

HEALTHCARE REFORM—NEW TAX CREDIT AVAILABLE TO SMALL BIOTECHS PREPARED TO ACT PROMPTLY

Within the more than 900 pages of the Patient Protection and Affordable Care Act (PPACA) is a provision for very significant tax credits or, if elected, outright cash grants for small companies devoted to developing new pharmaceuticals, drug delivery technologies, and molecular-level diagnostics. The full details of the Therapeutic Discovery Project Credit will not be available until the US Department of the Treasury carries out its mandate to establish the program by May 29, 2010. In the meanwhile, companies that may be eligible should begin preparing immediately to make the necessary applications, which will involve considerably more than filling out conventional tax forms. The Credit (including both the tax credit and the alternative elective grants) is limited to US\$1 billion in the aggregate and only applies to the 2009 and 2010 taxable years. Accordingly, there is likely to be significant competition for the Credit and it will be very important to move quickly once Treasury issues the enabling regulations.

The new law provides a 50 percent tax credit for certain expenses paid or incurred during taxable years commencing in 2009 and 2010 in connection with a “qualifying therapeutic discovery project.” Certain taxpayers that cannot take advantage of a tax credit may elect to receive a tax-free cash grant in the same amount, in lieu of the Credit. In order to qualify for the Credit, projects must be designed to result in either the eventual approval of a pharmaceutical or biologic agent, the development of molecular diagnostics to guide therapeutic decisions, or the development of a product, process, or technology to further the delivery or administration of therapeutics. While the primary focus is likely to be on pharmaceutical preparations, some forms of medical devices may qualify as well.

The Credit differs from more traditional investment tax credit allowances, in that the Credit is only available to taxpayers who apply to and are selected by Treasury. Only the rough outlines for selection criteria are enumerated in the new statute, but at the minimum qualifying projects must: (1) result in new therapies to treat areas of unmet medical need or prevent, detect, or

Brussels

+32 (0)2 290 7800

Denver

+1 303.863.1000

London

+44 (0)20 7786 6100

Los Angeles

+1 213.243.4000

New York

+1 212.715.1000

Northern Virginia

+1 703.720.7000

San Francisco

+1 415.356.3000

Washington, DC

+1 202.942.5000

US Healthcare Reform

For more information and access to Arnold & Porter's latest resources on this topic including advisories, upcoming events, publications, and the US Healthcare Reform Chart, which aggregates information on US legislation, please visit: <http://www.arnoldporter.com/HealthcareReform>.

This advisory is intended to be a general summary of the law and does not constitute legal advice. You should consult with counsel to determine applicable legal requirements in a specific fact situation.

© 2010 Arnold & Porter LLP

arnoldporter.com

US TREASURY CIRCULAR 230 NOTICE

ANY US FEDERAL TAX ADVICE INCLUDED IN THIS COMMUNICATION (INCLUDING ANY ATTACHMENTS) WAS NOT INTENDED OR WRITTEN TO BE USED, AND CANNOT BE USED, FOR THE PURPOSE OF (I) AVOIDING US FEDERAL TAX-RELATED PENALTIES OR (II) PROMOTING, MARKETING, OR RECOMMENDING TO ANOTHER PARTY ANY TAX-RELATED MATTER ADDRESSED HEREIN.

treat chronic or acute diseases or conditions; (2) reduce long-term healthcare costs in the United States; or (3) significantly advance the goal of curing cancer within a 30-year period. Additionally, qualifying projects must also create or sustain high quality, high-paying jobs in the United States and advance US competitiveness in the sciences. Treasury is mandated to establish a program for selection within 60 days after the date of enactment, but is given no guidance as to the program beyond the minimum qualifications. Treasury is directed to consult with the US Department of Health and Human Services in developing the program, which may either delay issuance of the regulations or result in regulations that leave determinations to considerable discretion.

Grant Program. Instead of a traditional tax credit, taxpayers may elect to receive the Credit as a cash grant that will not be included in the taxpayer's taxable income. The grant program will be modeled after Section 1603 of the American Recovery and Reinvestment Act of 2009 (ARRA), which applies to specified energy property investments and it is likely that the base form of application will look similar to the form for applying grants under the ARRA. Grants under the ARRA, however, are based on a bright-line test and are theoretically unlimited in amount, whereas the aggregate amount of the Credit under PPACA is limited to US\$1 billion for both taxable years 2009 and 2010, and to projects that have been selected by Treasury after an evaluation on their merits. It is safe to assume that the therapeutic discovery project applications will be more voluminous and that they will each involve an exercise somewhat akin to writing a grant proposal to National Institutes of Health.

