Solving the PFIC Problem – The US Tax Classification of Canadian Mutual Fund Trusts

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Abstract:

A common view is that Canadian mutual fund trusts can cause major US tax problems for US Persons that invest in them, because the potential application of the punitive Passive Foreign Investment Company (PFIC) regime may apply to it. This view is based on a one sentence summary conclusion in a non-binding IRS memorandum on an unrelated topic. The article outlines two possible sets of solutions to the PFIC problem as it applies to Canadian mutual fund trusts. The solutions depend on whether the Canadian mutual fund trust is classified as a partnership or a corporation for US tax purposes. The key determinant between the two classifications is whether or not all investors in the trust have limited liability for the debts and obligations of the trust. If all of the investors have limited liability, then the trust is properly classified as a corporation for US tax purposes and is thus very likely a PFIC. In this scenario, there are three potential solutions to the PFIC problem: 1) holding the mutual fund inside an RRSP; 2) taking the QEF election; 3) taking the mark-to-market election. All three solutions are suboptimal. It is possible that Canadian mutual fund trusts are actually partnerships for US tax purposes. If the trust is a partnership, it cannot be a PFIC. There are four arguments to support a partnership classification: 1) trusts formed prior to the enactment of certain provincial statutes granting holders limited liability may be partnerships for US tax purposes; 2) trusts to which these statutes do not apply may be partnerships for US tax purposes; 3) a newly formed trust can elect a partnership classification; and 4) all Canadian mutual fund trusts might be partnerships for US tax purposes. For an individual investor US Person, the benefits of a partnership classification are substantial. The PFIC regime is removed and the income is taxed the way any other investment is. There is no annual reporting for the vast majority of investors. This position can be taken on an individual’s US tax return. A partnership classification can also be implemented at the fund level. For funds that do not invest in the United States, there are few drawbacks and many advantages to a partnership classification. For funds that do invest in the US there are a few drawbacks that can be managed. In sum, PFIC problem as it applies to Canadian mutual fund trusts can be managed.

1Of SKL Tax, Vancouver (email: max@skltax.com). We would like to thank Allan McBurney and Stephen Katz of SKL Tax for several of the ideas found in this paper and for their exceptional mentorship. We would also like to thank Prof. Allison Christians of McGill University for her comments and insight at each stage of this paper.
# Table of Contents

1. **BACKGROUND AND OVERVIEW OF THE PFIC REGIME** .................................................. 5

2. **EXISTING AUTHORITY ON CANADIAN MUTUAL FUNDS AS PFICS** ................................. 8

3. **SOLVING THE PFIC PROBLEM IF CANADIAN MUTUAL FUNDS ARE CORPORATIONS** ............ 10
   A. **HOLDING CANADIAN MUTUAL FUNDS INSIDE AN RRSP** ........................................... 10
   B. **The QEF election** ............................................................................................................ 12
   C. **The mark-to-market election** .......................................................................................... 14
   D. **Conclusion: Inadequate Solutions to the PFIC Problem** .................................................. 15

4. **CANADIAN MUTUAL FUNDS CAN BE PARTNERSHIPS FOR US TAX PURPOSES** ............... 15
   A. **Older Canadian Mutual Fund Trusts are Likely Partnerships** .......................................... 16
      I. **Is the Entity Separate from its Owners?** ........................................................................ 18
      II. **Is the Entity Caught by Special Rules?** ......................................................................... 18
      III. **Is a Canadian Mutual Fund Trust a Trust for US tax purposes?** ................................. 18
      IV. **Does the Entity Have More than One Member?** ......................................................... 21
      V. **Is the Entity Automatically Classified as a Corporation?** ............................................ 21
      VI. **Is the Entity Domestic (American)?** ........................................................................... 22
      VII. **Is the Entity an “Eligible Entity”?** .............................................................................. 22
      VIII. **Is the Entity a Default Partnership or Corporation?** ................................................ 24
      IX. **Do the Beneficiaries of Canadian Mutual Fund Trusts have Limited Liability?** .......... 24
      X. **Classification of Canadian Mutual Funds Prior to 1997** ............................................... 36
      XI. **Conclusion – Funds Organized prior to 2004 are Likely not PFICs** ................................. 40
   B. **Trusts Not Subject to the Limited Liability Statutes may also be Partnerships** .................. 42
   C. **Newly-Formed Trusts can Make an Election to be Partnerships** ....................................... 42
   D. **All Canadian Mutual Fund Trusts may be Partnerships for US Tax Purposes** .................... 43

5. **THE PUBLICLY-TRADED PARTNERSHIP RULES WILL NOT DENY FLOW-THROUGH TAXATION** ... 46

6. **FILING REQUIREMENTS OF INDIVIDUAL INVESTORS UNDER A PARTNERSHIP CLASSIFICATION** .... 50

7. **FILING OBLIGATIONS FOR MUTUAL FUNDS THAT ARE PARTNERSHIPS** .......................... 51

8. **DRAWBACKS OF PARTNERSHIP CLASSIFICATION** ............................................................. 51
   A. **Potentially Increased US Estate Tax Risk** ........................................................................ 51
   B. **Potentially Higher Canadian Tax Withholding** ............................................................... 54
      I. **Article IV(7)(b) of the Treaty Should Not Apply** ............................................................. 54
      II. **Even the Application of Article IV(7)(b) is Not Overly Problematic** ............................. 58
   C. **Overview of Drawbacks** .................................................................................................. 59

9. **CONCLUSION: PFIC PROBLEMS ARE SOLVABLE** .............................................................. 60
The mutual fund trust structure is commonly used in Canada for a wide range of investment vehicles including consumer oriented financial products (mutual funds and ETFs) as well as income trusts, and real estate investment trusts. As such, the US tax classification of this structure is of crucial importance to: US Person Investors resident in Canada, Canadian financial institutions seeking US Person Investors, and investors in Canadian mutual funds who reside in the US. Many Canadians, including those who are US Person Investors or those who have moved to the United States, invest in these funds to save for retirement.

A common view is that Canadian mutual fund trusts are Passive Foreign Investment Companies (“PFICs”) for US tax purposes. The IRS has not taken a clear position on the issue. In a non-binding memorandum concerning the application of the US estate tax, the IRS made an unsubstantiated one sentence declaration that the Canadian mutual fund trusts held in the RRSP are likely corporations for US tax purposes. From this, the common practice of treating Canadian mutual fund trusts as PFICs has evolved. If that’s right, the US tax on any gain on the sale of the investment may approach or exceed 60-80%. That’s an adverse result that lacks any tax policy justification. The purpose and problem with the PFIC regime is addressed in section 1 below. The IRS’s view is discussed in section 2.

This paper argues that the PFIC problem is manageable. We present strategies that both individual investors and fund companies can utilize to solve the PFIC problem. We take two different approaches to solving the PFIC problem. The first set of solutions assumes that Canadian mutual funds are corporations for US tax purposes and are thus PFICs.

3 CCA 201003013 (Sept. 30, 2009).
These solutions include:

1. Holding Canadian mutual funds inside an RRSP;
2. Making the QEF election on an individual investor’s US tax return; or
3. Making the mark-to-market election on an individual investor’s US tax return.

As discussed below, these solutions only provide limited possible PFIC relief. For the mark-to-market and the QEF elections to work, the investor must pay PFIC tax on any gain realized before the election takes effect. Further, the QEF election requires specialized information from the fund that will be expensive for a fund company to prepare. This severely limits the utility of the elections for long-term investors who may not have been aware that their mutual funds had the risk of being PFICs.

The second set of solutions assumes that Canadian mutual fund trusts are partnerships for US tax purposes. By definition, partnerships cannot be PFICs. These solutions include:

4. Taking the position that certain, older Canadian mutual trusts are partnerships for US tax purposes and thus not PFICs;
5. Taking the position that certain Canadian mutual fund trusts not covered by the limitation of liability statutes are not PFICs;
6. Making a check-the-box election at the fund level to classify a Canadian mutual fund trust as a PFIC for US tax purposes; or

\[\text{\footnotesize{\textsuperscript{4} Reed supra note 2 at 37.}}\]
7. Taking the position that all Canadian mutual fund trusts are partnerships for US tax purposes and thus not PFICs.

Adopting a partnership classification for a Canadian mutual fund trust has the advantage of solving the PFIC problem for US person Investors with almost no annual paperwork on the part of those investors. Further, these solutions can apply retroactively to when the fund was created or the investor purchased the investment. There are a few potential drawbacks with a partnership classification.

First, for fund administrators, formally adopting a partnership classification may increase the US estate tax risk for non-US investors in the fund. But there is a reasonably good case that an interest in a foreign partnership is an intangible asset and thus not subject to the estate tax.

Second, a partnership classification imposes a US federal tax compliance obligation on the fund itself if the fund invests in securities in the United States. However, there is no such compliance obligation for funds that do not invest in the United States.

Third, a partnership classification may increase Canadian withholding tax on certain distributions to US resident investors. But this is not certain and any extra Canadian tax can be offset by a US foreign tax credit. Regardless, extra Canadian tax is a vastly preferable outcome for US resident investors when compared to the PFIC regime.

1. BACKGROUND AND OVERVIEW OF THE PFIC REGIME

The PFIC rules were enacted as part of the comprehensive tax reform of 1986. They were designed to prevent US citizens from achieving tax deferral offshore. As befits a regime designed to combat offshore tax evasion, the PFIC regime is very punitive. A “US Person
Investor” in a PFIC may be subject to certain adverse US federal income tax consequences with respect to the sale, exchange or other disposition of the stock of a PFIC and with respect to certain distributions made by the PFIC. Here, “US Person Investor” is defined as a US Person (US citizen, US resident, Green card holder, US partnership, US corporation, or US trust) holding shares of stock of a Canadian mutual trust. In general, a non-US corporation will be treated as a PFIC for US federal income tax purposes in any taxable year in which either:

a) At least 75% of its gross income is "passive income"; or

b) On average, at least 50% of the value of its assets is attributable to assets that produce passive income or are held for the production of passive income. 5

Passive income for this purpose generally includes, among other things, dividends, interest, certain royalties, gains from commodities and securities transactions, and gains from the sale of capital assets. 6

Assuming that Canadian mutual fund trusts are corporations (discussed in detail below), they readily meet the PFIC definition because:

a) They are organized under laws outside of the United States;
b) They realize passive income; and/or
c) They own a large percentage of assets which produce passive income.

If a non-US corporation is treated as a PFIC in any taxable year, such corporation will generally be treated as a PFIC in each subsequent year, regardless of the level of passive income and

5 IRC §1297(a).
6 Ibid at §1297(b)(1).
passive assets in such subsequent years (unless certain elections are made at the investor level).\textsuperscript{7} Section 1291(a) requires a US Person Investor to pay a special tax plus an interest charge on the following:

a) Gain recognized from the disposition of stock of a PFIC (including a pledge of stock of a PFIC); and

b) The receipt of an “excess distribution”.

An excess distribution is generally defined as a distribution in any one year to the extent that it exceeds 125\% of the average distributions received in the prior three years.\textsuperscript{8} In general, (i) any gain realized or excess distribution received would be allocated rateably to each taxable year (or portion of a taxable year) in the US Person Investor’s holding period for the shares in the PFIC; (ii) the amount so allocated to the current taxable year will be taxed as ordinary income (not capital gain) earned in the current taxable year; (iii) the amount so allocated to earlier taxable years will be taxed at the highest marginal rates applicable to ordinary income for those earlier taxable years; and (iv) an interest charge for the deemed benefit of deferral of US federal income tax will be imposed with respect to the tax deemed attributable to each such earlier taxable year.

For example, if a PFIC makes no distributions to shareholders for three years, but then pays a dividend in year four, the entire amount of the dividend will be an excess distribution.

