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Passive Foreign Investment Company (PFIC) rules

U.S. tax rules may significantly affect U.S. investors

The Passive Foreign Investment Company (PFIC) rules are designed to prevent U.S. persons from deferring tax on passive income earned through non-U.S. corporations, or from converting this income into capital gains that are taxed at preferential rates. A PFIC is a non-U.S. corporation (including non-U.S. mutual fund trusts and non-U.S. pooled fund trusts) which is primarily invested in passive assets or generally earns passive income. Examples of securities that are classified as PFICs are Canadian mutual funds, Canadian pooled funds, Canadian Exchange Traded Funds (ETFs) and many Canadian income trusts or real estate investment trusts (REITs).

As a result of the PFIC rules, income from a PFIC may be treated as ordinary income for U.S. tax purposes which is subject to U.S. 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. This article discusses options to mitigate the PFIC tax consequences and describes the annual U.S. tax filing requirements if a U.S. investor holds a PFIC at any time during the year.

The information in this article is intended to provide information for Canadian residents who are U.S. persons, however, the PFIC rules apply to U.S. persons no matter where in the world they reside. The information is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax advisor before acting on any of the information in this article.

Do the PFIC rules apply to you?

Only U.S. persons are affected by the PFIC rules. A U.S. person includes a U.S. citizen, U.S. green card holder and U.S. resident. A Canadian who spends a significant amount of time in the U.S. (i.e. more than 183 days in the calendar year) may be considered to be a U.S. person for purposes of the PFIC rules. If your spouse is not a U.S. person consider having your spouse invest in the PFIC instead.

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What is a PFIC?

A non-U.S. corporation held by a U.S. person is considered to be a PFIC if it meets one of the following tests:

1) Income test - 75% or more of gross income in a particular year is from passive income (e.g. dividends, interest, royalties, rents or annuities, etc.); or

2) Asset test - The average value of the passive assets (e.g., cash, bonds, stocks, etc.) accounts for 50% or more of the total assets of the corporation.

Which investments may be PFICs?

The PFIC tests must be applied annually. It is possible that an investment may not qualify as a PFIC one year, but qualify as a PFIC in a subsequent year. You should consider this when choosing investments that have the potential to change status (e.g. income trusts or REITs). If you are not certain whether a particular investment is a PFIC, consult with a qualified tax advisor before acting.

- Canadian mutual fund trusts, mutual fund corporations and pooled funds are considered to be corporations for U.S. tax purposes. As these securities primarily hold investments that are passive in nature they are generally considered to be PFICs.

- Exchange Trade Funds (ETFs) listed on a Canadian stock exchange are generally PFICs; however, ETFs listed on a U.S. stock exchange that are set up as U.S. domestic entities are not.

- Shares of a private corporation that does not carry on an active business, but holds passive investments, such as a Canadian holding company, will be considered to be a PFIC (whether or not the investments in the holding company themselves are PFICs).

- Canadian income trusts and Canadian real estate investment trusts (REITs) that do not primarily carry on an active business are PFICs. However, it is possible that a REIT that engages in active business activities may not be considered a PFIC. An example of such a REIT is one that carries on an active real estate business and uses its own employees to operate and manage the real estate properties (rather than contracting out the property management). Where the REIT or income trust cannot confirm its status as a PFIC, ask your tax advisor to make this assessment.

- It is uncertain whether segregated funds are PFICs. The IRS has not provided clarity on this matter. Accordingly, if you are a U.S. person speak to your tax advisor before investing in a segregated fund.

- Consider investing directly in publicly traded stock and bonds of non-U.S. corporations as they are generally not considered PFICs if the issuing company primarily carries on active business and does not meet the PFIC tests.

U.S. taxation for holders of PFICs

U.S. investors holding a PFIC at any time in the year may be taxable under one of three possible taxation regimes: excess distribution, Qualified Electing Fund (QEF) or mark-to-market. The excess distribution regime is the default taxation regime. However, you may elect to have either one of the other two possible tax regimes apply.

Excess distribution regime

The excess distribution regime permits a deferral of U.S. tax until earnings are distributed or the PFIC is sold. However, when a distribution occurs or the PFIC is disposed of there are unfavourable U.S. tax consequences. The distribution is broken into two parts: an amount taxed in the current year as ordinary income and an "excess distribution amount" subject to unfavourable U.S. tax treatment.

The excess distribution amount is a complex calculation, however it is generally composed of: 1) any gain from the sale of the PFIC; and 2) distributions to the extent that the total of actual distributions during the year exceeds 125% of the average actual distributions received in the three preceding years.

