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BEFORE THE HEARING OF THE SUBCOMMITTEE ON HEALTH OF THE HOUSE WAYS AND MEANS COMMITTEE “MORE CURES FOR MORE PATIENTS: OVERCOMING PHARMACEUTICAL BARRIERS”

HOUSE LONGWORTH OFFICE BUILDING

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I want to thank Chairman Doggett and Ranking Member Nunes for the invitation to appear before the committee today.

My testimony will focus on three points:

1. America currently has a large and growing trade deficit in pharmaceutical products.

2. The Tax Cuts and Jobs Act created new incentives for the offshoring of pharmaceutical production and other high technology manufacturing jobs. As I will discuss later, the biggest sources of pharmaceutical imports are not countries known for low wages, but rather countries known for their high tolerance of transfer pricing games and generous tax treatment of multinational firms.

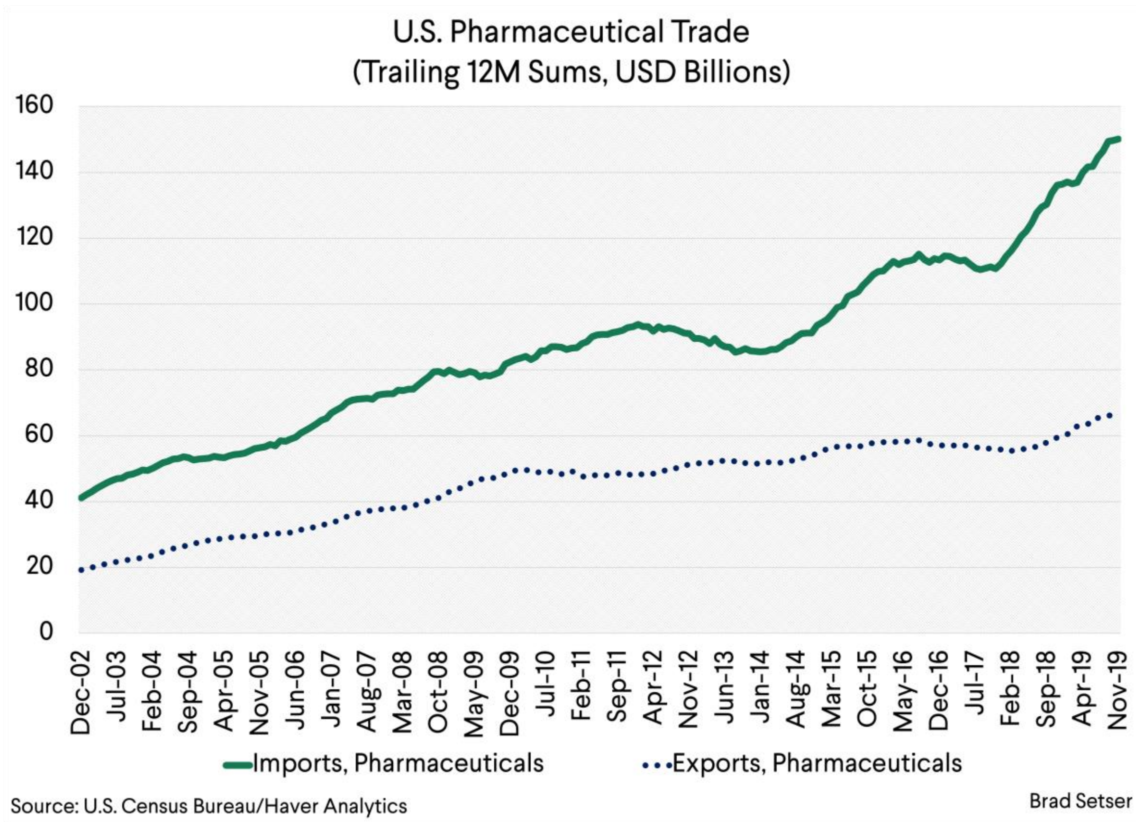
3. The Tax Cut and Jobs Act provided a large windfall to the shareholders of pharmaceutical firms who had shifted their profits and often production abroad to reduce their U.S. tax burden—but it hasn't generated lower prices for American consumers or a significant increase in investment in pharmaceutical research and development.

The work of the Ways and Means committee staff[1] has illustrated that Americans pay by far the world's highest prices for drugs. Yet today, Americans are getting far too little back from our biggest pharmaceutical companies.