The gross amount of any distribution in respect of the stock of a PFIC that is not an "excess distribution" will be taxable under the rules generally applicable to corporate distributions.\textsuperscript{9} The dividend, however, will not be eligible for the preferential tax rate applicable to certain

\textsuperscript{7} IRC §1297(b)(1).
\textsuperscript{8} IRC §1291(b).
\textsuperscript{9} Prop. Treas. Reg. § 1.1291-2(e).
"qualified dividend income" received by individuals.\textsuperscript{10} US Person Investors normally have to file one Form 8621 annually for each fund that they own. \textsuperscript{11} Form 8621 is unwieldy and costly to have prepared by a professional tax advisor. US Person Investors who own fewer than US $25,000 of PFIC stock do not have to file Form 8621 annually.\textsuperscript{12}

2. EXISTING AUTHORITY ON CANADIAN MUTUAL FUNDS AS PFICs

There is no official guidance on whether Canadian mutual funds are PFICs or not. The worry that Canadian mutual funds might be PFICs for US tax purposes started with the issuance of Chief Counsel Advice 201003013. Prior to this document, there appears to be little to no awareness of the possibility that Canadian mutual funds might be PFICs. This is strange given the status and substance of CCA 201003013. CCA 201003013 concerns the assessing of a taxpayer’s US estate tax liability, and not an entity classification of a Canadian mutual fund trust. The “Facts” section of the CCA does not provide any information regarding the mutual funds at issue. As such, it is possible that the taxpayer himself made representations regarding the entity classification of the mutual funds.

The only reference to the entity classification of Canadian mutual funds is a short, unsubstantiated, declaration that reads:

You indicated that the RRSP held shares in several mutual funds that are organized as trusts. However, a mutual fund may have been formed as a “trust” under Canadian law, but be properly classified as a corporation under U.S. law. Based on the information provided, it appears that all the Canadian mutual funds

\textsuperscript{10} Supra note 9 at §1(h)(11)(C)(iii).
\textsuperscript{11} Treas. Reg. §1.1298-1T (b)(1).
\textsuperscript{12} Treas. Reg. §1.1298-1T (c)(2)(i)(A)(1).
held by Decedent’s RRSP would be classified as corporations for U.S. tax purposes.\textsuperscript{13}

It is important to note that the CCA contains no analysis to justify this conclusion. Further, the CCA specifically deals only with those mutual funds held inside this particular decedent’s RRSP. It does not deal with all mutual funds, nor does it deal with all mutual funds held inside all RRSPs. In fact, it is possible that these mutual funds were unique in some way or another; it is impossible to verify this.

There is another reason to be suspect of the CCA’s conclusion. By classifying Canadian mutual funds as corporations, the IRS did not have to address a far thornier issue. As discussed below, the IRS refuses to take a position as to whether property owned through a foreign fiscally transparent entity is subject to the US estate tax. If, in CCA 201003013, the IRS had classified the mutual funds in question as partnerships, it would have had to take a position on this question. So while the result of CCA is friendly to the taxpayer, the IRS avoided having to answer a much bigger question in taking this position.

Importantly, Chief Counsel Advice does not have the force of law. Indeed, the advice itself states that it “may not be used or cited as precedent.”\textsuperscript{14} Furthermore, the IRS manual states that Chief Counsel Advice “does not set out official rulings or positions of the Service and may not be attached or referred to in other advisory products or subsequent Chief Counsel Advice as precedent.”\textsuperscript{15}

Effectively, the understanding that Canadian mutual funds may be corporations (note that even the CCA did not call them PFICs) for U.S. tax purposes is based on an unsubstantiated one-line

\textsuperscript{13} Chief Counsel Advice 201003013 [“CCA”].
\textsuperscript{14} Ibid.
\textsuperscript{15} Internal Revenue Service, “IRS Manual: Section 33.1.2.2.3.4.”
conclusion that does not have the force of law. Understandably, the common thinking in practice is to err on the side of caution and treat Canadian mutual funds as PFICs. Nevertheless, in the next section we examine strategies that can be used to solve the PFIC problem assuming that Canadian mutual fund trusts are corporations (and therefore almost certainly PFICs) for US tax purposes.

3. SOLVING THE PFIC PROBLEM IF CANADIAN MUTUAL FUNDS ARE CORPORATIONS

Even operating under the assumption, which is challenged below, that Canadian mutual fund trusts are corporations for US tax purposes, there are three potential solutions to the PFIC problem – namely: A) Holding mutual funds inside an RRSP; B) the QEF election; and C) the mark-to-market election. All three have their limitations.

A. Holding Canadian mutual funds inside an RRSP

Holding PFIC stock inside an RRSP negates the adverse PFIC consequences. The Canada-US Tax Treaty applies to income taxes imposed by the US Internal Revenue Code. The PFIC tax regime is certainly an income tax regime and is thus covered by the Treaty. Paragraph XVIII(7) of the Canada-US Tax Treaty states that “taxation” may be deferred with respect to “any income

16 Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital, Canada and the United States, 26 September 1980 at art 2 s.2(b) (“Canada-US Tax Treaty”).
accrued in the plan but not distributed by the plan until such time as and to the extent that a
distribution is made from the plan or any plan substituted therefor." This applies to RRSPs.

If Canadian mutual funds are PFICs, and they are held inside of an RRSP, then the PFIC charge
described above may be permanently avoided. According to official IRS publications, when
income comes out of an RRSP it is considered pension income and subject to tax as such. For
instance, Rev. Proc. 2014-55 describes distributions from an RRSP as follows:

Distributions received by any beneficiary or annuitant from a Canadian retirement
plan, including the portion thereof that constitutes income that has accrued in the
plan and has not previously been taxed in the United States, must be included in
gross income by the beneficiary or annuitant in the manner provided under section
72, subject to any applicable provision of the Convention.

Note that Code Section 72 is the section that deems income from an annuity to be taxable. As
such, the IRS’s own view is that income taken out of an RRSP is pension income and the PFIC
charges may not be applicable. Even if Canadian mutual funds are PFICs, there is no reporting
required if the funds are held inside of an RRSP. Combined with the IRS’s understanding of
RRSP income as pension income, this lack of reporting further suggests that a US court would
not subject Canadian mutual funds held inside of an RRSP to the PFIC charge.

The limitation to this strategy is the available amount of RRSP room. Some investors own
significant investments outside of an RRSP.

17 Canada-US Tax Treaty Article VII.
19 Treas. Reg. §1.1298–1T(b)(3)(ii)
B. The QEF election

Assuming that Canadian mutual funds are corporations for US tax purposes (and thus almost certainly PFICs), a US Person Investor may be able to solve the PFIC problem by making a timely election to treat the company as a “Qualified Electing Fund” (“QEF”).\(^\text{20}\) If a timely QEF election is made, the electing US Person Investor will generally avoid the adverse consequences of the company being classified as a PFIC described above, but will be required annually to include in gross income the following:

(i) As ordinary income, a pro rata share of the PFIC’s ordinary earnings; and
(ii) As long-term capital gain, a pro rata share of the PFIC’s net capital gain; and
(iii) In either case, whether or not cash associated with such earnings is distributed by the PFIC in each year in which it is so earned.\(^\text{21}\)

The Canadian mutual fund trust would be required to provide each electing shareholder with an Annual Information Statement, which is required to include the following information: (i) dates of tax year to which statement applies; (ii) the unitholder’s pro rata share of the trust’s ordinary earnings and net capital gain for the trust’s tax year, or sufficient information to allow the unitholder to calculate these figures, or a statement that the trust has permitted the unitholder to examine its books, records and other documents to calculate the trust’s ordinary earnings and net capital gain and the unitholder’s pro rata share of such amounts; (iii) the amount of cash and fair market value of property distributed or deemed distributed to the unitholder

\(^{20}\) IRC §1291(c)(2).
\(^{21}\) IRC §1293(a).
during the trust’s tax year; and (iv) a statement that the trust will permit the unitholder to inspect a copy of the PFIC’s books, records and other documents.\textsuperscript{22}

The timeliness of this election is crucial. If the QEF election is made in the first year that a US Person Investor owns the investment, then all PFIC problems will be avoided. Taking the QEF election in any year following the first-year that the investor owned the investment is a different story. In order for the QEF election to be effective (and thus avoid PFIC problems going forward) in a year following the first year in which the investor owned the investment, the investor must realize any gain from the date that the investor purchased the investment. This gain will be subject to the excess distribution regime described above.\textsuperscript{23}

Put differently, making an effective QEF election that actually solves the PFIC problem in a year after the first year in which the investor owns the investment requires the investor to pay the PFIC tax from the date that the investment was purchased until the year in which the QEF election was made. Therefore, taking a QEF election that would solve PFIC problems going forward may have a high tax cost for a US Person Investor who has owned the investment for a long period of time but could be effective for an investor who has recently purchased the investment.

A retroactive QEF election is possible, but only with the permission of the IRS, and only if the QEF information is available (this is not always the case). Even if the QEF election has been made, Form 8621 must still be filed: meaning that, while the QEF election may reduce specific tax exposure related to holding the investment, it will not reduce the annual compliance costs.

\textsuperscript{22} Treas. Reg. §1.1295-1(g).
\textsuperscript{23} IRC §1291(d)(2)(A).
The final downside of the QEF election is that dividends received from a QEF will be taxed as ordinary income and not be eligible for the lower rates of qualified dividends.24

C. The mark-to-market election

Assuming that Canadian mutual funds are corporations for US tax purposes (and thus likely PFICs) the mark-to-market election can be taken to solve the PFIC problem. Under the mark-to-market election, the US Person Investor reports the annual gain in value as ordinary income (and not capital gain) - even if the gain was not realized - on his/her US tax return.25 This may result in double taxation. Canada will not necessarily grant foreign tax credits for the US tax paid because of the mark-to-market election. Further, when the investments are actually sold, Canadian tax will apply normally to the sale without regard to previously paid US tax resulting from the mark-to-market election.

The mark-to-market election has a further drawback that is similar to the drawback of the QEF election. An effective mark-to-market election taken in a year following the first year in which the investor owned the investment requires the realization of gain built up to date. This gain is subject to the excess distribution regime. In other words, in order for the mark-to-market election to be effective, the US Person Investor will pay PFIC tax on any gain that has built up since the time the investor owned the investment.26 Finally, the compliance costs for the mark to market election are significant, given that a Form 8621 will have to be filed for each fund, for each year.

25 IRC §1296(a)(1).
26 IRC §1296(j).
D. Conclusion: Inadequate Solutions to the PFIC Problem

The three solutions presented above will likely be inadequate for many investors. RRSP contribution room is limited and many investors hold their investments outside of an RRSP. The QEF and mark-to-market elections only work if PFIC tax is paid on the unrealized gain prior to the election being taken. This is not only expensive but may eventually result in double taxation, as Canada will impose income tax when the investment is actually sold. A better solution is needed. The next section outlines the argument that Canadian mutual fund trusts are actually partnerships for US tax purposes and thus cannot be PFICs.

4. CANADIAN MUTUAL FUNDS CAN BE PARTNERSHIPS FOR US TAX PURPOSES

The first three strategies discussed above (funds held inside of an RRSP, the QEF election, and the mark-to-market election) all first assume that Canadian mutual fund trusts are corporations for US tax purposes and thus very likely PFICs. There is a good argument that this view is incorrect. We are of the view that certain, and possibly all, Canadian mutual funds are actually partnerships for US tax purposes and not corporations. By definition, they are therefore not PFICs. From the perspective of the individual investor a partnership classification is very beneficial. The PFIC regime can no longer apply. Instead, the income distributions from the Canadian mutual fund trust retain their character. Additionally, the annual reporting requirements are significantly less complex.
As discussed further below, the key factor in determining whether a Canadian mutual fund trust is a partnership or corporation for US tax purposes is whether or not the investors in the fund have limited liability. If all investors have limited liability, then the trust is classified as a corporation and is thus a PFIC. If any investor does not have limited liability, then the trust is classified as a partnership and thus is not a PFIC.

