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INTERNATIONAL TAX ISSUES OF THE U.S. PHARMACEUTICAL INDUSTRY

by

JONATHAN L. MEZRICH*

INTRODUCTION

An Industry Under Siege

Under every new administration, some industries thrive, while others are victimized. The government's treatment of the pharmaceutical industry is no exception. In the past decade there has been a 180 degree switch in policy with regard to the treatment of the ethical drug manufacturing industry, moving from unusual favoritism during the Reagan administration, to President Clinton's use of the pharmaceutical industry as a scapegoat for much of America's health care cost problems.

History of the U.S. Pharmaceutical Industry

In the 1930s, merely a handful of proven medicinal drugs existed, and these were sold without a prescription.¹ None of these drugs were discovered through scientific research methodology or an understanding of disease processes. However, the climate changed drastically just before World War II. Vitamins and hormones were discovered and marketed, wiping out several illnesses and paving the foundation for modern systematic research.² The development of penicillin in England in 1940 further refined research and development (R & D) processes.³ But the real instigation of the pharmaceutical industry occurred during World War II, and was due to the U.S. government's spending of almost \$3 million to subsidize wartime penicillin research and manufacturing.⁴ This led to the creation of numerous federal medicine plants which were later sold to private firms at half price.⁵ Further, the granting of U.S. patents for medicinal compounds in 1948 secured monopoly treatment for those companies willing to invest in novel pharmaceutical product research.⁶ Rapidly, the U.S. pharmaceutical industry became a multinational force in the 1950s. But as the industry grew, international competition also grew, and R & D expenditures, required to remain at the top of the

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¹ PHARMACEUTICAL PANEL, NAT'L RESEARCH COUNCIL, THE COMPETITIVE STATUS OF THE U.S. PHARMACEUTICAL INDUSTRY 8 (1983).

² *Id.* at 8-9.

³ *Id.* at 9.

⁴ *Id.*

⁵ *Id.*

⁶ *Id.*

industry increased accordingly. Thus, as with many post-World War II industries, the U.S. held an early lead on worldwide-sale market share, but began to lose ground to Japanese and European manufacturers throughout the 1970s.⁷

Heading for Disaster in the Early 1980s

In "The Competitive Status of the U.S. Pharmaceutical Industry," a government study on the drug industry conducted by the Committee on Technology and International Economic and Trade Issues, it was noted that the U.S. was losing ground in market share and research percentage, and it was projected that the U.S. would suffer in the wake of fast rising U. K., Japanese and German manufacturers, unless some government action was taken.

An overview of these trends indicates a marked drop for the U.S. presence in world pharmaceutical markets around 1960, followed by stability in the U.S. share of new drug introductions and sales. . . In contrast, the U.S. share of R & D expenditures and drugs entering clinical trials. . . has continued to decline, strongly suggesting an eventual further decline in U.S. shares of introductions, sales and exports.⁸

The study proposed changes in patenting drugs, FDA regulation, and tax incentives to get this industry back on track.⁹

In light of studies such as this, under the Reagan presidency, the government enacted a variety of tax measures, as well as patent term extension legislation. Under this Republican administration, the U.S. saw the creation of such pro-pharmaceutical legislation as The Economic Recovery Tax Act of 1981, The Drug Price Competition and Patent Term Restoration Act of 1984, and The Orphan Drug Act of 1983.

The 1990s - A Change in Perspective

By 1991, the pharmaceutical industry had rehabilitated itself (from a position bordering on competitive disadvantage), but U.S. government opinion had now swung to the other extreme. Politicians from the left, under the leadership of Congressmen such

⁷ See HENRY G. GRABOWSKI, DRUG REGULATION AND INNOVATION, EMPIRICAL EVIDENCE, AND POLICY OPTIONS 1-2 (1976). "American preeminence persisted, though in attenuated degree, through the 1960s. In the past decade, however, the competitive advantage of American firms has been not only reduced but apparently eliminated." PHARMACEUTICAL PANEL, *supra* note 1, at 7.

⁸ *Id.* at 4.

⁹ *Id.* at 4-5.

as Senator David Pryor, chairman of the Senate's Special Committee on Aging, began a vendetta-like assault on the drug industry.¹⁰

"The Drug Manufacturing Industry: A Prescription for Profits," the staff report of the Senate Special Committee on Aging, was issued in September, 1991. Backed by Senate Committee Chairman David Pryor, it faults the pharmaceutical industry for making profits beyond the consumer price index, taking advantage of U.S. tax incentives for R & D, charging foreign consumers less for prescription drugs than the same drugs are selling in the U. S., and exploiting the § 936 Possessions Tax Credit. Pryor believes that because the government has given certain advantages to the drug industry, the industry now owes the American people cheap medicine.

We give drug manufacturers FDA approval for drugs, then a patent from anywhere between 8 and 10 years, which allows them to charge monopoly prices for their drugs. Then we given them millions of dollars in research credits each year to find the cures for the diseases of our time. Then we underwrite the cost of research and development through billions of dollars in federally funded NIH grants. Not satisfied with this, then we turn around and give them hundreds of millions of dollars in tax deductions to market and to advertise their products. To top it all off, . . . we give them billions

¹⁰ Sen. David Pryor has not made any pretense about his hostility toward pharmaceutical manufacturers. "Simple 'greed' explains why drug manufacturers raised their prices six times the rate of inflation between 1980 and 1992" remarked Senator Pryor. Norm Brewer, *Study Accuses Drug Industry of Price Gouging*, Gannett News Serv., Feb. 3, 1993, available in LEXIS, Nexis Library, GNS file. Further, Senator Pryor "recently joked that pharmaceutical industry lobbyists shouldn't schedule their vacations during the first 100 days of 1993." Viveca Novak, *The Other Drug Lords: When the Pharmaceutical Industry Comes Calling, Congress Listens*, COMMON CAUSE MAG., July-Sept. 1992, available in LEXIS, Nexis Library, CCAUSE File. Pryor also threatened that "[I]f that (I.R.C. § 936 amendment) doesn't work, we're going to have to teach the industry that God doesn't grant patents, government does." Michael Unger, *The Other Drug War: Congress Members Consumers Join to Fight the High Cost of Prescription Drugs*, NEWSDAY (Nassaw ed.), Oct. 4, 1992, Business section, at 88.

It is somewhat hard to understand the zealous crusade of this Arkansas Senator, which he has maintained since the early 1980s, despite all pharmaceutical bill proposals he has sponsored to date being soundly defeated in the U.S. Senate. "I believe that the drug industry is more feared than respected by Congress," says Pryor, a perpetual foe." Novak, *supra*. It is feared that with the election of friend President Clinton, Pryor's position will now have newfound legitimacy. See *Of Three Arkansas Pals and a Raccoon Roast*, N.Y. TIMES, Mar. 27, 1993, § 1, at 1. "Senator Pryor will have considerable influence in shaping health care policy. . . Mrs. Clinton thinks the world of him." *Pharmaceuticals: Clinton and Pryor Target Drug Industry*, Health Line, February 17, 1993, available in LEXIS, Nexis Library, HLTLNE File (quoting clinton political strategist James Carville). The I.R.C. § 936 amendments contained in the Omnibus Budget Revenue Reconciliation Act of 1993 demonstrate that Pryor has already begun to exert considerable influence.

of dollars in section 936 tax breaks in Puerto Rico, to go to Puerto Rico and manufacture the drugs that we use in America.¹¹

In the 1991 report, Pryor outlined some of the changes he would like enacted. Among the Senate Committee on Aging Report's suggestions to tax policy regulation were:

1. Cut the § 936 credit for companies deriving profits in excess of the consumer price index, and give the savings to a Federal Prescription Drug Trust fund to meet targeted Medicare needs;

2. Require the Treasury Department to report to Congress on any tax incentives given to the pharmaceutical industry and give assessments on the appropriateness of how such incentives are being used; and

3. Require the Treasury Department and Department of Health and Human Services (HHS) to jointly set up a program to ensure that tax credits are used for actual product R & D, and not manufacturers' market research.¹²

Senator Pryor and others have proposed or intend to propose various forms of government intervention in the pharmaceutical industry in the areas of Patent Term Extension (to accelerate the availability of generic drugs), R & D Tax Credit availability,

¹¹ *Pryor Attacks Pharmaceutical Industry*, TAX ANALYSTS TAX NOTES TODAY, May 26, 1992, available in LEXIS, TAXANA Library, TNT File. Other critics have echoed similar concern that market pressures are not working, and that the industry owes a debt to the public who supports it.

[C]ritics argue that the market for drugs is flawed — and give three main reasons why. The first is that health-insurance companies stand between consumers and the services they use, so neither patients nor doctors have the influence to bear down on drug prices. The second reason is that drug firms take advantage of federally financed development — for example, through the National Institutes of Health — without adequately reimbursing the taxpayer. Third, a federal provision gives tax credits to firms that set up manufacturing operations in United States possessions, notably Puerto Rico. Drug makers are by far the biggest beneficiaries, which may save them as much as \$2 billion a year.

Drug Companies: Golden Pills, ECONOMIST, Mar. 20, 1993 at 73-74.

Note, although this article's author has predicted, on the subject of patent-term extension, that unless pharmaceutical manufacturers begin some form of industry-wide monitoring of prices of patent extended drugs, the government may begin to regulate such drugs, it is still this author's position that internal industry regulation would be better than a forced government price setting program. See Jonathan L. Mezrich, *The Patentability and Patent Term Extension of Lifesaving Drugs: A Deadly Mistake*, 74 J. PAT. [& TRADEMARK] OFF. SOC'Y 77 (Feb. 1992). It should be fairly obvious that we can not let drug prices be set by Congressmen who do not even understand the concept of, let alone the risks involved in, pharmaceutical research and development. "Perhaps the low point in a recent floor debate occurred when one senator exclaimed: 'It is hard to believe that a company could charge so much for such a tiny pill.' It is also hard to believe that such a tiny intellect serves in what is members call the world's greatest deliberative body." Murray Weidenbaum, *Congress Tampered with a Winner in the U.S. Pharmaceutical Industry*, L.A. TIMES, Sept. 20, 1992, at D-2.

¹² See STAFF OF SENATE SPECIAL COMM. ON AGING, 102d CONG., 1ST SESS., THE DRUG MANUFACTURING INDUSTRY: A PRESCRIPTION FOR PROFITS 17-18 (Comm. Print 1991).

the Orphan Drug Act, a royalty provision to repay the government for government-sponsored (NIH) research on new drugs, FDA regulations, and, most prominently, the § 936 Possessions Tax Credit.¹³ In a February 3, 1993 report by the Senate Special Committee on Aging, entitled "Earning a Failing Grade: A Report Card on 1992 Drug Manufacturer Price Inflation," Pryor noted that pharmaceutical inflation was approximately six times the overall U.S. inflation rate.¹⁴ He found that only 16% of the profit was placed back into R & D, while 35% was used for marketing and advertising efforts.¹⁵ He noted that drug prices in other industrialized countries, notably Canada, are substantially lower.¹⁶ Pryor claimed that drug company profitability has been "excessive," topping the "Fortune 500" median profit level in 1992.¹⁷

The Pharmaceutical Manufacturers Association Position

Partially in response to rising price concerns and reports such as these, the President of the Pharmaceutical Manufacturers Association (PMA), Gerald J. Mossinghoff, was asked to appear before the U.S. House of Representatives Committee of Ways and Means, on July 18, 1991, to discuss the state of the pharmaceutical industry and its efforts in international competitiveness. Mossinghoff emphasized the competitiveness of the industry, and stressed how low U.S. prescription drug costs are as compared to total health care costs; he also explained the need for high investment in R & D, and the risky proposition of R & D spending.¹⁸ In light of international pressures on the industry,

¹³ See Novak, *supra* note 10. "Following this public flogging, prosecutors like Sen. David Pryor (D-Ark) will request additional sentencing: still higher taxes, price controls and, indirectly, a government takeover of medical research." Mitchell E. Daniels, Jr., *Perspective on Pharmaceuticals: A Health-Care Scapegoat Responds; Blaming Drug Companies For All Our Ills Harms Research and Ignores the Cost-effectiveness of the Industry*, L.A. TIMES, Mar. 9, 1993, at B7. See also *Senators Push Federal Curbs on Drug Prices*, CHI. TRIB., Feb. 3, 1993, at C-1; Jacqueline Frank, *Focus - U.S. Senators Seek Action on High Drug Prices*, Reuters, Feb. 3, 1993, available in LEXIS, Nexis Library, FINRPT File.

