Applicability of U.S. passive foreign investment company (PFIC) rules to Canadian mutual funds

The United States PFIC rules require information disclosure and detailed income reporting for certain foreign investment structures owned by U.S. persons. U.S. tax administration is generally under that country's Internal Revenue Service (IRS).

Pursuant to an IRS letter ruling from January 22, 2010, non-U.S. mutual funds held by U.S. persons are now considered PFICs. Accordingly, a Canadian mutual fund or exchange-traded fund (whether in the legal form of a trust or corporation) will be treated by the IRS as a PFIC if either of the following tests is satisfied:

1. Income test: 75% or more of gross income for the year is passive income
2. Asset test: 50% or more of the assets for the year are held for the purpose of producing passive income

Reporting obligation

A U.S. person includes a U.S. citizen or resident alien ("green card" holder) of the United States, as well as domestic corporations, estates and partnerships. (Note that the IRS may consider a person to be a resident alien for tax purposes, even though that person no longer resides in the U.S.)

U.S. persons are generally required to report worldwide income to the IRS. Further, a unique reporting and taxation regime applies to PFIC holdings.

Assuming a U.S. person holds a Canadian mutual fund that meets the definition of a PFIC, he or she is required to annually report the PFICs that he or she holds using IRS Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*. An individual form must be filed for every PFIC the U.S. person owns. Form 8621 should be filed with the individual's U.S. tax return, which is generally due by April 15 every year.

Tax treatment

There are three methods of PFIC reporting available for U.S. persons.

Qualified Electing Fund (QEF) election

The U.S. person may elect to annually report and be taxed upon his or her pro rata share of the PFIC's earnings and net capital gains. At the first such election, the PFIC is generally deemed to have been sold at fair market value (FMV), with accrued gains from prior years realized and taxed as ordinary income.

A PFIC annual information statement containing the QEF details is required from the mutual fund company in order to make this election. The taxpayer's accountant would use this information to complete and file Form 8621 each year.

Mark-to-market election

The U.S. person includes in his or her income the excess/decline of the PFIC's FMV over its adjusted basis (FMV of the PFIC at the end of the previous year). This election treats the mutual fund as being disposed for tax purposes at the end of every taxation year. The inclusion is regular income or regular loss.

Numerous qualification criteria (beyond the scope of this brief) must be satisfied in order to make this election.

Excess distribution method

If the taxpayer chooses not to make an election or takes no action, the PFIC will be treated as a 1291 fund (per section 1291 of the *Internal Revenue Code*), and a complex tax treatment ensues.

Distributed income is taxed in the normal way. Punitive rules apply to annual "excess distributions" that exceed 125% of the average distributions over the preceding three taxation years. Generally, this will capture proceeds of disposition. This is not treated as a capital gain, but instead is charged at the highest U.S. tax rate at the time, apportioning the gains over the holding period years and applying an interest-charge levy for implied underpaid taxes.

Application to registered retirement savings plans (RRSPs) or registered retirement income funds (RRIFs)?

Previously, to benefit from the tax-sheltering in an RRSP/RRIF a U.S. person must have filed, on an annual basis, IRS Form 8891, *U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans*. On October 7, 2014, the IRS issued a revenue procedure which eliminates the need to file Form 8891 to benefit from the tax-sheltering. The new procedure is effective January 2015 and will apply automatically even if the individual has failed to file Form 8891 in previous taxation years, provided the individual has been (and continues to be) compliant with his/her U.S. tax-filing obligations. On this latter point, individuals must have attempted compliance for each taxable year or request IRS approval to late-file an election, with failure to comply resulting in onerous penalties. Note that since 2012, an interest in a RRSP or RRIF must have been reported on IRS Form 8938, *Statement of Specified Foreign Financial Assets* in conjunction with Form 8891.

Beginning in 2014, the IRS no longer required individuals who hold an interest in an RRSP or RRIF plan and who are required to file Form 8938 to complete Form 8891. On a go-forward basis, it appears that where the exemption to file Form 8891 applies, IRS Form 8938 or FinCEN (U.S. Treasury's Financial Crimes Enforcement Network) Form 114, *Report of Foreign Bank and Financial Accounts* must be used to disclose an interest in an RRSP or RRIF.

Invesco Canada Ltd. (Invesco) mutual funds

Invesco is obligated to comply with Canadian financial and tax reporting rules. We have taken the position that adding a further layer of compliance under U.S. tax rules would add significant cost, without a clear indication that there is a net benefit to investors.

As a result, we will not issue Annual Information Statements for the QEF election. We will monitor developments in this area and continue to periodically review our position on PFIC reporting in future years.

Further questions?

U.S. tax issues for Canadian residents can be complex, so it may be prudent to refer clients to a U.S. tax expert.

If you would like to learn more about how U.S. tax rules may affect your Canadian clients, you may wish to review our Tax & Estate bulletins titled *United States tax compliance issues for Canadian residents – Glossary* and *U.S. estate tax planning for Canadians*.

For more information about this topic, contact your advisor, call us at 1.800.874.6275 or visit our website at www.invesco.ca.

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