

# US TAX ALERT



**US TAX ALERT** is a commentary on topics of current interest – usually topics relating to recent changes in tax law, new IRS administrative practices or current interpretations arising from tax cases. Professional advice should be obtained before acting on any of this information.

## CANADIAN MUTUAL FUNDS AND ETFS - A TRAIN WRECK FOR AMERICANS

In reviewing information to help US citizens complete their 2012 US 1040 tax returns, we noticed that their margin, RESP and TFSA accounts sometimes contained Canadian mutual funds and ETFs. The alarm bells went off! Such investments give rise to draconian US tax treatment and some very complicated reporting. In addition to filing the 1040 tax return itself, form 8621 is required to make tax elections and calculate and report what is commonly called PFIC income. The form first came into existence in 2011 so it is still unfamiliar territory and is still being modified by the IRS.

### WHAT'S THE PROBLEM?

US citizens in Canada who own Canadian mutual funds and/or ETFs should listen very carefully. If you do not fix the problem by selling these investments, your tax bill to the IRS could be substantial. The Passive Foreign Investment Company (PFIC) rules are designed to discourage US residents and US citizens living outside the United States from investing in PFICs.

A PFIC is defined as a non-US investment company meeting certain income or asset tests. Canadian mutual funds and ETFs satisfy the conditions and therefore are classified as PFICs for US tax purposes. We understand that segregated funds are not included as PFIC's according to some advisors but we have not confirmed this.

If you have a Canadian mutual fund you can add form 8621 to many other compliance forms that Americans living in Canada must file. They also may include a TDF 90-22.1 (FBAR), 3520/3520A (TFSA and RESP), 8938 (non US investments), 8891 (RRSP/RRIF) and others as well. Compliance filings beyond the US 1040 income tax return can take more time to complete than the tax return itself.

Back to the PFIC and form 8621...

### PFIC REPORTING

Because the United States taxes virtually all of the income (distributed and undistributed) of domestic (US) mutual funds, they consider it unfair that Americans who invest in foreign mutual funds (PFICs) do not pay tax on the income to the same extent they would if they bought US funds.

The US has adopted a number of rules for Americans investing in PFICs in order to account for this unreported income. This memo deals with the *market to market* election which in a practical sense is the only one available. A general overview of the income treatment under this election is as follows:

- Realized gains of PFICs are taxable as ordinary income and not as capital gains
- If the value of a PFIC at year end exceeds its cost, the excess is taxable as ordinary income
- If there is a realized or unrealized loss at year end, it will only be deductible from income to the extent that appreciation has been included as PFIC income in a previous year
- Realized losses on PFICs are treated as capital losses to the extent they exceed gains previously taxed as PFIC income.
- The distributed income of the fund loses its tax identity and is taxed as ordinary income and not available for special tax treatment.
- All calculations are done on a fund by fund basis so gains and losses on different funds cannot be offset

Further, since PFIC income is taxed as ordinary income (a separate line item amount), capital loss and carryovers from previous years that might otherwise be available cannot be used. In a very simple example, here is how the PFIC income calculation works:

	Year 1	Year 2
FMV – Year end	\$12,500	\$14,000
Cost	10,000	12,500
Income (loss)	\$2,500	\$1,500
Addition to cost	\$2,500	\$1,500

If the fund is sold in year 3 for say \$12,000, the loss of \$2,000 could be deducted from income because it is less than the \$4,000 included in income in previous years. If, however, the stock is sold for say \$7,000, only \$4,000 of the \$7,000 loss would be deductible.

## RRSP/RRIF INVESTMENTS IN PFICS

It is generally thought that the US PFIC rules do not apply to Canadian mutual funds invested within RRSPs because of the Canada-US tax treaty exempting retirement accounts from current income treatment providing form 8891 is filed with the 1040 tax return to defer that income. There is some thought that the IRS may be looking at ways to go after such income as well.

Since TFSAs and RESPs are not retirement accounts, normal income and PFIC income are always taxable in the United States on an annual basis because there is no tax treaty protection.

## PFIC REPORTING

For each fund reported on form 8621, the taxpayer must show the number of units at the beginning and end of the year, the date the units were acquired and sold during the year (if applicable) and the description of each share class.

The PFIC reporting rules first received significant IRS attention in 2011 but there is still confusion. Unfortunately, there is a well-known pattern in US tax law interpretation – IRS positions change with

little notice, are often out of sync with usual practices, details sometimes remain unfinalized and tax practitioners are not agreement with each other.

### **FOREIGN TAX CREDITS**

PFIC income that shows up on the US 1040 tax return will not arise under Canadian tax rules. Hence, there is no such income reported on the US return from Canadian sources and therefore no resulting foreign tax credit to reduce the tax on PFIC income. This mismatching of incomes for foreign tax credits can be a major problem - sometimes leading to double taxation.

### **ACCOUNTING FOR PFIC GAINS AND LOSSES**

This is an accounting nightmare. We have developed a template to do the PFIC calculations. We need detailed information from clients on each fund owned at any time during each year. Every fund must be reported every year on form 8621 even if there is no gain or loss.

### **PENALTIES**

There are no penalties for failing to file form 8621 (and make the *market to market* election) except in years when income is earned or when PFIC shares are sold. However, by not filing, future distributions may be subject to punitive tax on distributions.

### **FOREIGN ACCOUNT TAX COMPLIANCE ACT (FATCA)**

The new FATCA rules in the United States will require Canadian financial institutions to report financial transactions of US citizens to the IRS starting in 2014. Otherwise, a 30% withholding tax will apply on certain distributions to the owner. This closes the lid even tighter on PFIC disclosure. Also, the days will soon be gone when Americans living in Canada refuse to file US tax and information returns. *This US Tax Alert first appeared in the MoneySaver magazine.*

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