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Getting Caught Between the Borders: The Proposed Exemption of the Canadian Mutual Fund from the Passive Foreign Investment Company Rules

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COMMENT

GETTING CAUGHT BETWEEN THE BORDERS: THE PROPOSED EXEMPTION OF THE CANADIAN MUTUAL FUND FROM THE PASSIVE FOREIGN INVESTMENT COMPANY RULES

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INTRODUCTION

Many of us get transferred to unfamiliar cities, states, or even countries for our jobs. Moving outside of one's home country can be daunting when one is faced with a new home, friends, culture, and laws. Unsuspecting newcomers can get caught violating rules they were never even aware existed. That is exactly what happened to investor Keith.

After working at ABC Company in New York City for ten years, Keith was relocated to Canada. Keith and his family left their lives in New York but maintained their US citizenship in anticipation of eventually returning home. After getting settled in Canada, Keith, a middle aged man, wanted to invest some of his savings within the country he was living. Keith met an investment adviser who suggested he consider investing in a mutual fund, an investment vehicle that pools money from many different investors, like Keith, to invest in a portfolio of securities, including stocks, bonds, and other funds.[1] Keith could purchase shares of a mutual fund while only paying a nominal fee to reap the benefits of the mutual funds' professional management.[2] Keith thought paying a minimal

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1. *See Mutual Funds*, INVESTOR.GOV, http://investor.gov/investing-basics/investment-products/mutual-funds#.UrSk_amWGRI (last visited Dec. 17, 2013) [hereinafter *Mutual Funds*] (exploring the mutual fund asset class); *Mutual Funds Explained*, CNN MONEY, http://money.cnn.com/magazines/moneymag/money101/lesson6/index2.htm (last visited Dec. 17, 2013) [hereinafter *Mutual Funds Explained*] (defining what a mutual fund is).

2. *See* CANADIAN REVENUE AGENCY, RC4169(E), TAX TREATMENT OF MUTUAL FUNDS FOR INDIVIDUALS 1, http://www.cra-arc.gc.ca/E/pub/tg/rc4169/rc4169-12e.pdf [hereinafter CRA TREATMENT OF MUTUAL FUNDS] (explaining how Canadian mutual funds operate); CANADIAN SECURITIES ADMINISTRATORS, UNDERSTANDING MUTUAL FUNDS 2, http://www.osc.gov.on.ca/documents/en/Investors/res_mutual-funds_

service fee for the shares sounded promising because, presumably, a knowledgeable and skilled professional would select a variety of securities that would earn Keith more money than if he did so on his own.[3]

Following this advice, Keith invested US$1000 in Mutual Fund XYZ in 1993. Twenty years later, in 2012, Keith was ecstatic that his investment had grown to US$21,000, and cashed out. When Keith's tax consultant noticed this US$20,000 gain, he was surprised. After doing the math, the consultant told Keith he owed US$19,416 out of this US$20,000 to the Internal Revenue Service ("IRS"), the US government agency responsible for collecting taxes. Keith was sure this had to be a mistake. Unbeknownst to Keith, however, the mutual fund, a seemingly mainstream investment vehicle, was plagued by the Passive Foreign Investment Company ("PFIC") taint. The PFIC rules impose penalties for tax deferral on income not actually received, higher tax rates and burdensome compliance costs.

It is estimated that, just like Keith, over one million US taxpayers own Canadian mutual funds and, consequently, are impacted by the PFIC rules.[4] And, like Keith, many of these investors are unaware that they own shares in a PFIC or the tax consequences and filing requirements of such investments. Aiming to encourage continued investment in Canadian mutual funds, the Investment Funds Institute of Canada ("IFIC") is currently lobbying the US Congress to exempt Canadian mutual funds from the PFIC categorization.[5]

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en.pdf [hereinafter CSA ON MUTUAL FUNDS] (articulating the advantages of investing in Canadian mutual fund).

3. *See* CSA ON MUTUAL FUNDS, *supra* note 2, at 2 (proposing the benefits of mutual fund investments); *Mutual Funds*, *supra* note 1 (emphasizing the advantages of mutual funds, namely professional management).

4. *See* Jamie Golombek, *Americans in Canada: Tax Problems Grow*, FIN. POST (Toronto), Apr. 20, 2013, http://business.financialpost.com/2013/04/20/americans-in-canada-tax-problems-grow (illuminating the widespread impact of the Passive Foreign Investment Company ("PFIC") regime); Rudy Mezzetta, *IFIC Asks for Changes to PFIC Rules*, INV. EXEC. (Apr. 16, 2013), http://www.investmentexecutive.com/-/ific-asks-for-changes-to-pfic-rules (highlighting the number of US taxpayer in Canada impacted by the PFIC regime).

5. *See* Mezzetta, *supra* note 4 (discussing the Investment Fund Institute of Canada ("IFIC") effort to exempt Canadian mutual funds). *See generally* Letter from Joanne De Laurenttis, President & CEO, The Inv. Funds Inst. of Can., to Honorable Adrian Smith, Chair & Honorable John Larson, Vice-Chair, Fin. Servs. Working Group, H. Comm. on Ways & Means, U.S.H.R. 1 (Apr. 15, 2013) [hereinafter IFIC Letter], *available at*

A PFIC is a non-US asset that generates a threshold amount of passive income.[6] The IRS has created strict guidelines imposing astronomical taxes, rapidly accumulating interest and penalty charges, significant compliance costs, and overall confusion on the PFIC.[7] In some circumstances, as with Keith, the total PFIC tax can come close to or even surpass the total income earned.[8] This then poses the question—why would someone like Keith invest in an asset that is categorized as a PFIC?

Despite the difficulties with the PFIC regime, assets considered PFICs still offer US investors certain advantages.[9] Most importantly, US investors are encouraged to diversify their portfolios by investing in a wide spectrum of asset classes, risk levels, and countries.[10] PFIC assets can assist in achieving this investment objective.[11] Specifically, the mutual fund vehicle offers this sought-after diversification at a low cost by pooling money collected from a variety of individuals to purchase many different securities.[12] Mutual funds are also advantageous

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https://www.ific.ca/wp-content/uploads/2013/09/Submission-Financial-Services-Working-Group-Ways-and-Means-Committee-Smith-and-Larson-PFIC-R.pdf/5299/ (lobbying the United States to exempt Canadian mutual funds and the rationale).

6. 26 U.S.C. § 1297(a) (2012) (defining what is considered a PFIC).

7. *See generally* IFIC Letter, *supra* note 5, at 1 (outlining problems with the PFIC regime that discourages investment in non-US passive assets); N.Y.C. BAR, REPORT OFFERING PROPOSED GUIDANCE REGARDING THE PASSIVE FOREIGN INVESTMENT COMPANY RULES (2009), *available at* http://www.nycbar.org/pdf/report/uploads/20071778-ReportRePassiveForeignInvestmentCompanyRules.pdf (addressing issues with the current Passive Foreign Investment Company ("PFIC") framework).

8. *See* N.Y.C. BAR, *supra* note 7, at 11, 13 (exemplifying the excessive distribution regime).

9. *See* IFIC Letter, *supra* note 5, at 1 (proposing reasons for investing in PFICs). *See generally* VANGUARD RESEARCH, CONSIDERATIONS FOR INVESTING IN NON-U.S. EQUITIES (2012), *available at* http://www.vanguard.com/pdf/icriecr.pdf (discussing opportunity for US investors to own non-US assets, including those considered PFICs).

10. *See* IFIC Letter, *supra* note 5, at 1 (highlighting advantages of foreign investment). *See generally* VANGUARD RESEARCH, *supra* note 9 (explaining reasons for US investors to diversify their portfolios and invest in non-US assets).

11. *See Mutual Funds*, *supra* note 1 (identifying advantages of the mutual fund, including facilitating diversification). *See generally* VANGUARD RESEARCH, *supra* note 9 (encouraging US investors to diversify their investment portfolios).

12. *See Mutual Funds*, *supra* note 1 (exploring how the mutual fund operates by pooling money to invest in a variety of assets); *Mutual Funds Explained*, *supra* note 1 (describing how the mutual fund is a pooled investment vehicle facilitating diversification).

because they are widely available and highly liquid. [13] This means mutual funds can easily be bought or sold on the market. A mutual fund has the added benefit of employing the service of a professional manager for a relatively low cost.[14] Accordingly, individual investors lack control over the composition of the fund and regulators require the mutual fund managers to provide certain disclosures to investors, thereby facilitating transparency.[15]

Non-US managed mutual funds, which qualify as PFICs, provide investors with exposure not only to international assets, but also further diversification with respect to strategies, managers, and techniques.[16] While US mutual funds also provide exposure to international assets, there is no evidence that US managers are superior to international managers.[17] The current US taxation system, however, creates a major impediment to US investors attempting to reap the benefits of international mutual funds by imposing higher tax rates, penalties, and compliance obstacles.[18]

While legislators had valid reasons for promulgating the PFIC regulations, namely to discourage US citizens from deferring or avoiding US taxation by investing in non-US corporations, the PFIC rules are over-inclusive[19] In practice, the

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13. *See* CSA ON MUTUAL FUNDS, *supra* note 2, at 2 (noting mutual funds are highly liquid assets); *Mutual Funds*, *supra* note 1 (finding liquidity to be among the many benefits of the mutual fund vehicle).

14. *See* CSA ON MUTUAL FUNDS, *supra* note 2, at 2 (highlighting the relatively low cost of investing in a mutual fund); *Mutual Funds*, *supra* note 1 (finding investors chose to invest in mutual funds to reap the benefits of affordable professional management).

15. *See See* CSA ON MUTUAL FUNDS, *supra* note 2, at 6 (outlining how investors in Canadian mutual funds are protected). *See generally* IFIC Letter, *supra* note 5 (explaining that Canada is not a tax haven and is highly regulated similar to the United States).

16. *E.g.*, IFIC Letter, *supra* note 5, at 1 (promoting investment in Canadian mutual funds). *See* VANGUARD RESEARCH, *supra* note 9 (promoting investor diversification).

17. *See generally* IFIC Letter, *supra* note 5 (exploring reasons why investors should not be discouraged from investing in Canadian mutual funds).

18. *See generally* Golombek, *supra* note 4 (illuminating the problems for US taxpayers when foreign mutual funds are treated as PFICs); Mezzetta, *supra* note 4 (arguing that the PFIC rules will discourage investment in Canadian mutual funds).

