

The Tax Cuts and Jobs Act of 2017 and the Pharmaceutical Industry

Health Policy Portal

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Although the pharmaceutical industry has historically generated higher-than-average profits, manufacturers frequently point to the U.S. tax system as an impediment to meaningful innovation and expansion of domestic infrastructure. Yet in recent years, large U.S. drug manufacturers have generated controversy by seeking mergers with foreign firms — so-called tax inversions, which involve movement of a corporation's legal headquarters to a country with a lower tax rate than the U.S. — and have been criticized for keeping substantial revenues tied up overseas rather than “repatriating” the funds back to their U.S. operations, where they would be subject to U.S. taxes.

The passage of the Tax Cuts and Jobs Act from the Republican-led Congress will heavily impact these issues. Three central components of the Act are a reduction in the U.S. statutory corporate tax rate, a one-time repatriation tax holiday for foreign holdings of U.S. corporations, and a switch to a territorial system for taxation for multinational corporations. For corporations with more than \$10 million in annual revenue, the Act lowered the maximum tax rate from 35% to 21%. It also allows repatriation of corporate foreign profits at markedly reduced rates of 14.5% for cash holdings and 7.5% for non-cash holdings. Finally, the U.S. system of corporate taxation has been converted from a worldwide system (in which foreign revenues were subject to U.S. taxes) to a territorial system (in which only domestic rev-

enues are subject to U.S. taxes). By making these changes to the tax code, the Act purports to stem inversions by U.S. corporations and stockpiling of revenues overseas.

So how will such changes affect large pharmaceutical manufacturers? The top eight U.S.-based pharmaceutical manufacturers by reported 2016 gross revenue were Johnson & Johnson, Pfizer, Merck, Gilead, AbbVie, Amgen, Eli Lilly, and Bristol-Myers-Squibb. After obtaining gross revenues and effective tax rates for each corporation from publicly available annual reports and 10K filings, we estimated what these manufacturers' 2016 federal tax liability would have been under the Act by adjusting the baseline tax rate from 35% to 21% with all else held constant. By doing so, we preserve the effect of major tax incentives for pharmaceutical manufacturers, including the research and experimentation tax credit, the orphan drug tax credit, and the credit for taxes paid to foreign jurisdictions. Though the orphan drug tax credit was reduced in the Act from 50% to 25% of qualified research expenditures, it accounted for only \$1.76 billion industry-wide in 2016.¹

The top eight manufacturers earned a median of \$28.0 billion in gross revenue in 2016 (interquartile range [IQR] \$22.5–\$43.1 billion) (Table 1). Median income before taxes was \$8.1 billion (IQR \$5.6–\$11.1 billion). A flat corporate tax on this amount at the statutory rate of 35% would have resulted in a median payment of \$2.8 billion per manu-

About This Column

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Table 1

Gross Revenues with Estimated and Reported Tax Burdens of Large Pharmaceutical Manufacturers

	Johnson & Johnson	Pfizer	Merck	Gilead Sciences	AbbVie	Amgen	Eli Lilly	Bristol-Myers Squibb	Median
Total Revenue in 2016	71,890	52,824	39,807	30,390	25,638	22,991	21,222	19,427	28,014
Income Before Taxes in 2016	19,803	8,351	4,659	17,097	7,884	9,163	3,374	5,915	8,118
2016 Tax Obligation at Statutory Rate of 35%	6,931	2,923	1,631	5,984	2,759	3,207	1,181	2,070	2,841
2016 Actual Tax Paid (ETR)	3,263 (16.5%)	1,123 (13.4%)	718 (15.4%)	3,609 (21.1%)	1,931 (24.5%)	1,441 (15.7%)	636 (18.9%)	1,408 (23.8%)	1,425 (17.7%)
Estimated Taxes Owed Under TCJA (ETR)	1,958 (9.9%)	674 (8.1%)	431 (9.3%)	2,165 (12.7%)	1,159 (14.7%)	865 (9.4%)	382 (11.3%)	845 (14.3%)	855 (10.6%)

*All values in \$ millions

facturer (IQR \$2.0–\$3.9 billion). By comparison, the median reported effective tax rate in 2016 was 17.7% (IQR 15.6–21.8%), resulting in a median of \$1.4 billion in taxes (IQR \$1.0–\$2.3 billion). Starting with a new statutory tax rate of 21% under the Act, the median effective tax rate for 2016 drops to 10.6% (IQR 9.4–13.1%) based on 2016 tax deductions per company — an estimated median tax obligation of \$855 million (IQR \$0.6–\$1.4 billion). Our model therefore arrived at a median tax savings of \$570 million per company. Of note, the effective tax rate includes only taxes on domestic revenue; manufacturers obtained deductions on their U.S. tax bill due to taxes paid to foreign governments.² A 2017 report found that these eight manufacturers held approximately 90% of all 2016 and 2017 cash holdings abroad.³

