6 Tax Considerations For Life Sciences Collaboration Deals

By **Peter Connors, Michael Hirschfeld and David Schulman** (October 20, 2022)

Collaboration agreements are a mainstay of the biotech industry, but they raise some unique tax considerations. Here are six common tax issues they present:

Peter Connors

Michael Hirschfeld

David Schulman

1. The funding payments may be subject to withholding taxes.

2. Starting in 2022, research and development expenses are no longer tax-deductible.

3. Income earned offshore in a foreign corporation from intangibles is subject to a lower rate of taxation than income earned in a U.S. corporation.

4. The collaboration arrangement could be treated as a tax partnership, particularly if it has co-promotion and profit-sharing terms.

5. If the arrangement is deemed to be a tax partnership, some expenses could be disallowed.

6. If the arrangement appears likely to be deemed a tax partnership, the parties should take defensive measures.

The Basics: Life Sciences Collaboration Agreements

For emerging companies with innovative technologies and an R&D focus, collaboration agreements provide funding, validation, clinical development and commercialization capabilities.

They often involve U.S. and non-U.S. entities and cross-border activities, which can add complications. For biotech or pharmaceutical companies, the agreements provide access to innovative new therapies and cutting-edge R&D.

The parties to a collaboration agreement pledge to work together to develop a therapeutic or technology. The agreements specify who does what.

One party typically licenses its intellectual property to the other. It is not uncommon for the agreement to include a joint steering committee to handle project administration and go or no-go decisions. The agreement may include an outright transfer of certain intellectual property, or at least exclusive rights. Agreements often include co-promotion rights and profit allocations.

These arrangements raise the possibility that regulators will deem a life sciences collaboration agreement a tax partnership, as the IRS chief counsel recently did, even though most collaboration agreements assert that the arrangement is not intended to create a partnership.

Six Things to Know About Taxes and Life Sciences Collaboration Agreements

1. The funding payments may be subject to withholding taxes.

Payments to persons outside the U.S. for using intellectual property in the U.S. are subject to a 30% withholding tax. While license payments are typically paid over a certain period of time, the funding payment could be characterized as a prepaid royalty, subject to withholding taxes, even if the payment is not in cash.

The U.S. has treaties that reduce the rate of withholding on license payments, but treaty relief requires the recipient to be a resident in the country that is a party to the treaty.

The licenses in a collaboration agreement may be characterized as sales of intellectual property if they provide the licensee with exclusive rights. These too can be subject to withholding taxation.

Amounts paid in connection with the sale are subject to withholding if the payments are contingent on the productivity, use or disposition of the intellectual property.

2. Starting in 2022, R&D expenses are no longer tax-deductible.

The Tax Cuts and Jobs Act made major changes to the R&D tax deduction rules that had been in place for almost 70 years.

Starting in 2022, companies can no longer deduct R&D expenditures. Instead, they have to deduct them over five tax years, beginning with the midpoint of the tax year in which the research or experimental expenditures are paid or incurred. R&D expenses incurred outside the U.S. must be deducted over 15 years.

This will be the first time since 1954 that companies will amortize rather than immediately deduct R&D costs, a requirement not unique to life sciences companies.

Some have called for these changes to be reversed. For now, though, parties negotiating a collaboration agreement still must decide how the tax benefit for these expenditures will be allocated even though the bulk of the tax deductions may be deferred.

Many European jurisdictions treat R&D expenses differently, and some have favorable regimes for R&D activities. If the collaboration involves an entity outside the U.S., the parties should consider whether to locate R&D activities outside of the U.S.

3. Income earned offshore in a foreign corporation from intangibles is subject to a lower rate of taxation than income earned in a U.S. corporation.

Perhaps the most prominent change in the Tax Cuts and Jobs Act was the reduction of the corporate tax rate from 35% to 21%.

A further significant change involves the treatment of amounts earned in controlled foreign corporations. The law created a new category of offshore income, global intangible low-taxed income, commonly referred to as GILTI.

In broad terms, this category covers most remaining offshore income — 50% of which is subject to current taxation. When this income is repatriated to the U.S. parent, it is not taxable.
While this income was not currently taxable under the law before the Tax Cuts and Jobs Act,

it would have been subject to full taxation at the 35% rate if repatriated.

The fact that this income is low-taxed creates an incentive to keep income offshore. As a result, if the income from the arrangement has a foreign-source component, it is often advantageous to earn the income in an offshore corporation.

Parties could consider creating foreign corporations as part of structuring a collaboration arrangement, particularly where intellectually property can be transferred outside of the U.S. at an early stage in development, when its value — and corresponding taxation — may be lowest.