19. *See* STAFF OF J. COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, H.R. DOC. NO. 3838, at 1023 (Comm. Print 1987) [hereinafter EXPLANATION OF THE TAX REFORM ACT OF 1986], *available at* http://www.jct.gov/jcs-10-87.pdf (explaining the rationale for enacting the PFIC regulations);

PFIC regime captures assets that do not facilitate the legislative intent of preventing tax evasion and tax deferral.[20] Specifically, the inclusion of certain regulated Canadian assets in the PFIC rules is improper because, unlike the Cayman Islands, Bermuda, or Luxembourg, Canada is certainly not a tax haven.[21] US investors do not exploit Canadian mutual funds to avoid or defer US taxation.[22] Hence, subjecting US investors in Canadian mutual funds to the PFIC rules causes such investors, just like Keith, to incur a combination of higher tax rates, interest for underpayment of phantom income taxes, and penalty charges—all without serving a clearly delineated legislative purpose.[23]

This Comment focuses on the PFIC regime and the inclusion of the Canadian mutual fund. Part I of this Comment provides an overview of the PFIC regime and the treatment of Canadian mutual funds. Part II next outlines the issues, inefficiencies, and conflicts with the PFIC regime, specifically related to Canadian mutual funds. Part III proposes amending the United States-Canada Income Tax Convention to exempt Canadian mutual funds from the draconian results of the PFIC regime.

IFIC Letter, *supra* note 5 (describing how the PFIC rules are over-inclusive by incorporating the Canadian mutual fund).

20. *See* Kimberley S. Blanchard, *PFICs*, 6300-1ST, TAX MGMT. PORT. (BNA) Foreign Income, at II.A-1 (2012), http://www.bloomberglaw.com/p/413136a3746d6dd26afac c7888c8f11f/document/2759533096 (outlining the reasons for the PFIC rules); IFIC Letter, *supra* note 5, at 1 (arguing there is no reason to include Canadian mutual funds in the PFIC category).

21. *See* IFIC Letter, *supra* note 5, at 3 (challenging the application of the PFIC regime to Canada); *see also* Lisa Mahapatra, *Tax Havens: A Map of Former, Current and Emerging Tax Shelter Countries*, INT'L BUS. TIMES (Sept. 6, 2013), http://www.ibtimes.com/tax-havens-map-former-current-emerging-tax-shelter-countries-interactive-map-1403162 (listing countries that are tax havens, not including Canada); Richard Murphy, *World's Best Tax Havens*, FORBES (July 6, 2010), http://www.forbes.com/2010/07/06/tax-havens-delaware-bermuda-markets-singapore-belgium.html (listing the top ten tax havens).

22. *See* Lucy S. Lee & Stafford Smiley, *Taxation of Passive Foreign Investment Companies: Current Rules, Problems and Possible Solutions*, 38 WGL-CTAX 39, 43 (2011) (explaining the issues with the PFIC regime); *see also* IFIC Letter, *supra* note 5, at 3 (challenging application of the PFIC regime to Canada).

23. *See* N.Y.C. BAR, *supra* note 7, at 1 (critiquing the PFIC rules and ineffectiveness of the available elections); *see also* Mezzetta, *supra* note 4 (explaining the problem with the PFIC regime for Canadian mutual funds).

I. *THE PFIC REGIME*

The PFIC regulations are incredibly complicated. Investors have trouble not only determining whether they own a PFIC, but also adequately complying with the regulations once ownership becomes apparent. Thus, Part I of this Comment explains the PFIC tax regime to highlight the issues associated with subjecting Canadian mutual funds to PFIC treatment. Part I.A first provides an overview of the PFIC regime. Part I.B then explores the three different PFIC regimes: Excess Distribution Regime, Qualified Election Fund ("QEF"), and Mark-to-Market ("MTM"). Part I.C describes the foreign tax credit, and Part I.D highlights the filing and compliance costs under the PFIC regime. Lastly, Part I.E discusses the Canadian mutual fund PFIC, and its treatment in Canada and the United States.

A. *Overview of the PFIC*

The PFIC is any non-US asset that generates passive income.[24] Passive income is defined as income "generated from [a non-US] personal holding company."[25] This generally includes non-US income derived from dividends, interest, royalties, rent, commodity transactions, foreign currency gains, and certain property transactions.[26]

By enacting the PFIC regime, the US legislature intended to eliminate tax deferral and evasion that resulted from investing outside the United States.[27] Legislators wanted to prevent US taxpayers from avoiding the required current taxation on all assets by investing in the same passive US assets indirectly through a non-US investment vehicle.[28] Prior to the PFIC regulations, investors could defer taxation without penalty

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24. *See* 26 U.S.C. § 1297(a) (2012) (defining the PFIC).

25. § 954(c) (explaining what is considered passive income).

26. *Id.* (providing examples of passive income).

27. *See* EXPLANATION OF THE TAX REFORM ACT OF 1986, *supra* note 19 (exploring the rationale for enacting the PFIC regulation). *See generally* Lee & Smiley, *supra* note 22 (articulating the purpose of the PFIC rules to eliminate advantages of foreign investment).

28. *Accord* EXPLANATION OF THE TAX REFORM ACT OF 1986, *supra* note 19 (exploring the reasoning for the PFIC regulation); N.Y.C. BAR, *supra* note 7, at 1 (finding the purpose of the PFIC rules is to eliminate advantages of international investment).

until the gains were realized by investing through an international corporation rather than a US investment company.[29] In doing so, investors could convert income, which should be treated as ordinary income, into the more favorable capital gains income.[30] In essence, the PFIC regulations were promulgated to target individuals utilizing international investment corporations to gain US tax advantages.[31]

To determine if an international asset is considered a PFIC for US tax purposes, there is an income test and an asset test.[32] Under the income test, an international corporation is considered a PFIC if "75 percent or more of the gross income" in that taxable year is passive income.[33] Under the asset test, an international corporation is a PFIC if fifty percent or more of the average percentage of assets during that taxable year produce, or are held for the production of, passive income.[34]

For purposes of conducting the two tests, an investor must apply the "look-through" rules if a foreign corporation owns (directly or indirectly) at least twenty-five percent of another corporation.[35] "[S]uch foreign corporation shall be treated as if it (1) held its proportionate share of assets of such other corporation and (2) received directly its proportionate share of the income of such corporation."[36]

29. *See* EXPLANATION OF THE TAX REFORM ACT OF 1986, *supra* note 19, at 1023 (stating what investors were doing prior to the PFIC rules to gain tax advantages); N.Y.C. BAR, *supra* note 7, at 1 (finding the PFIC rules were created in response to investors abusing international investment vehicles for advantageous taxation).

30. *See* EXPLANATION OF THE TAX REFORM ACT OF 1986, *supra* note 19, at 1023 (highlighting how the PFIC sought to prevent investors from using international corporations to convert ordinary income into the advantageous capital gains); N.Y.C. BAR, *supra* note 7, at 1 (explaining how investors were converting ordinary income into capital gains prior to the PFIC rules).

31. *See* EXPLANATION OF THE TAX REFORM ACT OF 1986, *supra* note 19, at 1023 (exploring the reasoning Congress needed to enact the PFIC rules); Blanchard, *supra* note 20, at II.A-1 (articulating the purpose of the PFIC regime to eliminate foreign tax advantages).

32. 26 U.S.C. § 1297(a) (2012) (explaining the PFIC tests); *see* Blanchard, *supra* note 20, at II.C (stating if an asset passes either the asset or income test it is subject to the PFIC rules).

33. § 1297(a)(1) (describing the income test).

34. § 1297(a)(2) (articulating the asset test).

35. § 1297(c) (outlining when to apply the look-through rules).

36. *Id.* (indicating how to apply the look-through rules).

In addition to the asset and income tests, an asset can also be subject to the PFIC regime under the "once a PFIC, always a PFIC" rule.[37] Under this rule, an asset is treated as a PFIC, regardless if it passes the asset or income test for the year, if at any time during the taxpayer's holding period the asset was a PFIC and no election was made.[38] Thus, even if the asset no longer meets the asset or income test in later years, the PFIC continues to be subject to the excess distribution regime because no election was made and such PFIC is considered tainted.[39] The PFIC taint can be avoided if an investor makes the QEF election in year one of the holding period (referred to as a pedigreed PFIC) or later makes a purging election.[40]

A purging election is essentially a deemed sale or dividend distribution from the PFIC where the sale or dividend is subject to the excess distribution regime just this one time.[41] After this deemed sale or dividend distribution, a new holding period begins for a pedigreed PFIC no longer subject to the PFIC taint.[42] The purging election is the next best option when an investor misses a filing deadline because only under rare circumstances can an investor make a retroactive election.[43]

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37. § 1298(b)(1) (stating the "once a PFIC, always a PFIC" rule); *see* Blanchard, *supra* note 20, at X.A (indicating there is a PFIC taint under certain circumstances)

38. § 1298(b)(1) (explaining how the "once a PFIC, always a PFIC" rule operates); *see* N.Y.C. BAR, *supra* note 7, at 20 (analyzing the "once a PFIC, always a PFIC" restriction).

39. § 1298(b)(1) (stating the "once a PFIC, always a PFIC"); *see* Blanchard, *supra* note 20, at X.A (exploring the PFIC taint).

40. § 1298(b)(1) (time for determining PFIC status); *see* Blanchard, *supra* note 20, at X.A (identifying the exceptions to the PFIC taint).

41. *See* Blanchard, *supra* note 20, at X.B (describing the purging election as a method to eliminate the PFIC taint); N.Y.C. BAR, *supra* note 7, at 20 (identifying how to purge the PFIC taint).

42. *See* Blanchard, *supra* note 20, at X.B (stating after the purging election, a new holding period begins where the PFIC taint no longer applies); N.Y.C. BAR, *supra* note 7, at 20 (explaining the basic methods to remove the PFIC taint).

43. *See* DEPARTMENT OF TREASURY, INTERNAL REVENUE SERVICE, INSTRUCTIONS FOR FORM 8621 (Rev. December 2013) 4 (2013) [hereinafter FORM 8621 INSTRUCTIONS] (stating retroactive elections can only occur under two limited circumstances); Blanchard, *supra* note 20, at V.C (exploring when a retroactive election can be made).

B. *The Three PFIC Regimes:*

A PFIC asset can be categorized under one of the three PFIC regimes depending on if the investor made an election and the characteristics of the asset. Part I.B.1 focuses on the excess distribution regime, next Part I.B.2 explores the QEF regime and lastly, Part I.B.3 discusses the MTM regime.

