**PLR counts clinical testing expenses incurred after accelerated approval date toward orphan drug credit**

**February 27, 2018**

**In brief**

The Internal Revenue Service (IRS) on January 12, 2018 released a taxpayer-favorable private letter ruling (PLR 201802003), concluding that a taxpayer claiming the orphan drug credit (ODC) for qualified clinical trial expenses (QCTEs) may include QCTEs incurred after the date on which the Food and Drug Administration (FDA) granted a drug ‘accelerated approval.’

The PLR is noteworthy in that it seems to recognize that not all drug development post-marketing study activities are excluded as post-commercialization under Reg. sec. 1.41-4(c)(2)(ii). This is consistent with the general principle that the post-commercial research exclusion is not intended to disallow from credit eligibility expenditures that otherwise meet the general research credit (and ODC) eligibility requirements.

Under that exclusion, expenses related to post-commercialization activities generally are not allowed in calculating the research credit under Section 41 of the Internal Revenue Code, and therefore not in calculating the Section 45C ODC as well.

**In detail**

**Background**

Section 45C provides a credit for clinical testing expenses relating to so-called orphan drugs — certain drugs intended to treat rare diseases or conditions that are designated as such by the FDA. For tax years beginning prior to January 1, 2018, the ODC equals 50% of QCTEs for the tax year. For years beginning on or after January 1, 2018, the ODC rate is reduced to 25% of such amounts and may consider a reduced credit election.

For ODC purposes, QCTEs, as defined in Section 45C(b)(1)(A), are amounts paid or incurred by the taxpayer that would be described as qualifying research expenditures (QREs) under Section 41(b), with two modifications. First, ‘clinical testing’ is substituted for ‘qualified research’ in Sections 41(b)(2) and (3). Second, 100% (as opposed to 65% or 75%) of contract research expenses is treated as clinical testing expenses.

QCTEs generally are those incurred from the date on which the FDA designates a drug as an orphan drug and before the date on which the FDA grants final approval to market the drug.

In certain cases, the FDA may grant accelerated approval to market a drug under 21 CFR 314.500, prior to granting final approval to market that drug under Section 505(b) of the Federal Food, Drug, and Cosmetic Act (FDCA). The FDCA authorizes the FDA to accelerate the approval process for products for serious or life threatening diseases or conditions, taking into account the severity, rarity, or prevalence of the condition or availability or lack of treatment alternatives.
Under Section 506(c)(2) of the FDCA, the FDA can require the sponsor of a product approved under the accelerated approval process to conduct post-approval studies, referred to as post-marketing requirements studies (PMR), to verify and describe the predicted effect on irreversible morbidity or mortality or other clinical benefit. Depending on the results of the PMR, the FDA can withdraw its accelerated approval, determine that the studies verify and describe the drug’s clinical benefit, or notify the sponsor that the studies no longer are necessary for the safe and effective use of the drug.

Post-commercialization exclusion
Reg. sec. 1.41-4(c)(2)(i) provides the following exclusion from the definition of QREs, and therefore QCTEs as well: “Activities conducted after the beginning of commercial production of a business component are not qualified research.” This is known as the ‘post-commercialization exclusion.’

Under this exclusion, expenses related to post-marketing studies, typically classified as ‘Phase IV studies’ even if similar to protocols from earlier phases, generally are disallowed.

**Note:** Reg. sec. 1.41-4(c)(2)(iv) states: “Additional clinical testing of a pharmaceutical product after a product has been approved for a specific therapeutic use by the FDA and is ready for commercial production and sale is not treated as occurring after the beginning of commercial production if such clinical testing is undertaken to establish new functional uses, characteristics, indications, combinations, dosages, or delivery forms for the product. A functional use, characteristic, indication, combination, dosage, or delivery form shall be considered new only if such functional use, characteristic, indication, combination, dosage, or delivery form must be approved by the Food and Drug Administration.”

Applying that language, IRS examiners may allow expenses of post-marketing studies for new indications and uses, but those generally are considered ‘Phase IIIb’ studies (i.e., treated the same as Phase III trials conducted after submission of a new drug application (NDA), but prior to the medicine’s approval and launch).

**Observation:** The preamble to the regulations specifically states that Reg. sec. 1.41-4(c)(2)(iv) is not a rule of exclusion and that “the Treasury Department and the IRS believe that the research after commercial production exclusion (as well as the adaptation and duplication exclusions) do not cover research activities, including these additional clinical trials, so long as such trials satisfy the requirements for qualified research.” All Phase IV trials therefore should be evaluated to determine whether they meet the requirements for qualified research.

**PLR 201802003**

**Simplified facts**

The taxpayer in PLR 201802003 filed a new drug application (NDA) for a certain drug. The FDA granted orphan drug designation to that drug, after which the taxpayer applied to the FDA for approval to market it. The FDA approved the drug for treatment of a certain condition under the accelerated approval program, subject to the FDCA Section 506(c)(2) requirement of a PMR study to verify the drug’s clinical benefit.

The taxpayer requested a ruling from the IRS that its QCTEs may include expenses for clinical trials occurring after the date the FDA granted accelerated approval of the drug and before the date on which the taxpayer receives notification from the FDA that the post-marketing studies are no longer necessary for the safe and effective use of the drug, or the date on which the FDA determines that the required post-marketing study verifies and describes the drug’s clinical benefit.

**Analysis**

The PLR states that PMRs required as conditions of accelerated approval are clinical studies within the meaning of Section 45C. The IRS adds that “accelerated approval is not a final approval as contemplated by the cross reference to [the final approval provision of the FDCA] Section 45C(b)(2)(A)(ii)(II).”

The PLR therefore concludes that expenses relating to certain post-marketing studies incurred after accelerated approval may be included as QCTEs. The PLR clarifies that such expenses may qualify as QCTEs if they were a required condition of the accelerated approval and are incurred prior to the date the taxpayer “receives FDA notification that the post-marketing study requirements are no longer necessary for the safe and effective use of the Drug, or the date the FDA determines that the required Drug post-marketing study verifies and describes the drug’s clinical benefit.”

**The takeaway**

Taxpayers seeking to claim the ODC should consider the PLR’s conclusion when calculating their QCTEs to potentially benefit from the credit. Taxpayers also should evaluate trials associated with new indications, as well as all Phase IV trials, to determine whether they satisfy the requirements of Reg. sec. 1.41-4(c)(2)(iv) or Section 41 more generally.
Note: When considering both domestic and global clinical trials for rare diseases as well as new indications, taxpayers should consider clinical trials that satisfy the FDCA Section 505(i) definition regardless of location. Section 45C(b)(2)(A)(i) states that the clinical testing has to be carried out under an exemption for a drug being tested for a rare disease or condition under Section 505(i), which allows taxpayers to consider expenses for trials performed outside the United States as provided by Section 45C(d)(2)(A).

Let’s talk
For additional details on how the PLR may affect your business, please contact:

Pharmaceutical and Life Sciences
Kathleen Michael  
(973) 236-4210  
kathleen.michael@pwc.com

Benjamin Proce  
(973) 236-4864  
benjamin.proce@pwc.com

Washington National Tax Services
Kendall Fox  
(408) 921-9742  
kendall.b.fox@pwc.com

Specialized Tax Services
Randy Friedman  
(267) 330-3458  
randel.friedman@pwc.com

Craig Grosswald  
(646) 471-8684  
craig.b.grosswald@pwc.com

Brett Ritter  
(703) 918-6689  
brett.ritter@pwc.com

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