REPORTAGE | BIG PHARMA

BIG PHARMA'S TAXING SITUATION

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In the 1990s and early 2000s, pharmaceutical companies commanded entire towns in Puerto Rico. Every year, Barceloneta, a coastal community dubbed "Ciudad Viagra," churned out some 100 million of Pfizer's little blue pills. In 2000, there were some

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77 pharmaceutical companies in Puerto Rico, and by 2004, 19 of the world's top 25 prescription drugs were manufactured on the island.

The U.S. commonwealth's pharmaceutical industry, however, was built on shifting sands.

Puerto Rico had been a tax haven with one major advantage: Multinationals keen to avoid corporate taxes could fully repatriate their profits back to the U.S. mainland. This was complemented by tax-free income generated by intangible assets, such as pharmaceutical patents. And it even had a patriotic country code: Companies like Pfizer could truthfully say products were made in the U.S.A.

Since the Industrial Incentive Act of 1948, which freed firms from paying various local fees, the island has been a backyard tax haven. But it was the Tax Reform Act of 1976 that lured in Big Pharma. Section 936, one of the law's offshoots, effectively gave U.S. corporations a full tax exemption for operating in Puerto Rico.

Congress said it hoped the legislation would spur job creation. And by that measure, Section 936 seemed successful, providing an estimated 170,000 manufacturing jobs by the mid-1990s. For an island with a population of about 3.5 million, these relatively high-paying positions were a boon.

Still, the jobs were always precarious, relying on costly tax exemptions. As early as 1982, the U.S. Congress attempted to "lessen the abuse caused by taxpayers claiming tax-free income generated by intangible assets developed outside of Puerto Rico." Subsequent laws such as the Tax Equity and Fiscal Responsibility Act (1982), Tax Reform Act (1986), and Revenue Reconciliation Act (1993) sought to reduce the effective tax credit for companies.

But with the power of the pharmaceutical lobby, change was slow, and multinationals had ample time and loopholes to circumvent Congress. By 1994, the U.S. Government Accountability Office said that Section 936 was costing the federal government $3.9 billion a year.

But what Congress ultimately ended up doing—without any political representation from Puerto Rico—sacrificed the island's workers without getting much in return. Starting in 1996, Section 936 was gradually phased out, fully expiring in 2006. Today, Big Pharma can route their profits through new safe harbors, and their profits remain hardly taxed. Congress didn't so much as close loopholes as shift them elsewhere.

Puerto Rico still provides incentives to companies like Pfizer, including an exemption from income, property, municipal, and other taxes (where a tax is levied, such as an excise, it is just 1 percent). These tax benefits don't expire until 2029. But when repatriation rules changed, so did Pfizer's corporate structure, transferring both drug production and patent ownership elsewhere. When companies move their money and production facilities, they squirrel away profits and often harm the economies of countries they've abandoned. Between 1996 and 2014, the number of manufacturing jobs in Puerto Rico fell by about half.

An analysis of the public disclosures of nine pharmaceutical companies show they ducked paying approximately $140 billion in taxes by holding more than $405 billion of their income offshore. Pfizer led the pack with $25.9 billion in avoided tax, followed by Merck ($21 billion), and Johnson & Johnson ($18.6 billion).

The arguments used by pharmaceutical companies to justify this tax dodging are spurious. The true cost of developing drugs is intentionally opaque, but it's clear that pharmaceutical companies rely on intangible assets such

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as patents, which are financed, subsidized, and developed by public institutions—whose funding corporations deny with their creative accounting. The alleged cost of obtaining a patent trotted out by companies is frequently the product of mispricing and artificial expenses. And while pharmaceutical companies may be needed for mass commercialization and distribution of drugs, the value of these companies is overwhelmingly related to intangible assets, which are largely untaxed.

HIDDEN AND INTANGIBLE

Land and other genuinely scarce items are no longer the most valuable assets in the world. By 1998, about 80 percent of corporate market value was located in intellectual property, which is considered an intangible asset. For companies that are heavily dependent on intangibles, such as Pfizer—with a market cap of $191 billion—the company's actual book value or net tangible asset (NTA) is about $5.9 billion in the red. Others like Bristol-Myers Squibb and Eli Lilly show similarly high market caps—$105 billion and $85 billion respectively—compared to net assets of only $6 billion and $10.7 billion.

