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## **American taxpayers who own Canadian investment funds may be subject to U.S. taxes**

By Rudy Mezzetta | Mid-October 2014

**U.S. TAXES ON CANADIAN** mutual funds have long been a murky area. Now, some Canadian asset-management firms are providing assistance to their clients who are American taxpayers by providing them with a form that allows them to make a potentially important election.

The form deals with the U.S. passive foreign investment corporation (PFIC) rules. Under those rules, an annual information statement (AIS) gives mutual fund unitholders affected by PFIC rules the option of making a special election that reduces the potential U.S. tax hit that is created by holding a PFIC.

"[Providing these statements] puts our investors in a decent tax position," says Peter Bowen, vice president of tax research and solutions with Toronto-based **Fidelity Investments Canada ULC**, whose firm provides the information for the AIS to clients on request. "Otherwise [an American] owning a Canadian mutual fund is very problematic."

So far, the majority of Canadian mutual fund firms have decided not to provide their unitholders who are subject to PFIC rules with an AIS. Some firms argue that providing U.S. tax reporting for their funds is neither practical nor necessarily an effective solution.

"Adding a further layer of compliance [in addition to existing Canadian tax reporting] under U.S. law would add significant costs to investors, without a clear indication that there is a net benefit [for them]," states a tax note published on the PFIC issue by Toronto-based **Invesco Canada Ltd.**, which does not provide the statements to its clients.

The issue of American taxpayers in Canada who own Canadian mutual funds has been a troubling one for the Canadian mutual fund industry since 2010. That's when the U.S. Internal Revenue Service (IRS) indicated in a ruling that it considered non-U.S. mutual funds and exchange-traded funds (ETFs) to be PFICs. A PFIC is an investment in which either 75% or more of the gross income for the year is passive income, or if 50% or more of the assets for the year produce passive income.

Generally, American taxpayers in Canada must file a U.S. tax return annually, stay current with all other U.S. tax reporting obligations and file a Canadian tax return.

And, for each Canadian fund owned, an American taxpayer must file a U.S. Form No. 8621 to report any income received from the PFIC or any gain realized from a sale. Under the complex PFIC rules, these gains and distributions may be taxed as ordinary income, essentially eliminating the normal tax advantages of owning Canadian mutual funds.

An American taxpayer has the option of making one of two elections under the PFIC rules to avoid these tax results: a mark-to-market election, which, in many cases, is not a great improvement over taking no election.

Or, the taxpayer may choose the qualified electing fund (QEF) election, under which the taxpayer is taxed on his or her pro rata share of the fund's earnings and gains in the year, as if the fund had been sold.

In general, the QEF election usually is the best option for an American taxpayer who wishes to own a Canadian mutual fund. In order to make this election, however, the firm that issues the mutual fund units must provide the taxpayer with annual information statements calculated using U.S. tax principles.

Over the past year, several Canadian mutual fund firms announced that they would begin offering unitholders the AIS to make the QEF election for all or some of their funds upon request. These firms include Fidelity, CI Investments Inc., CIBC Asset Management Inc., Mackenzie Financial Corp., IA Clarington Investments Inc., EdgePoint Investment Group Inc., and Purpose Investments Inc. (All firms are based in Toronto). Dimensional Fund Advisors Canada ULC, based in Vancouver, has been providing AISes for several years.

These firms suggest that by providing investors affected by PFIC with an AIS, their investors have greater flexibility in dealing with the issue. Without an AIS, most unitholders are unlikely to be aware of the option of making an election.

However, most Canadian mutual fund and ETF firms have decided not to provide their unitholders with an AIS. These firms contend that American taxpayers in Canada might be better off looking at other investments, such as individual stocks or U.S.-listed ETFs.

"Our view [is] that mutual funds are not an optimal investment vehicle for clients impacted by PFIC [rules]," according to a statement issued by TD Wealth, the wealth-management arm of **Toronto-Dominion Bank**.

The compliance burden and costs that an investor faces in preparing the required Form No. 8621 for each Canadian fund they own might diminish the value of owning the fund in the first place.

"It gets cumbersome, and the accounting costs get high," says Veronika Chang, who specializes in U.S. tax law with Toronto-based **Morris Kepes Winters LLP**. Some clients, she adds, hold dozens of Canadian mutual funds in their investment portfolio, with each fund needing its own Form No. 8621. "[Preparing] the statements alone is just pure pain."

In addition, a QEF election ideally is made in the first year a fund is purchased. For mutual funds that have been held for a long period, accrued gains from years before the year in which a QEF election is made would be taxed as ordinary income, representing an additional cost to the taxpayer.

Finally, it's possible that investments held within an RRSP or a registered retirement income fund (RRIF) do not fall under the PFIC regime - although the IRS has yet to confirm this assertion.

Thus, American taxpayers in Canada should be able to hold any Canadian fund in their RRSP or RRIF without triggering the PFIC rules, as long as those taxpayers file an IRS Form No. 8891 and an information return for Canadian RRSPs and RRIFs annually.

Whether Canadian mutual fund companies offer an AIS to their unitholders or not, all firms suggest that investors affected by the PFIC rules seek expert cross-border advice, as each person's investment and tax circumstances differ.

The Canadian firms also agree that American taxpayers in Canada would be better off if the U.S. exempted Canadian mutual funds from the PFIC rules altogether, which is what the Toronto-based **Investment Funds Institute of Canada** (IFIC) advocates in an April 2013 letter to the U.S. Financial Services Committee on Ways and Means.

Officials from IFIC travelled to Washington, D.C., earlier this year to meet with the committee.

"[The members of the committee] understood we had a legitimate issue," says James Carman, senior policy advisor for taxation with IFIC.

But while IFIC has continued to have active conversations with American tax officials on the matter of exempting Canadian funds, there has been no change in policy by the U.S. as of yet.

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