

ECONOMIC ANALYSIS

Drug Company Profits Shift Out of United States

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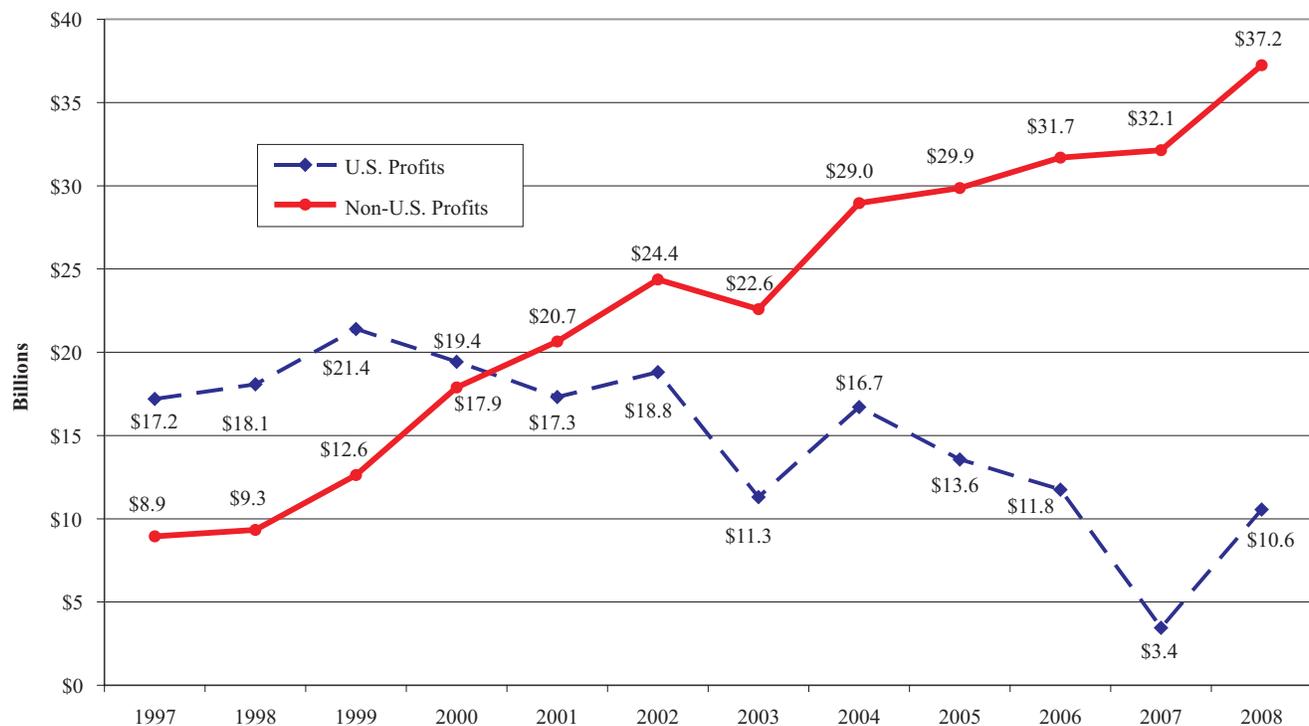
Where do America's largest pharmaceutical companies make their money? Annual reports released over the last few weeks show the continuation of a decade-long trend: There is a striking change in geographic mix from domestic to foreign profits. In the late 1990s, about two-thirds of pharmaceutical before-tax profits were in the United States. A decade later, about four-fifths of before-tax profits are outside the United States. You can see this for yourself in Figure 1. (Figures A1 through A9 at the

end of this article show the corresponding figures for individual companies.)

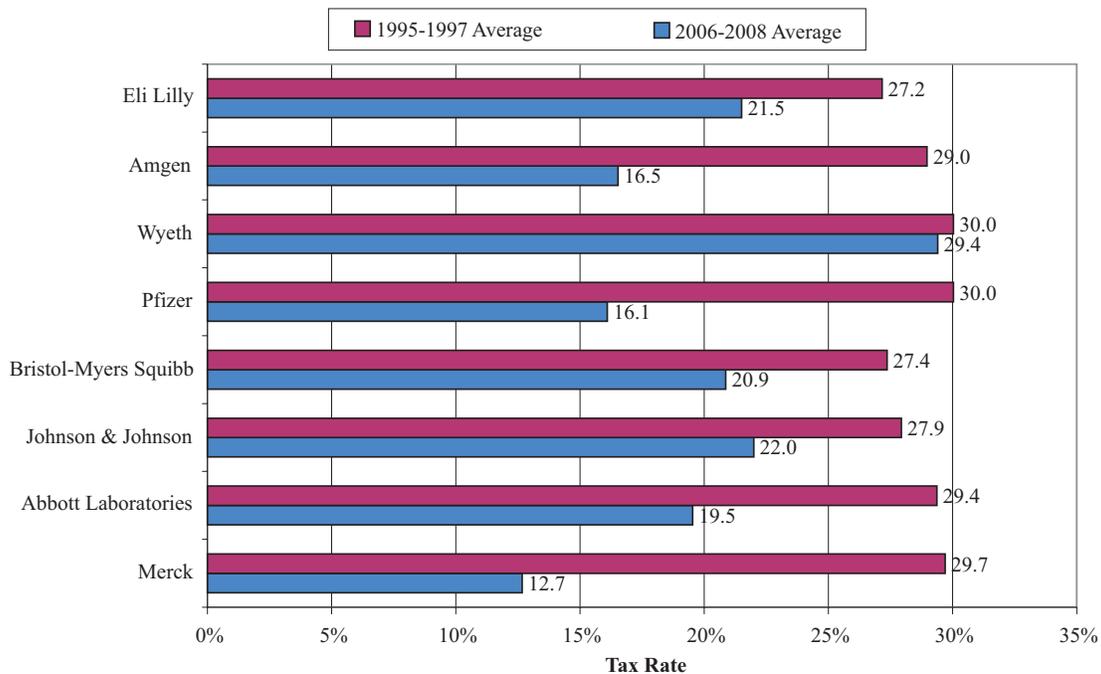
This migration has been beneficial to the companies' bottom line. Most foreign jurisdictions where drug companies do business generally have lower corporate tax rates than the United States. Ireland, with a 12.5 percent corporate rate, is a particular favorite. So the outbound profit shift has resulted in a marked decline in effective tax rates. This is shown in Figure 2. For example, Abbott Laboratories had an average effective tax rate of 29.4 percent from 1996 to 1998. Its average effective tax rate for 2006 through 2008 was 19.5 percent.