This is par for the course. By 2009, just 7 percent or $3.8 trillion of an estimated $27.3 trillion in corporate intangible capital was disclosed to governments and investors on financial statements, according to Brand Finance, an intangible capital valuation consultancy.

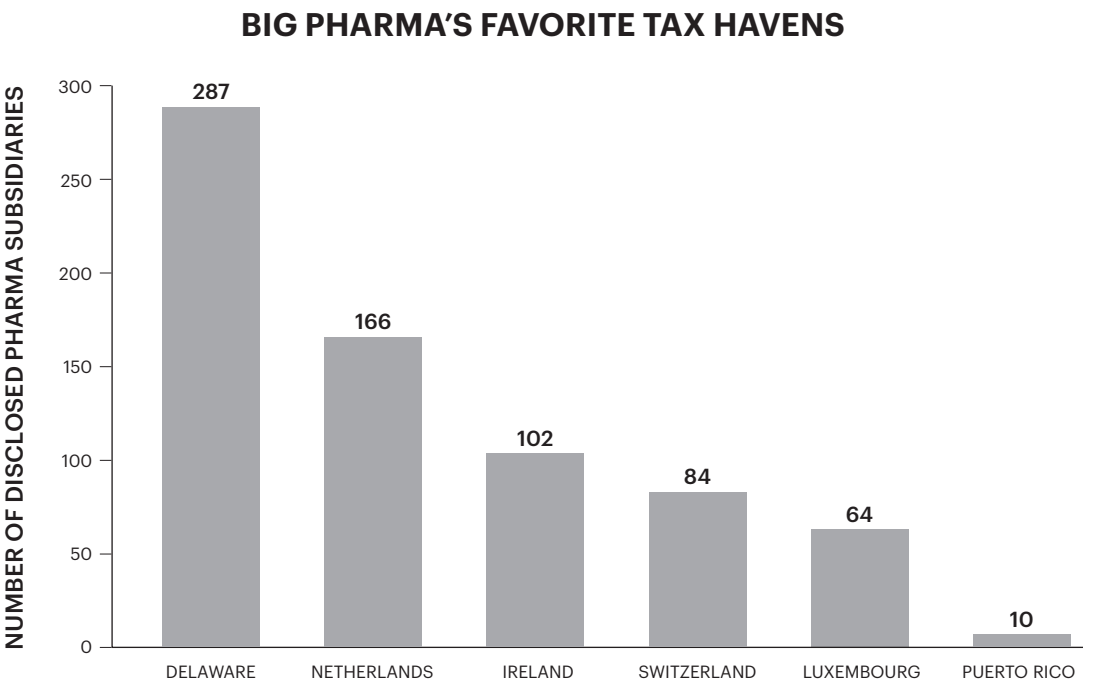
The financial accounting process for patents is trickier than other assets. The value of a patent inheres to the parent entity while the patent itself legally belongs to a specific subsidiary, which may have been created with the sole purpose of managing such intangible assets. The patent is transferred on the authority of the parent company and may be shifted multiple times depending on the tax planning structure devised by the company's accountants. The subsidiary may be based in any location, including a tax haven, as the patent, like other intangible wealth, is not constrained by law to remain in the jurisdiction where it was developed.

So, in July 1999, the Viagra (sildenafil citrate) patent was logged under the ownership of an entity called Pfizer Research and Development N.V/S.A, based in Ireland and Belgium: the former offering a 0 percent tax within certain jurisdictions and the latter providing an 80 percent tax deduction from patent incomes. In 2003, the patent was transferred from Pfizer's Research entity based at Dublin's International Financial Services Center to Pfizer Ireland Pharmaceutical where it has remained. The actual drug ingredients are manufactured in Ireland's Ringaskiddy hub, but it was in the Isle of Man, a U.K. tax haven, that Pfizer's Ringaskiddy Production Company was incorporated. Later, two holding companies based in Delaware (Pfizer PFE Holding 1 and Pfizer PFE Holding 2) were created as conduits for income from Pfizer's intangible assets.

