

## How Tax Reform Could Impact The Health Care Industry

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The U.S. House and Senate have now each released their version of the “Tax Cuts and Jobs Act” (in the Senate’s case, a detailed summary rather than legislative language). Each bill contains provisions that could have a significant impact on the health care industry. Below, we describe key provisions that are in — and not in — the House and Senate bills that are likely to be of particular interest to the industry.

### Changes in Corporate Taxes and International Taxation: Both House and Senate Bills

Both bills would dramatically alter the existing corporate tax framework, particularly as it relates to multinational companies. The bills would reduce the corporate tax rate from 35 percent to 20 percent (with a one-year delay in the Senate bill), while limiting interest deductibility.

The bills would also impose a one-time repatriation tax on deferred overseas earnings, at a rate of 14 percent (House) or 10 percent (Senate) for earnings held in cash and seven percent (House) or five percent (Senate) 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 minimum tax imposed (at an effective rate of 10 percent under the House bill and 12.5 percent under the Senate bill) 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 House bill contains a very broad 20 percent excise 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 percent excise tax on the import price. Alternatively, the foreign affiliate can agree to pay U.S. income tax on a deemed profit.



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The Senate bill contains its own anti-base erosion provision that limits the deductibility of payments from U.S. companies to foreign related parties.

### ***Potential impact***

The House and Senate proposals are a mixed bag for corporate taxpayers. On the positive side, the reduction in the corporate tax rate would be beneficial to U.S. health care companies. The one-time repatriation tax may also prove beneficial to U.S. health care 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 health care 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 anti-base erosion rules will significantly affect the tax planning of foreign parented groups with U.S. affiliates.

### **Orphan Drug Tax Credit: Repealed in House, Reduced in Senate**

“Orphan drugs” are drugs that are designed to treat rare diseases that either impact (1) fewer than 200,000 people in the United States or (2) 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 percent of the cost of human clinical testing for such drugs. Under the House bill, this tax credit would be repealed. That would save \$54 billion over ten years.

Under the Senate bill, the value of the credit would be reduced. The credit would generally be limited to 50 percent of the qualified testing expenses in excess of 50 percent of the average qualified testing expenses for the prior three years. The Senate bill would also place additional limitations on what counts as qualified testing expenses. The Senate’s modifications are expected to save \$30 billion over ten years.

### ***Potential impact***

Some members of the pharmaceutical industry have expressed strong opposition to the House’s 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.

The Senate’s bill appears to reflect a compromise: It would roughly cut the value of the credit in half. Even if the credit is eliminated, 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: House Bill Only**

Under current law, taxpayers can receive a deduction for out-of-pocket medical expenses that exceed 10 percent 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 health care insurance.

***Potential impact***

Repeal of this deduction may have negative implications for the nursing home and home health care 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.

**Suspension/Elimination of the Medical Device Tax: Not in Either Bill**

The Affordable Care Act (ACA) included a 2.3 percent 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 Jan. 1, 2018. Neither bill addresses 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: Not in Either Bill**

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 tax bill should repeal the individual mandate. Neither tax bill addresses this issue.

***Potential impact***

At least to date, the House and Senate leadership have eschewed repeal of the individual mandate because of concern that a repeal provision would make it impossible for the bill to pass the Senate.

Additionally, 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 health care bills have proposed various alternatives to the individual mandate that are intended to mitigate the risk of adverse selection. It would be risky to repeal the individual mandate without some substitute that addresses adverse selection.

Nevertheless, this issue is not dead, because the Congressional Budget Office has estimated that repealing the individual mandate would save \$338 billion (due to fewer people purchasing subsidized insurance or applying for Medicaid). Repealing the mandate thus could obviate the need for some of the tax increases that are included in the current bill or could facilitate additional tax cuts. It is possible that the leadership of the House or Senate may revisit this issue in the coming weeks.

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