4. The arrangement could be treated as a tax partnership, particularly with co-promotion and profit-sharing terms.

Collaboration agreements typically specify that the arrangement is not intended as a partnership for tax purposes, but it's the arrangement's substance that governs how authorities treat it from a tax perspective.

Two court cases address what kinds of agreements constitute partnerships.

In its 1949 Commissioner v. Culbertson decision,[1] the U.S. Supreme Court focused on whether parties acting in good faith and with a business purpose intend to join together in the conduct of a business.

In Luna v. Commissioner,[2] the U.S. Tax Court in 1964 analyzed a number of factors to determine whether a partnership existed, including:

- The agreement of the parties and their conduct in executing its terms;
- The contributions each party has made to the venture;
- The parties' control over income and capital, and the right of each to make withdrawals;
- Whether each party was a principal and co-proprietor, sharing a mutual proprietary interest in net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving contingent compensation in the form of a percentage of income;
- Whether business was conducted in the joint names of the parties; and
    - Whether the parties:
        - Filed federal partnership returns or otherwise represented themselves as joint venturers to the IRS or others;
        - Maintained separate books of account; and
        - Exercised mutual control over and assumed mutual responsibilities for the enterprise.

In a recent chief counsel advice,[3] the IRS determined that a collaboration between two corporations was a partnership for tax purposes. The agency said the companies acted with a business purpose, joined together to conduct an enterprise, and shared in profits and losses.

Sharing in losses alone may not indicate a tax partnership, though, since the losses allocated to each participant may just reflect each party claiming losses for invested capital.

Sharing profits from U.S activities may be enough to trigger tax partnership status. If profits from only non-U.S. activities and non-U.S. source income are shared, though, there may be less risk of a partnership determination.

Since its release, the chief counsel advice has created a stir in the life sciences industry, as collaboration agreements often involve sharing profits.

A partnership is a pass-through entity for tax purposes, so treating the collaboration agreement as a partnership does not result in an added tax that would occur if a jointly owned corporation conducted such activities.

Nonetheless, rules in the partnership tax paradigm can affect the determination of taxable income or loss from the collaboration arrangement.

A partnership designation also triggers reporting and regulatory requirements, including some that can be categorized as tax traps, and failing to make such filings can expose parties to penalties.

If one party to a collaboration agreement is an entity outside the U.S., withholding requirements apply to arrangements classified as partnerships. Failure to withhold tax can expose the parties to penalties — even if U.S. tax has been fully paid by the participant outside the U.S.

If a foreign participant or cross-border activities are involved, the complicated new Schedule K-2 and K-3 reporting requirements apply. In fact, even if only U.S. participants are involved in U.S. activities, the K-2 and K-3 may still be required if its U.S. participants claim foreign tax credits, or their U.S. tax determination is affected by international operations. Failure to file K-2s and K-3s may lead to a penalty.

5. If the arrangement is deemed to be a tax partnership, some expenses could be disallowed.

Collaboration agreements that are deemed partnerships should spell out the methodology for sharing profits and losses and the underlying components of profit or losses. Companies have flexibility in how to share partnership items.

When a partnership is deemed to exist, the fallback methodology for sharing partnership items is based on a partner's share of profits or losses.

This issue came up in the same chief counsel advice in the context of a deduction for domestic production activities.

The IRS regulations provide that the deduction with respect to qualified production activities are determined at the partner level. As a result, each partner must compute its deduction separately. Each partner is allocated its share of partnership items — including items of income, gain, loss and deduction — cost of goods sold allocated to such items of income, and the gross receipts that are associated with such items of income.

6. If the arrangement appears likely to be deemed a tax partnership, the parties should take defensive measures.

If tax partnership status appears likely, the parties could retain their basic collaboration agreement but bite the bullet and file a U.S. partnership tax return.

In that case, they should add an exhibit to the collaboration agreement containing provisions customarily found in a partnership or limited liability company agreement, such as tax allocation and maintenance of capital account provisions, as well as partnership representation and tax audit provisions.

Where U.S. profits are shared, this defensive maneuver may cause less pain than dealing with a potential tax audit where a determination by the IRS that a partnership exists appears likely.

Peter Connors is a partner at Orrick Herrington & Sutcliffe LLP. He previously served as president of the American College of Tax Counsel.

Michael Hirschfeld is a managing director at Andersen Tax LLC. He formerly served as chair of the American Bar Association's tax section.

David Schulman is a partner at Orrick.

[1] Commissioner v. Culbertson, 337 U.S. 733 (1949).

[2] Luna v. Commissioner, 42 T.C. 1067 (1964).

[3] https://www.irs.gov/pub/irs-wd/1323015.pdf.