Effectively, the company is able to use the patent owner, such as Pfizer Ireland, to charge its other subsidiaries royalties, which can then be remitted to any bank account of choice. The strategy reduces the disclosed pre-tax profits through creating artificial expenses. Income is siphoned to offshore entities, and debt and losses are registered in non-tax haven jurisdictions such as the U.S. A company can then claim a tax rate of between 25 and 35 percent while also determining the actual value that is subject to taxation.

For such reasons, Pfizer Ireland is also the proud owner of other blockbuster drugs such as Lipitor (atorvastatin). Generating $10.7 billion in revenue from 2003-2014, Lipitor was created by Warner Lambert—a company purchased by Pfizer in 2000 for $90 billion. Pfizer's intangible assets, listed at $35 billion, only disclose those assets like Lipitor that are acquired from other companies.

The value of acquired intangibles is frozen to the date of purchase (and capitalization), and thereafter amortized annually, usually in tax



havens like the Netherlands. This occurs even if the value and revenue related to the intangible asset increases. That is, accretion, or added value, of acquired intangibles isn't registered, only depreciation. During the past three years, Pfizer documented over $13 billion in amortized intangible value—equivalent to about 8 or 9 percent of revenue annually. But the company did not disclose which intangibles were amortized.

Pfizer also did not reveal the value of those intangible assets internally developed, like Viagra. In what is the accounting world's biggest blind spot, these assets are also not published in annual reports. Brand Finance acknowledges, "most high value, internally generated, intangible assets never appear in conventional balance sheets."

Internally developed intangibles are the assets most prone to financial fudging as the value is wholly determined by the company. According to reporting formats established by the International Accounting Standards Board (IASB), there is no demand or resources for these assets to be financially articulated on balance sheets. Yet expenses related to internally developed assets are considered legitimate, even where these same expenses cannot be verified and are, like the value of the assets themselves, entirely subjective. The IASB has said discreeTly it has "paused" research on how to value and tax internally developed intangibles, which comprises the bulk of corporate value for technology, pharmaceutical, beverage, and other companies.

Pfizer maintains about $74 billion in offshore capital, using a web of more than 200 entities based in tax havens, chiefly those specializing in shifting profit from intangible assets around places like Delaware, the Netherlands, Luxembourg, and Ireland. The reasons are simple: In the Netherlands, taxes on intangibles are just 5 percent. In Luxembourg, taxes are reduced by 80 percent if transactions occur within subsidiaries of the same parent company, and

Delaware, the mothership of intangible asset trickery, boasts a complete exemption for intangible assets provided money dances around holding companies engaged in "management."

Pfizer's $25.9 billion tax dodge, though the largest, was not the only one. We looked at a handful of pharmaceutical companies, large and small, and calculated their tax avoidances: Merck ($21 billion), Novartis ($19.2 billion), Johnson & Johnson ($18.6 billion), Amgen ($10.5 billion), Bristol-Myers Squibb ($8.4 billion), Eli Lilly ($8.2 billion), AbbVie ($8 billion), Abbott ($8 billion), Gilead ($5.5 billion), Baxter ($4.2 billion), Celgene ($2.3 billion), and McKesson ($1.4 billion). Just 13 pharmaceutical companies have avoided paying over $140 billion in taxes by offshoring $405 billion. (This excludes other multinationals with significant drug divisions such as Procter & Gamble, which should owe $15.4 billion in tax.)

Each company used similar language to describe its avoidance:

> -"At December 31, 2014, foreign earnings of $60.0 billion have been retained indefinitely by subsidiary companies for reinvestment; therefore, no provision has been made for income taxes that would be payable upon the distribution of such earnings," disclosed Merck.
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> -"The effective tax rate is lower than the U.S. statutory rate of 35% primarily attributable to undistributed earnings of certain foreign subsidiaries ... U.S. taxes have not been provided on approximately $24 billion of undistributed earnings of foreign subsidiaries as of December 31, 2014," stated Bristol-Myers Squibb.

These disclosures, albeit in very fine print, are public. The use of multiple tax havens for complementary purposes, ranging from manufacturing of drugs to spiriting of funds, is legal. What is kept hidden, however, are two layers of transactions: The first is the annual income, loans, expenses, and services between subsidiaries of the same parent company. The second is the financial dealings involving internally developed intangible assets, which are shielded from public scrutiny and entirely self-regulated.