1. Excess Distribution Regime

If a US taxpayer owns stock of a PFIC and makes no election, such individual will be subject to the § 1291 excess distribution rules.[44] An "excessive distribution" is defined as the portion of any distribution that exceeds 125% of the average PFIC distribution over the past three years or if less than three years then based on the prior years.[45] The "non-excess" portion of distributions are taxed under the general US tax rules.[46] Additionally, all gains recognized from the disposition of a PFIC share are subject to the excess distribution taxation scheme.[47]

All excess distributions are allocated ratably to each day in the taxpayer's holding period for the stock after December 31, 1986.[48] The amount allocated to the pre-PFIC period and the current year are included in the shareholder's ordinary income, taxable at the prevailing ordinary income tax rate without any penalty charges.[49] For the remainder of the periods, however, PFIC investors incur a penalty for the deferred tax amount and are charged interest compounded daily, calculated in accordance with the tax underpayment rate for each year under § 6621.[50] Collectively, the excess distributions and interest are

44. *See* 26 U.S.C. § 1291(b) (2012) (outlining the excess distribution regime).
45. *See* § 1291(b)(2)(B) (clarifying what is included in the excess distribution calculation).
46. *See* § 1291(a)(2) (emphasizing only excess distributions are subject to this rule); N.Y.C. BAR, *supra* note 7, at 10 (applying the statute to non-excess distributions).
47. *See* § 1291(a)(2) (informing taxpayers that all sales of PFIC assets are subject to the excess distribution treatment).
48. § 1291(a)(1) (explaining how excess distributions are allocated to the taxpayers holding period).
49. § 1291(a)(1)(B) (describing the PFIC treatment for the pre-PFIC period and current year).
50. § 1291(c) (highlighting the PFIC calculations for prior PFIC years); 26 U.S.C. § 6621 (explaining the interest for tax underpayment).

referred to as the deferred tax amount.[51] Rather than being taxed at more favorable rates determined by the character of the income, the deferred income is across the board taxed as ordinary income at the highest marginal tax rate for such year.[52] Only a foreign tax credit can be used to offset the tax.[53] New regulations were proposed on April 1, 1992, but they have not been finalized.[54]

2. The QEF Election

A shareholder can entirely avoid the excess distribution regime by making a QEF election.[55] Instead of waiting until the PFIC makes a distribution, the QEF election allows the shareholder to currently be taxed on the PFIC's ordinary earnings and net capital gains.[56]

The QEF election must be made by the US shareholder, rather than by the PFIC.[57] Shareholders must file Form 8621 with their federal income tax return indicating this election.[58] The election for a taxable year must be made prior to the filing deadline for tax returns in that taxable year.[59] If such deadline is not met, a retroactive election is permitted under (1) the protective regime, where the investor preserves the right to make a retroactive election, or (2) the consent regime when the

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51. *See* § 1291(c) (outlining what the PFIC deferred tax is); Blanchard, *supra* note 20, at V.A (exploring the application of the excess distribution rules).

52. § 1291(a)(1)(B) (describing specifically how the PFIC is taxed under this section); *see* Blanchard, *supra* note 20, at V.A (describing the taxation scheme in the excess distribution regime).

53. *See* § 1291(g) (analyzing the operation of the PFIC tax credits); Blanchard, *supra* note 20, at V.A (focusing on the available tax credits under the excess distribution rules).

54. *See* Treatment of Shareholders of Certain Passive Foreign Investment Companies, 57 Fed. Reg. 11024 (proposed Apr. 1, 1992) (proposing amendments to the current PFIC rules); Blanchard, *supra* note 20, at V.A (stating new regulations have been proposed but not yet adopted to clarify the excess distribution rules).

55. 26 U.S.C. § 1295(b)(1) (2012) (overviewing the QEF regime).

56. *Id.* (describing how an investor makes a QEF election); s*ee* FORM 8621 INSTRUCTIONS, *supra* note 43, at 2 (explaining the operation of the QEF regime).

57. § 1295(b)(1) (articulating who makes the QEF election); Blanchard, *supra* note 20, at VI.B (stating who and how to make a QEF election).

58. Treas. Reg. § 1.1295-3(f)(1) (2013) (explaining the PFIC filing requirements); *see* Blanchard, *supra* note 20, at VI.D (finding Form 8621 must be filed to make the election). *See generally* FORM 8621 INSTRUCTIONS, *supra* note 43, at 1 (instructing how to fill out Form 8621).

59. § 1295(b)(2) (stating how to make the QEF election).

investor does not qualify under the protective regime, the investor can request that the IRS permit a retroactive election.[60]

In order to make a QEF election, the PFIC must provide a shareholder with sufficient information to determine the ordinary earnings and net capital gain of such company.[61] The PFIC must release an Annual Information Statement that indicates the investor's pro rata share of ordinary earnings and net capital gains for the taxable year, sufficient information for the shareholder to make the calculation, or a statement that the PFIC allowed the shareholder to inspect documents necessary to make the calculation.[62] The PFIC annual statement also needs to include the value of distributions or deemed distributions to the shareholder during the taxable year.[63] The PFIC must release a statement declaring shareholders can inspect necessary documents to ensure the PFIC's ordinary earnings and capital gains were computed in compliance with the IRS rules, or documentation that the IRS has already approved of the calculations.[64]

Once the QEF election is made, it applies to all subsequent years unless the international corporation is no longer considered a PFIC or the shareholder revokes the election.[65] Nevertheless, to maintain the QEF election the PFIC

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60. *See* FORM 8621 INSTRUCTIONS, *supra* note 43, at 4 (categorizing the two ways to make a retroactive QEF election); Blanchard, *supra* note 20, at V.C (suggesting a possible way to make a retroactive election).

61. § 1295(a)(2) (stating the information required to make a QEF election).

62. Treas. Reg. § 1.1295-1(g)(i)-(ii) (2013) (requiring the PFIC to provide information related to the ordinary income and net capital gains of the PFIC so investors have the necessary information for the QEF election); *see* FORM 8621 INSTRUCTIONS, *supra* note 43, at 5 (highlighting that the PFIC statement must include information about ordinary income and net capital gains in order for the investor to make the QEF election).

63. Treas. Reg. § 1.1295-1(g)(ii) (2013) (explaining the information necessary to be included in the PFIC Annual Information Statement, including all distributions).

64. Treas. Reg. § 1.1295-1(g)(iv)(A) (2013) (outlining the information needed to make a QEF election); *see* FORM 8621 INSTRUCTIONS, *supra* note 43, at 5 (describing what needs to be included in the PFIC Annual Information Statement); Robert W. Wood & Jonathan Van Loo, *PFICs Are Here to Stay–And So Is FATCA*, 2013 WOODCRAFT TAX NOTES 805, 807-08 (May 13, 2013), *available at* http://www.woodllp.com/Publications/Articles/pdf/PFICs.pdf (illustrating the information requirements to make the PFIC election).

65. § 1295(b)(1) (stating the QEF status applies to all subsequent years); *see* Blanchard, *supra* note 20, at VI.A (explaining how the timing of the QEF elections operates).

shareholder must provide information to satisfy the annual filing requirements.[66]

3. The MTM Election

As an alternative to the QEF election, the MTM election can also be used to avoid the excess distribution regime and assume current taxation.[67] A PFIC investor can make the MTM election under § 1296 if the PFIC asset is considered a "marketable stock."[68] A "marketable stock" refers to any stock that is regularly traded on a national securities exchange registered with the US Securities and Exchange Commission ("SEC") or a national market system established under Section 11A of the Securities Exchange Act of 1934; or any exchange or market the Secretary deems fit.[69] An investor must make the election by the filing Form 8621 by the deadline for the taxable year.[70]

Under the MTM election, a shareholder annually includes in gross income the difference between the fair market value of the PFIC stock at the close of the year and the adjusted basis, which is essentially the annual gain on the asset as if it is sold at the end of each year.[71] If the adjusted basis of the PFIC exceeds the fair market value of the PFIC, then the taxpayer is allowed a deduction for the lesser of the excess or the "unreversed inclusions" of the stock.[72] "Unreversed inclusions" refer to the excess of the taxpayer's MTM gains for prior taxable years over

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66. *See* FORM 8621 INSTRUCTIONS, *supra* note 43, at 4 (describing what a PFIC investor must do annually); Blanchard, *supra* note 20, at VI.D (articulating requirements for a PFIC investor to maintain the QEF election annually).

67. *See* FORM 8621 INSTRUCTIONS, *supra* note 43, at 4 (describing what a PFIC investor must do annually under the MTM election); Lee & Smiley, *supra* note 22, at 42–43 (2011) (detailing the MTM regime requirements).

68. 26 U.S.C. § 1296(a) (stating that an MTM election can only be made when the asset is a "marketable stock").

69. § 1296(e)(1) (defining what a "marketable stock" includes); *see* Lee & Smiley, *supra* note 22, at 42–43 (exploring the MTM regime and its requirements).

70. § 1296(a) (instructing how to make the MTM tax calculation); *see* FORM 8621 INSTRUCTIONS, *supra* note 43, at 5 (Rev. December 2012) (describing the necessary calculations under the MTM election).

71. § 1296(a)(1) (explaining how to determine the tax consequences under the MTM regime).

72. § 1296(a)(2) (specifying when deductions are permitted under the MTM election); *see* Blanchard, *supra* note 20, at IX.D (explaining taxation under the MTM regime).

the taxpayer's MTM loss for prior taxable years.[73] The PFIC adjusted basis is increased by the amount included in gross income for past years and decreased by the amount allowed for deductions.[74] Under all circumstances, gains, dispositions, or other distributions from the PFIC under the MTM election are taxed as ordinary income.[75]

C. *The Foreign Tax Credit*

The United States-Canada Income Tax Convention (the "Treaty") is designed to prevent individuals from being subject to taxation on the same income in both Canada and the United States.[76] To prevent double taxation, a foreign tax credit is available under certain circumstances.[77] If a taxpayer owes taxes outside of the United States on non-US source income and is also subject to US taxes on the same income, such taxpayer may be entitled to take a credit for the amount of the foreign taxes accrued to reduce the US taxes owed.[78] Essentially a foreign tax credit can reduce the US tax liability by the amount already paid or accrued in non-US taxes.[79] A taxpayer is eligible to take a

73. § 1296(d) (defining "unreversed inclusions"); *see* Blanchard, *supra* note 20, at IX.D (exploring how losses are treated under the MTM regime).

74. § 1296(b)(1) (detailing how to calculate the adjusted basis).

75. § 1296(c)(1) (guiding investors on how to calculate the applicable taxes under the MTM regime).

76. *See* DEP'T OF TREASURY, INTERNAL REVENUE SERVICE, FOREIGN TAX CREDIT FOR INDIVIDUALS, PUBLICATION 514, at 1–2 (2014) [hereinafter IRS, Foreign Tax Credit] (finding US citizens are taxed on worldwide income and normally entitled to a credit for any foreign taxes paid or accrued). *See generally* Convention Between The United States of America and Canada with respect to Income and Capital, U.S.-Can., September 26, 1980, T.I.A.S. No. 11087 (highlighting how one purpose of the treaty was to prevent double taxation of income).

