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U.S. tax pain: Canadian mutual funds and ETFs

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From an investment perspective, mutual funds and exchange-traded funds (ETFs) make sense for many Canadians. They allow them to reduce investment risk by diversifying their holdings through exposure to multiple industries and sectors of the economy, without the need to hold many individual stocks and bonds.

However, for U.S. citizens and those who have U.S. residency status (i.e. green card-holders), this strategy can create significant U.S. tax reporting complexities and additional tax costs. This article broadly reviews the U.S. classification of Canadian mutual funds and ETFs. For a more detailed look at passive foreign investment companies (PFICs) and controlled foreign corporations (CFCs), see the companion article in this issue of *U.S. Tax Alert*, "Understanding the filing requirements for PFICs and CFCs."

U.S. tax regulations may treat Canadian mutual funds and ETFs as passive foreign investment companies (PFICs), which can have significant reporting requirements on IRS Form 8621. For each PFIC (each individual mutual fund\ETF), a separate Form 8621 is required. Some foreign corporations are also considered to be PFICs if more than 75 per cent of their gross income is passive in nature (e.g. interest, dividends, capital gains, rental income) or at least 50 per cent of their assets are used to earn passive income.

PFICs held in Canadian registered plans such as RRSPs, RRIFs and RPPs are exempt from filing Form 8621 as the income in these types of plans is taxed when it is withdrawn.

Registered education savings plans (RESPs) may be considered foreign trusts, in which case any mutual funds or ETFs contained within the RESPs would not require disclosure on Form 8621. However, as they are foreign trusts, they require forms 3520 & 3502a (Foreign Trust with a U.S. Owner), which are even more onerous than Form 8621. As well, U.S. owners of RESPs are subject to U.S. tax on income and capital gains, and on any government grants received. Thus, if the owner's spouse is not a U.S. status person, the RESPs are best held in the spouse's name alone.

Some practitioners have suggested that the IRS would treat tax free savings accounts (TFSAs) as similar to RESPs. Other practitioners disagree, suggesting that a TFSA is not a foreign trust so Forms 3520 and 3520a are not required. However, if mutual funds or ETFs are held in a TFSA, the filing of Form 8621 may be required for each mutual fund or ETF. In addition, when U.S. citizens hold TFSAs, even though the income and growth in the plans are tax free in Canada, they remain subject to tax in the U.S.

Form 8621 is not required for a PFIC of a particular tax year when there are no distributions from the PFIC during the year and the PFIC's owner has not made one of the PFIC elections described below. A PFIC's income is calculated under Section 1291, unless one of the available elections is made.

The two available elections are the qualified electing fund (QEF) election and the mark-to-market election.

In the absence of an election, the owner of a PFIC will be taxed under Section 1291 on the amount that the yearly distribution exceeds 125 per cent of the average of the last three years of distributions, and also on any capital gains realized on the sale of any fund units.

With the QEF election, the owner of the PFIC is taxed on the owner's share of the earnings of the PFIC, reduced by any income or capital gains from the fund already reported on the owner's U.S. tax return.

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The mark-to-market election is available if the PFIC is a "marketable stock," which generally means it traded on a national or foreign securities exchange. This election requires the owner to revalue the PFIC at the end of each year and report any increase in value as ordinary income. Losses in value may be deducted if they offset previously reported gains under this election.

The IRS does not have an individual penalty for failing to file Form 8621. However, if an owner fails to report PFICs on Form 8938 Report of Specified Foreign Financial Assets, the IRS may assess a penalty of $10,000 for each instance of failure to report.

If you have U.S. status and currently hold Canadian mutual funds or ETFs, and you are not in compliance with your U.S. tax reporting obligations, we can help. Contact your local Collins Barrow office to review your situation and discuss the options to reduce your U.S. reporting and tax burden.

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