The Growing Trade Deficit in Pharmaceuticals

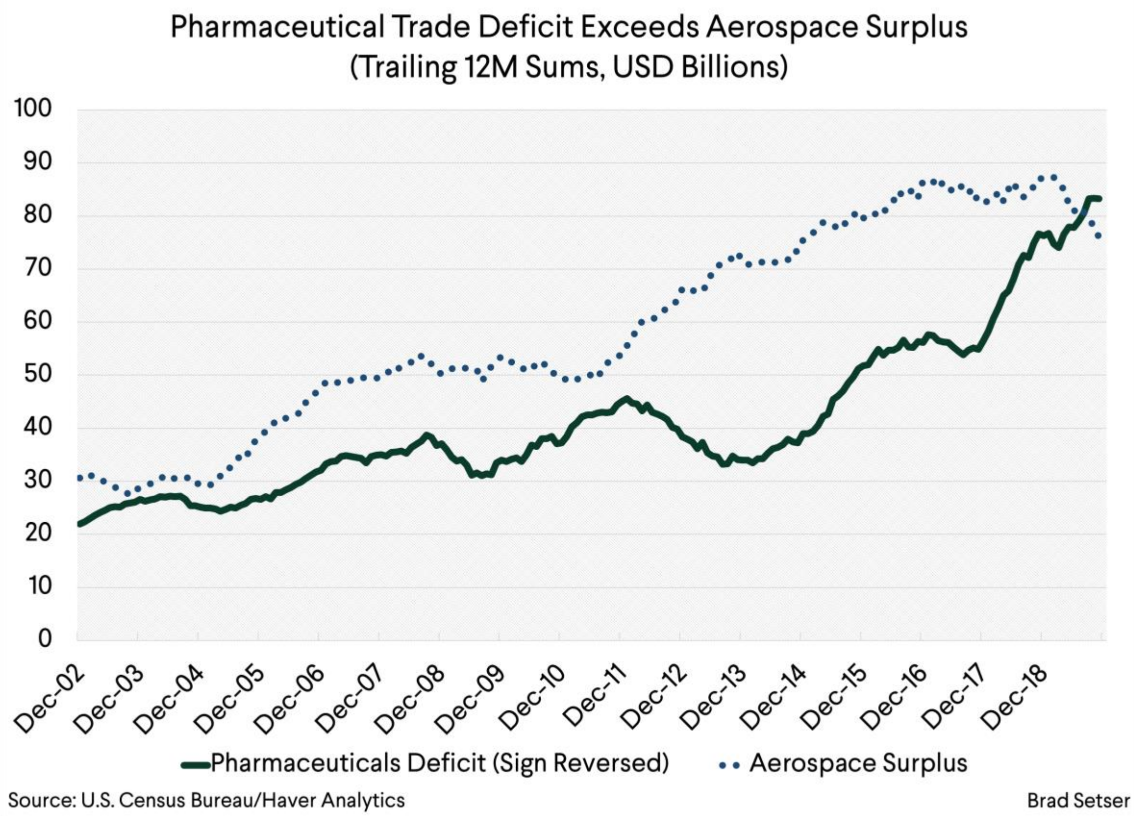
The United States is the home of many of the world's most successful pharmaceutical companies. It is a global hub for pharmaceutical research—in no small part because of government funding for the National Institute of Health. But the United States' leading pharmaceutical companies increasingly produce their most valuable drugs outside of the United States. The trade deficit in pharmaceuticals is now quite significant, as $65-70 billion in pharmaceutical exports fall well short of covering $150 billion in imports.

[1] "A Painful Pill to Swallow: U.S. vs. International Prescription Drug Prices," House Ways and Means Committee Staff, September 2019, https://waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/documents/U.S.%20vs.%20International%20Prescription%20Drug%20Prices_0.pdf.



This is not a trade deficit that is easily explained by competition with low wage countries. Switzerland accounts for more U.S. imports, in dollar terms, than India and China combined. Ireland alone accounts for about a quarter—$35-40 billion—of total pharmaceutical imports.

