MUTUAL FUNDS AND PFIC – AN UPDATE

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ABOUT MAX REED

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Max solves US tax problems for Canadians including:

- Adding corporations on the UX tax implications of cross-border transactions and initial public offerings;
- Helping citizens in Canada deal with US tax issues including renouncing their US citizenship; and
- Advising Canadian investment funds on investments into the United States and receiving investments from US taxpayers.

Max is the co-author (with Dick Pound of Stikeman Elliot) of A Tax Guide for American Citizens in Canada, as well as over 20 technical and plain language articles on a wide range of cross-border tax topics. Recognized for his expertise, Max is often invited to speak at conferences and seminars for tax professionals and the general public. He was invited to testify before the Canadian House of Commons Finance Committee on the impact of US tax law on Canadians.

Prior to joining SKL, Max worked at White & Case LLP, an international law firm in new York City where he provided US tax advice to individuals, corporations, and foreign states.

He holds a BA and two law degrees from McGill University, where he won several academic and leadership awards and is admitted to the bars of BC and New York.

About Polaris Tax Counsel

- Our new firm name!
- Canada/US cross-border tax law firm
- Lawyers in Toronto and Vancouver
- We do:
    - Cross-Border Estate Planning/Inheritance
    - Cross-Border Corporate Tax planning
    - Tax and immigration services related to renunciation
    - Help with your client’s tough issues
    - Disputes with IRS (including penalty resolution and voluntary disclosures)
- We don’t do: compliance work

Overview of Presentation

- Update from 2016 Presentation
- PFIC Basics
- PFIC Pain
- Canadian law on mutual funds
- Entity Classification
- Arguments that CMFTs are not PFICs
- Compliance requirements
- Conclusion

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Updates From 2016 Presentation

- No IRS guidance since the 2010 Chief Council Advice
- Sought a ruling from IRS for a fund client
  - IRS Chief Counsel indicated informally they were in support of the position
  - Told us “they had better things to do”
- Position disclosed on many tax returns (7 figures of exposure)
  - No inquiries
- Refund claims
  - A million dollars in refunds granted on the logic of the argument that mutual fund trusts are partnerships

PFIC Basics

- PFIC = passive foreign investment company
- Put in place in 1986 to discourage offshore tax deferral
- A PFIC is a foreign corporation that earns primarily passive income or has assets that earn passive income
- Bad tax result if left unaddressed
- Some elections (QEF, MTM) make things better, but not for long-term owners

PFIC Pain

- PFIC tax and reporting are expensive
- Distributions taxed as ordinary income and possibly worse
- All gain on sale taxed as an "excess distribution"
- Gain is pro-rated back to when the investment was purchased
- No foreign tax credit for Canadian tax paid on the sale [1291(g)]
- Often 60-70% US tax on the sale due to length held

PFIC Options

- No issues in an RRSP
- QEF election
    - Only works well if made in the first year of ownership
    - After the first year, have to pay PFIC tax to make it work
    - Complex paperwork remains
- Difficult for funds to provide the information
- Mark-to-market election
    - Same issues as above
    - Double tax on the sale (US tax in one year, Canadian in another)

Overview of Canadian Mutual Funds

- Some mutual funds are formed as corporations in Canada
    - Those are 100% PFICs
- Most Canadian mutual funds are trusts
- There is another position that is available

Basics of Canadian Mutual Funds

- Most financial institutions have taken the position that CMFTs are PFICs
- This position is beneficial to the financial institution – not so much to the individual investor
- It is open to the individual taxpayer to take a different position on his/her US tax return
- Presentation tracks paper: “US tax classification of Canadian mutual fund trust” [Canadian Tax Journal, 63:4 (2015)]

Existing IRS Authority

- Only source of IRS authority is Chief Counsel Advice 201003013
- IRS internal memorandum concerning estate tax
- Concluded Canadian mutual funds were corporations
- Corporation = PFIC
- No explanation why
- Based on assumed facts provided by taxpayer that were beneficial to the taxpayer
- Memorandum is not binding, cannot be relied upon, and is limited to specific facts
- No other IRS guidance since then

Basics of Entity Classification

- Most Canadian mutual funds are organized as trusts in Canada
- Cannot be trusts in the US because of business purpose/associates
- Either partnerships or corporations
- Difference is whether all investors have limited liability
- If any investor has **any** liability – a partnership
- Partnership cannot be a PFIC

Entity Classification (2)

- Limited liability defined as "creditors may seek satisfaction of all or **any** portion of the debts or claims against the entity from the member as such."
- Supreme Court of the US – plain meaning of "any" is expansive
- Canadian law determines whether there is limited liability

Types of Liability Exposure

- Outlined in Mark R. Gillen, "Income Trust Unitholder Liability: Risks and Legislative Response" (2005) 42:3 Can. Bus. L.J. 325.
- Two types – control risk and indemnity risk
- Control risk is disclosed in many mutual fund prospectuses
- Liability risk satisfies the "any" liability standard

Funds That Are Not “Reporting Issuers”

- Limitation of liability legislation only applies to funds that are “reporting issuers”
- If a fund is not a “reporting issuer” then the liability exposure remains
- Fund is a partnership for US tax purposes
- Mutual fund trusts that are not “reporting issuers” may not be PFICs

Pre-2004 Mutual Funds

- Starting in 2004 various provinces passed legislation to grant limited liability to beneficiaries of Canadian business trusts
- Before 2004, beneficiaries had some liability risk so the funds may have been partnerships for US tax purposes
- Remain partnerships despite change in liability status [Treas. Reg. 301.7701-3(a)]
- If CMFT has always been a partnership, can never be a PFIC

All CMFTs Are Not PFICs

- CMFT prospectus discloses “remote” liability risk
- Risk arises from CMFT investing in a jurisdiction where there is no limited liability
- The statutes that limit liability do not properly exclude the “control risk”
- Despite statute, still some liability risk so still a partnership
- Higher risk position

Compliance Requirements

- No special disclosure forms
  - US Person owns small fraction of foreign partnership
  - Form 8865 only applies if US $100,000 transaction with one partnership in one year
  - No Form 8621
- Take income from CMFT information slips, convert to US dollars, put on Form 1040
- Compliance approach is practical - not perfect

Compliance Requirements (2)

- Some compliance imperfections
- No Schedule K-1 provided
- Schedule K-1 not required to file Form 1040
- No long-term/short-term gain reporting
- No classification of dividends
- Return of capital from mutual fund is return of capital from partnership (i.e. tax free)

Compliance Requirements (3)

- Partnership basis rules are complex
- CMFT distributes all income each year
- Basis is purchase price of CMFT unit
- Re-purchase of fund units – new basis based on re-purchase price
- Can calculate long-term/short-term gain on disposition of units very easily
- Same way income is reported from US mutual funds

Conclusions

- Supportable, equitable filing position that has been used by many practitioners for a long-time (perhaps unknowingly)
- Removes punitive tax regime and complex compliance requirements
- Anecdotal support that the position works well
- Informal guidance from IRS that this is not a high priority area