77. 26 U.S.C. § 902(a) (2012) (permitting a taxpayer to claim a foreign tax credit against US taxes accrued); *see* DEP'T OF TREASURY, INTERNAL REVENUE SERVICE, INSTRUCTIONS FOR FORM 1116, at 1 (2013) [hereinafter FORM 1116 INSTRUCTIONS] (enabling taxpayers to claim a foreign tax credit after filing this form).

78. *See* IRS, Foreign Tax Credit, *supra* note 76 (stating a foreign tax credit is available in the same year an investors pays a qualified foreign tax). *See generally* FORM 1116 INSTRUCTIONS, *supra* note 77, and accompanying text (highlighting when taxpayers can take a foreign tax credit).

79. 26 U.S.C. § 904(a) (2012) (explaining how the foreign tax credit is limited); *see* IRS, Foreign Tax Credit, *supra* note 76 (summarizing how the foreign tax credit works and how it is limited by the extent of US taxes accrued in that year).

foreign tax credit by filing Form 1116 for qualifying foreign income.[80]

The foreign tax credit is always limited by the US taxes incurred multiplied by a fraction.[81] The numerator of the fraction is an individual's taxable income from sources outside the United States and the denominator is such individual's total taxable income from the US and foreign source income (worldwide income).[82] In determining the limit on the US foreign tax credit, a taxpayer must separate the different sources of foreign income and then determine the limit for each source independently.[83]

If the foreign tax credit available exceeds the limit, a taxpayer can carryback and carryover unused foreign tax credit outlined under § 904(c).[84] A taxpayer is allowed to carryback unused foreign tax credit one year and then carryover unused foreign tax credit ten years.[85]

D. *Filing and Compliance Requirements*

All PFIC investors are required to file Form 8621, called the "Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Election Fund," annually, if the investor receives a distribution, recognizes a gain on a

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80. FORM 1116 INSTRUCTIONS, *supra* note 77, and accompanying text (instructing a taxpayer to file Form 1116 to receive a foreign tax credit on income that qualifies under § 901 and § 904).

81. § 904(a) (articulating the limitation of the foreign tax credit); *see* IRS, Foreign Tax Credit, *supra* note 76, at 11 (emphasizing that the foreign tax credit is limited by a fraction of US income).

82. § 904(a) (outlining the extent of a foreign tax credit a taxpayer can annually utilize); *see* IRS, Foreign Tax Credit, *supra* note 76 (detailing how to calculate the allowable foreign tax credit for the year).

83. § 904(d) (requiring taxpayers to separately apply the foreign tax credit rules to each type of income); *see also* IRS, Foreign Tax Credit, *supra* note 76 (instructing taxpayers to separate the different sources of income to determine the foreign tax credit available for each type of income).

84. § 904(c) (stating how to utilize unused foreign tax credits); *see* IRS, Foreign Tax Credit, *supra* note 76 (highlighting what taxpayers can do with unused foreign tax credits that exceed the limit for the year).

85. § 904(c) (detailing how the carryback and carryover of the unused portion of the foreign tax credit operates).

disposition, or makes an election.[86] Depending on what the taxpayer is attempting to do, there are different filing deadlines and reporting requirements as discussed above under the different regimes.[87]

The class of investors required to file Form 8621, and any other filing requirements the Secretary may require, was expanded to include "each United States person who is a shareholder of a [PFIC]" under § 1298(f).[88] Thus, regardless if there is a distribution, disposition, or inclusion, a PFIC investor must comply with the filing requirements.[89] This change only impacts PFIC reporting for taxable years starting after December 30, 2013.[90] While technically this change was effective as of March 2010, not until December 30, 2013, did the IRS issue final and temporary regulations actually implementing the § 1298(f) requirements.[91] Nevertheless, the new regulations provide certain exceptions when there is a chain of ownership to minimize duplicate reporting, while still ensuring sufficient information is reported to ensure compliance with the PFIC regime.[92] The December 30, 2013 regulations also provided several other exceptions.[93]

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86. FORM 8621 INSTRUCTIONS, *supra* note 43, at 1 (stating when individuals must file Form 8621); Blanchard, *supra* note 20, at XI.B (explaining that all PFIC investors must file Form 8621).

87. *See generally* FORM 8621 INSTRUCTIONS, *supra* note 43 (overviewing the different regimes and the respective requirements); *supra* Part 1.B (describing the three different PFIC regimes).

88. 26 U.S.C. § 1298(f) (2012) (indicating who must comply with the PFIC filing requirements); *see* Blanchard, *supra* note 20, at XI.B (stating the new regulations do not apply to PFIC owners in previous years).

89. *See* Sullivan & Cromwell LLP, IRS issues Regulations Regarding Ownership and Information for Passive Foreign Investment Companies 3 (January 7, 2014), https://www.sullcrom.com/files/Publication/ff172417-32ae-4146-9ebf-8ec01b731fc4/Presentation/PublicationAttachment/c579a44c-fc39-4144-850c-948da65c0aa6/SC_Publication_IRS_Issues_Regulations_Regarding_Ownership_and_Information_Reporting.pdf (emphasizing that all PFIC investors must file annually irrespective of the PFIC activity).

90. *See* Blanchard, *supra* note 20, at XI.B (stating the new regulations do not retroactively apply); Sullivan & Cromwell LLP, *supra* note 89 (highlighting the fact that the December 30, 2013, rules only affect PFIC owners going forward).

91. *See* Blanchard, *supra* note 20, at XI.B (explaining the progression of implementing the § 1298(f) requirements). *See generally* Sullivan & Cromwell LLP, *supra* note 89 (summarizing the changes from March 2010 through December 2013).

92. *See* Blanchard, *supra* note 20, at XI.B (describing the objective of implementing changes to the PFIC requirements to reduce duplicate filing). *See*

E. *PFIC Spotlight: The Canadian Mutual Fund*

Canadian mutual funds are categorized by the IRS as PFICs, and, thus, are subject to the tax and compliance complications of the PFIC regime.[94] Because shares of mutual funds are marketable securities, investors may be able to make the MTM election.[95]

Industry specialists believe non-US mutual funds from countries with a similar taxation and regulatory framework as the United States should not be subject to the PFIC rules.[96] This is especially applicable to Canada—a country that has strong, long standing ties with the United States and is far from being characterized as a tax haven.[97] The Canada Revenue Agency ("CRA") has vowed to increase its efforts to curtail tax evasion by Canadian citizens in other countries—striving to punish not only the individuals but also the institutions facilitating tax evasion.[98] Hence, tax evasion is certainly neither behavior the Canadians endorse nor facilitate.[99]

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generally Sullivan & Cromwell LLP, *supra* note 89, at 5–6 (emphasizing the rationale for the PFIC exceptions found in the new regulations).

93. *See* Blanchard, *supra* note 20, at XI.B (outlining two additional exceptions to the PFICs expanded class of investors required to file annual reports). *See generally* Sullivan & Cromwell LLP, *supra* note 89, at 6–7 (noting additional exceptions in the regulations when PFIC investors do not need to comply with the filing requirements).

94. *See* Golombek, *supra* note 4 (referring to the Canadian mutual fund as a PFIC); Mezzetta, *supra* note 4 (arguing Canadian mutual funds should no longer be considered a PFIC).

95. *See supra* notes 67–75 and accompanying text (explaining what assets qualify for the MTM election).

96. *See* Golombek, *supra* note 4 (challenging categorizing Canadian mutual funds as PFICs); IFIC Letter, *supra* note 5 (highlighting the close relationship between Canada and the United States, including the treaty).

97. *See* Golombek, *supra* note 4 (reasoning Canadian mutual funds should be exempt from the PFIC rules); IFIC Letter, *supra* note 5 (emphasizing Canadian mutual funds should not fall under the PFIC regime because Canada is not a tax haven).

98. *See* Dean Beeby, *Wealthy Canadians Own Up to Offshore Tax Havens*, GLOBAL NEWS (Apr. 14, 2013, 2:29 PM), http://globalnews.ca/news/479230/wealthy-canadians-own-up-to-offshore-tax-havens/ (explaining efforts by the Canadian Revenue Agency to curtail tax evasion); John Greenwood, *Canada's Revenue Agency Struggling to Keep Up with Rise in Tax-Haven Cases, AG Report Says*, FINANCIAL POST (Toronto) (Nov. 26, 2013, 5:15 PM), http://business.financialpost.com/2013/11/26/auditor-general-liechtenstein-bank-affair-reveals-how-cra-not-ready-for-rising-tax-haven-cases/ (discussing the Canadian Revenue Agency increasing efforts to curtail and penalize tax evasion).

99. Greenwood, *supra* note 98 (emphasizing how the Canadian are actively trying to stop tax evasion).

Much like the United States, Canada has strong regulatory oversight.[100] Canadian regulators have certain reporting requirements, transparency rules, methods to file and investigate financial institutions, and other means to monitor the financial sector in an effort to prevent fraud, tax evasion, and other illegal activity.[101]

Annually, Canadian mutual funds distribute all income and gains to investors thereby subjecting investors to current taxation in Canada, rather than the mutual fund deferring distributions and, thus, deferring taxation.[102] In Canada, investors are subject to current taxation on money actually earned, irrespective if the earnings are cashed in or reinvested.[103] Distributed income maintains its character, and, thus, earnings (interest, dividends, and capital gains) are all taxed at the appropriate variable tax rates.[104] For example, dividend income at the mutual fund level remains dividend income at the investor level for Canadian tax purposes.[105]

To calculate an investor's capital gain or loss, the investor must subtract the total of the adjusted cost basis ("ACB") and any other expenses or outlays incurred in selling the shares,

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100. *See generally* CRA TREATMENT OF MUTUAL FUNDS, *supra* note 2, at 1 (explaining regulation of the Canadian markets and mutual fund treatment in Canada); CSA ON MUTUAL FUNDS, *supra* note 2, at 2 (outlining how mutual fund investors are protected).

101. *See generally* CRA TREATMENT OF MUTUAL FUNDS, *supra* note 2, at 1 (describing the Canadian mutual fund treatment and market in Canada); CSA ON MUTUAL FUNDS, *supra* note 2, at 6 (educating investors on how Canadian mutual fund investments are protected).

102. *See* CSA ON MUTUAL FUNDS, *supra* note 2, at 4 (explaining how investors make money from a Canadian mutual fund); Mezzetta, *supra* note 4 (highlighting the problem with the PFIC regime for Canadian mutual funds).

103. CRA TREATMENT OF MUTUAL FUNDS, *supra* note 2, at 1 (articulating how Canadian mutual fund distributions are taxed). *See generally* RBC GLOBAL ASSET MGMT., TAXES AND INVESTING IN MUTUAL FUNDS (2013), *available at* http://funds.rbcgam.com/_assets-custom/pdf/taxes-and-investing-in-mutual-funds.pdf (describing how Canadian mutual funds distribute income and how they are taxed)..

