Jon Tyson
[redacted]

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Senate bipartisan group on international taxation
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Dear Senate bipartisan group on international taxation,

I am a US citizen who has invested quite heavily in a Canadian company that is considered a so-called "passive foreign investment company" (PFIC) under sections 1291-1298 of the IRC.

The company in question is Oncolytics Biotech,[1] a NASDAQ-listed Canadian development-stage biotech that is attempting to develop a treatment for numerous types of cancer. Since its inception in 1998, it has accumulated a deficit of $250M while conducting human clinical trials in over 1000 cancer patients. Many of the company's clinical trials have been conducted under the sponsorship of the National Cancer Institutes of both the US and Canada.

Although it is obvious that Oncolytics is neither a "passive company" nor an "investment company," section 1297(b) of the IRC designates Oncolytics Biotech as a PFIC because "75% or more of the corporation's gross income for its taxable year is passive income." The company falls afoul of this definition because it has no income except a small amount of interest on its working capital. (Indeed, the company does not yet have an approved product.)

Failure to recognize and properly deal with the PFIC status of an investment is a tax landmine stepped upon by many an unwitting investor. By default, the company is taxed as a so-called "section 1291" fund.

Section 1291 taxation is has been widely referred to as "draconian": Through a combination of backdating of gains and compound back-interest on the resulting back-taxes, section 1291 will, for sufficiently long holding periods, result in a tax of GREATER THAN 100% on capital gains or other so-called "excess distributions." (See page 13 of [1] and page 119 of [2].) However, the time required to reach draconian >100% levels depends critically on the prevailing interest rate, as applied to back-taxes on back-dated gains. (See section 4.1 of [3].) Unfortunately, the section 1291 curse persists for the investor even after the company itself ceases to fall afoul of the IRS definition of PFIC, by the "once a PFIC always a PFIC" rule of section 1298(b)(1).

Default section 1291 taxation of biotechs serves no policy purpose, and it conflicts with President Nixon's war on cancer.

[1] In part because of my efforts, Oncolytics has started posting its *PFIC annual information statments* on its website.

I would like to make the following suggestions for PFIC taxation:

1. Section 1291 taxation of "excess distributions" should be modified so that the tax rate can never climb past 100% for long-term shareholders:

   (a) Section 1291 backdating of "excess distributions" *in equal proportions to each day of the holding period* should be modified to recognize that the fact that investment profits tend to accumulate exponentially by compound interest, rather than linearly, like a salary. In particular, backdated profits should be more weighted towards to the later years of the holding period. (The law understands compounding when it comes to taxing backdated gains with back-interest, so it should understand compounding when it applies to generation of profits.)

   (b) The section 1291 system of backdating and back-interest should be moderated by some sort of "alternative maximum tax." I propose that no amount allocated to a back-year should ever be taxed at greater than 60%, including the back-interest resulting from backdating. (The 60% number is a judgement call, but obviously it should be some number less than 100%.)

   (c) Investors who are not in the highest tax bracket should not have their backdated "excess distributions" taxed at the highest marginal rate. This rate upjumping is a punishment intended for offshore taxes dodges, but it also falls squarely on investors in foreign biotechs in such non-tax-haven countries as Canada! Furthermore, any future "Warren Buffett" top marginal rate of 90% on the super-rich should not fall on a middle-class PFIC investor.

   (d) An investor who is aware that he holds a PFIC could avoid eventual >100% section 1291 tax by selling and repurchasing shares at period intervals, using the some portion of the proceeds to pay the tax. Such periodic sales reset the "compound interest time-bomb clock" on backdated taxes. The IRS should cap the tax & interest on section 1291 funds at a level that would make such periodic sales unnecessary.

2. The commissioner should be given discretion to retroactively waive the PFIC status of development-stage biotechnology companies at the request of US investors. The enormous expense and regulatory prerequisites for biomedical research should make a legitimate biotech easily recognizable to the commissioner.

3. The definition of "passive foreign investment corporation" should be narrowed to exclude companies which are neither "passive" nor "investment corporations".

4. Companies with a prolonged period of large operating losses should not be treated as PFICs.

5. Unless the law is substantially revised, the extremely misleading term "passive foreign investment company" should be immediately replaced with something less likely to mislead the unwitting. The term "unprofitable or formerly unprofitable foreign company" is more accurate in many cases.

6. Investors in marketable PFICs should be freely allowed to make retroactive QEF elections. Currently, such an option is only available if the investor's tax professional files an affidavit admitting his own past errors in advising his client.

7. In the case of an investment purchased on a major national stock exchange, the investor should be given means to replace the requisite *PFIC annual information statement* required for a QEF election with some assessment based on the company's public filings. Not all companies provide the necessary PFIC statement.

8. Both section 1291 "excess distributions" and section 1296 "mark to market" taxation of PFICs should be modified so that they no longer punish investors for gains accumulated over years of rising stock prices before the company actually becomes a PFIC. (Note that both 1291 and 1296 tax such capital gains as ordinary income.)

9. Similarly, section 1291 should be modified so it would no longer penalize that part of a shareholder's gains which arises through a rise in share price after the company itself ceases to be a PFIC.

10. Section 1296 currently allows taxpayers in the "mark to market" regime to treat capital losses as ordinary losses, to the extent which they reverse gains previously taxed as ordinary income. Unfortunately, this deductibility is lost if the company itself ceases to be a PFIC. This should be corrected, either

    (a) by allowing losses against unreserved inclusions to be carried back to the prior PFIC years, or

    (b) by allowing a taxpayer to elect to treat his "mark to market" shares as a PFIC in years for which they are no longer a PFIC.

    The first alternative (a) is preferable, since it avoids problems caused by rate-mismatches between years of gains and compensating losses.

References

[1] New York City Bar Committee on Taxation of Business Entities, "Report offering proposed guidance regarding passive foreign investment company rules," Sept 21, 2009; http://tinyurl.com/mm8qk93.

[2] Stephen Fox and Robert Feinschreiber, "Passive foreign investment company rules are complex and unforgiving," Journal of Taxation of Investments, Winter, 1993,10:110-129; http://tinyurl.com/kdr32xd.

[3] Jon Tyson, "Oncolytics Biotech is a PFIC: Steps to avoid harsh US taxation," http://tinyurl.com/mh9vlnr. (April 6, 2014).

Sincerely,

Jon Tyson