INSIGHTS FROM THE BDO LIFE SCIENCES PRACTICE

LIFE SCIENCES TAX REFORM FAQ

The Tax Cut and Jobs Act (TCJA) was the largest overhaul to the United States' tax code since 1986. The implications for organizations in all sectors are numerous and complex. To help navigate these changes, we've answered some of the most important questions facing life sciences organizations following tax reform:

WHAT ARE THE LONG-TERM IMPLICATIONS FOR LIFE SCIENCES COMPANIES?

Reduction of the corporate tax rate to 21 percent is generally seen as a boon to life sciences organizations. The benefits of this reduction—as well as the 20-percent deduction available to S corporations—for the most part outweigh industry concerns with other parts of the law. The reduction may allow organizations to make capital investments, operational improvements, increase benefits for hiring and retention, and engage in expansions and acquisitions.

Some life sciences organizations are considering a change of entity to capitalize on changes. Organizations may weigh the benefits of the lower corporate rate versus the opportunities pass-throughs present and may decide to switch. Such determinations will be made on a case-by-case basis, as organizations may have different priorities and should take a long-term view of the benefits.

Conversely, the elimination of taxpayer's ability to carryback net operating losses (NOLs) and limitation of NOLs' use to 80 percent of taxable income might have undesirable consequences. When life sciences organization earnings are volatile, the new restrictions may tighten an organization's cash flow and consequent ability to make new investments or grow the business. These changes are particularly relevant for emerging organizations, which often have significant NOLs for the first few years of their operations and may be especially impacted. Due to the NOL limitation, other means for reducing tax liability - such as the R&D tax credit - will be more important going forward.

WHAT NEW INTERNATIONAL TAX RULES WERE CREATED?

The new law introduces an "exemption tax system" meant to encourage tax-free repatriation of earnings held abroad. More specifically, the new system features a participation exemption for dividends received by domestic C corporations from certain foreign subsidiaries. The measure does not create a pure territorial tax system and leaves other measures of the worldwide tax system (such as subpart F, Section 956) in place.

The new system may encourage certain organizations to bring back earnings from their foreign subsidiaries, but there may be limits. Many life sciences organizations may need to maintain capital in foreign jurisdictions to continue to grow their businesses abroad. While they may repatriate some earnings and replace them with outbound loans, organizations might find it easier to simply keep their cash abroad.

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WHAT HAPPENS IF AN ORGANIZATION DECIDES TO REPATRIATE INCOMES EARNED AND HELD ABROAD?

The new law imposed a one-time ‘transition tax’ on U.S. shareholders for accumulated, untaxed earnings of controlled foreign corporations and certain foreign corporations wherein a domestic corporation owns at least 10 percent. The tax aims to raise revenue from income that had not been previously subject to tax, but at a rate attractive enough to entice organizations to invest some of their profits stateside. The tax rate is 15.5 percent on the foreign corporation’s earnings held in cash and cash equivalent assets, and 8 percent rate on earnings attributable to non-cash assets regardless of whether the amounts are actually distributed.

While the move towards a quasi-territorial tax system is seen as a win for life sciences organizations, the one-time ‘toll’ to repatriate earnings may disproportionately affect them as well.

For many life sciences organizations, this is a one-time opportunity to repatriate cash at a low tax rate. And while the original tax filing deadline of April 17 has already passed, those who have requested an extension and wish to pay the transition tax in installments must elect to do so in their 2017 federal income tax return. They must also pay the first installment (8 percent) with their 2017 income tax return or lose the right to defer payments.

WHAT DO LIFE SCIENCES COMPANIES NEED TO KNOW ABOUT GILTI AND FDII?

You catch more flies with honey than vinegar, and Congress decided to use both to encourage reshoring of intangible property. Two new provisions—‘Global Intangible Low-Taxed Income’ (GILTI) and ‘Foreign Derived Intangible Income’ (FDII)—were created to motivate organizations to bring valuable IP stateside.

GILTI applies to U.S. shareholders that own 10 percent or more of a controlled foreign corporation (CFC) and taxes any income that exceeds a statutorily-defined routine return. Income that exceeds the set limit is deemed ‘GILTI’ and is subject to the tax.

