RBC Wealth Management

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Passive Foreign Investment Company (PFIC) rules

What U.S. investors need to know

The Passive Foreign Investment Company (PFIC) rules are one of the U.S. anti-tax deferral rules that apply to U.S. persons (i.e., U.S citizens, green-card holders and resident aliens). The rules can impose punitive U.S. tax and additional tax reporting requirements on you no matter where in the world you live. The rules were designed to prevent the deferral of U.S. tax on passive income earned through certain non-U.S. investments and from converting ordinary income from the disposition of these investments into tax-preferred capital gains. Examples of securities that may be considered PFICs include Canadian domiciled mutual fund trusts and mutual fund corporations, Canadian Exchange Traded Funds (ETFs), Canadian Real Estate Investment Trusts (REITs) and Canadian pooled funds. In addition, the shares you own in a Canadian private corporation such as a Canadian holding company may be subject to these rules.

The PFIC rules can apply when these types of investments are held directly in a non-registered investment portfolio and certain types of registered plans or indirectly through other structures such as partnerships, corporations, estates and trusts. The punitive tax treatment results in certain types of income, such as qualified dividends and long-term capital gains that ordinarily qualify for preferable U.S. tax rates, being taxed at ordinary income tax rates. These rates can be significantly higher than Canadian tax rates for certain types of income such as capital gains or dividends (depending on the province or territory). In addition, any tax owing from the PFIC may be subject to an interest charge.

The PFIC rules may also apply to U.S. partnerships, corporations, estates and trusts, however, this article provides an overview of the cross-border tax implications that apply only to U.S. individuals living in Canada.

The PFIC rules are very complex and can result in punitive U.S. tax, interest penalties and compliance costs that may negate any return from these investments. Therefore, it's important that you obtain advice from a qualified tax advisor before you invest in PFIC type investments or dispose of PFICs you currently own.

What is a PFIC?

To qualify as a PFIC, an investment must be classified as a **foreign corporation** for U.S. income tax purposes, and it must satisfy either the PFIC **income test** or **asset test**. The PFIC income and asset tests must be applied annually to the foreign corporation to determine if it's considered to be a PFIC for that tax year. Generally, once the investment you hold qualifies as a PFIC, the PFIC rules apply to you throughout the period you own that investment, even if the investment no longer meets the PFIC tests. Hence, you may come across the phrase, "once a PFIC always a PFIC."

Foreign corporation

For purposes of the PFIC rules, an investment is classified as a foreign corporation if it's set up as a corporation in a non-U.S. country. However, it's also possible for an investment that's set up as a trust in a foreign country to be classified as a foreign corporation if it qualifies as a business entity (i.e., it conducts any business or investment activity other than merely preserving property for its beneficiaries) and all its owners or members have limited liability for the entity's obligations. For example, most Canadian domiciled mutual funds, ETFs, REITs, and pooled funds that are trusts in Canada may qualify as foreign corporations for purposes of the PFIC rules.

Income test and asset test

1) **Income test** – Under the income test, a foreign corporation is a PFIC if at least 75% of the corporation's gross income for the taxable year is passive income (i.e., consists of dividends, interest, capital gains, rents, royalties, annuities and other passive income).

2) **Asset test** – Under the asset test, a foreign corporation is a PFIC if the average value of passive assets held by the corporation during the tax year is at least 50% or more of all assets (by value) held by the corporation during the tax year. Passive assets are assets that produce passive income or that are held to produce passive income. Some examples include, cash, bonds and stocks.

The application of these tests is complicated by several look-through rules. A discussion of these rules is beyond the scope of this article. However, as an example, if a foreign corporation owns 25% or more of the shares of another corporation or interest in a partnership, the foreign corporation is treated as if it directly earns or holds a proportionate share of the income and assets of that entity for purposes of the income and asset tests. This rule may allow a holding company to escape being classified as a PFIC by looking through the assets and income of its operating subsidiaries.

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Due to the complexity of the rules, it's important to seek tax advice from qualified professionals to determine whether an investment may be a foreign corporation and a PFIC. Often, the information may not be easily accessible by the public to be able to conclude on the PFIC status.