Pharmaceutical imports were substantial prior to the Tax Cut and Jobs Act, as pharmaceutical firms have long been among the most aggressive of U.S. firms in shifting profits and production abroad. But they have increased by around $40 billion (close to 20 percent) over the last two years. These imports, together with pharmaceuticals produced in Puerto Rico—an unincorporated territory of the United States that lies outside of the scope of federal income tax for complex reasons—account for a large share of total pharmaceutical sales in the United States. Not many know that the United States' trade deficit in pharmaceutical products is now as large as America's trade surplus in aerospace.



The importance of low tax jurisdictions in the trade data in this sector provides an important clue for the motivation pharmaceutical firms have for offshoring profits and production. Many pharmaceutical companies conduct the bulk of their research and development in the United States, but then seek to minimize their tax burden by transferring their intellectual property to places like Bermuda and producing their drugs in yet another low tax jurisdiction like Ireland. The resulting products are then imported back to the United States, where typically they are often sold at a higher price than in the rest of the world.[2] Such schemes allow pharmaceutical firms to transfer the large profits on their U.S. sales to low tax jurisdictions. As Former Treasury Secretary Lawrence Summers noted: "All too often, corporations are able to make use of tax havens, differences in accounting treatment across jurisdictions, and other devices to reduce tax liabilities."[3]

The profits pharmaceutical and other large U.S. firms book in the main low tax jurisdictions totaled $367 billion in 2017 using the IRS country-by-country data set.[4] The most recent U.S. balance of payments data shows around $325 billion in profits in the seven most prominent low tax jurisdictions, a $40 billion rise in the two years after the Tax Cuts and Jobs Act.[5] Such profit shifting allows some of America's most

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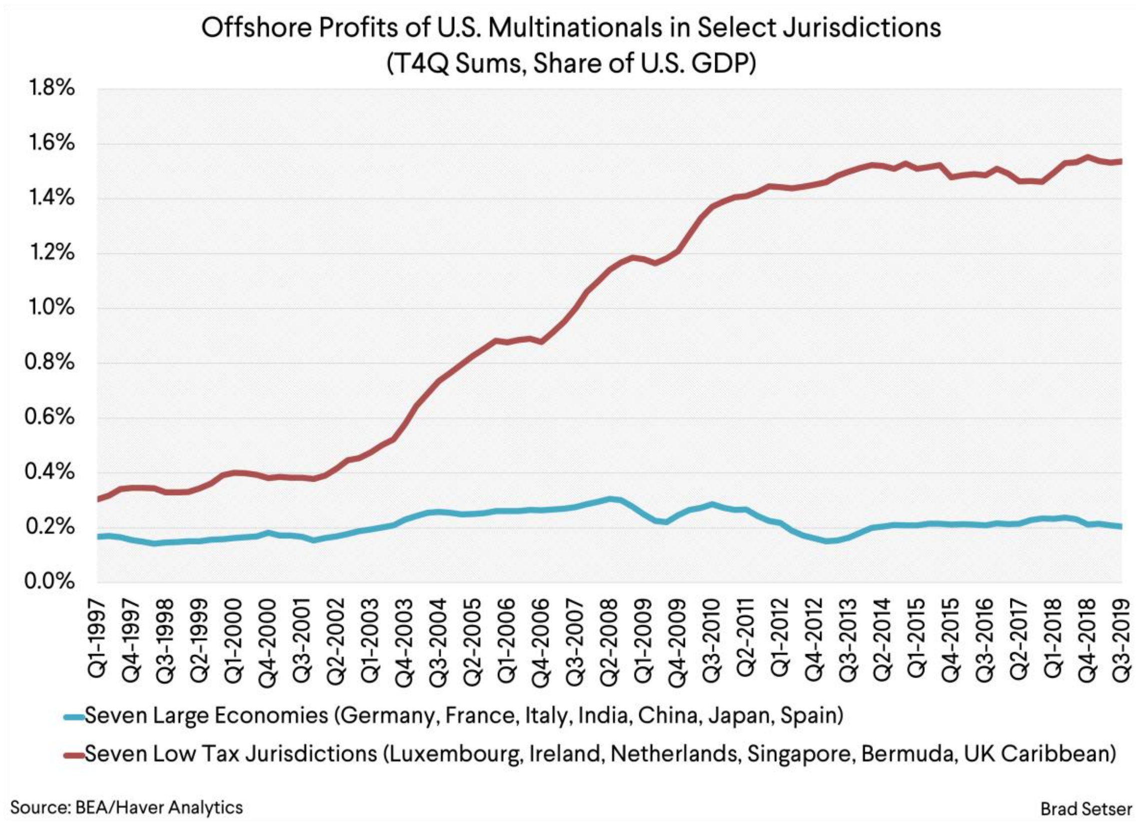
[2] Nana Ama Sarfo, "TCJA-Altered Landscape Keeping Firms from Relocating," *Tax Notes International*, July 15, 2019, https://www.taxnotes.com/featured-analysis/tcja-altered-landscape-keeping-firms-relocating/2019/07/12/29qg0.