There are four arguments available to support a partnership classification:

A. Canadian mutual fund trusts formed prior to 2004 are likely partnerships;
B. Canadian mutual fund trusts that are not “reporting issuers” are likely partnerships;
C. A newly formed Canadian mutual fund trust can elect partnership classification;
D. All Canadian mutual fund trusts may be partnerships.

Each strategy is examined in turn below.

A. **Older Canadian mutual fund trusts are likely partnerships**

Responding to concerns from the investment fund industry, various provinces have enacted legislation to grant beneficiaries of mutual fund trusts limited liability. Canadian mutual fund trusts, organized in the common law provinces, formed prior to the enactment of these statutes are likely partnerships for US tax purposes. The following provinces enacted these statutes in the
following years: Ontario - 2004\textsuperscript{27}, Manitoba - 2005\textsuperscript{28}, Alberta - 2004\textsuperscript{29}, British Columbia - 2006\textsuperscript{30}, Quebec- 1994\textsuperscript{31}, Saskatchewan - 2006.\textsuperscript{32}

Prior to this legislation being passed, institutional investors were largely unwilling to invest in mutual fund trusts as a result of the liability exposure. This practice was noted by the Canadian Standing Senate Committee on Banking, Trade, and Commerce chaired by the Honourable Michael K. Kirby.\textsuperscript{33} Though this practice does not prove any liability from a legal perspective, it does at the very least indicate a common understanding in the industry that the risk of unitholder liability was not merely theoretical.

The determination of the default classification of a Canadian mutual fund trust comes down to whether all beneficiaries of the trust have limited liability. If the trust was organized prior to the enactment of the statutes, then it was and remains a partnership for US tax purposes because the beneficiaries of the trust did not have limited liability at the time that the trust was organized.

To fully understand this argument, it is necessary to go through all of the steps under the US entity classification rules established under Treasury Regulation 7701 to classify a Canadian mutual fund trust for US tax purposes. For clarity, the multiple steps required to arrive at this conclusion are set out sequentially.\textsuperscript{34}

\textsuperscript{27} Trust Beneficiaries’ Liability Act, SO 2004, c 29, Schedule A.
\textsuperscript{28} Investment Trusts Unitholders’ Protection Act, CCSM 2005, c 105.
\textsuperscript{29} Income Trusts Liability Act, SA 2004, c I-1.5.
\textsuperscript{30} Income Trust Liability Act, SBC 2006, c 14.
\textsuperscript{31} Art 1322 CCQ; please note that this paper is concerned with common law jurisdictions only. This is a function of the Quebec Trust being different in legal status from common law trusts. As such, the argument herein deals exclusively with Canadian mutual funds organized in common law provinces.
\textsuperscript{32} Income Trust Liability Act, SS 2006, c I-2.02.
\textsuperscript{34} See also generally on this point Reed, \textit{supra} note 2 at 34-36.
i. **Is the Entity Separate from its Owners?**

If the entity is not separate from its owner, the entity classification regime does not apply as a function of the “entity” not being an entity for tax purposes. Canadian mutual funds are separate from their owners because the trust has a structure that is not tied to its beneficiaries.\(^\text{35}\)

ii. **Is the Entity Caught by Special Rules?**

If the entity falls into a special category, the general rules for entity classification don’t apply. Canadian mutual fund trusts are not subject to any special regime. An example of an entity that does fall under special treatment is a Real Estate Investment Conduit, subject to a special regime under the Code.\(^\text{36}\) Canadian mutual fund trusts do not fall into any of these regimes, despite the assumption that they might be caught by the same rules as US mutual funds. However, US mutual funds are usually Regulated Investment Companies (“RICs”) and are therefore governed by sections 851-855 of the Code. Moreover, all RICs are registered under the *Securities Act of 1940* (“The 40 Act”). Canadian mutual funds do not usually register with the Securities and Exchange Commission of the United States. Moreover, in order to register as a RIC, an entity must be a “domestic corporation,” which, as Canadian entities, Canadian mutual funds are not.\(^\text{37}\)

iii. **Is a Canadian Mutual Fund Trust a Trust for US tax purposes?**

The Treasury Regulations allow for several types of trust, only two of which are relevant here: first, an “ordinary” trust, and second, an “investment” trust. Each one has its own particularities, but neither describes a Canadian mutual fund:

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\(^{35}\) Treas. Reg. §301.7701-1(a).

\(^{36}\) Treas. Reg. §301.7701-1(b).

\(^{37}\) IRC §851(a).
a) An “ordinary” trust: An “ordinary” trust is a legal arrangement, in which the trustee “take[s] title to property for the purpose of **protection or conserving it for the beneficiaries** under the ordinary rules applied in chancery or probate courts.” While trustees do indeed take title to the property in Canadian mutual funds, the goal is not simply to conserve and protect the beneficiary’s property. The goal is maximize investment returns for the unitholders (beneficiaries). A mutual fund whose goal was mere conservatorship would likely not remain commercially viable. Additionally, there is case law and commentary that offers further insight into the difference between a business entity and an “ordinary” trust. In two cases, the US tax court held that two characteristics distinguish business entities from “ordinary” trusts: (1) whether the trust has associates, and (2) whether the trust has an objective to carry on a business. Additionally, Treasury Regulation §301.7701-1(b) uses the same language.

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38 The full definition is as follows: In general, the term “trust” as used in the Internal Revenue Code refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. Usually the beneficiaries of such a trust do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. However, the beneficiaries of such a trust may be the persons who create it and it will be recognized as a trust under the Internal Revenue Code if it was created for the purpose of protecting or conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them. Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.


40 The full text of this regulation reads: “For the classification of organizations as trusts, see §301.7701-4. That section provides that trusts generally do not have associates or an objective to carry on business for profit. Sections 301.7701-2 and 301.7701-3 provide rules for classifying organizations that are not classified as trusts.”
Finally, the preamble to the regulations that reformed the entity classification rules outlines the same distinction (and did not alter the regulations regarding trusts).\(^{41}\)

Naturally, a Canadian mutual fund trust has an objective to carry on a business. This is the raison-d’être of a mutual fund. Additionally, Canadian mutual fund trusts have associates as the units in the trust are transferrable.\(^{42}\) Because they have an objective to carry on a business and have associates (by virtue of interests being transferable), Canadian mutual fund trusts do not meet the definition of an “ordinary” trust.

b) *An investment trust:*\(^{43}\) In the two cases mentioned above (*Elm Street Trust* and *Bedell Trust*), an investment trust is defined as “a trust created to facilitate direct investment in the assets of the trust through a pooling arrangement that creates the opportunity to diversify investments.”\(^{44}\) This would seem to describe Canadian mutual fund trusts. However, if the trustee has the power to vary the investments of the trust, it will be considered a business entity.\(^{45}\) Canadian mutual funds rely on this power on behalf of the trustee. Indeed, the ability to rely on the expertise of the trustee in varying the investments of the fund is part of the value proposition of Canadian mutual fund trusts. As a result, Canadian mutual fund trusts fall under the “business entity” category rather than the trust category.\(^{46}\)

\(^{41}\) Preamble to Prop Treas. Reg. § 301: “The regulations provide that trusts generally do not have associates or an objective to carry on business for profit. The distinctions between trusts and business entities, although restated, are not changed by these regulations.”


\(^{43}\) Treas. Reg. §301.7701-4(c)(1).

\(^{44}\) *Supra* note 40.

\(^{45}\) Treas. Reg. §301.7701-4(c)(1).

\(^{46}\) Treas. Reg. §301.7701-4(c)(1).
iv. Does the Entity Have More than One Member?

Provided the entity is not a trust and is not caught by any special set of rules, its classification is determined by looking at the number of members the trust has. If it has only one member, it is indistinguishable from its owner and is disregarded for entity classification purposes. If the entity has two or more members, it can either be a partnership or a corporation. It is important to note that, while “member” is not defined in the Regulations, it is generally understood interchangeably with beneficial owner. As an investment product offered to a wide range of people, a Canadian mutual fund trust will typically have many beneficial owners (members). It is therefore either a corporation or a partnership for US tax purposes.

v. Is the Entity Automatically Classified as a Corporation?

There are seven different kinds of “automatic” corporations. If the entity does not meet any of these definitions, it must be examined under the default entity classification rules. A Canadian mutual fund trust does not meet any of these definitions.

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47 Treas. Reg. §301.7701-2(a).
48 Treas. Reg. §301.7701-2(a).
49 Specifically, an entity that is not classified as a corporation under Treas. Reg. §§ 301.7701-2(b)(1), 301.7701-2(b)(3), 301.7701-2(b)(4), 301.7701-2(b)(5), 301.7701-2(b)(6), 301.7701-2(b)(7), or 301.7701-2(b)(8) is an “eligible entity that may select its classification.”
50 The Canadian mutual fund trust does not meet any of the following definitions: 1) Treasury Regulations § 301.7701-2(b)(1) - it is not a business entity organized under a federal or state statute that is referred to as incorporated; 2) Treasury Regulations § §301.7701-2(b)(3) – it is not a business entity organized under a state statute that refers to the entity as a “joint stock-company or joint-stock association”; 3) Treasury Regulations § 301.7701-2(b)(4) – it is not an insurance company; 4) Treasury Regulations § 301.7701-2(b)(5) – it is not a State-chartered entity that conducts banking activities; 5) Treasury Regulations § 301.7701-2(b)(6) – it is not wholly owned by a foreign government; 6) Treasury Regulations § 301.7701-2(b)(7) – it is not taxable as a corporation.
vi. Is the Entity Domestic (American)?

This is the first step of the default classification analysis. An entity is classified as foreign if it is not domestic.\textsuperscript{51} Domestic entities are only those organized under the laws of the United States (or any state thereof).\textsuperscript{52} Naturally, a Canadian mutual fund trust is not organized under the laws of the United States or any state thereof. As such, it is a foreign entity.

vii. Is the Entity an “Eligible Entity?”

If an entity is not one of the “automatic” corporations defined above, then it is generally an “eligible entity.” As an “eligible entity,” it may elect to be classified as a corporation or a partnership for US tax purposes.\textsuperscript{53} Since a Canadian mutual fund does not fall into any of the seven categories enumerated earlier, it is likely an eligible entity and may elect taxation as either a partnership or a corporation.\textsuperscript{54}

Private Letter Rulings (“PLRs”) would seem to agree with this view. In PLR 200752029, the IRS issued a ruling that a mutual fund trust in an unnamed jurisdiction was a foreign eligible entity that could elect its classification under Treasury Regulation §301.7701-3(a).

\footnotesize
\begin{itemize}
\item under a specific section of the IRC; and
\item 7) Treasury Regulations § 301.7701-2(b)(8) – it is not on the per se corporations list.
\end{itemize}
\textsuperscript{51} IRC §7701(a)(5).
\textsuperscript{52} IRC §7701(a)(4).
\textsuperscript{53} Treas. Reg. §301.7701-3(a).
\textsuperscript{54} Treas. Reg. §301.7701-3(a).
The IRS performed an analysis similar to the one conducted above. It first established that the entity was separate from its owners. The entity was not an “ordinary” trust as a result of its profit-making motive. The trustee had the power to vary the investment, thereby barring classification as an investment trust. The trust did not meet one of the “automatic” corporation definitions. As such, the fund was a foreign eligible entity and could elect to make a classification to be treated as a corporation or partnership for US tax purposes.

In this case, the fund had elected to be classified as an association taxable as a corporation. The Fund represented that it was not a PFIC, which was accepted by the IRS. The PLR does not, however, address the default classification of a mutual fund if the fund chooses not to elect anything.

Though the PLR follows the same analysis outlined above, it does not state the country of origin of the fund, thereby making a direct application of the reasoning to Canadian mutual funds somewhat difficult. However, the PLR does make clear that a mutual fund trust may be a foreign eligible entity.

In another PLR, PLR 200024024, the IRS follows the same steps as it did in PLR 200752029 but this time for a “fonds commum [sic] de placement” organized under the laws of a foreign jurisdiction. The IRS concluded that the Fund was a “business entity” within the meaning of Treasury Regulation 301.7701-2(a), and was not an “automatic” corporation. As such, it was an “eligible entity” and could elect its classification for federal tax purposes.