Interaction of PFIC rules with Controlled Foreign Corporation (CFC) rules

The U.S. anti-tax deferral rules also include CFC rules that are designed to limit a U.S. taxpayer's ability to defer tax using a foreign corporation. A CFC is defined as a foreign corporation where more than 50% of the total votes or value of the corporation are owned directly or indirectly by a U.S. shareholder or shareholders. A U.S. shareholder is a person who owns at least 10% or more of the total voting shares or value of the foreign corporation. There are complex attribution rules that attribute shares owned by related persons to a shareholder for the purpose of determining if they're a U.S. shareholder. Note that shares owned by a related non-resident alien are not attributed to a shareholder.

Since there's no minimum ownership required to meet the PFIC rules, it's quite possible if you own shares of a Canadian corporation, such as a Canadian holding company, the shares may qualify as both a PFIC and a CFC. When the CFC and PFIC rules overlap, generally the tax laws provide that the CFC rules will apply and not the PFIC rules. However, the PFIC rules can still apply if the foreign corporation qualified as a PFIC before it was a CFC or before 1998.

Note that a U.S. shareholder of a foreign corporation that's a CFC who owns less than 10% of the shares of voting shares or value of the foreign corporation is not subject to the CFC rules. If, however, the foreign corporation also qualifies as a PFIC, that shareholder will be subject to the PFIC rules instead. For example, if you're one of three unrelated U.S. citizens who own shares of a Canadian corporation, which has significant passive income or assets, and you own only 5% of the shares, you will be considered a shareholder of a PFIC rather than a shareholder of a CFC. For the other two U.S. citizen shareholders, the Canadian corporation will be considered a CFC, so the PFIC rules do not apply to them.

If you're a U.S. shareholder and you own, directly or indirectly, 50% or more of the value of a CFC that invests in PFICs, there are look-through rules that apply the PFIC rules to you for the PFIC investments owned by the CFC.

For example, you may own all the shares of a Canadian holding company that's a CFC, and that company invests in Canadian mutual funds that are PFICs. In this case, you're subject to the PFIC rules for the investments held by the Canadian holding company.

If you own shares of a corporation that's a PFIC, investments by that corporation that are PFICs will be attributed to you, even if you don't own 50% of that company.

A detailed discussion of the CFC rules is beyond the scope of this article. Speak to a qualified tax advisor for more information.

Exception to PFIC status for startups or a change of business

There are exceptions to PFIC status for shares of a foreign corporation that only qualify as PFICs in the startup year, or in a year the corporation undergoes a change of business.

Start-up exception: This exception provides that a foreign corporation will not be treated as a PFIC for the first taxable year the corporation has gross income (the start-up year), provided that: no predecessor of the corporation was a PFIC, the corporation establishes to the satisfaction of the Internal Revenue Service (IRS) that the corporation will not be a PFIC for either of the first two tax years following the start-up year, and the corporation actually does not meet the PFIC tests for either of the first two tax years following the start-up year.

Change of business exception: This exception provides that the foreign corporation is not treated as a PFIC for any taxable year if: neither the foreign corporation nor a predecessor was a PFIC in any prior taxable year, the foreign corporation establishes to the satisfaction of the IRS that substantially all of its passive income for the tax year is attributable to proceeds from the disposition of one or more active trades or businesses and it does not expect to meet the income and asset test for either of the two succeeding tax years, and it actually does not meet these tests in those two years.

A detailed discussion of these two exceptions is beyond the scope of this article. Please ask a qualified tax advisor for more information.

Examples of investments that are PFICs

This is not an exhaustive listing:

- **Canadian mutual funds, pooled funds and ETFs** – Given the nature of the income generated and the assets held, these investments, whether set up as trusts or corporations, will generally qualify as foreign corporations for U.S. tax purposes and will meet at least one of the PFIC tests.

If you own shares of a corporation that's a PFIC, investments by that corporation that are PFICs will be attributed to you, even if you don't own 50% of that company.

