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HOW US TAX REFORM WILL AFFECT BIOPHARMA SUPPLY CHAINS

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Now that tax reform legislation has been enacted in the US, biopharma companies are working to understand its many potentially far-reaching implications. Supply chain managers in the biopharma industry need to ask certain key questions about how the new law will affect their companies' global networks, investments, and M&A strategies.

Many politicians and business leaders in the US have long identified an overly complex and uncompetitive tax code as one of the reasons for a decades-long reduction in US-based manufacturing. With the passage of its new tax law, many in the US government are hoping to see a surge of investment in US industry that may help stem or partially reverse this decline.

The most significant provisions of the new tax law include a reduction in the corporate tax rate from 35% to 21%; a shift from a global to a more territorial model; mandatory repatriation of offshore cash, with a one-time tax of 15.5%; immediate expensing of investment in tangible business property; and new limits on interest deductibility.

How will these changes affect supply chain strategy and investment in the US biopharma industry? Of course, the answer will depend on a host of factors that will interact with one another in complex and often unpredictable ways. Yet it is possible to make a few key generalizations about the implications of the new US tax regime:

- Overall, we expect the reduction in the US corporate tax rate and more favorable treatment of expenses to make US-based supply chain investments more attractive than they previously were, although there will still be other countries offering more inviting tax arrangements. Ongoing uncertainty about the lifetime of the US changes will also reduce their effectiveness in influencing investment decisions.

- The switch from global to territorial taxation is significant and, along with reduced incentives for having income attributable to intangible assets held overseas, will likely reduce the current incentives for complex internal pricing structures.

- The reduction of incentives for using transfer pricing and licensing arrangements to lower tax bills will allow companies to focus decision making on other drivers of supply chain efficiency, such as costs, labor effectiveness, and talent availability. And US-based firms may have more investment decisions to make, given the injection of cash they will receive from being required to repatriate foreign earnings currently held overseas. (In the past, however, these cash infusions have not been used primarily for capital investment.)

- Because of a variety of provisions in the new tax law, biopharma M&A activity—which fell significantly in 2017—may increase in 2018.

Tax Reform Impact, Provision by Provision

Here's how each of the major provisions of the new US tax law may affect biopharma supply chains:

A Reduction in the US Corporate Tax Rate. The biopharma industry has been a prime exemplar of a larger trend in which companies have shifted their manufacturing operations in one of two directions. Some biopharma firms have gone to developed countries, such as Ireland and Singapore, that offer an attractive combination of highly skilled labor and low tax rates—creating an environment particularly attractive for production of innovative and branded products. Others, especially manufacturers of lower-priced generics, have shifted manufacturing operations to countries such as India and China, which have lower wages and materials costs—in some cases taking advantage of export-oriented Special Economic Zones (SEZs).

To the extent that brick-and-mortar investment decisions have been tied to the location of IP, the reduction in the US corporate tax rate from 35% to 21% may reduce the incentive for companies to make capital investments in the lowest-tax regions. Yet lower rates continue in a small number of other countries with strong existing manufacturing bases. (Ireland's corporate tax rate remains at 12.5%, and Singapore's is at 17%.) So this change in US law—while making the US much more competitive with most OECD countries—may not be enough to alter decisions about capital-heavy supply chain investments.

In a scenario in which companies choose to locate new patents in the US, with an associated shift away from complex transfer-pricing arrangements (see below), we may see a landscape with supply chain decisions focused on factors such as cost, labor skills and efficiency, and regulatory environment rather than optimized for tax.

The reduced US corporate tax rate will also increase the profitability of sales and divestitures, potentially stimulating the M&A market. The lower rate makes asset swaps and divestitures more attractive by reducing the tax rate for sellers and by enabling buyers to more efficiently purchase an entire company and sell off the pieces that don't fit with their priorities. As a result, we may start to see more focused portfolios, with greater concentration within a therapeutic area. There will also likely be a shift of technology and assets to companies that can run them more efficiently at scale.

A Move to a Territorial Tax Model. Prior to 2018, the US was unusual in taxing a US-based company's global earnings rather than just those booked in the US. The new, lower 21% tax rate now applies only to US earnings. The previous global tax obligation, combined with a relatively high tax rate, encouraged US companies operating overseas to concentrate profits outside of the US and then delay or avoid repatriation—creating large cash holdings overseas. Needless to say, removing the global tax obligation and reducing the US tax rate will reduce the incentive to pool future profits overseas.

