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Health Reform Will Set Off Biotech Tax Credit Rush

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Buried in the recently passed health reform package is a provision that provides an unusual and tremendous benefit to small and mid-sized (under 250 employees) biotech firms and their investors. This extraordinary gift from Congress (courtesy of a push by Sens. Robert Menendez, D-N.J.; Maria Cantwell, D-Wash.; and John Kerry, D-Mass.) provides a 50% tax credit for qualified biotech investments for tax years 2009 and 2010, or a grant for the same amount tax-free.

Thus a biotech company that has a tax liability can see its tax bill slashed and a business that has no tax liability can receive a nontaxable grant for the same amount. Bottom line: With this new provision a biotech business can look to put big money in its pocket immediately. Your business makes a qualified investment of $1 million and it gets a $500,000 tax credit or a $500,000 check from Uncle Sam. Wow.

This benefit is available for pass-through entities, such as partnerships and S corps, as well as traditional C corporations. (Pass-throughs pass on their taxable income and tax credits to their individual investors' tax returns.). Readers may have heard me complain about how the individual AMT keeps these business owners from taking advantage of business tax benefits, such as the typical research and development tax credit. Not so here. (However, a pass-through partner that is a government agency and certain tax-exempt entities will not receive the benefit.)

The grant part of the new biotech credit is important, given what I have found in working with numerous firms across the country: A significant number of biotech firms that are doing work that would otherwise qualify for the regular R&D tax credit don't get any value from it because they do not have a tax liability or are denied immediate benefits from it by the AMT. Innovative firms that might need R&D help the most don't get it, because they're not yet producing a taxable profit. But neither the requirement of a tax liability nor the AMT are at issue here, and we expect hundreds of companies that didn't qualify for the R&D Tax Credit will qualify for this new credit or grant.

While it's called a grant, the biotech credit is a variation of what Congress has been doing with individuals: Using the tax code and the Internal Revenue Service to deliver benefits it considers socially desirable in the form of refundable tax credits. For example, the child credit, the earned income tax credit and the American Opportunity college tax credit, all transfer cash, in some cases, to families who don't owe any individual income tax.)

Here's a quick question-and-answer briefing on the requirements for the new biotech credit/grant, technically called the "Qualifying Therapeutic Discovery Project Credit."

What does the credit cover?

The credit/grant covers research in tax years beginning in 2009 and 2010. The taxpayer is provided a 50% credit/grant for qualified investments in "qualifying therapeutic discovery projects." What expenses count as qualified investments? The aggregate amount of costs paid or incurred in the taxable year for expenses necessary for and directly related to the conduct of a qualifying discovery project. What doesn't count? The pay of employees covered by 162(m)(3) of the tax code--think CEOs--doesn't count. Other excluded items: interest expenses; facility maintenance expenses (e.g. mortgage or rent payments, insurance, utility and maintenance and costs of employment of maintenance personnel); and certain indirect costs (basically general and administrative costs) as defined in the Treasury Regulations at 1.263A-1(e)(4).

What is a qualifying therapeutic discovery project?

According to the legislation, it's a project designed to do one of three things:

--Treat or prevent diseases or conditions by conducting pre-clinical activities, clinical trials and clinical studies, or carrying out research protocols for the purpose of securing federal government approval by the FDA.

--Diagnose diseases or conditions or to determine molecular factors related to diseases or conditions by developing molecular diagnostics to guide therapeutic decisions.

--Develop a product, process or technology to further the delivery or administration of therapeutics.

Finally, to qualify, a venture may not have more than 250 employees in all businesses of the taxpayer--meaning a small biotech project at a big company wouldn't qualify.

Which biotech companies might benefit?

Those that are investing significant resources in pre-clinical or clinical studies, which may take years to come to fruition to ultimately satisfy FDA requirements, could now recoup a significant portion of their expenses. Additionally, biotech start-ups focusing on the development of diagnostic assays or applications to advance therapeutics and treatments can also benefit. Finally, companies currently engaged in basic or applied research which may ultimately contribute to curing caner within the next 30 years may also be excellent candidates. Along these lines, companies studying signal transduction pathways, gene therapy and stem cell research seem like prime candidates.

What's the catch?

While this new credit is a great opportunity for biotech companies, they are not just handing out checks in D.C. (well, not unless you are a bank). Unlike most tax credits, this new benefit is not available in unlimited amounts to all eligible taxpayers. There is a set pot of money ($1 billion for the two tax years) and you will have to apply and compete. Think of it as a combination refund tax claim and a Wal-Mart or Best Buy Friday-after-Thanksgiving super special available only to the first 100 shoppers at each store. You have to get in line early and apply to the Treasury/IRS; after the money is gone there are no more refunds--the super sale is over.

The application to the Treasury/IRS will certainly be focused intensely on the dollars at issue. Remember: At the end of the day these are IRS folks, and their natural inclination is to look hard at the dollars your business is claiming. Similar to the R&D tax credit, you will need to have detailed justification of your expenses for a project. Especially important is balancing the need to maximize your credit/grant by ensuring it includes all allowable expenses (a huge problem I see in the R&D Credit area with businesses over- and under-counting) and making sure you do not include unallowable expenses. You do not want your application set aside because the IRS worries your expenses are not properly documented or not in compliance with the tax code, Treasury regulations and IRS guidance.

What special hurdles are there?

After clearing the key hurdles of accuracy, documentation and justification for costs, the Treasury/IRS will look at (in consultation with the Department of Health and Human Services) projects with emphasis on a number of different criteria. There are two broad sets of criteria, the first dealing with medical benefit, the second with jobs and the economy.

The medical benefit factors that will put your application in good standing include: projects that will result in new therapies that will treat areas of unmet medical need or prevent, detect or treat chronic or acute diseases and conditions; projects that reduce long-term health care costs in the U.S.; and, finally, projects that significantly advance the goal of curing cancer within the next 30 years. Of course, you do not have to do all (or possibly even any) of these things for your application to qualify. But these are research areas that will improve the chance of your application being approved.

How does this relate to jobs?

Congress has also directed that applications that create and sustain high-quality, high-paying jobs in the U.S. and advance U.S. competitiveness in the fields of life, biological and medical sciences be looked upon with greater favor by Treasury/IRS. Obviously this new potential source of funding could provide support for hiring of additional graduate students, post-doctoral fellows and lab support staff. While there doesn't appear to be a bar against research done outside the U.S., the strong sentiment and encouragement by Congress to Treasury is that the focus should be on U.S. jobs.

How soon must you apply?

Congress has given guidance to the Treasury that this program should be in place in 60 days and applications approved within 30 days after that. That is probably pretty ambitious, but it certainly signals that Congress expects the Treasury to get moving quickly. Given that there are only so many dollars available, businesses need to be taking steps now to begin planning and drafting their applications based on the criteria, with particular emphasis on justification of dollars and expenditures that are qualified investments on a project-by-project basis.

Why project-by-project? Because that is how the IRS is almost certainly going to look at this--that is how it looks R&D credit claims. A segregated project-by-project approach will also allow your business a stronger chance of being awarded at least a partial credit or grant. While one project might not qualify, others will.

A key will be those proposals that are clear on the justification for the dollars; you don't want Treasury/IRS to have to spend extra time scrutinizing your proposal as other applications are approved and soak up all the funding. Interested business owners should be sharpening their pencils now to apply for these funds--this may well move on a fast train from the Treasury.

Every once in a while something that is "too good to be true" turn out to actually be true. This is one of those times.

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