104. *See* RBC GLOBAL ASSET MGMT., *supra* note 103, at 5–10 (explaining how income distributions maintain their character for tax purposes); CSA ON MUTUAL FUNDS, *supra* note 2, at 5; CRA TREATMENT OF MUTUAL FUNDS, *supra* note 2, at 1 (describing taxation of mutual funds).

105. *See* RBC GLOBAL ASSET MGMT., *supra* note 103, at 5–10 (providing how Canadian mutual fund distributions are taxed); CRA TREATMENT OF MUTUAL FUNDS, *supra* note 2, at 1 (exploring the taxation scheme of Canadian mutual funds).

from the proceeds of the disposition.[106] The ACB is calculated as the average cost of all shares multiplied by the number of shares.[107] The proceeds of disposition are calculated as the total number of shares multiplied by the share per unit price.[108]

In sum, Part I highlighted how the PFIC regime was originally promulgated to prevent tax evasion and deferral.[109] The PFIC regime, however, is extremely legalistic and burdensome for US taxpayers invested in non-US passive assets.[110] The Excess Distribution, QEF, and MTM regimes all have their own set of tax rules and corresponding challenges.[111] This Comment specifically focuses on US taxpayers invested in the Canadian mutual fund PFIC.

II. *PFIC PROBLEMS*

The PFIC framework does not operate exactly as the legislators intended. In fact, in many instances the PFIC rules create inconsistent results. Part II.A discusses the harsh penalties and compliance complications under the excess distribution regime. While the QEF and MTM regimes were created to ameliorate the effects of the excess distribution regimes, they are criticized as less than ideal solutions. Part II.B explains how the QEF regime is ineffective because investors are rarely able to satisfy the information burden to make the election and accordingly, receive the more favorable treatment. Part II.C discusses how the MTM election also has limited utility and generates its own problems for investors. Next, Part II.D

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106. *See* RBC GLOBAL ASSET MGMT., *supra* note 103, at 4 (instructing how to make the ACB calculation); CRA TREATMENT OF MUTUAL FUNDS, *supra* note 2, at 2 (clarifying how mutual funds are taxed, including the ACB calculation).

107. *See* RBC GLOBAL ASSET MGMT., *supra* note 103, at 4 (describing the ACB calculation); CRA TREATMENT OF MUTUAL FUNDS, *supra* note 2, at 2 (describing taxation of mutual funds).

108. *See* RBC GLOBAL ASSET MGMT., *supra* note 103, at 4 (explaining what are considered to be the actual gains of the mutual fund); CRA TREATMENT OF MUTUAL FUNDS, *supra* note 2, at 2 (highlighting the steps to calculate the mutual funds' capital gain).

109. *See supra* notes 24–43 and accompanying text (noting reasons for enacting the PFIC legislation).

110. *See supra* Part I (outlining the many challenges for investors in the PFIC regime).

111. *See supra* notes 44–75 and accompanying text (illuminating the three different PFIC regimes and applicable tax treatment).

addresses additional issues with the PFIC regime, including the compliance costs, PFIC rules no longer promoting the legislative intentions, FATCA initiation, and PFIC rules favoring individual assets over pooled vehicles. Part II.E lastly outlines the complications of subjecting a Canadian mutual fund to this regime.

A. *The Unintended Results of the Excess Distribution Rules*

Commentators suggest that the PFIC excess distribution rules cast far too wide a net, beyond the regulators' original intent of preventing tax deferral.[112] Instead of simply leveling the playing field between US and international passive investments, the rules penalize US investors in international passive assets.[113] Under the excess distribution regime, all gains are treated as ordinary income without regard to the character of the income; excess distributions are allocated to prior years, taxed at the highest ordinary income tax rate per year, and charged a penalty for underpayment on the deferred tax.[114] Whether no actual distribution or disposition is made, or all income is distributed, investors are subject to the excess distribution taxes.[115] Furthermore, it is important to note that the deferred tax amount is treated similarly to a tax penalty that can only be offset by a foreign tax credit, and not losses.[116]

Investor Keith is a prime example of taxation under the default rules. To recap, Keith, a US taxpayer purchased the PFIC Canadian mutual fund on January 1, 1993, for US$1000 and then sold it on December 31, 2012, for US$21,000.[117] Since

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112. *See* Blanchard, *supra* note 20, at V.A (highlighting the excess distribution regime, including its deficiencies); Mezzetta, *supra* note 4 (outlining the problem with the PFIC regime for Canadian mutual funds).

113. *See* Blanchard, *supra* note 20, at II.E (explaining the tax deferral policy and accompanying issues under this regime); Lee & Smiley, *supra* note 22, at 43 (critiquing the excess distribution regime).

114. *See supra* notes 44–54 and accompanying text (discussing the PFIC regime default rules).

115. *See* Blanchard, *supra* note 20, at II.E (exploring the excess distribution taxation); N.Y.C. BAR, *supra* note 7, at 10 (summarizing the excess distribution regime).

116. *See* 26 U.S.C. § 1291(g) (2012) (stating the special tax credits available under this default regime); Blanchard, *supra* note 20, at V.A (describing how the deferred tax amount can only be offset by a foreign tax credit).

117. *See* N.Y.C. BAR, *supra* note 7, at 13 (providing an example to show the harsh taxes under the excess distribution regime).

Keith made no election (and was in fact unaware he owned a PFIC), he would be subject to the excess distribution tax which is almost equal to the income he earned. Keith incurred a total US tax payment of US$19,415.53 on income of US$20,000.[118] This is assuming a tax rate of 39.6% and an interest charge for underpayment of four percent compounded daily.[119]

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118. *See id.* (showing that taxes can be close or even greater than profits under the excess distribution regime). *See generally* Part I.B.1 (consequences of the excess distribution regime if no election is made).

119. *See* N.Y.C. BAR, *supra* note 7, at 13 (exemplifying how profits are reduced by the tax rate and interest for underpayment). *See generally* Part I.B.1 (describing what factors are used in calculating taxes for the excess distribution regime).

Year	**Allocable part of the gain (US$)**	**Tax (US$)**	**Interest (US$)**	**Total payment (US$)**
1993	1,000.00	396.00	846.72	1,242.72
1994	1,000.00	396.00	813.52	1,209.52
1995	1,000.00	396.00	781.63	1,177.63
1996	1,000.00	396.00	750.98	1,146.98
1997	1,000.00	396.00	721.54	1,117.54
1998	1,000.00	396.00	693.25	1,089.25
1999	1,000.00	396.00	666.06	1,062.06
2000	1,000.00	396.00	639.95	1,035.95
2001	1,000.00	396.00	614.86	1,010.86
2002	1,000.00	396.00	590.75	986.75
2003	1,000.00	396.00	567.59	963.59
2004	1,000.00	396.00	545.33	941.33
2005	1,000.00	396.00	523.95	919.95
2006	1,000.00	396.00	503.41	899.41
2007	1,000.00	396.00	483.67	879.67
2008	1,000.00	396.00	464.71	860.71
2009	1,000.00	396.00	446.49	842.49
2010	1,000.00	396.00	428.98	824.98
2011	1,000.00	396.00	412.16	808.16
2012	1,000.00	396.00	0.00	396.00
Total	**$20,000.00**	**$7,920.00**	**$11,495.53**	**$19,415.53**

Source: Calculations Based on the New York City Bar Report.[120]

As the table suggests, this regime can result in taxation almost equal to the actual PFIC income earned, and in some instances taxation even greater than income earned.[121] These

120. N.Y.C. BAR, *supra* note 7.

121. *See* N.Y.C. BAR, *supra* note 7, at 11–13 (exemplifying the excess distribution regime). *See generally* Blanchard, *supra* note 20, at V (noting the severe tax penalties under the excess distribution regime).

scenarios often result when the PFIC is held over a long period of time and there are large excess distributions.[122]

B. *False Hope for Redemption in the QEF Election*

In theory, the QEF election was designed to entirely avoid the § 1291 excess distribution regime and to treat the PFIC as a US asset without the higher ordinary tax rates or penalty charges.[123] In practice, critics argue that the two prerequisite steps to make the election, discussed below, are far too burdensome.[124] These steps often deny investors the opportunity to make the election.[125]

First, the shareholder must make a timely election to completely avoid the PFIC excess distribution regime.[126] If the QEF election is made in the first PFIC year, the asset becomes a pedigreed PFIC, and then the investor can entirely avoid the excess distribution regime under § 1298(b)(1).[127] In contrast, if a retroactive QEF election is made later, the PFIC is subject to both the § 1291 excess distribution and QEF rules.[128] The § 1298(b)(1) "once a PFIC, always a PFIC" rule applies to PFICs that are not pedigreed PFICs.[129]Retroactive elections are only

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122. *See* N.Y.C. BAR, *supra* note 7, at 11–13 (illustrating the harsh consequences that can result under the excessive distribution regime).

123. *See supra* notes 55–66 and accompanying text (providing an overview of the QEF election).

124. *See* FORM 8621 INSTRUCTIONS, *supra* note 43, at 1 (instructing investors on how to make the QEF election); Blanchard, *supra* note 20, at VI.A (describing the necessary steps to make a QEF election).

125. *See* Blanchard, *supra* note 20, at VI.B (warning the deadlines and information burden can prevent investors from making the election); N.Y.C. BAR, *supra* note 7, at 15–16 (hinting at the challenges of making the QEF election, namely the corporation agreeing to provide the necessary information).

126. *See* Blanchard, *supra* note 20, at VI.A (explaining how to make a timely QEF election); N.Y.C. BAR, *supra* note 7, at 16 (stating when the election must be made to be considered timely).

127. 26 U.S.C. § 1298(b)(1) (2012) (exploring the impact of the time an investor makes a QEF election); Treas. Reg. § 1.1291-1(b) (2013) (describing the pedigreed PFIC); *see* N.Y.C. BAR, *supra* note 7, at 15–16 (defining when a PFIC is a pedigreed PFIC).

128. *See* N.Y.C. BAR, *supra* note 7, at 15–16 (defining when a PFIC is not pedigreed and subject to the PFIC taint); Blanchard, *supra* note 20, at VI.F (explaining treatment of pedigreed PFICs).