After-tax earnings get a lot of attention on Wall Street. A 10 percentage point decline in an effective tax rate will typically increase after-tax profits between 12 and 14 percent. Higher reported after-tax earnings translate into higher stock prices.

Figure 1. Foreign and Domestic Profits of Seven Large U.S. Drug Companies, 1997-2008



Source: Annual reports of Abbott Laboratories, Bristol-Myers Squibb, Eli Lilly, Johnson & Johnson, Merck, Pfizer, and Schering-Plough. Amgen and Wyeth excluded due to incomplete data in early years.

Figure 2. Effective Tax Rates of Large Drug Companies: 1995-1997 and 2006-2008 Compared

Source: Company annual reports. Schering-Plough not included because losses in later years make effective tax rates not meaningful.

Reasons

As globalization increasingly takes hold, it is only natural for the domestic share of a multinational's profits to decline. As companies do more business abroad, they will earn more abroad. Is increased real business activity behind the large profit shift shown in Figure 1?

Abbott Laboratories had an average effective tax rate of 29.4 percent from 1996 to 1998. Its average effective tax rate for 2006 through 2008 was 19.5 percent.

Figure 3A shows the foreign shares of before-tax profits, sales, and assets of seven large U.S. pharmaceutical companies during the 1996-1998 period. Figure 3B shows the same foreign shares for 2006-2008. In Figure 3A, foreign profit shares are roughly commensurate with sales and assets. Figure 3B generally shows small increases in the foreign share of assets and significant increases in the foreign share of sales. But even the increases in foreign sales cannot account for the tremendous increase in foreign profits. For most of the companies, foreign profit shares are far greater than shares of foreign sales. For three of the companies — Abbott, Schering-Plough, and Eli Lilly — foreign profits as a

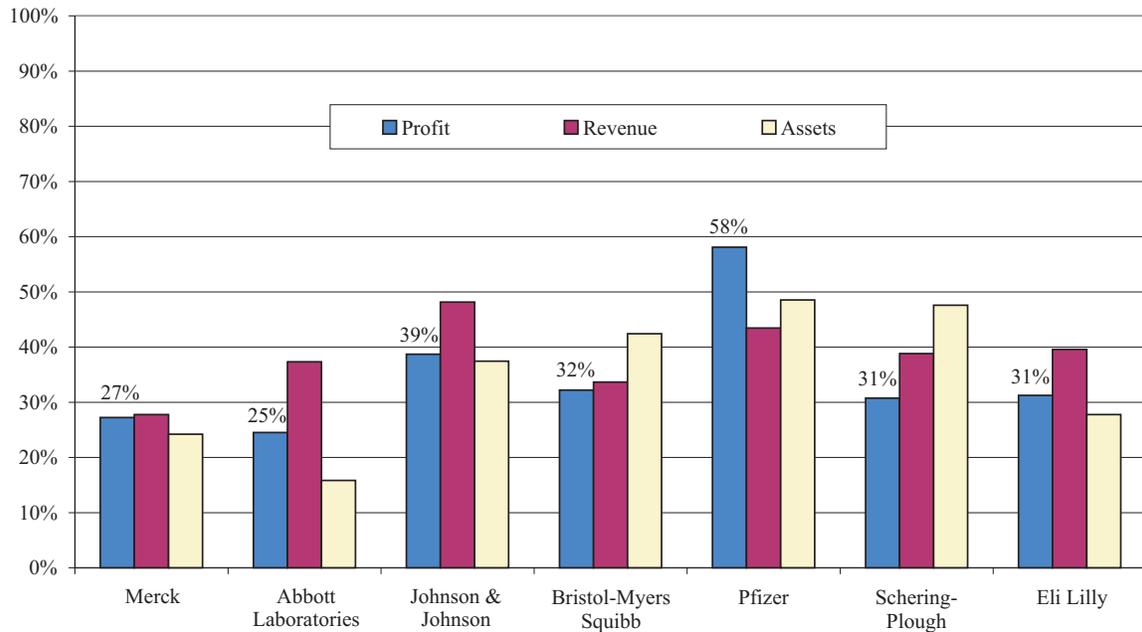
share of worldwide profits exceeded 100 percent in 2006-2008. (Foreign profits in excess of 100 percent mean the company earned a profit on a worldwide basis while its domestic profits were negative.)