It's important to check whether the corporation or fund has provided any information regarding the security's PFIC status (often published in an investor relations section on their website) and whether the corporation or fund provides annual information statements (discussed later). In some cases, the corporation or fund may have elected for U.S. tax purposes to be taxed in the U.S. as a partnership, which means it may not itself be a PFIC; however, it could still expose you to the PFIC rules if it invests in PFICs.

- **Canadian income trusts and Canadian REITs** – These investments qualify as foreign corporations, and many do not carry on an active business. For example, REITs often outsource the management of their real estate inventories, so they will qualify as PFICs. If the REITs use their own employees to actively manage and operate their real estate business, it's possible they may not meet the income or asset tests and will not qualify as PFICs. You will have to check the status annually (apply the PFIC tests) to confirm that the investment continues to not be a PFIC. Often, a REIT or income trust cannot confirm its status as a PFIC.
- **Shares of a private Canadian corporation** – If a private corporation does not carry on an active business, and primarily earns passive income or holds passive assets (e.g., a Canadian investment holding company), the shares will likely qualify as PFICs. Due to look-through rules discussed earlier, you may need to consider both the holding company and any other companies it owns as a consolidated group to determine it meets the income or asset tests. If the holding company is a PFIC to you, any PFICs owned by that holding company will be attributed to you. If the holding company qualifies as a CFC, the PFIC rules may not apply; however, if you own at least 50% of the value the shares of a CFC, the PFIC rules can apply to any investments held by the CFC that qualify as PFICs.
- **Segregated funds, hedge funds and private equity funds** – Each of these types of investments could potentially qualify as PFICs. If the fund itself cannot confirm, you will need to seek tax advice from a qualified tax professional to confirm. It may be very difficult to obtain the information to confirm its status.

Examples of investments that are not PFICs

- **Shares of active private or publicly traded foreign corporations (including common or preferred shares)** – Companies that carry on an active trade or business will generally not meet the income or asset test and will not qualify as PFICs. For private company stock, you must also consider whether the CFC rules apply.
- **Corporate bonds and other debt of foreign corporations that don't qualify as PFICs** – If you invest in corporate bonds and other debt investments of a foreign corporation that itself is not a PFIC, then generally these investments should not qualify as a PFIC. Note that if the bond is convertible to the stock of a PFIC, the bond may be considered to be a PFIC.
- **Shares of U.S. private or publicly traded corporations (including common or preferred shares)** – If you invest in the stock of U.S. corporations, these investments are not PFICs. However, depending on the type of U.S. corporate structure, you, or the U.S. corporate structure itself, will be subject to the PFIC rules if the U.S. corporate structured invests in PFICs.
- **U.S. domiciled iShares or REITs** – Since these investments are domiciled in the U.S., they are not PFICs. However, it's very important to confirm with the fund whether there's exposure to the PFIC rules through indirect ownership of PFIC investments through these investments.
- **Canadian bank, insurance company and securities dealers** – Investments in shares of Canadian banks, insurance companies and securities dealers that are licensed to conduct their business in the U.S. are generally exempt from the PFIC rules. Investments in these types of foreign entities that are not licensed to do business in the U.S. may be considered an investment in a PFIC. However, there are proposed rules that provide exemptions that would treat the passive income earned by these entities as active income for purposes of the PFIC tests. Therefore, investing in the stock and bonds of these foreign entities would generally not qualify as PFICs.

If you're not certain whether a particular investment is a PFIC, consult with a qualified tax advisor before purchasing the investment.

U.S. taxation of PFICs

Investing in a PFIC subjects you to adverse U.S. tax treatment, significant additional costs for tax compliance and possible interest penalties. There are three distinct tax regimes that can apply when you invest in a PFIC. The default and perhaps the one with the most adverse tax implications is the **excess distribution** regime. You might be able to elect to have either of these two more favourable tax regimes apply instead: the **Qualified Electing Fund (QEF)** or the **Mark-to-Market** regimes. The particular regime that applies will determine the nature and timing of the income inclusion for you. It will also determine the character of any gain or loss on the sale of the investment.

