Client Update
The "Tax Cuts and Jobs Act"—How It Impacts the Healthcare Industry

The tax bill released by House Republicans (H.R. 1) contains provisions that could have a significant impact on the healthcare industry. Below, we describe key provisions that are in—and not in—the bill that are likely to be of particular interest to the industry.

WHAT'S IN THE BILL?

Changes in Corporate Taxes and International Taxation.

As discussed in more detail in our client memo, the bill would dramatically alter the existing corporate tax framework, particularly as it relates to multinational companies. The bill would reduce the corporate tax rate from 35% to 20%. It would also require a one-time repatriation tax on deferred overseas earnings, at a rate of 12% for earnings held in cash and 5% for earnings held in non-cash assets. This repatriation tax would be payable over eight years. Going forward, the United States would have a "territorial" tax system in which dividends received by U.S. companies from their foreign subsidiaries would generally be tax free. However, there would be a 10% tax imposed on the "excess profits" (defined as the overall income in excess of a stated return on tangible depreciable property) of foreign subsidiaries of U.S. companies, whether or not repatriated. The bill also contains an overall limit on interest deductibility and a very broad excise tax provision that would impose a 20% tax on deductible or capitalized payments from U.S. companies to foreign related parties. For example, a U.S. pharmaceutical company that purchases products from a related foreign affiliate will be faced with a 20% excise tax on the import price. Alternatively, the foreign affiliate can agree to pay U.S. income tax on a deemed profit.

Potential Impact. The bill is a mixed bag for corporate taxpayers. On the positive side, the reduction in the corporate tax rate would be beneficial to U.S. healthcare companies. The one-time repatriation tax may also prove beneficial to U.S. healthcare companies if those companies desire to reinvest in the United States the significant stockpile of cash held overseas. That could result in a combination of increased research and development and mergers and acquisition activity. For companies planning to expand primarily overseas, however, the repatriation tax is likely viewed as a negative, since current law would permit the continued deferral of offshore earnings. The other international changes are likely to be of particular interest to multinational healthcare companies. Although the territorial tax is generally positive, the current tax on excess foreign profits is likely to affect existing structures (including intellectual property holding structures) of U.S. parented groups. The broad excise tax will significantly affect the tax planning of foreign parented groups with U.S. affiliates.

Repeal of the Orphan Drug Tax Credit.

"Orphan drugs" are drugs that are designed to treat rare diseases that either impact (i) fewer than 200,000 people in the United States or (ii) more than 200,000 people in the United States if the cost of developing the drug exceeds anticipated revenue from the drug. Currently, companies that develop orphan drugs are entitled to a tax credit in the amount of 50% of the cost of human clinical testing for such drugs. According to a recent analysis from the Department of Treasury, the cost of the tax credit for 2017 is about $2.3 billion and that amount is anticipated to rise to $15 billion by 2027 (absent elimination of this provision).

Potential Impact. Some members of the pharmaceutical industry have expressed strong opposition to the repeal of this tax credit because it will make orphan drug development more costly. An industry-sponsored report issued by Ernst and Young anticipates that eliminating this tax credit would reduce the number of orphan drug approvals by one third. Nonetheless, there would still be significant incentives for developing orphan drugs, including seven-year marketing exclusivity and the exemption from the requirement to sell drugs to government-supported hospitals and clinics at a significant discount.

Repeal of the Medical Expense Deduction.

Under current law, taxpayers can receive a deduction for out-of-pocket medical expenses that exceed 10% of their adjusted gross income. It is estimated that 8.8 million tax filers used this deduction, claiming about $87 billion in deductions. This deduction is frequently used by people over 50 who have significant long-term care expenses that are typically not covered by Medicare or commercial healthcare insurance.

Potential impact. Repeal of this deduction may have negative implications for the nursing home and home healthcare industries. Without the benefit of this deduction, those individuals who lack long-term care insurance and are not eligible for Medicaid may find long-term care (including the care they are currently receiving) to be unaffordable.

WHAT'S NOT IN THE BILL

Suspension/Elimination of the Medical Device Tax.

The Affordable Care Act (ACA) included a 2.3% excise tax on the sale price of medical devices. In December 2015, then-President Obama signed a bill that suspended the tax for two years. If Congress does not take action, the medical device tax will go into effect again on January 1, 2018. This bill does not address the medical device tax.

Potential impact. The medical device industry strongly opposes the device tax and has been aggressively lobbying for Congress to repeal it prior to reinstatement. It remains to be seen when, or if, Congress will address this issue.

Elimination of the Individual Mandate.

The ACA imposes a tax on many individuals who do not purchase health insurance (known as the "individual mandate"). President Trump and some Congressional Republicans have suggested that the upcoming tax bill should repeal the individual mandate, but the tax bill does not address this issue.

Potential impact. It is not surprising that the House is not proposing to address the individual mandate as part of a tax bill. Repealing the individual mandate, without additional corresponding modifications elsewhere in the bill, could have significant unintended consequences. The ACA provides that insurers must charge the same premium regardless of current or preexisting health conditions. This requirement creates a strong incentive for adverse selection, *i.e.*, people waiting to purchase health insurance until they are concerned that they are sick or at risk of becoming sick. The individual mandate is intended to counteract adverse selection by penalizing people who have not purchased health insurance. Absent the mandate, some healthy people may stop purchasing health insurance—making health insurance more expensive for everyone else. Prior Republican healthcare bills have proposed various alternatives to the individual mandate that are intended to mitigate the risk of adverse selection. It appears unlikely that Congress would repeal the individual mandate without some substitute that addresses adverse selection.

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