PASSIVE FOREIGN INVESTMENT COMPANY (PFIC) REPORTING FOR U.S. PERSONS

In 2019, CI Investments annually provides PFIC Annual Information Statements (AIS) for its clients who are U.S. persons and who own CI funds. The AIS is required in order to make the Qualified Electing Fund (QEF) election and for ongoing U.S. income tax reporting.

CI wants to make U.S. tax and information reporting of its funds as straightforward and cost-effective as possible for its U.S. person clients. The QEF election is the most favourable, least onerous method for reporting PFIC details for US income tax purposes for US persons who own Canadian mutual funds outside of registered retirement savings plans (RRSPs) and registered retirement income funds (RRIFs)

This document will provide you with some context and background about PFICs, related implications and what it means for your clients. There are two key points to remember:

- Even an AIS from a Canadian PFIC, a U.S. person owning a Canadian mutual fund unit or share is still required to elect on a timely basis to utilize the QEF election and is still subject to annual PFIC reporting, which leads to additional compliance costs.
- With the implementation of Foreign Account Tax Compliance Act (FATCA) in 2014, it is clear that the IRS will be aware of U.S. persons owning PFICs and is pursuing the compliance of such.

BACKGROUND

In the late 1980s, the U.S. Congress implemented the PFIC tax regime, which targets passive foreign investments held by U.S. persons. The goal of the regime is to curb the extent to which US persons can defer US taxation by investing within foreign corporations. While these tax rules are not new, the IRS is taking a much more aggressive stance in administering them. Included in these tax rules is the definition of a PFIC, the calculation and treatment of income from a PFIC, and the required annual information reporting related to owning a PFIC.

PFIC DEFINED

A PFIC is defined as a foreign corporation (including certain types of trusts or other entities that are considered corporations under U.S. tax rules) that meets at least one of the following tests:

- The Income Test – 75% or more of its income is derived from passive sources; or
- The Asset Test – 50% of the average FMV of the assets of the corporation held during the year are passive in nature.

From a Canadian standpoint, typical examples of PFIC include:

- Units of a Canadian mutual fund trust;
- Shares of a Canadian mutual fund corporation (Corporate Class);
- Units of a Canadian exchange traded fund (ETF);
- Shares of a Canadian investment holding company in certain circumstances.

The default income tax and reporting rules for PFICs are onerous and punitive. All income distributions and capital gains realized may be treated as “excess distributions” and taxed at the highest ordinary income rates, rather than the preferential qualified dividend and capital gains tax rates. In addition, income or gains may be prorated or reallocated over different tax years, triggering significant tax and interest for years not previously reported.

There are two elections that U.S. persons can consider to avoid the application of the above excess distributions punitive taxation regime:

1. The Mark-to-Market election; and
2. Qualified Electing Fund (QEF) election.

MARK-TO-MARKET ELECTION

The Mark-to-Market election simply implies the U.S. person is deemed to have disposed of the PFIC units or shares annually to recognize any gain on the units or shares that have accrued throughout the year. The Mark-to-Market election is available where the units or shares are traded on a public stock exchange or the FMV can be readily determined.

With the Mark-to-Market election, all deemed gains from the units or shares are treated as ordinary income. Losses associated with a decline in value of units or shares may be recognized but only to the extent a Mark-to-Market gain for the units or shares was recognized in a prior year.

The Mark-to-Market election is generally used where the QEF election is not available and the U.S. person wants to avoid the punitive excess distributions tax regime.

QUALIFIED ELECTING FUND (QEF) ELECTION

When a Canadian mutual fund manager such as CI GAM provides a PFIC AIS, its U.S. unitholders or shareholders can elect to make the QEF election for income tax and information reporting purposes. It is important to keep in mind that U.S. persons cannot make the QEF election without the AIS and once the QEF election has been made for a particular fund, it remains in effect for all future years, provided the US person files form 8621 (discussed later) each year..

The PFIC AIS sets out the investor's pro-rata share of a fund's ordinary earnings, net capital gains and other distribution information in accordance with U.S. tax legislation. Simply put, fund income and net gains are converted from Canadian reporting and tax basis to U.S. reporting and tax basis and such income reported on the AIS is reported on the U.S. person's U.S. tax return assuming the investor has made the QEF election.

With CI GAM providing the PFIC AIS annually, clients who are U.S. persons can make the QEF election and avoid the onerous and punitive excess distributions regime. Also, while income would normally be taxed as ordinary income, where applicable, capital gains would retain it's character and receive preferential tax treatment.

