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QUALIFYING THERAPEUTIC DISCOVERY PROJECT TAX CREDIT

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The recently enacted health insurance reform legislation contains provisions that will allow small businesses to claim a significant tax credit for certain investments in therapeutic discovery projects. Generally, a qualifying therapeutic discovery project (QTDP) credit is worth 50 percent of a "qualified investment" in any QTDP. This alert will briefly discuss the important aspects of the credit.

QUALIFYING THERAPEUTIC DISCOVERY PROJECT

A QTDP is defined in § 48D(c)(1) of the Internal Revenue Code as a project which is designed to (1) treat or prevent diseases or conditions by conducting pre-clinical activities, clinical trials, and clinical studies, or carrying out research protocols for purposes of securing proper government approval; (2) diagnose diseases or conditions or determine molecular factors related to diseases or conditions by developing molecular diagnostics to guide therapeutic decisions; or (3) develop a product, process, or technology to further the delivery or administration of therapeutics.

QUALIFIED INVESTMENT

A qualified investment includes costs paid or incurred in a tax year for expenses necessary for and directly related to the conduct of a QTDP. Certain costs are excluded, such as certain payments to highly compensated employees, interest expenses, facility maintenance expenses (including rent or mortgage payments, insurance, utilities, and costs incurred for employment of maintenance personnel), and service costs (costs associated with a service department or function as defined in § 1.263A-1(e)(4) of the Treasury Regulations). The qualifying investment cannot exceed the amount certified by the IRS as eligible (see below).

ELIGIBLE TAXPAYERS

The QTDP credit is only available to small businesses, specifically taxpayers employing no more than 250 employees in all businesses. Certain aggregation rules (*i.e.* code provisions addressing controlled groups and affiliated organizations) apply in this context for purposes of defining a single employer.

TIMING

The investment must be made during a tax year beginning in 2009 or 2010. The year in which the investment is "placed in service" is irrelevant for purposes of the timing requirement. Only the date on which the costs were paid or incurred, depending on a taxpayer's method of accounting, is important. In other words, if the QTDP is to result in the production or development of property, the availability of the credit does not depend on when the property is placed in service.

CERTIFICATION

The IRS, in consultation with the Secretary of Health and Human Services, must establish a QTDP program to consider and award certifications for qualified investments eligible for the QTDP credit. *This must be done by May 21, 2010.* The certification program put forth by the IRS will provide particulars related to the application process but it is already clear that the IRS must approve or deny each application within 30 days of submission and that total credits allowed under the program cannot exceed $1 billion for the two-year period.

SELECTION CRITERIA

The IRS will consider only those projects that show reasonable potential to (1) result in new therapies targeting unmet medical needs or chronic or acute diseases and conditions; (2) reduce long-term health care costs; or (3) significantly advance the goal of curing cancer within a 30-year period. Further, the IRS will give consideration to projects having the greatest potential to create and sustain jobs and to advance our country's competitiveness in the fields of life, biological, and medical sciences.

DENIAL OF DOUBLE BENEFITS

A complicated set of rules applies to the interaction between the QTDP credit and other available deductions and credits. Generally, the provisions operate to deny a double benefit from a single investment or, more specifically, on the portion of a single investment to which the QTDP credit is attributable. To illustrate: if a $5 QTDP credit is claimed with respect to a qualifying investment of $10 and the $10 expense would otherwise be deductible, the deduction is disallowed to the extent of the $5 QTDP credit. Presumably, the remaining $5 is deductible. Special rules apply in the context of deductions for expenses that would be "qualified research expenses," "basic research expenses," or "qualified clinical testing expenses" if the credits under § 41 (credit for research activities) or § 45C ("orphan drug" credit for expenses related to rare diseases and conditions) were allowed with respect to such expenses for the same tax year. The thrust of these special rules is similar to that of the general rule (*i.e.* a denial of a double benefit from a single investment) with minor modifications.

On the credit side, expenses taken into account for purposes of the QTDP credit generally cannot be taken into account for purposes of the § 41 research credit or the § 45C "orphan drug" credit. The QTDP credit is unavailable with respect to an investment for which bonus depreciation is allowed under either § 168(k), or the sections dealing with New York Liberty Zone and Gulf Opportunity Zone property. Similarly, the QTDP credit is not available with respect to property on which a U.S. Treasury grant was made under other provisions of the health reform legislation. Note that, generally, taxpayers may apply for a grant in lieu of the QTDP credit. This option has not been codified but is found in the legislation. The option will be valuable in certain circumstances.

BASIS REDUCTION

If the QTDP credit is allowed with respect to property of a character subject to an allowance for depreciation, the basis of that property must be reduced by the amount of the credit.

RESTRICTIVE RULES

The QTDP credit is a component of the § 46 investment credit, which in turn is a component of the § 38 general business credit. As such, the QTDP credit is subject to certain restrictions, which apply to the general business and investment credits.

Several of the restrictive rules are summarized below:

- Nonrecourse financing for credit-eligible property must be "qualified commercial financing."
- As a component of the general business credit, the QTDP credit is subject to § 38(c), which generally does not allow the general business tax credit against the alternative minimum tax and limits its allowance against regular income tax. Any credit disallowed or limited under § 38(c), however, may be carried forward.
- In certain circumstances where property is disposed of or ceases to meet credit requirements, the credit may be subject to recapture.
- Property used primarily outside the U.S. is disqualified.
- Other special rules apply with respect to leased property, special types of entities, and allocation of credits among a trust or estate and its beneficiaries.

If you would like to discuss how any of these changes may affect your business, or have any other BioPharma, tax planning, or estate planning questions, please contact Ryan Udell (215.864.7152), Mike Mentzel (215.864.7156), Kevin Koscil (215.864.6827), Scott Borsack (215.864.7048), or Bill Hussey (215.864.6257).

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