The excess distribution 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 U.S. graduated tax rates). Amounts allocated to prior tax years are taxed at the maximum federal marginal tax rate (currently 39.6%) plus an interest charge for the period the tax was outstanding. Note: preferential tax rates for qualified dividends and long-term capital gains (i.e. currently 15% or 20% depending on your income level) would not apply.

It may be possible to claim a foreign tax credit on your U.S. tax return for Canadian income tax paid related to the PFIC. However, the effective U.S. tax rate may exceed the Canadian tax rate for certain types of income such as capital gains or dividends (depending on the province or territory).

Qualified Electing Fund (QEF) and Mark-to-Market regimes

You may elect to have the QEF or Mark-to-Market regime apply by filing IRS Form 8621 *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*. These alternative tax regimes recognize the share of the PFIC earnings or appreciation in value as taxable income each year. While both of these alternative regimes will accelerate the timing of your tax obligations, they will avoid the interest charge and potentially higher tax that would otherwise apply under the default regime.

The QEF regime requires that the U.S. person include in their gross income a pro rata share of the PFIC's earnings and profits for the year. These are classified into either ordinary income or capital gains depending upon the underlying income of the PFIC. A U.S. person must generally make the QEF election in the first year of investment in the PFIC. If the PFIC does not provide an annual information statement, it may not be possible to make the election.

The Mark-to-Market regime requires the U.S. person to recognize a gain or loss on the PFIC each year as if the U.S. person sold the PFIC at fair market value at the end of the taxation year. However, this gain is treated as ordinary income (a loss would be treated as an ordinary income loss). Also, since Canadian taxation may not occur in the same year, double taxation may result due to the inability to claim foreign tax credits.

You should seek advice from your tax advisor regarding your option to make these elections and what is right in your particular circumstances.

U.S. income tax filing requirements

Starting in 2013, all U.S. persons who directly or indirectly own shares in a PFIC at any time during the year are required to annually file IRS Form 8621, even if distributions are not received. Previously, IRS Form 8621 was required only when 1) distributions were made from the PFIC; 2) the taxpayer wanted to make an election for an alternative taxation regime; or, 3) the PFIC was sold. A separate form must be filed for each PFIC owned, unless an exception applies. Additional fees may be incurred to have these forms prepared by your tax advisor.

The new regulations provide a list of exceptions to the annual PFIC reporting requirement. Two of these exceptions apply to: 1) PFIC holdings with a total year-end value that is small (de minimis holdings exception); and 2) PFICs held in non-U.S. pension plans.

De Minimis Holdings exception

Annual PFIC reporting does not apply if the year-end value of all PFICs owned by a U.S. person does not exceed US$25,000 (US$50,000 if married filing jointly). This reporting exception is available only if no elections have been made to have an alternative taxation regime apply, such as the QEF or Mark-to-Market regimes and no excess distributions from or dispositions of the PFIC have occurred during the year.

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 difficult. Therefore, you should ask your tax advisor for assistance in determining your eligibility.

It should be noted that even if this reporting exception applies in a given year, it does not provide any relief from the general PFIC taxation rules that may apply to distributions made from the PFIC or the disposition of the PFIC itself.

Foreign pension plans exception

Annual PFIC reporting does not apply to PFICs held in foreign pension plans (including Individual Retirement Arrangements) where the taxation of income earned in the foreign plan is deferred, under the Canada-U.S. tax treaty (Treaty), until distributions

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are made from the plan. For this reason, PFICs held in a Canadian Registered Pension Plan (RPP) or Individual Pension Plan (IPP) are generally exempt from the annual PFIC reporting requirement. PFICs held in a Registered Retirement Savings Plans (RRSP) or Registered Retirement Income Fund (RRIF) may also be exempt from the PFIC annual reporting requirements. It is important to note that there may be different interpretations among tax advisors as to whether the excess distribution regime will apply when the PFIC is sold within or withdrawn from the RRSP/RRIF. Therefore, speak to your tax advisor for advice regarding the PFIC reporting requirements before acquiring a PFIC in your RRSP/RRIF.

Note: The IRS no longer requires the filing of IRS Form 8891 *U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans* to request a deferral under the Treaty. Also, Registered Education Savings Plans (RESPs), Tax-Free Savings Accounts (TFSAs) and Registered Disability Savings Plans (RDSPs) are not foreign pension plans; therefore they are not exempt from the PFIC annual reporting requirements.

Evaluating your investment in PFICs

The PFIC rules are complex in nature and the resulting tax implications can vary from investor to investor. The potential additional costs of holding PFIC investments should be considered when evaluating the potential return on your investment.