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Massachusetts Life Sciences Initiative Offers Biotech Industry \$250 Million in Tax Benefits

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One quarter of the Commonwealth's new \$1 billion life sciences initiative, signed into law by Governor Deval Patrick on June 16, 2008, has been set aside for tax incentives for life sciences companies, placing Massachusetts in the forefront among states using tax policy to attract biopharmaceutical development. The "Act Providing for the Investment in and Expansion of the Life Sciences Industry in the Commonwealth" (the "Act") not only creates opportunities but also raises questions about how companies can obtain benefits under the Act. The Act provides up to \$25 million annually in tax benefits from January 1, 2009 through December 31, 2018.

Administration of the Act and Criteria for Eligibility

The Massachusetts Life Sciences Center (the "Center"), a quasi-public agency created by the Massachusetts legislature in June of 2006, is responsible for the Act's administration. The Center is governed by a board of seven directors representing constituencies of the life sciences industry, including individuals from the public, corporate, professional and academic fields. To be eligible for tax incentives and other benefits provided by the Act, a company must apply to the Center for certification, and the company's application must be approved by a vote of a majority of the directors. Each application must contain a certification proposal that includes:

- A. An estimate of the additional state tax revenue that the life sciences company expects to generate during its period of certification;
- B. A plan to create the expected additional revenue stating, among other items, a year-by-year projection

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of (i) additional revenue that will inure to the Commonwealth, (ii) the number of additional and retained permanent full-time employees, and (iii) the salaries the company expects to pay such employees;

C. Documentation of any agreements between the life sciences company and banking institutions with which the company has agreed to establish accounts (in furtherance of the Commonwealth's small business capital access program); and

D. If applicable, documentation that the company has received approval for a "certified project" that has been designated as such by the Economic Assistance Coordinating Council.

The Center may approve an application if it finds that the life sciences company meets the above requirements, the company is expected to meet the new state revenue and employment growth projections specified in the company's certification proposal, and the company's application and any investigation conducted by the Center evidence that the company will meet other criteria the Center may prescribe. Further, the Act suggests that the Center might consider the following criteria in evaluating applications for certified life sciences company status:

- Whether the life sciences company has sufficient Massachusetts "business contacts" as evidenced by its business activity within the Commonwealth (such as the number of full-time employees the company retains in Massachusetts);
- The company's potential to further technological advancements in the life sciences;
- The company's potential to offer a breakthrough medical treatment for a particular disease or medical condition;
- The company's potential for leveraging additional funding or attracting additional resources to the Commonwealth;
- The company's potential to promote life sciences

manufacturing in the Commonwealth; and

- Evidence of potential royalty income “and contractual means to recapture such income.”

A certified life sciences company will retain its certification for five years and must file annual reports during that period. Certification may, however, be revoked upon the occurrence of certain events, such as a failure to achieve at least 70 percent of the return on investment projected in the certification proposal. Effective as of the revocation of a company’s certification, a company will lose the benefits it obtained pursuant to the Act at least prospectively.

Each tax incentive must be expressly granted by the Commonwealth’s Secretary of Administration and Finance in writing. The Department of Revenue has been charged with generating a detailed accounting of the projected costs and benefits to the Commonwealth of all tax incentives awarded to certified life sciences companies under the Act.

Tax Incentives Provided

The benefits authorized by the Act represent a *ceiling* on what a certified life sciences company potentially could receive – that is, the Center may in its discretion restrict the types and levels of benefits provided to each particular applicant. For example, the Center might determine that a particular certified company that is eligible for all of the tax incentives under the Act should nonetheless receive only the refundable research and development credit described below, or that the company should only receive investment tax credits at the rate of, say, 6 percent (which is less than the statutorily authorized limit of 10 percent).

Certified life sciences companies will be eligible for the following benefits during the periods from January 1, 2009 through December 31, 2018:

- A 10 percent Investment Tax Credit (ITC) against individual or corporate excise taxes, as applicable, will apply to the cost of tangible depreciable property used exclusively within Massachusetts. The 10 percent ITC is an increase over the 3 percent ITC generally afforded by statute for qualifying manufacturing and research and development corporations. If a company has insufficient tax liability to absorb the credit, it may be made up to 90 percent refundable.