¹⁴ *Drugs, Drug Industry Inflation Higher than Overall Rate, Study Finds*, Daily Report for Executives, Feb. 4, 1993, available in LEXIS, Nexis Library, DREXEC File [hereinafter *Drug Industry Inflation*]; *supra* note 10.

¹⁵ *Drug Industry Inflation*, *supra* note 14. While the marketing expense is high, it is likely a "Catch 22" — if the company does not extensively advertise, it will not sell as many products as its competitors, and hence, will not be able to lower prices appreciably (due to low volume of sales). On the other hand, that 35% profit invested in marketing has become, like R&D costs, a fixed cost of competitiveness, and thus limits the ultimate possibilities for lowering prices. Although advertising clearly generates increased profits (or it would not be expended), it creates a higher base-cost-per-unit below which the price will not be dropped. Yet clearly a suggestion that the 35% profit would be better spent in lowering the price of the drugs, is uninspired; if a pharmaceutical company does not keep up with competitors' advertising efforts, it will lose volume of sales (as drugs tend not to be sold well "word of mouth"), and will thus ultimately need to raise its prices to keep the same level of profits (minus the 35%) previously enjoyed. While it's likely that the market forces have been adequately dictating what percentage of profits economically should be expended on marketing, the only real solution to this advertising cost dilemma could be some form of legislative advertising. Such regulation is generally not desirable to the business community, would create enforcement problems, and would wreak havoc for companies competing internationally.

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ Gerald J. Mossinghoff, *Pharmaceutical Manufacturers Association President Testifies on International Competitiveness*, Tax Analysts Tax Notes Int'l, July 24, 1991, available in LEXIS, TAXANA Library, TNI File.

Mossinghoff surmised that for the pharmaceutical industry to remain at its current level of competitiveness:

- (1) Stable tax policy is essential to enable U.S. companies to undertake the long-range planning and investment that is the foundation of technological innovation. Thus the 34% maximum corporate rate, established in 1986, must be maintained. Other countries reduced their rates in response to our reduction, and it would be short-sighted and counter-productive were we now to turn around and increase the U.S. rate;¹⁹
- (2) It is important to establish a permanent credit for increased research expenses;
- (3) It is also important to establish a permanent system of allocation of domestic R & D to U.S. and foreign source income (rather than successive moratoria which provide no assurance of permanence and make long-range planning impossible);
- (4) Mossinghoff suggested that some form of tax incentive be given to stimulate domestic R & D, noting that "other industrialized countries do not penalize their multinationals — our competitors;"²⁰
- (5) The § 936 Possessions Tax Credit must be maintained — as the U.S. tends to be disadvantaged in developing countries, as the U.S. does not allow companies to take advantage of "tax sparing" agreements;

These 'tax sparing' agreements enable foreign-based companies to operate with much lower costs than U.S. firms in these emerging markets. The one exception to this U.S. policy is Section 936 . . . which provides a credit for U.S. companies against U.S. taxes on the profits from manufacturing facilities in Puerto Rico;²¹

- (6) The FDA drug approval process needs to be streamlined;
- (7) The country should increase levels of intellectual-property and patent protection;²²

¹⁹ *Id.* It appears that President Clinton's recent tax increase thus may cause concern for this industry.

²⁰ *Id.* The PMA probably goes too far in suggesting that the government is penalizing the industry by not giving drug companies additional incentives. However, the general theme, that the industry may need additional incentives in order to maintain their competitiveness may be correct.

²¹ *Id.* See discussion of tax sparing *infra* p. 31.

²² *Id.*

U. S. tax policies need to be improved to encourage research and development and to ensure that our tax policies are as favorable to the foreign operations of U. S. multinational corporations as are the tax policies of other governments to the foreign operations of their multinational corporations. Pharmaceutical companies from other countries are increasing their investments in research and development and intensifying the competition. Many governments around the world have policies that are inimical to the continuing investment by the U.S. pharmaceutical companies in research and development.

Id.

Mossinghoff has also challenged the accuracy of Senator Pryor's February 1992 report, noting, "[t]he price date of which the Senator bases his charges are list — or 'sticker' — prices, before deducting discounts, rebates, or other negotiated reductions. . . . Discounts and rebates reduce what customers actually pay for pharmaceuticals."²³

Clinton's Health Care Debacle

Just prior to his State of the Union address in which he unveiled his new tax proposals, President Clinton criticized the Drug Industry for the charging of prohibitive prices on prescription drugs, particularly targeting vaccine administration for government intervention, and he alleged that this industry was making profits at the expense of the nation's children.²⁴ To be fair, however, the drug industry is not at all the force of evil that certain government representatives would have us believe. Despite the poor odds of such an R & D intensive venture as drug research, the pharmaceutical industry has created one of the U.S.'s most recession-proof industries. Few U.S. industries have enjoyed the international prominence of the pharmaceutical industry. "Of the 97 new drugs that were introduced in world markets between 1975 and 1989, the United States was the source of 47 — almost half. We also have more major drugs in the pipeline than any other country in the world."²⁵ It is also clear that if President Clinton intends to significantly increase U.S. jobs, this industry is not the one to tamper with. "While manufacturing companies as a whole averaged a 2% decline in employment during the decade 1980 to 1990, the drug manufacturers increased their job forces by 24%."²⁶ Further, in their zeal to offer cheaper medicine to their constituents, politicians tend to

²³ *Drug Industry Inflation*, *supra* note 14. See also Constance Sommer, *Senate Panel Assails Drug Price Boosts; Pharmaceuticals: Leaders Call for More Regulation, Citing a Report That Some Industry Hikes Far Outpaced Inflation*, L.A. TIMES, Feb. 4, 1993, at D2. Mossinghoff has "accused Pryor of distorting the figures by looking only at outpatient drug sales, by focusing on prices of select drugs rather than each firm's complete line, and by ignoring discounts and rebates on list prices." *Prices on Prescription Drugs Climbing Faster than Inflation, Senate Panel Told*, MINNEAPOLIS STAR TRIB., Feb. 4, 1993, at 18A. Mossinghoff noted that drug prices "slowed dramatically" in 1992, dropping to 5.7% from 9.4% in 1991. *Id.* Another accounting describes the 1992 drug price inflation rate as 6.4%, noting "[c]onsumer prices rose at less than half that rate last year." *Senators Push Federal Curb On Drug Prices*, CHI. TRIB., Feb. 3, 1993, at C1. While this "twice the CPI" figure is still a bit discouraging, it is certainly better than Pryor's misleading "six times the CPI" figure.

²⁴ Richard L. Berke, *President Assails "Shocking" Prices of Drug Industry*, N.Y. TIMES, Feb. 13, 1993, § 1, at 1. See also "Nowhere has Mr. Clinton's rhetoric been so caustic as in his attacks on the terrified pharmaceutical industry for its alleged gouging of consumers. The president has accused vaccine makers of earning 'unconscionable' profits at the expense of America's children." *Drug Companies: Golden Pills*, *supra* note 11, at 74.

²⁵ Weidenbaum, *supra* note 11, at D2.

²⁶ *Id.* "Investors recognize something Mr. Clinton evidently has not: practically every new job created since the recession in 1990 has come from this vibrant industry." *Drug Companies: Golden Pills*, *supra* note 11, at 74. "If Mr. Clinton's thinking on trade and industrial policy makes sense, this is an odd industry to single out for punishment." *Id.* In the recent months, the painful effects of Clinton's drug industry plans have already become obvious. "Pharmaceutical industry layoffs totaled 3,240 in August compared to 2,400 in July. Johnson & Johnson announced 3,000 and Advanced Technology announced 240." *400,000 in 8 months! Layoffs Surge Past '91 Recession Pace*, Business Wire, Sept. 7, 1993, available in LEXIS, Nexis Library, OMNI File. "In the pharmaceutical industry, Johnson & Johnson, Merck & Co., and Marion Merrell Dow Inc. this year joined a growing list of companies that have announced work force reductions that run into the thousands." Christine Shenot, *Health-Care Job Picture Muddied by Layoffs*,

forget that companies that manufacture pharmaceuticals do so as a business, and set their prices based on market forces, not greed.²⁷

In fact, several companies, in an effort to appease the government and forestall intervention, have been voluntarily reducing their prices to some extent.²⁸ Yet it is not clear that Clinton's plan to lower the cost of health care by causing the pharmaceutical industry to forego profits, will be particularly effective. First, pharmaceutical costs account for only a small percentage of the total health care bill, and so even forcing the drug industry to offer drugs below the inflation rate would do little to make a dent in the

Debate in Washington, INVESTORS BUSINESS DAILY, Aug. 27, 1993, at 2. See also *U.S. Layoffs Sweep Past 350,000*, PR Newswire, Aug. 6, 1993; *U.S. Drugs Giant to Axe 3,000*, DAILY TELEGRAPH, Aug. 13, 1993, at 18; *Briefly: Health Care*, L.A. TIMES, Aug. 12, 1993, at D2; *Johnson and Johnson Announces Restricting Plans*, CNN Moneyline, Aug. 11, 1993.

²⁷ "These companies are not charities — they are charging what the market will allow them to charge," said Sam Peltzman, a professor of economics at the University of Chicago." Elisabeth Rosenthal, *Exploring the Murky World of Drug Prices*, N.Y. TIMES, Mar. 28, 1993, § 4, at 3. Peltzman further observed that "[i]f you tie the price of the drug to the cost of developing just the product, you miss the essence of pharmaceutical development, where nine out of ten products fail." *Id.*; Clearly, in the short run, drugs would be cheaper if drug price inflation was tied to the overall U. S. inflation rate. *Drugs, Consumers Could Save if Prices Are Linked to Inflation, Study Says*, Daily Report for Executives, Feb. 12, 1993, available in LEXIS, Nexis Library, DREXEC File. But this assumes that drug companies are able to stay competitive internationally, continue to find new products with substantially reduced R&D dollars, and remain located in the U. S. As this article will discuss, it is more likely that companies will either move overseas, or get out of the pharmaceutical business, if such limiting price controls are enacted.

²⁸ See Ronald Begley, *Pricing Pressure from Congress*, CHEM. WEEK, Aug. 12, 1992, at 26. "Pharmaceutical companies are responding to a pounding from Congress on the issue of big drug price increases and record-selling profits by trying harder to hold the line on year-to-year price increases." *Id.* In fact, Merck and Company, a firm explicitly assailed by President Clinton, had been holding their profits to the inflation rate since 1990. See *Drug Industry: The Other Side of the Pricing Argument*, Health Line, Feb. 19, 1993, available in LEXIS, Nexis Library, HLLTNE File; see also Gail Fitzer-Schiller, *Merck and Co. Strikes Back at Clinton*, Reuters, Feb. 19, 1993, available in LEXIS, Nexis Library, FINRPT File. "[Pfizer, Inc. Pharmaceutical vice chairman Edward] Bessey said most pharmaceutical companies including Pfizer, have committed publicly to holding price increases below the rate of inflation." *Pfizer Offers Free Drugs to Uninsured*, Reuter Bus. Report, Aug. 14, 1993, available in LEXIS, Nexis Library, OMNI File. See also Janel L. Fix, *Pfizer Offers Free Medicine to Uninsured*, USA TODAY, Aug. 16, 1993, money section, at 1B; Pfizer, Inc., has also recently begun a "Sharing the Care" Program to provide several of its top-selling drugs to uninsured indigent Americans, as a showing of the drug industry good will.

On September 15, 1993, Senator Pryor proposed a plan where prescription drug manufacturers would be asked to sign a voluntary agreement to curb drug prices. *Health Care, White House Says It Supports Voluntary Drug Price Controls*, Daily Report for Executives, Sept. 17, 1993, available in LEXIS, Nexis Library, DREXEC File. See also David Olmos, *Biotech Firms See Clinton Plan as Bitter Medicine; Health Care: Cutting-Edge Companies Fear Advent of Government Price Controls Will Strangle Industry. Proponents of Plan Say They are Crying Wolf*, L.A. TIMES, Sept. 18, 1993, at D-1. If a prescription drug's price increases faster than the rate of inflation, the manufacturer would be subject to government imposed penalties. *Id.* But there are other impediments to this type of drug industry cooperation. A Pharmaceutical Manufacturers Association price lowering plan was recently rejected on October 1, 1993, not by the drug industrialists, but by the U. S. Department of Justice — as it was determined to be illegal under the antitrust laws. Albert Crenshaw, *Plan to Curb Drug Prices Is Rejected; Justice Calls Link to Inflation Illegal*, WASH. POST, Oct. 2, 1993, at C1. "This administration is committed to making health care affordable and available to all Americans but antitrust laws cannot be violated in the process." *Id.* at C6 (statement of assistant Attorney General Anne K. Bingaman).

skyrocketing U.S. health costs.²⁹ Further, arguments can be made that today's high pharmaceutical costs still actually save money, because a good medicine tends to keep patients out of hospitals or eliminate the need for surgery or other therapies which may cost much more than even the most expensive drug.³⁰ Finally, President Clinton's attack on vaccine manufacturer's exploitative price increases contained some misinformation. President Clinton claimed that in the 1980s, vaccine prices rose from \$23 to more than \$200.³¹ However, he neglected to note that "... 80% of those price increases were for added protections, including a federal excise tax to compensate injured children,³² two additional vaccines for meningitis and hepatitis B,³³ and added doses to boost immunity levels."³⁴

This article will attempt to illustrate the recent tax issues in the pharmaceutical industry, now the "scapegoat" of the nation's health care problems, which have international effects; it will also defend the necessity of research credits and other tax incentives for this recently revived industry. Finally, it will attempt to evaluate the concerns raised by Gerald Mossinghoff of the PMA in his testimony before Congress.