Approval. Treasury must approve or deny an application for the Credit or grant within 30 days of its "submission"—one half the time allowed for review of applications for energy project credits/grants under ARRA. It is likely that Treasury will not be able to act within 30 days of receipt of an application. In the case of applications under the ARRA, Treasury has delayed approvals by declaring

applications to be incomplete until the applicant answers additional questions or makes additional submissions. In the case of a credit/grant program that is not limited in aggregate amount, that is an annoyance; in the case of a capped program such the Credit under PPACA, however, competing applications could conceivably be approved during the delay, rendering moot the stalled application. Strategy in structuring applications may be necessary to avoid stalled applications; but it is not yet clear what those strategies might be. Until Treasury establishes the program and announces its rules, it will not be clear how applications will be processed and whether approval will be on a first come, first served basis, or will be based on another priority or allocation system.

Included Expenses. Once a project is approved, the 50 percent Credit will apply to expenses "necessary for and directly related to the conduct of a qualifying therapeutic discovery project." As with computing the deduction for research and experimental expenses and the credit for increasing research and development activities, the required accounting will likely add a measure of complexity to the company's record keeping. For example, the Credit does not apply to any portion of the remuneration of the CEO of the company and, if the company is publicly traded, the four highest paid people other than the CEO. It also does not apply to interest expenses, facility maintenance expenses (mortgage, rent, insurance utilities, maintenance employees), or so-called "service costs" (typically, management overhead). Treasury may also adopt regulations excluding other categories of expenses. While facility maintenance costs are not included, the cost of depreciable property actively used in research should be eligible. The result is that the computation of creditable expenses may be materially different from that used historically in computing the tax credit for increasing research expenses. For very small companies, with individuals performing multiple roles, it is conceivable that the service cost exclusion alone could considerably reduce the amount of the available credit.

Eligible Taxpayers. The Credit is only available to a taxpayer that employs no more than 250 employees in all its businesses at the time of submission of the application. All employees within a controlled or affiliated group are counted, as are employees of an affiliated service group. For example, a small research company that shares staff, management or facilities with a much larger health maintenance organization (HMO) might not be eligible to receive the credit or grant, even if the HMO holds a minority stake in the research company.

Entities Not Eligible for Grants. The grant program is not available to government entities at any level, to most tax-exempt entities, to certain utilities, and, probably most importantly, any partnership or other pass-through entity with any member that is a government entity, tax-exempt, or utility. This may preclude participation in the grant program, for example, by limited liability companies to which a university has contributed intellectual property in exchange for an equity interest. While the Credit should still be available, there may be tax complications associated with allocating the benefits of the Credit among members where a tax-exempt entity is a member.

Adjustments. If the taxpayer claims the Credit for depreciable property, the basis of the depreciable property must be reduced by the amount of the Credit. Similarly, the Credit will not be allowed for any investment entitled to bonus depreciation under certain other incentive programs and any expense used in computing the Credit cannot also be deducted in computing taxable income. Expenses that are included in the amount of the Credit cannot be used in the computation of increased qualified research expenses for the purpose of the research and development (R&D) credit, but will increase the baseline used to determine whether there has been an increase in R&D spending in subsequent taxable years. If the R&D credit is finally renewed for 2011 and the applicant company is expanding rapidly, the loss of the R&D credit could conceivably be more significant than the benefit of the Credit under PPACA.

Recapture. Grants are subject to recapture in the event that the amount of the grant is more than the amount actually allowable, for example, if the applicant does not spend the specified amount entirely on qualifying activities.

Public Record. Grant information is not treated as tax return information. The identity of the grantee, description of the project, and amount of the award should be thought of as publicly available information. For a privately held company, this could be a material risk to competitive positioning.

Preparing Now. Even though Treasury has yet to promulgate the details of the program, interested companies must start preparing immediately to apply for the Credit. Because there are no limits on the amount available to each individual applicant, only on the amount available to all taxpayers in the aggregate, it is likely that there will be substantial competition for the Credit immediately after the details are promulgated.

We hope you find this advisory helpful. If you would like more information, please feel free to contact your Arnold & Porter attorney or:

Joseph G. Howe III
+1 202.942.5230
Joseph.Howe@aporter.com

Steve Parker
+1 703.720.7006
Steve.Parker@aporter.com

Ira Moskatel
+1 213.243.4223
Ira.Moskatel@aporter.com

Timothy O'Grady
+1 212.715.1786
Timothy.O'Grady@aporter.com