Tax Considerations of Collaboration Arrangements in the Life Sciences Sector

Research and development (R&D) is the lifeblood of life sciences, but it isn't easy — or cheap. To lighten the cost and risk burden of R&D, life sciences leaders are turning to collaborations and partnerships as they develop and commercialize new drugs, medical devices, and technologies.

These collaboration agreements can complicate an organization's tax filings. To ensure it is following proper tax guidelines and capitalizing on all available tax credits and incentives, a life science company needs to understand how to classify its collaboration arrangements.

Life science entities continue to adjust to transformative changes and are increasingly pursuing collaborations with third parties to develop or commercialize promising drugs, medical devices, and other technologies. The goal of these collaborations is to share their associated costs and risks.

General Background

Although collaborations can take various forms, a typical model involves a development-stage life science company exclusively licensing or selling intellectual property (IP) rights to an unrelated, mature life science company in exchange for upfront fees (or shares of profits), milestone payments, royalties, and/or equity investments. Collaboration agreements generally allocate rights and responsibilities between the parties for joint development, clinical trials, regulatory compliance, manufacturing, promotion, and commercialization. These arrangements may be documented in an asset purchase agreement, licensing agreement, alliance agreement, development agreement, co-marketing agreement, or other formal agreement between the parties.

Collaborative agreements generally provide for three types of payments: (1) a nonrefundable upfront payment at the time the agreement is concluded; (2) a milestone or installment payment that is contingent on research or other specified accomplishments; and (3) royalties for commercialization.

To determine the proper tax treatment of these payments, several issues must be addressed. The following sections discuss how to address those topics.

Partnership or Contract?

One threshold issue is whether the collaboration should be characterized as a partnership or contractual arrangement. The IRS has characterized collaborative arrangements as partnerships if specific hallmarks are present.[1] In general, a contractual arrangement may be recharacterized as a partnership if the participants carry on a trade or business or financial operation or venture and share in the resulting profits and losses. A joint undertaking merely to share expenses generally does not create a partnership for federal income tax purposes.

The determination of whether an arrangement is a partnership or contract depends on the facts and circumstances. Federal court rulings have articulated several factors to consider in determining whether an arrangement should be characterized as a partnership for tax purposes.[2]

Recharacterization of a contractual collaboration as a partnership can have some unintended tax consequences, including: (1) the economics of the deal concluded by the parties could differ from what was originally planned; (2) collaboration payments might not be treated as income or expenses but rather as partnership contributions and distributions; (3) there could be different tax reporting requirements (if treated as a partnership, a new entity would be deemed to have been formed for tax purposes, necessitating the filing of Form 1065, "Partnership Return of Income Filing"); and (4) tax accounting methods would be made at the partnership level rather than at the parties' level.

The best practice is to examine the terms of collaboration agreements to confirm the desired tax characterization, ensure the intentions of the agreement are in line with the parties' expectations, and that the intended tax consequences are achieved.

[1] Chief Counsel Memorandum – 201323015, Feb 23, 2013.

[2] In Comm'r v. Culbertson, 337 U.S. 733 (1949), the U.S. Supreme Court determined that a joint undertaking is a partnership for tax purposes if five factors are met. In Luna v. Comm'r, 42 T.C. 1067 (1964), the U.S. Tax Court developed an eight-factor framework to determine whether a business venture should be a partnership for tax purpose.

Sale or License?

Another tax issue that can arise in collaborative arrangements is whether a transfer of IP should be considered a sale of intangible property or a license to use intangible property.[3] Generally, a sale occurs for tax purposes when all substantial rights to the property have been relinquished, whereas a licensing arrangement exists when the person transferring the right retains control over (meaning over major decisions related to the IP) or a significant interest in the property.[4]

One of the biggest differences between a license and sale is that sale proceeds are taxed as capital gains, whereas license payments are taxed as ordinary income. For corporate taxpayers, capital gains and ordinary income are currently taxed at the same federal rate. However, the characterization as capital gains or ordinary income is meaningful if a corporation has capital losses and the ability to use those losses might be limited without the recognition of capital gains.[5] Under Internal Revenue Code (IRC) Section 1211, a corporation's net capital losses may be offset only to the extent of capital gains in that year. Further, under Section 1212, any unused capital losses can be carried back to each of the three prior tax years and carried forward for five tax years. Accordingly, determining whether there is a license or a sale could control whether a taxpayer can use tax attributes or must let them expire unused. That determination will also affect the timing of income recognition, including whether any income tax deferral opportunities exist.[6]