²⁹ Industry representatives have estimated that prescription pharmaceuticals represent only 5-7% of the U. S. Health Care bill. "Prescription drugs account for less than 7 cents of every health care dollar." *Drug Industry: The Other Side of the Pricing Argument*, Health Line, Feb. 19, 1993, available in LEXIS, Nexis Library, HLTLINE File. "Prescription drugs, though only 5 cents of the health-care dollar, are the most cost-effective nickel we spend." Daniels, *supra* note 13, at B7. Curiously, many Congressmen fail to appreciate the relative insignificance of pharmaceuticals to health care costs. "A good way to cut medical bills is to reduce the cost of prescription drugs." *Competitive Problems in the Pharmaceutical Drug Industry: Hearing before the Subcomm. on Antitrust, Monopoly, and Business Rights of the Senate Comm. on the Judiciary*, 100th Cong., 1st Sess. 1 (1987) (Opening statement of Senator Metzenbaum). It should be noted that the U. S. Senate Special Committee on Aging's view is that in 1990, "over 10 percent of all health care expenditures in the United States — about \$67 billion — were for prescription drugs." STAFF OF SENATE SPECIAL COMM. ON AGING 102d CONG., 2D SESS., A STATUS REPORT: ACCESSIBILITY AND AFFORDABILITY OF PRESCRIPTION DRUGS FOR OLDER AMERICANS, vii (Comm. Print 1992). While a 10% cost (if accurate) is a little more significant, it is still a small puddle in the pond.

³⁰ Daniels, *supra* note 13, at B7. See also Mossinghoff, 91 *supra* note 18. "Medicines not only save lives — they save money. Medicines are the most cost-effective form of medical therapy because they help to reduce the cost of alternative, more expensive forms of medical care, such as surgery or hospitalization." *Id.*

³¹ *End to Tax Credit for Some Drug Makers Urged*, L.A. TIMES, Feb. 16, 1993, at A12.

³² See I. R. C. § 9510 (1988), Vaccine Injury compensation Trust Fund, which supports U. S. Claims Court awards under the National Vaccine Injury Compensation Program, 42 U. S. C. 300aa-10, et seq. (1988).

³³ Now required in addition to the three standard childhood vaccinations of DPT (Diphtheria, Pertussis, Tetanus), MMR (Measles, Mumps, Rubella), and Polio.

³⁴ *End to Tax Credit for Some Drug Makers Urged*, *supra* note 31, at A12. See also Karen Riley, *Measure Would Halt Drug Firm Windfall*, WASH. TIMES, Feb. 16, 1993, at B-4. Berke, *supra* note 24, § 1, at 1.

RESEARCH AND DEVELOPMENT

The Life-blood of the Industry

The pharmaceutical industry is unique in the degree it depends on research and development expenditures to remain competitive.³⁵ Indeed such investment in R & D is a risky proposition, as a pharmaceutical corporation may take years to recoup its investment, if at all.³⁶ Still, with the aid of several credits and deductions for research and experimentation, the drug industry has been able to overcome this cost barrier, and has shown a profit well in excess of the consumer price index in recent years.³⁷ It appears likely that the quantity of research and development done by this industry is directly related to the high U.S. market share of pharmaceutical sales worldwide.³⁸ This being so, adjustments in research deductions and credits, and decisions affecting allocation and apportionment of R & D expenses, have profound effects on the international competitiveness of the ethical drug industry.³⁹ Additionally, certain allocation treatments of R & D expenditures may influence U.S. corporate decisions as to whether to locate R & D operations domestically or overseas.⁴⁰

R & D Deductions and Credits

Under § 174 of the Code, taxpayers may treat their worldwide R & D expenses as a current deduction in the year paid, or may amortize the expenses over a period of at least 5 years.⁴¹ The election to currently deduct or amortize is to be made in the first taxable

³⁵ "Research is the foundation of competitive strength for modern pharmaceutical firms." *The Competitive Status of the U.S. Pharmaceutical Industry*, *supra* note 1, at 23.

³⁶ "Drug research is probably the riskiest economic venture we know; only one of 5,000 possibilities researched ever becomes a marketed product." Daniels, *supra* note 13, at B7. *But cf.* DONALD DRAKE & MARIAN UHLMAN, MAKING MEDICINE, MAKING MONEY 67 (1993), in which the authors concede that it costs an average of \$231 million for each new drug to be brought to market, but contend that brand-name manufacturers are able to minimize R&D risks and capitalize on others efforts to reap high profits at the expense of consumers.

³⁷ See THE DRUG MANUFACTURER'S INDUSTRY: A PRESCRIPTION FOR PROFITS, *supra* note 12. "Drug companies undertake these massive searches knowing there will be a big payoff if they hit a winner . . . We can have lower drug prices if we accept less of that searching. That's the choice we face." Elisabeth Rosenthal, *Research, Promotion and Profits: Spotlight is on the Drug Industry*, N.Y. TIMES Feb. 21, 1993, § 1, at 1. Note: while the drug industry proved profitable even before the granting of various research credits and incentives, the industry is far more sensitive to world competition than other corporate investments. This is due to the inherent risk and expense of R&D. For instance, with a little capital and a lot of luck, a European or Japanese corporation could develop a drug that would quickly cut into the U. S world-sales market share; Conversely, a U. S. corporation expending billions on R&D could fail to recoup their investment and end up bankrupt.

³⁸ See generally GRABOWSKI, *supra* note 7.

³⁹ See William R. Peck, *U.S. Tax Policy Concerning Research and Development in the Multinational Context*, INT'L TAX J., Winter 1990, at 68.

⁴⁰ See Arthur Andersen study, discussed *infra* p. 18.

⁴¹ See Peck, *supra* note 39, at 70.

year, and does not require obtaining consent from the IRS.⁴² To qualify under § 174, R&D must be reasonably incurred in connection with the taxpayer's trade or business, and must qualify as activities which are experimental in nature.⁴³ Specifically, market research and other non-scientific research expenditures are excluded.⁴⁴ Worldwide R&D expenses of multinational corporations deductible under § 174 must be allocated between U.S. and foreign source income.⁴⁵

There is also an "incremental" R & D credit under § 41. This gives qualifying taxpayers a credit for 20% of a taxpayer's incremental increase in R & D expenses from prior years above a statutorily calculated, taxpayer specific, base amount.⁴⁶ This was created in order to stimulate increases in existing R & D activity. Although many companies may qualify for both the § 174 and § 41 incentives, § 280C(c) prevents overlap between the R & D credit (§ 41) and the deduction (§ 174).⁴⁷

⁴² I.R.C. § 174(a)(2)(A) (1988); See also INT'L BUREAU OF FISCAL DOCUMENTATION, TAX TREATMENT OF RESEARCH AND DEVELOPMENT EXPENSES 145 (1988).

⁴³ Peck, *supra* note 39, at 71.

⁴⁴ *Id.* Treas. Reg. § 1.174-2(a)(1) (1993) provides:

The term "research and experimental expenditures," as used in section 174, means expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. The term includes generally all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention or similar property, and the improvement of already existing property of the type mentioned. The term does not include expenditures such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions.

Id.

⁴⁵ See I.R.C. § 864(f) (1993); Treas. Reg. § 1.861-8(e) (1992); discussed *infra* p. 17; Peck, *supra* note 39, at 71.

⁴⁶ *Id.*; The 20% figure has been reduced from the original 25% allowance. The base amount is generally the average amount of the taxpayer's qualified expenses over the past three year period. INT'L BUREAU OF FISCAL DOCUMENTATION, *supra* note 42. I.R.C. § 41(c) (1993) requires the minimum base amount to be 50% of the qualified research expenses. I.R.C. § 41(d) (1988) somewhat limits the definition of R&D of § 174 to the more technologically significant R&D.

⁴⁷ "Section 280C(c) requires taxpayers either to reduce the [§ 174] deduction by 100 percent of their [§ 41] credit, or to reduce the credit by the product of the U. S. corporate tax rate and their section 41 credit." Peck, *supra* note 39, at 74. I.R.C. § 280C(c)(1) (West 1993) thus provides either that "No deduction shall be allowed for that portion of the qualified research expenses. . . or basic research expenses. . . otherwise allowable as a deduction for the taxable year which is equal to the amount of the credit determined for such taxable year. . ." Or the taxpayer may elect that "[t]he amount of credit determined under this subparagraph for any taxable year shall be the amount equal to the excess of — (i) the amount of credit determined under section 41(a). . . over (ii) the product of — (I) the amount described in clause (i), and (II) the maximum rate of tax under Section 11(b)(1)," I. R. C. § 280C(c)(3)(B) (West 1993). While both §174 and §41 are meant to be incentives to encourage domestic research, some critics question their present utility. See generally William Natbony, *The Tax Incentives for Research and Development: An Analysis and a Proposal*, 76 GEO. L. J. 347 (1987).

Allocation of Research and Development

Section 901 of the Code allows taxpayers a foreign tax credit against their U.S. taxes, for foreign taxes paid on foreign source income.⁴⁸ The U.S. taxes its citizens on their worldwide income, while foreign jurisdictions will typically tax U.S. citizens only on income derived within their borders. Hence, foreign created income may be subject to tax in two jurisdictions. The goal of the § 901 foreign tax credit is thus to eliminate this double taxation of U.S. persons and achieve some semblance of export neutrality.⁴⁹

Because of the credit scheme set out in § 901, it is important to industry that R & D expenses are allocated in such a way that a domestic corporation may best use this credit. Typically, a domestic corporation will want as much of those R & D expenses which were actually spent in the U.S., to be allocated to the United States. This is because a U.S. corporation may be subject to increased tax if a foreign country disallows an R & D expense deduction for U.S. located R & D that is allocated to foreign source income.⁵⁰

The § 904 limitation is specifically what accounts for the discrepancy. In simple terms, for the largest U.S. corporations the § 904 foreign tax credit limitation is calculated by multiplying the corporate rate (now 35%) times the corporation's foreign source income.⁵¹ If the Internal Revenue Service allocates more research expenses to the foreign source, this will decrease foreign source income, and hence decrease the foreign tax credit limitation.⁵² In such a situation, a company with excess foreign tax credits would pay more tax than if the R & D was allocated to U.S. source income.

For example: Corporation A, a large multinational drug manufacturer, has a \$200 U.S. tax liability, pays \$100 of foreign taxes, has excess foreign tax credits, and has \$10 of R & D expenses. If that \$10 is sourced domestically, Corporation A will pay \$190 of U.S. taxes, plus \$65 [$\$100 - 35$ (tax credit limitation of $\$100 \times 35\%$)] of foreign income, or \$255.

However, if the \$10 expense is sourced to the foreign source, it will reduce the foreign source income, and hence the foreign tax credit limitation, so Corporation A

⁴⁸ I.R.C. § 901(a) (1988) provides that "the tax imposed by this chapter shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b). . . ." I.R.C. § 901(b) (1988) provides that "Subject to the limitation in section 904, the following amounts shall be allowed as the credit under subsection (a): . . . any income, war profits, and excess profits tax paid or accrued during the taxable year to any foreign country or to any possession of the United States. . ." Section 904(a) contains the limitation of use of such a credit only to the US tax rate imposed on the taxpayer's foreign-source income, and states:

The total amount of the credit taken under section 901(a) shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year.

I.R.C. § 904(a) (1988).

would owe \$200 of U.S. taxes, plus \$68.50 [\$100 - (90 x 35%), the foreign tax actually paid minus the limitation = 31.50], or \$268.40. It should be obvious that, if one is talking in terms of millions of dollars, with a much higher percentage of R & D expenditures, this could easily be significant.