Shareholders can offset their GILTI by claiming a deduction through FDII. FDII creates a deduction against GILTI for any ‘excess’ income from associated sales and services sold to foreign parties and earned by U.S. taxpayers. The FDII has been compared to patent and intellectual property boxes deployed elsewhere in the world. Income eligible for FDII generally consists of sales (license and royalty income) and services provided to foreign customers. The FDII deduction makes the effective GILTI rate 13.125 percent, which will increase to 16.406 percent after 2025.

GILTI and FDII were almost certainly created with large life sciences organizations in mind, as many of the largest organizations do hold significant intangible property in foreign, low tax jurisdictions.

These dual provisions may indeed motivate organizations to bring some of their highly valuable operations back to the United States. Even if these incentives work as planned, FDII may eventually be challenged in world trade courts. And of course, we will need to wait and monitor for any unforeseen consequences that might manifest.

WHAT ABOUT BEAT?

In addition to IP, the law may have significant impact on other parts of life sciences organizations’ foreign-based operations. The “Base Erosion and Anti-Abuse Tax” (BEAT) aims to discourage earnings stripping out of U.S. activities, by imposing a tax on certain payments made to foreign affiliates of eligible C corporations. BEAT may motivate life sciences organizations to rethink how they structure their international operations and allocate their revenue. As with other new provisions and changes, making these decisions requires a thorough understanding the new tax law and an organization’s internal operations.

HOW WILL THE NEW LAW AFFECT ORPHAN DRUG AND RESEARCH & DEVELOPMENT ACTIVITIES?

The new rules limit the orphan drug credit to 25 percent - a reduction from 50 percent - of qualified, clinical testing expenses for the tax year. Life sciences organizations, particularly startups, consider the credit an important incentive to develop orphan drugs. The reduction in this credit might reduce an organization’s focus on developing orphan drugs and hamstring long-term development of treatments for rare diseases and conditions.

Organizations will also be required to write off research expenses over a longer period of time. Previously, taxpayers have had the choice of taking an immediate deduction or capitalizing the amounts and amortizing over five years. The research credit was left mostly untouched throughout recent legislative process, but the new requirement that research expenditures be capitalized and amortized between five and 15 years will have a huge impact on life sciences organizations heavily invested in those activities.

Taxpayers seeking to maximize the benefit of immediately deducting R&D expenditures should consider the effective date of the required amortization rule (i.e., Dec. 31, 2021) and if possible, accelerate their R&D activities prior to this date.

HOW WILL THE REFORM IMPACT EXECUTIVE COMPENSATION AND TALENT STRATEGY?

Life sciences organizations compete for top talent by offering employee perks like on-site meals and other amenities. The new tax law eliminates the ability to write-off employee fringe benefits, which includes meals, transportation, and anything deemed as entertainment or amusement. Employers will now have to either fully absorb the cost of those perks, scale them back, or cease to offer them entirely.

The new tax law modifies the types of compensation that are subject to the deduction limitation by repealing the performance-based and commission-based exceptions and adding “compensation payable under a written binding contract in effect on Nov. 2, 2017, and not

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materially modified thereafter." It also modifies the definition of "covered employees" to include:

- Any person serving as the CEO or CFO at any time during the taxable year
- The three highest compensated officers (excluding the CEO and CFO) reported in the SEC executive compensation disclosures

It also applies the $1 million deduction limit to former covered employees and their beneficiaries and extends it to all domestic publicly traded corporations, and all foreign companies publicly traded through American depositary receipts (ADRs).

These changes may further hurt life sciences organizations' ability to attract and maintain talented individuals. It could particularly impact smaller or emerging organizations, who are not able to absorb the cost of competitive perks.

WHAT ARE THE ACCOUNTING IMPLICATIONS OF TAX REFORM?

Many tax reform provisions provide accounting method planning opportunities that can result in permanent tax savings for taxpayers. See BDO's **Summary of Key Tax Reform Implications on Accounting Methods** alert for an overall analysis.

As many of these planning ideas can only be implemented in a limited time frame, taxpayers and tax professionals are encouraged to begin gathering information and evaluating action items as soon as possible to properly comply with the procedural rules for making accounting method changes.

WHAT SHOULD LIFE SCIENCES ORGANIZATIONS DO NEXT?

While this year's filing deadline has come and gone, organizations still have plenty of work to do. Life sciences companies should undertake an internal audit to understand how the rules will affect them in the long term. This process takes time, and requires intense focus, organizational buy-in, and external expertise.

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