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The US Tax Classification of Canadian Mutual Fund Trusts

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PRÉCIS

On pense généralement que les personnes américaines qui investissent dans des fiducies de fonds commun de placement canadiennes risquent de subir des conséquences fiscales américaines dissuasives à la disposition de leur placement, parce que ces entités pouvaient être traitées comme des sociétés de placement étrangères passives (*passive foreign investment companies* [PFIC]) en application du droit fiscal américain. Cette impression repose sur une phrase résumant et concluant une circulaire administrative non exécutoire sur un sujet sans lien avec celui-ci, qui a été publiée par le Internal Revenue Service en 2009. Bien qu'il ne soit pas du tout sûr que cette position soit bien celle du fisc américain, de nombreux praticiens ont choisi de pécher par excès de prudence et de présumer que les fiducies de fonds commun de placement canadiennes sont des PFIC aux fins de l'impôt américain.

Cet article présente deux ensembles de solutions possibles au problème du statut de PFIC pour les fiducies de fonds commun de placement canadiennes. Les solutions varient selon que la fiducie de fonds commun de placement canadienne est considérée comme une société de personnes ou comme une société par actions aux fins de l'impôt américain. Une société sera classée dans l'une ou l'autre des catégories selon que la totalité ou une partie seulement des investisseurs a une responsabilité limitée à l'égard des dettes et des obligations de la fiducie. Si tous les investisseurs ont une responsabilité limitée, la fiducie est bien considérée comme une société par actions aux fins de l'impôt américain et constitue fort probablement une PFIC. Dans ce scénario, il y a trois solutions possibles au problème du statut de PFIC : 1) détenir le placement dans un fonds commun de placement dans le cadre d'un régime enregistré d'épargne-retraite; 2) faire le choix relatif à un fonds électif admissible (*qualified electing fund*); ou 3) faire le choix d'évaluation à la valeur du marché (*mark-to-market election*). Les trois solutions sont sous-optimales. Il est possible que des fiducies de fonds commun de placement canadiennes soient en réalité des sociétés de personnes aux fins de l'impôt américain.

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Si la fiducie est une société de personnes, elle ne peut pas être une PFIC. Les fiducies sont considérées comme une société de personnes dans les quatre situations suivantes : 1) les fiducies formées avant l'adoption de certaines lois provinciales accordant aux investisseurs une responsabilité limitée peuvent être des sociétés de personnes aux fins de l'impôt américain; 2) les fiducies auxquelles ces lois ne s'appliquent pas peuvent être des sociétés de personnes aux fins de l'impôt américain; 3) une fiducie nouvellement formée peut choisir d'être classée en tant que société de personnes; et 4) toutes les fiducies de fonds commun de placement canadiennes peuvent être des sociétés de personnes aux fins de l'impôt américain. Le fait d'être considéré comme une société de personnes peut être très avantageux pour un investisseur individuel qui est une personne américaine. L'application potentielle du régime des PFIC disparaît, et le revenu est imposé comme un revenu tiré de n'importe quel autre placement. La plupart des investisseurs n'ont aucune déclaration annuelle à produire. Le particulier peut indiquer dans sa déclaration de revenus des particuliers qu'il choisit d'être traité comme une société de personnes. Un fonds peut aussi faire le choix d'être considéré comme une société de personnes. Pour les fonds qui n'investissent pas aux États-Unis, le statut de société de personnes comporte peut d'inconvénients et de nombreux avantages. Pour les fonds qui investissent aux États-Unis, il y a quelques inconvénients qu'il est possible de pallier. Bref, il existe des solutions faciles à gérer au problème du statut de PFIC dans le contexte des fiducies de fonds commun de placement canadiennes.

ABSTRACT

It is widely believed that US persons who invest in Canadian mutual fund trusts could be subject to punitive US tax consequences on the disposition of their investment, because these entities could be treated as passive foreign investment companies (PFICs) under US tax law. This view is based on a one-sentence summary conclusion in a non-binding memorandum on an unrelated topic issued by the Internal Revenue Service in 2009. While the position of the US tax authorities is far from certain, many practitioners have chosen to err on the side of caution and have acted on the assumption that Canadian mutual fund trusts are PFICs for US tax purposes.

This article outlines two possible sets of solutions to the PFIC problem as it applies to Canadian mutual fund trusts. The solutions depend on whether the Canadian mutual fund trust is classified as a partnership or as a corporation for US tax purposes. The key determinant between the two classifications is whether or not all investors in the trust have limited liability for the debts and obligations of the trust. If all of the investors have limited liability, the trust is properly classified as a corporation for US tax purposes and thus is very likely a PFIC. In this scenario, there are three potential solutions to the PFIC problem: (1) holding the investment in a mutual fund inside a registered retirement savings plan; (2) making the qualified electing fund election; or (3) making the mark-to-market election. All three solutions are suboptimal. It is possible that Canadian mutual fund trusts are actually partnerships for US tax purposes. If the trust is a partnership, it cannot be a PFIC. There are four arguments to support a partnership classification: (1) trusts formed prior to the enactment of certain provincial statutes granting investors limited liability may be partnerships for US tax purposes; (2) trusts to which these statutes do not apply may be partnerships for US tax purposes; (3) a newly formed trust can elect a partnership classification; and (4) all Canadian mutual fund trusts might be partnerships for US tax purposes. For an individual investor who is a US person, the

benefits of a partnership classification are substantial. The potential application of the PFIC regime is removed, and the income is taxed like income from any other investment. There is no annual reporting for the vast majority of investors. The position that partnership treatment applies can be taken on the individual's US tax return. A partnership classification can also be implemented at the fund level. For funds that do not invest in the United States, there are few drawbacks and many advantages to a partnership classification. For funds that do invest in the United States, there are a few drawbacks, but these can be managed. In short, there are manageable solutions to the PFIC problem as it applies to Canadian mutual fund trusts.

KEYWORDS: US-CANADA ■ MUTUAL FUNDS ■ UNITED STATES ■ CROSS-BORDER ■ RRSP ■ IRS

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INTRODUCTION

The mutual fund trust structure is commonly used in Canada for a wide range of investment vehicles, including consumer-oriented financial products (mutual funds and exchange-traded funds) as well as income trusts and real estate investment trusts (REITs). Accordingly, the US tax classification of this structure is of crucial importance to "US person investors" resident in Canada, Canadian financial institutions seeking US person investors, and investors in Canadian mutual funds who reside in the United States. For the purposes of this article, a US person investor is defined as a US person (US citizen, US resident, green-card holder, US partnership, US corporation, or US trust) holding units of a Canadian mutual fund trust. Many Canadians, including those who are US person investors and those who have moved to the United States, invest in these funds to save for retirement.

A common view is that Canadian mutual fund trusts are passive foreign investment companies (PFICs) for US tax purposes.[1] The US Internal Revenue Service (IRS) has not taken a clear position on the issue. In a non-binding memorandum concerning the application of US estate tax, the IRS made an unsubstantiated one-sentence declaration that investments in Canadian mutual fund trusts held in a registered retirement savings plan (RRSP) are likely corporations for US tax purposes.[2] From this, the common practice of treating Canadian mutual fund trusts as PFICs has evolved. As discussed in more detail below, if the US PFIC regime applies to such entities, the US tax on any gain on the sale of the investment may approach or exceed 60 to 80 percent. This figure reflects the imposition of tax on the sale, exchange, or other disposition of stock of a PFIC at the highest marginal rate (39.6 percent), to which is added compound interest on that tax stretching back to the time when the investment was first purchased. This is an adverse result that lacks any tax policy justification.

This article argues that the PFIC problem is manageable. We present strategies that both individual investors and fund companies can use to deal with the risk of PFIC treatment. The solutions we suggest are based on two different approaches.

The first set of solutions assumes that Canadian mutual funds are corporations for US tax purposes and thus are PFICs. These solutions include

- holding Canadian mutual fund investments inside an RRSP;
- making the "qualified electing fund" (QEF) election on an individual investor's US tax return; or
- making the mark-to-market election on an individual investor's US tax return.

1 See Max Reed, "Classification of Canadian Mutual Funds for U.S. Tax Purposes" (2014) 40:5 *International Tax Journal* 31-39, at 33. Some of the content of this article is similar to that found in the *International Tax Journal* article. The overlap between the two is indicated in the notes.

2 Internal Revenue Service, Chief Counsel Advice (CCA) 201003013, September 30, 2009.

As discussed below, these solutions provide only limited potential PFIC relief. For the mark-to-market and QEF elections to work, the investor must pay PFIC tax on any gain realized, before the election takes effect. Further, the QEF election requires specialized information from the fund that will be expensive for a fund company to prepare. This severely limits the utility of the elections for long-term investors who may not have been aware that the mutual funds in which they had invested could be PFICs.

The second set of solutions assumes that Canadian mutual fund trusts are partnerships for US tax purposes. By definition, partnerships cannot be PFICs. These solutions include

- taking the position that certain older Canadian mutual fund trusts are partnerships for US tax purposes and thus are not PFICs;
- taking the position that certain Canadian mutual fund trusts not covered by the limitation of liability statutes are not PFICs;
- making a check-the-box election at the fund level to classify a Canadian mutual fund trust as a partnership for US tax purposes;[3] or
- taking the position that all Canadian mutual fund trusts are partnerships for US tax purposes and thus are not PFICs.

Adopting a partnership classification for a Canadian mutual fund trust has the advantage of solving the PFIC problem for US person investors and requiring almost no annual paperwork on the part of those investors. Further, these solutions can apply retroactively to the time when the fund was created or the investor purchased the investment. There are a few potential drawbacks with a partnership classification.

First, for fund administrators, formally adopting a partnership classification may increase the US estate tax risk for non-US investors in the fund. However, a reasonably persuasive case can be made that an interest in a foreign partnership is an intangible asset and thus not subject to US estate tax.

Second, a partnership classification imposes a US federal tax compliance obligation on the fund itself if the fund invests in securities in the United States. However, there is no such compliance obligation for funds that do not invest in the United States.

Third, a partnership classification may increase Canadian withholding tax on certain distributions to US-resident investors. But this is not certain, and any extra Canadian tax can be offset by a US foreign tax credit. Regardless, extra Canadian tax is a vastly preferable outcome for US-resident investors as compared with the tax payable under the PFIC regime.

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3 Reed, supra note 1, at 37.

BACKGROUND AND OVERVIEW OF THE PFIC REGIME

The PFIC rules were enacted as part of the comprehensive tax reform of 1986. They were designed to prevent US citizens from achieving tax deferral offshore. As befits a regime designed to combat offshore tax evasion, the PFIC regime is very punitive. As noted above, a US person investor in a PFIC may be subject to certain adverse US federal income tax consequences with respect to the sale, exchange, or other disposition of the stock of a PFIC and with respect to certain distributions made by the PFIC. In general, a non-US corporation will be treated as a PFIC for US federal income tax purposes in any taxable year in which either

- at least 75 percent of the corporation's gross income is "passive income"; or
- on average, at least 50 percent of the value of the corporation's assets is attributable to assets that produce passive income or are held for the production of passive income.[4]

Passive income for this purpose generally includes, among other things, dividends, interest, certain royalties, gains from commodities and securities transactions, and gains from the sale of capital assets.[5]

Assuming that Canadian mutual fund trusts are corporations (as discussed in detail below), they readily meet the PFIC definition because

- they are organized under the laws of a jurisdiction outside the United States;
- they realize passive income; and/or
- they own a large percentage of assets that produce passive income.

If a non-US corporation is treated as a PFIC in any taxable year, it will generally be treated as a PFIC in each subsequent year, regardless of the level of passive income and passive assets in such subsequent years (unless certain elections are made at the investor level).[6] IRC section 1291(a) requires a US person investor to pay a special tax plus an interest charge on the following:

- gain recognized from the disposition of stock of a PFIC (including a pledge of stock of a PFIC); and
- the receipt of an "excess distribution."

An excess distribution is generally defined as a distribution in any one year to the extent that it exceeds 125 percent of the average distributions received in the prior three years.[7] In general,

4 Internal Revenue Code of 1986, as amended (herein referred to as "IRC"), section 1297(a).

5 IRC section 1297(b)(1).

6 Ibid.

7 IRC section 1291(b).

- any gain realized or excess distribution received would be allocated rateably to each taxable year (or portion of a taxable year) in the US person investor's holding period in respect of the shares in the PFIC;
- the amount so allocated to the current taxable year will be taxed as ordinary income (not as a capital gain) earned in the current taxable year;
- the amount so allocated to earlier taxable years will be taxed at the highest marginal rates applicable to ordinary income for those earlier taxable years; and
- an interest charge for the deemed benefit of deferral of US federal income tax will be imposed with respect to the tax deemed attributable to each such earlier taxable year.