Thus, unless a foreign country allows some corresponding form of deduction for expenses which the U.S. Treasury Department allocates to foreign source income, the U.S. corporation will pay "double" taxes on some portion of its income; these overall tax costs may arguably be a disincentive to locating R & D-intense operations in the U.S.⁵³

It should be noted that the discrepancy caused by the § 904 limitation only applies to corporations with excess foreign tax credits.⁵⁴ A company may have excess foreign tax credits if currently or in a previous year: (1) foreign corporate tax rates are higher

⁴⁹ In effect, by allowing a foreign tax credit, the U.S. is ceding its right to tax income earned in a foreign jurisdiction.

⁵⁰ Peck, *supra* note 39, at 69.

⁵¹ MICHAEL J. MCINTYRE, *THE INTERNATIONAL INCOME TAX RULES OF THE UNITED STATES*, 3-62 (1989). See *Treasury Department Report on its Impact of Research and Development Regulation*, Daily Report for Executives, June 16, 1983, available in LEXIS, Nexis Library, DREXEC File (hereinafter *Treas. Dept. R&D Report*). The Treasury Department report notes that the Code defines the foreign tax credit limitation as:

Maximum allowable foreign tax credit = tentative U.S. tax on worldwide taxable income X

$\frac{\text{foreign source taxable income}}{\text{worldwide taxable income}} = \frac{\text{tentative US tax on worldwide taxable income}}{\text{worldwide taxable income}}$

worldwide taxable income

worldwide taxable income

X foreign source taxable income,

and "since the reduced corporate rates [example uses 1983 corporate tax rate of 46%] for U.S. taxpayers with \$100,000 or less of taxable income are probably not significant for most multinational corporations, the limitation can be thought of as : 46% X foreign source taxable income. Thus, the allowable foreign tax credit is the less of the U.S. or foreign taxes on foreign source taxable income."

Id.

⁵² Note — This decreases the foreign source income as far as the Treasury Department is concerned. However, if a foreign country does not allow a corresponding deduction, such a deemed decrease will work against a taxpayer, as it decreases the limitation without decreasing the taxes owed.

⁵³ Some foreign countries allow deductions for research costs only when the research work is done locally. Thus the regulations sometimes reduce foreign source taxable income for costs that do not reduce the amounts taxed by foreign countries. This incongruence between U.S. and foreign rules may cause the foreign tax credit limitation to be less than the rates imposed by foreign countries, even when U.S. and foreign rates are similar. As a result, some have argued, U.S. companies are encouraged to shift portions of their research activities to foreign countries in order to bring foreign tax liabilities more in line with the foreign tax credit limitation.

3 BORIS I BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS*, at 70-48 (3d ed. 1991).

⁵⁴ *Treasury Dept. R&D report*, *supra* note 51. "In other words, the tax rates of the foreign country must be higher than those of the United States. If foreign tax rates are lower than U.S. rates, the R&D deduction problem disappears for two reasons. First, the foreign tax credit will wipe out the entire foreign tax anyway. Second, albeit superfluously, who cares if the foreign jurisdiction denies deductions if it wasn't taxing very much in the first place?" Joel S. Newman, *Research and Development Allocates Under Sections 861 and 864: An Author's Query*, 60 TAX NOTES 641, 642 (Aug. 2, 1993).

than the U.S.; (2) U.S. and foreign sourcing rules overlap; (3) there is a difference between the U.S. and foreign expense allocation rules; or (4) there is a difference in the timing of the reporting of income or deductions.⁵⁵ It should be pointed out that such concerns may not be an issue for the several countries with which the U.S. has a bilateral income tax treaty providing for reasonable deductions for research expenses with respect to business profits.⁵⁶

Because of the high tax costs involved and the need for advance tax planning, corporations which do a large portion of their R & D domestically have continually pushed for a permanently codified allocation system which would allow them to apportion most, if not all, of their U.S.-based R & D expenditures to U.S. source income.⁵⁷ In many cases, it is not clear whether such a scheme would be any further from reflecting economic reality than the Treasury's harsher regulations, discussed below.

There is not necessarily one 'right way' to allocate expenses to foreign income in some situations. It is particularly difficult to allocate expenses

⁵⁵ Peck, *supra* note 39, at 69.

Excess foreign tax credits result when the amount of foreign creditable income taxes paid or accrued in a given year exceeds the taxpayer's foreign tax credit limitation. . . Excess credits can also arise for a variety of other reasons, all of which involve the limitation. Differences between the income-sourcing rules of the United States (whose rules are generally consistent with international norms generally recognized by developing countries) and those of other countries may result in U. S. treatment of income taxed by another country as domestic income for purposes of the foreign tax credit. Timing differences in the reporting of income and deductions under U. S. and foreign tax laws may result in a taxpayer's being unable to utilize some foreign tax credits in a year in which income is reported in a foreign country but not in the United States. Domestic losses may reduce worldwide taxable income and pre-credit U. S. tax, and, hence, the amount of foreign tax credits that can be used currently. Perhaps most importantly, effective corporate income tax rates in many industrialized countries are higher than U. S. income tax rates.

Joint Committee on Taxation Staff Pamphlet Setting Out Background on Research and Experimentation Expense Source Allocation Rules, Considered at House ways and Means Oversight Subcommittee Hearing October 26, 1983, Daily Report for Executives, Oct. 16, 1983, available in LEXIS, Nexis Library, DREXEC File (hereinafter Tax Pamphlet).

⁵⁶ Peck, *supra* note 39, at 70.

⁵⁷ The government should also consider permitting research and development expenditures incurred in the United States to be allocated solely to the U.S. income of the taxpayer. Treasury regulations recently issued to implement Sec. 1.861-8 of the Internal Revenue Code require that R&D expenditures be apportioned to both foreign source and domestic income in an effort to recognize that fact that innovations in the United States often result in licensing and other revenue from foreign sources. However the effects of the regulations are (1) to apportion expenses to foreign source income even when that income is incidental to the innovation; (2) to result in double taxation because foreign governments do not allow this allocation to be taken into account when figuring taxes due them; (3) to encourage the location of R&D facilities abroad instead of at home to escape the effects of the regulations, thereby diminishing both the amount of R&D conducted in the United States and, in the long term, the tax revenue generated from its conduct. Recent changes in tax law have provided temporary reprieve from these Treasury regulations. Consideration could be given to making the reprieve permanent.

THE COMPETITIVE STATUS OF THE U.S. PHARMACEUTICAL INDUSTRY, *supra* note 1, at 80-81.

in the case of R & D because expenses often cannot be related directly to any income. Even if R & D expenses can be related directly to income, that income is often generated years after the research is conducted.⁵⁸

Additionally, while it would indeed be frustrating for the Treasury to lose revenue on U.S. related income by allowing it to be offset by expenses more properly linked to foreign sources, at least erring in the taxpayer's favor here would be an incentive which may translate into additional competitiveness of U.S. based R & D intensive industry, and an incentive towards research investment.

The Treasury Regulations - §1.861-8(e)

In 1973, the Treasury Department issued a first attempt to codify rules for allocation of research expenditures which was highly criticized for its overzealous allocation percentage to foreign source income.⁵⁹ So in 1977 the treasury Department made another attempt, issuing the present regulations, found in §1.861-8(e).⁶⁰ The goal was to allow an accurate allocation of R & D expenses to U.S. and foreign source income, but not permit the R & D expended on products sold overseas to be used to offset domestic income. In effect, the Treasury sought to tie the R & D costs to the jurisdiction where related income was generated. Before any allocation is made, the regulations provide for R & D expenses undertaken solely to satisfy a legal requirement of a political entity, where the results cannot be reasonably expected to generate additional amounts of income outside that geographic source, to be allocated to that jurisdiction.⁶¹ The regulations provided for use of either a sales method or gross income method.

1. The Sales Method - §1.861-8(e)(3)(ii)

The sales method provides for a portion (30% after 1979) of the deduction to be allocated exclusively to the country in which the R & D is considered performed,⁶² and the remainder is to be split between U.S. and foreign sources in proportion to the taxpayer's sales of goods and services within the product category.⁶³

⁵⁸ *Tax Pamphlet, supra note 55.*

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ Treas. Reg. § 1.861-8(e)(3)(i)(B) (1992). The regulations state that an example of this would be that costs of a test required to satisfy U.S. Food and Drug Administration requirements, where the test is not required elsewhere and is not expected to generate income elsewhere, may be allocated to U.S. source income. *Id.* This assumes that there often will be no economic advantage to foreign sales by virtue of having a proven "safe" product.

⁶² Treas. Reg. § 1.861-8(e)(3)(ii)(A) (1992).

⁶³ Treas. Reg. § 1.861-8(e)(3)(ii)(B) (1992).

R & D is considered performed in the country where activities accounting for greater than 50% of the R & D costs are done.⁶⁴ The exclusive allocation (of 30%⁶⁵ to the source where at least 50% of the R & D is done) is required because the regulations note that R & D tends to be most valuable in the location where it is performed, as new products tend to be sold in the nearest market first, and local research tends to benefit a broader base of products in local markets (as only certain items are selected for overseas marketing).⁶⁶ Allocations are done based on sales within relevant product categories.⁶⁷ A treatise by Professors Bittker and Lokken offers a good illustration of the application of the sales method:

Assume a domestic corporation's deduction for research costs for a particular year is \$100, \$30 of which is allocated exclusively to U.S. source income because the United States is the situs of the research; within the product category in which the research is done, the corporation has sales revenues for the year of \$1,000 including \$600 yielding gross income from U.S. sources and \$400 producing foreign source income. The portion of the research deduction taken in determining foreign source taxable income is \$28 (\$70 times \$400/\$1000). The amount assigned to U.S. source income is \$72 (\$30 under the exclusive allocation rule and \$70 times \$600/\$1,000 under the sales apportionment rule).⁶⁸

⁶⁴ Treas. Reg. § 1.861-8(e)(3)(ii)(A) (1992); If there is sufficient split so that no one country has greater than 50%, the entire amount will be allocated by sales.

⁶⁵ While under the regulations, the exclusive portion is normally 30%, the taxpayer can use a larger portion if the research and development is "reasonably expected to have very limited or long delayed application outside the geographic source where it was performed." Treas. Reg. § 1.861-8(e)(3)(ii)(A) (1992). "The delayed application concept proved especially beneficial to taxpayers that retained vital secret processes in the United States for significant periods of time." Jon E. Bischell, *Deduction and Allocation of Research and Development Expenditures: The Final Chapter or Just Another Installment?* 16 INT'L TAX J. 225, 228 (Summer 1990).

⁶⁶ *Id.*

⁶⁷ BITTKER & LOKKEN, *supra* note 53, at 70-52. The term "product category" refers to the classification of products enumerated in the STANDARD INDUSTRIAL CLASSIFICATION (SIC) MANUAL, EXECUTIVE OFFICE OF THE PRESIDENT, OFFICE OF MANAGEMENT AND BUDGET (1972); Treas. Reg. § 1.861-8(e)(3)(i)(A) (1992).

⁶⁸ BITTKER & LOKKEN, *supra* note 53, at 70-52. The Treasury Department offers a similarly simple example:

To illustrate the sales method, assume that a corporation performs \$100 of R&D in the United States and has its sales divided evenly (50-50) between the United States and foreign markets. In this case, \$30 would be 'exclusively apportioned' to the United States and the remaining \$70 in R&D expenses would be apportioned equally between domestic and foreign source income, \$35 to each source.

U.S. DEPARTMENT OF THE TREASURY, THE IMPACT OF THE SECTION 861-8 REGULATION ON U.S. RESEARCH AND DEVELOPMENT (June 16, 1983), available in LEXIS, Nexis Library, TAXANA File.

2. The Gross Income Method - 1.861-8(e)(3)(iii)

An alternative to the sales method provided in the regulations is the gross income method. Under this method, the R & D expenses are apportioned ratably, based on the taxpayer's gross income.⁶⁹ However, the allocated amount must be at least 50% of what would have been allocated under a sales method. Bittker and Lokken illustrate:

Assume a domestic corporation's allocation of its deduction for research and development costs under the sales method would be 40 percent to the statutory grouping (gross income from foreign sources) and 60 percent to the residual grouping, whereas a strict apportionment by gross income would assign only 10 percent to the statutory grouping. If the taxpayer elects the gross income method under the regulations, the statutory grouping is allocated 20 percent of the deduction (one half of the apportionment under the sales method), and the other 80 percent goes to the residual grouping.⁷⁰

3. The Controversy Surrounding the 1977 Regulations

Industry was far from satisfied with the Treasury's system of R & D allocation. Due to lobbying pressures, Congress overrode this method with a series of 8 temporary moratoria.⁷¹ The problems Congress was trying to correct were two-fold:

1. That such allocation hurts U.S.-located companies' competitiveness abroad. The U.S. regulations on R & D match domestic corporations' R & D with foreign source income when sales are made, or gross income acquired, in foreign countries, even if all the costs were incurred in the U.S. However, many foreign countries only allow deductions for R & D performed locally. This discrepancy was hurting some U.S. companies abroad, as the regulations would reduce the foreign source income for costs that did not reduce the amounts taxed in foreign countries. The incongruence between the U.S. and foreign rules made the foreign tax credit limitation less than the taxes imposed in foreign countries (even where the tax rates were the same);

2. It encourages U.S. companies to move R & D facilities abroad, as was considered in the following two studies:

⁶⁹ Treas. Reg. § 1.861-8(e)(3)(iii) (1992).