As with PLR 200752029, the IRS does not make clear what the default classification of the trust would be. Regardless, the PLR confirms that a mutual fund trust may be a foreign eligible entity.
viii. **Is the Entity a Default Partnership or Corporation?**

Any foreign eligible entity with more than a single member may elect to be classified as a partnership or corporation for US tax purposes on Form 8832. However, if this election is not made, the entity will have a default classification. Since 1997, the only benchmark used to distinguish between default classification as a partnership or corporation is whether the members have limited liability. By this logic, a foreign eligible entity with two or more members is by default a partnership if at least one member does not have limited liability. On the other hand, it is a default corporation if all members have limited liability.\(^{55}\)

ix. **Do the Beneficiaries of Canadian Mutual Fund Trusts have Limited Liability?**

a) The level of liability required under the US Internal Revenue Code

The question as to whether beneficiaries of a mutual fund trust have sufficient limited liability so that those trusts are considered corporations under US law is an interplay between US tax law and Canadian trust law. To start out, consider under US tax law what level of limited liability is required in order for an entity to be classified as a corporation for US tax purposes. The definition of “limited liability” under the Internal Revenue Code is whether “the creditors of the entity may seek satisfaction of all or any portion of the debts or claims against the entity from the member as such. [Emphasis added]” It is unclear precisely what level of liability is required to meet this definition. However, the plain meaning (the standard way of interpreting statutes in

\(^{55}\) Treas. Reg. §301.7701-3(b)(2)(i).
the US\textsuperscript{56} of the word “any” suggests that limited liability is a litmus paper test - meaning that if the members have even the smallest risk of personal liability then the entity may not have limited liability as it is defined in the Code.

The Supreme Court of the United States has interpreted the word “any” in a similar manner albeit in a different context. In \textit{United States v. Gonzales et al.} 520 U.S. 1 (1997), the Supreme Court of the United States wrote the following:

\begin{quote}
Read naturally, the word “any” has an expansive meaning, that is, “one or some indiscriminately of whatever kind.” […] Congress did not add any language limiting the breadth of that word, and so we must read §924(c) as referring to all “term[s] of imprisonment” […] There is no basis in the text for limiting §924(c) […]\textsuperscript{57}
\end{quote}

This would indicate a reading of the word “any,” where there is no limiting language, as being indicative of a litmus paper test. This interpretation is also iterated in \textit{United States v. Alvarez-Sanchez} 511 U.S. 350 (1994) where a statute referring to “any” law enforcement is deemed to include \textit{all} law enforcement officers.\textsuperscript{58} Finally, \textit{Lewis v. United States} 445 U.S. 55 (1980) notes the importance of a lack of modifying language. In that case, the scope of the term \textit{court} was in question: where “[n]o modifier is present, and nothing suggests any restriction,” no restriction ought to be read in to the statute.\textsuperscript{59} There is no restrictive language present in the definition of limited liability in the Internal Revenue Code.\textsuperscript{60}

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\textsuperscript{56} \textit{Lynch v. Alworth-Stephens Co.}, 267 U.S. 364 (1925) at 370 (“[T]he plain, obvious, and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and the ingenuity and study of an acute and powerful intellect would discover.”)

\textsuperscript{57} \textit{United States v. Gonzales et al.} 520 U.S. 1 (1997) at 5.

\textsuperscript{58} \textit{United States v. Alvarez-Sanchez} 511 U.S. 350 at 350, 356, 358.

\textsuperscript{59} \textit{Lewis v. United States} 445 U.S. 55 (1980) at 60.

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As such, United States statutory interpretation principles and case law regarding the meaning of the word “any” demand that an expansive reading of the word “any” in relation to “any liability.” Put differently, the Code should be read to mean that a mere smidgen of potential liability is sufficient to qualify an entity as a default partnership as per the entity classification rules.

The rejoinder to this reading is foreseeable. On this logic, even a Canadian corporation would not be classified as a corporation for US tax purposes because its shareholders have some potential personal liability (i.e. the risk of piercing the corporate veil). But this rejoinder ignores that entities (such as a Canadian corporation) that are akin to a US corporation are placed on the per se corporations list discussed above. Classes of entities that function similarly to a US corporation are simply put on this list to remove any doubt. Canadian mutual fund trusts are not on this list. Canadian corporations are. Further, entities subject to these default rules have the option of electing their status. This means that for many entities it doesn’t matter what their default status is – their owners will simply elect the desired status. Consequently, the objection that the Code should not be read this way is meritorious but rebuttable.

A purposive reading of the definition of limited liability further suggests that a Canadian mutual fund trust should be classified as a partnership by default. The intent of the Code’s classification mechanism is straightforward. Entities that resemble corporations should be taxed as corporations. Entities that more closely resemble partnerships should be taxed as a partnership. Setting aside the liability question for the moment, from a tax perspective the Canadian mutual fund trust functions much more like a partnership than it does a corporation. It is a flow through entity that normally pays no entity level tax. Like a general partnership, most of the decisions made by the trust are made by the trustee (akin to a general partner) on behalf of many other passive participants.
From a broader policy perspective, equity favors the position that Canadian mutual funds are partnerships for US tax purposes. There are strong arguments that the PFIC regime was not intended to apply to Canadian mutual funds. The PFIC regime was enacted as part of the Tax Reform Act of 1986.\textsuperscript{61} The Joint Committee on Taxation’s Bluebook, which explains the reasons behind the significant tax reform, sets out the purpose of the PFIC rules as follows:

Congress did not believe that tax rules should effectively operate to provide U.S. investors tax incentives to make investments outside the United States rather than inside the United States. Since current taxation generally is required for passive investments in the United States, Congress did not believe that U.S. persons who invest in passive assets should avoid the economic equivalent of current taxation merely because they invest in those assets indirectly through a foreign corporation.\textsuperscript{62}

Canadian mutual funds do not provide any tax deferral to a US Person Investor. They distribute all of their income annually for both Canadian and US tax purposes. Thus, applying the PFIC rules to Canadian mutual fund trusts does not serve the purpose that the PFIC rules were designed to achieve.

A Canadian mutual fund trust classified as a partnership would subject a US Person Investor in a Canadian mutual fund trust to roughly the same US taxation as if they had invested in a US RIC.\textsuperscript{63} The analogy is fruitful. There is no tax policy justification, compelling or otherwise, to subject a Canadian resident US Person Investor to a significantly more punitive tax regime than a US resident US Person Investor would be subject for investing in common consumer financial products located in their country of residence. Why should a US citizen who is resident in


\textsuperscript{62} Explanation of the Tax Reform Act of 1986.

Canada pay 80% tax to a foreign country on the sale of her retirement assets? There is no good answer.

Admittedly, these policy arguments may not prove useful in the interpretation of and application of the default US entity classification rules. But they do provide colour and context to the analysis. In our view, along with the technical analysis provided here, they would be help compel the US tax court to rule that a Canadian mutual fund trust is a partnership for US tax purposes if it was ever asked to do so. Furthermore, there is some precedent that suggests a purposive approach should be used when interpreting statutes. In this case, such a reference would make sense given the inherent mismatch between a Passive Foreign Investment Company and a plain vanilla Canadian investment product. Such an approach is set out in *King v. Burwell* where the Supreme Court of the United States decided that words must be read “in their context and with a view to their place in the overall statutory scheme.”64 A look to the context and purpose of the Code and Treasury Regulations7 would indicate that Canadian mutual funds are not the intended target of the PFIC rules.

b) Limited Liability is a question of Canadian law

Nevertheless, the analysis turns, in the Code’s words, “solely on local law.” Thus, if it can be shown that, as a matter of Canadian law, the beneficiaries have any potential liability then a Canadian mutual fund trust may be classified by default as a partnership for US tax purposes. There is a good argument that the beneficiaries of certain funds organized in certain provinces do

not have limited liability. At different times, Ontario (2004), Manitoba (2005), Alberta (2004), British Columbia (2006), Saskatchewan (2006), and Quebec (1994) passed legislation that granted limited liability to the beneficiaries of mutual fund trusts. Prior to the enactment of legislation, there were concerns that the beneficiaries of Canadian mutual fund trusts did not enjoy limited liability. The Bank of Canada issued a report in 2003, which concluded, “although this [personal liability of unit holders] is legally feasible, a number of Canadian securities firms have given legal opinions that there is little probability of this type of event occurring.” Similarly, the Government of Alberta issued a report referring to potential personal liability of unit holders, concluding that, "although the chances are thought to be remote, such an occurrence could have a potentially devastating impact on the financial well-being of unit holders.” The Government of Saskatchewan, in justifying its statute, states, “in situations where the trust property is insufficient to cover the liabilities, beneficiaries may be called upon to indemnify the trustee for amounts in excess of the investor's initial investment.”

The Bank of Canada, and the Governments of Alberta and Saskatchewan identified a remote, but still real, risk that beneficiaries of Canadian mutual fund trusts faced liability exposure. Statutes were, in many provinces, enacted as a result of these risks identified. Logic dictates that governments don’t legislate without reason and would not have enacted such statutes had the risk not been real. Furthermore, Robert Flannigan notes “it was [the] state of the law that propelled

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65 Supra note 27.
66 Supra note 28.
67 Supra note 29.
68 Supra note 30.
69 Supra note 32.
70 Supra note 31.
the demand for a statutory immunity for business trust beneficiaries.” The next section explores the type of limited liability faced by Canadian mutual fund trusts in more detail.

i) Sources of liability under Canadian law – the Indemnification Risk

Professor Mark Gillen of the University of Victoria Faculty of Law has written an excellent paper on the liability exposure of beneficiaries of Canadian mutual fund trusts. His article was focused on the issue from a Canadian business law perspective rather than a US tax perspective.

He identified three sources of potential liability for the beneficiaries of mutual fund trusts. Two are applicable here. First, beneficiaries of mutual fund trusts could be liable for the debts of the trustee because the trustee (and more importantly, its creditors) have the right to be indemnified out of the assets of the fund. If there are insufficient assets in the fund, the beneficiaries might be liable to the creditors. This is known as the “Indemnification Risk”. It functions as follows. Under Canadian law, a trust cannot be liable in contract or tort because it is not a legal person. But the trustees (usually financial institutions in the case of retail mutual fund trusts) are legal persons. In order to carry out their duties as trustees, they enter into contracts and they may

75 Mark R. Gillen, “Income Trust Unitholder Liability: Risks and Legislative Response” (2005) 42:3 Can. Bus. L.J. 325. [Gillen] This section is largely based on the ideas in Professor Gillen’s article. We are indebted to his work on this issue (albeit in a different context). The particular sections of his paper are referenced below. We have reproduced many of Professor Gillen’s footnotes verbatim and have indicated as such to aid the reader finding the primary sources.
commit torts. As a matter of general Canadian trust law, if trustees incur liability while they are performing their duties, they are entitled to indemnification out of the assets of the trust.  

This right to indemnity is commonly found in the organizing documents that govern Canadian mutual fund trusts. For instance, the trust documentation that RBC uses for its mutual funds includes a clause under which the trustee can be indemnified for all liability it incurs, while acting in good faith, out of the assets of the fund. If the trust assets and the trustee's assets were insufficient to meet the liability, then the trustee's creditors might seek to enforce the right of indemnification in their favour. As such, the beneficiaries may be liable for the debts of the trustee and the fund in their entirety.

This liability risk to the beneficiaries is offset by the fact that the Trustee often contractually releases the beneficiaries from liability. For instance, the RBC Trust Agreement releases the unitholders from any liability. Nevertheless, it is not clear if, in bankruptcy for example, a third party creditor would be required to respect this agreement. In sum, the Indemnification Risk creates a theoretical, if perhaps unlikely to actually occur, risk that the beneficiaries of a mutual fund trust do not have limited liability.