For example, if a PFIC makes no distributions to shareholders for three years but then pays a dividend in year four, the entire amount of the dividend will be an excess distribution.

The gross amount of any distribution in respect of the stock of a PFIC that is not an excess distribution will be taxable under the rules generally applicable to corporate distributions.[8] The dividend, however, will not be eligible for the preferential tax rate applicable to certain "qualified dividend income" received by individuals.[9] US person investors normally have to file a separate form 8621 annually for each fund that they own.[10] Form 8621 is unwieldy, and it can be costly to have it completed by a professional tax adviser. US person investors who hold less than US$25,000 worth of PFIC stock do not have to file form 8621 annually.[11]

EXISTING AUTHORITY ON CANADIAN MUTUAL FUNDS AS PFICs[12]

There is no official guidance on whether Canadian mutual funds are PFICs or not. The worry that Canadian mutual funds might be PFICs for US tax purposes started with the issuance of the IRS's Chief Counsel Advice (CCA) 201003013 in September 2009.[13] Prior to the release of this document, there appears to have been little or no awareness of the possibility that Canadian mutual funds might be PFICs.

The reaction to CCA 201003013 is strange, given its status and substance. The memorandum concerns the assessing of a taxpayer's US estate tax liability, and not an entity classification of a Canadian mutual fund trust. The "Facts" section of the CCA

8 Prop. Treas. reg. section 1.1291-2(e).

9 IRC section 1(h)(11)(C)(iii).

10 Temp. Treas. reg. section 1.1298-1T(b)(1). See IRS form 8621, "Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund."

11 Temp. Treas. reg. section 1.1298-1T(c)(2)(i)(A)(1).

12 The content of this section is based on Reed, supra note 1.

13 Supra note 2.

does not provide any information regarding the mutual funds at issue. Accordingly, it is possible that the taxpayer himself made representations regarding the entity classification of the mutual funds.

The only reference in the CCA to the entity classification of Canadian mutual funds is a short, unsubstantiated declaration that reads:

> You indicated that the RRSP held shares in several mutual funds that are organized as trusts. However, a mutual fund may have been formed as a "trust" under Canadian law, but be properly classified as a corporation under U.S. law. Based on the information provided, it appears that all the Canadian mutual funds held by Decedent's RRSP would be classified as corporations for U.S. tax purposes.[14]

It is important to note that the CCA contains no analysis to justify this conclusion. Further, the CCA specifically deals *only* with the mutual funds held inside this particular decedent's RRSP. It does not deal with all mutual funds, nor does it deal with all mutual funds held inside all RRSPs. In fact, it is possible (though there is no way to verify this) that these mutual funds were unique in some respect.

There is another reason to be suspicious of the CCA's conclusion. By classifying Canadian mutual funds as corporations, the IRS did not have to address a far thornier issue. As discussed below, the IRS refuses to take a position as to whether property owned through a foreign fiscally transparent entity is subject to US estate tax. If, in CCA 201003013, the IRS had classified the mutual funds at issue as partnerships, it would have had to take a position on this question. So while the result of the CCA is friendly to the taxpayer, the IRS avoided having to answer a much bigger question in taking the position that it did.

Importantly, a CCA does not have the force of law. Indeed, CCA 201003013 specifically states that it "may not be used or cited as precedent."[15] Furthermore, the IRS's *Internal Revenue Manual* states that chief counsel advice "does not set out official rulings or positions of the Service and may not be attached or referred to in other advisory products or subsequent Chief Counsel advice as precedent."[16]

Effectively, the belief that Canadian mutual funds may be corporations (note that even the CCA did not call them PFICs) for US tax purposes is based on an unsubstantiated one-line conclusion that does not have the force of law. Understandably, the common thinking in practice is to err on the side of caution and treat Canadian mutual funds as PFICs. Nevertheless, in the next section, we examine strategies that can be used to solve the PFIC problem assuming that Canadian mutual fund trusts are corporations (and therefore almost certainly PFICs) for US tax purposes.

14 Ibid., at 5.

15 Ibid., at 1.

16 Internal Revenue Service, *Internal Revenue Manual* (Washington, DC: IRS), section 33.1.2.2.3.4.

SOLVING THE PFIC PROBLEM IF CANADIAN MUTUAL FUNDS ARE CORPORATIONS

Even operating under the assumption, which is challenged below, that Canadian mutual fund trusts are corporations for US tax purposes, there are three potential solutions to the PFIC problem

1. holding mutual fund investments inside an RRSP;
2. making the QEF election; or
3. making the mark-to-market election.

All three have their limitations.

Holding Canadian Mutual Fund Investments Inside an RRSP

Holding PFIC stock inside an RRSP negates the adverse PFIC consequences. The Canada-US tax treaty applies to income taxes imposed by the IRC.[17] The PFIC tax regime is certainly covered by the treaty. Article XVIII(7) of the treaty, which deals with the taxation of pensions and annuities, states that "taxation" may be deferred "with respect to any income accrued in the plan but not distributed by the plan, until such time as and to the extent that a distribution is made from the plan or any plan substituted therefor." This applies to RRSPs.

If Canadian mutual funds are PFICs, and the investment is held inside an RRSP, the PFIC charge described above may be permanently avoided. According to official IRS publications, income from an RRSP is considered pension income and is subject to tax as such. For instance, Rev. proc. 2014-55 describes distributions from an RRSP as follows:

> Distributions received by any beneficiary or annuitant from a Canadian retirement plan, including the portion thereof that constitutes income that has accrued in the plan and has not previously been taxed in the United States, must be included in gross income by the beneficiary or annuitant in the manner provided under section 72, subject to any applicable provision of the Convention.[18]

IRC section 72 is the section that deems income from an annuity to be taxable. The IRS's own view is that income taken out of an RRSP is pension income, and the PFIC charges may not be applicable. Even if Canadian mutual funds are PFICs, there is no reporting required if the investment is held inside an RRSP.[19] Combined with

17 The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007 (herein referred to as "the Canada-US treaty"), article II(2)(b).

18 Rev. proc. 2014-55, 2014-44 IRB 753.

19 Temp. Treas. reg. section 1.1298-1T(b)(3)(ii).

the IRS's understanding of RRSP income as pension income, this lack of reporting further suggests that a US court would not subject investments in Canadian mutual funds held inside an RRSP to the PFIC charge.

The limitation with respect to this strategy is the available amount of RRSP room. Some investors own significant investments outside an RRSP.

The QEF Election

Assuming that Canadian mutual funds are corporations for US tax purposes (and thus almost certainly PFICs), a US person investor may be able to solve the PFIC problem by making a timely election to treat the mutual fund in which the investment is made as a "qualified electing fund."[20] If a timely QEF election is made, the electing US person investor can generally avoid the adverse consequences of PFIC classification, described above, but is required to include in gross income annually,

- as ordinary income, a pro rata share of the PFIC's ordinary earnings, and
- as long-term capital gain, a pro rata share of the PFIC's net capital gain.

In either case, the income inclusion is required whether or not cash associated with such earnings is distributed by the PFIC in the year in which it is earned.[21]

In addition, the Canadian mutual fund trust is required to provide each electing shareholder with an annual information statement that includes the following information:[22]

1. the dates of the tax year to which the statement applies;
2. the unitholder's pro rata share of the trust's ordinary earnings and net capital gain for the trust's tax year, or sufficient information to allow the unitholder to calculate these figures, or a statement that the trust has permitted the unitholder to examine its books, records, and other documents to calculate the trust's ordinary earnings and net capital gain and the unitholder's pro rata share of such amounts;
3. the amount of cash and the fair market value of property distributed or deemed distributed to the unitholder during the trust's tax year; and
4. a statement that the trust will permit the unitholder to inspect a copy of its books, records, and other documents.

The timeliness of the QEF election is crucial. If the election is made in the first year in which the US person investor owns the investment, and the above requirements are met, all PFIC problems will be avoided. Making the election in a later year is a different story. In order for the QEF election to be effective (and thus avoid PFIC

20 IRC section 1291(d)(2).

21 IRC section 1293(a).

22 Treas. reg. section 1.1295-1(g).

problems in subsequent years), the investor must realize in that later year any gain accruing from the date of purchase of the investment. This gain will be subject to the excess distribution regime described above.[23]

Put differently, making an effective QEF election in a year after the first year of ownership of the investment requires the investor to pay the PFIC tax from the date on which the investment was purchased until the year in which the QEF election is made. Therefore, taking in a later year a QEF election that would solve future PFIC problems could have a high tax cost for a US person investor who has owned the investment for a long period of time, but could be worthwhile for an investor who has recently purchased the investment.

A retroactive QEF election is possible, but only with the permission of the IRS, and only if the QEF information is available (this is not always the case). Even if the QEF election has been made, form 8621 must still be filed; in other words, while the QEF election may reduce specific tax exposure related to holding the investment, it will not reduce the annual compliance costs. The final downside of the QEF election is that dividends received from a QEF are taxed as ordinary income and are not eligible for the lower rates applicable to qualified dividends.[24]

The Mark-to-Market Election

Assuming that Canadian mutual funds are corporations for US tax purposes (and thus almost certainly PFICs), the mark-to-market election can be taken to solve the PFIC problem. Where this election is made, the US person investor reports the annual gain in the value of the investment as ordinary income (not as a capital gain)—even if the gain was not realized—on the investor's US tax return.[25] This may result in double taxation. Canada will not necessarily grant foreign tax credits for the US tax paid because of the mark-to-market election. Further, when the investment is actually sold, Canadian tax will apply normally to the sale without regard to previously paid US tax resulting from the mark-to-market election.

The mark-to-market election has a further drawback that is similar to the drawback of the QEF election. An effective mark-to-market election taken in a year following the first year in which the investor owned the investment requires the realization of gain accrued to date. This gain is subject to the excess distribution regime. In other words, in order for the mark-to-market election to be effective, the US person investor will pay PFIC tax on any gain that has accumulated during the time the investor has owned the investment.[26] Finally, the compliance costs for the mark-to-market election are significant, given that a form 8621 will have to be filed for each fund, for each year.

23 IRC section 1291(d)(2)(A).

24 Notice 2004-70, 2004-44 IRB 724.

25 IRC section 1296(a)(1).

26 IRC section 1296(j).

Conclusion: Inadequate Solutions to the PFIC Problem

The three solutions presented above will likely be inadequate for many investors. RRSP contribution room is limited, and many investors hold their investments outside an RRSP. The QEF and mark-to-market elections work only if PFIC tax is paid on the unrealized gain before the election functions properly. This is not only expensive but may eventually result in double taxation, since Canada will impose income tax when the investment is actually sold. A better solution is needed. The next section outlines the argument that Canadian mutual fund trusts are actually partnerships for US tax purposes and thus cannot be PFICs.

CANADIAN MUTUAL FUND TRUSTS CAN BE PARTNERSHIPS FOR US TAX PURPOSES

The first three strategies discussed above (funds held inside an RRSP, the QEF election, and the mark-to-market election) all first assume that Canadian mutual fund trusts are corporations for US tax purposes and thus almost certainly PFICs. There are grounds for arguing that this assumption is incorrect. We are of the view that certain, and possibly all, Canadian mutual funds are actually partnerships, and not corporations, for US tax purposes; therefore, by definition, they are not PFICs. From the perspective of the individual investor, a partnership classification is very beneficial. Since the PFIC regime can no longer apply, income distributions from the Canadian mutual fund trust retain their character, and the annual reporting requirements are significantly less complex.

As discussed further below, the key factor in determining whether a Canadian mutual fund trust is a partnership or a corporation for US tax purposes is whether the investors in the fund have limited liability. If all investors have limited liability, the trust is classified as a corporation and thus is a PFIC. If any investor does not have limited liability, the trust is classified as a partnership and thus is not a PFIC.

Four arguments are available to support a partnership classification:

1. Canadian mutual fund trusts formed prior to 2004 are likely partnerships.
2. Canadian mutual fund trusts that are not "reporting issuers" are likely partnerships.
3. A newly formed Canadian mutual fund trust can elect partnership classification.
4. All Canadian mutual fund trusts may be partnerships.

Each strategy is examined in turn below.