Research is the bedrock of pharmaceutical company profitability. But shifts in research cannot explain the change in foreign profitability or its levels. Based on data from the Commerce Department, Figure 4 shows that foreign affiliates of U.S. pharmaceutical companies performed 17 percent of those companies' worldwide research. In 2007 that figure remained unchanged.

Higher prices charged to U.S. customers suggest that the U.S. share of profits should exceed the U.S. share of sales.

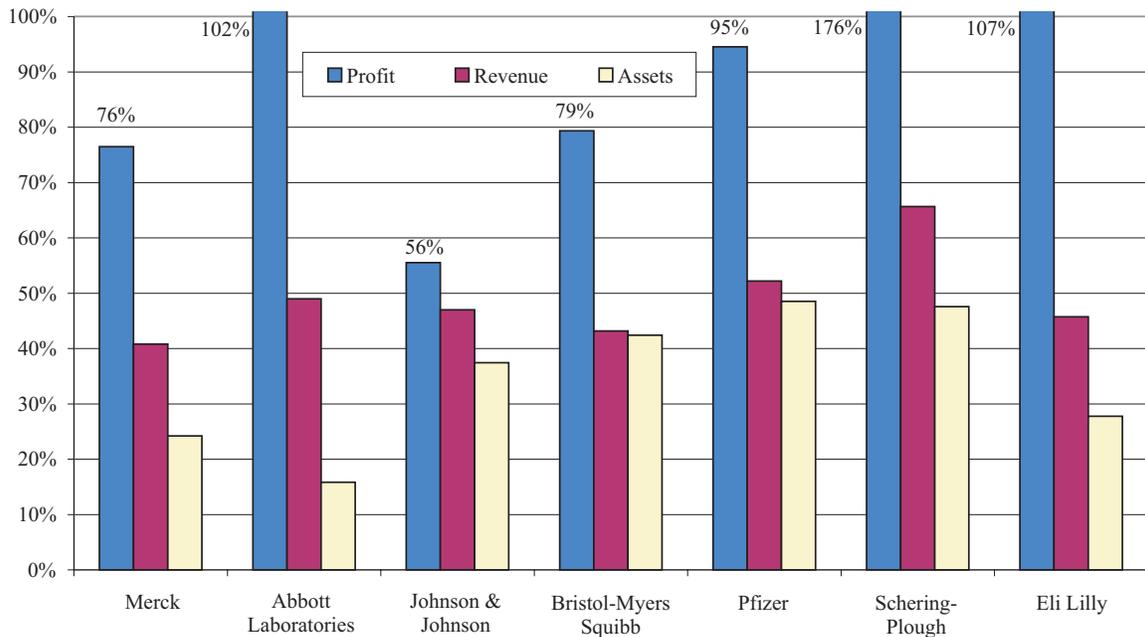
Finally, the levels of foreign profit are difficult to reconcile with the widely known fact that U.S. pharmaceutical companies charge significantly higher prices to their U.S. customers than to foreign customers. The reason for this, as explained by the pharmaceutical industry itself, is price controls by foreign governments. (See "Foreign Government Pharmaceutical Price and Access Controls," submission by the Pharmaceutical Research and Manufacturers of America to the U.S. Department of Commerce, July 1, 2004.)

Figure 3A. Drug Company Foreign Shares of Profit, Sales, and Assets, 1996-1998



Source: Company annual reports.

Figure 3B. Drug Company Foreign Shares of Profit, Sales, and Assets, 2006-2008



Source: Company annual reports.

It is difficult to make apples-to-apples comparisons of prices between domestic and foreign drugs. And because it is such a hot political question, estimates vary widely. A 2004 report by the Con-

gressional Budget Office concludes that average prices for patented drugs in other industrialized countries are 35 to 55 percent lower than in the

Figure 4. Foreign Component of U.S. Drug Company Research

Source: Bureau of Economic Research, U.S. Department of Commerce, Operations of Multinational Companies. In 2007 U.S. drug companies performed \$41.4 billion of research in the United States and \$8.2 billion of research in foreign affiliates.

United States (“Would Prescription Drug Importation Reduce U.S. Drug Spending?” Apr. 29, 2004). Higher prices charged to U.S. customers suggest that the U.S. share of profits should exceed the U.S. share of sales, but Figure 3B shows the opposite.

All this leaves aggressive transfer pricing practices as the likely explanation for the shift in profits outside the United States. Treasury’s devotion to the arm’s-length method is particularly misguided when it comes to cross-border transfers of intangible assets. Application of the arm’s-length method relies on the discovery of comparable transactions by unrelated parties. Comparables for intangible assets — by their nature unique — are rare. So when it comes to intangible assets, the arm’s-length method in practice is reduced to a rickety collection of vague principles and rules of thumb. The research-intensive pharmaceutical industry is heavily laden with intangible assets and therefore is little constrained by arm’s-length principles.

Time for Change?

In 2003 the Senate Finance Committee initiated an inquiry into the IRS advance pricing agreement program, which provides advance rulings to companies on difficult transfer pricing issues. (For a statement, see *Doc 2003-26954* or *2003 TNT 246-28*.) A draft study was written, and it concluded that the

IRS was giving away the store by agreeing to terms highly favorable to big business. (For prior coverage, see *Tax Notes*, Jan. 21, 2008, p. 366, *Doc 2008-801*, or *2008 TNT 10-3*.) The Finance Committee never issued a final report and has offered no explanation why. Perhaps House Ways and Means Committee member Richard E. Neal, D-Mass., can pick up where the Finance Committee left off when his subcommittee does its study of transfer pricing this year. (For prior coverage, see *Tax Notes*, Mar. 1, 2010, p. 1019, *Doc 2010-4172*, or *2010 TNT 38-3*.)

