout the period of ownership; the U.S. person does not receive any income from the fund. In December 2019, the U.S. person sells the mutual fund for \$25,000, realizing a gain of \$5,000. Under the PFIC rules, the U.S. person would be treated as realizing a capital gain of \$1,000 each year from 2015 through 2019. The highest tax rate in the year would be applied to the gain allocated to each year and interest is charged for each year the tax was “unpaid”. The high rate of tax and the interest charge may be significant. In addition, due to the complexity of the rules; the U.S. person may incur additional compliance fees.

Planning for U.S. persons living in Canada

Given the potentially punitive U.S. tax implications for U.S. persons living in Canada, careful consideration of the PFIC rules should be factored into any analysis of whether a Canadian mutual fund or an ETF is a desirable investment. If you are or may be considered to be a U.S. person for U.S. tax purposes, you should speak with your TD advisor as well as a cross-border tax advisor.



This article provides a general overview of some of the U.S. and Canadian tax considerations for Canadian residents around certain types of U.S. retirement accounts. It does not address additional considerations applicable to persons who are U.S. citizens, green card holders or individuals who are otherwise treated as residents of the United States for U.S. tax purposes. The U.S. and Canadian tax rules are complex, and tax consequences can vary depending on your individual circumstances. Be sure to speak with your tax specialist before taking any action with respect to any retirement accounts.

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