Forward-thinking life sciences companies may want to consider the impact of potential tax reform on their supply chain, R&D, and more.

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In light of the potentially fast pace of legislative developments relevant to tax legislation, some of the information in this document may no longer be current or accurate after the publication date.

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Overview

With the status of healthcare reform uncertain, Congress and President Trump may focus on major tax legislation soon. There are many proposals being discussed as part of U.S. corporate tax reform, including border adjustability, nondeductibility of net interest expense, immediate expensing of U.S. asset acquisitions, nontaxation of future foreign subsidiary profits of U.S.-based multinationals, and a reduced corporate tax rate. All of these were outlined in the House Republican’s Tax Reform Task Force Better Way blueprint (the “Blueprint”).

It is not certain if tax reform will be enacted in the short term and, if so, what its details will be. Nonetheless, if tax reform is enacted based on the Blueprint, this would represent a fundamental transformation of the U.S. international tax system from a worldwide income-tax based approach to a territorial, destination-based tax system. In the overview of its proposed changes, the Blueprint states: “From the perspective of America’s place in the global economy, the new tax system will focus on investment in America and investment for America. The focus on business cash flow, which is a move toward a consumption-based approach to taxation, will allow the United States to adopt, for the first time in history, the same destination-based approach to taxation that has long been used by our trading partners. This will end the self-imposed unilateral penalty for exports and subsidy for imports that are fundamental flaws in the current U.S. tax system.”

Of all the potential new provisions in the Blueprint, one that has particular currency for the life sciences industry is border adjustability. Although technical details have not yet been released, under such a provision, the U.S. tax base presumably would consist of business income received from, and business expenses paid to, other U.S. taxpayers. And it presumably would exclude business income received from, and business expenses paid to, non-U.S. taxpayers. Of course, the way this would play out with specific pharmaceutical, biotech, medical device, and medical equipment companies would depend on each company’s unique parameters, as well as applicable legislative provisions of border adjustment.

Although the fate of a border-adjusted tax system is unknown at present, Republicans in the Congress and the Trump Administration have expressed their desire to encourage investment in the United States and create jobs, as well as create a level playing field for American companies. Given these goals, even with the uncertainty of a border-adjusted tax system, life sciences companies should start assessing their business readiness for potential comprehensive U.S. tax reform and give careful thought to potential future investment locations and the implications for the supply chain.

Further, it is possible that changes to healthcare legislation may be considered again at some point in the future. If such healthcare legislation ultimately is enacted, it may change the dynamics of the pharmaceutical and medical products value chain and could impact the taxes enacted as part of the Affordable Care Act (e.g., branded prescription drug fees, medical device excise tax, etc.). In addition, some members of Congress have openly criticized pharmaceutical companies for very high drug prices, while President Trump has previously floated the idea of negotiating better drug prices and opening the U.S. drug market to imports from other countries, including Canada. Life sciences companies should monitor potential healthcare or pricing developments in Congress and the Trump Administration as management considers operational changes due to potential tax reform, because they could also impact the value chain analysis, transaction flows, and transfer pricing policies.

2 The border-adjusted tax proposal has many unanswered questions. Our observations are subject to change if, and when, Congress works through the complex considerations of such a tax system. While House Ways and Means Committee Chairman Kevin Brady and Speaker Paul Ryan have continued to endorse a border-adjusted tax system, its ultimate fate is unknown. For example, neither Senate leadership nor the Trump Administration has endorsed the proposed border adjustment yet. This article is not intended to discuss the merits or shortcomings of a border-adjusted tax provision, including the policy or economic theories behind the proposal. It also does not take a position on whether such provision should or should not be adopted, nor does it propose alternatives. This article is intended to make some observations with regard to potential implications to life sciences companies, especially operations and supply chain, if the Blueprint (or other proposals attempting to accomplish similar goals) is enacted. Since the Blueprint is a conceptual document and not proposed legislation, the discussion herein is based on the general outlines of the proposal, which would likely be further refined during the legislative process.
3 This article focuses primarily on implications of potential U.S. tax reform, including a border adjustment, on a life sciences company’s supply chain, not on other aspects of the economy or a company’s operations. As briefly noted below, similar principles may apply to other business and corporate functions, such as information technology (IT) and shared service centers. We also do not address herein the potential foreign exchange implications of border adjustability on revenue and costs, nor the concern that associated tax costs of border adjustability may be passed on by suppliers to customers.
4 Other trends in the life sciences and healthcare industry may also affect the value chain analysis, such as value-based (or outcomes-based) pricing and new entrants into the market, including those partnering with technology companies.
Life sciences companies should start assessing their business readiness for potential comprehensive U.S. tax reform, and give careful thought to potential future investment locations and the implications for the supply chain.
Impact on Supply Chain