It is time for the United States to consider alternatives such as formulary apportionment or, more realistically, a hybrid arm’s-length formulary method.

The arm’s-length method does not work well in theory or in practice. It is time for the United States to consider alternatives such as formulary apportionment or, more realistically, a hybrid arm’s-length formulary method. (For analysis, see *Tax Notes*, Jan. 18, 2010, p. 271, *Doc 2010-823*, or *2010 TNT 11-6*.) The Obama administration’s new proposal to repeal deferral for excess returns in low-tax

jurisdictions can be considered a step in that direction. The need for major reform of our transfer pricing laws has been apparent for decades. Calculations like those presented here suggest that matters are getting far worse instead of better. ■

(Appendix figures begin below.)

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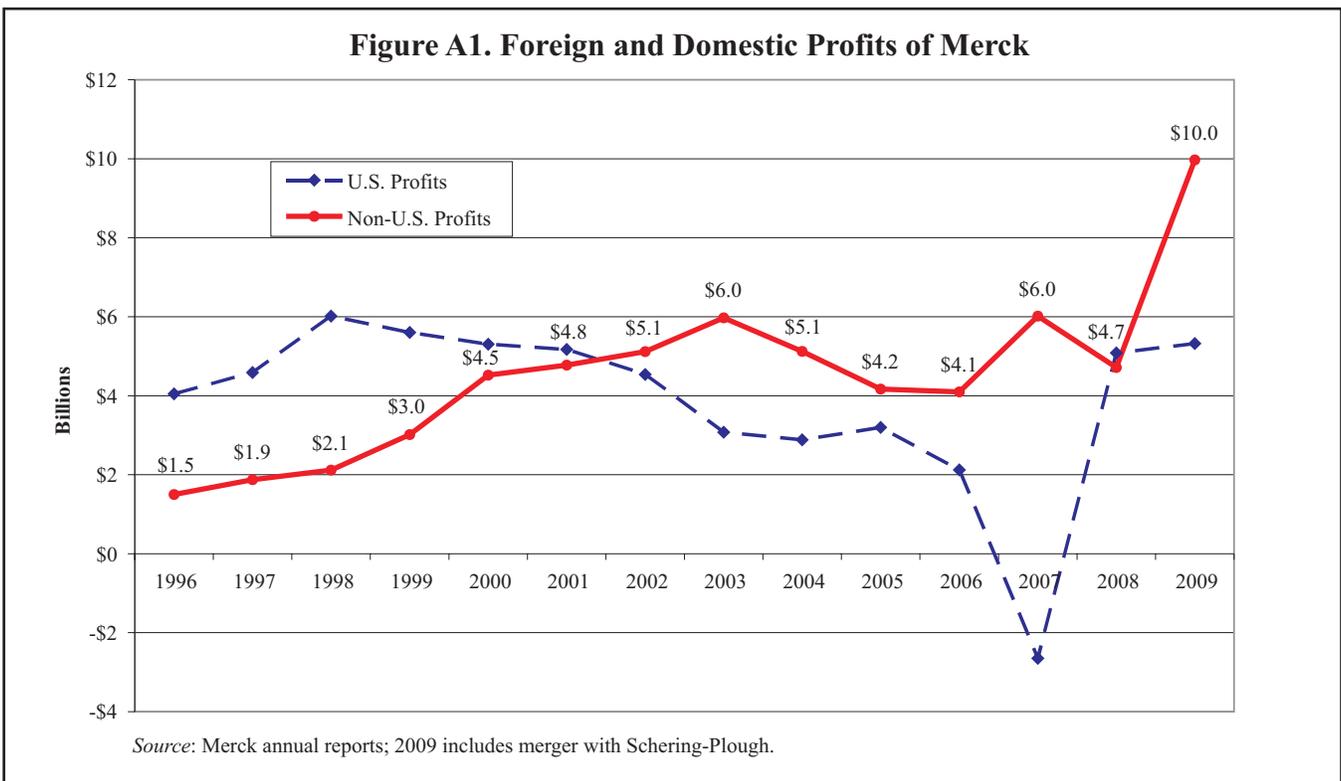
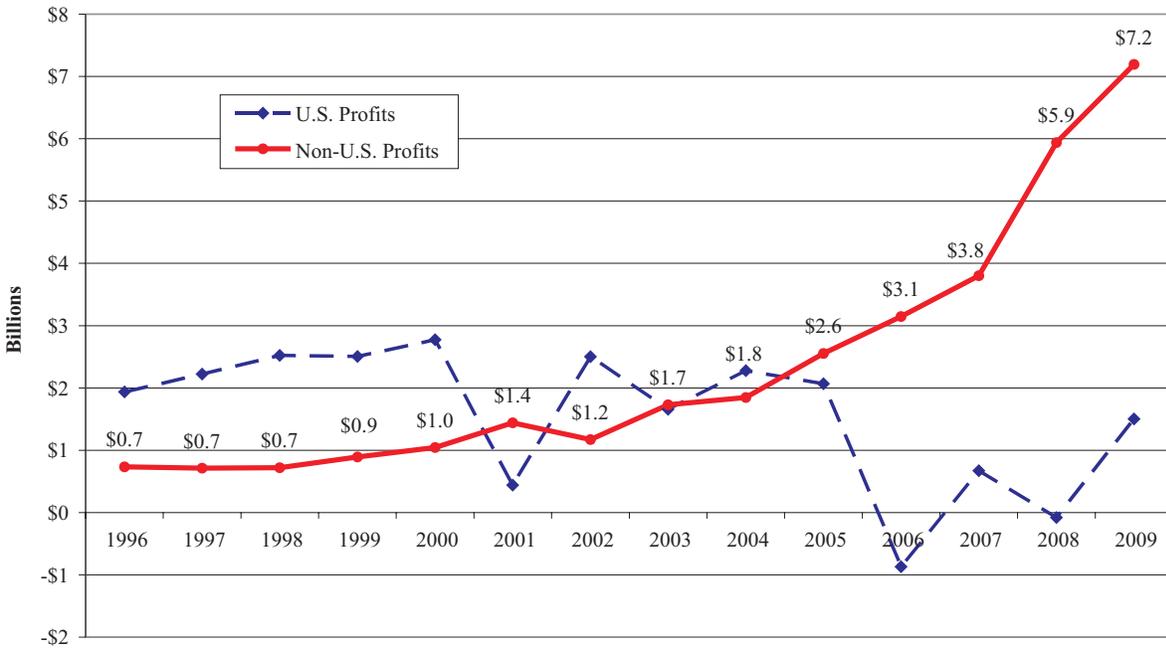
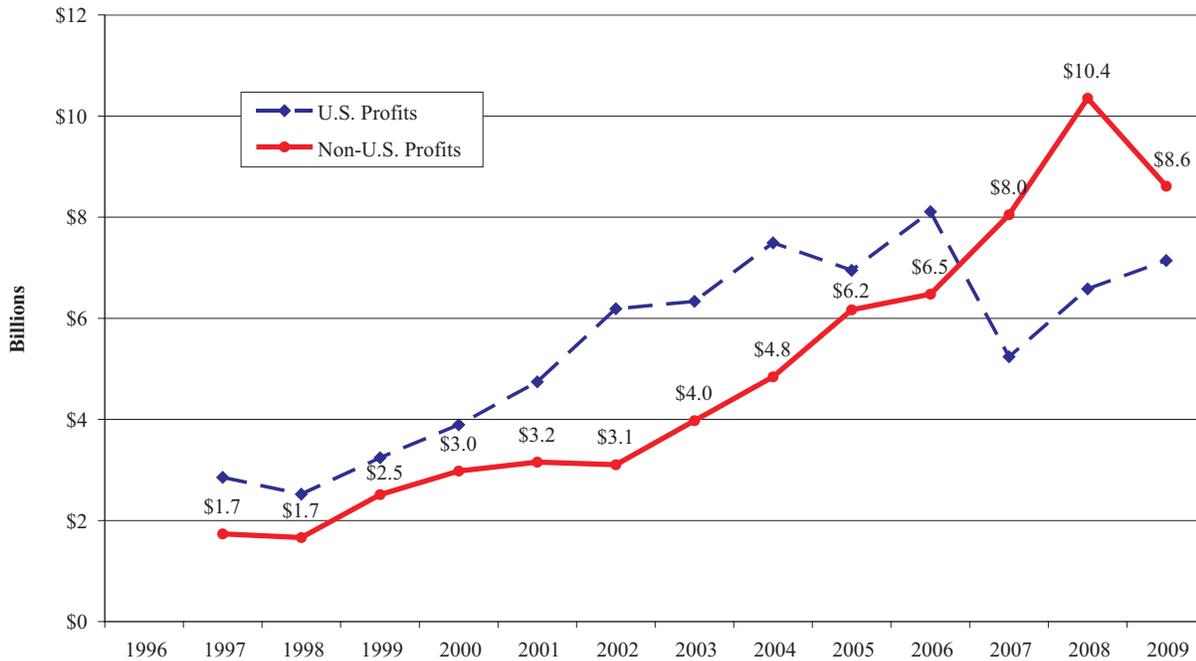