⁷⁰ BITTKER & LOKKEN, *supra* note 53, at 70-53.

⁷¹ In fact, of the 16 years since the Treasury regulations were enacted, they have been applied in fewer than five. *R&D, TEI Urges Revised R&D Allocation Rule, Asks Treasury to Extend Moratorium*, Daily Report for Executives, May 7, 1992, available in LEXIS, Nexis Library, DREXEC File.

4. The Arthur Andersen study⁷²

Following the first two year moratoria in 1981, created by the Economic Recovery Tax Act (ERTA), which allowed a 100% allocation of U.S. R & D to domestic source income, the Treasury Department began a study on the effect of the research allocation on American manufacturing firms and how they structured their businesses, the efficacy of the ERTA, and whether the §1.861-8 regulations created an incentive to relocate operations to foreign jurisdictions.⁷³ Concerned that this anticipated 1982 report on R&D from the Treasury Department would greatly underestimate the volume of activities transferred abroad as a result of the R & D allocation regulations, four industry associations commissioned the accounting firm of Arthur Andersen to generate an independent report on the effects of ERTA and the §1.861-8 regulations.⁷⁴ The report was intended to be used as a companion effort to the upcoming Treasury Department study.⁷⁵

Arthur Andersen's study consisted of surveys sent to 325 multinational firms representing 85% of all U.S. R & D activity, which asked questions on "foreign tax laws, the nature of the foreign government, availability of funding and raw materials, regulatory considerations, the political climate, labor costs, geographic location, and foreign interest rates."⁷⁶ The study was ultimately completed based on responses to such surveys received by 85 of the largest corporations, having aggregate sales of approximately \$400 billion, collectively more than 3.5 million employees, and collective total R & D expenditures in excess of 12 billion dollars.⁷⁷

The ultimate (albeit poorly supported) finding of the accounting firm's study was that the § 1.861-8 regulations in fact did encourage U.S. firms to move R & D investments to operations abroad, and "that R & D investment in foreign markets by U.S. companies is increasing faster than in U.S. markets."⁷⁸ The report also noted that a significant number of survey respondents suggested that creation of a permanent credit based on the generous model of the ERTA moratorium would reverse the trend and be "an important step in rebuilding technological superiority in U.S. industry and in revers-

⁷² ARTHUR ANDERSEN & CO., NATIONAL RESEARCH AND DEVELOPMENT STUDY (January 1983).

⁷³ *Firms Favor Making 1981 Rules Permanent to Halt Expanded Activity Abroad, Survey Finds*, Daily Report for Executives, Jan. 31, 1983, available in LEXIS, Nexis Library, DREXEC File (hereinafter *Firms Favor Making 1981 Rules Permanent*).

⁷⁴ *R&D: Industry Commissions Own Analysis on Effects of Cost Allocation Tax Rules*, FED. CONT. REP., March 29, 1982 at A8. The four industry groups commissioning the study were the Electronics industries Association, the National Association of Manufacturers, the Emergency Committee on American Trade, and the Pharmaceutical Manufacturers' Association.

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Firms Favor Making 1981 Rules Permanent*, *supra* note 73.

⁷⁸ *Tax Pamphlet*, *supra* note 55.

ing the trends evidenced in this study.”⁷⁹ However, tax considerations were found to be just one of many factors companies considered in determining the location of R & D efforts, and the Treasury Department was quick to minimize the importance of this study.⁸⁰ It is also not clear how much weight ought to be given to this study based on its partisan genesis.⁸¹

⁷⁹ *Firms Favor Making 1981 Rules Permanent*, *supra* note 73 (quoting Arthur Andersen study). The primary findings of the study were:

- * The research and development allocation requirements of Section 861 increase the overall tax liability of U.S. multinational corporations by generally placing firms in an excess foreign tax credit position.

- * Survey respondents considered the pre-1981 tax act rules as a disincentive to domestic conduct of research and experimentation. Specifically Section 861 was singled out as a detriment to domestic R&D operations by ‘a significant group.’

- * The U.S. is the only nation requiring the allocation of domestic R&D expenditures. In fact, other developed nations have instituted various incentives to attract and stimulate R&D activities within their borders.

- * Management most frequently reviews R&D decisions in light of long-term competitiveness or is influenced by factors leading to a favorable R&D environment. Characteristics such as a sufficient supply of skilled manpower, adequate R&D facilities, and various government incentives or disincentives play a significant role in these decisions.

- * Most corporations have shown an increase in their foreign R&D expenditures as a percentage of their worldwide R&D expenditures over the past 10 years. . .

- * The percentage increase in respondents’ foreign-to-total R&D exceeded the percentage change in the ratio of foreign sales to total sales, meaning that R&D investment occurred independently of expanding operations (measured by sales). A significant reallocation of R&D abroad took place over the 10-year period studied.

- * The growth on a percentage basis of respondents’ foreign-to-total R&D manpower confirms the shift of R&D abroad. Employment of highly skilled scientists and engineering professionals increased faster abroad than in the U.S.

- * Most respondents believe that lifting the moratorium will encourage an expansion of foreign R&D investments in the future.”

ARTHUR ANDERSON & CO., *supra* note 72.

See also Study Cites Need to Make 1981 Tax Rule Permanent to Encourage More R&D in US, INT’L TRADE REPORTER’S U.S. IMPORT WKLY., Mar. 2, 1983, available in LEXIS, Nexis Library, INTRAD File.

⁸⁰ The relatively modest role of tax factors in determining the location of R&D appears to be supported by a recent study by Arthur Andersen and Co. . . . The study reports, [that] the results indicate that the most common incentive for determining timing, placement, and scope of R&D projects is the competency of the available work force. The geographical location of necessary raw materials and research data was the second most frequent response.

Treas. Dept. R&D Report, *supra* note 51. “While the Arthur Andersen study finds that taxes have some influence on the location of R&D investment, this factor is not of primary importance to the firms included in the study,” *Tax Pamphlet*, *supra* note 55.

⁸¹ Other organizations have subsequently commissioned their own studies on R&D allocation under § 1.861-8. On April 3, 1987, the Council on Research and Technology (CORETECH), an interest group made up of public policy, research, and educational institutions, issued a study as a lobbying tool to bolster their claim of the necessity for an increased permanent R&D credit. *Coretech Study Hails R&D; Calls for Additional Incentives and the Restoration of R&D Tax Credit*, Tax Analysts Tax Notes International, Apr. 15, 1987, available in LEXIS, Nexis Library, TNI File. “[The study] convincingly . . . demonstrates that the Treasury regulations under § 1.861-8 are both unfair and unwise — that any tax revenue derived will come dollar-for-dollar out of a reduction in U.S. R&D spending — and that the wrong solution to the 861 problem will encourage more U.S. R&D to go abroad.” *Id.* (quoting CORETECH Counsel Stuart Eizenstat).

5. The Treasury Department Study⁸²

Based on Congressional mandate,⁸³ the Treasury Department performed a study of R & D allocation, the 1977 regulations, and ERTA. The analysis the Treasury Department used is fairly complicated. The Treasury based its study on information taken off their Form 1118 ('Computation of Foreign Tax Credit - Corporations') computer files.⁸⁴ They used this information to determine which U.S. companies were in excess foreign tax credit positions, and made adjustments to the sampling of companies for expected IRS audit adjustments.⁸⁵ They then used this information to estimate an average excess foreign tax credit position per industry.⁸⁶ The end result was thus an audit adjusted excess credit index.⁸⁷ The Treasury then used a 1977 U.S. Commerce Department benchmark survey as industry information on R & D spending and domestic and foreign sales; with this they projected the R & D data to 1982, based on the growth of total industry-financed R & D.⁸⁸ The Treasury Department then made a preliminary estimate of an average company's R & D allocation to foreign income by industry, calculated the resultant increase in U.S. tax liabilities, and adjusted the results for §482 cost-sharing adjustments, and actual R & D allocation information made available on SEC documentation.⁸⁹ Finally, the Treasury Department also considered the impact on R & D intensive firms, and the possibility of additional companies becoming excess foreign credit companies by virtue of the R & D allocations.⁹⁰

The Treasury Department concluded that

[i]f the Regulation's R & D rules had been in effect in 1982, instead of the ERTA moratorium, the U.S. tax liabilities of U.S. firms would have been \$100 million to \$240 million higher. Since privately-funded R & D performed in the United States was about 37 billion in 1982, the estimated increase in U.S. tax liabilities represents an increase in the cost of privately-financed U.S. R & D of between .27 and .65 percent, or, less than 1.0 percent.⁹¹

⁸² *Treas. Dept. R&D Report, supra note 51.*

⁸³ The Economic Recovery Tax Act of 1981, P.L. No. 97-34, 95 Stat. 172, (1981); "In the Economic Recovery Tax Act of 1981 (ERTA) the Congress directed the Treasury Department to study the impact of the R&D rules of Treasury Regulation Sec. 1.861-8 on research activities conducted in the United States and on the availability of the foreign tax credit," *Tax Pamphlet, supra note 55.*

⁸⁴ *Id.*

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ *Id.* (citing U.S. Department of Commerce, Bureau of Economic Analysis, U.S. Direct Investment Abroad, 1977, Washington, D.C. 1971).

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ *Id.*

The Treasury, based on these results, suspected that the end result would be a reduction of domestic R & D spending.⁹² However, the Treasury believed that the reduction of U.S. R & D expenditures would not be accompanied by an increased investment in foreign R & D, due to prohibitive start-up costs in foreign jurisdictions; the need for economies of scale from centralized R & D in the U.S. (for U.S. companies); and the need for industries' R & D facilities to be coupled with their manufacturing operations.⁹³ "Based on these considerations, it appears that foreign R & D is not highly substitutable for R&D performed in the United States."⁹⁴

The Treasury's study, while negating the theory that greater foreign R & D allocation mandates movement of R & D facilities abroad, concluded that, "[t]he Treasury Department recognizes that the reduction in R & D may adversely affect the competitive position of the United States. Accordingly, the Treasury supports a two-year extension of the present moratorium."⁹⁵

The I.R.C. Temporary Solution: § 864(f)

In 1989, as part of the codification of the Technical and Miscellaneous Revenue Act of 1982 (TAMRA), Congress enacted § 864(f).⁹⁶ Section 864(f) first provided that if R & D is done only to meet legal requirements of one location (and not expected to generate income elsewhere), that research is allocated to that location.⁹⁷ For all other R & D, if the research was attributable to U.S. activities, then 64% of expenses were allocated to the U.S. Conversely, if the research was attributable to foreign activities, then 64% were allocated to the foreign jurisdiction.⁹⁸

The remaining 36% of R & D expenses were allocated on the basis of gross sales or gross income as provided in the § 1.861-8(e) regulations (but a gross income allocation to foreign sources must have been at least 30% of what the gross sales deduction would have been.)⁹⁹

Rev. Proc. 92-56

For three years, from 1989-92, I.R.C. § 864(f) applied for taxpayers. Following this, the regulations were slated to go back into effect and provide for a typically lower U.S. expense allocation, unless another statutory change or moratorium was enacted. In

⁹² *Id.*

⁹³ *Id.*

⁹⁴ *Id.*

⁹⁵ *Id.*

⁹⁶ Peck, *supra* note 39, at 79.

⁹⁷ I.R.C. § 864(f)(1)(A) (West 1993). As in the regulations, this would allow research to satisfy FDA requirements to be allocated wholly to U.S. source income.

⁹⁸ I.R.C. § 864(f)(1)(B) (West 1993).