Older Canadian Mutual Fund Trusts Are Likely Partnerships

Responding to concerns from the investment fund industry, various provinces have enacted legislation to grant beneficiaries of mutual fund trusts limited liability. Canadian mutual fund trusts organized in the common-law provinces and formed prior to the enactment of these statutes are likely partnerships for US tax purposes. The

following common-law provinces enacted limited liability statutes in the following years:[27] Ontario, 2004;[28] Manitoba, 2005;[29] Alberta, 2004;[30] British Columbia, 2006;[31] and Saskatchewan, 2006.[32]

Prior to this legislation being passed, institutional investors were largely unwilling to invest in mutual fund trusts as a result of the liability exposure.[33] Although their caution does not stand as proof of any liability from a legal perspective, it does at the very least indicate a common understanding in the industry that the risk of unitholder liability was not merely theoretical.

The determination of the default classification of a Canadian mutual fund trust comes down to whether all beneficiaries of the trust have limited liability. If the trust was organized prior to the enactment of the statutes, it was and remains a partnership for US tax purposes because the beneficiaries of the trust did not have limited liability at the time the trust was organized.

To fully understand this argument, it is necessary to go through all of the steps under the US entity classification rules that are applied in classifying a Canadian mutual fund trust for US tax purposes. For clarity, the multiple steps (contained in Treas. reg. section 301.7701) are set out sequentially below.[34]

Is the Entity Separate from Its Owners?

If the entity is not separate from its owners, the entity classification regime does not apply since the "entity" is then not an entity for US tax purposes. A Canadian mutual fund trust is separate from its owners because the trust has a structure that is not tied to its beneficiaries.[35]

Is the Entity Caught by Special Rules?

If the entity falls into a special category, the general rules for entity classification do not apply. Canadian mutual fund trusts are not subject to any special regime. An example of an entity that does fall under special treatment is a real estate investment conduit, which is subject to a special regime under the IRC.[36] Canadian mutual fund

27 Quebec, a civil-law jurisdiction, enacted similar legislation in 1994: Civil Code of Québec, CQLR c. C-1991, article 1322. The legal status of a trust in Quebec law is different from the legal status of common-law trusts. In this article, we are concerned exclusively with the US tax treatment of Canadian mutual fund trusts organized in common-law provinces.

28 Trust Beneficiaries' Liability Act, 2004, SO 2004, c. 29, schedule A, as amended.

29 Investment Trusts Unitholders' Protection Act, CCSM c. I105.

30 Income Trusts Liability Act, SA 2004, c. I-1.5, as amended.

31 Income Trust Liability Act, SBC 2006, c. 14, as amended.

32 Income Trust Liability Act, SS 2006, c. I-2.02, as amended.

33 See, for example, Canada, Senate, *The Governance Practices of Institutional Investors: Report of the Standing Senate Committee on Banking, Trade and Commerce* (Ottawa: Senate, November 1998).

34 The discussion from this point to the text at note 63 is drawn from Reed, supra note 1, at 34-36.

35 Treas. reg. section 301.7701-1(a).

36 Treas. reg. section 301.7701-1(b).

trusts do not fall within any special regime, despite the assumption that they might be caught by the same rules as US mutual funds. US mutual funds are usually "regulated investment companies" (RICs), and therefore governed by IRC sections 851 through 855, and all RICs are required to be registered under the Investment Company Act of 1940.[37] Canadian mutual funds do not usually register with the US Securities and Exchange Commission (SEC). Moreover, in order to register as a RIC, an entity must be a US "domestic corporation,"[38] which, as a Canadian entity, a Canadian mutual fund trust obviously is not.

Is a Canadian Mutual Fund Trust a Trust for US Tax Purposes?

The Treasury regulations allow for several types of trust, only two of which are relevant here: an "ordinary" trust and an "investment" trust. Each has its own particularities, but neither describes a Canadian mutual fund:

1. *An ordinary trust*. An ordinary trust is a legal arrangement "whereby trustees take title to property for the purpose of *protecting or conserving it for the beneficiaries* under the ordinary rules applied in chancery or probate courts."[39] While trustees do indeed take title to the property in Canadian mutual funds, the goal is not simply to conserve and protect the beneficiary's property. The goal is maximize investment returns for the unitholders (beneficiaries). A mutual fund whose goal was mere conservatorship would likely not remain commercially viable. There is also case law that offers further insight into the difference between a business entity and an ordinary trust. In *Elm Street Realty Trust* and *Bedell Trust*,[40] the US Tax Court held that two characteristics distinguish business entities from ordinary trusts: (1) whether the trust has

37 Pub. L. no. 76-768; 15 USC section 80a-1 et seq.

38 IRC section 851(a).

39 Treas. reg. section 301.7701-4(a) (emphasis added). The full definition is as follows: "In general, the term 'trust' as used in the Internal Revenue Code refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. Usually the beneficiaries of such a trust do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. However, the beneficiaries of such a trust may be the persons who create it and it will be recognized as a trust under the Internal Revenue Code if it was created for the purpose of protecting or conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them. Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit."

40 *Elm Street Realty Trust v. Commissioner*, 76 TC 803, at 809 (1981); and *Bedell Trust v. Commissioner*, 86 TC 1207, at 1218 (1986).

associates, and (2) whether the trust has an objective to carry on a business. Treas. reg. section 301.7701-1(b) uses the same language.[41]

Finally, the preamble to the regulations that reformed the entity classification rules recognizes the same distinction (and did not alter the regulations regarding trusts).[42] Naturally, a Canadian mutual fund trust has an objective to carry on a business; this is the raison-d'être of a mutual fund. Additionally, Canadian mutual fund trusts have "associates," since the units in the trust are transferable.[43] Therefore, Canadian mutual fund trusts do not meet the definition of an "ordinary" trust.

2. *An investment trust*. In *Elm Street Realty Trust* and *Bedell Trust*,[44] an investment trust is defined as a trust created to "facilitate direct investment in the assets of the trust" through a pooling arrangement that creates the opportunity to diversify investments. This definition is reflected in the Treasury regulations.[45] It seems to describe a Canadian mutual fund trust. However, if the trustee has the power to vary the investments of the trust, it will be considered a business entity.[46] Canadian mutual funds rely on this power on behalf of the trustee. Indeed, the ability to rely on the expertise of the trustee in varying the investments of the fund is part of the value proposition of Canadian mutual fund trusts. As a result, Canadian mutual fund trusts fall under the "business entity" category rather than the trust category.[47]

Does the Entity Have More Than One Member?

Provided that the entity is not a trust and is not caught by any special set of rules, its classification is determined by looking at the number of members the entity has. If it has only one member, it is indistinguishable from its owner and is disregarded for entity classification purposes.[48] If the entity has two or more members, it can be

41 The full text of Treas. reg. section 301.7701-1(b) reads, "For the classification of organizations as trusts, see Treas. Reg. section 301.7701-4. That section provides that trusts generally do not have associates or an objective to carry on business for profit. Sections 301.7701-2 and 301.7701-3 provide rules for classifying organizations that are not classified as trusts."

42 TD 8697, 1997-1 CB 215 (preamble to Treas. reg. section 301.7701-1): "The regulations provide that trusts generally do not have associates or an objective to carry on business for profit. The distinctions between trusts and business entities, although restated, are not changed by these regulations."

43 See Carter G. Bishop, "Forgotten Trust: A Check-the-Box Achilles' Heel" (2010) 43:3 *Suffolk University Law Review* 529-64, at 555; *Bedell Trust*, supra note 41, at 1220-21; and *Morrissey v. Commissioner*, 296 US 344, at 360 (1935).

44 Supra note 40.

45 Treas. reg. section 301.7701-4(c)(1).

46 Ibid.

47 Ibid.; see also Reed, supra note 1, at 34 for a discussion of this distinction.

48 Treas. reg. section 301.7701-2(a).

either a partnership or a corporation.[49] While "member" is not defined in the regulations, the term is generally understood to be synonymous with "beneficial owner."[50] As an investment product offered to a wide range of people, a Canadian mutual fund trust will typically have many beneficial owners (members). It is therefore either a corporation or a partnership for US tax purposes.

Is the Entity Automatically Classified as a Corporation?

The Treasury regulations define seven different kinds of "automatic" corporations.[51] If the entity does not meet any of these definitions, it must be examined under the default entity classification rules.[52] A Canadian mutual fund trust does not meet any of these definitions.[53]

Is the Entity Domestic (American)?

The first step of the default classification analysis is to determine whether the entity is domestic or foreign. An entity is classified as foreign if it is not domestic.[54] Domestic entities are only those organized under the laws of the United States or of any state thereof.[55] Since a Canadian mutual fund trust is not organized under the laws of the United States or of any state thereof, it is a foreign entity.

Is the Entity an "Eligible Entity"?

If an entity is not an "automatic" corporation as described above, it is generally an "eligible entity." As an "eligible entity," it may elect to be classified as a corporation or a partnership for US tax purposes.[56] Since a Canadian mutual fund does not fall into any of the seven enumerated categories, it is likely an eligible entity and may elect taxation as either a partnership or a corporation.[57]

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49 Ibid.

50 Reed, supra note 1, at 35.

51 An entity is automatically classified as a corporation if it meets any of the following definitions: (1) Treas. reg. section 301.7701-2(b)(1)—it is a business entity organized under a federal or state statute that is referred to as incorporated; (2) Treas. reg. section 301.7701-2(b)(3)—it is a business entity organized under a state statute that refers to the entity as a "joint stock company or joint-stock association"; (3) Treas. reg. section 301.7701-2(b)(4)—it is an insurance company; (4) Treas. reg. section 301.7701-2(b)(5)—it is a state-chartered entity that conducts banking activities; (5) Treas. reg. section 301.7701-2(b)(6)—it is wholly owned by a foreign government; (6) Treas. reg. section 301.7701-2(b)(7)—it is taxable as a corporation under a specific section of the IRC; and (7) Treas. reg. section 301.7701-2(b)(8)—it is on the per se corporations list.

52 Specifically, if an entity is not automatically classified as a corporation under any of the Treas. reg. sections cited in note 51, supra, it is an "eligible entity that may select its classification."

53 See supra note 51.

54 IRC section 7701(a)(5).

55 IRC section 7701(a)(4).

56 Treas. reg. section 301.7701-3(a).

57 Ibid.

The IRS has issued private letter rulings (PLRs) that seem to agree with this view. In PLR 200752029,[58] the IRS ruled that a mutual fund trust in an unnamed jurisdiction was a foreign eligible entity that could elect its classification under Treas. reg. section 301.7701-3(a).

The IRS performed an analysis similar to the one conducted above. It first established that the entity was separate from its owners. The entity was not an ordinary trust, as a result of its profit-making motive. The trustee had the power to vary the investment, thereby barring classification as an investment trust. The trust did not meet one of the "automatic" corporation definitions. Accordingly, the mutual fund trust was a foreign eligible entity and could elect treatment as either a corporation or a partnership for US tax purposes.[59]

In this case, the fund had elected to be classified as an association taxable as a corporation. The fund represented that it was not a PFIC, a position that was accepted by the IRS. The PLR does not address the default classification of a mutual fund if the fund chooses not to elect either entity option.

Although the PLR follows the analysis outlined above, it does not state the country of origin of the fund, thereby making a direct application of the reasoning to Canadian mutual funds somewhat difficult. However, the PLR does make it clear that a mutual fund trust may be a foreign eligible entity.[60]

In PLR 200024024,[61] the IRS followed the same steps as in the PLR discussed above, but this time for a "fonds commum [sic] de placement" organized under the laws of a foreign jurisdiction. The IRS concluded that the fund was a "business entity" within the meaning of Treas. reg. section 301.7701-2(a) and was not an "automatic" corporation. Accordingly, it was an "eligible entity" and could elect its classification for federal tax purposes.

As in PLR 200752029, the IRS did not make it clear what the default classification of the trust would be. Regardless, the PLR confirms that a mutual fund trust may be a foreign eligible entity.

Is the Entity a Default Partnership or Corporation?

Any foreign eligible entity with more than a single member may elect to be classified as a partnership or a corporation for US tax purposes on form 8832.[62] However, if this election is not made, the entity will have a default classification. Since 1997, the only benchmark used to distinguish between default classification as a partnership or as a corporation is whether the members have limited liability. By this logic, a foreign eligible entity with two or more members is by default a partnership if at

58 Internal Revenue Service, PLR 200752029, September 11, 2007.

59 Reed, supra note 1, at 35.

60 Ibid.

61 Internal Revenue Service, PLR 200024024, March 15, 2000.

62 IRS form 8832, "Entity Classification Election."

least one member does not have limited liability.[63] On the other hand, the entity is by default a corporation if all of its members have limited liability.[64]

Do the Beneficiaries of Canadian Mutual Fund Trusts Have Limited Liability?