Figure A2. Foreign and Domestic Profits of Abbott Laboratories



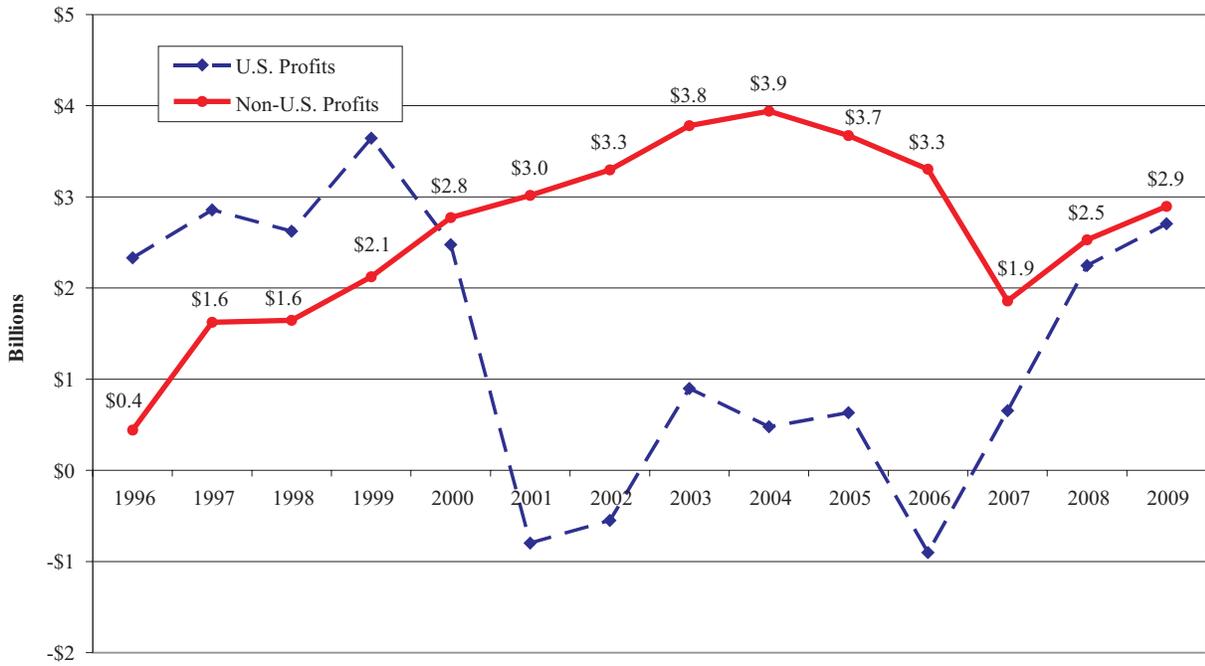
Source: Abbott Laboratories annual reports.

Figure A3. Foreign and Domestic Profits of Johnson & Johnson



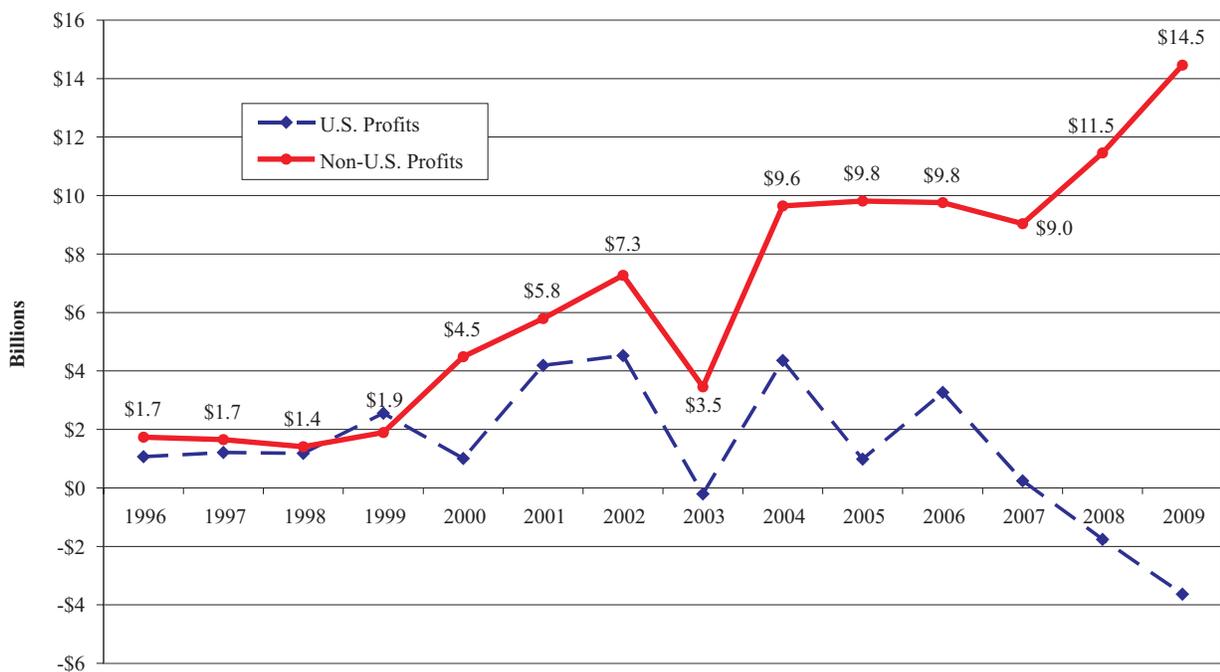
Source: Johnson & Johnson annual reports.