In biopharma, as well as in other industries, the global taxation model in the US encouraged a complex system of global transfer pricing designed to optimize for tax rates as well as other factors, such as cost. The calculations involved here will change—not just because of the switch to a territorial model but also because of other provisions in the new US tax law. The "base erosion and anti-abuse tax" (BEAT), for one, is designed to act as a form of minimum taxation by creating an additional tax bill for multinational companies making significant payments to foreign subsidiaries in a way that could reduce their US tax bills.

The new law also introduces a category of income called "global intangible low-taxed income" (GILTI), which creates a tax obligation of approximately 13% on overseas income if a company earns more than a 10% rate of return on tangible assets overseas. (As a balance to GILTI, there is a reduced US tax rate for US companies on overseas income from US-based intangible assets—essentially an export credit that lowers the tax rate on such income from 21% to 10%.)

As a result of these changes, biopharma companies that rely on a mix of intangible and tangible assets, spread across a global footprint, will need to rethink their current transfer pricing and licensing arrangements for intellectual property. Taken together, the BEAT and GILTI provisions may mean that new patents are more likely to be based in the US. The complex GILTI rules also have the potential to encourage investment in overseas assets in order to maximize the value of allowable overseas profits.

Repatriation of Overseas Earnings. Rather than allow voluntary repatriation of overseas profits at a lower tax rate, as has been the common approach in the past, the new law makes all existing overseas-held profits subject to a one-time lower tax rate (15.5% for cash assets and 8% for noncash assets such as manufacturing facilities) and deemed repatriated. This will result in a significant injection of available cash for US-based companies, creating additional liquidity for potential investments. (It should be noted that this will also create a large tax bill payable over the next eight years.)

As these companies have more cash on hand, competition for attractive targets in the M&A marketplace may increase, heightening the risk that buyers will overpay. (Conversely, increased—though not complete—certainty around tax policy will drive more predictable future earnings, and therefore more reliable valuations.) Although the changes here may not affect the buying power for larger companies that can easily borrow against their overseas profit pools, smaller companies may be able to consider targets previously thought accessible only to the biggest buyers.

Immediate Write-Off of Capital Expenses. Companies can now expense the full value of tangible assets during the year of purchase. This will make it more attractive to invest in new equipment and other manufacturing assets, with estimates suggesting that the value of this new tax break could be equivalent to as much as 3% of the purchase price.

Changes in Interest Deductibility. Under the new US law, interest deductibility is restricted to 30% of EBITDA until 2021, and 30% of EBIT from 2022 onward. As a result, highly leveraged acquisitions will become more costly, making M&A activity less likely to be financed in this way—or more restricted if this is the primary option available. For companies not newly flush with overseas cash, the new restrictions on interest deductibility may leave them doubly disadvantaged when considering major acquisitions, especially compared with more cash-liquid competitors.

Three Questions for Biopharma Supply Chain Managers

The changes described above will affect companies in the biopharma sector differently depending on their current exposure to US taxes and the global footprint of their supply chains and sales. Moreover, the long-term impact of these changes will depend on the longevity of the newly enacted provisions and how other countries choose to respond, perhaps with changes of their own. Finally, it remains to be seen how "sticky" certain features of the pretax reform regime will be, as there are significant barriers to change. For example, we don't yet know what the capital costs associated with shifting existing investments will be, nor the transaction costs for shifting existing IP from one location to another.

As a starting point, we suggest that biopharma leaders tackle three big questions arising from the US tax law changes, each of which leads to more detailed questions for supply chain managers.

1. How does tax reform impact the economic fundamentals of your business?
    - How exposed is your global supply chain footprint to tax reform changes?
    - Do you have to rethink your supplier or network strategy?
    - Are there current open decisions that will be affected?
    - Are there additional fixed asset investments that are now more attractive?
2. How can you make the most of additional repatriated cash or future profitability?
    - How can you use planned capital investments to drive competitiveness in your US operations?
    - Is this an opportunity to invest in the digitization of your supply chain?
3. Does your M&A strategy need to be updated to reflect policy changes—perhaps with more focus on asset swaps and divestitures?
    - Do you need to rethink how you value US versus non-US assets that might be part of a deal?
    - What would be the impact of a more focused portfolio on your supply chain? What would it mean for your site footprint if you lost noncore products?
    - Does your organization have the capabilities to deliver value from any upcoming M&A activity?

By focusing on these questions, leaders of biopharma companies can be prepared for the range of effects that US tax reform will bring about—and have a better understanding of how to make winning moves.

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