Recently, the multinational tax dodge has become yet more brazen, with Pfizer currently seeking to invert, or reincorporate, its headquarters to a tax haven—in this case, merging with Allergan to move to Ireland—in a bid to avoid the United States entirely. The way it works is that a company can acquire or merge with a smaller foreign company and change their corporate billing address to eliminate U.S. federal and state taxes. In 2014, Pfizer unsuccessfully tried to merge with the U.K.'s AstraZeneca using inversion, a practice U.S. President Barack Obama called legal but "wrong."

PHARMA'S FUZZY MATH

About half of the pharmaceutical industry's global sales—about $400 billion annually—are purchased as prescription drugs in the U.S. Last year, the top 25 prescription drugs catering to various forms of aches and pains churned out $145 billion in sales. The year before, Bayer's then-CEO Marijn Dekkers, in response to India's compulsory licensing attempt for cancer drug Nexavar, said: "We did not develop this medicine for the Indian market, let's be honest. We developed this product for Western patients who can afford this product."

Certainly, at over $10,000 per month for Nexavar in the U.S., where there exists no price ceiling on medicines, Bayer is cashing in. Big Pharma stridently declares the U.S. lacks price restrictions necessary to generate the revenue needed for innovation. The rest of the world, then, is free-riding on America's high health care costs. Pharma's argument seems to have convinced the U.S. Department of Commerce, which claims there is "close correlation between revenues and profit margins on the one hand and R&D expenditures on the other."

The numbers, though, suggest otherwise: Past studies show just 1.3 percent of net sales in the U.S. is re-invested in research. In reality, taxes, not pharmaceutical profits, subsidize the majority of research funding for new drug development: In 2006, 84 percent of research funding for 48 new drug innovations came from public sources such as the National Institutes of Health (NIH), according to the medical sociologist Donald Light.

Plus, European countries such as France, Italy, Germany, and the U.K. are no less innovative, despite mandating capped prices at levels affordable to citizens. Studies show European countries, which account for 28 percent of global sales and 36 percent of global R&D, produce 32 percent of new molecular entities (NMEs). The U.S., accounting for about 50 percent of global sales, produces 45 percent of global NMEs.

So, how much does it cost to develop a new, innovative drug—something approved by the FDA that adds original value or advances the existing treatment of cancer or diabetes or ulcers or arthritis? About a decade ago, a study produced by the Tufts Center for Study of Drug Development pegged the figure at $1 billion. Titled "The Price of Innovation" and published in the *Journal of Health Economics*, the study claimed the unbiased detailing of R&D expenditure for 68 randomly selected drugs through a survey of 10 large pharmaceutical companies. Between them, the companies were responsible for 42 percent of drug R&D expenses in the U.S. The study found the average cost of drug development to be $802 million each, a figure that increases to between $1.6 and $1.8 billion with inflation.

The Tufts Center declined to mention that pharmaceutical companies provided about 65 percent of its finances. There was also no way to verify the quality of information, as the names of the companies as well as the names and types of drugs were confidential. More importantly, the data was supplied by companies that profit from the impression that patents are hugely expensive and that they pay for them.

From 1996 to 2005, Big Pharma generated $558 billion in profits, produced from $288 billion in R&D and some $739 billion in marketing and administration, which includes direct-to-consumer advertising for platforms such as television, sales pitches, freebies, advertisements in medical journals, and the like.

The actual breakdown of R&D costs reveals some fuzzy math on the part of the Tufts Center, particularly when it comes to "capitalized costs," explained by the authors as "the expected return that investors forego during development when they invest in pharmaceutical R&D instead of an equally risky portfolio of financial securities." Simply put, what companies would have earned had they invested in Wall Street. "The Tufts consultants simply tacked it onto the industry's out-of-pocket costs. That accounting maneuver nearly doubled the $403 million to $802 million," said Marcia Angell, former editor-in-chief of *The New England Journal of Medicine* and senior lecturer at Harvard Medical School.

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The U.S. Office of Technology Assessment also notes, "The net cost of every dollar spent on research must be reduced by the amount of tax avoided by that expenditure." This includes tax savings of between 30 percent to 39 percent of

R&D costs. As Light and economist Rebecca Warburton have determined, the combined effect of taxpayer subsidies and credits reduces the overall costs from $403 million to $201 million—a far cry from the original billion dollar claim.