⁹⁹ I.R.C. § 864(f)(1)(C) (West 1993).

response to Congressional concern over the impending sunset of § 864(f), the Treasury Department was pressured into enacting Revenue Procedure 92-56.¹⁰⁰ This procedure stated that for 18 months (from the June 30, 1992 expiration of § 864(f) (for calendar year taxpayers) until the end of 1993), taxpayers, at their option may apply either § 864(f) or the § 1.861-8(e) regulations, while the Treasury Department considers the proper apportionment issue.¹⁰¹ While pharmaceutical company advocates have always pushed for a permanent R & D allocation system, few industrialists object to the § 864(f) and Rev. Proc. 92-56 U.S.-source allocation percentages, in light of the harsher 1977 Regulation alternative.¹⁰²

Additionally, Revenue Procedure 92-69 was enacted to give guidance in applying 92-56 in light of possible § 936 overlap. Revenue Procedure 92-69 states that if the § 936(h) election is in effect, expenses covered by the § 936 credit should not be double counted in allocating under 92-56.¹⁰³

These Revenue Procedures were enacted by the Treasury Department, and not Congress, and so the \$915,000,000 "given away" was not subject to the 1990 Budget agreement.¹⁰⁴ This bypass was engineered by then Senate Finance Committee Chairman, Lloyd Bentsen, Daniel Rostenkowski, Chairman of the House Ways and Means Committee and the U.S. Department of the Treasury.¹⁰⁵ Many find it questionable for these officials to have given such a tax break to research intensive corporations without looking to Congressional Budget restraints.¹⁰⁶

The Relationship Between § 864(f), the § 1.861-8(e) Regulations, and §§ 174 and 41

The above Revenue Procedure (92-56) tabled one issue still in the air - that the § 861 regulations create a disincentive to U.S. R & D, while the basic purpose of §§ 174 and

¹⁰⁰ David S. Hilzenrath, *Wriggling Out of Budget Constraints; Tax Break Maneuver Shows Bentsen's Skill in Evading 1990 Pact*, WASH. POST, Jan. 9, 1993, at A1.

¹⁰¹ Rev. Proc. 92-56, 1992-28, I.R.B. 7.

¹⁰² Yet critics feel that:

[a] permanent solution to the controversy would end the ongoing uncertainty in the area and put the United States in a position to compete with other industrialized countries in encouraging domestic research and development activity. Given the fact that foreigners file almost one-half of the patent applications received by the U.S. Patent Office, a permanent solution and encouragement to U.S. based R&D activities cannot come soon enough.

Bischell, *supra* note 65 at 230.

¹⁰³ Rev. Proc. 92-69, 1992-36, I.R.B. 18; See discussion of § 936, *infra* p. 25.

¹⁰⁴ Hilzenrath, *supra* note 100, at A1.

¹⁰⁵ *Id.*

¹⁰⁶ *Id.* "The cost of the tax break will add directly to the budget deficit because the government did not have to find a way to pay for it." *Id.* Further, it is possible that 92-56 will have a greater impact on the deficit than would simply a reenactment of § 864(f), as it allows those few taxpayers who can better use the 1977 regulations the option to achieve a better tax result. *R&D Businesses Say IRS Allocation Procedure Acknowledges Regulatory Solution is Apt*, Daily Report for Executives, July 6, 1992, available in LEXIS, Nexis Library, DREXEC File.

41, which are intended to create incentives to further R & D investment, is subverted. Some critics have argued that § 174 says R & D in the U.S. is deductible, but the § 861 regulations imply that if a company is competitive internationally, it won't get much of a U.S. deduction, as the IRS will allocate much of its expenses to foreign sources.¹⁰⁷ It would be prudent for the government to decide whether their goal is truly to encourage R & D, or simply to increase revenue intake, and legislate accordingly.

President Clinton's Proposed Offshore R & D Credit Plan

In February of 1993, President Clinton proposed a tax package which would modify the R & D allocation rules, effective December 31, 1993.¹⁰⁸ The proposal would allocate 100% of R & D expenses to the place of performance.¹⁰⁹ But as a trade-off, the plan would provide that all foreign source royalty income would be subject to the separate foreign tax credit limitation for passive income.¹¹⁰

Under § 904(d), separate (basket) limitations are kept track of in addition to the general foreign tax credit limitation. Among these is a passive foreign tax credit limitation.¹¹¹ Thus, under President Clinton's proposal, the passive foreign tax credit limitation would have included: royalties received from an unrelated person in the conduct of an active trade or business, and certain royalties received from foreign affiliates which are currently categorized in the Code on a "look-through" basis - royalties previously treated as general-limitation-type income.¹¹² The Treasury described the effects of this proposal as: "The proposal would eliminate the existing tax preference for licensing intangible property for use in foreign production activities. In addition, the rules governing the allocation of R & E would be simplified and would encourage the conduct of R & E in the United States."¹¹³

¹⁰⁷ Letter of Raymond J. Wiacek, *Lawyer Examines Problems with the Tax Treatment of Foreign R&D*, Tax Analysts Tax Notes Int'l, June 3, 1992, available in LEXIS, TAXANA Library, TNI File.

I have to tell you that I have never been able to convince any businessman preparing for a meeting with the Treasury or Congressional representatives that section 174 and the section 861 regulations are not internally inconsistent. The reply to my technical explanation is always: 'section 174 permits and induces my company to deduct its R&D, at the same time that the section 861 regulations effectively deny my company the deduction just because it competes internationally in high tax jurisdictions. The section 861 regulations are, therefore, a clear disincentive which negate section 174.'

Id.

¹⁰⁸ See William J. Clinton, *Clinton's Economic Plan Report "A Vision of Change for America"* Tax Analysts Tax Notes Int'l, Feb. 23, 1993, available in LEXIS, TAXANA Library, TNI File.

¹⁰⁹ *Treasury Officially Releases Explanation of Clinton Tax Package*, Tax Analysts Tax Notes Today, Feb. 26, 1993, available in LEXIS, TAXANA Library, TNI File.

¹¹⁰ *Id.*

¹¹¹ L.R.C. § 904(d)(1)(A) (1988).

¹¹² *Treasury Officially Releases Explanation of Clinton Tax Package*, *supra* note 109.

¹¹³ *Id.*

But it was soon apparent that this royalty "give-up" was a steeper price than companies were willing to pay for a full U.S.-source allocation of R & D. Because it was clear that the Treasury Department was the real winner of this proposal, it had already generated considerable protest.¹¹⁴ The widespread criticisms of this plan apparently did not

¹¹⁴ See, e.g., *McClure Objects to Proposal on Foreign-Source Royalties*, Tax Analysts Tax Notes Int'l, April 9, 1993, available in LEXIS, TAXANA Library, TNI File; *Foreign Royalty Income: Response to Treasury Briefing Paper*, Tax Analysts Tax Notes Int'l, May 11, 1993, available in LEXIS, TAXANA Library, TNI File; Catherine Hubbard, *Clinton's Royalty Proposal would Discourage Research Spending, Economist Predicts*, Tax Analysts Tax Notes Int'l, May 3, 1993, available in LEXIS, TAXANA Library, TNI File; *Business, Practitioner Groups Speak Out Against Clinton's Foreign Royalties Plan*, Daily Report for Executives, May 3, 1993, available in LEXIS, Nexis Library, DREXEC File; *Attorney Attacks Proposal to Treat Foreign-Source Royalties as Passive Income*, Tax Analysts Tax Notes Int'l, April 9, 1993, available in LEXIS, TAXANA Library, TNI File. The Committee on Royalty Taxation (CORT), a multinational-business coalition, made a compelling presentation to Congress as to what they view as the flawed approach of the proposed plan. Dexter F. Baker, *Royalty Committee's Testimony at W&M Hearing on Clinton's Economic Proposals, Including Foreign Provisions*, Tax Notes Int'l, April 5, 1993, available in LEXIS, TAXANA Library, TNI File. They believed that Clinton's proposal was unfair and unsound, and would result in a reduction of U.S. based R&D, investment, and jobs.

U.S. multinational companies affected by the proposal are an important source of high-wage, high-skill domestic jobs. . . . It seems incongruous to the Administration's stated goals of reducing the deficit, promoting high quality domestic jobs, and promoting U.S. based R&D, to single out for a massive tax increase those corporations that provide such jobs and conduct significant levels of R&D in the United States.

Id.

CORT's attack on Clinton's plan was three-fold. First, CORT disputes the President's unfairly penalizing companies with foreign plants, noting,

U.S. multinationals with royalty arrangements invest overseas to expand into and service new foreign markets, not to replace U.S. jobs. Given a choice, U.S. multinationals with royalty arrangements most often choose to produce their products in the U.S. However, . . . these companies often do not have that choice. Too often, a U.S. company seeking to break into a foreign market must choose between producing a product or providing a service locally or foregoing that market entirely.

Id.

CORT also disputed the claim that the President's solutions are the proper way to reconcile R&D deductions with appropriate U.S. source income, noting,

The 64 percent allocation rule already represents the best efforts of many people over numerous years and after lengthy debate to formulate the extent that U.S. based R&E gives rise to foreign source income. Accordingly, no compensatory 'recapture' of R&E deductions is required. Moreover, if the Treasury wishes to reopen the R&E allocation debate, it should do so independently of the characterization of royalty income for foreign tax credit purposes.

Id.

Finally, they questioned the Treasury's rationale as to proper sourcing of royalty income:

It has been rumored that some Treasury officials reportedly believe that royalties should be sourced where the underlying intangibles are created, not where they are used. Such a change would represent a radical shift in U.S. international tax policy and would create havoc with our treaty partners. . . . If Treasury truly believes that royalties should be sourced where the intangibles are developed, it should repeal the 30 percent withholding tax for the use of intangibles developed in other taxing jurisdictions. Since it has not proposed to do so, this rationale sounds more like an afterthought than a consistently applied view of proper tax policy.

Id.

Twenty-six members of the House Ways and Means Committee also separately sent letters to Clinton's Secretary of Treasury, Lloyd Bentsen, *Clinton's Proposed Section 936 Changes Will Not Hurt Puerto Rico, Treasury Says*, Daily

fall on deaf ears, and the version of the Omnibus Revenue Reconciliation Act of 1993 which was actually enacted did not include these passive basket limitation royalty provisions.

The Latest Installment: R & D Allocation Under OBRA '93

The Omnibus Budget Revenue Reconciliation Act of 1993,¹¹⁵ temporarily adopted an allocation scheme similar to 864(f) for a period of one year following the last year in which Rev. Proc. 92-56 applied to the taxpayer.¹¹⁶ However, instead of automatically allocating 64% of expenses attributable to either U.S. or foreign activities to that source, the new law uses a 50% allocation. (i.e. 50% of expenses attributable to U.S. activities is allocated to U.S. source income, with the remaining 50% allocated on the basis of gross sales or gross income; 50% of expenses attributable to activities conducted outside the U.S. is allocated to foreign source income with the remaining 50% allocated on the basis of gross sales or gross income.)¹¹⁷ While this allocation scheme is not as detrimental to the drug industry as the plan originally proposed by the White House, the short-term duration of this temporary act will do nothing to eliminate planning uncertainty,¹¹⁸ and the lower percentage of expenses initially allocated to U.S. sources may prove expensive to the industry.

§ 936 POSSESSIONS TAX ISSUES

One of the most lucrative tax incentives given to the pharmaceutical industry is the § 936 Possession Tax Credit. Although not specifically designed for the benefit of drug companies, as much as 56% of this credit has historically been used by U.S. pharmaceu-

Report for Executives, April 28, 1993, available in LEXIS, Nexis Library, OMNI File. The Committee members believed that the proposal could hurt U.S. corporations' competitiveness due to higher tax burdens on their foreign operations, and actually could lead to increased reinvestment of income abroad, rather than domestically. *Ways and Means Members Express Concern Over Clinton's International Tax Proposals*, Tax Notes Int'l, April 30, 1993, available in LEXIS, Nexis Library, OMNI File. The letter explained:

One of the fundamental decisions made in the Tax Reform Act of 1986 was to permit companies to treat their active business operations as a unit for foreign tax credit purposes. The ability to "basket" different types of active business income together encourages companies to repatriate (through dividends) foreign source earnings. Those dividends carry with them the taxes paid on the underlying foreign earnings and, absent a cross crediting mechanism, their repatriation could have a significantly increased U.S. tax cost. Thus, if the royalties proposal were enacted, it would be more cost efficient in many cases for U.S. companies to reinvest those earnings in productive activities abroad rather than in the United States.

Id.

¹¹⁵ Revenue Reconciliation Act of 1993, Pub. L. No. 103-66 (enacted August 10, 1993).

¹¹⁶ *A Tax Bill Baedeker, A Guide to the 1993 Tax Laws*, 60 TAX NOTES 811, 871 (Aug. 12, 1993).

¹¹⁷ I.R.C. § 864(f)(1)(B) (as amended by the 1993 Act, § 13234(a)); The RIA Complete Analysis of the Revenue Reconciliation Act of 1993 at 234-6.

