

# Wealth Without Borders

Your Quarterly Cross Border Newsletter

*The purpose of this newsletter is to share cross-border wealth management news and insights with our cross border clients and colleagues.*

## UNDERSTANDING THE PUNITIVE AND COMPLEX TAXATION OF PFICS

One extremely complex cross border wealth management issue, which we often address with our clients, is the impact of the Passive Foreign Investment Company (PFIC) rules.

### WHO IS IMPACTED BY PFIC RULES?

Anyone who is classified under US tax law as a US person is affected by PFIC rules. For tax purposes, a US person includes a US citizen, a US green card holder or US resident.

Many of our clients are Canadian residents who are classified as US persons even though they are living in Canada. These clients are obligated to file a US tax return and comply with the PFIC legislation. PFIC rules are designed to discourage US taxpayers from potentially obtaining tax deferral benefits through non-US investments. The rules are extremely complicated and treat undistributed value in a PFIC as ordinary income in the current year, instead of as capital gains in the year of disposition.

### WHICH INVESTMENTS MAY BE CONSIDERED PFICS?

**Mutual Fund Trusts.** Canadian mutual fund trusts, mutual fund corporations and pooled funds are generally considered foreign corporations for US tax purposes rather than being treated as trusts, as they are for Canadian tax purposes. These funds, which primarily hold passive investments, are generally considered PFICs.

**Exchange Traded Funds (ETFs).** ETFs listed on a Canadian stock exchange are generally considered PFICs.

**Real Estate Investment Trusts (REITs).** Canadian income trusts and Canadian REITs that do not carry on an active business are generally classified as PFICs.

**Private and Public Corporations without Active Business.** Private corporations that primarily hold passive investments and do not carry on an active business are categorized as PFICs. Even some energy and mining companies could be considered PFICs as some no longer have feasible operating projects.

### US TAXATION OF INVESTMENTS IN PFICS

A US person holding a PFIC investment is subject to tax when a distribution is received or when a PFIC is sold. These taxation rules are referred to as “excess distribution” rules. Under these rules, the income is divided in two parts: an amount taxed in the current year as ordinary income and an excess distribution amount subject to adverse US tax treatment.

The excess distribution amount is a complicated calculation generally composed of:

- 1) Any gain from the sale of the PFIC; plus,
- 2) The amount that the total of the actual distributions in the year exceeds 125% of the average of the distributions received in the three preceding years.

#### Current Rates & Data

##### Govt of Canada

90 day	0.25%
1 year	0.30%
2 year	0.27%
5 year	0.38%
10 year	0.59%
30 year	1.19%

##### U.S. Treasury

90 day	0.11%
1 year	0.15%
2 year	0.18%
5 year	0.36%
10 year	0.71%
30 year	1.41%

##### Canada Prime Rate

2.45%

##### U.S. Prime Rate

3.25%

##### Exchange Rates

CAD/USD	0.71
USD/EUR	1.09
JPY/USD	107.41

This calculated excess distribution amount is allocated on a pro rata basis over the period that the taxpayer was invested in the PFIC. Amounts allocated to the current year are taxed as ordinary income, subject to the graduated US tax rates. However, the amounts allocated to prior tax years are punitively taxed at the maximum applicable tax rate for that prior year. The IRS considers this tax as unpaid in the prior years and accordingly charges accrued interest on the tax owing. This tax legislation is exceptionally punitive. In fact, the amount owing may exceed the actual distribution received!

#### WHAT ARE US INCOME TAX FILING REQUIREMENTS?

US persons who own shares in a PFIC at any time during the year are required to annually file *IRS Form 8621 – Information Return by a Shareholder of a Passive Foreign Investment Company*. A separate form must be filed for each PFIC owned. There is an exception from this reporting requirement if the value of the PFIC investment is small. Completing this form is onerous and time-consuming.

#### SWM CROSS BORDER WEALTH MANAGEMENT SOLUTIONS

We can provide the expertise and experience to identify which investments are classified as PFICs. The IRS does not determine whether a security is a PFIC until **after** tax filings are complete and after an investor and/or their accountant assumes some potential **liability**. Identifying PFICs before the IRS does is essential!

Our team can then suggest strategies to mitigate the application of the PFIC rules. We will ensure that investments are structured properly according to specific client circumstances. These strategies include:

**Spouse Investing in PFICs.** If a client's spouse is not a US person, we may suggest the spouse own the PFIC.

**Investing Directly in Specific Corporations.** Rather than investing in a Canadian mutual fund or pooled fund, we may suggest investing directly in publicly traded stocks or bonds of non-US corporations that carry on an active business. We can advise which corporation is appropriate for the specific circumstances of each client.

**Hold the PFIC Investments in Qualifying Registered Accounts.** We may propose that PFICs be held in registered accounts like RRSPs/RRIFs and LRSPs/LIRAs. Income earned in these accounts is deferred until distributions are made from the plan. However, it is not advisable to hold PFICs in TFSA or RESP accounts because these accounts are generally treated as foreign trusts under US tax law.

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## CROSS BORDER TIDBITS

#### COVID-19 RESPONSE FROM US AUTHORITIES: THE CARES ACT

In response to the COVID-19 Pandemic US Authorities passed the CARES (Coronavirus Aid, Relief, and Economic Security) Act. Some of the provisions relevant to cross border wealth management include:

**Tax Filing Deadlines.** The IRS postponed 2019 US tax filing deadlines to July 15, 2020

**IRS Waives RMDs for 2020.** Individuals and beneficiaries will not be required to take their 2020 Required Minimum Distribution (RMD) from their IRAs.

**IRS Waives 10 % Premature Distribution Penalty for Coronavirus Related Distributions in 2020.** A coronavirus related distribution (CRD) is a distribution made between January 1 and December 31, 2020. There are criteria to meet surrounding the diagnosis or financial impact of COVID-19 to be eligible. An individual can withdraw up to \$100,000 from eligible retirement plans, and the CRD funds that are recontributed over the three-year period following the date after distribution will be treated as having satisfied the general 60-day rollover requirement.

As always, we recommend clients speak with their tax professional for guidance, as these IRS announcements are fluid and subject to change.

**This newsletter has been brought to you by Steele Wealth Management:**

Brian Steele, CA, CPA, CFA | Jeannine Campbell | Laura Prust, CIM, CPCA  
Kelly Edmonds | Elizabeth Kernohan | Sam Ryder, CFA | Matthew Bell, CFA

Phone: (519) 883-6030 Toll-Free: 1 (877) 642-6408

Email: [steelewealthmanagement@raymondjames.ca](mailto:steelewealthmanagement@raymondjames.ca)

Address: Unit 1, 595 Parkside Drive | Waterloo, Ontario | N2L 0C7

Website: [www.steelewealthmanagement.com](http://www.steelewealthmanagement.com)

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