Passive Foreign Investment Company (PFIC)

Starlight Capital is helping investors comply with U.S. PFIC tax rules.

Starlight Investments Capital LP ("Starlight Capital") knows there is concern among investors about the U.S. passive foreign investment company (PFIC) rules. These rules could significantly affect "U.S. persons" who hold Canadian mutual funds and ETFs, so we are providing you with information about these complex rules.

We believe it is important for those who may be affected by these rules to have the information necessary to make informed decisions. However, we also believe that investors affected by these rules should not make changes to their Canadian holdings without first speaking with their advisors and a U.S. tax specialist.

Starlight Capital provides PFIC Annual Information Statements (AIS) for all of the mutual funds and private pools for the 2020 tax year. We will also be making available PFIC AIS for the ETFs.

Learn more in our PFIC overview.

The following list of frequently asked questions has been created to help you better understand how PFIC rules might affect you.

Frequently asked questions on PFIC rules

1. Who are U.S. persons?

The definition of a U.S. person is broad and generally includes U.S. residents, U.S. citizens, U.S. green card holders, other persons with a substantial connection to the U.S. and certain entities organized in the U.S. It should be noted that U.S. citizens and green card holders are considered U.S. persons regardless of their country of residence. Some Canadian residents could be unaware that they have U.S. tax filing requirements.

2. What is a PFIC?

A PFIC (passive foreign investment company) is a non-U.S. corporation that has 75% or more of its gross income consisting of passive income or 50% or more of the average fair market value of its assets consisting of assets that produce passive income.

Passive income includes, among other things, dividends, interest, rent, royalties and capital gains from the disposition of securities.

The Internal Revenue Service (IRS) has confirmed that Canadian mutual funds and ETFs are classified as corporations for U.S. tax purposes and, as such, are subject to the PFIC rules.

3. How do the PFIC rules work?

U.S. persons who own PFICs must report, annually, each PFIC investment on a separate IRS Form 8621 (Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund). An investor or advisor can find Form 8621 here.

The U.S. taxation of PFICs can be punitive, although two elections may be available to improve the taxation:

a. Mark-to-market election: Under the mark-to-market election, investors must, on an annual basis
    - report all distributions (interest, dividends, capital gains, etc.) as ordinary income; and
    - recognize all increases/decreases to the value of the fund as a gain/loss on their holdings as if the funds were sold at the end of each year. This gain/loss is rated as ordinary income.

b. Qualified electing fund (QEF) election: Under the QEF election, investors must, on an annual basis, include their pro rata share of the mutual fund's or ETF's earned income for U.S. tax purposes.

Please note that T3 and T5 slips issued by Canadian mutual funds and ETFs are for Canadian tax purposes only and do not contain sufficient information to support a QEF election.

Starlight Capital provides investors with all of the information they need to make a QEF election on Form 8621. Importantly, on disposition, the gain on a PFIC that has followed the QEF election is treated as a capital gain taxed in the year of disposition.

4. Which option, mark-to-market or QEF, is better?

Investors should consult their financial advisor or a U.S. tax specialist to make this decision. Generally, however, the QEF election is preferred, because it is more closely aligned with the tax treatment of mutual fund and ETFs investments by both the U.S. and Canadian tax systems.

5. What are the consequences of not making a mark-to-market or QEF election?

If the U.S. person does not make one of the two elections above (mark-to-market or QEF), the following tax treatment would apply:

- Any gains recognized on disposition of the PFIC shares and distributions received from a PFIC during the year greater than 125% of the average distributions received during the previous three years would be taxed as ordinary investment income. This income would be considered earned over the holding period on a pro rata basis.

The amounts allocated to prior tax years will be subject to U.S. tax at the highest marginal rate and also subject to a deemed interest charge.

6. How should a PFIC be reported for a mutual fund and ETF with a fund-of-funds structure?

For a mutual fund and ETF with a fund-of-funds structure, the top-level fund and each of the underlying funds require a separate Form 8621 to be filed. Starlight Capital will make available the PFIC Annual Information Statements needed for both the top-level fund and the underlying funds, so that U.S. persons can make the QEF election. Investors should consult their U.S. tax specialist to understand the tax preparation costs associated with these types of holdings, as the costs may be higher than for a single fund structure.

7. How does Starlight Capital help simplify the PFIC reporting requirements and tax preparation costs?

For each of our funds and ETF's, an AIS will be provided on our website at www.starlightcapital.com. The Starlight Capital fund and ETF's AIS provides a pro rata per unit per day share of the ordinary earnings and net capital gains of the fund or ETF for the tax period. Investors need to multiply their number of shares they held times the number of days they held them, times the factors in the AIS to determine their personalized PFIC reporting amounts.

8. Are investors at any U.S. tax disadvantage when investing in a mutual fund or ETFs that regularly distributes return of capital (ROC)?

An investor that makes a QEF election for a mutual fund or ETF that regularly distributes ROC will not be at any U.S. tax disadvantage.

The investors will report their pro rata share of ordinary earnings and net capital gains, as shown on the AIS, as additions to their U.S. tax basis. If the investor makes the QEF election, all cash distributions from the mutual fund or ETF will be treated as tax-free ROC for U.S. tax purposes, to the extent of previously taxed income reported on the AIS or to the extent of the investors' remaining basis in that mutual fund. A U.S. tax specialist should be consulted to ensure the basis calculation considers all of these circumstances.

9. How do these rules affect different types of accounts, such as non-registered accounts, TFSAs and RRSPs?

These rules affect investments in non-registered accounts, TFSAs and RESPs. For PFICs held in retirement savings accounts such as RRSPs and RRIFs, most tax advisors suggest the PFIC rules should not be applicable. However, Starlight Capital recommends speaking to a U.S. tax advisor.

10. What are the tax implications for a U.S. person where the PFIC fiscal year-end of the top-level fund is different from the PFIC fiscal year-end of its underlying fund(s)?

Due to certain mutual funds having fund-of-funds structure, top-level fund(s) and underlying fund(s) may have different PFIC fiscal year-ends. The top-level fund(s) and each of the underlying fund(s) require a separate Form 8621 to be filed per U.S. tax regulations.

Top-level fund(s) and each of the underlying fund(s), with the same or different PFIC fiscal year ends, can be reported **as provided** on your personalized AIS. Information on top-level or underlying fund(s) not held during a fund's' taxation year will not be displayed on your AIS and/or supplemental information sheet (SIS).

Investors should speak to their U.S. tax specialist to discuss how to individually report each of the underlying fund(s) for U.S. tax purposes.

11. How is a U.S. cost basis calculated?

The calculation of the U.S. cost basis is similar to the calculation of the Canadian adjusted cost basis, but additional considerations apply. For instance, if a QEF election is made, any amounts included in income (including those reported on underlying funds in fund-of-funds situations) increase the U.S. cost basis. Cash distributions under a QEF election decrease the cost basis, while distributions that are reinvested in the PFIC (“property distributions”) do not. A U.S. tax specialist should be consulted to ensure the basis calculation considers all of these circumstances.

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