77 See, e.g., Waters' Law of Trusts in Canada, at 1155: "The trustee is entitled to be indemnified for all the costs, charges and expenses which he has reasonably incurred." See also s. 95 of the Trustee Act, R.S.B.C. 1996, c. 464, which provides that "a trustee [...] is answerable and accountable only for the trustee's own acts, receipts, neglects or defaults, and not for those of other trustees or a banker, broker or other person with whom trust money or securities may be deposited, nor for the insufficiency or deficiency of securities or any other loss, unless it happens through the trustee's own willful default, and may reimburse himself or herself, or pay or discharge out of the trust premises, all expenses incurred in or about the execution of his or her trusts or powers." as cited in Gillen supra note 67 at 332, note 23.
78 RBC Funds, Amended and Restated Master Declaration of Trust, clause 15.2
79 Gillen supra note 75 at 332.
80 Ibid at 333.
81 RBC Funds, Amended and Restated Master Declaration of Trust, clause, 18.3
ii) Sources of liability under Canadian law – the Control risk

The second potential source of liability is referred to as the Control Risk.\textsuperscript{82} The Control Risk arises because the trust-beneficiary relationship may also be classified as a principal-agent relationship. A principal-agent relationship arises “when the principals control the agent’s action, both the principal and agent consent to the relationship, and the agent has legal authority to affect the principal’s legal position.”\textsuperscript{83}

An agency relationship is a question of fact. It does not require a legal agreement between the parties.\textsuperscript{84} It can be implied from the circumstances. If a trustee is found to be an agent on behalf of one or more beneficiaries, then the beneficiaries may be held directly liable as principals. A trustee might be found to be an agent of the beneficiaries where the beneficiaries have a significant degree of control over the acts done in respect of the trust.

Beneficiaries of Canadian business trusts have been found liable previously because of the existence of a principal-agent relationship. For instance, in \textit{Trident Holdings v. Danand Investments}\textsuperscript{85} the Ontario Court of Appeal found that the beneficiaries were liable for the debts of the trustee because the parties were in an agency arrangement because of the control that the beneficiaries had over the agent.

The same was found in \textit{Advanced Glazing v. Multimetro et al.}\textsuperscript{86}. There the British Columbia Supreme Court found that the beneficiaries had “the general power to control the conduct of

\textsuperscript{82} Gillen \textit{supra} note 75 at 342.
\textsuperscript{83} Grosvenor Canada Limited v. South Coast British Columbia Transportation Authority 2015 BCSC 177 at para 58 \textit{[Grosvenor]}.
\textsuperscript{84} Grosvenor \textit{supra} note 83 at para. 58.
\textsuperscript{85} \textit{Trident Holdings v. Danand Investments} (1988), 64 O.R. (2d) 65, 49 D.L.R. (4th) 1 (Ont. C.A.) \textit{[Trident]}.
\textsuperscript{86} Advanced Glazing v. Multimetro et al. 2000 BCSC 804 \textit{[Advanced Glazing]}.
MMC such that MMC is their agent” and “the broad power of investor control enables the investors to be personally liable” for the debts of the trustee.\textsuperscript{87} There is no minimum legal threshold of control at which an agency relationship is created.\textsuperscript{88} Each set of facts and circumstances must be analyzed. As the BC Supreme Court put it in Advanced Glazing, “where both agent and trust relations exist, the greater the power of control over the agent/trustee the greater the likelihood that the principles of agency, rather than the principles of trust, are applicable.”\textsuperscript{89}

These principles are applicable to mutual fund trusts. Beneficiaries of mutual fund trusts have powers over the trustees that, very generally, often include the power to change the investment objectives of the fund, replace the trustees, and increase or decrease the amount of funds payable to the trust. The RBC Declaration of Trust, for instance, includes a clause that allows the unitholders to vote over “any other matter in respect of which applicable Securities Legislation would apply.”\textsuperscript{90}

It is true that the organizing documents of mutual funds generally restrict the amount of control that a beneficiary can exercise. For instance, they often reserve specific investment decisions to the trustee. This might suggest a lower level of control that would not rise to the level of agency. However, there is Canadian case law that indicates even explicit contractual language does not, at the end of the day, remove power from the beneficiaries of a business trust. This case law includes:

\begin{flushright}
\textbf{\textsuperscript{87} Ibid at para 73.}  \\
\textbf{\textsuperscript{88} Grosvenor supra note 83 at para 64.}  \\
\textbf{\textsuperscript{89} Advanced Glazing supra note 86 at para 67.}  \\
\textbf{\textsuperscript{90} RBC declaration of Trust – article 16.12.1.4.}
\end{flushright}
• *Orange Capital, L.L.C. v. Partners Real Estate Investment Trust* in which, even in the face of a contract stating otherwise, unitholder voting rights in relation to action by the trustee (or replacement thereof, as was the case in *Orange Capital*) will be upheld on the basis of achieving a “commercially sensible result.”

• *Crown Hill Capital Corp. (Re)*, in which the fiduciary duty of the trustee in a business trust was held to include obtaining explicit informed consent of the unitholders where there is reasonable doubt regarding whether the trustee can or cannot enter into a given contract. Deferral to the trustee’s judgement by virtue of the “business judgment rule” was found not to apply.

• *Renegade Capital Corp. v. Dominion Citrus Ltd.*, in which the court found trustees to be obligated to seek explicit approval of action that may be materially adverse to the interests of the unitholders themselves despite the fact that the powers of the unitholders were severely limited by contract.

The point here is not to draw a firm conclusion as a matter of Canadian law that the Control Risk means that beneficiaries have liability for the debts and obligations of a Canadian mutual fund trust. This remains a contentious point under Canadian law. But rather to suggest that this risk is real enough to arguably push the default US tax classification of Canadian mutual funds to partnerships – especially in the absence of a statute stating otherwise.

With that said, though there is some contention where control over the trustee is not absolute, there is none where the trustee is a “mere” agent (or “bare” trustee) of the beneficiary (as was the

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91 *Orange Capital, L.L.C. v. Partners Real Estate Investment Trust* 2014 ONSC 3793 at para. 49 [*Orange Capital*].
92 *Crown Hill Capital Corp. (Re)* 2013 LNONOSC 656 at para. 114 [*Crown Hill Capital*].
93 Ibid at para 145.
94 *Renegade Capital Corp. v. Dominion Citrus Ltd.* 2013 ONSC 1590 at para 138 [*Renegade Capital*].
case in *Trident*). Thus, as Robert Flannigan notes, there is no reason to assume the same cannot be true in cases where the beneficiary has some control over the trustee, such as a business trust where the unitholders can exercise some control over a trustee with discretion.\(^{95}\)

The attractiveness of this argument from a US tax perspective is that the Control Risk is widely accepted as a matter of US law regarding US business trusts.\(^{96}\) That would mean that an American court adjudicating a dispute over the US tax classification of a Canadian mutual fund trust would be familiar with why trust beneficiaries may be liable for the debts and obligations of the fund and may be favorably disposed to it.

c) How does the change in liability status affect the US tax classification of a Canadian mutual fund trust?

Absent a statute to the contrary, the above analysis indicates at least some potential liability for the beneficiaries of mutual fund trusts. If so, between 1997 (when the current regulations were enacted) and 2004 (or the other appropriate date when the statute granting beneficiaries limited liability was enacted), beneficiaries of mutual fund trusts did not have limited liability because of the Control Risk. There were thus, under the entity classification regulations that have been in place since 1997, classified as partnerships. Then, after the statute was enacted, the liability

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\(^{95}\) *Supra* note 74 at 275.

status of the beneficiaries changed. However, the US tax classification of the mutual fund trust did not change. Treasury Regulation section 301.7701-3(a) reads in part:

An entity whose classification is determined under the default classification retains that classification (regardless of any changes in the members' liability that occurs at any time during the time that the entity's classification is relevant as defined in paragraph (d) of this section) until the entity makes an election to change that classification under paragraph (c)(1) of this section. [Emphasis added]

In other words, a mutual fund trust retains its initial default classification until an election is made otherwise. A mutual fund trust established prior to the enactment of the statutes, was arguably a partnership for US tax purposes. Because of the above Treasury Regulation, it remains a partnership for US tax purposes until it elects otherwise despite the subsequent change in its liability status. Few, if any, Canadian mutual fund trusts have made any US entity classification elections even though they are able to do so. 97 Partnerships can’t be PFICs. So there is a good case that Canadian mutual fund trusts established prior to 2004 are not PFICs as a function of their retaining their original default entity classification.

x. Classification of Canadian Mutual Funds Prior to 1997

The current rules for entity classification were adopted in 1997. Thus, for funds formed after January 1, 1997 but prior to 2004, the above argument will apply perfectly. More consideration needs to be given to funds that were organized prior to 1997. In short, there is still a good argument that funds formed prior to 1997 were classified under the previous set of US entity classification regulations (known as the “Kintner regulations”) were (and remain) classified as partnerships for US tax purposes. That classification needs to be examined.

97 Reed supra note 2 at 36.
i) Application of the Kintner regulations to Canadian mutual fund trusts

It is arguable that under the Kintner regulations, which were in effect between 1960-1997, Canadian mutual fund trusts were classified as partnerships for US tax purposes. The Kintner regulations used a four-factor test to determine entity classification. The four factors were: free transferability of interests, continuity of life, limited liability, and centralized management. An entity that had at least three of these four factors was considered a corporation. Take these four factors in turn:

1) **Continuity of life** - Continuity of life meant whether the entity continued after the death or exit of one member from the entity.  

   98 This is clearly the case for Canadian mutual fund trusts.

2) **Centralized management and control** - Centralized management meant that an identifiable group of people, distinct from the entire membership of the entity had the power to make management decisions on behalf of the entity.  

   99 As discussed above, because of the fiduciary relationship between the trustee and the beneficiaries of a mutual fund trust, the beneficiaries have a certain amount of control over the trustee that is inherent in the structure of the trust and applicable regardless of what the organizing document states. This level of control by the beneficiaries might rise to the level necessary to constitute a lack of centralized management – especially in light of some of the cases discussed above. The management structure of a Canadian mutual fund trust might be another indicator of a lack of central management and control. Often, the trustee of the mutual fund trust has the power to appoint a manager. Whether this delegation is sufficient to conclude that there is a lack of

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99 Treas. Reg. §301.7701-2(c)(1).
central management and control is unclear. Against these two points lies the broad authority of a trustee of a mutual fund trust to make investment decisions over which the beneficiaries have little say. In sum, it’s not clear whether the mutual fund trust would be considered to have centralized management and control.

3) **Limited liability** - Limited liability had the same meaning that it does under the post-1997 regulations. For the reasons described above, it is arguable that not all members of the fund had limited liability.

4) **Free Transferability of interests** – The interests in a mutual fund trust are transferrable only if each of an entity's members had the power to transfer all attributes of ownership to a person not currently a member of the organization without consent from the other members. There is a reasonable argument that units of the typical Canadian mutual fund are not freely transferrable because, unlike corporate shares, they can only be sold back to the fund itself or transferred with consent of the fund administrator.

ii) Transition between the Kintner regulations and the check the box regulations

To fully understand the current default classification of Canadian mutual fund trusts in the post-1997 era, it is necessary to examine the transition between the Kintner regulations and the “check-the-box” regulations. Generally, unless it elected otherwise, an entity retained its classification under the check-the-box regulations that it had under the Kintner regulations. Thus, because there is an argument that Canadian mutual fund trusts were partnerships under the pre-1997 regulations, that classification can carryforward to the post-1997 era as well. Absent an

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100 Treas. Reg. §301.7701-2(e)(1).