The Level of Liability Required Under the IRC

The question as to whether beneficiaries of a mutual fund trust have sufficient limited liability that those trusts are considered corporations under US law involves the interplay between US tax law and Canadian trust law. To start out, consider what level of limited liability is required under US tax law for an entity to be classified as a corporation for US tax purposes. The definition of "limited liability" under Treas. reg. section 301.7701-3(b)(2)(ii) is whether "the creditors of the entity may seek satisfaction of all or *any portion* of the debts or claims against the entity from the member as such [emphasis added]." It is unclear precisely what level of liability is required to meet this definition. However, applying the standard approach to the interpretation of statutes in the United States,[65] the plain meaning of the word "any" suggests that limited liability is a litmus test, meaning that if the members have even the smallest risk of personal liability, the entity may not have limited liability as defined in the Treasury regulations.[66]

The US Supreme Court has interpreted the word "any" in a similar manner, albeit in a different context. In *United States v. Gonzales et al.*, the court wrote:

> Read naturally, the word "any" has an expansive meaning, that is, "one or some indiscriminately of whatever kind." . . . Congress did not add any language limiting the breadth of that word, and so we must read §924(c) as referring to all "term[s] of imprisonment." . . . There is no basis in the text for limiting §924(c).[67]

This suggests a reading of the word "any," where there is no limiting language, as being indicative of a litmus test. This interpretation is also iterated in *United States v. Alvarez-Sanchez*, where a statute referring to "any" law enforcement is deemed to include *all* law enforcement officers.[68] Finally, *Lewis v. United States*[69] notes the importance of a lack of modifying language. In that case, the scope of the term "court"

63 Reed, supra note 1, at 35.

64 Treas. reg. section 301.7701-3(b)(2)(i).

65 *Lynch v. Alworth-Stephens Co.*, 267 US 364, at 370 (1925): "[T]he plain, obvious, and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and the ingenuity and study of an acute and powerful intellect would discover."

66 Reed, supra note 1, at 35.

67 *United States v. Gonzales et al.*, 520 US 1, at 5 (1997).

68 *United States v. Alvarez-Sanchez*, 511 US 350, at 350, 356, and 358 (1994).

69 *Lewis v. United States*, 445 US 55 (1980).

was in question. The US Supreme Court held that where "[n]o modifier is present, and nothing suggests any restriction," no restriction ought to be read into the statute.[70] There is no restrictive language present in the definition of limited liability in the Treasury regulations.[71]

Accordingly, US principles of statutory interpretation and case law demand an expansive reading of the word "any" in determining the question of liability. Put differently, the Treasury regulations should be read to mean that the merest possibility of liability is sufficient to qualify an entity as a default partnership under the entity classification rules.

The rejoinder to this reading is foreseeable. On this logic, even a Canadian corporation would not be classified as a corporation for US tax purposes because its shareholders have some potential personal liability (owing to the risk that the corporate veil may be pierced). But this rejoinder ignores the fact that entities (such as a Canadian corporation) that are akin to a US corporation are placed on the per se corporations list discussed above. Classes of entities that function similarly to a US corporation are simply put on this list to remove any doubt. Canadian mutual fund trusts are not on this list. Canadian corporations are. Further, entities subject to these default rules have the option of electing their classification. This means that for many entities, their default status is irrelevant—their owners will simply elect their preferred classification. Consequently, the objection that the Treasury regulations should not be read this way is meritorious but rebuttable.

A purposive reading of the definition of limited liability further suggests that a Canadian mutual fund trust should be classified as a partnership by default. The intent of the classification mechanism is straightforward: Entities that resemble corporations should be taxed as corporations; entities that more closely resemble partnerships should be taxed as partnerships. Setting aside the liability question for the moment, from a tax perspective a Canadian mutual fund trust functions much more like a partnership than a corporation. It is a flowthrough entity that normally pays no entity-level tax. As in a general partnership, most of the decisions made by the trust are made by the trustee (akin to a general partner) on behalf of many other passive participants.

From a broader policy perspective, equity favours the position that Canadian mutual funds are partnerships for US tax purposes. There are strong arguments that the PFIC regime was not intended to apply to Canadian mutual funds. The regime was enacted as part of the Tax Reform Act of 1986.[72] The Joint Committee on Taxation's bluebook, which explains the reasons behind the significant tax reform, sets out the purpose of the PFIC rules as follows:

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70 Ibid., at 60.

71 See also *Collector v. Hubbard*, 79 US 1 (12 Wall) 1, at 15 (1870); *Maine v. Thiboutot*, 448 US 1, at 4 (1980); *Department of Housing and Urban Development v. Rucker*, 535 US 125, at 130-31 (2002); and *Brogan v. United States*, 522 US 398, at 400-1 (1998).

72 Pub. L. no. 99-514, enacted on October 22, 1986.

> Congress did not believe that tax rules should effectively operate to provide U.S. investors tax incentives to make investments outside the United States rather than inside the United States. Since current taxation generally is required for passive investments in the United States, Congress did not believe that U.S. persons who invest in passive assets should avoid the economic equivalent of current taxation merely because they invest in those assets indirectly through a foreign corporation.[73]

Canadian mutual funds do not provide any tax deferral to a US person investor. They distribute all of their income annually for both Canadian and US tax purposes. Thus, applying the PFIC rules to Canadian mutual fund trusts does not serve the purpose that the PFIC rules were designed to achieve.

Classification of a Canadian mutual fund trust as a partnership would subject a US person investor to roughly the same US taxation as if that person had invested in a US RIC.[74] The analogy is fruitful. There is no tax policy justification, compelling or otherwise, to subject a Canadian-resident US person investor to a significantly more punitive tax regime than that which would apply to a US-resident US person investor for investing in common consumer financial products located in the investor's country of residence. Why should a US citizen who is resident in Canada pay 80 percent tax to a foreign country on the sale of his or her retirement assets? There is no good answer.

Admittedly, these policy arguments may not prove useful in the interpretation and application of the default US entity classification rules. But they do lend colour and context to the analysis. In our view, along with the technical analysis provided here, they would be helpful in persuading the US Tax Court to find that a Canadian mutual fund trust is a partnership for US tax purposes, if it were ever asked to address the question. Furthermore, there is some precedent in support of the argument that a purposive approach should be used when interpreting statutes. In this case, such a reference would make sense given the inherent mismatch between a PFIC and a "plain vanilla" Canadian investment product. Such an approach is set out in *King v. Burwell* where the US Supreme Court decided that words must be read "in their context and with a view to their place in the overall statutory scheme."[75] Reference to the context

73 United States, Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, JCS-10-87 (Washington, DC: US Government Printing Office, May 4, 1987), at 1023.

74 Investment Funds Institute of Canada (IFIC), "Re: Senate Finance Committee's Request for Input on Improving the U.S. Tax Code—Comments Regarding Territorial Taxation and the Passive Foreign Investment Corporation Rules," submission to the United States Senate Committee on Finance, April 15, 2015 (www.ific.ca/wp-content/uploads/2015/04/IFIC-Submission-%E2%80%93-U.S.-Senate-Finance-Committee-%E2%80%93-Reforming-the-U.S.-Tax-Code-April-15-2015.pdf/10437/).

75 *King v. Burwell*, United States Supreme Court docket no. 14-144 (June 25, 2015). See also *Graham County Soil and Water Conservation Dist. v. United States ex rel. Wilson*, 559 US 280, at 290 (2010); and *Hardt v. Reliance Standard Life Ins. Co.*, 560 US 242, at 251 (2010).

and purpose of the Code and Treasury regulations indicates that Canadian mutual funds are not the intended target of the PFIC rules.

Limited Liability Is a Question of Canadian Law

Ultimately, the analysis turns on local law.[76] Thus, if it can be shown that, as a matter of Canadian law, the beneficiaries have *any* potential liability, a Canadian mutual fund trust may be classified by default as a partnership for US tax purposes. There is a persuasive argument that the beneficiaries of certain funds organized in certain provinces do not have limited liability. As noted earlier, at different times Ontario (in 2004), Manitoba (in 2005), Alberta (in 2004), British Columbia (in 2006), and Saskatchewan (in 2006) passed legislation that granted limited liability to the beneficiaries of mutual fund trusts.[77] Prior to the enactment of legislation, there were concerns that the beneficiaries of Canadian mutual fund trusts did not enjoy limited liability. The Bank of Canada issued a report in 2003 that concluded, "[A]lthough this [personal liability of unitholders] is legally feasible, a number of Canadian securities firms have given legal opinions that there is little probability of this type of event occurring."[78] Similarly, the government of Alberta issued a report referring to potential personal liability of unitholders, concluding that "although the chances are thought to be remote, such an occurrence could have a potentially devastating impact on the financial well-being of unit holders."[79] The government of Saskatchewan, in justifying its statute, stated, "[I]n situations where the trust property is insufficient to cover the liabilities, beneficiaries may be called upon to indemnify the trustee for amounts in excess of the investor's initial investment."[80]

The Bank of Canada and the governments of Alberta and Saskatchewan identified a remote, but still real, risk that beneficiaries of Canadian mutual fund trusts faced liability exposure. Limited liability statutes were enacted by several provinces as a result of these identified risks. Governments do not legislate without reason, and the provinces that chose to enact such statutes would not have done so had the risk not been real. Furthermore, as Robert Flannigan notes, "it was [the] state of the law that propelled the demand for a statutory immunity for business trust beneficiaries."[81] The next section explores in more detail the type of limited liability faced by Canadian mutual fund trusts.

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76 Treas. reg. section 301.7701-3(b)(2)(ii).

77 See supra notes 28-32. Also see supra note 27, with respect to similar legislation enacted in Quebec.

78 Michael R. King, *Income Trusts: Understanding the Issues*, Bank of Canada Working Paper 2003-25 (Ottawa: Bank of Canada, September 2003), at 19.

79 Alberta Revenue, *Income Trusts: Governance and Legal Status, a Discussion Paper* (Edmonton: Alberta Revenue, July 2004), at 5.

80 Government of Saskatchewan, "Income Trust Liability Act" (www.justice.gov.sk.ca/Income-Trust-Liability-Act).

81 Robert Flannigan, "The Political Path to Limited Liability in Business Trusts" (2006) 31:3 *Advocates Quarterly* 257-92, at 275.

Sources of Liability Under Canadian Law—The Indemnification Risk

Mark Gillen (of the University of Victoria Faculty of Law) has written an excellent article on the liability exposure of beneficiaries of Canadian mutual fund trusts.[82] His article focuses on the issue from a Canadian business-law perspective rather than a US tax perspective.

Gillen identifies three sources of potential liability for the beneficiaries of mutual fund trusts. Two are pertinent here. First, beneficiaries of mutual fund trusts could be liable for the debts of the trustee because the trustee and, more importantly, the trustee's creditors have the right to be indemnified out of the assets of the fund. If there are insufficient assets in the fund, the beneficiaries might be liable to the creditors. This is known as the indemnification risk. It functions as follows. Under Canadian law, a trust cannot be liable in contract or tort because it is not a legal person.[83] But the trustees (usually financial institutions in the case of retail mutual fund trusts) are legal persons. In carrying out their duties as trustees, they may enter into contracts, and they may commit torts. As a matter of general Canadian trust law, if trustees incur liability in the course of performing their duties, they are entitled to indemnification out of the assets of the trust.[84]

This right to indemnity is commonly found in the organizing documents that govern Canadian mutual fund trusts. For instance, the trust documentation that the Royal Bank of Canada (RBC) uses for its mutual funds includes a clause under which the trustee can be indemnified for all liability that it incurs, while acting in good faith, out of the assets of the fund.[85] As Gillen notes, such provisions may expose the beneficiaries of a trust to liability for the trustee's debts: "If the trust assets and the trustee's assets were insufficient to meet the liability, then the trustee's creditors might seek

82 Mark R. Gillen, "Income Trust Unitholder Liability: Risks and Legislative Response" (2005) 42:3 *Canadian Business Law Journal* 325-70. This section is largely based on the ideas in Gillen's article. We are indebted to him for his work on this issue (albeit in a different context). (Readers should note that we have relied on Gillen's citation of source documents and have reproduced a number of his footnotes verbatim, without editing or verifying the form and content of those citations. In all cases, we have indicated that such reference notes are taken from Gillen's article.)

83 Gillen, ibid., at 332, note 21: "See, e.g., *Kingsdale Securities Co. Ltd. v. MNR*, 74 DTC 6674, at 6681 (FCA). See also Sir Arthur Underhill and David J. Hayton, *Law Relating to Trusts and Trustees*, 15th ed. (London: Butterworths, 1995), at 4."