Figure A4. Foreign and Domestic Profits of Bristol-Myers Squibb



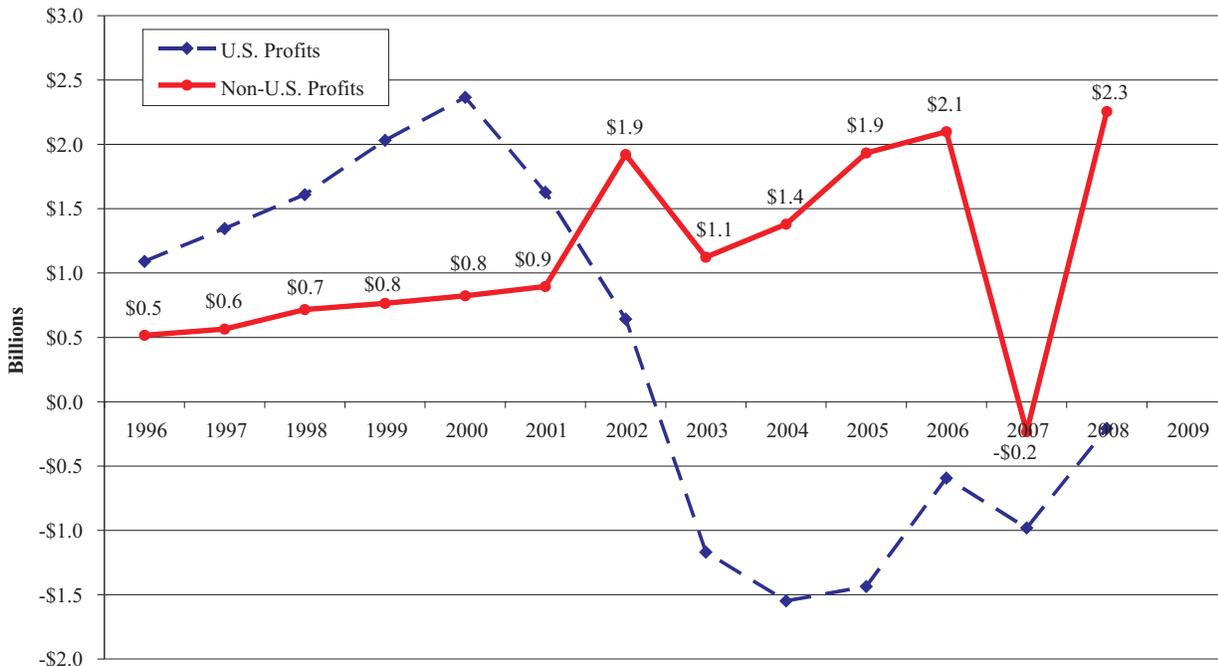
Source: Bristol-Myers Squibb annual reports.

Figure A5. Foreign and Domestic Profits of Pfizer



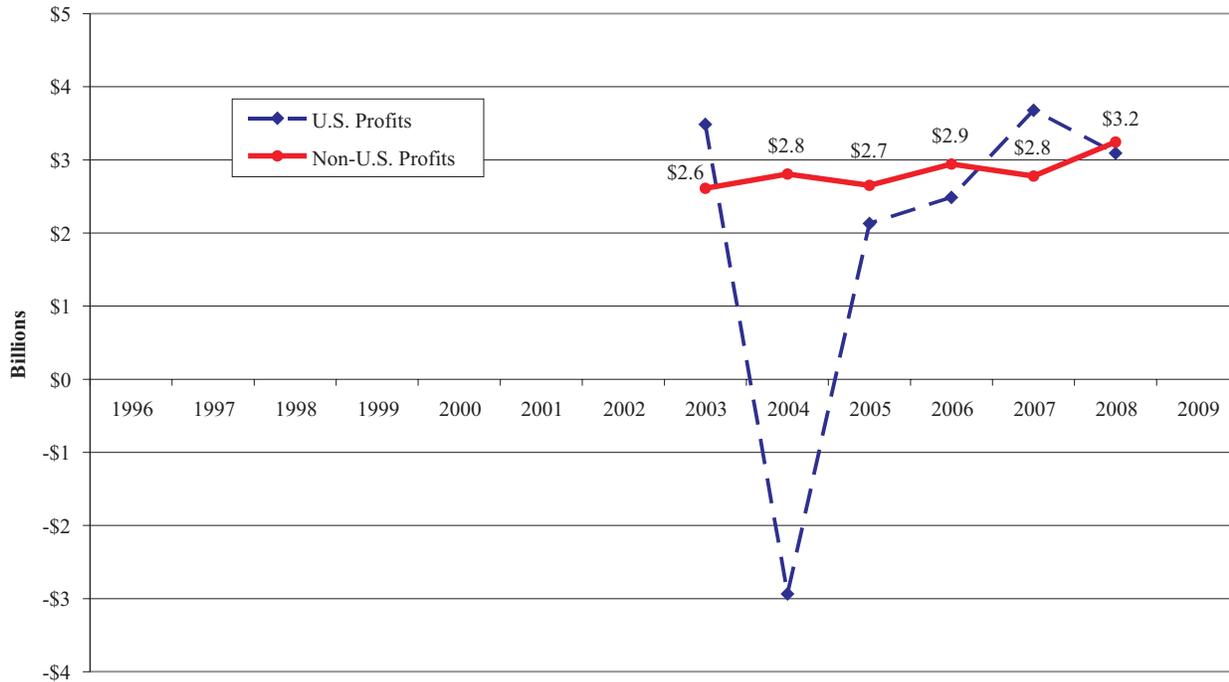
Source: Pfizer annual reports; 2009 data includes merger with Wyeth.