[3] Larry Summers, "A broader tax base that closes loopholes would raise more money than plans by Ocasio-Cortez and Warren," March 28, 2019, http://larrysummers.com/2019/03/28/a-broader-tax-base-that-closes-loopholes-would-raise-more-money-than-plans-by-ocasio-cortez-and-warren/.

[4] This leaves out another $200 billion in stateless income.

[5] Clausing, 2020 and IRS Country by Country Report Data, https://www.irs.gov/statistics/soi-tax-stats-country-by-country-report.

successful firms to avoid their fair share of tax, and effectively raises the burden on small businesses and others who cannot employ sophisticated tax strategies to move their profits offshore.



One measure of the scale of this tax avoidance: it is estimated that if the foreign subsidiaries of U.S. firms in low tax jurisdictions paid a real price for the use of intellectual property created in the United States rather than the artificially low price they now pay, measured U.S. output would increase by around a percentage point of GDP.[6] It is, to my knowledge, not possible to use the U.S. data to estimate precisely the contribution of pharmaceutical companies to such profit shifting, but it is clearly substantial.

To summarize—pharmaceutical companies often generate the bulk of their sales and profits in the United States, where they charge far higher prices than in most other large markets. But they often attribute the bulk of their profit to subsidiaries in the world's low tax jurisdictions. The inflated bill Americans pay for filling their prescriptions is matched by an inflated import bill.

The Tax Cuts and Jobs Act Promotes Offshoring

The rise in pharmaceutical imports is likely, in part, a reaction to the incentives to offshore pharmaceutical production that were included in the Tax Cuts and Jobs Act (TCJA).

There is little doubt that the international provisions of the tax code needed to be reformed—the old system of global taxation with indefinite deferral encouraged firms to shift profits to low tax jurisdictions, build up financial assets in their offshore subsidiaries, and then to borrow domestically against their

[6] Fatih Guvenen, Raymond J. Mataloni, Dylan G. Rassier, and Kim J. Ruhl, "Offshore Profit Shifting and Domestic Productivity Measurement," Federal Reserve Bank of Minneapolis, April 2018, https://www.minneapolisfed.org/research/wp/wp751.pdf.

offshore profits if they wanted to pay dividends or conduct stock buybacks without ending their deferral.[7] There is a misconception that these funds were trapped abroad. In reality, they were typically invested in U.S. financial assets—Pfizer's Irish subsidiary might be buying the bonds sold by Microsoft United States, and vice versa.[8]

But there is no doubt that this part of the tax code created perverse incentives. U.S. pharmaceutical imports from low tax jurisdictions were steadily rising prior to the Tax Cuts and Jobs Act, and pharmaceutical companies were among those firms that most aggressively used inversions to abandon, in effect, the United States and become full-time tax residents of low tax jurisdictions.

There are certain provisions of the Tax Cuts and Jobs Act that do have analytical merit. There is a case for full expensing of domestic investment for example, though not for combining expensing with a deduction for interest

But the Tax Cuts and Jobs Act, unfortunately, failed to end the incentives for profit shifting in the pharmaceutical and other sectors that have long been present in the tax code. Rather than getting rid of tax incentives to offshore profits, the Tax Cuts and Jobs Act replaced the old incentives to offshore profits with new incentives to offshore both profits and jobs. As Rebecca Kysar has noted, "[the] new international rules aimed at intangible income incentivize offshoring and do not sufficiently deter profit shifting."[9] The United States would be among the last places a tax optimizing U.S. company would want to report the profit on a high-margin drug sold in the United States, and it also often would not be the best place to produce the drug's active pharmaceutical ingredients.