Similar to other industries, life sciences companies that manufacture primarily within the United States would likely realize tax benefits under a border-adjusted tax and other proposals in the Blueprint, such as a lower U.S. corporate tax rate and immediate expensing. These companies likely would benefit from the reduced U.S. tax rate on profits attributable to their U.S. sales, as well as the exemption from U.S. tax on profits attributable to exports.

Life sciences companies that import a significant percentage of their products for sale within the United States, and that generally have a low U.S. gross margin (e.g., certain generic drug products or companies with intellectual property (IP) and manufacturing outside the United States), may realize little or no tax benefits, or in fact may have increased U.S. taxes under the Blueprint. While the specific mechanism is not yet finalized, the border adjustment is expected to tax imports by disallowing a tax deduction for the cost of the goods imported. Companies that fit this model should closely examine the impact of deduction denial for imports as they evaluate the Blueprint. Further, companies should consider the implications of the Blueprint’s border-adjustment proposition on their suppliers and business customers.

Many life sciences companies have integrated supply chains, with raw materials, components, or finished goods sourced or manufactured in various jurisdictions. While imported products intended for sale in the U.S. market may be taxed under a border adjustment, foreign sales of products presumably would not be subject to U.S. tax, no matter where the product is manufactured.

Under the Blueprint, it is expected that profits of foreign subsidiaries that manufacture and sell products in foreign markets might not be subject to U.S. tax, either currently or upon repatriation of such profits to the U.S.-based multinational, even if the foreign subsidiary pays limited taxes. This would be more beneficial than current tax law, which taxes the foreign subsidiary earnings when repatriated (sooner in some cases) at the 35 percent U.S. rate, minus the foreign taxes paid on such earnings.

As a result, the following high-level observations about a border-adjusted tax system can be made from a U.S. tax perspective only:

— Manufacturing products in low-tax foreign countries to supply foreign markets should generally continue to be tax beneficial, as the profits should not be subject to U.S. tax, even if ultimately repatriated by a foreign subsidiary to a U.S. parent company.

— Manufacturing products in foreign countries to supply the U.S. market would not be as tax advantageous, primarily due to the disallowed tax deduction on the import of such product.

— Manufacturing products in the United States to sell within the United States generally should be more tax beneficial, primarily due to the reduced U.S. corporate tax rate and possible immediate expensing of capital investments.

— Manufacturing products in the United States to sell into foreign markets generally should be much more tax beneficial, due to the exemption from U.S. tax altogether on the income attributable to such exported product.

While the general observations above can be expected to apply to many manufacturing companies, the life sciences value chain is often complex, involving importing and/or exporting of various components and raw materials (e.g., the active ingredients in drugs), or performing sales, research and development (R&D), manufacturing, packaging, and assembly in different jurisdictions.

Therefore, under border adjustment, each aspect of the value chain should be analyzed in and of itself and as it relates to the other aspects, and the particular facts and circumstances should be taken into account.

Management should also consider the impact of other potential U.S. tax reform changes on the cost of capital when considering investment locations, such as the possible nondeductibility of U.S. interest expense and the relatively free access to future foreign cash under a territorial tax system (with a low tax cost to repatriate current offshore cash earnings).
Similar to other industries, life sciences companies that manufacture primarily within the United States would likely realize tax benefits under a border-adjusted tax and other proposals in the Blueprint.
Under the Blueprint, the proposals would encourage continued development and ownership of IP within the United States, as well as continued performance of both value-added and administrative services within the United States.
Border adjustment is expected to treat other business receipts and expenses in a similar way, including payments for services (e.g., R&D) and intangibles (e.g., royalties). Receipts from foreign transactions likely would be exempt, while payments to foreign persons likely would be nondeductible. In addition to imposing tax on U.S. consumption, the proposals would encourage continued development and ownership of IP within the United States, as well as continued performance of both value-added (R&D) and administrative services (shared services or IT) within the United States. A company likely could realize tax benefits if it continues to perform R&D in the United States, owns the IP within the United States, and receives royalty income for use of the IP outside of the United States. Under this scenario, the royalty income is expected to be exempt from U.S. taxation.