129. Treas. Reg. § 1.1295-1(c)(2) (2013) (describing the PFIC taint); *see* N.Y.C. BAR, *supra* note 7, at 16 (defining the QEF regime based on the time the QEF election is made).

permissible under limited circumstances.[130] Hence, if investors simply do not realize they are subject to the PFIC regime, miss the deadline to make a timely election, and are denied the opportunity to make a retroactive election, such investors forfeit the more favorable tax rates under the QEF regime.[131]

Second, the shareholder must obtain the necessary information from the PFIC to make the QEF election.[132] This can be difficult information to acquire because the United States uses the Generally Accepted Accounting Principles ("GAAP") accounting system and all other countries use the International Financial Reporting Standards ("IFRS").[133] Accordingly, a Canadian PFIC would be required to keep separate books applying all of the US tax rules and PFIC regulations in order to provide investors with the necessary information.[134] This information must be produced annually or the QEF status terminates.[135] In addition to converting the records to comply with US accounting principles, the PFIC must agree to take on the liability of accurately reporting in order to make the election.[136] Thus, scholars argue that the PFIC information requirements place an undue burden on PFICs

130. *See supra* notes 55–66 and accompanying text (providing an overview of the QEF election).

131. *See* Blanchard, *supra* note 20, at VI.C (explaining when the election is to be made); Wood & Van Loo, *supra* note 64, at 808 (exploring the consequences of missing the election filing deadline).

132. *See supra* notes 55–66 and accompanying text (overviewing the QEF regime).

133. *See* Blanchard, *supra* note 20, at VII.A (instructing how to make the necessary calculations for QEF election); Remi Forgeas, *Is IFIRS That Different from U.S. GAAP?*, IFRS RESOURCES (June 16, 2008), http://www.ifrs.com/overview/General/differences.html (differentiating between the US GAAP system and IFRS).

134. *See* IFIC Letter, *supra* note 5, at 2 (articulating the steps PFICs must take to comply with the election requirements); Wood & Van Loo, *supra* note 64, at 808 (describing the steps for a PFIC to meet the QEF filing requirements).

135. *See* FORM 8621 Instructions, *supra* note 43, at 4 (instructing what information the PFIC must provide annually); Scott F. Usher & Diana L. Pitner, *QEF Elections Under PFIC Rules*, AICPA (October 1, 2012), http://www.aicpa.org/publications/taxadviser/2012/october/pages/clinic-story-07.aspx (summarizing the QEF regime and method to make the election).

136. *See* Blanchard, *supra* note 20, at VI.D (emphasizing the burden placed on the PFIC in order for investors to make the QEF election).

whose only connection to the United States may be through a minority investor.[137]

In sum, the QEF election imposes a heavy burden on US taxpayers and PFICs.[138] Without the cooperation of the PFIC, investors are unable to make the election.[139] Hence, in many instances, investors are denied the benefits of the QEF election.

C. *The Next Best Option—the MTM Election*

Since the QEF election can rarely be made, the next best option to escape the excess distribution regime is the MTM election.[140] The MTM election was also designed to ameliorate the punitive effects of the excess distribution regime.[141] Many criticize the MTM's limited utility because it only applies to a small subset of PFICs considered to be marketable securities.[142] Additionally, the MTM election can only be made when an investor directly holds the PFIC or holds it through a pass-through entity under § 1296(g).[143] Even when such election can in fact be made, the investor is still subject to ordinary income tax rates on all appreciation in value of the PFIC rather than the more favorable capital gains tax rate that applies under the QEF election.[144] Hence, investors in Canadian mutual funds reap only

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137. *Id.* (highlighting the imposition the QEF requirements place on the PFIC itself in order for an investor to comply with the QEF rules); Wood & Van Loo, *supra* note 64, at 808 (describing the challenges involved in making the QEF election).

138. *See* Blanchard, *supra* note 20, at VI.D (detailing how an investor can make the QEF election); IFIC Letter, *supra* note 5, at 2 (exploring difficulties investors encounter in making the QEF election).

139. *See* Blanchard, *supra* note 20, at VI.D (explaining the requirements to make the QEF election); Usher & Pitner, *supra* note 135 (summarizing issues encountered with the QEF regime).

140. *See* Lee & Smiley, *supra* note 22, at 43 (discussing how the MTM regime is an alternative to the excess distribution regime); Wood & Van Loo, *supra* note 64, at 805 (exploring the MTM and QEF elections).

141. *See* Blanchard, *supra* note 20, at IX.A (outlining the mark-to-market regime); Lee & Smiley, *supra* note 22, at 43 (critiquing the PFIC regime).

142. *See* Blanchard, *supra* note 20, at IX.A (outlining when the MTM regime can be used); Lee & Smiley, *supra* note 22, at 43 (exploring the limited utility of the MTM regime).

143. 26 U.S.C. § 1296(g) (2012) (describing who can make the MTM election); *see* Blanchard, *supra* note 20, at IX.A (detailing the requirements to make the MTM election).

144. 1296(c) (explaining how the PFIC is taxed under the MTM regime); *see* N.Y.C. BAR, supra note 7, at 18 (highlighting the MTM tax rules).

partial benefits by making the MTM election because such investors are still subject to ordinary income taxes on the mutual funds appreciation.[145]

D. *PFIC Problems Plaguing All Three Regimes*

Regardless of the regime the PFIC is categorized under, there are many inherent problems with the PFIC regulations. Part II.D.1 first discusses the high compliance costs. Part II.D.2 next explains that the legislative purpose for enacting the regulation does not apply to Canadian mutual funds. Part II.D.3 then demonstrates that the PFIC regime discourages investment in pooled vehicles by not subjecting individual assets to the same rigorous treatment. Lastly, Part II.D.4 explores the impact of the imminent Foreign Account Tax Compliance Act ("FATCA") initiation.

1. Outrageous Compliance Costs

Requiring a PFIC owner to file Form 8621 is very time consuming and burdensome, even for US tax specialists.[146] The form instructions indicate that the estimated time to properly comply with the PFIC filing requirements is over thirty-one hours per PFIC.[147] It is nearly impossible for the average PFIC investor to complete the form without incurring the added cost of consulting tax experts.[148]

Form 8621 also requires detailed information about the PFIC, which is not always accessible to a minority investor and can be a significant burden on the PFIC to produce.[149] Another

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145. *See* Lee & Smiley, *supra* note 22, at 42–43 (describing the MTM regime as less preferable than the QEF regime because there is still ordinary income on all appreciation in value of the PFIC). *See generally* Blanchard, *supra* note 20, at IX (outlining the MTM tax treatment, which is not as favorable as the QEF treatment).

146. *See* FORM 8621 Instructions, *supra* note 43, at 12 (outlining the requirements to file this form); Golombek, *supra* note 4 (critiquing the compliance costs of the PFIC regulations for US investors in Canada).

147. *See* FORM 8621 Instructions, *supra* note 43, at 12 (estimating the time required to file this form); Golombek, *supra* note 4 (criticizing how long it takes to file Form 8621 required to comply with the PFIC regulations).

148. *See* Golombek, *supra* note 4 (stating PFIC investors generally require professional assistance to file the PFIC forms).

149. *See supra* Part II.B.2 (summarizing the information a PFIC must provide for an investor to make an election under Form 8621).

obstacle to complying with the PFIC regime is that many investors are simply ignorant of the fact that they are PFIC investors and subject to certain reporting guidelines.[150] Investors, who are unaware of the PFIC classification of their investments, do not comply with the strict election and filing deadlines, and hence suffer severe financial consequences.[151]

2. Application of the PFIC Regime to Canadian Mutual Funds

The PFIC regulations were promulgated to eliminate the tax incentives of investing in passive assets outside of the United States.[152] Overtime, tax rates for different sources of income have fluctuated.[153] Today, Canadian mutual funds do not provide the same tax advantages for US taxpayers that the PFIC regulations were initially promulgated to eliminate.[154] When the rules were promulgated in 1986, the qualified dividend tax rate and long-term capital gains tax rate were different.[155] PFIC dividends were not considered derived from a "qualified foreign corporation."[156] Thus, the rules required PFIC dividends to be

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150. *See* Blanchard, *supra* note 20, at V.C (investors often miss PFIC issues and such investors are not able to make a retroactive elections). *See generally supra* notes 44–75 and accompanying text (noting the problems encountered by PFIC investors who do not realize they own a PFIC until too late).

150. 26 U.S.C. § 1295(a)(2) (2012) (stating what information is required to make a QEF election).

151. *See* Blanchard, *supra* note 20, at V.C (identifying issues when investors fail to meet the filing deadlines); Wood & Van Loo, *supra* note 64, at 808 (exploring the consequences of missing the election filing deadline); *supra* Part II.B (focusing on consequences for investors ignorant that they own a PFIC and then do not comply with the requirements).

152. *See supra* notes 24–43 and accompanying text (discussing the legislative history for enacting the PFIC rules).

153. *See* Lee & Smiley, *supra* note 22, at 43 (explaining how tax rates for capital gains and income have fluctuated and are now equal); *see also A taxpayer's Guide to 2013,* FIDELITY (Feb. 27, 2013), https://www.fidelity.com/viewpoints/personal-finance/taxpayers-guide (stating the qualified dividend tax rate is the long-term capital gains rate for both 2012 and 2013).

154. *See supra* notes 24–43 and accompanying text (noting the tax reasons for enacting the PFIC rules).

155. *See* EXPLANATION OF THE TAX REFORM ACT, *supra* note 19, at 1023 (explaining the relevant tax rates when the PFIC rules were promulgated); *see also* Lee & Smiley, *supra* note 22, at 43 (describing the tax regime when the PFIC rules were enacted).

156. 26 U.S.C. § 1(h)(11)(C)(iii) (2012) (defining the "qualified foreign corporation").

taxed at the highest ordinary income tax rate.[157] By subjecting PFIC dividends to the highest ordinary income tax rate, legislators eliminated the tax advantages of investing through an international investment company.[158] Today, tax rates are equal, so the tax advantage of converting foreign dividends to capital gains no longer exists.[159] Thus, investors are now penalized for utilizing an investment vehicle that has no inherent tax advantage.[160]

More specifically, the PFIC rules cast far too wide a net by encompassing Canadian mutual funds.[161] First, as the Investment Funds Institute of Canada ("IFIC") indicates, Canada is not a tax haven, has a long history with the United States, including a tax treaty, and, thus, should not be the target of US regulation.[162] Second, US investors do not utilize the Canadian mutual fund class to defer or evade US taxes, nor to gain other unfair advantages that the PFIC regulations seek to curtail.[163]

Under the current PFIC framework, Canadian and US mutual funds are subject to an entirely different tax and

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157. *See* Blanchard, *supra* note 20, at II.G (explaining the applicable dividend rate for PFICs); Wood & Van Loo, *supra* note 64, at 807 (stating the tax rates that apply to PFICs).

158. *See* EXPLANATION OF THE TAX REFORM ACT, *supra* note 19, at 1023 (describing how the PFIC rules increased the tax rate for non-US passive investments, thereby eliminating the tax incentives); Lee & Smiley, *supra* note 22, at 43 (explaining how the PFIC rules eliminated the tax incentive to invest through non-US passive assets).