At the same time, the license versus sale determination will affect the timing of the tax deduction for both the licensee and buyer. If the transaction is a license, the licensee's payments are generally deductible ratably over the term of the license if the applicable statutes for deduction and related timing of deduction have been met . The buyer's tax treatment of the payment would likely result in the creation of asset basis, which may be amortizable under either IRC Section 167 (over the license term or the life of the patent) or 197 (over 15 years or the remainder of the 15 years once incurred). Similarly, income recognition for the IP licensor or seller under Section 451 may be affected by the determination. The timing of income will depend not only on the character of the transaction but also on when cash is received and, in some cases, when the revenue is recognized for financial reporting purposes.

[3] Mylan, Inc. v. Comm'r T.C. Memo 2016-45 (Sept. 16, 2015).

[4] IRC Section 1235 provides guidance in analyzing whether a transaction is a license or a sale and has been applied in the corporate context. Although Section1235 does not define the term "all substantial rights," the legislative history indicates that perpetual and exclusive agreements "to manufacture, use and sell for the life of the patent are considered to be 'sales or exchanges' because, in substantive effect, all 'right, title, title, and interest…is transferred.'" H.R. [or S.R.] 1662 (1954).

[5] There is also basis offset against capital gain; not with ordinary income.

[6] If a sale, gain is recognized immediately (unless installment sale available). If a license, Section 451 controls the timing of income (generally immediate inclusion, but one-year deferral may be possible under Section 451(c)).

BDO INSIGHT

Consider whether the collaboration should be structured as an IP purchase or license.

Ascertain whether it is possible to defer the recognition of taxable income for any upfront payments under IRC Section 451(c), which provides for a one-year deferral of income.

Evaluate the tax accounting methods accorded to the payments—whether such amounts are deductible or capitalizable (and, if capitalizable, the period of time over which they may be amortized), when these payments should be recognized into income, and whether any potential deferral of income or accelerated deduction opportunities exist.

R&D Tax Credits – Which Party Benefits?

Question can arise regarding which party in a collaboration arrangement is entitled to R&D credits. Allocating R&D expenses is crucial because both parties cannot claim the same expenses to support an R&D credit claim. Generally, in collaboration arrangements, the party that bears the financial risk of the research's success is entitled to treat the related expenses as support for an R&D credit claim. This assumes that both parties in a collaboration agreement retain rights to use the research results without needing permission to use them or paying for the right to use them.

The inclusion of upfront fees and milestone payments can make it difficult to determine who ultimately bears the financial risk. It is essential to analyze all aspects of the agreement, because terms such as warranty, acceptance, inspection, and cancellation clauses are critical in understanding who bears the financial risk and who is entitled to the R&D credit for those expenses. In many cases, financial risk related to milestone payments is not an all-or-nothing conclusion because some milestone payments can carry varying degrees of financial risk.

Also, collaboration agreements and research agreements among related entities often do not consider who bears the financial risk and who has rights to the research. Instead, they generally allocate the expenses for the credit to the entity that performed the work, regardless of who ultimately paid for it or owns the IP.

Even though regulations for IRC Section 174 have yet to be released, pre-regulatory guidance addresses collaboration and research arrangements. While the definitions of the terms "financial risk" and "rights to use research results" are similar for the R&D credit and under Section 174, there are some important differences. The rules regarding research payers and providers for the R&D credit are structured so that in general, only one entity claims an R&D credit for the expenses incurred. This stems from the requirement that an entity that wants to claim the credit for research activities must have both financial risk and rights to the research results.

Notice 2023-63, which provides guidance on Section 174, states that an entity will incur Section 174 expenses if it has either financial risk or rights to the research results. The "or" component can result in both the research payer and provider having Section 174 expenses.

Notice 2023-63 also addresses the granting of rights through royalty or license agreements within the research agreement. Any right for which a taxpayer must pay for the use of or seek permission to use the research it developed under an agreement cannot be considered for the R&D credit. The Section 174 guidance generally follows a similar structure, with one notable exception: A research provider's expenses can be classified as Section 174 expenses if the research agreement allows use of the research upon securing the permission of a related party. This can create situations in which both related taxpayers have Section 174 expenses on the same activity and expense. Future regulations, expected in the second half of 2024, might address these issues.