One significant open question for life sciences companies is whether Puerto Rico would be considered a part of the United States for purposes of a border-adjustment provision. Traditionally, many life sciences companies have utilized Puerto Rico as a low-tax manufacturing location, due to incentive grants from Puerto Rico. Congress has not provided insight into the status of Puerto Rico under border adjustability. Depending upon the answer, life sciences companies may need to reconsider their Puerto Rico strategy, especially considering the excise tax imposed on purchasers of Puerto Rico-manufactured products. Under a U.S. territorial system, such excise tax may no longer be creditable against U.S. taxes, and the Puerto Rico economy could be significantly affected by the decision.

As a result of the potential provisions of U.S. tax reform under consideration, life sciences companies should monitor the development of such provisions and consider the potential impact on their supply chains.

— Border adjustment, a significant reduction in the U.S. tax rate, and immediate expensing may encourage a company (whether U.S.-based or foreign-based multinational) to maintain or increase U.S. manufacturing, depending upon the company’s current supply chain and markets. It is important to note that, while tax laws may encourage U.S. manufacturing, a company may incur higher production costs in the United States. However, companies that are already considering strategies to reduce production costs, such as automating processes, using digital labor to reduce labor content, or redesigning products, may want to consider accelerating the implementation of these strategies if moving production to the United States is otherwise viable.

— In other cases, maintaining a significant offshore presence would likely continue to be both operationally sound and tax efficient. One factor that could impact a company’s decision is how the tax laws in foreign jurisdictions may change. Many countries have passed, or are considering, legislation for a “patent box,” which provides a lower tax on patent-defined profits. Countries are also reducing corporate income tax rates.

The Blueprint proposes that R&D incentives (presumably in some form of credit) be maintained.

As noted above, the specific mechanics and provisions of the border adjustment are not yet known, so there is some level of uncertainty as to how one would calculate the income exempt from tax (e.g., on a gross basis or income after certain expense allocation). However, the Blueprint’s principles generally would allow a tax deduction for wages and investment in U.S. assets (assumed purchased from a U.S. person and not imported).

However, uncertainty also exists in foreign tax laws. For example, although Switzerland has historically been considered an advantageous location for operations due to tax incentives, a new tax system proposal was recently rejected by Swiss voters. In addition, companies with significant operations in the United Kingdom should monitor Brexit provisions that may also influence supply chain decisions. Finally, there is the possibility that foreign governments would retaliate through taxes or tariffs if the United States is viewed as acting like a tax haven for its foreign source income, which could adversely impact the tax benefits of exporting from the United States.

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Although it is not certain whether tax reform will be enacted in the near future and what its details would be, a general consensus exists among congressional Republicans and the Trump Administration that the U.S. corporate tax rate should be reduced to be more competitive, that tax policy should encourage U.S. investment and jobs, and that reform should address the U.S. taxation of foreign earnings. The Blueprint proposes to reduce the U.S. corporate tax rate from 35 to 20 percent. During the campaign, President Trump suggested a 15 percent tax rate, although it is unclear how his thinking on tax reform may have evolved. However, he clearly supports reducing taxes on U.S. businesses.\textsuperscript{9}

If some form of comprehensive corporate tax reform eventually were enacted supporting these objectives, the fate of the border-adjusted consumption tax feature should not determine whether life sciences companies strategize about their future supply chain now.\textsuperscript{10} They should assess whether the business will be able to adapt to all aspects of potential tax reform.\textsuperscript{11}

Depending upon the specific provisions enacted, the three objectives mentioned above generally encourage U.S. manufacturing and investment in IP or tangible property. Border adjustability pays for a major portion of the rate reduction and can help maintain revenue neutrality for proposed tax reform legislation. If border adjustability is not enacted but the corporate rate is reduced,\textsuperscript{12} other provisions broadening the U.S. tax base, which may include foreign earnings, may have to be adopted.