159. *See* Lee & Smiley, *supra* note 22, at 43 (finding the same tax advantages with foreign investments no longer exist); *see also* EXPLANATION OF THE TAX REFORM ACT, *supra* note 19, at 1023 (explaining the tax regime when the PFIC rules were promulgated).

160. *See* Lee & Smiley, *supra* note 22, at 43 (critiquing the PFIC regime for being punitive); *see also* IFIC Letter, *supra* note 5, at 3 (arguing investors are penalized for investing in PFICs).

161. *See* IFIC Letter, *supra* note 5, at 3 (challenging the PFIC regime application to Canadian mutual funds); N.Y.C. BAR, supra note 7, at 1 (highlighting how the PFIC rules are over-inclusive).

162. *See* IFIC Letter, *supra* note 5, at 1 (challenging the application of the PFIC regime to Canadian mutual funds); Media Release, Investment Institute of Canada, IFIC Proposes Excluding Canadian Funds from PFIC Rules (Apr. 16, 2013) [hereinafter Summary of IFIC Proposal], *available at* https://www.ific.ca/en/news/april-16-2013-ific-proposes-excluding-canadian-funds-from-pfic-rules/ (summarizing the reasons why Canadian mutual funds should be exempt from the PFIC rules).

163. *See* IFIC Letter, *supra* note 5, at 1 (arguing US taxpayers do not use Canadian mutual funds for tax deferral). *See generally supra* Part I.E (outlining the Canadian mutual fund vehicle and how it is regulated).

compliance regime.[164] However, the President and CEO of the IFIC urges "[t]here is sufficient similarity between the tax treatment of mutual funds in Canada and the US to support the exclusion of Canadian mutual funds from the PFIC rules."[165] Canadian mutual funds are not structured as an "offshore tax shelter".[166] In fact, the Canadian market and mutual fund industry are highly regulated.[167] Additionally, the structure of a mutual fund, a pooled investment vehicle, mitigates the potential for being utilized as an abusive tax vehicle because individual investors lack control over the fund and regulators require certain disclosures to investors to facilitate transparency.[168] Lastly, all income and gains are distributed annually so the PFIC is not an abusive tax deferral vehicle.[169]

3. PFIC Regulations Favor Individual Assets Over Pooled Investment Vehicles

An inherent problem with the PFIC rules is that they encourage investment in individual securities rather than pooled vehicles.[170] For example, purchasing shares of an active stock on the Canadian market would not be considered a PFIC, but purchasing shares of a Canadian mutual fund that owns

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164. *See* Lee & Smiley, *supra* note 22, at 43 (arguing the PFIC regime penalizes investors for selecting non-US passive assets, rather than just leveling the playing field); Golombek, *supra* note 4 (warning US investors to avoid Canadian mutual funds because of the PFIC complications, which investors can entirely avoid by investing in US mutual funds).

165. *See* IFIC Letter, *supra* note 5, at 2 (challenging the need to apply the PFIC rules in Canada); *supra* notes 94–108 and accompanying text (highlighting the Canadian mutual fund vehicle and similarities with the United States).

166. *See* IFIC Letter, *supra* note 5, at 2 (arguing Canada is not tax haven and thus, Canadian mutual funds cannot be utilized as a tax shelter); *see also supra* notes 21–22 and accompanying text (discussing how Canada is not a tax haven).

167. *See generally supra* notes 94–108 and accompanying text (outlining regulation of the Canadian mutual fund market).

168. *See* IFIC Letter, *supra* note 5, at 2 (arguing if would make sense for Canadian mutual funds to be subject to the PFIC rules if investors had control over the assets).

169. Mezzetta, *supra* note 4 (highlighting how Canadian mutual funds distribute income annually, so it cannot be utilized to avoid US taxation); *see also* CSA ON MUTUAL FUNDS, *supra* note 2, at 4 (describing how Canadian mutual funds distribute income).

170. *See* IFIC Letter, *supra* note 5, at 2 (arguing the PFIC regime favors individual securities rather than pooled investment vehicles, like mutual funds); Summary of IFIC Proposal, *supra* note 162 (critiquing the inequality that results from the PFIC rules).

active companies would be considered a PFIC.[171] The Organization for Economic Co-Operation & Development ("OECD") believes an investment in a collective vehicle should not result in different tax consequences than if the assets are individually owned.[172] Canadian mutual funds are among the pooled assets OECD believes should be treated as equal to non-pooled assets because they are widely held assets, create a diversified portfolio, and provide investor protection.[173] So, these rules can be viewed as discouraging US taxpayers from investing in pooled securities and gaining the advantages of such investments.[174]

4. Imminent FATCA Initiation

With the onset of the Foreign Account Tax Compliance Act ("FATCA") in 2014, Canadian financial services companies are forced to disclose information on US taxpayers to the IRS.[175] This forced disclosure program will likely expose US taxpayers residing in Canada who have not been filing Form 8621 to report PFIC holdings.[176] Critics argue that when investors weigh

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171. *See supra* Introduction (noting Keith could have avoided the PFIC regime by selecting his own securities rather than purchasing shares of the mutual fund).

172. *See* ORG. FOR ECON. CO-OPERATION & DEV., MODEL TAX CONVENTION ON INCOME AND ON CAPITAL 2010, at 4 (2012) (suggesting that investing in individual assets should not be encouraged over pooled investment vehicles); *accord* IFIC Letter, *supra* note 5, at 2 (reinforcing OECD's position that investment in pooled vehicles should not create different tax results than investing in individual securities).

173. *See supra* notes 3–6 and accompanying text (articulating the benefits of the mutual fund vehicle). *But see* Jason Heath, *Mutual Funds: The Good, The Bad and The Ugly*, FIN. POST (February 12, 2013, 9:58 AM), http://business.financialpost.com/2013/02/12/mutual-funds-the-good-the-bad-and-the-ugly (challenging the conception that mutual funds are inherently good investments).

174. *See* Summary of IFIC PROPOSAL, *supra* note 162; IFIC Letter, *supra* note 5, at 2 (challenging the PFIC regime in Canada).

175. *See generally* THUN FIN. ADVISORS, FATCA (FOREIGN ACCOUNT TAX COMPLIANCE ACT): WHAT AMERICAN INVESTORS NEED TO KNOW NOW (Jan. 2012), http://www.thunfinancial.com/articles/US-FATCA-Foreign-Account-Tax-Compliance-Act-Law-What-American-Expats-Need-to-Know.pdf [hereinafter FATCA: WHAT AMERICAN INVESTORS NEED TO KNOW NOW] (outlining the implications of FATCA); Marc D. Shepsman, Comment, *Buying FATCA Compliance: Overcoming Holdout Incentives to Prevent International Tax Arbitrage*, 36 FORDHAM INT'L L.J. 1769 (2013) (exploring the potential consequences of the FATCA initiation for the United States).

176. *See* Terry F. Ritchie & James Sheldon, *New Rules for US Taxpayers with Mutual Funds*, ADVISORS.CA (Jan. 22, 2014), http://www.advisor.ca/tax/tax-news/new-rules-for-u-s-taxpayers-in-canada-with-mutual-funds-141931 (stating FATCA will expose US taxpayers not complying with the PFIC filing rules). *See generally* FATCA: WHAT

the burden of the PFIC regime, including the hefty taxes and cumbersome compliance costs, investors will opt to simply dispose of their PFIC holdings.[177]

E. *PFIC Spotlight: the Consequences for US Taxpayers Invested in Mutual Funds*

As discussed, the PFIC regime is over-inclusive because it incorporates assets that are not utilized by investors to avoid or defer current taxation.[178] Mutual funds owned by US taxpayers are a prime example of this problem.[179]

Assume that Investor *A* invests US$1000 in "PFIC mutual fund" at the beginning of year 1 and holds the asset until the end of year 4. Under the PFIC regime, *A* is eligible to make the MTM election because a mutual fund is considered a marketable security.[180] Assuming *A* made this timely election, *A* would be responsible for paying US taxes on the annual increase in value of the PFIC determined at the end of each year as if the asset was sold.[181] The ordinary income tax rate would be applied rather than the more favorable capital gains rate.[182] *A* would also be required to pay taxes on the actual distributions received from the PFIC mutual fund at the ordinary income tax rate.[183] For simplicity of this example, assume the PFIC mutual fund that *A* is invested in does not make any annual distributions during *A*'s four-year holding period.

AMERICAN INVESTORS NEED TO KNOW NOW, *supra* note 175 (exploring how FATCA will increase the number of US taxpayers in Canada who are filing US tax returns); Wood & Van Loo, supra note 64 (illustrating the implications of FATCA on the PFIC regime).

177. IFIC Letter, *supra* note 5, at 1–2 (arguing that FATCA may result in US investors simply opting not to invest in PFICs, including Canadian mutual funds).

178. *See supra* note 152–169 and accompanying text (describing how the PFIC regime incorporates assets that do not further the legislative intent for enacting the rules).

179. *See id.* (focusing on how the PFIC regime should not incorporate the Canadian mutual fund).

180. *See supra* notes 68–69 and accompanying text (discussing how an investor is eligible to make an MTM election when the security is marketable).

181. *See supra* note 70 and accompanying text (explaining how assets are taxed under the MTM election).

182. *See* supra note 75 and accompanying text (stating the tax rate that applies to a PFIC asset under the MTM regime).

183. *See id.*

During this same period (years 1 through 3) *A* incurs no non-US taxes because there are no actual distributions.[184] Investors only incur non-US taxes on realized gains (actual distribution), not on unrealized gains.[185] For non-US tax purposes, the first tax event in this example does not occur until the end of year 4 when *A* sells the PFIC mutual fund holding.

In year 4, upon sale of all stock in the PFIC, *A* would incur taxes in both the US and non-US country.[186] For non-US tax purposes, *A* must pay taxes on the total gain on the asset over the entire holding period because none of the PFIC's unrealized gains have been taxed in prior years.[187] This is calculated as the redemption value (sale price) minus the adjusted cost base, in this case the purchase price.[188] For US tax purposes, *A* only has to pay taxes on the increase in value of the asset over the past year (year 3 to 4), the same manner *A* was taxed on the increase in value of the asset in prior years.[189]

Since there are both US and non-US tax consequences in year 4, *A* can use a foreign tax credit to offset the US taxes owed.[190] The non-US taxes are significantly higher than the US taxes in year 4. A foreign tax credit can only be used to the extent of US income in that year.[191] Thus, a portion of the foreign tax credit in year 4 cannot be used. The excess foreign tax credit from year 4 can carryback one year to the extent of

184. *See supra* note 103 and accompanying text (stating Canada only taxes realized gains).

185. *See id.* (finding investors are only taxed on actual distributions and not on phantom income or increases in value of stock in Canada).

