The Navigator

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Passive Foreign Investment Company (PFIC) Rules

Harsh U.S. tax implications for U.S. investors

The Internal Revenue Service (IRS) provided additional clarification recently related to the taxation of a non-US mutual fund, non-US pooled fund trust or other foreign investment that is classified as a Passive Foreign Investment Company (PFIC). The IRS clarified that Canadian-based mutual funds or pooled fund trusts will generally be considered corporations for U.S. tax purposes regardless of whether these funds are organized as trusts for Canadian tax purposes. As a result, a "U.S. person" including a U.S citizen, U.S. resident and U.S. green-card holder that invests in Canadian-based mutual funds or pooled fund trusts may be subject to the harsh U.S. tax rules that apply to PFICs.

This article is intended for Canadian residents who are U.S. persons, however, it also applies to U.S. persons no matter where they reside. The content is for information purposes only and does not provide tax or legal advice. It is imperative that you obtain professional advice from a qualified tax or legal advisor specializing in cross-border tax planning before you act on any of the information provided in this article. This will ensure that your own circumstances have been considered properly and that action is taken on the latest information available.

What is a Passive Foreign Investment Company (PFIC)?

A PFIC is a non-U.S corporation where 75% or more of the corporation's gross income in a particular year is from passive income (e.g., foreign holding company income, dividends, interest, royalties, rents or annuities, etc.) or the average value of passive assets (e.g., cash, bonds, stocks, etc.) owned by the corporation accounts for 50% or more of the total assets of the corporation. Since most Canadian-based mutual funds including pooled fund trusts primarily hold investments that are passive in nature, they will likely be considered PFICs. Once a non-US corporation is considered a PFIC it may retain this status annually for U.S. tax purposes.

U.S. taxation of PFICs

U.S. persons owning shares of a PFIC that receive material distributions (e.g., large dividends and capital gains) may be subject to U.S. tax at top marginal rates instead of regular marginal rates or lower rates for long-term capital gains, as well as an interest charge. For example, any distribution in excess of 125% of the average distributions received by the investor over the immediately preceding three-year period is allocated on a pro rata basis over the period of the taxpayer's investment in the PFIC. The tax liability is generally calculated in the following manner: (a) prorate the income or gain on a daily basis over the life of the investment, (b) apply the highest marginal tax rate to the income allocated to each year (except the portion of income allocated to the year of the distribution or the periods the investment was not a PFIC), regardless of the actual marginal rate of the taxpayer for that year, then (c) charge interest on that tax. This is a simplified description of a very complex calculation so you must refer to your tax advisor for further details to your own particular situation.

It may be possible to claim some of the U.S. tax (but possibly not the interest charge) as a foreign tax credit on your Canadian tax return to minimize your overall tax burden. However, with the calculation of tax at the highest tax rate and the addition of an interest charge, it is clear that the effective U.S. tax rate will far exceed the current highest tax rate in the U.S. and it may also exceed your Canadian marginal tax rate on this income resulting in an excess tax paid to the U.S. due to the PFIC rules.

It may be possible to claim some of the U.S. tax (but possibly not the interest charge) as a foreign tax credit on your Canadian tax return to minimize your overall tax burden.

The PFIC rules may be avoided by investing in individual stocks, bonds or segregated funds. If you desire pooled fund type investments, you may invest in iShares, which are exchange-traded funds (ETFs), trading on the NYSE, and are generally not considered PFICs.

U.S. reporting requirements

If you invest in PFICs you may be required to file IRS Form 8621 — Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund. The IRS is currently revising the filing requirements of this form. One of the possible new filing requirements may be the requirement to file this form annually, regardless of whether there is a distribution from the PFIC in the year, you make any possible tax elections (discussed next) or if you dispose of the stock. Accountants preparing Form 8621 generally charge additional fees to prepare these forms, which you should consider when evaluating your return on investment.

Tax elections may be difficult to make

To avoid or reduce the harsh U.S. PFIC rules, in some limited cases, two common tax elections may be made: the Qualified Electing Fund (QEF) or the "mark-to-market" election. The QEF election requires the U.S. person to include in their gross income a pro rata share of the ordinary earnings as ordinary income, and the net capital gains as long-term capital gains. The mark-to-market election requires the U.S. person to recognize the gain or loss on the PFIC as if the U.S. person sold the PFIC at fair market value at the end of the taxable year. A gain is treated as ordinary income. These elections, (made via form 8621) may accelerate your tax obligations but avoids any interest charges and may result in more favourable U.S. tax consequences than not making an election. However, in practice, these elections may be difficult to make since the information required for making a QEF election is generally not included in many mutual fund reporting packages, and mutual funds often do not trade on a qualified exchange, which is a requirement for a mark-to-market election.

Investments not considered a PFIC

The PFIC rules may be avoided by investing in individual stocks and bonds. Alternatively, if you desire pooled fund type investments, you may invest in iShares, which are exchange-traded funds (ETFs), trading on the NYSE, and are generally not considered PFICs (although you should confirm that the U.S. ETF is set up as a U.S. domestic entity). Note that iShares trading on the TSX are structured as Canadian-based mutual funds and, therefore, are likely considered PFICs. For segregated funds of an insurance company the IRS has not confirmed whether the PFIC rules will apply, therefore, speak to your tax advisor for advice before investing in segregated funds.

Canadian-based income trusts or Real Estate Investment Trusts (REITs) that carry on an active business may escape the PFIC rules; however, you should consult with a qualified tax advisor for confirmation. Note that U.S. citizens in Canada who own shares of a private Canadian active corporation or Canadian passive holding company are also potentially subject to the PFIC rules.

Holding Canadian mutual funds or other PFICs in a TFSA or RESP does not exempt you from the harsh U.S. tax rules or the requirement to file Form 8621. There is also uncertainty regarding whether the PFIC rules will not apply to investments held in registered accounts such as RRSPs or RRIFs where Form 8891 has been filed. Therefore, ask your tax advisor for advice before investing in PFICs in your registered accounts.

Conclusion

The PFIC rules are complex. If you wish to dispose of your PFIC investments and invest in alternative securities that are not affected by the PFIC rules, please contact your RBC advisor who can assist you, together with your tax advisor, on alternative investment choices. U.S. persons resident in Canada should also speak to a cross-border tax advisor regarding the Canadian and U.S. tax consequences that may result from the disposition of investments in PFICs. Your RBC advisor may suggest possible strategies that you should discuss with your tax advisor to offset accrued capital gains realized on the disposition of these investments including, the purchasing of flow-through shares, tax loss selling and in-kind donation of securities.

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› Please contact us for more information.

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