Three provisions of the new tax code combine to put the United States last: Global Intangible Low Tax Income (GILTI), Foreign Derived Intangibles Income (FDII), and the exception for tangible imports from an offshore subsidiary in the Base Erosion and Anti-abuse Tax (BEAT).

These are all well-known provisions (and acronyms) in the tax world. But their impact is worth explaining, as the bulk of Americans are not among the small subset of companies that are now designing their global operations to avoid paying the new 21 percent U.S. tax rate.

First, the Global Intangible Low Tax Income, or GILTI. The GILTI was designed to assure that firms' shifting profits to a zero tax jurisdiction like Bermuda paid some U.S. corporate tax. It thus is a step away from a purely territorial tax system toward a hybrid model—under the new tax law, U.S. firms don't generally owe U.S. tax on profits earned abroad, unless those profits are the profit from "intangibles" in a low tax jurisdiction. The 10.5 percent GILTI rate, together with an 80 percent credit for foreign taxes paid, was intended to limit the amount of U.S. tax paid by firms that are taxed at 13.125 percent or more on their offshore profits, though the actual application of the law is far more complex.[10]

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[7] Kimberley A. Clausing, "Profit Shifting Before and After the Tax Cuts and Jobs Act," January 20, 2020, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3274827 and Michael Smolyansky, Gustavo Suarez, Alexandra Tabova, "U.S. Corporations' Repatriation of Offshore Profits: Evidence from 2018," Federal Reserve/FEDS Notes, August 06, 2019, https://www.federalreserve.gov/econres/notes/feds-notes/us-corporations-repatriation-of-offshore-profits-20190806.htm.

[8] Zoltan Pozsar, "Repatriation, the Echo-Taper and the €/$ Basis," Credit Suisse Global Money Notes, January 29, 2018, https://plus.credit-suisse.com/rpc4/ravDocView?docid=V7bFUL2AD-WEpBrM.

[9] Rebecca M. Kysar, "Critiquing (And Repairing) the New International Tax Regime," *The Yale Law Journal Forum*, October 25, 2018, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3436942.

[10] "Trump's Tax Law and International Tax: More Complexity, Loopholes, and Incentives to Ship Jobs Overseas," The United States Senate Committee on Finance, July 18, 2019,

GILTI though suffers from a series of significant design flaws. For one, it was simply set at too low a rate, one that still encourages profit shifting away from the United States' 21 percent headline rate. For another, it wasn't calculated on a country-by-country basis—so a firm that pays high taxes in Germany can use those tax payments to offset profits shifted to zero or low tax jurisdictions like Bermuda or Ireland.[11] This would be obvious if firms were required to disclose their GILTI and FDII payments separately.[12] The ability to credit taxes paid abroad but not taxes paid in the United States creates a perverse incentive for companies with significant income in very low tax jurisdictions to prefer even high-tax foreign income over U.S. income.

Finally, GILTI provides a tax exemption for the first 10 percent return on assets abroad, so the more physical assets that a firm has abroad, the lower the tax burden associated with the GILTI. A firm with large profits in say Bermuda would automatically lower its calculated U.S. tax if it built a factory in Ireland. No such permanent benefit is provided to an investment in tangible assets in the United States.

Fundamentally, this gets the incentives backwards. The 10.5 percent GILTI rate is substantially lower than the headline 21 percent rate, and tax planners always search for the lowest rate in the tax system. Firms that have already shifted profits abroad are also encouraged to shift production and jobs abroad. It isn't a surprise that firms that are known to have their intangible assets in the Caribbean and their production in Ireland are reporting especially low effective tax rates under the new tax law.[13] And it should not be a surprise that firms that benefitted heavily from the ability to keep profits abroad under the old tax law seem to have increased their offshore investments after the new tax law was passed.[14]

Second, Foreign Derived Intangible Income, or FDII. These provisions were designed to make it attractive for U.S. firms to retain the profits from their intellectual property in their U.S. headquarters rather than shift those profits abroad. But "intangible" income is calculated in a way that effectively creates a disincentive for production in the United States: "intangible" income cannot be measured directly, so it has been defined as profit on foreign sales in excess of an expected 10 percent return on a firm's tangible assets in the United States. As a result, a firm that reduces its tangible U.S. assets by licensing its intellectual property to an offshore subsidiary that supplies global markets from a factory abroad would have a lower tax rate than a firm that keeps its factory in the United States.[15]

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https://www.finance.senate.gov/imo/media/doc/Wyden%20Report%20%20Trumps%20Tax%20Law%20and%20International%20Tax%20071818.pdf.