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Excess distribution regime

This is the default tax regime. The purpose of this regime is to approximate the tax that would have been imposed if the PFIC had distributed all income earned each year on a current-year basis. The rules under this regime are quite intricate and the tax implications can be quite punitive. A detailed explanation of the excess distribution regime rules is beyond the scope of this article.

In general, you're not subject to tax in the U.S. until there's a distribution from the PFIC or the PFIC is sold (or deemed to be sold). At that time, the taxable amount is broken into two parts: an amount that's taxed in the current year as ordinary income and the "excess distribution amount."

The calculation of the excess distribution amount is complex. An excess distribution includes all of the gain triggered on a sale of the PFIC, as well as the part, if any, of a current year's distribution from the PFIC that exceeds 125% of the average actual distributions received in the three preceding years (or the shorter period for which the U.S. person has held its stock if less than three years). The total excess distribution amount is allocated on a pro rata basis over the period of the taxpayer's investment in the PFIC. Amounts allocated to the current year or years in which the investment was not a PFIC are taxed as ordinary income earned during the year (subject to graduated tax rates). Amounts allocated to prior PFIC tax years are taxed at the maximum federal marginal tax rate plus an interest charge for the period the tax was outstanding. The preferential tax rates that normally would apply to certain types of income, such as qualified dividends and long-term capital gains, do not apply.

As an example, if you invest in a PFIC (e.g., Canadian mutual fund) on January 1 of Year 1 and on December 31 of Year 5, you receive a $600 distribution and $400 of it qualifies as an excess distribution; the $200 that does not qualify as an excess distribution is subject to U.S. tax based on regular graduated U.S. tax rates in Year 5. The $400 excess distribution is allocated ratably over the 5-year holding period. Therefore, $80 is allocated to each of Year 1 to 5. The $80 allocated to Year 5 is subject to U.S. tax based on regular graduated U.S. tax rates. The $80 allocated to Year 1 to Year 4 is subject to U.S. tax at the top marginal tax rate applicable to those tax years, plus an interest charge because the tax liability associated with that tax year has not been paid yet. The income allocated to Year 1 to 4 is not included in Year 5 income, but any outstanding tax and interest penalties for Year 1 to 4 is included on the tax return for Year 5 and is added to the tax liability for that year. If the mutual fund was disposed of, resulting in a capital gain, the tax implications would be worse because the entire gain is an excess distribution. The portion allocated to the current year is taxed at graduated tax rates; the portion allocated to previous years is taxed at the top marginal tax rate plus interest penalties.

It is possible to claim a foreign tax credit on your U.S. tax return for Canadian income tax paid. However, the effective U.S. tax rate together with the penalties may significantly exceed the Canadian taxes paid, which might result in an unsatisfactory after-tax rate of return.

QEF and Mark-to-Market regimes

Instead of the excess distribution regime, you may be able to elect to have the QEF regime apply to the PFIC investment. If you can't elect to have the QEF regime apply, you may be able to elect to have the mark-to-market regime apply. Both alternative regimes accelerate the timing of your tax obligations; however, you're not subject to the interest charge and the higher U.S. tax that often applies under the excess distribution regime.

The ability to make these elections does not mean the PFIC investment is a good choice, relative to other investment choices. You should take into consideration the compliance costs and after-tax returns relative to alternative investments that are not PFICs.

QEF regime

To be able to make a QEF election, the PFIC must provide an annual information statement, which provides a breakdown of the ordinary income and net capital gains. Under the QEF regime, you must include on your U.S. tax return, a pro rata share of the PFIC's ordinary earnings and net capital gains regardless of whether the PFIC has actually made a distribution of those earnings in that particular year. If there's no distribution, there are rules that allow you elect to defer the actual payment of the tax liability that arises from the QEF inclusion, but the deferred tax is subject to an interest charge. Ask a qualified tax advisor for more information.

It is possible to claim a foreign tax credit on your U.S. tax return for Canadian income tax paid. However, the effective U.S. tax rate together with the penalties may significantly exceed the Canadian taxes paid, which might result in an unsatisfactory after-tax rate of return.