84 Gillen, supra note 82, at 332, note 23: "See, e.g., *Waters' Law of Trusts* in Canada, at 1155: 'The trustee is entitled to be indemnified for all the costs, charges and expenses which he has reasonably incurred.' See also Trustee Act, RSBC 1996, c. 464, as amended, section 95, which provides that 'a trustee [. . .] is answerable and accountable only for the trustee's own acts, receipts, neglects or defaults, and not for those of other trustees or a banker, broker or other person with whom trust money or securities may be deposited, nor for the insufficiency or deficiency of securities or any other loss, unless it happens through the trustee's own willful default, and may reimburse himself or herself, or pay or discharge out of the trust premises, all expenses incurred in or about the execution of his or her trusts or powers.' "

85 Royal Bank of Canada, RBC Funds, "Amended and Restated Master Declaration of Trust," June 27, 2014 (http://funds.rbcgam.com/pdf/financial-reports-and-prospectuses/rbc-declaration-of-trust.pdf), at article XVIII(3).

to enforce the right of indemnification in their favour."[86] Thus, the beneficiaries may be liable for the debts of the trustee and the fund in their entirety.[87]

This liability risk to the beneficiaries is often offset by a provision in the trust agreement that releases the beneficiaries from liability; for instance, the RBC trust agreement releases the unitholders from any liability.[88] Nevertheless, it is not clear if—in bankruptcy, for example—a third-party creditor would be required to respect this agreement. In sum, an entitlement to indemnification creates a theoretical, though perhaps remote, risk that the beneficiaries of a mutual fund trust may not have limited liability.

Sources of Liability Under Canadian Law—The Control Risk

The second potential source of liability is referred to as the control risk.[89] The control risk arises because the beneficiary-trust relationship may also be classified as a principal-agent relationship. A principal-agent relationship arises "when the principals control the agent's action, both the principal and agent consent to the relationship, and the agent has legal authority to affect the principal's legal position."[90]

An agency relationship is a question of fact. It does not require a legal agreement between the parties.[91] It can be inferred from the circumstances. If a trustee is found to be an agent on behalf of one or more beneficiaries, the beneficiaries may be held directly liable as principals. A trustee may be found to be an agent of the beneficiaries where the beneficiaries have a significant degree of control over the acts performed in respect of the trust.

Beneficiaries of Canadian business trusts have been found liable in some cases because of the existence of a principal-agent relationship. For instance, in *Trident Holdings Ltd. v. Danand Investments Ltd.*,[92] the Ontario Court of Appeal found that the parties were in an agency arrangement by virtue of the control that the beneficiaries had over the agent, and therefore the beneficiaries were liable for the debts of the trustee.

Similarly, in *Advanced Glazing v. Multimetro et al.*, the Supreme Court of British Columbia found that the beneficiaries had "the general power to control the conduct of MMC such that MMC is their agent" and "the broad power of investor control enables the investors to be personally liable" for the debts of the trustee.[93] There is

86 Gillen, supra note 82, at 333.

87 Ibid., at 332-33.

88 Supra note 85, at article XVIII(2). See Reed, supra note 1, at 36, for an argument that such a provision effectively shields beneficiaries from liability.

89 Gillen, supra note 82, at 343.

90 *Grosvenor Canada Limited v. South Coast British Columbia Transportation Authority*, 2015 BCSC 177, at paragraph 58.

91 Ibid., at paragraph 59.

92 (1988), 64 OR (2d) 65 (CA).

93 2000 BCSC 804, at paragraph 73.

no minimum legal threshold of control at which an agency relationship is created.[94] Each set of facts and circumstances must be analyzed. As the court put it in *Advanced Glazing*, "where both agent and trust relations exist, the greater the power of control over the agent/trustee the greater the likelihood that the principles of agency, rather than the principles of trust, are applicable."[95]

These principles are applicable to mutual fund trusts. Beneficiaries of mutual fund trusts have powers over the trustees that, very generally, often include the power to change the investment objectives of the fund, replace the trustees, and increase or decrease the amount of funds payable to the trust. The RBC declaration of trust, for instance, includes a clause that allows the unitholders to vote over "any other matter in respect of which applicable Securities Legislation would apply."[96]

It is true that the organizing documents of mutual funds generally restrict the amount of control that a beneficiary can exercise. For instance, they often reserve specific investment decisions to the trustee. This might suggest a level of control that would not rise to the level of agency. However, there is Canadian case law that indicates that even explicit contractual language does not ultimately remove power from the beneficiaries of a business trust. This case law includes the following:

- *Orange Capital LLC v. Partners Real Estate Investment Trust*.[97] The court upheld unitholder voting rights in relation to action by the trustee (or replacement thereof, as in this case), even in the face of contractual terms to the contrary, on the basis of achieving a "commercially sensible result."[98]
- *Crown Hill Capital Corp. (Re)*.[99] The fiduciary duty of the trustee in a business trust was held to include obtaining explicit informed consent of the unitholders where there is reasonable doubt as to whether the trustee can or cannot enter into a given contract.[100] Deferral to the trustee's judgment by virtue of the "business judgment rule" was found not to apply.[101]
- *Renegade Capital Corporation v. Dominion Citrus Limited*.[102] The court found trustees to be obligated to seek explicit approval of action that may be materially adverse to the interests of the unitholders themselves despite the fact that the powers of the unitholders were severely limited by contract.[103]

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94 *Grosvenor*, supra note 90, at paragraph 64.

95 *Advanced Glazing*, supra note 93, at paragraph 67.

96 Supra note 85, at article 16.12.1.4.

97 *Orange Capital LLC v. Partners Real Estate Investment Trust*, 2014 ONSC 3793.

98 Ibid., at paragraph 49.

99 *Crown Hill Capital Corp. (Re)*, 2013 LNONOSC 656.

100 Ibid., at paragraph 114.

101 Ibid., at paragraph 145.

102 *Renegade Capital Corporation v. Dominion Citrus Limited*, 2013 ONSC 1590.

103 Ibid., at paragraph 138.

The point here is not to draw a firm conclusion as a matter of Canadian law that the control risk means that beneficiaries have liability for the debts and obligations of a Canadian mutual fund trust. This remains a contentious point under Canadian law. Rather, we suggest that this risk is real enough to arguably push the default US tax classification of Canadian mutual funds to a finding of partnership—especially in the absence of a statute stating otherwise.

That said, while there is some contention in circumstances where control over the trustee is not absolute, there is none where the trustee is a "mere" agent, or "bare" trustee, of the beneficiary (as was the case in *Trident*). Thus, as Flannigan notes, there is no reason to assume that the same cannot be true in cases where the beneficiary has some control over the trustee—for instance, where the unitholders of a business trust can exercise some control over a trustee with discretion.[104]

The attractiveness of this argument from a US tax perspective is that the control risk is widely accepted as a matter of US law regarding US business trusts.[105] This means that a US court adjudicating a dispute over the US tax classification of a Canadian mutual fund trust would be familiar with the grounds on which trust beneficiaries may be held liable for the debts and obligations of the fund and may be favourably disposed to such a finding.

How Does the Change in Liability Status Affect the US Tax Classification of a Canadian Mutual Fund Trust?

Absent a statute to the contrary, the above analysis indicates at least some potential liability for the beneficiaries of Canadian mutual fund trusts. If the analysis is correct, between 1997 (when the current Treasury regulations were enacted) and 2004 (or the other appropriate date when the statute granting beneficiaries limited liability was enacted), beneficiaries of such trusts did not have limited liability because of the control risk. Thus, under the entity classification regulations in place since 1997, Canadian mutual fund trusts were classified as partnerships. After the limited liability statutes were enacted, in cases where the statutes applied, the liability status of the beneficiaries changed. However, the US tax classification of the mutual fund trust did not change. Treasury reg. section 301.7701-3(a) reads in part:

104 See supra note 81, at 275.

105 Gillen, supra note 82, at 337, note 36: "See, *e.g.*, *Williams v. Milton*, 102 N.E. 355 (Mass. S.J.C. 1913); *Frost v. Thomson*, 106 N.E. 1009 (Mass. S.J.C. 1914); *Home Lumber v. Hopkins*, 190 P. 601 (1920); *Neville v. Gifford*, 242 Mass. 124, 136 N.E. 160 (1922); *Goldwater v. Altman*, 292 P. 624 (1930); *Levy v. Nellis*, 1 N.E. 2d 251 (1936); *State Street Trust Co. v. Hall*, 311 Mass. 299, 41 N.E. 2d 30 (1942); *Piff v. Berresheim*, 92 N.E. 2d 113 (1950), revg 86 N.E. 2d 411 (1949); *In re Medallion Realty Trust*, 120 B.R. 245 (1990 D. Mass.); and *In Re Eastmare*, 150 B.R. 495 (1993 Bankr. D. Mass.); but see contra *Lawyer's Title Guarantee Fund v. Koch*, 397 So. 2d 455 (Fla. App. 1981). See also the discussion in Symposium, Closely Held Businesses in Trust: Planning, Drafting and Administration (1981) 16 Real Prop. Prob. & Trust J. 341."

> An entity whose classification is determined under the default classification retains that classification (*regardless of any changes in the members' liability that occurs at any time during the time that the entity's classification is relevant as defined in paragraph (d) of this section*) until the entity makes an election to change that classification under paragraph (c)(1) of this section [emphasis added].

In other words, a mutual fund trust retains its initial default classification until it elects otherwise. A mutual fund trust established prior to the enactment of the statutes was arguably a partnership for US tax purposes. Because of the above Treasury regulation, it remains a partnership for US tax purposes until it elects otherwise despite the subsequent change in its liability status. Few, if any, Canadian mutual fund trusts have made a US entity classification election, even though they are able to do so.[106] Partnerships cannot be PFICs. So the case can be made that Canadian mutual fund trusts established prior to 2004 (or the later date of an applicable statute) are not PFICs as a function of their retaining their original default entity classification.

Classification of Canadian Mutual Funds Prior to 1997

As noted above, the current rules for entity classification were adopted in 1997. Thus, for Canadian mutual funds formed after January 1, 1997 but prior to 2004 (or the date of an applicable statute), the above argument will apply perfectly. More consideration needs to be given to funds that were organized prior to 1997. In short, it can still be argued that funds formed prior to 1997 were classified under the previous set of US entity classification regulations (known as "the Kintner regulations") and thus were (and remain) classified as partnerships for US tax purposes. That classification needs to be examined.

Application of the Kintner Regulations to Canadian Mutual Fund Trusts

It is arguable that under the Kintner regulations, which were in effect between 1960 and 1997, Canadian mutual fund trusts were classified as partnerships for US tax purposes. The Kintner regulations used a four-factor test to determine entity classification. The four factors were continuity of life, centralized management, limited liability, and free transferability of interests. An entity that had at least three of these four factors was considered a corporation. Each of these factors was applied as outlined below:

1. *Continuity of life*. Continuity of life meant that the entity continued after the death or exit of one member from the entity.[107] This is clearly the case for Canadian mutual fund trusts.

106 Reed, supra note 1, at 36.

107 Former Treas. reg. section 301.7701-2(a)(1).

2. *Centralized management*. Centralized management meant that an identifiable group of people, distinct from the entire membership of the entity, had the power to make management decisions on behalf of the entity.[108] As discussed above, because of the fiduciary relationship between the trustee and the beneficiaries of a Canadian mutual fund trust, the beneficiaries have a certain amount of control over the trustee that is inherent in the structure of the trust and applicable regardless of what the organizing document states. This level of control by the beneficiaries may rise to the level necessary to constitute a lack of centralized management, especially in light of some of the cases discussed above. The management structure of a Canadian mutual fund trust may be another indicator of a lack of central management and control. Often, the trustee of the mutual fund trust has the power to appoint a manager. Whether this delegation is sufficient to conclude that there is a lack of centralized management is unclear. Against these two points lies the broad authority of a trustee of a mutual fund trust to make investment decisions over which the beneficiaries have little influence. In sum, it is not clear whether a Canadian mutual fund trust would be considered to have centralized management.
3. *Limited liability*. Limited liability had the same meaning that it has under the post-1997 regulations. For the reasons described above, it is arguable that not all members of a Canadian mutual fund trust have limited liability.
4. *Free transferability of interests*. Free transferability of interests meant that each member of an entity had the power to transfer all attributes of ownership of that member's interest in the entity to a person that was not currently a member of the entity without the consent of the other members.[109] There is a reasonable argument that units of the typical Canadian mutual fund are not freely transferable because, unlike corporate shares, they can only be sold back to the fund itself or transferred with consent of the fund administrator.