In the instance the QEF election was not made in the first year the U.S. person owned the fund, the "tainted" PFIC continues to be subject to the punitive excess distributions tax regime. The U.S. person can "purge" the "tainted" PFIC by electing to dispose of the fund units or shares and immediately requiring them while making the QEF election. While any deemed gain from the elected disposition would normally be subject to tax based on the excess distributions regime, on a go-forward basis. The fund units or shares would no longer be subject to the punitive tax regime pursuant to the QEF election made. It is advisable to work with a competent cross border tax advisor to calculate relevant income taxes in these circumstances. For most U.S. persons, it is anticipated that making the QEF election will be beneficial from a U.S. tax perspective.

FORM 8621: INFORMATION RETURN BY A SHAREHOLDER OF A PASSIVE FOREIGN INVESTMENT COMPANY OR QUALIFIED ELECTING FUND

With limited exceptions, every U.S. person must complete Form 8621 and submit with their respective tax return annually, **per PFIC fund** by their respective tax filing deadline.

As well, where a PFIC holds another fund that is a PFIC, the U.S. person must complete a separate Form 8621 for the indirectly held PFIC. One such example of this scenario is a Canadian "fund of fund" investment solution.

The IRS website has instructions on how to complete Form 8621 at: http://www.irs.gov/pub/irs-pdf/i8621.pdf.

Temporary regulations provide that U.S. persons owning PFICs through foreign pension funds are exempt from PFIC annual reporting requirements if the foreign pension fund operates principally to provide pension or retirement benefits in a country that has negotiated an income tax convention with the United States and such income of the pension fund is exempt from taxation until the income is paid to, or for the benefit of, the owner. As Canada has such a tax treaty with the United States, Canadian mutual funds held in RRSPs, RRIFs or other RRPs are exempt from PFIC reporting. Please note that the U.S. has not recognized RDSPs, RESPs, or TFSAs as foreign pension plans at this time, and therefore are not exempt from PFIC reporting. In fact, in addition to PFIC filings, these plans often require other U.S. tax and information filings.

FAQS

1. What does this mean for U.S. person clients who hold Canadian mutual funds?

U.S. persons (by virtue of citizenship, green card or US residency) are required to complete a 1040 U.S. Individual Income Tax Return annually along with information reporting forms relevant to their financial accounts or assets.

When a U.S. person owns a unit or share of a Canadian mutual fund, they will have to complete Form 862, Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund. The form must be completed and submitted with the U.S. person's respective tax return annually for each PFIC fund owned by the respective tax filing deadline.

2. What action, if any, should U.S. person clients take if they hold Canadian mutual funds?

With QEF election data being made available by a number of fund companies, U.S. persons owning a Canadian mutual fund unit or share can consider a Form 8621 would normally be used to request the election, adding to compliance costs.

U.S. persons residing in Canada should work with a competent cross-border tax advisor who is familiar with the various U.S. income and information return obligations relating to the various Canadian investment account structures to ensure all income and information is reported completely and correctly.

3. Is there a difference between CI GAM's mutual fund trust and Corporate Class funds?

While each mutual fund corporation is different, since 2017 our view is that, generally, there is no material difference between class and trust funds for US PFIC purposes. Both are considered PFICs and are treated largely the same for US tax purposes. There may be slight differences between the structures due to the ability of corporate class funds to share expenses across the entire mutual fund corporation (whereas trust funds do not have this benefit), but in many cases the differences are not material for US tax reporting purposes.

Prior to 2017, there was a greater benefit for mutual fund trusts in that they allowed US taxpayers to avoid administrative challenges with cost base calculations when corporate class tax-deferred switching created misalignments for Canadian and US tax purposes. With the elimination of tax-deferred switching between corporate class funds in 2017, trust and class funds became largely similar for US tax reporting purposes.

Visit us at ci.com/en/tax-retirement-and-estate-planning.

IMPORTANT DISCLAIMERS

This communication is published by CI Global Asset Management ("CI GAM"). Any commentaries and information contained in this communication are provided as a general source of information and should not be considered personal investment advice. Facts and data provided by CI GAM and other sources are believed to be reliable as at the date of publication. Certain statements contained in this communication are based in whole or in part on information provided by third parties and CI GAM has taken reasonable steps to ensure their accuracy.

Market conditions may change which may impact the information contained in this document. Information in this communication is not intended to provide legal, accounting, investment or tax advice, and should not be relied upon in that regard. Professional advisors should be consulted prior to acting on the basis of the information contained in this communication.

You may not modify, copy, reproduce, publish, upload, post, transmit, distribute, or commercially exploit in any way any content included in this communication. You may download this communication for your activities as a financial advisor provided you keep intact all copyright and other proprietary notices. Unauthorized downloading, re-transmission, storage in any medium, copying, redistribution, or republication for any purpose is strictly prohibited without the written permission of CI GAM.

CI Global Asset Management is a registered business name of CI Investments Inc.

©CI Investments Inc. 2021. All rights reserved.

Published August 20, 2021

21-08-423503_E (08/21)