Caution for Canadian snowbirds

Pay attention to Passive Foreign Investment Company rules

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By Kim Inglis

According to Investor Economics, one million U.S. citizens living in Canada have $30 billion invested in mutual fund industry assets. Meanwhile, TD Economics reports that over 500,000 Canadians spend significant periods of time in the United States. While the former likely know their U.S. tax reporting requirements, the latter may not. They could be unaware that a Canadian can be deemed a U.S. person subject to U.S. tax filing requirements if holding certain investment vehicles.

The definition of a U.S. person is broad. It generally encompasses U.S. citizens and residents, U.S. green card holders, and anyone with a substantial connection to the U.S. including many snowbirds. The Internal Revenue Service (IRS) says anyone deemed to be a U.S. person holding certain investment vehicles is subject to Passive Foreign Investment Company (PFIC) rules.

The "Substantial Presence" test determines who is impacted, which generally means anyone who has been physically in the U.S. at least 31 days in the current year and 183 days during the rolling 3-year period that includes the current year and the 2 years immediately prior. The rolling period aspect of the test catches many people unaware, particularly snowbirds who tend to track their time in the U.S. on a calendar year basis.

A PFIC is a non-U.S. corporation that has either 75% or more of its gross income consisting of passive income or 50% or more of the fair market value of its assets consisting of assets that produce passive income. According to an IRS directive, this means the majority of Canadian mutual funds, mutual fund trusts, and exchange-traded funds (ETFs) are PFICs. In some instances, certain public companies such as REITs are considered to be PFICs.

U.S. persons holding PFICs have three options regarding taxation. The default taxation method (Excess Distribution) is the most onerous. Generally speaking, gains and distributions are fully taxed as income. Also, amounts allocated to the previous three years are subject to U.S. tax at the highest marginal rate and subject to deemed interest charges.

However, there are two alternative elections that U.S. persons can make. One is the Mark-to-Market election, which requires investors to report all distributions as ordinary income and recognize all increases/decreases to the value of the investment as a gain/loss on their holdings, even if they were not disposed of.

The preferred election for most investors is the Qualified Electing Fund (QEF), which requires investors to report their pro-rata share of the fund's earned income and capital gains for U.S. tax purposes. This means that distributions or gains from sale would be taxed in a similar fashion to how mutual funds in the U.S. are normally taxed.

Several mutual fund companies supply tax-reporting information to help U.S. persons make the QEF election, and investors should ask their fund companies for the necessary data. For

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example, Fidelity Investments provides a PFIC Annual Information Statement. On the ETF front, Purpose Investments and iShares provide PFIC reporting for many of their funds.

PFIC filing rules are exceedingly complex and non-compliance can bring costly consequences. Investors should seek advice from qualified U.S. tax experts.

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