Credit Against FDA Fees

- The United States Food and Drug Administration (the “FDA”) is authorized to collect fees known as “user fees” from companies that develop and produce certain human drug and biological products. A company can incur as part of the human drug development and approval process, among other fees, FDA application fees, establishment fees, product fees, and supplement

fees. The Act authorizes the Center to grant certified life sciences companies that incur research and development costs for human drugs predominantly within Massachusetts a credit against individual or corporate excise taxes measured by the entire amount of such user fees that may be made up to 90 percent refundable.

Carry Forwards

- Generally, Massachusetts corporations can carry forward net operating losses (“NOLs”) for up to five years. The Act authorizes the Center to extend the amount of time a life sciences company may carry forward its NOLs incurred in any taxable year to 15 years.

Eliminating “Throwback” Rule

- A corporation with activity in states other than Massachusetts generally determines its Massachusetts income for purposes of calculating its state corporate excise by applying a formula composed of three factors – property, payroll and sales. Manufacturing entities, by contrast, are permitted to apportion income to Massachusetts based solely on sales. The general rule for sourcing sales of tangible personal property is destination-based: if the property is delivered to a purchaser in Massachusetts, the sale is attributed to Massachusetts. In addition, Massachusetts has imposed a “throwback” rule, which reassigns receipts from sales outside of Massachusetts back to Massachusetts in cases where (A) the company is not taxable in the destination state, and (B) the taxpayer’s salesperson is not chiefly based at the taxpayer’s business premises outside of Massachusetts. The Act enables the Center to eliminate this “throwback” rule for certified life sciences companies, which should decrease the tax base upon which such companies’ Massachusetts corporate excise is calculated.
- In Massachusetts, a corporation that qualifies as a “research and development corporation” (“R&D corporation”) generally becomes eligible for a 3 percent non-refundable ITC, as described above. In addition, the sale or use of machinery or replacement parts and materials used exclusively in research and development by an R&D corporation is exempt from sales and use tax. To qualify for R&D corporation status, a business typically must be a corporation that demonstrates that its principal activity in Massachusetts is research and development, and that either (A) the corporation derives more than two-thirds of its Massachusetts receipts from research and development during the taxable year, or (B) more than two-thirds of the corporation’s Massachusetts expenditures are allocable to its research and development activities during the

taxable year. (A corporation that qualifies for R&D status solely because of the expenditures test is eligible for sales tax benefits but not for the ITC.) The Act will permit the Center to waive the statutory requirements for certified life sciences companies, so that a certified life sciences company may become eligible only for the sales or use tax exemption benefits (but not for the ITC) that accompany R&D corporation status, regardless of the form of entity the life sciences company has chosen and whether or not the company meets the receipts or expenditures test.

- The Act further incentivizes research and development by converting the previously nonrefundable research and development credit into a 90 percent refundable credit for certified life sciences companies. The Act also authorizes the Center to treat clinical trial activities occurring outside the Commonwealth as creditable for such companies.
- Section 45C of the IRC provides for an “orphan drug credit”, for expenses incurred in clinical testing of drugs for a rare disease or condition. At the federal level, the credit equals 50 percent of a taxpayer’s current-year qualified clinical testing expenses. There is also a federal rule that eliminates the otherwise-allowable deduction for such expenses. The rule is intended to avoid conferring a double benefit for these expenditures. Massachusetts has no equivalent credit, but it has historically disallowed the deduction in conformity with the federal rule. The Act authorizes the Center to in effect reinstate the deduction for Massachusetts purposes on a company-by-company basis.
- The Act’s final tax incentive is a sales tax exemption for sales of tangible personal property “for use in connection

with the construction, alteration, remodeling, repair or remediation of research, development or manufacturing facilities and utility support systems,” where utility support systems are defined to include site, civil, mechanical, electrical and plumbing systems. While this exemption has been characterized as exempting only personal property used to construct and repair utility support systems, it appears that the language of the Act is broader, and should be read to include the “bricks and mortar” used to construct life sciences company facilities.

What Comes Next

The Center is expected to hire a “point person” to work with prospective and current certified life sciences companies, the Office of Housing and Economic Development, the Department of Revenue, and other governmental agencies to facilitate the administration of the life sciences tax incentives. The Center has also expressed a goal to flesh out the application process and criteria for certification by later this fall. Companies that may qualify for life sciences tax benefits therefore should monitor closely the progress of the Center as it moves forward to implement the program in the coming months.

The information in this Advisory is not intended to constitute legal advice or a legal opinion as to any particular matter. □

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