[11] Ireland's Capital Allowance for Intangible Assets (CAII) has allowed many firms to achieve effective tax rates of under 3 percent on their Irish subsidiaries. Many U.S. firms operating in Ireland thus do owe GILTI even though Ireland's headline rate is 12.5 percent. See: https://en.wikipedia.org/wiki/Ireland_as_a_tax_haven#Green_Jersey_BEPS_tool

[12] Peter Eavis, "Why the Impact of the Trump Taxes Remains Partly Hidden," *New York Times*, December 30, 2019, https://www.nytimes.com/2019/12/30/business/corporate-tax-cuts-impact.html.

[13] Peter Loftus, "AbbVie Says Tax Overhaul Will Slash 2018 Effective Tax Rate to 9%," *Wall Street Journal*, January 26, 2018, https://www.wsj.com/articles/abbvie-says-tax-overhaul-will-slash-2018-effective-tax-rate-to-9-1516986352.

[14] Brooke Beyer , Jimmy F. Downes, Mollie E. Mathis, and Eric T. Rapley, "The Effect of the Tax Cuts and Jobs Act of 2017 on Multinational Firms' Capital Investment: Internal Capital Market Frictions and Tax Incentives," *UNC Tax Center*, May 2019, https://tax.unc.edu/index.php/publication/the-effect-of-the-tax-cuts-and-jobs-act-of-2017-on-multinational-firms-capital-investment-internal-capital-market-frictions-and-tax-incentives/. "This study provides evidence that firms with high pre-TCJA repatriation costs have an increase in foreign, rather than domestic, capital expenditures. This outcome conflicts with a stated goal of the TCJA to spur domestic economic growth and highlights an unintended consequence of the TCJA."

[15] Kysar, October 25, 2018.

To put it bluntly, a firm that develops a pharmaceutical product in the United States and also produces the product in the United States for domestic sales would, all else equal, be taxed at 21 percent—setting aside the provisions of the tax code that allow a firm to get tax credit for research and development costs and for the actual expenses associated with building a U.S. factory. By contrast, a firm that develops the pharmaceutical in the United States, shifts the right to exploit that research to a subsidiary in a low tax jurisdiction and produces the product in Ireland or a similar location, and then imports the active ingredient from Ireland or a similar location back to the United States for domestic sales would likely be taxed at a rate of somewhat below 13.125 percent.[16]

Finally, one of the provisions of the Tax Cuts and Jobs Act that was designed to discourage companies from shifting profits out of the United States through intercompany transfers—the Base Erosion and Anti-abuse tax (BEAT)—exempts imports of tangible goods from its provisions. This means that it explicitly does not discourage multinational companies, including U.S. companies, from importing active pharmaceutical ingredients from their offshore subsidiaries in low tax jurisdictions.

These problems should not be a surprise. The incentives for tax avoidance created by the Tax Cuts and Jobs Act were widely discussed at the time of its approval by the U.S. Congress.[17] And, unfortunately, the actual trade data is bearing out these warnings. Imports of pharmaceutical products have soared after the passage of the Tax Cuts and Jobs Act, even as firms raised prices and made their potentially life-saving innovations more expensive for American consumers.

Like many Americans, I love the Irish—but the U.S. tax code should not be designed to put Ireland first.

Buybacks, Not Research and Development

How have pharmaceutical companies used the windfall from the Tax Cuts and Jobs Act?

We basically know the answer. To buy back their own stock.

Pharmaceutical companies have been among the largest recipients of the tax windfall from the generous treatment of previously offshored profits in the Tax Cuts and Jobs Act. The deferred tax on profits held abroad under the old tax law was settled at a relatively low rate of 8 percent on tangible assets or 15.5 percent on financial assets. This windfall was compounded by the generous tax treatment of pharmaceutical companies that offshore production while keeping their U.S. prices high under the new law. The overall effective tax rate on the pharmaceutical sector is estimated to have fallen from just over 20 percent in 2016 to just under 15 percent in 2018.[18]

There is little evidence of higher wages, or increased investment in pharmaceutical research and development,[19] and the price of pharmaceuticals has clearly not come down. By the first quarter of 2019,

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[16] The actual provisions of the law are slightly more complex. Bonus depreciation phases out between 2023 and 2026. The GILTI rate is schedule to rise from 10.5 percent to 13.125 percent after 2025, and the FDII rate is scheduled to rise in parallel from 13.125 percent to 16.4 percent.