Transition Between the Kintner Regulations and the Check-the-Box Regulations

To fully understand the current default classification of Canadian mutual fund trusts, it is necessary to examine the transition between the Kintner regulations and the "check-the-box" regulations. Generally, unless it elected otherwise, an entity retained the classification under the check-the-box regulations that it had under the Kintner regulations.[110] Thus, because there is an argument that Canadian mutual

108 Former Treas. reg. section 301.7701-2(c)(1).

109 Former Treas. reg. section 301.7701-2(e)(1).

110 Treas. reg. section 301.7701-3(b)(3) (as amended by TD 8697, supra note 42) (providing that an entity not making the election will have the same classification as claimed before the 1997 regulations came into effect).

fund trusts were partnerships under the pre-1997 regulations, that classification can carry forward to 1997 and after as well. Absent an election, the IRS will respect the claimed pre-1997 classification of an entity after January 1, 1997 if

1. under the pre-1997 rules, the entity had a "reasonable basis" for its claimed classification;
2. any change in the entity's status within 60 months prior to January 1, 1997 was recognized by all of the entity's members; and
3. the IRS did not notify the entity before May 8, 1996 that the entity's classification was under review.[111]

All three criteria can be satisfied. The position described above (that the pre-1997 period classification of a Canadian mutual fund trust was a partnership) is clearly "reasonable." That status likely did not change within the 60 months before 1997, and the IRS likely did not notify Canadian mutual fund trusts of a change in classification. In short, there is an acceptable position to be taken that a Canadian mutual fund trust was a partnership under the Kintner regulations. If there is a reasonable basis for the pre-1997 position, the IRS should respect it after January 1, 1997.

Consider the alternative. What if a US court did not accept that under the Kintner regulations a Canadian mutual fund trust was a partnership for US tax purposes? Two scenarios are possible. First, assume that a court concludes that a Canadian mutual fund trust was a corporation under the Kintner regulations and also, despite all of the arguments to the contrary above, under the check-the-box regulations. The US person investor would then have continuously owned shares in a foreign corporation since the date of purchase of the shares. If the foreign corporation was a PFIC, the results could be very expensive. Second, assume that a US court accepts that a Canadian mutual fund trust was a partnership for US tax purposes under the check-the-box regulations, but not under the Kintner regulations. Further assume that if the trust was a corporation, it was also a PFIC. Under this scenario, the Canadian mutual fund trust ceased to be a corporation for US tax purposes on January 1, 1997 when the check-the-box regulations came into effect. This would result in a deemed liquidation of the fund for US tax purposes and thus liability for PFIC tax recognizable by all US person investors in the trust in 1997. At first glance, this might appear to be a bad result. But if US person investors who currently invest in a Canadian mutual fund trust did not own their investment in 1997, they do not have to worry about a deemed liquidation. The trust itself is not subject to US tax—only its US person investors' interests are. For US person investors who did own an interest in a fund that underwent a deemed liquidation in 1997, this year is likely statute-barred, so as a practical matter, the question of liability for tax in respect of the liquidation is irrelevant.

111 Treas. reg. section 301.7701-3(h)(2).

Put simply, for US tax purposes, the conversion of the trust from a corporation to a partnership is relevant only to those who owned an interest in the fund at that time, and even then any tax consequence is barred by the statute of limitations. In short, although the classification is more complicated for funds organized prior to 1997, there remains a reasonable argument that the funds were and remain partnerships for US tax purposes.

Conclusion: Funds Organized Prior to 2004 Are Likely Not PFICs

There are grounds to argue that certain Canadian mutual fund trusts that were organized before the enactment of the limited liability statutes are partnerships and not corporations for US tax purposes, and thus not PFICs. This is because the beneficiaries of these funds did not have limited liability. This position is not risk-free. Even prior to the enactment of the limited liability statutes, the liability exposure of beneficiaries of Canadian mutual fund trusts was remote. It is thus possible that a US court would conclude that the liability is so abstract and theoretical that, for the purposes of US law, it does not count and that all of the members of the mutual fund do indeed have limited liability.

This possibility is illustrated by analogy to a Canadian corporation. As a matter of law, Canadian corporations provide limited liability. Accordingly, they are automatically treated as corporations for US tax purposes. Even so, shareholders of Canadian corporations will occasionally be subject to liability for the debts and obligations of the corporation. Canadian courts will pierce the corporate veil and subject the shareholders to liability for the debts and obligations of the corporation if it is just and equitable to do so.[112] US courts, without any reference to Canadian mutual funds, have drawn a similar analogy. In *Yamagata v. United States*,[113] the US Federal Court of Claims held that a Japanese *kabushiki kaisha* was a corporation for US tax purposes despite the fact that the owners had some theoretical liability for the debts of the entity.

Nevertheless, the above analysis shows that such liability may be possible, even if unlikely. In litigation, often the simplest argument wins. The position that Canadian mutual funds formed prior to the enactment of the limited liability statutes are not PFICs is relatively easy to grasp. Until 2004, there was a problem of potential liability exposure for beneficiaries of mutual fund trusts. The mutual fund industry lobbied for a remedy. So governments introduced a new law to solve the problem.[114] Under the US rules, the entity classification status of a Canadian mutual fund trust organized prior to 2004 (or the year of an applicable statute) is frozen until an election

112 *Kosmopoulos v. Constitution Insurance Co.*, [1987] 1 SCR 2.

113 Docket nos. 07-698T and 07-704T (Fed. Ct. Cl. 2014).

114 Supra notes 28-32.

is made otherwise. Therefore, Canadian mutual fund trusts that were previously classified as partnerships remain partnerships for US tax purposes.

It is more likely than not that a US court reviewing this position would conclude that funds formed prior to the enactment of the statutes granting limited liability to investors in the fund, as of today, are not corporations for US tax purposes and thus cannot be PFICs.

Trusts Not Subject to the Limited Liability Statutes May Also Be Partnerships

The second strategy to achieve partnership classification for a Canadian mutual fund trust is to argue that the limited liability statutes simply do not apply to certain trusts. These mutual fund trusts are still exposed to the control risk, and thus for the reasons outlined above they may be, by default, partnerships for US tax purposes. There are two groups of funds to which this analysis might apply. First, Canadian mutual fund trusts organized in a jurisdiction where there is no limited liability statute obviously cannot claim coverage by such a statute. Second, the limited liability statutes only apply to certain Canadian mutual fund trusts. For instance, the Ontario statute[115] only applies to trusts that are "reporting issuers." Thus, funds that are not "reporting issuers" under the relevant provincial securities legislation may not be corporations for US tax purposes, and thus may not be PFICs, by virtue of the liability exposure of their beneficiaries resulting from the control risk.

Newly Formed Trusts Can Elect To Be Partnerships

The third strategy for a Canadian mutual fund trust to achieve partnership classification is to elect it on formation. As discussed above, Canadian mutual fund trusts are foreign eligible entities under the US entity classification regime.[116] This is confirmed by PLR 200752029 described above.[117] The election is made by filing form 8832. It must be made at the fund level. The election would work very well for newly created funds. From the commencement of the fund, it would indisputably be a partnership for US tax purposes, regardless of the liability of its beneficiaries. The election does not work as well for existing funds. It can be used to confirm a fund's existing status as a partnership (a protective election), but it only applies retroactively for the prior 75 days. The risk with this option is that if, before making the election, the trust was considered a corporation for US tax purposes, the conversion from a corporation to a partnership would constitute a liquidation and trigger PFIC tax for the US person investors. Funds should not make this election without being confident that they have always been partnerships for US tax purposes.

115 Supra note 28.

116 Treas. reg. section 301.7701-3(a).

117 See supra note 58 and the related text.

All Canadian Mutual Fund Trusts May Be Partnerships for US Tax Purposes

A fourth possible strategy is to take the position that all Canadian mutual fund trusts are partnerships for US tax purposes—not just those organized prior to the enactment of the limited liability statutes or those to which the statutes do not apply. There is an argument to this effect. It is a "reasonable position" required under IRC section 6662. But the argument is risky, and it might not hold up in litigation. It runs as follows.

Regardless of any legislation in place, beneficiaries of a Canadian mutual fund trust are subject to the control risk described earlier. Arguably, the limited liability statutes protect only against the indemnification risk, and not the control risk. For example, section 1(1) of the Ontario Trust Beneficiaries' Liability Act reads in part:

> The beneficiaries of a trust are not, as beneficiaries, liable for any act, default, obligation or liability of the trust or any of its trustees if, when the act or default occurs or the obligation or liability arises. . . .[118]

On a "plain meaning" reading, this provision protects the beneficiaries from liability only as beneficiaries, and not as principals for the acts of their agents.[119] So the beneficiaries are still subject to the control risk. The text of the Alberta statute is the same.

This argument rests on a theoretical point. There is no case law on its merits. Given the legislature's intention to protect beneficiaries of Canadian business trusts, a Canadian court may be reluctant to hold the beneficiaries personally liable, even though they may be liable as principals rather than as beneficiaries. Nevertheless, the liability risk remains, and it may be sufficient to result in classification of the fund as a partnership for US tax purposes, or to at least support the adoption of such classification as a filing position, given the requirement of the "limited liability" definition that no member may be held liable for "any portion" of creditors' claims against the entity.

There are other scenarios in which the beneficiaries of a Canadian mutual fund trust covered by a limited liability statute have liability risks. Assume, for example, that the mutual fund trust invests in a REIT outside a jurisdiction with such a statute. The investment generates liability for the mutual fund trust, but there is no statute to protect the beneficiaries. Accordingly, the creditors of the mutual fund trust may be able to attempt to collect debts and obligations of the trust from the beneficiaries. This risk is specifically disclosed in the documentation of many mutual fund trusts. For instance, RBC's *Simplified Prospectus* states:

> A fund that invests in trusts faces the risk that, as a holder of units of a trust, the fund may be held liable and subject to levy or execution for satisfaction of all obligations and claims of the trust. This risk may arise with income trusts, which include real estate

118 Supra note 28, at section 1.

119 Gillen, supra note 82, at 359-62.

> investment trusts and other forms of business trusts. The risk is considered remote. Alberta, Ontario, Saskatchewan, British Columbia and Manitoba have legislation to eliminate this risk in respect of holders of units of trusts that are reporting issuers organized under the laws of such provinces. *To the extent that the funds are subject to such claims and such claims are not satisfied by the fund, there is a risk that a unit holder of the fund could be held personally liable for the obligations of the trust*. The possibility of a unit holder incurring personal liability of this nature is considered extremely remote.[120]

Although, as the RBC disclosure statement suggests, the risk may be "extremely remote," it is important to recognize that it does exist. Given that the Treasury regulations state that there is no limited liability where there is the potential for personal liability for "any" debts of the trust, this liability risk may be sufficient to support a position that a Canadian mutual fund trust is, by default, not a corporation for US tax purposes. The acknowledgment of risk indicates at the very least an awareness of the potential exposure of unitholders. As noted in the discussion of statutory interpretation above, the mere presence of *any* liability is enough to classify an entity as a partnership. The fact that Canadian mutual funds continue to disclose this risk to unitholders indicates that the risk is indeed real. Accordingly, it could be argued that even mutual funds covered by limited liability legislation are not corporations under the US entity classification rules in Treas. reg. section 301.7701.

It may be unlikely that a US court would judge the risk sufficient to give rise to the degree of exposure for beneficiaries of a mutual fund trust required to support classification of the trust as a partnership for US tax purposes. Regardless, this position may be sufficiently meritorious to be taken on a US tax return, as a result of the strict meaning of the word "any." For the beneficiaries of Canadian mutual fund trusts that are covered by a limited liability statute, there is a position that can be taken, albeit a less securely grounded one, that despite the statutes, Canadian mutual fund trusts are partnerships for US tax purposes.

THE PUBLICLY TRADED PARTNERSHIP RULES WILL NOT DENY FLOWTHROUGH TAXATION

We have presented above four strategies that support the position that a Canadian mutual fund trust can be classified as a partnership for US tax purposes. Certain large partnerships, however, are at risk of being taxed as corporations if they are deemed to be "publicly traded partnerships" (PTPs). As long as a Canadian mutual fund trust is not registered with the US SEC under the 1940 Investment Company Act (as is generally the case),[121] the PTP rules should not prevent it from being taxed as a flowthrough entity for US tax purposes.

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120 Royal Bank of Canada, RBC Funds, *Simplified Prospectus* (Toronto: RBC Global Asset Management: June 2011), at 8 (emphasis added).