186. *See supra* notes 71–75 and accompanying text (explaining the MTM taxation scheme on the annual increase in value of the asset); supra notes 103-104 and accompanying text (highlighting Canada only taxes assets on realized gains, which includes disposition of an asset).

187. *See supra* notes 106–108 and accompanying text (discussing how Canada taxes Canadian mutual funds and how Canadian capital gains are calculated).

188. *See id.*

189. *See supra* notes 71–75 and accompanying text (noting that under the MTM regime investors are subject to taxation on the increase in value annually, this includes the year of disposition).

190. *See supra* notes 76–85 and accompanying text (emphasizing a foreign tax credit is available when a US taxpayer is taxed on the same income in the US and non-US country).

191. *See supra* notes 81–82 and accompanying text (noting how the foreign tax credit is limited).

the US taxes owed in year 3.[192] It should be noted that foreign tax credits can only carryback one year and carryover ten years.[193] After the carryback, there is still a portion of foreign tax credit remaining that is wasted because *A* has no future income and *A* cannot carryback a foreign tax credit two years.

For purposes of this example, in year 4 *A* has US$310.50 in non-US taxes, but *A* can only use the amount of US taxes accrued in year 4, US$34.72, from the non-US taxes as a foreign tax credit. Nevertheless, *A* can carryback US$203.98 to offset the taxes in year 3. The remaining US$71.80 of foreign tax credit cannot be used.

Due to this misalignment, Investor *A* is subject to double taxation on a portion of the income earned. There is no foreign tax credit available in years 1 through 3. The foreign tax credit available in year 4 can be used to offset the income in year 4 and then *A* can carryback the unused portion to offset taxes in year 3. There is no mechanism, however, to offset years 1 and 2 taxes that are accrued in the respective years in the United States but not until year 4 in the non-US country. Hence, *A* incurs additional taxes due to the misalignment of tax events in the United States and non-US country.

The table below shows the total non-US and US taxes after accounting for the foreign tax credit.

The following assumptions were made:

- The US dollar and the non-US dollar are at par, so no exchange rate calculations are necessary
- The non-US country only taxes distributed income
- This is investor *A*'s only foreign source income and *A* has no future income
- US tax rates:
  - Ordinary income, interest and short term tax rates of 43.40%. This tax rate includes the highest ordinary income tax rate of 39.6% and the Medicare tax of 3.8%
  - Long term capital gains tax rate of 23.80%

192. *See supra* notes 84–85 and accompanying text (explaining the foreign tax credit carryback provisions).

193. *See supra* note 85 and accompanying text (detailing how the foreign tax credit carryback and carryover operates).

- Non-US tax rates:
    - Capital gains tax rate of 23%

Year	**Event**	**Value on last day of year (US$)**	**Unrealized gains (US$)**	**Realized gains (US$)**	**Non-US tax (US$)**	**US tax (US$)**	**Net US tax after foreign tax credit (US$)**	**Total tax (US$)**
0	A purchases the asset on the last day of the year	1000						
1		1270	270	0	0	117.18	117.18	117.18
2		1800	530	0	0	230.02	230.02	230.02
3		2270	470	0	0	203.98	0	0
4	A sells the asset on the last day of the year	2350	80	1350	310.5	34.72	0	310.5
Total			1350	1350	310.5	585.9	347.2	657.7

On the other hand, if investor *A* was not subject to the PFIC regime, the taxes incurred would be significantly reduced. There would be no US tax event in years 1 through 3. For US tax purposes, the investor would only be taxed in year 4, upon disposition of the asset, at the more favorable long-term capital gains rate (23.80%). In both the United States and the non-US country, the PFIC mutual fund would not be taxed until disposition in year 4. Since all US and non-US taxes would be incurred during the same year, the foreign tax credit could be used against the total US tax consequence and significantly reduce the taxes owed.[194]

Interestingly, the country in which this investor purchased the mutual fund in was, in fact, Canada, just like investor Keith. After considering the Canadian regulatory framework and the mutual fund market, as well as Keith's traumatic encounter with the PFIC mutual fund, one must wonder why the Canadian mutual fund remains categorized as a PFIC subject to the higher tax rates exemplified in the table above and the added compliance costs.

In sum, investors and experts are particularly critical of the treatment of Canadian mutual funds under the PFIC regime.[195] The QEF election is generally unavailable, the MTM election offers little relief from the excess distribution regime, and compliance costs remain high.[196] Furthermore, subjecting Canadian mutual funds to the PFIC regime does not further the legitimate goals of the regime and instead, interferes with the US investment in Canadian mutual funds.[197]

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194. *See generally* notes 76–85 and accompanying text (explaining when and how the foreign tax credit operates).

195. *See supra* notes 154–171 and accompanying text (highlighting the issues with the PFIC regime, particularly with the Canadian mutual fund).

196. *See supra* notes 112–145 and accompanying text (arguing that none of the PFIC regimes offer sufficient relief to Canadian mutual fund investors).

197. *See supra* notes 154–171 and accompanying text (supporting the argument that the original legislative intent is no longer furthered by including Canadian mutual funds in the PFIC rules).

III. *THE PROPOSED EXEMPTION OF CANADIAN MUTUAL FUNDS FROM THE PFIC REGULATIONS*

To resolve the current issues with the PFIC regulations, Part III proposes exempting Canadian mutual funds from the PFIC categorization. Part III.A outlines a proposal to tax Canadian mutual funds under the ordinary US tax rules and the corresponding rationale. Part III.B then discusses the benefits of exempting Canadian mutual funds from the PFIC rules.

A. *The Proposal*

The United States-Canada Income Tax Convention (the "Treaty") should exempt Canadian mutual funds that meet the PFIC asset or income test where the investor does not exert control.[198] This would include investors with less than fifty percent of the voting rights of the PFIC, and thus, unable to exert control. In doing so, US taxpayers would still be subject to taxation in the United States and Canada but under a more favorable framework. For US tax purposes, the investor would benefit from variable tax rates based on the character of income received rather than uniformly being subjected to the highest ordinary income tax rate regardless of the source of the income.[199] Additionally, US taxpayers who do not fall into the highest tax bracket would benefit from the tax rates of the lower brackets determined by the level of income earned.[200]US taxpayers would also avoid additional penalties for alleged underpayment of taxes in earlier years that can result in very high interest when compounded over extended periods of time.[201] This proposal is a natural extension of the Treaty that seeks to reduce double taxation and facilitate cross border

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198. *See supra* notes 19–23 and accompanying text (proposing exempting Canadian mutual funds from the PFIC regime).

199. *See generally supra* notes 24–75 and accompanying text (underscoring the severe tax consequences under the PFIC regime).

200. *See generally supra* notes 24–75 and accompanying text (explaining how investors could benefit from lower tax rates if they qualify for a lower tax bracket).

201. *See generally supra* notes 24–75 and accompanying text (exploring the PFIC tax penalty and interest).

transactions between the neighboring countries—Canada and the United States.[202]

This proposal should be adopted for several reasons. First, including Canadian mutual funds in the PFIC regime does not further the original legislative intent for enacting the PFIC regime.[203] Investors cannot use Canadian mutual funds as a vehicle for tax evasion because the assets are regulated by Canadian governing bodies and individual investors cannot exert control.[204] Canadian mutual funds also distribute all income annually and thus, taxes are not deferred.[205] Subjecting Canadian mutual funds to the PFIC regime penalizes investors for choosing international passive investments, rather than simply leveling the playing field.[206] In contrast, the new proposal would level the playing field between non-US and US passive investments, as was originally intended by the legislation.[207]

Second, if no change is made, given the imminent FATCA initiation, US taxpayers will be discouraged from investing in Canadian mutual funds and denied the benefits of this investment class.[208] The benefits include: foreign investment, diversification, professional management, and a pooled investment vehicle.[209] Under the proposed regime, the tax implications of investing in individual US assets and pooled

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202. *See generally* Convention Between the United States of America and Canada with respect to Income and Capital, U.S.-Can., Sept. 26, 1980, T.I.A.S. No. 11087 (outlining the framework for the relationship between Canada and the United States with respect to income).

203. *See supra* notes 154–71 and accompanying text (articulating the original intent of the PFIC regulations and how Canadian mutual funds do not further this intent).

204. *See supra* notes 96–110 and accompanying text (describing regulation of Canadian mutual funds).

205. *See supra* note 104 and accompanying text (stating how Canadian mutual funds distribute income annually, eliminating the need for this tax deferral regime).

206. *See supra* notes 27–31 and accompanying text (articulating the intent of the PFIC regulations to level the playing field between US and non-US passive investments).

207. *See id.*

208. *See supra* notes 177–79 and accompanying text (identifying the challenges with the FATCA initiation).

209. *See supra* notes 9–17 and accompanying text (noting the advantages of the mutual fund vehicle).

mutual fund vehicles would be identical and thus, not influence one's investment decision-making process.[210]

B. *Benefits of the Proposal*

This proposal resolves many of the issues for US investors in Canadian mutual funds under the current regimes.[211] If adopted, investors would avoid the excess distribution regime's deferred tax interest, penalty charges, and highest marginal ordinary tax rate.[212] The proposed regime would essentially tax PFIC's the same as under the QEF regime without incurring the burdensome compliance costs, filing deadlines and complications accompanying the PFIC categorization.[213] Additionally, the proposal would eliminate the regulatory costs of the PFIC regime and uniform application of the highest ordinary income tax rate when an investor makes the MTM election.[214]

In sum, the proposal would continue to promulgate the original purpose of the PFIC regulations without unnecessarily imposing compliance costs, filing deadlines and other cumbersome implications on Canadian mutual funds investors that do not further the legislative intentions.[215]

CONCLUSION

Due to the overwhelming issues with the current PFIC framework, Canadian mutual funds must be exempt from the PFIC categorization. Perhaps the rationale for enacting the PFIC rules is still relevant to trusts and other unregulated non-US passive assets that can ultimately be utilized by US taxpayers to gain favorable tax treatment. Nevertheless, it is imperative legislators update the PFIC regime to reflect the current

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210. *See supra* note 184–87 and accompanying text (highlighting the discrepancy between treatment of individual securities and pooled vehicles).

211. *See supra* Part II (exploring the issues with the PFIC regime and Canadian mutual fund treatment).

212. *See supra* notes 44–54 (identifying the challenges of the excess distribution regime).

213. *See supra* notes 55–66 and accompanying text (focusing on the QEF election and its inefficiencies).

214. *See supra* notes 67–75 and accompanying text (outlining the MTM election).

215. *See supra* Part II (highlighting issues with the current PFIC framework).

environment and, hence, exempt Canadian mutual funds. If this change is adopted, US taxpayers will be encouraged to continue to invest in Canadian mutual funds and reap the benefits, rather than opting out merely because of the complexity and financial burden of the PFIC regime.