

New 50% Tax Credit/Cash Grant for Life Science Companies Requires Timely Determination of Eligibility and Application

April 21, 2010

The Patient Protection and Affordable Care Act of 2010, as amended by the Health Care and Education Reconciliation Act of 2010 (the Healthcare Reform Law), provides for a valuable new 50% tax credit or equivalent cash grant, for certain companies in the life sciences industry that made (or will make) a “qualified investment” with respect to a “qualified therapeutic discovery project” in a taxable year beginning in 2009 or 2010. This credit/grant is capped at \$1 billion and therefore will be distributed on a first-come, first-served basis. These benefits are generally available only to those companies that have no more than 250 employees (with additional limitations on flow-through entities owned in part by governmental or tax-exempt entities), and that incur particular costs associated with the discovery of therapeutic products.

Companies in the life sciences industry having no more than 250 employees should carefully examine their business activities, costs, and organizational structures to determine whether they are eligible for this new 50% tax credit or cash grant. For example, those life science companies that team up with governmental or tax-exempt hospitals and research institutions might not be eligible depending on how these arrangements are structured. Because the total benefits are capped at \$1 billion and there likely will be many applicants competing for the credits and grants, eligible companies should be prepared to act quickly once the Treasury begins to accept applications in May or June of this year.

The key features of the credit/grant are as follows:

- **Qualifying companies may seek a cash grant as an alternative to the credit.** This is particularly important for companies that currently do not have federal income tax liability (for example, as a result of net operating losses). The cash grant is designed to be economically equivalent, on an after-tax basis, to the 50% tax credit. There are stricter limitations, however, with respect to companies that are owned in part by governmental or tax-exempt entities. For example, a partnership (including any LLC or joint venture treated as a partnership for tax purposes) having any governmental or tax-exempt partner will likely be ineligible for the cash grant, although this limitation might be avoided through the use of “blocker” entities. While cash grant applications for 2009 may be made as soon as guidance is issued, cash grant applications for 2010 may not be made until the first day after the end of the company’s 2010 tax year (for example, January 1, 2011 for calendar-year taxpayers).

- **The credit or grant is available only to a company that employs no more than 250 employees in all the company’s businesses at the time application is made.** For this purpose affiliated entities are combined under complex aggregation rules. For example, a subsidiary or a partnership entity may itself have no more than 250 employees but may be required to count employees of its shareholders or partners. Each company’s ownership and organizational structure should be examined with these rules in mind.
- **The credit will be used to reduce federal income tax liability in 2009 or 2010.** An application must be filed with the U.S. Department of the Treasury (the Treasury) to qualify for the credit. Applications for 2009 or 2010 will be accepted by the Treasury as soon as procedural guidance is issued, which should be on or soon after May 22, 2010. Companies claiming a credit for 2009 that are currently extended on their 2009 tax returns should be able to determine the applicable credit by the due date of their 2009 returns if they are prepared to act quickly. A follow-up LawFlash will be issued as soon as this guidance is issued.
- **The credit will be equal to 50% of a “qualifying investment” related to a “qualifying therapeutic discovery project.”** There are various qualifications and exceptions designed to ensure that companies do not claim both deductions and credits with respect to the same expenses, such as research and development expenses. A detailed review of a company’s costs—on a project-by-project basis—is necessary to determine the amounts eligible for the credit.

What Costs Are Covered by the Credit or Grant?

The credit or grant first requires that a company make a “qualifying investment” in a taxable year beginning in either 2009 or 2010. A “qualifying investment” is any cost that is “necessary for and directly related to the conduct of a qualifying therapeutic discovery project,” *other than the following*:

- Compensation to certain highly paid officers
- Interest expenses
- Facility maintenance expenses, which include mortgage or rent payments, insurance payments, utility and maintenance costs, and costs of employment of maintenance personnel
- General and administrative costs that are required to be capitalized under IRS regulations
- Any investment for which bonus depreciation is allowed
- Other expenses identified by the IRS in future guidance

The second requirement is to determine that the company is conducting a “qualifying therapeutic discovery project,” which includes projects designed to do the following:

- Conduct preclinical or clinical research to support marketing approval for a new drug
- Develop molecular diagnostics, affecting therapeutic decisions
- Develop drug delivery or administration technologies

How and When Is an Application to Be Prepared and Filed?

By May 22, 2010, the Secretary of the Treasury (the Secretary), in consultation with the Secretary of Health and Human Services, is required to establish a program to consider and award certifications for qualified investments that are eligible for the credit or cash grant. The Secretary bears responsibility for

determining whether a project is eligible for the credit or cash grant, and will award the credit or grant only to those projects that show reasonable potential to accomplish one or more of the following:

- Result in new therapies to treat unmet medical need or to prevent, detect, or treat chronic or acute diseases and conditions
- Reduce long-term healthcare costs in the United States
- Significantly advance the goal of curing cancer within the 30-year period beginning on the date the Secretary establishes the program

In administering the awards, the Secretary is also required to consider which projects have the greatest potential of doing the following:

- Create and sustain (directly or indirectly) high-quality, high-paying jobs in the United States
- Advance the United States' competitiveness in the fields of life, biological, and medical sciences.

It is likely that applications will be accepted by the Secretary shortly following the issuance of the guidance on or about May 22, 2010. The Secretary will be required to accept or reject an application (and make payment of any cash grant) within 30 days after the later of the date of a company's submission of an application for the credit or grant, or the date on which the qualified investment is made. Companies seeking credits for costs incurred in both 2009 and 2010 may file a single application for costs for both years. An application for a credit for 2009 costs may, at the company's election, be considered an application for a cash grant in the alternative. An application for a cash grant for 2010 may not be made until the period between the day after the last day of company's 2010 tax year (for example, January 1, 2011 for calendar year taxpayers) and the due date for filing such return (taking extensions into account).