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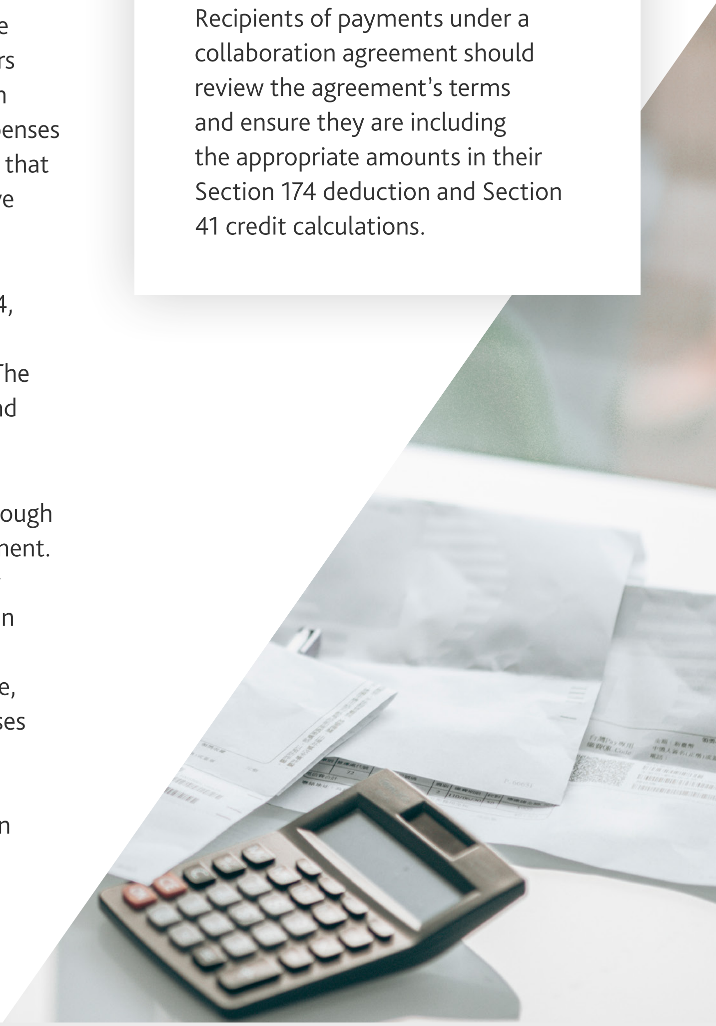
Recipients of payments under a collaboration agreement should review the agreement's terms and ensure they are including the appropriate amounts in their Section 174 deduction and Section 41 credit calculations.



Additional Considerations

In the context of collaboration agreements, life science companies should consider several other key factors.

FINANCIAL STATEMENT REPORTING

ASC 808, "Collaborative Agreements," does not provide specific recognition or measurement guidance on the accounting for a transaction between participants of a collaborative arrangement. That lack of authoritative guidance has led to diversity in the manner of accounting for these transactions. Implementation of ASC 606, "Revenue From Contracts With Customers," created uncertainty regarding whether a collaborative arrangement should be accounted for under ASC 606 or other guidance. In November 2018, the Financial Accounting Standards Board issued ASU 2018-18 to clarify the interaction between ASC 808 and ASC 606.

ASC 740 INCOME TAX ACCOUNTING

Once the proper tax and accounting treatments for collaboration agreements are determined, companies will need to consider the appropriate **income tax accounting**. One factor is the recognition of deferred tax assets, which would need to be assessed for realizability as part of a company's overall valuation allowance determination. Companies also would need to consider whether any uncertain tax positions need to be recorded under ASC 740-10.