Many life sciences companies currently establish their manufacturing operations in low-tax jurisdictions. If tax reform does not include border adjustability, there may instead be a minimum tax on certain foreign earnings, e.g., former Chairman David Camp’s proposal to impose a minimum tax on intangible property income of controlled foreign corporations.\textsuperscript{13} Separately, as a candidate, President Trump proposed a 15 percent tax on worldwide income. Both proposals effectively would eliminate deferral of some or all offshore earnings and drive a worldwide system of taxation with earnings subject to immediate U.S. tax. President Trump also may support imposing tariffs on some imports. The tax benefits of owning IP and manufacturing offshore may be significantly reduced or eliminated altogether if these or similar proposals are adopted. Foreign-based life sciences companies that may have previously limited their U.S. manufacturing footprint due to the high tax rate on their U.S. profits (approaching 39 to 40 percent after considering state taxes) may want to reconsider U.S. manufacturing in the future.

\textsuperscript{9} Comments from President Trump on February 28, 2017, during his address to a joint session of Congress that his economic team “is developing historic tax reform that will reduce the tax rate on our companies so they can compete and thrive anywhere and with anyone... it will be a big, big, cut.”

\textsuperscript{10} Some companies have already considered the implications of base erosion and profit shifting (BEPS), which may have required some supply chain modifications, especially with regard to IP ownership and exploitation. One of the BEPS considerations in determining where income should be allocated is where key decision-making takes place with regard to the development, enhancement, maintenance, protection, and exploitation of intangibles (sometimes referred to as the “DEMPE” functions). As a company considers the impact potential tax reform may have on its supply chain strategy, it’s worth keeping BEPS considerations in mind. A deeper discussion of BEPS considerations is beyond the scope of this paper.

\textsuperscript{11} Such assessment should also provide management with the information necessary to work through trade associations or ad hoc groups if management determines attempting to influence the direction of tax reform is a viable strategy.

\textsuperscript{12} Depending upon other provisions that may be enacted, the reduced rate may or may not be 20 percent.

\textsuperscript{13} 2014 Ways and Means Chairman’s Tax Reform Discussion Draft, March 2014.
There are other factors besides tax that affect where a company manufactures its products, including, among others, the source of raw materials or components; availability, quality, and cost of labor; the complexity or simplicity of manufacturing, assembly, and packaging; trade agreements; logistics and transportation; the numerous regulatory considerations for drugs and medical products; incentives; and manufacturing capacity and synergies. Changing manufacturing locations takes time and may include, among others, new investment in, or movement of, plants and equipment; managing the complexity of moving biological sites; hiring and training qualified personnel; supply chain sourcing, logistics, and customs considerations;\(^{14}\) determining new IT requirements; and obtaining FDA approval for the change.

However, if the after-tax return on investment is expected to change due to eventual U.S. tax reform, companies would be wise to start considering the alternatives of where future investment in, or rationalization of, manufacturing facilities and IP should take place—or whether there are viable U.S.-based suppliers that can replace foreign-based suppliers for certain components, raw materials, or other production-related materials or services. Management may determine there are actions to take regardless of the tax reform outcome, or there will be scenario planning for various potential tax reform outcomes, or there may be wait-and-see scenarios that will require more information. If physical changes in manufacturing locations or supply chain logistics are not feasible, companies should consider whether changes in the economic relationships among the parties (related or unrelated) or transaction flows can optimize the after-tax results following comprehensive tax reform.

In summary, if management believes there is a strong likelihood that comprehensive U.S. tax reform will be enacted in the near- or mid-term, those with well thought-out strategies should be able to adapt and take advantage of the tax benefits, or limit the tax costs, sooner rather than later.

\(^{14}\) Although there are exemptions from customs duties for many pharmaceutical and medical products, trade developments should be monitored, especially in light of some of the administration’s comments regarding trade agreements, including the potential renegotiation of the North America Free Trade Agreement.