101 Treas. Reg. §301.7701-3(b)(3) (as amended by T.D. 8697, 1997-2 I.R.B. 11) (providing that entity not making election will have same classification as claimed prior to new regulations).
election, the IRS will respect the claimed pre-1997 classification of an entity in the post 1997 period if: a) under the pre-1997 rules the entity had a “reasonable basis” for its claimed classification; b) any change of the entity’s status within 60 months prior to January 1, 1997 was recognized by all its members; c) and the IRS did not notify the entity before May 8, 1996 that the entity’s classification was under review. All three criteria can be satisfied. The position described above (that the pre-1997 period classification of a Canadian mutual fund trust was a partnership) is clearly “reasonable”. That status likely did not change within 60 months of 1997 and the IRS likely didn’t notify Canadian mutual fund trusts of the change in classification. In short, there is an acceptable position to take that a Canadian mutual fund trust was a partnership under the Kintner regulations. If there is a reasonable basis for the pre-1997 position, the IRS will respect it in the post-1997 period.

Consider the alternative. What if a US court did not accept that under the Kintner regulations a Canadian mutual fund trust was a partnership for US tax purposes? Two scenarios are possible. First, assume the court concludes that the Canadian mutual fund trust was a corporation under the Kintner regulations and also, despite all of the arguments to the contrary above, under the check-the-box regulations. If so, the US Person Investor would have continuously owned shares in a foreign corporation since he/she purchased the shares. If the foreign corporation was a PFIC, then the results could be very expensive. Second, assume that a US court accepted that a Canadian mutual fund trust was a partnership for US tax purposes under the check-the-box regulations, but not under the Kintner regulations. Further assume that if the trust was a corporation then it was also a PFIC. Under this scenario, the Canadian mutual fund trust ceased

\[102\] Treas. Reg. §301.7701-3(h)(2).
to be a corporation for US tax purposes on January 1, 1997 when the check-the-box regulations came into effect. This would result in a liquidation of the fund for US tax purposes and gain and thus PFIC tax recognizable by all US Person Investors in the trust in 1997. At first glance, this might appear to be a bad result. But if US Person Investors who currently invest in a trust didn’t own their investment in 1997 they don’t have to worry about any liquidation. The trust itself is not subject to US tax – only its US Person Investors’ interests in it are. For US Person Investors who did own an interest in a fund that underwent liquidation in 1997, then this year is likely statute barred so as a practical matter it is irrelevant.

Put simply, for US tax purposes the conversion of the trust from a corporation to a partnership is only relevant to those who owned an interest in the fund at that time and even then any tax consequence is barred by the statute of limitations. In short, although the classification is more complicated for funds organized prior to 1997, there remains a good argument that the funds were and remain partnerships for US tax purposes.

xi. Conclusion – Funds Organized prior to 2004 are likely not PFICs

There is a good argument that certain Canadian mutual fund trusts that were organized prior to the enactment of the limited liability statutes are partnerships for US tax purposes and not corporations and thus not PFICs. This is because the beneficiaries of these funds did not have limited liability. This position is not risk free. Even prior to the enactment of the limited liability statutes, the liability exposure of beneficiaries of Canadian mutual fund trusts was remote. It is thus possible that a US court would conclude that the liability is so abstract and theoretical that for the purposes of US law it does not count and that all of the members of the mutual fund do indeed have limited liability.
This possibility is illustrated through an analogy to a Canadian corporation. As a matter of law, Canadian corporations provide limited liability. As such, they are automatically treated as corporations for US tax purposes. Even so, shareholders of Canadian corporations will occasionally be subject to liability for the debts and obligations of the corporation. Canadian courts will pierce the corporate veil and subject the shareholders to liability for the debts and obligations of the corporation if it is just and equitable to do so.\(^\text{103}\) US courts, without any reference to Canadian mutual funds, have made this analogy. In *Yamagata v. US* the US federal court of claims held that the remote possibility that a Japanese *kabushiki kaisha* was a corporation for US tax purposes despite the fact that the owners had some theoretical liability for the debts of the entity.\(^\text{104}\)

Nevertheless, the above analysis shows that such liability was possible – even though it wasn’t likely. In litigation, often the simplest argument wins. The position that Canadian mutual funds formed prior to the enactment of the limited liability statues aren’t PFICs is relatively easy to grasp. There was a problem (liability exposure for beneficiaries of mutual fund trusts) prior to 2004. The mutual fund industry lobbied for the problem to change. So governments introduced a new law to solve the problem.\(^\text{105}\) The entity classification status for a Canadian mutual fund trust organized prior to 2004 is frozen until an election is made otherwise. Therefore, Canadian mutual fund trusts were partnerships and remain partnerships for US tax purposes.

\(^{103}\) *Kosmopoulos v. Constitution Insurance Co.* [1987] 1 SCR 2; 1987 CanLII 75 [*Kosmopoulos*].
\(^{104}\) US Court of Federal Claims, Nos. 07-698T, 07-704T
\(^{105}\) *Supra* note 74.
It is thus more likely than not that a US court reviewing this position would conclude that funds formed prior to the enactment of the statutes granting limited liability to the investors of the fund, as of today, are not corporations for US tax purposes and thus cannot be PFICs.

B. Trusts not Subject to the Limited Liability Statutes may also be Partnerships

The second strategy to achieve a partnership classification for Canadian mutual fund trust is that the limitation of liability statutes simply do not apply to certain trusts. These mutual fund trusts are still exposed to the Control Risk and thus for the reasons outlined above they may be, by default, partnerships for US tax purposes. There are two groups of funds to which this analysis might apply. First, Canadian mutual fund trusts organized in a jurisdiction where there is no limited liability statute are obviously not covered by such a statute. Second, the limited liability statutes only apply to certain Canadian mutual fund trusts. For instance, the Ontario statute only applies to trusts that are “reporting issuers”. Thus, funds that are not “reporting issuers” under the relevant provincial securities legislation may not be corporations for US tax purposes and thus may not be PFICs by virtue of their beneficiaries having liability resulting from the Control Risk.

C. Newly-Formed Trusts can Make an Election to be Partnerships

The third strategy for a Canadian mutual fund trust to achieve partnership classification is to elect it on formation. As discussed above, Canadian mutual fund trusts are foreign eligible

\[106 \textit{Supra} \text{ note 27.}\]
entities under the US entity classification regime.\textsuperscript{107} This is confirmed by PLR 200752029 described above. Such an election is made by filing Form 8832. It must be made at the fund level. The election would work very well for newly-created funds. From the commencement of the fund, they would indisputably be partnerships for US tax purposes – regardless of the liability of their beneficiaries. This election does not work as well for existing funds. The election can be used to confirm a fund’s existing status as a partnership (a protective election), but it can only be retroactive for 75 days. The risk with this option is the following: if, prior to making this election, the trust was considered a corporation for US tax purposes, then the conversion from a corporation to a partnership would constitute a liquidation and trigger PFIC tax for the US Person Investors. Funds should not make this election without being confident that they have always been partnerships for US tax purposes.

D. All Canadian Mutual Fund Trusts may be Partnerships for US Tax Purposes

A fourth possible strategy is to take the position that all Canadian mutual fund trusts are partnerships for US tax purposes - not just those organized prior to the enactment of the limited liability statutes or those to which the statutes do not apply. There is an argument to this effect. It is a “reasonable position” required under code section 6662. But the argument is risky. And it might not hold up in the US tax court in litigation. It runs as follows.

Regardless of any legislation in place, beneficiaries of a Canadian mutual fund trust have they are subject to the Control Risk described in 4(A) above. Arguably, the limitation of liability statutes only protect against the Indemnification Risk and not the Control Risk. Take the Ontario Trust Beneficiaries Act as an example. Section 1(1) of the Act reads as follows:

\textsuperscript{107} Treas. Reg. §301.7701-3(a)
The beneficiaries of a trust are not, as beneficiaries, liable for any act, default, obligation or liability of the trust or any of its trustees if, when the act or default occurs or the obligation or liability arises.\textsuperscript{108}

The plain meaning of this provision only protects the beneficiaries from liability as beneficiaries – not as principals for the acts of their agents.\textsuperscript{109} So the beneficiaries are still subject to the Control Risk. The text of the Alberta statute is the same. This is a theoretical point. There is no case law on it. Given the legislature’s intention to protect beneficiaries of Canadian business trusts, a Canadian court may be reluctant to hold the beneficiaries personally liable, even though they may be liable as principals rather than as beneficiaries. As such, the liability risk remains. This liability may be sufficient to classify the fund as a partnership for US tax purposes or to at least adopt this as a filing position given the requirement that any member have “any” liability.

There are other scenarios in which the beneficiaries of a mutual fund trust covered by a limitation of liability statute have liability risks. Assume, for example, that the mutual fund trust invests in a REIT outside of a jurisdiction that has a statute granting limited liability to mutual fund trusts. The investment generates liability for the mutual fund trust. But there is no statute to protect the beneficiaries. As such, the creditors of the mutual fund trust may be able to attempt the collection of debts and obligations of the mutual fund trust from the beneficiaries. This risk is specifically disclosed in the documentation of many mutual fund trusts. For instance, RBC’s Simplified Prospectus states:

A fund that invests in trusts faces the risk that, as a holder of units of a trust, the fund may be held liable and subject to levy or execution for satisfaction of all obligations and claims of the trust. This risk may arise with income trusts, which include real estate investment trusts and other forms of business trusts. The risk is considered remote. Alberta, Ontario, Saskatchewan, British Columbia and

\textsuperscript{108} Supra note 27 at s.1
\textsuperscript{109} Gillen supra note 75 at 362.
Manitoba have legislation to eliminate this risk in respect of holders of units of trusts that are reporting issuers organized under the laws of such provinces. To the extent that the funds are subject to such claims and such claims are not satisfied by the fund, there is a risk that a unit holder of the fund could be held personally liable for the obligations of the trust. The possibility of a unit holder incurring personal liability of this nature is considered extremely remote.\textsuperscript{110} [Emphasis added]

As the RBC disclosure statement indicates, the risk is “extremely remote.” However, the important aspect is that the risk does exist. Given that the Treasury Regulations state that there is no limited liability where there is the potential for personal liability for “any” debts of the trust, then this liability risk, identified by but not exclusive to RBC, may be sufficient to support a position that a Canadian mutual fund trust is by default, not a corporation for US tax purposes.

This risk is part of the normal disclosure in many mutual fund prospectuses. This acknowledgement of risk indicates at the very least an awareness to the potential risks to unitholders. As noted in the section on statutory interpretation, the mere presence of any liability is enough to classify an entity as a partnership. The fact that Canadian mutual funds continue to disclose this risk to unitholders would indicate that this risk is indeed real. This would make a case suggesting that even mutual funds covered by legislation (since 2004) are not corporations as per the U.S. entity classification rules found in Treas. Reg. §301.7701.

It may be unlikely that a US court would judge this risk as sufficient to support the conclusion that a beneficiary of a mutual fund trust would have sufficient liability exposure so that the mutual fund trust would be classified as a partnership for US tax purposes. Regardless, this position may be sufficiently meritorious to take on a US tax return as a result of the strict meaning of the word “any.” For the beneficiaries of Canadian mutual fund trusts that are

\textsuperscript{110} Royal Bank of Canada, \textit{Simplified Prospectus} at page 8.
covered by a limitation of liability statute, there is a position that can be taken, albeit a higher-risk one, that despite the statutes, the mutual fund trusts are partnerships for US tax purposes.

5. The Publicly-Traded Partnership Rules will not Deny Flow-Through Taxation

Above, we present four strategies by which a Canadian mutual fund trust can be classified as a partnership for US tax purposes. Certain large partnerships, however, are at risk of being taxed as corporations if they are deemed to be “publicly traded partnerships” (PTP). As long as a Canadian mutual fund trust is not registered under the 1940 Investment Company Act (which most Canadian mutual fund trusts do not\(^\text{111}\)), the PTP rules should not prevent it from being taxed as a flow-through entity for US tax purposes.