121 See supra note 37 and the related text. As noted earlier, only funds organized in the United States as "regulated investment companies" (RICs) must register under the 1940 Act. Many Canadian mutual funds include language in their prospectuses indicating that they are not

The PTP rules were designed to protect the US corporate tax base by preventing large businesses from reducing their liability for tax by simply operating as partnerships. IRC section 7704 provides that a PTP is treated as a corporation for all federal tax purposes (including the application of the PFIC rules).[122] A partnership is "publicly traded" if interests in it are "traded on an established securities market" or are "readily tradable on a secondary market or the substantial equivalent thereof."[123] Most Canadian mutual fund trusts available to the public will meet these criteria.[124]

Thankfully, there is an exception, which is known as the "qualifying income exception." An entity deemed to be a PTP does not constitute a corporation for a taxable year if, for that taxable year and each preceding taxable year during which the partnership was in existence, 90 percent of the gross income of the partnership was "qualifying income."[125] "Qualifying income" includes interest, dividends, rents from real property, gain from the sale of real property, gain from the sale of stock, income and gains from commodities, and a few more esoteric items.[126] Most Canadian mutual fund trusts earn nothing but dividends, interest, and capital gains, and so would easily qualify for this exception.

The qualifying income exception is, however, limited. IRC section 7704(c) states that a PTP will not be taxable as a corporation if 90 percent of its income is passive. However, IRC section 7704(c)(3) limits the applicability of this exception. The qualifying income exception does not apply to "any partnership, which would be described in section 851(a) if such partnership were a domestic corporation." In turn, IRC section 851(a) reads:

> For purposes of this subtitle, the term "regulated investment company" means any domestic corporation—
>
> (1) which, at all times during the taxable year—
>
> (A) *is registered* under the Investment Company Act of 1940, as amended (15 USC 80a-1 to 80b-2) as a management company or unit investment trust, or
>
> (B) has in effect an election under such Act to be treated as a business development company, or
>
> (2) which is a common trust fund or similar fund excluded by section 3(c)(3) of such Act (15 USC 80a-3(c)) from the definition of "investment company" and is not included in the definition of "common trust fund" by section 584(a) [emphasis added].

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registered in the United States. This language is usually very similar to the following: "The funds and the securities offered under this Simplified Prospectus are not registered with the United States Securities and Exchange Commission and they are sold in the United States only in reliance on exemptions from registration." National Bank Investment, *Jarislowsky Fraser Funds Simplified Prospectus* (Montreal: National Bank Investment, September 2014), note on the title page (www.jflglobal.com/media/uploads/documents/2014-11/Prospectus_EN.pdf).

122 IRC section 7704(a).

123 IRC section 7704(b).

124 Treas. reg. section 1.7704-1(c)(1); Treas. reg. section 1.7704-1(c)(2).

125 IRC section 7704(c)(2).

126 IRC section 7704(d)(1).

Thus, the question that must be answered is the following: If a Canadian mutual fund trust were a US domestic corporation, would it meet the description in IRC section 851(a)? To answer this question, it is necessary to examine IRC section 851(a) in detail.

The preamble of section 851(a) is easily dispensed with. If a Canadian mutual fund trust were hypothetically considered a US domestic corporation, it would obviously be an entity that is described in the preamble.

Next, consider the three operative clauses. Taking the last two first, section 851(a)(1)(B) would not apply, given that no Canadian mutual fund trust has made or would make such an election. Furthermore, such an election would prima facie establish the entity as registered under the 1940 Act and, as noted, that is normally not the case. Section 851(a)(2) also would not apply. Section 3(c)(3) of the 1940 Investment Company Act applies only to funds and trusts that "are employed by a bank solely as an aid to the administration of trusts, estates, or other accounts created and maintained for a fiduciary purpose" and are also "not advertised or offered for sale to the general public."[127] Canadian mutual fund trusts are not aids to a fiduciary product; they are collective investment vehicles. Further, they are advertised to the general public. Therefore, even if they were domestic corporations, they would not meet the conditions in section 851(a)(2).

Only section 851(a)(1) might, but ultimately does not, describe a Canadian mutual fund trust, assuming that it could be considered a US domestic corporation. The plain meaning of the phrase "at all times during the taxable year—is registered" is that a PTP must actually be registered under the 1940 Investment Company Act in order to be denied reliance on the qualifying income exception. Accepted rules of US statutory interpretation, discussed above, suggest that this reading is correct.[128] Since Canadian mutual fund trusts do not register under the 1940 Act, they cannot be described by IRC section 851(a), even with the hypothetical addition of domestic status.

This view is supported by legislative history. The congressional report enacting the legislation in 1987 explained IRC section 7704(c)(3) as follows:

> As under the House bill, the provision [section 7704(c)] does not apply to any partnership that would be described in sec. 851(a) if it were a domestic corporation. Thus, a publicly traded partnership that is registered under the Investment Company Act of 1940 generally is treated as a corporation under the provision.[129]

This statement was repeated verbatim in the Senate Committee Report to the 1997 Taxpayer Relief Act.[130] This language makes it clear that the legislative intent in

127 Investment Company Act of 1940, supra note 37.

128 See supra note 65 and the related text.

129 HR rep. no. 100-495, 100th Cong., 1st sess. (1987), at 946.

130 HR rep. no. 105-220, 105th Cong., 1st sess. (1997), at 471.

enacting IRC section 7704(c)(3) was to deny the qualifying income exception only to those PTPs that are actually registered under the 1940 Act. A US law firm reached the same conclusion in an opinion that it rendered publicly (available on the SEC website),[131] as did the authors of a publication of the Bureau of National Affairs in a comment on section 7704.[132]

In short, although Canadian mutual fund trusts will likely be subject to the PTP rules, as long as they are not registered under the 1940 Investment Company Act they will be able to benefit from the qualifying income exception, because by far the largest portion of their revenue is passive income. The PTP rules should not deny a Canadian mutual fund trust flowthrough taxation for US tax purposes.

FILING REQUIREMENTS OF INDIVIDUAL INVESTORS UNDER A PARTNERSHIP CLASSIFICATION

Taking the position that a Canadian mutual fund trust is a partnership for US tax purposes is very beneficial for individual US person investors. Most obviously, the funds are not PFICs for US tax purposes, and thus the individual investor does not have to deal with a punitive tax regime designed to combat offshore tax deferral. The annual compliance burden for the individual investor is also dramatically reduced.

Assuming that the Canadian mutual fund trust is a partnership for US tax purposes, the US person investor owns a small fraction of a foreign partnership. The income from this partnership will have to be reported on form 1040 ("U.S. Individual Income Tax Return"); however, no additional reporting is required unless the US person's investment in a single Canadian mutual fund exceeds a specified threshold in a given year.[133] Form 8865 must be filed if a US person investor's share of all interests in a foreign partnership is greater than 10 percent or if a US person investor contributes more than US$100,000 to a foreign partnership in a taxable year. The vast majority of investors in large mutual funds will not fall into either of these categories. A more cautious taxpayer basing his or her tax filing on the partnership classification may want to pre-emptively disclose that position to the IRS on form 8275 ("Disclosure Statement"), which is used to disclose unorthodox tax positions. Filing the form insulates the taxpayer from some penalties and may shorten the time period under the statute of limitations (the period within which the IRS must audit a return before a reassessment becomes statute-barred).[134]

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131 Skadden, Arps, Slate, Meagher and Flom LLP, "Re: MacroShares Major Metro Housing Down Trust," opinion letter from Skadden, Arps, Slate, Meagher and Flom LLP, 2008 (www.sec.gov/Archives/edgar/data/1435967/000111650208001226/exhibit81.htm).

132 Matthew W. Lay, Eric Sloan, and Amy Lutton, *Publicly Traded Partnerships*, Tax Management Portfolio no. 723 (Arlington, VA: Bureau of National Affairs, 2012), at 45.

133 IRC section 6038.

134 IRC section 6662(d)(2)(B)(ii)(I).

FILING OBLIGATIONS FOR MUTUAL FUNDS THAT ARE PARTNERSHIPS

The filing obligations that accompany a partnership classification can be onerous for an investment fund that invests in the United States. For funds that do not invest in the United States, there are no filing obligations. A foreign partnership that does not have income effectively connected with a US trade or business or US-source income does not have to file a US tax return or provide a form K-1 to its investors.[135] If a Canadian mutual fund trust chooses to invest in the United States, it will likely have to file a form 1065 annually and issue form K-1 to its US person investors, or to all investors if the trust is engaged in a US trade or business.[136] Most Canadian mutual fund trusts are not engaged in a US trade or business because they trade only in securities on their own account and do not act as a broker or dealer that sells US securities directly to customers.[137]

DRAWBACKS OF PARTNERSHIP CLASSIFICATION

Potentially Increased US Estate Tax Risk

A potential drawback for Canadian mutual fund trusts that adopt a partnership classification is the increased US federal estate tax risk to which such a move may expose their non-US investors. However, even for funds that invest in the United States, there is a reasonably strong argument that their investors should not be subject to US estate tax.

US estate tax applies to decedents, including Canadians who are not US person investors, who have US-situs assets at their death. Stocks issued by a US corporation are US-situs assets and thus subject to estate tax.[138] The question is whether US stocks owned through a Canadian mutual fund trust are US-situs assets. If the Canadian mutual fund trust is a corporation for US tax purposes, there is no US estate tax exposure since the beneficiary owns stock in a foreign corporation. The estate tax applies only to stock issued by a US domestic corporation.[139]

However, as noted above, partnerships are flowthrough entities for US tax purposes. Thus, the owners of the partnership may be assumed to own its assets directly. It is unclear whether owning US-situs assets through a foreign partnership subjects a non-US person investor to US estate tax. It may be that a foreign partnership interest (such as an interest in a Canadian mutual fund trust that has adopted partnership

135 Schedule K-1 to IRS form 1065, “U.S. Return of Partnership Income.” See Treas. reg. section 1.6031(a)-1(b)(1)(i).

136 Treas. reg. section 1.6031(a)-1(b)(3).

137 IRC section 864(b)(2)(A)(ii).

138 IRC section 2104(a).

139 Ibid.

classification for US tax purposes) would be considered foreign intangible property and therefore not subject to US estate tax.[140]

Furthermore, there is a view that a beneficiary's interest in a partnership is characterized as a personal property interest in the partnership itself rather than in the underlying assets held by the partnership.[141] It would follow that in the case of a partnership like a mutual fund, where the individual investor does not have the power to vary the investments (despite having some control over the trustee), interests in the fund would be treated as foreign personal intangible property. Equity would favour this view, since investors in mutual funds do not have investment expertise and, for that reason, buy units in such a fund as assets in and of themselves. Part of the value proposition of the mutual fund is the particular expertise of the trustee.

Where this is the case, the interest in the partnership is commonly treated as being similar to stock in a company for estate tax purposes. Accordingly, the situs of the investor's interest is determined on the basis of where the partnership is managed, rather than the situs of the underlying assets. This understanding is set out in the US-Australia treaty, article III(1)(g) of which provides that "a partnership shall be deemed to be situated at the place where the business of the partnership is carried on."[142]

The IRS refuses to clarify the question of potential estate tax exposure and will not issue rulings on it.[143] However, in the event that US partnership status does expose a non-US person investor in a Canadian mutual fund trust to US estate tax, Canadian residents benefit from a significant exemption from such tax under the Canada-US treaty.[144] As long as the total value of a Canadian resident's estate is US$5.43 million or less (the 2015 credit amount), there will be no liability for US estate tax if the appropriate forms are filed. This means that very few Canadian residents would have any US estate tax exposure.

The estate tax issue remains an important consideration for Canadian mutual fund trusts considering the adoption of a partnership structure at the institutional level. Such trusts should be alert to the potential US estate tax risk to potential investors who are not US person investors. This risk does not matter for individual US citizen investors in Canada who may be considering adopting the partnership position on a US tax return; those investors will be subject to US estate tax by virtue of

140 Treas. reg. section 20.2014-1(a)(1).

141 Jeffrey A. Schoenblum, *Multistate and Multinational Estate Planning*, vol. 2, section 20.05[i], at 156.

142 The Convention Between the Government of the United States of America and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Sydney, on August 6, 1982, as amended by the protocol signed on September 27, 2001.

143 Treas. reg. section 20.2105-1(e); Rev. proc. 2000-7, 2000-1 CB 227.

144 Canada-US treaty, article XXIX B(2).

their citizenship. Nor does it matter for Canadian mutual fund trusts that do not invest in the United States, since only US-situs property is subject to US estate tax. Where the issue does matter is in contemplating the consequences for Canadian investors who could be exposed if the United States were to rule against the traditional understanding that such partnership interests are similar to stock in a corporation from an estate tax perspective.