¹¹⁸ "Congress's failure to provide a permanent solution to the issue is a disappointment, and many commentators attribute the decision to provide another temporary fix to Congress's reluctance to address the revenue costs of a permanent solution.", John Turro, *U.S. Enacts Controversial Budget Legislation*, Tax Notes Int'l, Aug. 16, 1993, available in LEXIS, Nexis Library, TAXANA File.

tical corporations.¹¹⁹ This is because drug company R & D investment typically leads to valuable intangible property, which is easy to transfer to U.S. possessions such as Puerto Rico. Senator Pryor has repeatedly attempted to remove what he has termed, this "mother of all tax breaks" from the pharmaceutical industry.¹²⁰

Much of the ammunition of Senators opposing the § 936 credit comes from a series of government studies culminating with a May 1992 Government Accounting Office (GAO) study,¹²¹ and an Office of Technology (OTA) report issued on February 25, 1993. The GAO study stated that a total of 26 drug companies were able to save \$8.5 million in federal and local taxes in the 1980s.¹²² It is also noted that drug manufacturers received \$70,788 in tax credits per Puerto Rican employee hired (in 1987), while the average wages paid to employees was only about \$26,500.¹²³ Drug lobbyists dispute the value of this study by noting that it fails to note that the drug companies have provided 115,000 jobs on the island, and that the per job figure does not account for non-pharmaceutical jobs that were indirectly generated by Puerto Rican investment.¹²⁴

The OTA study, purporting to use the pharmaceutical industry's own data, noted that in the decade of 1976-87, pharmaceutical companies generated 2-3% greater economic returns than corporations in other industries, after adjusting for risk differences.¹²⁵ The study also found that drug companies had an after-tax surplus return of approximately 4.3% of the price of each new drug over its product life; this was approximately \$36 million more than was required to recoup its R & D investment.¹²⁶ The PMA contests the 4.3% profit surplus figure, by claiming the OTA used a 46% tax rate for R & D expenditures and a 32% rate for related income generated, thereby drastically understating the industry's tax liability and inflating the net profit.¹²⁷ The PMA claims the same tax rate should have been used for costs and revenues, which would have significantly reduced the percentage.¹²⁸

¹¹⁹ *Sec. 936 Tax Credit Revision Is Goal for 103rd Congress Ways and Means Chairman Rostenkowski Says; PMA 'Strongly Opposes' Bill's Proposed 15% Reduction in Tax*, The Pink Sheet 1992; 54(30): 9-10, July 27, 1992.

¹²⁰ *Tax Code is Not Tool For Fixing Drug Prices, Senate Finance Chairman Bentsen Indicates In Arguments Against Pryor Plan; Hatch and Bradley Join Opposition*, The Pink Sheet 1992; 54(11): 5-7, Mar. 16, 1992.

¹²¹ *Tax Benefits for the Pharmaceutical Industry*, 138 CONG. REC. S.6632, 102d Cong., 2d Sess. (daily ed. May 14, 1992) (statement of Sen. Pryor).

¹²² *Id.* at S.6641; Milt Freudenheim, *Business and Health: Trying to Curb Price of Drugs*, N.Y. TIMES, June 9, 1992, at D2.

¹²³ Freudenheim, *supra* note 122.

¹²⁴ *Id.*; "They said the GAO analysis had omitted an estimated 4.7 additional jobs per employee, which the drug makers said were indirectly supported by pharmaceutical industry spending." Milt Freudenheim, *Tax Credits of \$8.5 Billion Received by 22 Drug Makers*, N.Y. TIMES, May 15, 1992, at D3.

¹²⁵ *Drugs, Drug Industry Reacts to OTA Report on Costs, Rewards of Pharmaceutical R&D*, Daily Report for Executives, Mar. 1, 1993, available in LEXIS, Nexis Library, OMNI File.

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ *Id.*

The OTA report also found that pharmaceutical companies spend 22% of their total sales on advertising and marketing, or approximately \$10 billion, which Congressmen are quick to note are dollars that could be used to reduce drug costs.¹²⁹ And the OTA noted that 58% of industry research is invested in “me too” drugs, which are drugs designed to make a profit, but add little therapeutic benefit.¹³⁰

The I.R.C. § 936 is a complicated rule which allows U.S. corporations operating in Puerto Rico and other U.S. Possessions to receive a U.S. tax credit on income generated from an active trade or business in the Possession.¹³¹ With respect to intangible property income, the credit is somewhat limited by § 936(h)(1)(A) which reallocates income from patents and other intellectual property back to the U.S. corporate shareholders.¹³² However,

[m]any § 936 corporations can avoid the reallocation scheme by electing to compute taxable income under a cost sharing or profit splitting method. Under the cost sharing method, the corporation makes annual payments to affiliated entities engaged in research and development activities in amounts intended to reimburse these entities for the costs of research and development that will ultimately benefit the § 936 corporation. The payments are deductible by the corporation and therefore reduce the income qualifying for the credit to amounts intended to represent a fair return on the costs incurred by the corporation itself. Under the profit split method, the combined taxable income of the § 936 corporation and all affiliated businesses from sales of goods and services produced by the corporation in a possession is split equally between the corporation and its affiliates.¹³³

The pharmaceutical industry generally has elected to use the profit split method “which typically has the effect of exempting from Federal taxes half of the profits the companies generate” in the possession.¹³⁴

¹²⁹ News Conference with Rep. Henry Waxman, D-CA. Topic: Release of Office of Technology Assessment Report on Cost and Profits of Pharmaceutical Research and Development, Fed. News Service, Feb. 25, 1993, available in LEXIS, Nexis Library, FEDNEW File.

¹³⁰ *Id.*, Such drugs are to be used in addition to other medications, but do not represent a novel curative element.

¹³¹ “In order to qualify for the section 936 credit, a domestic corporation must derive at least 75 percent of its gross income from the active conduct of a trade or business within a possession over a three-year period, and at least 80 percent of the corporation’s gross income must be derived from sources within a possession during that period.” *Treasury Officially Releases Explanation of Clinton Tax Package*, *supra* note 109.

¹³² BITTKER & LOKKEN, *supra* note 53, at 67-8. At one time, a U.S. company could simply conduct R&D in the U.S., take a current §174 deduction on the research expenses, and then transfer the resultant patent tax free (under §351) to a Puerto Rican subsidiary. The company could then obtain §936 credits on profits from the sales of the Puerto Rican subsidiary. *Id.* This practice was somewhat limited in 1982, and again in 1986. *Id.*

¹³³ *Id.* at 67-9.

¹³⁴ Leah Beth Ward, *The Offshore Threat To Pharmaceuticals*, N.Y. TIMES, Mar. 14, 1993, § 3, at 5.

Senator Pryor's original legislative proposal mandated limiting the § 936 credit to the Consumer Price Index (i.e. drug profits tied to national inflation rates). His original bill thus simply tied permissible profits directly to the consumer price index (CPI); this was later modified to be a 20% credit reduction for each point above CPI. Pryor's bill, The Prescription Drug Cost Containment Act of 1991,¹³⁵ had little support from either Republicans or Democrats, and was defeated in the Senate.¹³⁶

Pryor has recently taken a different tack, proposing that §936 be limited to employee wages expended in the possession. In his 1993 bill,¹³⁷ Pryor seeks to phase out the existing credit over five years in favor of a wage-based credit. Pryor has maintained that the § 936 credit has not appreciably been effective in creating jobs in Puerto Rico.¹³⁸ To remedy this, Pryor's plan would ultimately replace the current possessions credit with a credit of 40% of the first \$20,000 of qualified wages paid to workers in Puerto Rico.¹³⁹ During the five year phase-in, Pryor's bill would allow 100% of wages paid in the first year, 85% in the second year, 70% in the third, 55% in the fourth, and finally 40% in the fifth year.¹⁴⁰ The tax savings would be applied toward a 100% deduction for health care insurance premiums for the self-employed.¹⁴¹

It should be noted that Pryor's wage-based credit proposal is similar to an ill-fated plan offered by President Ronald Reagan in 1985. In §12.05 of a Reagan Administration plan entitled, "The President's Proposals To the Congress for Fairness, Growth and Simplicity," the then existing tax-free treatment under § 936 would have been replaced by a wage credit worth 60% of an employee's salary at the minimum wage, plus 20% of the amount paid, up to four times the minimum wage.¹⁴² This proposal was met with

¹³⁵ S2000, 137 CONG. REC. S. 17291 (daily ed., Nov. 20, 1990) (Statement of Sen. Pryor).

¹³⁶ *Partnership With the People*, 139 CONG. REC. S. 1221, 1223 (daily ed. Jan. 5, 1993) (statements of Sen. Pryor). "The drug companies won that battle, but now we will be fighting on a different turf."

¹³⁷ *Possessions Wage Credit Act of 1993*, 139 CONG. REC. S. 1593 (daily ed., Feb. 16, 1993) (statement of Sen. Pryor).

¹³⁸ However it should be noted that a Price Waterhouse study "The Impact of a Complete Repeal of Section 936" tends to disagree, and suggests that Pryor's proposal would have "devastating consequences for the Puerto Rican Economy, including a loss of at least 70,000 jobs," and would result "in a deeper recession on the island than any the United States has experienced in the post World War II period," *Puerto Rican Economy Threatened by "Double - Barreled Attack," Foundation Alleges*, Tax Analysts Tax Notes Today, Mar. 1, 1993, available in LEXIS, Nexis Library, TNT File.

¹³⁹ *Summaries of Today's Important Tax Items*, Tax Analysts Tax Notes Today, Feb. 18, 1993, available in LEXIS, Nexis Library, TNT File.

¹⁴⁰ *Id.* John Turro, *Pryor Bill Would Replace Possessions Credit with Wage Credit*, Tax Analysts Tax Notes Int'l, Feb. 18, 1993, available in LEXIS, Nexis Library, TNI File.

¹⁴¹ *Pryor Introduces Bill to Replace Sec. 936 Credit with Wage Credit*, Daily Labor Report, Feb. 18, 1993, available in LEXIS, Nexis Library, DLABRT File.

¹⁴² Anne Swardson & Henry Boyd Hall, *Puerto Rico Gains Ground in Tax-Break Lobbying*, WASH. POST, July 12, 1985, at B3. *Puerto Rico's Governor Says He Will Work To Curb Abuses in Effort To Salvage Section 936*, Tax Analysts Tax Notes Int'l, June 12, 1985, available in LEXIS, Nexis Library, TNI File. *Puerto Rico - U.S.A. Foundation Fights To Save Section 936*, Tax Analysts Tax Notes Int'l, June 26, 1985, available in LEXIS, Nexis Library, TNI File. The ultimate result of the wage credit would equal a maximum of \$5,062 per worker," Swardson and Hall, *supra*.

intense Puerto Rican and U.S. corporate lobbying efforts, and was ultimately discarded by the administration.¹⁴³ While lobbyists were able to convince the government in 1985 that a wage-based credit would result in disastrous unemployment for Puerto Rico, it does not appear that they have the same impact today.¹⁴⁴

President Clinton's § 936 Solution

President Clinton also proposed his own limitation of the § 936 credit in his February 1993 proposed tax package.¹⁴⁵ The Clinton plan would have limited a company's § 936 tax credit to 65% of compensation paid to possession employees.¹⁴⁶ Clinton's plan noted that current data on § 936 "suggests that while section 936 has created employment in Puerto Rico, the number of jobs created is too small in relation to the tax expenditure."¹⁴⁷ The Treasury had abstracted the effect of the President's proposal to be:

Possessions corporations that have created a relatively large number of jobs will continue to enjoy the tax credit that they now receive. Possession corporations for which tax credits exceed 65% of payrolls will lose some of their tax benefits unless they expand their Puerto Rican employment. The result should be a much more cost-effective possessions credit.¹⁴⁸

§ 936 Under OBRA '93

In August, Congress passed the Omnibus Budget Revenue Reconciliation Act of 1993. Section 13227 of OBRA '93 now provides sever limitations on the use of the § 936 credit. A corporation may now obtain a § 936 credit limited to either:

(1) 60% of qualified compensation incurred, plus a depreciation percentage of tangible property used in the territory, plus (if not using a profit split method) a portion of the possession income taxes, or;

(2) The corporation may use a 60% percentage of the § 936 credit that would have been applicable under the pre-OBRA '93 rules; This percentage is to be phased back 5%

¹⁴³ Howard Gleckman, *Puerto Rico Head Says Tax Break Curb Would Hurt Island's Economy*, THE BOND BUYER, July 15, 1985 at 4; *Study Hits Reagan Plan to Replace Possessions Tax Break*, Daily Report for Executives, June 18, 1985, available in LEXIS, Nexis Library, DREXEC File. *Repeal of Section 936 Credit Will Devastate Possessions' Economies, Senate Finance Committee Told*, Tax Analysts Tax Notes Int'l, Oct. 9, 1985, available in LEXIS, Nexis Library, TNI File. *International Provisions of Reagan Reform Plan Come Under Fire From U.S. Corporations*, Int'l Trade Reporter, July 17, 1985, available in LEXIS, Nexis Library, INTRAD File.