[17] David Kamin et al, "The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the 2017 Tax Legislation," *Minnesota Law Review*, December 18, 2017, http://www.minnesotalawreview.org/wp-content/uploads/2019/07/5Kamin_FINAL.pdf.

[18] Jonathan Gardner, "Biopharma happily takes the tax cuts, but the jobs are harder to find," *BioPharma Dive,* May 9, 2019, https://www.biopharmadive.com/news/biopharma-happily-takes-the-tax-cuts-but-the-jobs-are-harder-to-find/553925/.

[19] Katy Milani, "Profits Over Patients: Americans Are Paying for a Financialized Pharmaceutical Industry," Roosevelt Institute, June 2019, http://rooseveltinstitute.org/wp-content/uploads/2019/06/RI_Profit-Over-Patients-

total announced buybacks by pharmaceutical companies alone after the passage of the Tax Cuts and Jobs Act reached $79 billion.[20] Even before the Tax Cuts and Jobs Act, large pharmaceutical companies typically returned more dollars to their shareholders through dividends and buybacks than they invested in new research and development.[21] After the tax cuts, that trend only accelerated.

For the pharmaceutical sector at least, there should be little doubt then that the Tax Cuts and Jobs Act has been all tax cuts and no jobs.

Conclusion

There are relatively straightforward reforms to the Tax Code that would reduce the incentives now present to offshore pharmaceutical profits, production and jobs. Chairman Doggett has proposed eliminating the tax preference for investing abroad in the "No Tax Breaks for Outsourcing Act." Taxing the world-wide profits of American firms, especially if the tax was calculated on a country-by-country basis, would eliminate the current incentive to offshore profits and jobs. Tax credits should be provided for taxes actually paid in a given country, not hypothetical returns on assets transferred abroad.

If this isn't possible, more modest reforms could generate substantial improvements—raising the global minimum to 75 percent or more of the headline rate and calculating it on a country-by-country basis would eliminate most of the incentive to offshore.[22] Getting rid of the deemed return on tangible investment and making the minimum tax a true global minimum tax, instead of a minimum tax that only applies to intangible investment, also would help. Firms should be required to disclose the amounts they pay in GILTI and FDII, and a country-by-country breakout of their reported profits.

Such a shift would of course retain a credit for all or a substantial portion of income tax actually paid abroad—it just wouldn't allow a firm to reduce its minimum tax on profits booked in Bermuda by investing in an Irish factory. Over time, more ambitious reforms could apportion global income in proportion to sales, which would imply—especially for the pharmaceutical sector—higher U.S. tax payments. Remember that many pharmaceutical firms get the majority of their global revenue from the U.S. market, but don't report earning the bulk of their profit in the United States.

The basic principle here is simple: the tax system shouldn't reward pharmaceutical companies, or other leading U.S. companies, for shifting jobs and production offshore. High prices and rising imports of pharmaceuticals only highlight the urgency of reforming the new tax code to make sure that firms that offshore profits and jobs aren't rewarded, and global companies pay the same rate as American small business. Given that pharmaceutical companies often charge three to four times as much for a drug in the United States as they charge for the same drug in other advanced economies, it is hardly unreasonable to ask that these firms pay their fair share of tax.

Thank you.

Financialization_brief_201906.pdf and Smolyansky et al, "U.S. Corporations' Repatriation of Offshore Profits: Evidence from 2018, August 06, 2019.

[20] Stock Buybacks Data, Americans for Tax Fairness, Accessed on 2/31/2020, https://americansfortaxfairness.org/stock-buybacks/.

[21] "Hazardous to Your Health: How the Trump tax cuts to Big Pharma widen inequality and undermine the health of women and girls," OXFAM America Media Briefing, April 9, 2019, https://ousweb-prodv2-shared-media.s3.amazonaws.com/media/documents/Hazadous_to_Your_Health_April_9_2019-back_cover_1.pdf.

[22] Kimberley A. Clausing, "Fixing the Five Flaws of the Tax Cuts and Jobs Act," February 3, 2020, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3397387.