Potentially Higher Canadian Withholding

There is one further potential drawback of a partnership classification—denial of benefits to the trust under the Canada-US treaty. This drawback applies only to Canadian mutual fund trusts that take the position that they are partnerships at an institutional level. The issue is irrelevant for an individual investor taking a partnership position on his or her US tax return. A denial of treaty benefits would require a Canadian mutual fund trust to withhold Canadian tax at a rate of 25 percent on payments to US residents.[145] Fortunately, there is a reasonable argument that treaty benefits should not be denied. Even if treaty benefits are denied, US-resident investors can simply use the extra Canadian tax withheld as a foreign tax credit against their personal US taxes. If extra Canadian tax is owed, because the US-resident investor has insufficient foreign-source income to make full use of the foreign tax credit, this is still a preferable result than the application of the PFIC regime.

Article IV(7)(b) of the Treaty Should Not Apply

Article IV(7)(b) of the Canada-US treaty will deny treaty benefits to a US resident who receives payments from a Canadian mutual fund trust if all of the following conditions are met:

1. Under the laws of Canada, the US resident is considered to have received the payments from an entity resident in Canada.
2. Under US law, the mutual fund trust is fiscally transparent.
3. Under US tax law, the treatment of the amount received is not the same as it would be if the Canadian mutual fund trust were fiscally transparent.

The first two criteria are easily satisfied. For Canadian tax purposes, the mutual fund trust is a resident of Canada and, if classified as a partnership, it is fiscally transparent for US tax purposes.

The third criterion is trickier. There is an argument, which is not flawless, that the US tax treatment of a distribution to a US resident from a Canadian mutual fund trust electing partnership classification is similar to the US tax treatment that would apply to the distribution if the fund were a corporation for US tax purposes. To start out, consider one of the examples offered by the technical explanation to the 2007

145 Part XIII of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended.

protocol to the treaty.[146] The example involves a US corporation that is the sole shareholder of a Canadian unlimited liability company (ULC), which is a disregarded entity for US tax purposes. The ULC pays a dividend to the US corporation. For Canadian tax purposes, this payment is a dividend. For US tax purposes, the payment is disregarded. Had the ULC elected a corporate classification for US tax purposes, the payments from the ULC to the US corporation would have been a dividend for US tax purposes. This is quite a different result than that under a scenario where a ULC is a fiscally transparent entity. Accordingly, article IV(7)(b) applies and treaty benefits are denied. From this, we can infer that the payment has to take on a substantially different character in order for article IV(7)(b) to apply.

Fundamentally, this is a Canadian tax question because the matter at issue is how much Canadian tax a Canadian mutual fund trust would have to withhold on a payment to a US resident. Thus, it is the views of the Canada Revenue Agency (CRA) on article IV(7)(b) that need to be considered. The CRA has addressed the "same treatment" test in a few different rulings. For example, in CRA document no. 2009-0318491I7, it stated:

> The determination of whether the quantum of the amount is not the same under Article IV(7)(b) is made without reference to losses, deductions or credits available under the [US Internal Revenue] Code in computing the United States tax liability of the recipient of the amount, or in the computation of the consolidated taxable income of a group of corporations which includes the recipient. In other words, the determination of same treatment will be made by reference to the gross amount of the item of income.[147]

Importantly, this ruling indicates that it is gross income that is the important amount, not the amount of US tax paid. The CRA further spells out the three key factors to be considered in making the determination:

1. the timing and recognition of the amount,
2. the character of the amount, and
3. the quantum of the amount.

The comparison that must be made in order to determine whether the same treatment would apply under a partnership classification and a corporate classification is straightforward. The timing, character, and quantum of the amount received by a US resident from a distribution by a Canadian mutual fund trust must be the same as determined under US tax rules regardless of the classification of the entity.

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146 Department of the Treasury Technical Explanation of the Protocol done at Chelsea on September 21, 2007 amending the Convention between the United States and Canada with respect to taxes on income and on capital done at Washington on September 26, 1980, as amended by the Protocols done on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997.

147 CRA document no. 2009-0318491I7, November 13, 2009.

Otherwise, Canada will deny treaty benefits and extra tax will have to be withheld from the payment to the US resident. For the purposes of this discussion, assume that under both classifications the Canadian mutual fund trust does not engage in a US trade or business through a US permanent establishment, so that there is no entity-level US corporate tax.

The quantum of the income to the US resident under US tax principles will be the same under both classifications. Canadian mutual fund trusts normally distribute all of their income. Under both classifications, the quantum will be the sum of distributions received by the US resident. A corporate or partnership classification does not change this. Similarly, the timing of the receipt of the income will be the same under both a corporate and a partnership classification: the income will be received in the year in which it is distributed by the fund.

The character of the income may be slightly different. If a Canadian mutual fund trust is a partnership for US tax purposes, all of the income will retain its character for US tax purposes when it flows through to the investor. If the fund is a corporation, and not a PFIC, then all of the income that is distributed will be dividend income for US tax purposes. Therefore, the character will be different. But the odds are that if Canadian mutual fund trusts are corporations for US tax purposes, they will be PFICs. The PFIC regime imposes a special tax regime that is different than the tax regime applicable if the fund elects classification as a partnership. Nevertheless, if the fund is a PFIC, a US investor will likely take the QEF election. This will, in spirit, make the fund a flowthrough entity for US tax purposes—meaning that the tax treatment of the distribution will be very similar to that of a Canadian mutual fund trust that has elected partnership classification. So there is a scenario (and one that is likely to occur)—namely, where a US person investor takes the QEF election—under which the distributions will maintain essentially the same character regardless of the Canadian mutual fund trust's classification. The flaw in this argument is obvious: to achieve similar character of income, an election is necessary under US law. Still, that election is likely to be made.

A purposive approach to applying article IV(7)(b) buttresses this conclusion. Article IV(7)(b) is an anti-avoidance rule that was designed to deter the creation of structures whereby interest is deducted twice or an interest deduction is taken without a corresponding inclusion of income. The US Joint Committee on Taxation report on the proposals for the 2007 protocol makes it clear that the intended purpose of article IV(7)(b) was to prevent

> (1) duplicated interest deductions in the United States and Canada, or (2) a single, internally generated interest deduction in one country without offsetting interest income in the other country.[148]

148 United States, Staff of the Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada*, JCX-57-08 (Washington, DC: Joint Committee on Taxation, July 8, 2008), at 100.

A US partnership classification of a Canadian mutual fund trust achieves neither of these unwanted results. All that it avoids is the application of an extremely punitive tax regime to a mundane consumer financial product that thousands use to save for retirement. In short, to the extent that it matters to the CRA or to a Canadian tax court, equity favours the non-application of article IV(7)(b). There is a reasonable technical argument that article IV(7)(b) should not apply. Given equitable considerations, the CRA may be inclined to agree.

Even the Application of Article IV(7)(b) Is Not Overly Problematic

If article IV(7)(b) were to apply, Canadian mutual funds would have to withhold 25 percent of payments made to US-resident investors. This would be in excess of what is currently withheld. There are a number of factors that make this additional withholding less expensive to the US-resident investor than it might otherwise be. First, under the Income Tax Act, without regard to the treaty, the withholding would not apply to US-resident investors who hold the investment in a registered retirement, education, or disability savings plan, a tax-free savings account, or other registered plan.[149] Many Canadian mutual funds are held inside registered plans. Second, the Income Tax Act exempts from withholding capital gains allocated to non-resident beneficiaries and capital distributions from certain mutual fund trusts.[150] The 25 percent withholding would apply only to distributions of dividends from the fund; it would not apply to dispositions of the units of the fund. Third, a foreign tax credit would be available under the US tax system for the full amount of the withholding. Excess credits that cannot be used in one year can be carried forward for 10 years. Finally, from the perspective of the US-resident investor, increased Canadian withholding is vastly superior to the application of the PFIC regime, with its very punitive tax consequences and complex reporting requirements.

Overview of Drawbacks

A partnership classification for a Canadian mutual fund trust removes the onerous PFIC regime. We have discussed four strategies above. Both individual investors and fund administrators can use three of them. The fourth, a formal partnership election, can only be made at the fund level. A partnership classification imposes a low burden on the individual investor. Not only are the punitive PFIC rules eliminated, but the annual tax reporting is also made much easier.

For fund administrators, a partnership classification is virtually painless for funds that do not invest in the United States. There is no compliance obligation and no increased US estate tax risk. Further, administrators do not have to trouble themselves with providing the QEF paperwork and can guarantee that their funds are

149 See supra note 145.

150 Ibid., paragraph 104(21)(b).

PFIC-free. For funds that do invest in the United States, a partnership classification makes everything more complex, and the benefits are less clearcut. However, the prospect of being able to attract US person investors by having a PFIC-free mutual fund may outweigh the potential compliance costs.

CONCLUSION: PFIC PROBLEMS ARE SOLVABLE

The PFIC regime was established in 1986 to combat offshore tax deferral. As befits such a regime, its rules are complex and punitive. It was never designed to apply to the retirement savings of US person investors who reside outside the United States. Indeed, from a tax policy perspective, there is no justification (compelling or otherwise) for its application. A common view is that Canadian mutual fund trusts are corporations for US tax purposes and thus very likely PFICs. This view emerged in 2010 after the issuance of CCA 201003013. This CCA did not focus on the US tax classification of Canadian mutual funds, nor did it include any facts or analysis related to the mutual funds at issue. Indeed, it simply stated a conclusion. The CCA specifically states that it is not binding on taxpayers. Put simply, a single sentence in a non-binding memorandum led many practitioners to adopt the position that Canadian mutual funds were PFICs, out of a concern for the onerous consequences of being subject to this regime.

In this article, we have set out to show that the PFIC problems facing US person investors in Canadian mutual funds are not irresolvable. We have done so by exploring solutions based on two different classifications of Canadian mutual fund trusts. Canadian mutual fund trusts are either corporations or partnerships for US tax purposes. Assuming that they are corporations, there are three strategies for solving the PFIC problem: holding the investment in an RRSP, making the QEF election, or making the mark-to-market election. All three strategies are largely unsatisfactory. RRSP contribution room is limited. Both the QEF and the mark-to-market elections require the payment of PFIC tax on any prior accumulated gain before they work properly. Also, both elections may result in double taxation and require the investor to undertake complex and expensive annual compliance work.

Alternatively, Canadian mutual fund trusts can be partnerships for US tax purposes. The key factor in the choice between classification as a partnership and classification as a corporation is whether the investors have any liability. If the investors have limited liability, the trust is a corporation for US tax purposes. If the investors have any liability, the trust is a partnership for US tax purposes. US rules of statutory interpretation indicate that this is a litmus test that hinges on the plain meaning of the word "any."

Until the early 2000s, this liability exposure was sufficient to discourage institutional investment in Canadian mutual fund trusts, and it was recognized by politicians, practitioners, and investment advisers that the risk was not merely theoretical. Several provincial governments responded by enacting statutes granting limited liability to the unitholders of Canadian mutual fund trusts, starting in 2004.

The investors in Canadian mutual fund trusts formed prior to the enactment of these statutes had liability for the debts and obligations of the fund. Thus, all funds

were likely partnerships for US tax purposes prior to 2004. The enactment of the statutes may have changed the liability status of the investors, but it did not alter the US tax classification of the funds already formed under the US regulations. Trusts to which the statutes do not apply, because they are organized in provinces without a statute or because they are not "reporting issuers," are also likely partnerships. Fund administrators can very easily make an election to classify newly formed trusts as partnerships for US tax purposes. Finally, there is an argument, albeit a riskier one, that all Canadian mutual fund trusts are partnerships (even those covered by provincial legislation and formed after 2004) because, even with the enactment of the statutes, the investors' liability remains.

A partnership classification poses little problem for an individual investor. All it requires is for the income from the fund to be reported on the US person investor's annual form 1040. No special paperwork is required. Many US person investors in Canada who are unaware of the PFIC problem, or unwilling to grapple with the complexity and expense of confirming the US treatment of their investment, have already been relying on this strategy (perhaps unknowingly). Given the uncertainty and complexity in this area, and the lack of an official IRS position, there is nothing preventing the individual investor from taking his or her own view of the US tax classification of an investment—even if a fund's administrators have taken a contrary position. For fund providers, a partnership classification can retroactively provide PFIC relief to all of a fund's investors. There is little downside in adopting this strategy for funds that do not invest in the United States. Adopting it for funds that do invest in the United States is more complicated and more expensive, but may ultimately be more attractive to potential US person investors.

In short, the mutual fund trust structure that is so common in Canada need not be a tax hazard to US taxpayers who invest in these funds. Such an outcome is relieving to the millions of Canadians who either have US citizenship or have moved to the United States and whose retirement savings might have otherwise faced a rather expensive tax penalty.