It is expected that the guidance will track many of the provisions the Secretary issued in July 2009, in connection with its administration of the cash grants in lieu of renewable energy tax credits authorized by the American Recovery and Reinvestment Act of 2009. That guidance provided both substantive rules and procedural requirements in order to obtain cash grants from the Secretary for qualifying projects. It also provided a form of application, which likely must be submitted online. We will not likely know all the information that will be required in the application until the May 22, 2010 guidance is issued. At a minimum, companies likely will be required to submit a detailed description of the costs comprising the "qualified investment."

Which Companies Are Eligible for the Credit or Grant?

The credit or grant is available to the particular entity (for example, corporation, LLC, or partnership) or individual that employs no more than 250 employees in all the company's businesses at the time the application is submitted, subject to aggregation rules that treat certain affiliated entities as a single company. In the case of a flow-through entity, the benefit of the credit or grant will be enjoyed by the entity's investors (subject, in the case of a credit, to the investor having a federal income tax liability and avoiding passive loss restrictions, among various other limitations). In general, under the aggregation rules, all employees of all corporations that are members of the same controlled group of corporations count towards the 250 cap in the legislation. The rules are similar in the case of partnerships or LLCs taxed as partnerships, and would generally count all employees of the partnership's or LLC's affiliates as employees of the partnership or LLC for purposes of the 250-employee limitation.

There are additional considerations in the case of companies structured as flow-through entities. In general, for any flow-through entity (for example, LLC or partnership) that has a governmental or tax-exempt partner, a portion of any “qualifying therapeutic discovery project credit” must be allocated proportionately to such governmental or tax-exempt partner. Thus, to the extent of any such allocation, the credit is effectively “wasted.” As for the cash grant, however, we expect that the upcoming Treasury guidance will confirm that any flow-through entity having a governmental or tax-exempt partner of any amount (for example, even a 1% partner) *will not* be eligible to receive a cash grant *unless* such partners hold their interests in the entity through C corporation “blockers.” These considerations will be important for those life sciences companies that team up with hospitals and research institutions that are either governmental or tax-exempt.

If a flow-through entity has a foreign entity or individual as a partner, rules similar to those applicable to governmental and tax-exempt partners will likely apply unless a substantial amount of the foreign partner’s income is taxed in the United States.

What Are the Tax Consequences of the Credit or Grant?

Neither the credit nor the receipt of the cash grant is taxable for federal income tax purposes. They do, however, reduce the basis of project property that is subject to depreciation by the full amount of the credit or cash grant.

The credit is subject to recapture (in the form of taxable income recognition) if the project (including any interest in the flow-through entity that owns the project) is sold or ceases to satisfy the requirements of the program within five years after the project is placed in service for federal income tax purposes. The amount of recapture will vary depending upon how soon a sale or other recapture event takes place after the property is placed in service. For example, it is expected that 100% of the credit would be subject to recapture if a sale took place within the first year after the property is placed in service. By contrast, 20% of the credit would likely be subject to recapture if the sale took place after the fourth full year after the property is placed in service. Similar recapture rules apply to the cash grant, except the recapture event will trigger an obligation to repay the Treasury a portion of the cash grant, rather than income recognition.

An individual investor’s ability to claim the credit may be limited by the passive activity loss rules. It is unclear whether the same limitations would apply in the case of the cash grant.

Morgan Lewis has the relevant knowledge and skills to assist life sciences companies in an examination of their activities, costs, and organizational structure, to determine their eligibility for a tax credit or grant, and to assist in the preparation of a timely application. In addition to the firm’s experience in advising life science companies in a variety of legal areas, our attorneys have recently advised energy companies in filing applications with the Treasury Department, and working with IRS officials to obtain cash grants and allocations of tax credits for solar energy and advanced coal-based generation projects. The applicable rules and processes for obtaining credits or grants for qualifying therapeutic discovery projects are expected to be quite similar.

For more analysis of the Healthcare Reform Law and other issues affecting the life sciences sector, see the following Morgan Lewis LawFlashes: “Healthcare Reform Law: Impact on Pharmaceutical Manufacturers,” (April 15, 2010)¹; “Healthcare Reform Law: A New Regulatory Pathway for Biosimilar

¹ Available at http://www.morganlewis.com/pubs/WashGRPP_ImpactOnPharmaManufacturers_LF_15Apr10.pdf

Biological Products (April 15, 2010)”²; and “Healthcare Reform Law: Comparative Effectiveness Provisions Concerning Healthcare Products and Services,” (April 19, 2010).³

If you have any questions or would like more information on any of the issues discussed in this LawFlash, please contact the authors of this LawFlash, **Gary B. Wilcox** (202.739.5509; gwilcox@morganlewis.com) and **Wendy C. Unglaub** (215.963.5281; wunglaub@morganlewis.com), or any of the following key members of our cross-practice Healthcare Reform Law resource team:

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² Available at http://www.morganlewis.com/pubs/WashGRPP_RegulatoryPathForBiosimilarBiologicalProducts_LF_15apr10.pdf.

³ Available at http://www.morganlewis.com/pubs/WashGRPP_HCR-ComparativeEffectivenessProvisions_LF_19apr10.pdf.

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