LICENSED TO ILL

Additionally, more than a quarter of Big Pharma's products are developed externally—most often by cash-strapped public institutions, universities, and small companies.

This is called licensing, and often involves companies that receive federal funding. In 1980, the Bayh-Dole Act formalized this process with legislation that sought to establish the role of universities as trustees of federal funding acting on behalf of the public. It granted universities the right to pursue ownership outside of government. The Act opened the door for universities (as well as nonprofit research centers and other recipients) to serve as stewards for patented inventions, prioritizing what is medically important to the general citizenry. The Act emphasized the "health or safety needs which are not reasonably satisfied" and that such research should be "necessary to meet public uses."

But with the 1980s came President Ronald Reagan, who ushered in a virulent brand of corporate free riding. With the appointment of Pfizer's then-CEO Ed Pratt as chair of the U.S. Advisory Committee for Trade Negotiations, the U.S. helped pass the Trade Related Intellectual Property Rights (TRIPs) agreement—a one-sided deal administered by the World Trade Organization that disproportionately benefits large pharmaceutical companies with strict and lengthy patent protections.

Between the Bayh-Dole Act and stronger intellectual property rules, universities were incentivized to corporatize their models and mindsets. Plus, most small companies were bankrupted, swallowed up, bought out, or otherwise undermined by Big Pharma amid difficult capital-raising environments.

The Big Pharma game changed from who could develop the biggest blockbuster drug to who could license it first. The 15 biggest pharmaceutical entities produced, for instance, over 30 percent of NMEs from the 1980s onward, while smaller entities and university institutions increased production to nearly 70 percent of the industry's output.

In 2002, GlaxoSmithKline's then-CEO Bob Ingram said, "We're not going to put our money in-house if there's a better investment vehicle outside." He bemoaned companies like Pfizer and Merck deriving 30-35 percent of revenue from licensed products compared to GSK's 17 percent. Licensing an already developed drug removes significant costs.

Critical and effective drugs are often conceived and financed by public institutions. The company Burroughs Wellcome congratulated itself on discovering the formula for azidothymidines (AZTs) to counter HIV/AIDS. But a published letter to *The New York Times*, authored by Samuel Broder, a scientist with the National Cancer Institute (NCI) and his colleagues from Duke University, pointed out that the company "did not develop or provide the first application. Nor did it develop the technology to determine at what concentration such an effect might be achieved in humans ... was not first to administer AZT to a human being with AIDS, nor did it perform the first clinical pharmacology studies in patients ... nor immunological and virological studies necessary to infer that the drug might work ... All of these were accomplished by the [NCI] staff ... working with the staff of Duke University." Indeed, Broder added that the company, "did not work with live AIDS virus, nor wish to receive samples from AIDS patients."

Wellcome, later integrated into pharmaceutical giant GlaxoSmithKline, priced their AZT at $10,000 per year. The revenues generated by HIV/AIDS drugs were described in the U.S. Senate's Congressional Record as "staggering."

RX FOR CHANGE

In order to overcome the price distortions created by patent protections, which produce and rely on monopolies, governments must reserve the right to set price ceilings for medicines that have used public knowledge or funding. Where chronic or acute illnesses are concerned, governments should have the right to develop a generic version of the newest and best medicines for those that lack resources.

Also, so-called "home country" governments, the states in which companies have incorporated, should document Big Pharma's medicines by patent, jurisdiction, and ownership. Laws should also require companies to itemize internally developed intangible assets, the number of employees in each subsidiary, the extent of transfer pricing between subsidiaries, and to indicate where they pay taxes and record profits. Additionally, where public resources are used, the public must be able to access granular details about the drug's development. These measures will expose and transform the underlying structure of pharmaceutical companies, pushing the industry toward accountability and transparency.

Corporate tax dodging costs governments billions of dollars every year, and Big Pharma's claim that it needs this money to develop new drugs is disingenuous. For both the tax holes these companies create and the life-saving medicines they license, it's the public that ends up paying the tab. ●

(Pfizer did not respond to questions at the time of publication. Merck, Abbott, AbbVie, Amgen, Eli Lilly, and BMS declined or failed to respond to interview requests.)

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