Figure A6. Foreign and Domestic Profits of Schering-Plough



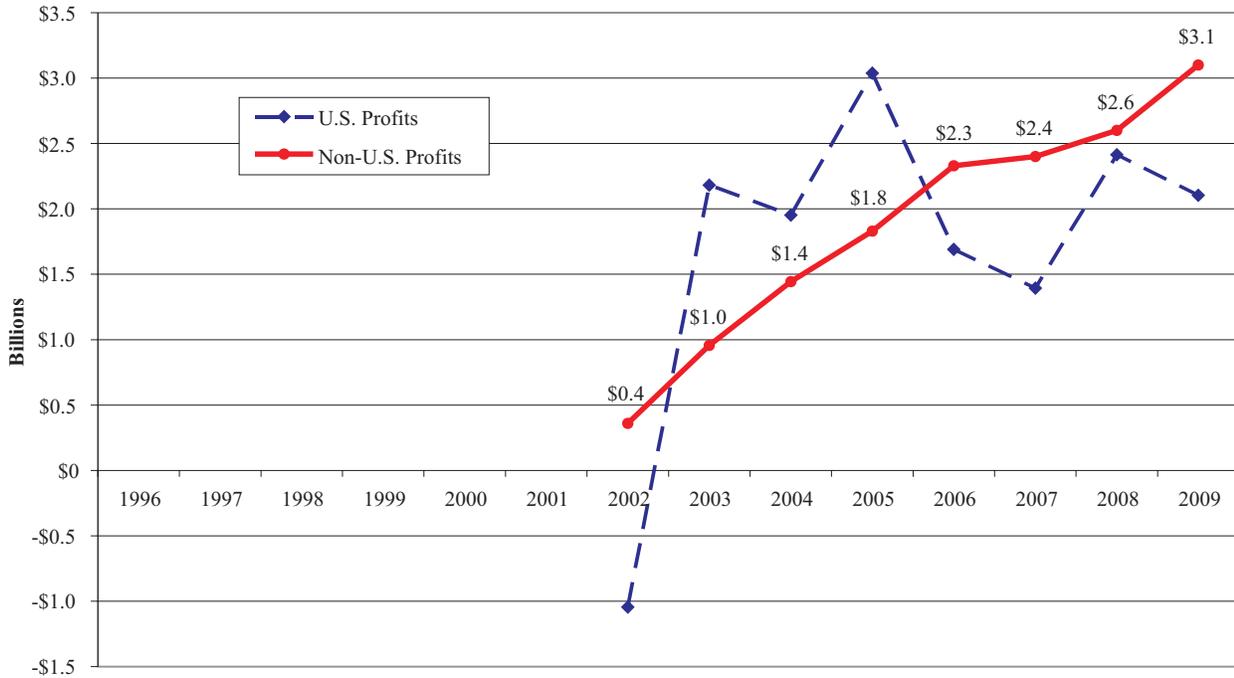
Source: Schering-Plough annual reports. Company merged with Merck in 2009.

Figure A7. Foreign and Domestic Profits of Wyeth



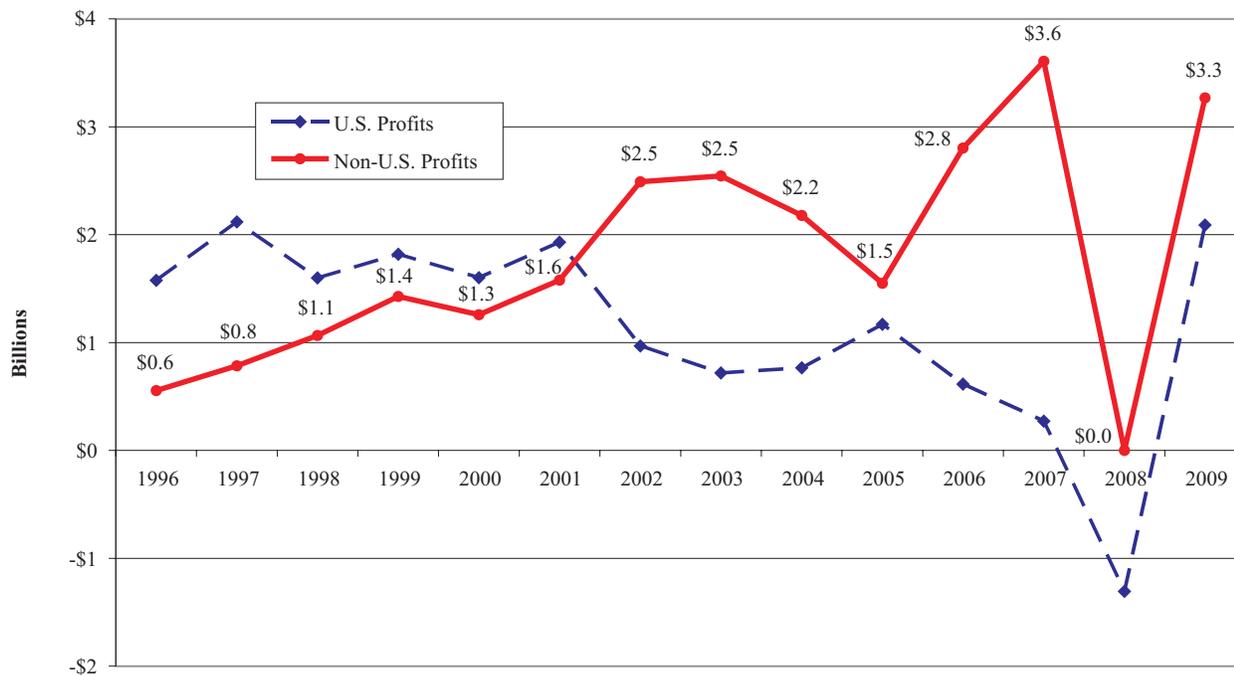
Source: Wyeth annual reports. Data before 2003 are not available. Company merged with Pfizer in 2009.

Figure A8. Foreign and Domestic Profits of Amgen



Source: Amgen annual reports. Data before 2002 are not available.

Figure A9. Foreign and Domestic Profits of Eli Lilly



Source: Eli Lilly annual reports.