While the QEF election accelerates the timing of the income inclusion, the income is taxed at more favourable tax rates. Graduated U.S. tax rates apply to the portion that qualifies as ordinary income and preferable U.S. tax rates on long-term capital gains apply to the portion that qualifies as net long-term capital gains.

The amounts reported on your U.S. tax return may not be the same as amounts reported on your Canadian tax slips and included in your return. However, if a PFIC is structured as a trust, the income inclusion on your Canadian return may somewhat mirror the amounts included on your U.S. return. This is because trusts allocate their income and capital gains to their unitholders annually as compared to corporations, which may retain their earnings and profits. As such, there may be an advantage to investing in PFICs that are structured as trusts versus corporations.

When you make a QEF election, you must adjust your cost base in the PFIC annually for U.S. income tax purposes. The cost base is increased by the income included on your U.S. income tax return. It's decreased by distributions to the extent they include previously taxed amounts. When you receive an actual distribution from a PFIC, it's not treated as a dividend and is received tax-free to the extent the amount was already included in your income and forms part of your cost base. Any portion of the distribution that's in excess of your cost base is treated as a taxable gain from the sale or exchange of property. It's important to track prior years' income inclusions and distributions to support what portion of the current-year distribution is tax-free versus taxable.

You should make a QEF election in the first tax year you acquire a PFIC investment. This is referred to as a "pedigreed" QEF. If you fail to make the election in the first year, you should speak to a qualified tax advisor to determine your options for filing a late or often referred to as a "retroactive" election or a "purging" election. The IRS will only allow a retroactive election in very limited circumstances. If you make a QEF election in a year after the first PFIC year, the QEF becomes an "unpedigreed" QEF. An unpedigreed QEF is subject to both the QEF rules and the excess-distribution rules. To create a "pedigreed" QEF that is subject only to the QEF rules, the owner must purge the PFIC taint by making (depending on the circumstances) either a deemed-dividend election or a deemed-sale election (a purging election). In general, a purging election allows you to deem the PFIC as being sold on the day before the election is made and applies the excess distribution regime up to that point and the QEF treatment going forward. A discussion of the details regarding filing a retroactive election or purging election are beyond the scope of this article.

Mark-to-Market regime

While the QEF regime would be the preferred alternative to the excess distribution regime, if the PFIC does not provide annual information statements, it will not be possible to make a QEF election. The Mark-to-Market election is the only viable alternative, provided the PFIC is marketable. Marketable securities include securities regularly traded on recognized U.S. or foreign securities exchanges. It's important to clarify with a qualified tax advisor as to whether your investment qualifies as a marketable security. This election will apply to the tax year for which the taxpayer makes it and all subsequent years, unless the PFIC ceases to be marketable or the IRS consents to revocation of the election. The election should be made in the first taxation year you acquire the PFIC because a retroactive election is very rarely permitted. Speak to a qualified tax advisor for more information.

Even though you've not actually sold the PFIC, this regime requires you to recognize changes in the stock's value over the course of the year (i.e., year-over-year unrealized gains or losses) as if you sold the stock on the last day of the calendar year. If the value of the stock increased over the year, the excess of the end-of-year value over the adjusted cost basis is included in your gross income. This gain is treated as ordinary income and is taxed at graduated tax rates. If the stock decreases in value, the recognition of losses in such transactions is more complex and is based in part on keeping track of a running balance of gains and losses from the fictional sale each year. A discussion of the mechanics of loss recognition under this tax regime is beyond the scope of this article. Please consult with a qualified tax advisor for more information.

Since Canadian tax is not triggered until you dispose or are deemed to dispose of the PFIC, there may be double tax that arises because you can't claim a foreign tax credit on your U.S. tax return for Canadian tax incurred in later years. However, you may have excess foreign tax credits from foreign tax paid in earlier years that you have carried forward and can be used on your U.S. income tax return, which may mitigate double taxation.

While the QEF regime would be the preferred alternative to the excess distribution regime, if the PFIC does not provide annual information statements, it will not be possible to make a QEF election. The Mark-to-Market election is the only viable alternative, provided the PFIC is marketable.

