24th Annual Health Sciences Tax Conference

Understanding the tax impact of joint ventures and collaborations within the life sciences sector

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Understanding the tax impact of joint ventures and collaborations within the life sciences sector
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Agenda

► Background
► Key tax issues associated with collaboration agreements
► Key observations and takeaways
Background
Background

► What is a collaboration agreement?
► What is driving the renewed focus?
► What are some of the business issues associated with such arrangements?
Background

► What is a collaboration agreement?
  ► An arrangement among parties as to the research, development, manufacture and ultimate sale/exploitation of a product

► Examples
  ► Licensing agreements (in-license or out-license)
  ► Contract research or contract manufacturing
  ► Risk-sharing arrangements (co-development; co-promotion)
  ► Joint venture or partnership
  ► Option-based collaboration with option to ultimately acquire smaller entity
  ► Any combination of above
Background

Typically, the collaboration agreement will provide for:

- Joint governance, usually in the form of a board made up of persons from both collaborators, but, on many issues, requiring unanimous consent
- Sharing of some elements that comprise net bottom-line profit
- A provision and acknowledgment of the creation of joint property, such as intellectual property (IP)

In some situations in which there is not a sharing of net bottom-line profits, there is a sharing of some above-the-line gross income/cost of goods sold items, as well as some sharing of development costs
Background

- Increase in collaboration agreements
  - Selective licensing by life sciences companies looking to fill in drug development pipelines, identify additional sources of revenue, expand into emerging technologies and remain competitive
  - Source of funding for biotechnology development due to lack of initial public offering (IPO) market and venture capital (VC) funding opportunities
  - Dollar amount of upfront license fees and milestone payments significantly increasing
  - Deals occurring earlier in biotech life cycle

- Companies making payments under collaboration agreements must evaluate rights and risks for purposes of claiming a deduction under Internal Revenue Code (IRC) Sec. 174 and a research and development (R&D) tax credit under IRC Sec. 41
Tax planning for collaboration and license agreements

► Typical financial components of license agreements
  ► Equity investments
  ► Upfront nonrefundable license fee
  ► Milestone payments
  ► R&D funding
  ► Sales-based royalties or sharing of residual profits
Key tax issues associated with collaboration agreements
Characterization

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Characterization

Depending upon how the parties draft and implement the agreement, it might be viewed as:

- *One where the parties conduct a single business for their common profit as partners*
- *Or*
- *Separate businesses for their individual profits as sole proprietors*

The terms of a collaboration agreement will dictate whether the agreement is characterized as a purchase of IP, a license arrangement or a partnership for US tax purposes.

- Tax ramifications differ significantly
  - Classification as a sale generally results in the deductibility of tax basis, installment sale treatment (and related interest charges under IRC §453A) and capital gain to seller; IRC §197 considerations to purchaser
  - License income typically taxed as ordinary income as payments are due or received
- Generally, a sale of a patent or IP rights will arise whenever the owner conveys the *exclusive* right to make, use and sell the property rights for the life of the technology (IRC §1235 analysis).
Characterization

► Relevant factors typically used to evaluate whether a contractual arrangement rises to the level of being an “entity” that might be classified as a partnership (see *Luna v. Commissioner*, 42 TC 1067 (1964)):
  ► Agreement of the parties and their conduct in executing the arrangement’s terms
  ► Contributions made by each party
  ► The parties’ control over income and capital and the right to make withdrawals
  ► Whether each party was a principal and co-proprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his or her services contingent compensation in the form of a percentage of income
  ► Whether business was conducted in the joint names of the parties
  ► Whether the parties filed federal partnership returns or otherwise represented to respondent or to persons with whom they dealt that they were joint venturers
  ► Whether separate books of account were maintained for the venture
  ► Whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise
Characterization

► Traditional/non-partnership treatment
  ► Merely a contractual arrangement between the parties.
  ► The foreign multinational corporation (MNC) will **not** have a US permanent establishment (PE) solely by virtue of its participation in the arrangement.
  ► The foreign MNC may have a PE if US biotech was considered a dependent agent in connection with the performance of a contract on behalf of foreign MNC, but is a factual determination and a higher threshold.
  ► Unless there is a PE, the receipt of income by a foreign MNC and US biotech would only be taxable in home country.
  ► Payments between parties may be characterized as proceeds, compensation for services, purchases of goods or services, or royalties.
  ► Some of the payments between parties could be subject to withholding taxes that may or may not be creditable.
Characterization