Next, we examined the economic impact of repatriating overseas revenues using two data sources for overseas holdings. According to those reports, the manufacturers in our cohort held a median of \$22.2 to \$37.1 billion in assets abroad in 2016.⁴ If all overseas holdings were in cash and were repatriated, the one-time repatriation under the Act would generate a median of \$3.2 to 5.4 billion per manufacturer (Table 2). This estimate represents a ceiling, because foreign non-cash holdings are repatriated at a lower rate and may include certain assets — such as

real estate or manufacturing equipment — that are not amenable to repatriation.

Proponents of repatriation tax holidays assert that foreign earnings of U.S. corporations could be brought back for research and development, domestic jobs, and infrastructure.

five corporations held a median of \$19.6 billion overseas and repatriated a median of 69% of those funds.⁵ At a nearly three-fold higher repatriation rate under the Act, major pharmaceutical manufacturers are likely to repatriate a smaller percentage of overseas revenues than they did in

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The last repatriation tax holiday, created under the American Jobs Creation Act of 2004, set a rate of 5.25%. A 2011 Senate subcommittee report of the 2004 repatriation found that five pharmaceutical manufacturers in our sample were among the top ten repatriating entities — Pfizer, Merck, Johnson & Johnson, Bristol-Myers Squibb, and Eli Lilly. In 2004, these

2004.

Several other themes emerged among major corporations repatriating funds in 2004: lost U.S.-based jobs and decreased research and development expenditures coupled with increased executive compensation, stock buybacks, and shareholder distributions.⁶ This occurred in spite of federal regulations at the

Table 2

Predicted Economic Impact of Repatriating Overseas Revenue by Large Pharmaceutical Manufacturers

		Johnson & Johnson	Pfizer	Merck	Gilead Sciences	AbbVie	Amgen	Eli Lilly	Bristol-Myers Squibb	MEDIAN
Credit-Suisse Estimates ⁴	Cash Overseas	41.3	22.5	21.9	27.4	7.4	35.9	9.8	8.0	22.2
	Repatriation (35%)	14.5	7.9	7.7	9.6	2.6	12.6	3.4	2.8	7.8
	Repatriation (14.5%)	6.0	3.3	3.2	4.0	1.1	5.2	1.4	1.2	3.2
Institute on Taxation and Economic Policy (ITEP) Estimates ⁴	Cash Overseas	66.2	197.1	63.1	37.6	29.0	36.6	28.0	25.7	37.1
	Repatriation (35%)	23.2	69.0	22.1	13.2	10.2	12.8	9.8	9.0	13.0
	Repatriation (14.5%)	9.6	28.6	9.1	5.5	4.2	5.3	4.1	3.7	5.4

*All values in \$ billions

time prohibiting the use of repatriated funds for such purposes. Yet the 2017 legislation does not impose any such restrictions on repatriated funds. A new report from U.S. Senator Cory Booker (D-NJ) notes that although AbbVie, Amgen Merck, and Pfizer have already announced plans for share buybacks, and AbbVie, Pfizer and several other manufacturers plan dividend increases for 2018, none has announced an intention to lower drug prices.⁷

The impact of the new tax law is likely to be felt for several years to come; although a territorial tax system limits the need for future repatriations by exempting foreign income from tax liability, the new law does not include sufficient protection against misuse. Unlike other countries with territorial tax systems, the Act may not go far enough to prevent U.S. corporations from utilizing tax avoidance mechanisms such as base erosion and profit shifting — a book-keeping maneuver by which a multinational corporation shifts more profitable operations overseas while keeping less profitable ones in the U.S. and U.S.-based pharmaceutical manufacturers still have considerable incentive to undergo corporate inver-

sion or otherwise relocate business operations overseas.

Reduced tax revenues may lead to future cuts in public funding of biomedical research, such as the allocations promised in the 21st Century Cures legislation through 2026. And although the pharmaceutical industry contributes substantial resources of its own to drug development, the National Institutes of Health and academic medical centers, supported by public funding, have historically been the origin of much transformative research that has led to drug innovation.⁸ In the pharmaceutical industry, the Tax Cuts and Jobs Act will provide new tax savings to large manufacturers without commitment to invest in research and development.

Note

The authors have no conflicts to disclose.

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