The PTP rules were designed to stop the erosion of the US corporate tax base by preventing large businesses from simply operating as partnerships. Section 7704 of the Code provides that a publicly traded partnership is treated as a corporation for all federal tax purposes (including the application of the PFIC rules).\(^\text{112}\) A partnership is “publicly traded” if interests in it are “traded on an established securities market” or are “readily tradable on a secondary market or the substantial equivalent thereof”\(^\text{113}\) Most Canadian mutual fund trusts available to the public

\(^{111}\) Only funds organized in the United States as “Registered Investment Companies” (“RICs”) must register under the 1940 Act. Many Canadian mutual funds include language in their prospectus that indicates that they are not registered in the United States. This language is usually very similar to the following: “The funds and the securities offered under this Simplified Prospectus are not registered with the United States Securities and Exchange Commission and they are sold in the United States only in reliance on exemptions from registration” from Jarislowsky Fraser (available at: http://www.jflglobal.com/media/uploads/documents/2014-11/Prospectus_EN.pdf)

\(^{112}\) IRC § 7704(a).

\(^{113}\) IRC § 7704(b).
will meet these criteria.\textsuperscript{114}

Thankfully, there is an exception, which is known as the “qualifying income exception”. An entity deemed a publicly traded partnership does not constitute a corporation for a taxable year, if for such taxable year, and each preceding taxable during which the partnership was in existence, 90\% of the gross income of the partnership is “qualifying income.”\textsuperscript{115} In turn, “qualifying income” includes: interest, dividends, rents from real property, gain from the sale of real property, gain from the sale of stock, income and gains from commodities, and a few other more esoteric items.\textsuperscript{116} Most Canadian mutual fund trusts earn nothing but dividends, interest, and capital gains and so would easily qualify for this exception.

The qualifying income exception is, however, limited. Code section 7704(c) states that a PTP will not be taxable as a corporation if 90\% of its income is passive. However, Code section 7704(c)(3) limits the applicability of this exception. The qualifying income exception does not apply to “any partnership, which would be described in section 851(a) if such partnership were a domestic corporation.” In turn, Code section 851(a) reads:

\begin{quote}
For purposes of this subtitle, the term “regulated investment company” means any domestic corporation—

(1) which, at all times during the taxable year—

(A) \textbf{is registered} under the Investment Company Act of 1940, as amended (15 U.S.C. 80a–1 to 80b–2) as a management company or unit investment trust, or

(B) has in effect an election under such Act to be treated as a business development company, or
\end{quote}

\textsuperscript{114} Treas. Reg. §1.7704-1(c)(1); Treas. Reg. §1.7704-1(c)(2).
\textsuperscript{115} IRC §7704(c)
\textsuperscript{116} IRC §7704(d)
which is a common trust fund or similar fund excluded by section 3(c)(3) of such Act (15 U.S.C. 80a–3(c)) from the definition of “investment company” and is not included in the definition of “common trust fund” by section 584(a).

Thus, the question that must be answered is the following: if a CMFT were a domestic US corporation, would it be described by Code section 851(a)? To answer that question it is necessary to look at Code section 851(a) in detail including the preamble and the three subsections. The preamble (referring to the words “the term “regulated investment company” means any domestic corporation”) is easily dispensed with. If a CMFT were hypothetically considered a domestic corporation, then it would obviously be described in the preamble. Next, turn to the three operative clauses. Take the last two first. Subsection 851(a)(1)(B) does not apply on account of the fact that no Canadian mutual fund trust has or intends to make such an election. Furthermore, such an election would *prima facie* establish the entities as registered under The 1940 Act, which they are not.

Subsection 851(a)(2) does not apply here either. Section 3(c)(3) of The 1940 Act only applies to funds and trusts that “are employed by a bank solely as an aid to the administration of trusts, estates, or other accounts created and maintained for a fiduciary purpose” and are also “not advertised or offered for sale to the general public”. Canadian mutual fund trusts are not aids to a fiduciary product. They are collective investment vehicles. Further, they are advertised to the general public. As such, even if they were domestic corporations they would not fall under the auspices of section 851(a)(2).

Only section 851(a)(1) might, but ultimately does not, describe a Canadian mutual fund trust if it were a domestic corporation. The key parts of section 851(a)(1) are bolded above. The plain meaning of the present tense words “at all times during the taxable year is registered” is that a PTP must actually be registered under The 1940 Act in order to be denied reliance on the
qualifying income exception. US statutory interpretation rules based on plain meaning would indicate this reading is correct.\textsuperscript{117} Since Canadian mutual fund trusts do not register under the 1940 Act they cannot be described by section 851(a) even with the hypothetical addition of domestic status.

This view is supported by legislative history. The Conference Report enacting the legislation in 1987 explained section 7704(c)(3) as follows:

As under the House bill, the provision [section 7704(c)] does not apply to any partnership that would be described in sec. 851(a) if it were a domestic corporation. Thus, a publicly traded partnership that is registered under the Investment Company Act of 1940 generally is treated as a corporation under the provision.\textsuperscript{118}

This same statement was repeated verbatim in the Senate Committee Report to the 1997 Taxpayer Relief Act.\textsuperscript{119} This language makes clear that the legislative intent in enacting Code section 7704(c)(3) was to deny the qualifying income exception only to those PTPs that are actually registered under The 1940 Act. The law firm Skadden reached this same conclusion in an opinion it rendered publicly that is available on the SEC website.\textsuperscript{120} So did the authors of the BNA portfolio on section 7704.\textsuperscript{121}

In short, Canadian mutual fund trusts will likely be subject to the publicly traded partnership rules. But, as long as they are not registered under the 1940 Investment Company Act they will be able to benefit from the qualifying income exception because the vast majority of their

\textsuperscript{117} Supra note 54.
\textsuperscript{120} Available at: http://www.sec.gov/Archives/edgar/data/1435967/000111650208001226/exhibit81.htm.
\textsuperscript{121} Matthew W. Lay, Amy Lutton and, Eric Sloan, Tax Management Portfolio No. 723 T.M., Publicly Traded Partnerships, at page 45.
revenue is passive income. The PTP rules should not deny a Canadian mutual fund trust flow through taxation for US tax purposes.

6. Filing Requirements of Individual Investors Under a Partnership Classification

Taking the position that a Canadian mutual fund trust is a partnership for US tax purposes is very beneficial for individual US Person Investors. Most obviously, the funds are not PFICs for US tax purposes and thus the individual investor does not have to deal with a punitive tax regime designed to combat offshore tax deferral. The annual compliance burden for the individual investor is also reduced dramatically.

Under this position, the Canadian mutual fund trust is a partnership for US tax purposes. The US Person investor will thus own a small fraction of a foreign partnership. The income from this partnership would, of course, need to be reported on Form 1040 as income of its type would normally be reported. No additional forms are necessary unless the person contributes over $100,000 to a single Canadian mutual fund in a given year.\(^\text{122}\) Form 8865 is required if a US Person Investor has greater than a 10% interest in a foreign partnership or if that person contributes over USD $100,000 to a foreign partnership in a given year. The vast majority of investors in large mutual funds will not fall into either of these scenarios. A more cautious taxpayer adopting this position may want to pre-emptively disclose the position taken to the IRS on Form 8275, which is used to disclose unorthodox tax positions. Filing it insulates the taxpayer

\[^{122}\text{IRC §6038.}\]
from some penalties and may shorten the statute of limitations (the time that the IRS has to audit a return).\textsuperscript{123}

7. Filing Obligations for Mutual Funds that are Partnerships

The filing obligations for an investment fund that accompany a partnership classification can be onerous if the fund invests in the US. For funds that do not invest in the US, however, there are no filing obligations. A foreign partnership that does not have income effectively connected with a US trade or business or US source income does not have to file a US tax return or provide a Form K-1 to its investors.\textsuperscript{124} If the mutual fund does invest in the US, it will likely have to file a Form 1065 annually and issue Form K-1 to its US Person Investors and not to all investors because the trust is not engaged in a US trade or business.\textsuperscript{125} Most Canadian mutual fund trusts are not engaged in a US trade or business because they trade only in securities for its own account and do not act as a broker or dealer who sells US securities directly to customers.\textsuperscript{126}

8. Drawbacks of Partnership Classification

A. Potentially Increased US Estate Tax Risk

A potential drawback for Canadian mutual fund trusts that adopt a partnership classification is the increased US federal estate tax risk to which such a move may expose their non-US investors. Even for funds that do invest in the US, there is a reasonably strong position that their investors should not be subject to the US estate tax.

\textsuperscript{123} IRC §6662 (d)(2)(B)(ii)(I).
\textsuperscript{124} Treas. Reg. §1.6031(a)-1(b)(1)(i).
\textsuperscript{125} Treas. Reg. §1.6031(a)-1(b)(3).
\textsuperscript{126} IRC §864(b)(2)(A)(ii).
The US estate tax applies to decedents, including Canadians who are not US Person Investors, who have US situs assets at their death. Stocks issued by a US corporation are US situs assets and thus subject to the estate tax. The question is whether US stocks owned through a Canadian mutual fund trust are US situs assets. If the Canadian mutual fund trust is a corporation for US tax purposes, there is no US estate tax exposure as the beneficiary owns stock in a foreign corporation. The estate tax only applies to stock issued by a domestic (US) corporation.

However, partnerships are flow through entities for US tax purposes. Thus, the owners of the partnership may be assumed to own the assets directly. It is unclear whether owning US situs assets through a foreign partnership subjects a non-US Person Investor to the US estate tax. It may be that a foreign partnership interest (such as an interest in a Canadian mutual fund trust that is adopting a partnership classification for US tax purposes) is foreign intangible property and not subject to the US estate tax.

Furthermore, there is a view that a beneficiary’s interest in a partnership is characterized as a personal property interest in the partnership itself rather than in the underlying assets held by the partnership. It would follow that interests in a partnership like a mutual fund, where the individual investor does not have the power to vary the investments (despite having some control over the trustee), interests in the fund would be treated as foreign personal intangible property. Equity would favour this view, as investors in mutual funds do not have investment expertise and buy the mutual fund as an asset in and of itself for this reason. Part of the value proposition of the mutual fund is the particular expertise of the trustee.

127 IRC §2104(a).
128 IRC §2104(a).
130 Jeffrey A. Schoenblum, Multistate and Multinational Estate Planning vol.2, §20.05[i], at 156.
Where this is the case, the interest in the partnership is commonly treated as behaving like stock in a company for estate tax purposes. As such, its situs is determined on the basis of where the partnership is managed rather than the situs of the underlying assets. This understanding is set out in the US-Australia Treaty where Article III(1)(g) provides that “a partnership shall be deemed to be situated at the place where the business of the partnership is carried on.”

The IRS refuses to clarify this and will not issue rulings on it. However, even if the partnership structure does expose the non-US Person Investor in a Canadian mutual fund trust to the US estate tax, Canadian residents do benefit from a significant exemption from the US estate tax under the Canada-US Tax Treaty. As long as the total value of a Canadian resident’s estate is USD $5.43 million or less (the 2015 credit amount), there will be no US estate tax exposure if the appropriate forms are filed. This means that only very few Canadian residents have any US estate tax exposure at all.

This remains an important consideration for Canadian mutual fund trusts considering adopting a partnership structure at an institutional level. They should be alive to the US estate tax risks to their Canadian investors who are not US Person Investors. This risk doesn’t matter for individual US citizen investors in Canada considering adopting these positions on a US tax return. They are already subject to the US estate tax by virtue of their citizenship. Nor does it matter for Canadian mutual fund trusts that do not invest in the US, as only US situs property is subject to the US estate tax. Where this does matter is in contemplating those Canadian investors who could be

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131 US-Australia Tax Treaty Article III(1)(g).
133 Canada-US Tax Treaty, Article XXIXB(2).
exposed if the United States is to rule against the traditional understanding of partnership interests like this being more similar to stock in a corporation from an estate tax perspective.