- Impact of collaboration agreements being treated as partnerships include:
  - The lack of appropriate elections having been made by the partnership
  - The possibility of open statute of limitation periods due to failing to comply with the Tax Equity and Fiscal Responsibility Act (TEFRA)
  - State tax consequences
  - Section 761 election out of Subchapter K
  - Section 199 calculation
- Also consider the impact of creating a partnership for federal tax purposes if the collaboration has a foreign participant
  - The possibility of a foreign collaborator as having a US PE issue
  - Section 875 imputation rule
  - Section 1446 withholding
  - Section 884 branch profits tax
Characterization

► Chief Counsel Advice (CCA) 201323015 (June 7, 2013)
  ► Written Collaboration Agreement (Agreement) between two corporations to develop and commercialize product constituted a partnership
  ► Corporation A granted Corporation B right to co-promote product in US and Canada and to develop/market worldwide
  ► Corporation A and Corporation B contributed cash and services to the enterprise
  ► Development/Commercialization Committee composed of equal number of representatives from Corporation A and Corporation B
  ► Corporation A and Corporation B share net profits and losses
  ► Sell product under jointly owned trademark
  ► Corporation A and Corporation B did not file a partnership return
Partnership characterization

► Most determinative factors
  ► Self-classification (agreement, tax return filings, publicly)
  ► Sharing of net income or profits
  ► Sharing of expenses that are material in the production of income, and a royalty/commission payment
  ► Joint management and control
  ► Joint ownership of property with an intention to exploit such property for mutual benefit

► Strategic consideration: proactive planning
Deemed partnership considerations

► Disguised sale of technology?
► State nexus issues?
► Permanent establishment issues?
► Section 199 deduction?
► R&D tax credits?
► Reporting requirements?
► Financial Interpretation Number (FIN) 48 reserves?
Option transactions

► Option to buy program assets
  ► Option is open-ended transaction – gain deferred
  ► Corporate-level tax if exercised
  ► Section 382 limitations on net operating losses (NOLs)
  ► Potential for significant level of double taxation

► Option to buy stock of company
  ► Option is shareholder-level transaction
  ► Deemed contribution of option proceeds to company
  ► Deferred gain to shareholders
  ► If option expires unexercised, then shareholder gain with no cash
  ► Valuation issues re: bifurcation of license rights vs option payment
  ► Taxable spin-outs of other programs

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International issues
Permanent establishment issues

► If the partnership carries on a trade or business in the US, that US trade or business will be attributed to the foreign partner.
  ► This will cause the foreign partner to have a US permanent establishment (PE or a taxable branch).
  ► The foreign partner will need to file a US tax return (1120F) to report the branch’s US “effectively connected income” (ECI), which is taxed at normal corporate rates (40%).
  ► The income may also be subject to a branch profits tax.
Partnership withholding

- The partnership is required to withhold at a rate of 38% on any allocable US ECI under IRC §1446 each quarter to a foreign partner.
- The foreign partner would then claim this as a credit against the tax owed on the Form 1120F.
- In computing the IRC §1446 withholding tax, the partnership cannot “carry forward” effectively connected losses from prior years.
Transfer pricing issues
Transfer pricing overview

► Related parties must transact with one another on an “arm’s-length” basis.
► “Arm’s-length” determinations are to be based on analysis of “comparable” transactions.
► Many companies have carefully thought out transfer pricing arrangements to address the inevitable exposures.
Transfer pricing issues in collaborations

► Does the collaboration arrangement itself constitute a “comparable uncontrolled transaction” that could be used by a taxing authority to challenge your pre-existing transfer pricing arrangements?
► Where more than one entity in your group participates in the arrangement, does each receive an “arm’s-length” return for its investments and functions?
Collaborations as comparables

► Does the split of profits between the collaborators establish a profit split benchmark for other arrangements between related parties?
► Are royalty rates in the collaboration deal comparables for other internal licensing arrangements or IP transfers?
► Do payments for marketing/detailing/distribution establish comparable prices for other internal arrangements?
Related-party dealings

► If one party’s collaboration functions are divided between two legal entities, the rewards to each must be consistent with “arm’s-length” dealing.
  ► Does the party taking R&D risk earn IP-related returns?
  ► Is the party performing marketing/distribution functions properly compensated?
Critical factors to balance

 ► Risks assumed
 ► Functions performed
 ► Assets and investments
 ► What does the collaboration say about the reward to assets/risks/and functions?
Tax accounting method considerations

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## Typical types of payments

