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Tax reform means more cash for big pharma – albeit with an up-front fee

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As US corporate tax cut legislation reaches a critical stage in its progress, it is a useful time to ask just how close to zero taxation profit-making big pharma groups could get.

Looking at the large cap pharmaceutical makers with the lowest effective rates in 2016 reveals that dropping the corporate levy by 14 points could in theory get some well into the single digits, though maybe not immediately. Uncertainty surrounding treatment of overseas income means it is difficult to say how low biopharma's taxes might go, but the tables below suggest that many companies could end up paying less than the average American.

35% to 21%

Congressional leaders announced Wednesday that they had reached a compromise that blends separate bills passed by the Senate and House of Representatives. For biopharma groups, the big news is that the compromise legislation will lower the corporate tax rate from 35% to 21%, rather than the 20% passed in both the House and Senate bills. What is not clear yet is how overseas profits will be taxed.

To evaluate how these changes might affect the sector, *EP Vantage* looked at how the US-based big cap biopharmas with the lowest effective rates in 2016 trimmed their tax bills, as disclosed in a tax reconciliation appendix in their annual reports. It should come as no surprise that the bulk of the savings results from overseas operations that do not repatriate any of those profits (*How low can you go? US pharma already shoulders light tax burden, April 27, 2017*).

How big cap US biopharma lowered its tax bill in 2016 (%)					
	Pfizer	**Merck & Co**	**Amgen**	**Celgene**	**Johnson & Johnson**
Statutory rate (%)	35	35	35	35	35
International operations*	-13.8	-34.8	-17.8	-21.1	-17.2
Tax settlements	-5.5	-	-	-0.4	-
US health care legislation	1.3	1.4	-	-	-
US R&D tax credit and manufacturing deduction	-1	-	-0.7	-	-1
Legal settlements and charges	-2.9	-	-	-	-
Accounting adjustments	-	13.4		-	-
Restructuring	-	3.1	-	-	-
Share-based payments	-	-	-1.3	-	-1.8
State taxes	-	3.7	0.1	0.8	-0.1
Changes to valuation allowance	-	-	-	0.5	-
Acquisition & collaboration based differences	-	-	-	-0.7	-
Tax on international income	-	-	-	-	1.3
All other	0.3	-6.4	0.4	1.6	0.3
Effective tax rate (%)	**13.4**	**15.4**	**15.7**	**15.7**	**16.5**

**Includes Puerto Rico. Note: Statutory and effective tax rate expressed as percent, all other percentage points. Source: Company annual reports.*

Applying the proposed 21% statutory rate to 2016 profits – an admittedly unsophisticated view of corporate finance – suggests that the government would have ended up owing Pfizer money, while Merck, Amgen, Celgene and Johnson & Johnson would have been billed less than 3% of their earnings.

Year-to-year fluctuations mean that 2016 is no predictor of the future – indeed, as recently as 2014 Merck paid a 31% effective rate – but it illustrates the power of that big corporate rate cut.

Overseas cash

How the tax legislation would actually affect biopharma is not abundantly clear because of the complexities of individual corporations' finances. One can draw some conclusions based on the broad outlines of the statutory cut and how the US treats overseas income.

The latter has been a priority of the biopharma sector because profits made overseas are subject to taxation in both the country where the revenue was generated as well as the US. Companies claim it is cost-prohibitive to repatriate overseas profit, and therefore some, like Abbvie and Pfizer, have sought to acquire European companies for a more favourable tax domicile.

The bills would establish a "territorial" system of taxation starting in 2018, meaning no taxes on overseas profits in the future. Overseas cash that had been subject to tax under the previous law would be deemed in 2018 to have been repatriated and taxed at a 14% rate in the House bill and 14.49% in the Senate bill. Non-cash assets could be repatriated at a 7% and 7.49% respectively.

Merck's 2016 tax reconciliation disclosure sheds more light on how the various moving parts of the tax legislation could affect big biopharmas. The New Jersey-based group revealed not just the effective rate but also the amount it paid or was excluded on each of the lines.

The New Jersey group reported income before taxes of $4.7bn. Applying the current US federal rate to that yielded a tax bill of $1.6bn. At a 21% rate under the new scheme this would have been $978m.

Illustration of tax reform changes using Merck's 2016 reconciliation ($m)		
	Existing law	**Congressional tax reform compromise illustration***
Taxable income	4,659	4,659
Federal statutory rate	1,631	978
Unremitted foreign earnings	2,044	2,044
Exclusion for unremitted foreign earnings	-1,623	
Tax on foreign earnings		296
All other tax liabilities/exclusions	710	710
Total tax bill	*718*	*1,985*
Compared to existing law		+1,267
Effective rate	*15%*	*43%*
Assuming equal installments over eight years		37
Total illustrative 2016 tax bill with installments		1,725
Effective rate		*37.0%*
**Assumes all unremitted foreign earnings are taxed at the 14.49% cash rate specified in the Senate bill*		

However, the one-time tax on overseas cash adds back in some liabilities. In an illustrative example using the Senate's formula – and assuming that all of its foreign income is deemed to be repatriated and taxed at the 14.49% rate – the group's tax bill would have risen to $2bn, or an effective rate of 43%.

Payment on the repatriation levy can be distributed over eight years, so a further analysis of this illustrative example reveals that, if distributed equally over that time, Merck's effective rate would have been 37%. So any benefit from a lower corporation tax rate could be delayed for those that decide to repatriate significant sums.

Of course, only accountants in these big pharma groups can know how legislative changes might influence their tax bills beginning January 1, 2018. And a provision passed by the Senate that would lower the effective tax rate on intellectual property is one among many that could affect individual companies differently. Moreover, passage is not yet certain in the Senate as a special election this week has trimmed the already-thin majority of President Donald Trump's Republican allies by one vote.

The big picture is that if tax reform passes big biopharma will find it less expensive to bring home cash next year, beefing up acquisition war chests or enabling share buybacks, and in subsequent years the industry will have a lower tax bill to prop up earnings. This will please investors across the sector.

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