B. Potentially Higher Canadian Tax Withholding

There is one further potential drawback of a partnership classification - denial of benefits to the trust under the Canada-US Tax Treaty. This drawback only applies to Canadian mutual fund trusts taking the position that they are partnerships at an institutional level. It is irrelevant for an individual investor taking such a position on his/her US tax return. A denial of treaty benefits would require a Canadian mutual fund trust to withhold 25% Canadian tax on payments to US residents. Fortunately, there is a reasonable argument that treaty benefits should not be denied. Even if treaty benefits are denied, US resident investors can simply use the extra Canadian tax withheld as a foreign tax credit against their personal US taxes. If extra Canadian tax is owed, as a result of there being an insufficient amount of foreign source income to make use of the foreign tax credit, then this is still a preferable result for a US resident investor than the application of the PFIC regime.

i. Article IV(7)(b) of the Treaty Should not Apply

Article IV(7)(b) will deny treaty benefits to a US resident who receives payments from a Canadian mutual fund trust if all of the following factors are met:

i) Under the laws of Canada, the US resident is considered to receive the payments from an entity resident in Canada.

ii) Under US law, the mutual fund trust is fiscally transparent.
iii) Under US tax law, the treatment of the amount received is not the same as it would be if the Canadian mutual fund trust is fiscally transparent.\textsuperscript{134}

The first two criteria are easily satisfied. For Canadian tax purposes, the mutual fund trust is a resident of Canada and, if classified as a partnership, it is fiscally transparent for US tax purposes.

The third criterion is trickier. There is an argument, which is not flawless, that the US tax treatment of a distribution from a Canadian mutual fund electing partnership classification to a US resident is similar to the US tax treatment of that distribution if that fund was a corporation for US tax purposes. To start out, consider one of the examples offered by the technical explanation to the 2007 protocol to the Treaty. The example involves a US corporation that is the sole shareholder of a Canadian ULC which is disregarded for US tax purposes. The ULC pays a dividend to the US corporation. For Canadian tax purposes, this payment is a dividend. For US tax purposes, the payment is disregarded. Had the ULC elected a corporate classification for US tax purposes, the payments from the ULC to the US Corporation would have been a dividend for US tax purposes. This is quite a different result than under a scenario where a ULC is a fiscally transparent entity. As such, Article IV(7)(b) applies and treaty benefits are denied. From this, we can divine that the payment has to take on a substantially different character in order for Article IV(7)(b) to apply.

Fundamentally, this is a Canadian tax question because at issue is how much Canadian tax a Canadian mutual fund trust would have to withhold on a payment to a US resident. Thus, it is

\textsuperscript{134} Canada-US Tax Treaty, Article IV (7)(b).
CRA’s views on Article IV(7)(b) that need to be considered. CRA has addressed the “same treatment” test in a few different rulings. In Ruling 2009-0318491I7, CRA stated:

The determination of whether the quantum of the amount is not the same under Article IV(7)(b) is made without reference to losses, deductions or credits available under the [U.S. Internal Revenue] Code in computing the United States tax liability of the recipient of the amount, or in the computation of the consolidated taxable income of a group of corporations which includes the recipient. In other words, the determination of same treatment will be made by reference to the gross amount of the item of income.\(^{135}\)

Importantly, this ruling indicates that gross income is the important number – not the amount of US tax paid. CRA further spells out the three criteria that would apply:

1) The timing and recognition of the amount
2) The character of the amount
3) The quantum of the amount

The necessary comparison in order to determine whether there is the same treatment under both a partnership classification and a corporate classification is straightforward. The timing, character and quantum of the amount under US tax rules received by a US resident from a distribution by a Canadian mutual fund trust would have to be the same regardless of the classification of the entity. Otherwise, Canada will deny treaty benefits and extra tax will have to be withheld from the US resident. For the purposes of this discussion, assume that under both classifications the Canadian mutual fund trust does not engage in a US trade or business through a permanent establishment. This means no entity level US corporate tax.

The quantum of the income to the US tax resident under US tax principles would be the same under both scenarios. Canadian mutual fund trusts normally distribute all of their income. Under

\(^{135}\) CRA Document no. 2009-0318491I7 (Nov. 13 2009).
both scenarios the quantum would be the sum of distributions received by the US resident. A corporate or partnership classification would not change this. Similarly, the timing of the receipt of the income will be the same under both a corporate and a partnership classification. The income would be received in the year that it is distributed by the fund.

The character of the income may be slightly different. If a Canadian mutual fund trust is a partnership for US tax purposes, then all of the income will retain its character for US tax purposes when it flows through to the investor. If the fund is a corporation, and not a PFIC, then all of the income that is distributed will be dividend income for US tax purposes. Therefore the character will be different. But the odds are that if Canadian mutual fund trusts are corporations for US tax purposes they will be PFICs. The PFIC regime imposes a special tax regime that is different than the tax regime applicable if the fund elected classification as a partnership. Nevertheless, if the fund is a PFIC, a US investor would likely take the QEF election. This would, in spirit, make the fund a flow through entity for US tax purposes – meaning that the tax treatment of the distribution would be very similar to that of a Canadian mutual fund trust that had elected partnership classification. So there is a scenario (that is likely to occur) – namely a US Person Investor taking the QEF election – under which the distributions would maintain essentially the same character regardless of the Canadian mutual fund trust’s classification. The flaw of this argument is obvious. To achieve similar character of income, an election is necessary under US law. Still, that election is likely to be made.

A purposive approach to applying Article IV(7)(b) buttresses this conclusion. Article IV(7)(b) is as an anti-avoidance rule that was designed to prevent structures where interest was deducted twice or an interest deduction without a corresponding inclusion of income. The US Joint
Committee on Taxation Report makes clear that the intended purpose of Article IV(7)(b) was to prevent:

- duplicated interest deductions in the U.S. and Canada; or
- a single, internally generated interest deduction in one country without offsetting interest income in the other country.\textsuperscript{136}

A US partnership classification of a Canadian mutual fund trust achieves neither of these results. All it avoids is the application of an extremely punitive tax regime to a mundane consumer financial product that thousands use to save for retirement. In short, to the extent that it matters to CRA or to the Canadian tax court, equity favors the non-application of Article IV(7)(b). There is a reasonable technical argument that Article IV(7)(b) should not apply. Given equitable considerations, CRA may be inclined to agree.

\textbf{ii. Even the application of Article IV(7)(b) is not overly problematic}

If Article IV(7)(b) does apply, Canadian mutual funds would have to withhold 25\% of payments they make to US resident investors. This would be in excess of what is currently withheld. There are a number of factors, which make this additional withholding less expensive to the US resident investor than it might otherwise be. First, under the \textit{Income Tax Act}, without regard to the Treaty, the withholding would not apply to US resident investors who hold the investment in an RRSP, RESP, TFSA, or RDSP or other registered plan. Many Canadian mutual funds are held inside registered plans. Second, the \textit{Income Tax Act} alone exempts capital gain income allocated

to non-resident beneficiaries and capital distributions from certain mutual fund trusts from withholding. This extra withholding would only apply to distributions of dividends from the fund. It would not apply to dispositions of the units of the fund. Third, a foreign tax credit would be available in the US system in the full amount of the withholding. Excess credits that cannot be used in one year can be carried forward 10 years. Finally, from the perspective of the US resident investor, increased Canadian tax withholding is vastly superior to the application of the PFIC regime with its very punitive tax consequences and complex reporting requirements.

C. Overview of Drawbacks

A partnership classification for a Canadian mutual fund trust removes the onerous PFIC regime. We discuss four strategies above. Both individual investors and fund administrators can use three of them. The fourth, a formal partnership election, can only be made at the fund level. A partnership classification involves imposes a low burden on the individual investor. Not only are the punitive PFIC rules eliminated, but the annual tax reporting is also made much easier.

For fund administrators, a partnership classification is virtually painless for funds that do not invest in the US. There is no compliance obligation and no increased US estate tax risk. Further, they do not have to trouble themselves with providing the QEF paperwork and can guarantee that their funds are PFIC-free. For funds that do invest in the US, a partnership classification makes everything more complex and the benefits are less clear-cut. However, the prospect of being able to attract US Person Investors by having a PFIC-free mutual fund may outweigh the potential compliance costs.

137 104(21)(b) Income Tax Act
9. Conclusion: PFIC problems are solvable

The PFIC regime was established in 1986 to combat offshore tax deferral. As befits such a regime, its rules are complex and punitive. It was never designed to apply to the retirement savings of US Person Investors who reside outside of the United States. Indeed, there is no (compelling or otherwise) justification from a tax policy perspective that it should apply. A common view is that Canadian mutual fund trusts are corporations for US tax purposes and thus very likely PFICs. This view spontaneously emerged in 2010 after the issuance of CCA 201003013. This CCA did not focus on the US tax classification of Canadian mutual funds. Nor did it include any facts or analysis related to the mutual funds at issue. Indeed, the CCA simply stated a conclusion. The CCA itself indicates that it is not binding on taxpayers. Put simply, a single sentence in a non-binding memorandum led many practitioners to adopt the position that Canadian mutual funds were PFICs out of a concern for this particularly punitive regime.

This paper set out to show that the PFIC problems facing US Person Investors in Canadian mutual funds are not irresolvable. It has done so through exploring solutions based on two different classifications of Canadian mutual fund trusts. Canadian mutual fund trusts are either corporations or partnerships for US tax purposes. First, assuming they are corporations, there are three strategies for solving the PFIC problem. These strategies – namely, the RRSP, the QEF election, and the mark-to-market election are largely unsatisfactory. RRSP contribution room is limited. Both the QEF and the mark-to-market election require the payment of PFIC tax on gain to date before they work properly. Similarly, both elections may result in double taxation and require the investor to undertake complex and expensive annual compliance work.
Canadian mutual funds can also be partnerships for US tax purposes. The key distinction between classification as a partnership and classification as a corporation is whether the investors have any liability. If the investors have limited liability, the trust is a corporation for US tax purposes. If the investors have any liability, the trust is a partnership for US tax purposes. The US statutory interpretation rules indicate that this is a litmus-paper test: the word “any” does really and truly mean “any.”

As a result of this liability exposure, various Canadian provinces started enacting statutes granting limited liability to the unitholders of Canadian mutual fund trusts starting in 2004. This push for legislation was the result of liability exposure discouraging institutional investment in mutual fund trusts, as well as politicians and thinkers alike noting that the liability exposure was more than simply academic.

The investors in Canadian mutual fund trusts formed prior to the enactment of these statutes had liability for the debts and obligations of the fund. Thus, all funds were likely partnerships for US tax purposes prior to 2004. The enactment of the statutes may have changed the liability status of the investors, but it did not alter the US tax classification of the funds already formed as per the US regulations. Trusts to which the statutes do not apply, because the trusts are organized in provinces without a statute or because they are not “reporting issuers,” are also likely partnerships (given that the liability-limiting statutes still do not apply to them). Fund administrators can very easily make an election to classify newly formed trusts as partnerships for US tax purposes. Finally, there is an argument, albeit a riskier one, that all Canadian mutual fund trusts are partnerships (even those covered by the post-2004 legislation and formed after 2004) because, even with the enactment of the statutes, the investors’ liability remains.
A partnership classification poses little problem for an individual investor. All it requires is for the income from the fund to be reported on the US Person Investor’s annual Form 1040. No special paperwork is required. Many US Person Investors in Canada who are unaware of the PFIC problem or unwilling to grapple with the complexity and expense have already been relying on this strategy (perhaps unknowingly). Given the uncertainty and complexity in this area, and the lack of an official IRS position, there is nothing preventing the individual investor from taking her own view of the US tax classification of an investment – even if a fund company has taken a contrary position. For fund providers, a partnership classification can retroactively provide PFIC relief to all of a fund’s investors. There is little downside in adopting this strategy for funds that do not invest in the US. Adopting it for funds that do invest in the US is more complicated and more expensive, but may ultimately be more attractive to potential US Person Investors.

In sum, the mutual fund trust structure that is so common in Canada need not be a tax hazard to US taxpayers who invest in those funds. Such an outcome is relieving to the millions of Canadians who either have US citizenship or who have moved to the US and whose retirement savings otherwise faced a rather expensive tax headache.