Deemed Sale of a PFIC

A deemed sale of your PFIC shares may occur for U.S. tax purposes if you gift your PFIC shares, terminate U.S. residence or relinquish U.S. citizenship.

Annual compliance requirements and penalties

Under each of the three tax regimes, there's an annual compliance requirement to file IRS Form 8621 – *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*. This form is also used to make an election to have the QEF or mark-to-market regimes apply instead of the excess distribution regime. The additional fees incurred to pay to have these forms completed can be significant depending on how many PFICs you own, since a separate IRS Form 8621 must be filed for each PFIC.

While there's no specific monetary penalties for failure to file Form 8621, this form is coordinated with Form 8938 filing requirements. Therefore, it's possible if you don't file Form 8621, you might have to disclose ownership of your PFICs on IRS Form 8938 – *Statement of Foreign Financial Assets*. Failure to disclose the PFIC on these forms may result in a US$10,000 penalty. If you file Form 8621 late, you may have an income tax liability on which penalties for late payment can apply. Also, failure to file Form 8621 can result in the suspension of the statute of limitations. This would result in the IRS having unlimited amount of time to audit your U.S. tax return and assess tax if you failed to report income.

Exceptions to the annual filing requirements

The following are some of the exceptions to the annual PFIC filing requirements:

Dual-resident exception – A green-card holder treated as a resident of Canada under the Canada-U.S. tax treaty tie-breaker rules is exempt from annual PFIC reporting, provided they have properly filed Form 8833 – *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)*. However, using the treaty tie-breaker rules may not be ideal for U.S. green-card holders living in Canada. Speak to a qualified tax professional before claiming this exemption to avoid the PFIC rules.

De minimis holdings exception – There is an exception to PFIC reporting if the aggregate year-end value of all PFICs you own does not exceed US$25,000 (US$50,000 if married filing jointly). This exception is available in a particular year only if you're filing under the excess distribution regime and there's no excess distribution or disposition of PFICs during that particular year. The calculation of the year-end value of all PFICs includes the aggregate value of all PFICs held directly, some held indirectly, and those for which a QEF or Mark-to-Market election has been made. Since the rules for determining the ownership of PFICs are complicated by including those owned indirectly (e.g., through partnerships, corporations or trusts), determining whether you qualify for the de minimis holdings exception may be very difficult. Speak to a qualified tax professional for assistance in determining your eligibility for this exception. Note that this exception applies to a given year, and it does not provide any relief from the PFIC reporting and taxation in years where there are distributions made from the PFIC or the PFIC is sold.

RRSP/RRIF and other foreign pension plans exception – There is an exemption from annual PFIC reporting with respect to PFICs held in a foreign trust that's a foreign pension fund operated principally to provide pension or retirement benefits, and pursuant to a tax treaty, the income earned by the pension fund may be taxed as the income of the U.S. person only upon a distribution to the U.S. person.

For this reason, many tax advisors believe that PFICs held in a Canadian retirement savings plan, such as registered pension plans, individual pension plans, registered retirement savings plans, registered retirement income funds, locked-in RRSPs, life income funds and other similar types of retirement plans, are generally exempt from the annual PFIC reporting requirements. Many tax advisors interpret this to mean that the PFIC rules do not apply to these plans even when there are distributions from these plans. However, some tax advisors have a different interpretation regarding the application of the PFIC rules when there's distribution from the plan. Therefore, speak to a qualified tax professional for tax advice.

Registered education savings plans, tax-free savings accounts, and registered disability savings plans are not foreign pension plans; therefore, PFICs held in these accounts are not exempt from the PFIC rules and annual reporting requirements.

Short-term ownership exception – There is an exception to PFIC reporting with respect to PFICs owned for 30 days or less that were acquired during the tax year or in the immediately preceding tax year, provided you did not receive an excess distribution and did not make any elections in respect of the PFIC.

Evaluating your exposure to the PFIC rules

The PFIC rules are complex and may result in punitive tax without careful consideration of filing appropriate tax elections. The tax and compliance costs of annual reporting should be considered when evaluating your financial goals and the overall return on your investment. You should seek advice from a qualified tax professional before investing in PFICs.