<table>
<thead>
<tr>
<th>Type</th>
<th>Description</th>
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<tbody>
<tr>
<td>Upfront fees</td>
<td>- Refundable or nonrefundable</td>
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<td></td>
<td>- Payable upon signing of the agreement</td>
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<tr>
<td>Milestone payments</td>
<td>- Fixed amount that is contingent on research achieving certain goals</td>
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<tr>
<td>Royalties</td>
<td>- Contingent payment due upon commercialization of drug compound</td>
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Federal tax considerations – payor

Upfront payments and milestone payments

- Section 174 research and experimentation (R&E)
- Section 41 R&D credit
- Section 263(a)
- Uniform capitalization (UNICAP) implications for future production
Tax accounting method considerations – payor

- Equity component premium likely treated as non-deductible equity investment due to form of the agreement
- Up-front license payment likely amortized over the shorter of the term of the agreement or 15 years
- Milestone payments amortized over the remaining amortization period associated with the upfront payment
Other federal tax considerations – recipient

Upfront payments and milestone payments

Rev. Proc. 2004-34
One-year deferral

Overall tax position

Section 59(e) and §174(b) elections to defer expenses incurred under the agreement
Tax accounting method considerations – recipient

- Equity considerations
  - Sale at excess premium (valuation considerations)
    - Should a portion of 15% premium be classified as license payment?
  - Section 382 limitations
    - Anti-stuffing provisions
    - Substantial nonbusiness assets
    - Increase for built-in gains (2003-65)
    - Potential for built-in loss? (capitalized R&D expenses)
Tax accounting method considerations – recipient

- License fees and milestone payments
  - Revenue recognition – book/tax difference
    - Cash method – year of receipt
    - Accrual method – earlier of:
      - Year payment was earned
      - Year payment was due
      - Year payment is received
  - Limited one-year deferral opportunity (Rev. Proc. 2004-34)
    - IRS Draft Coordinated Issue Paper (August 2006)
    - IRS Audit Directive
    - Recent Private Letter Ruling (200815029)
Tax accounting method considerations – R&D credit

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R&D credit – qualifying expenses

- Qualified research expenses (QRE):
  - In-house research expenses (wages and supplies), plus
  - Contract research expenses

- Contract research expenditures
  - 65% of amounts paid to anyone other than an employee to perform qualified research for the taxpayer
  - Contract research must be performed under an agreement which:
    - Is entered into prior to the performance of qualified research
    - Provides that research be performed on behalf of the taxpayer
    - Requires the taxpayer to bear the expense even if the research is not successful (i.e., payment is not contingent upon success of the research)
  
  - If payments are contingent upon the success of the research, then the payment is considered payment for property rights, not for research. This payment would also not be considered “funding” from a section 41 perspective for the researcher {Treas. Regulation Section 1.41-2(e)(1)}. 

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R&D credit – funded research

► Funding has two elements:
  ► Risk – who bears the economic risk if the research fails?
  ► Rights – who has substantial rights in the research?
► Taxpayer must reduce research expenditures by the amount of funding received (“funding” in the §41 sense)
► Important for both contracted and sub-contracted research
  ► Payments the taxpayer received to conduct research
  ► Payments the taxpayer makes to others to conduct research on its behalf
R&D credit – rights issues

► Research is treated as fully funded (not qualified) if the taxpayer enters into an agreement to perform research and, pursuant to the agreement, does not retain “substantial rights in the research.” {Treas. Reg. §41-5(d)(2)}

► The retention of any rights with economic value, other than a security interest, should be treated as substantial, e.g.:
  ► The right to make, use or sell
    Or
  ► The right to exclude others from making, using or selling

► Both parties to a contract may retain substantial rights to the research
R&D credit – collaboration payments

- Upfront nonrefundable payments may be labeled differently – not a controlling factor
  - Upfront fees
  - Reimbursement of prior R&D
  - License fees
- Upfront payments are generally treated by the payer as a capital expenditure under 263(a) for the acquisition of intellectual property
R&D credit – collaboration payments

► **Milestone payments – payer treatment**
  ▶ Contingent upon achieving certain development results
  ▶ Ultimate payment is not guaranteed
    ▶ Therefore it is not “at risk”
    ▶ Therefore it is not considered “funded research”
  ▶ Milestone payments in this case do not constitute research and experimental expenditures under §174 nor qualified research expenditures under §41

► **Milestone payments – payee treatment**
  ▶ Income to the recipient under §451
  ▶ Will not reduce QREs, as the payments are not considered “funded”
  ▶ Development costs incurred by B are considered QREs and B entitled to R&E credit, assuming B retains rights to the research

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Key observations and takeaways
Questions?
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