NET OPERATING LOSS UTILIZATION

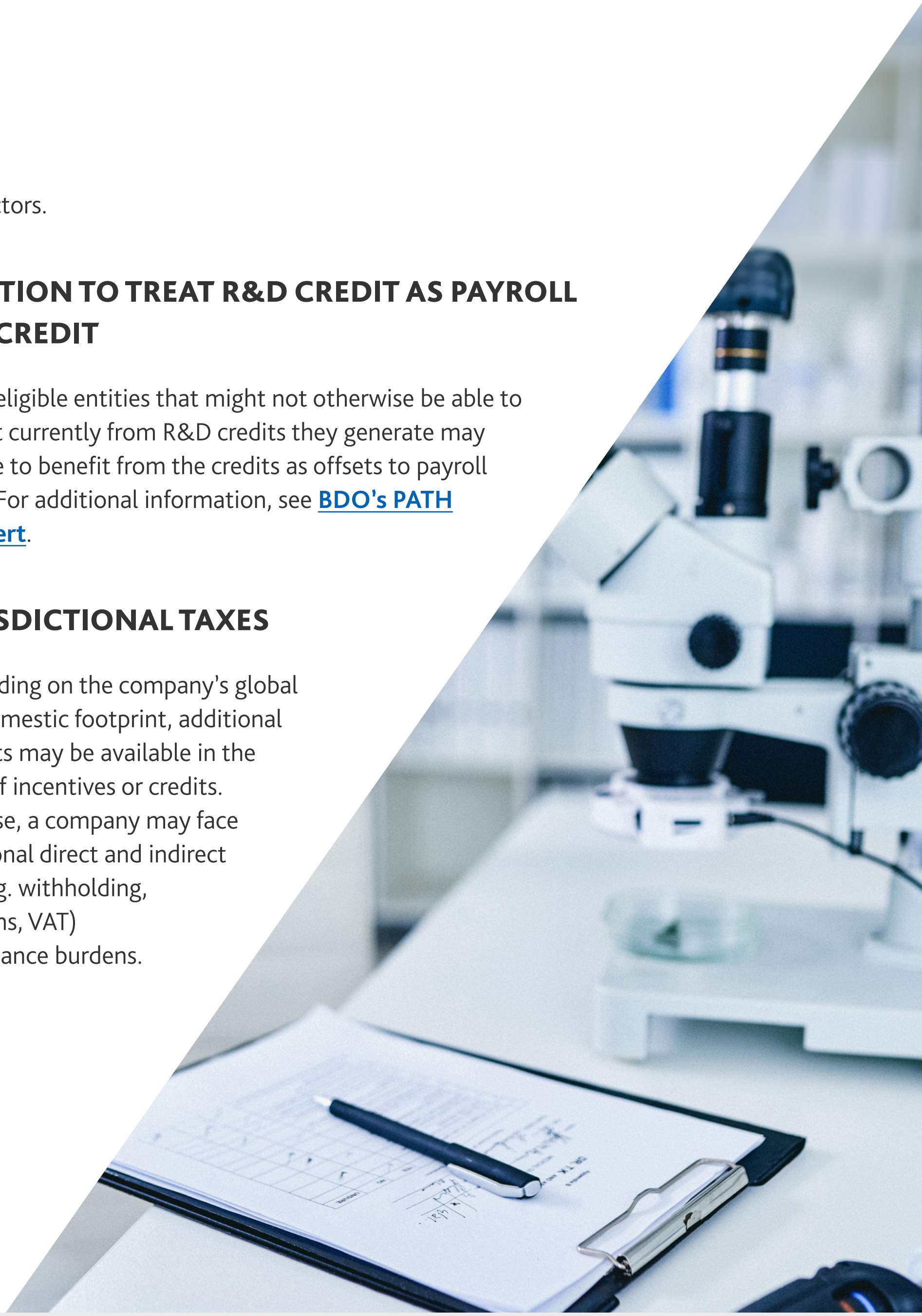
Collaboration agreements may provide a source of revenue for companies that are historically in loss-making positions. This may allow for the use of existing net operating losses (NOLs) to offset a portion of the income subject to limitations. Companies also will need to determine whether there is a limitation on the ability to use NOLs because of an ownership change as determined under **IRC Section 382**.

ELECTION TO TREAT R&D CREDIT AS PAYROLL TAX CREDIT

Some eligible entities that might not otherwise be able to benefit currently from R&D credits they generate may be able to benefit from the credits as offsets to payroll taxes. For additional information, see **BDO's PATH Act alert**.

JURISDICTIONAL TAXES

Depending on the company's global and domestic footprint, additional benefits may be available in the form of incentives or credits. Likewise, a company may face additional direct and indirect tax (e.g. withholding, customs, VAT) compliance burdens.



Summary

Life science companies contemplating and entering collaboration agreements will benefit from a thorough advance tax analysis. Unforeseen and costly compliance burdens can be avoided, and tax positions optimized, when such considerations are addressed throughout the life of the deal from planning to filing. Determining whether a collaboration results in a partnership that was intended to be solely a contractual relationship or whether the terms of the agreement result in a sale or license of property (tangible or intangible) are the types of preliminary tax analysis required by all parties to an agreement. Incentives such as the R&D credit and who is entitled to claim them will accordingly flow from the analysis.

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