¹⁴⁴ See, e.g., a full-page advertisement *Where Do the 3.6 Million Americans Live Who Have Been Asked To Sacrifice the Most By the U.S. Treasury? Puerto Rico*, WASH. POST, April 27, 1993, at C14.

¹⁴⁵ *Treasury Officially Releases Explanation of Clinton Tax Package*, supra note 109.

¹⁴⁶ *Puerto Rican Economy Threatened by "Double-Barreled Attack" Foundation Alleges*, supra note 138.

¹⁴⁷ *Treasury Officially Releases Explanation of Clinton Tax Package*, supra note 109.

¹⁴⁸ *Id.*

per year to 40% in 1998 and beyond.¹⁴⁹ Because, as mentioned above, the pharmaceutical industry has generally found the profit split method most beneficial, it appears that they will be limited to the latter § 936 limitation.¹⁵⁰ The OBRA '93 provisions represent a severe limitation to the use of the § 936 credit for industries such as pharmaceutical manufacturing, and are sure to have profound effects on the industry's competitiveness.¹⁵¹

Other § 936 Proposals

On August 4, 1993, Congressman Jim Cooper (D-Tenn.) proposed H.R. 2857, a bill to completely repeal § 936 from the Internal Revenue Code.¹⁵² This extreme proposal was probably tabled by the subsequent passing of § 936 provisions in OBRA '93. However this bill may suggest that legislators are far from satisfied with the current tax credit treatment of the pharmaceutical industry. Although not presently under consideration, there have also been other proposals for revising the § 936 possessions tax credit. Not long ago, House Ways and Means Chairman Daniel Rostenkowski proposed a "Foreign Tax Rationalization and Simplification Bill."¹⁵³ Section 411 of that proposal would have reduced the § 936 credit by 15%.¹⁵⁴ Although the PMA opposed this proposal as well, it is by far the most generous of the changes which have been proposed.

¹⁴⁹ *A Tax Bill Baedeker, A Guide to the 1993 Tax Law*, *supra* note 116.

¹⁵⁰ *See supra* note 138.

A possession corporation that uses the economic-activity limitation to compute its Code Sec. 936 credit and which also uses the profit split method to allocate income from intangible property in a tax year. . . is allowed to deduct a certain amount of possession income taxes for that year in determining its U.S. income tax liability. The amount allowed as a deduction equals the possession income taxes for that tax year multiplied by a fraction. The fraction consists of the possession corporation's increased U.S. tax liability resulting from the economic-activity limitation divided by the possession corporation's U.S. tax liability determined without the Code Sec. 936 credit. However, no deduction for possession income taxes is allowed in computing the Code Sec. 936 credit or in determining the amount of possession income taxes that may be deducted

(The RIA Complete Analysis of the Revenue Reconciliation Act of 1993 at 264).

¹⁵¹ In sum, for industries utilizing the §936 credit, "in 1994 they can choose to receive a tax credit for 60% of the profits, falling to 40% in 1998, or they may choose a wage-based credit equal to 60% of wages paid plus fringe benefits up to 15% of the base wage. The wage credit is capped at \$48,960 per employee. Companies are also eligible for depreciation allowances ranging from 15-65%." *What the New Tax Regime Means*, Lagniappe Letter, Aug. 20, 1993, available in LEXIS, Nexis Library, OMNI File. "The final result was an estimated \$3.8 billion over five years in revenues from narrowing Section 936. It was less than the administration wanted, but about as much as business would tolerate." Max Boot, *Anatomy of a Budget Winner*, CHRISTIAN SCIENCE MONITOR, Aug. 12, 1993 at 2.

¹⁵² *Cooper Bill, H.R. 2857, Would Repeal Possessions Credit*, Tax Notes Int'l Aug. 16, 1993, available in LEXIS, TAXANA Library, TNI File.

¹⁵³ H.R. 5270, 102d Cong., 2d Sess. (1992).

¹⁵⁴ *Sec. 936 Tax Credit Revision is Goal for 103rd Congress, Ways & Means Chairman Rostenkowski Says; PMA 'Strongly Opposes' Bill's Proposed 15% Reduction in Tax*, *supra* note 119; *U.S., Foreign Multinationals Unlikely to Support Foreign Tax Reform Bill*, Daily Report for Executives, June 1, 1992, available in LEXIS, Nexis Library, DREXEC File.

Tax Sparing and § 936

One of the biggest reasons pharmaceutical industry advocates claim to need the § 936 credit is because it allows U.S. corporations to compete with other nations who take advantage of “tax sparing.”¹⁵⁵ “Tax sparing” refers to the practice of one country allowing its taxpayers to claim a foreign tax credit for a tax in another country not actually paid.¹⁵⁶ “The purpose behind tax sparing is to allow a developing nation to offer businesses a ‘tax holiday’ (e.g., freedom from taxes for a specified period of time) as an investment incentive without the tax holiday benefit accruing to the developed nation.”¹⁵⁷

However, for policy reasons, the United States will not enter into treaties involving tax sparing agreements. One reason is out of a general policy that a U.S. treaty should not provide U.S. taxpayers with U.S. tax benefits as opposed to simply avoiding double taxation. Another reason is that tax sparing agreements discriminate against companies investing in the U.S. and encourage location of investment abroad.¹⁵⁸

The U.S. “tax sparing” policy limits U.S. pharmaceutical industry competitiveness, as it requires U.S. corporations to incur greater costs in developing markets in less developed countries (L.D.C.s), who offer such tax holidays than do their European counterpart firms. However, because of the tax haven treatment companies have been getting in possessions such as Puerto Rico, they have still been able to maintain their competitive advantage. Admittedly, the § 936 credit/tax sparing analogy is not a perfect one. However, the point Mossinghoff and others appear to be making is that non-U.S. pharmaceutical corporations may perform operations in tax sparing treaty countries and save taxes, which may ultimately be passed on as a savings to their consumers.¹⁵⁹ Similarly, use of a possessions corporation may generate similar savings via the § 936 credit. Critics claim that § 936 modifications may eliminate this trade equity, and force U.S. companies to forego several L.D.C. markets.

¹⁵⁵ “Unlike all major countries . . . the U.S. generally does not provide special tax arrangements for investments by American corporations in developing countries. These ‘tax-sparing’ agreements enable foreign-based companies to operate with much lower costs than U.S. firms in these emerging markets. The one exception to this U.S. policy is section 936. . .” *supra* note 18.

¹⁵⁶ RICHARD L. DOERNBERG, *INTERNATIONAL TAXATION IN A NUTSHELL*, § 5.04 (1989); “In some circumstances a foreign country may grant a tax exemption for a period of years or some other special tax concession if a desired project is being undertaken.” JON E. BISCHER AND ROBERT FEINSCHREIBER, *FUNDAMENTALS OF INTERNATIONAL TAXATION*, 220 (2d ed. 1985); “A foreign country’s tax sparing provision has the effect of reducing its tax on U.S. corporations that invest in the country since the U.S. corporation need not pay the full foreign country tax, in other words, a part of that tax is ‘spared,’” *Tax Sparing: A Question of Treasury Policy or Puerto Rico Politics?*, *Tax Analysts Tax Notes Int’l*, June 3, 1987, available in LEXIS, TAXANA Library, TNI File.

¹⁵⁷ DOERNBERG, *supra* note 156.

¹⁵⁸ *Id.* Mimi E. Gild, *Tax Treaty Shopping: Changes in the U.S. Approach to Limitation on Benefits Provisions in Developing Country Treaties*, 30 VA. J. INTL L. 553, 559 (1990).

¹⁵⁹ The competitive advantage is particularly clear when selling drugs directly to consumers in the L.D.C.s offering the tax sparing.

**TECHNOLOGY TRANSFER ISSUES -
§ 482 AND § 367(d) TRANSFERS OF INTANGIBLES**

One of the hottest tax topics affecting the U.S. pharmaceutical industry is transfer pricing.¹⁶⁰ Although there are incentives and advantages in allowing the allocation of R & D expenses to U.S. source income, it was feared that after taking advantage of such deductions, drug companies would simply transfer intangibles tax-free to related foreign subsidiaries, to be then exploited at lower foreign tax rates.¹⁶¹ The U.S. circumvented these practices by enacting §§ 367(d) and § 482.

The I.R.C. § 367(d) provides that an outbound transfer of intangibles for the stock of a foreign subsidiary in an otherwise tax-free nonrecognition transaction is to be treated as a sale of the intangible, with deemed payments contingent on the future profitability of the intangible.¹⁶² "A U.S. corporation exporting technology is therefore treated as if it had sold the patent to its subsidiary in exchange for deemed royalty payments."¹⁶³ The disincentive presented by § 367(d) is thus that the payments deemed owed on the royalty may be higher than that which would be agreed upon in an arms-length transaction between two distinct corporations.¹⁶⁴ However, § 367(d) creates a number of additional problems for taxpayers.

First, since the deemed payments are treated as U.S. - source income, a U.S. corporation will incur current U.S. tax but will receive no actual payments from the foreign subsidiary, which can cause a potential liquidity crunch. In addition, a substantial risk of double taxation arises, since the foreign country is imposing tax on the income from the exploitation of the patent and may disallow a deduction for the deemed royalty payment. If a deduction is allowed, the country may restrict it to the value of the patent based upon an arm's length standard at the time of the transfer.¹⁶⁵

It appears that these disadvantages are unavoidable if the Treasury must protect U.S. intangible revenue from being exported tax-free.

¹⁶⁰ Although beyond the scope of this article, OBRA '93 § 13236 has recently give § 482 new bite with several revamped penalty provisions.

¹⁶¹ Peck, *supra* note 39, at 80.

¹⁶² *Id.*

¹⁶³ *Id.*; I.R.C. § 367(d)(2)(A) (1988).

¹⁶⁴ Peck, *supra* note 39, at 80.

¹⁶⁵ *Id.*

One text provides a good illustration of how § 367(d) applies:

[S]uppose X Corp., a U.S. corporation, incurs various research expenses deductible under I.R.C. §§ 162 or 174 (thereby reducing U.S. source income) in developing a patented pharmaceutical product. When the product is commercially feasible, X Corp. transfers the product to Y Corp., a wholly-owned foreign subsidiary in a transaction normally accorded nonrecognition under I.R.C. § 351. Under I.R.C. § 367(d), X Corp. will have to report U.S. source ordinary income each year equal to an arm's length royalty.¹⁶⁶

Thus, § 367(d) creates a disincentive to the transfer of intangibles by a U.S. pharmaceutical company to its foreign subsidiary corporations for stock under §§ 351 or 361.¹⁶⁷

The I.R.C. § 482 allows the IRS the opportunity to reallocate income between related corporations which transfer intangibles amongst each other under sales or licensing agreements (even absent a tax-free exchange for stock).¹⁶⁸ The goal of § 482 is to prevent the understatement of U.S. income through manipulative transfers of intangibles, and require such licensing and sales to be made as if corporations were dealing with an unrelated party at arm's-length.¹⁶⁹ The § 482 regulations have undergone a variety of changes as to the correct allocations to be made, with a most recent attempt being issued on January 13, 1993.¹⁷⁰ The application of § 482, and the Treasury regulations have traditionally been the subject of considerable debate.¹⁷¹

Because of the research-intensiveness of the industry, and the importance of patenting in the pharmaceutical field, most of the landmark transfer pricing cases involved drug companies. These cases, abstracted below, encompassed a variety of issues, several of the cases involved U.S. subsidiaries of foreign corporations, and most of them involved

¹⁶⁶ DOERNBERG, *supra* note 156, §11.02

¹⁶⁷ Note: I.R.C. § 367(d) (1988) does not apply to possessions corporations, which are treated as domestic, not foreign, corporations.

¹⁶⁸ I.R.C. § 482 (1988) provides:

In any case of two or more organizations . . . owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion or allocate gross income, deductions, credits, or allowances between or among such organizations . . . if he determines that such distribution, apportionment or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations. . . In the case of any transfer (or license) of intangible property . . . the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

¹⁶⁹ Peck, *supra* note 39, at 81.

¹⁷⁰ *Internal Revenue Service Temporary Regulations, Intercompany Transfer Pricing Regulations Under Section 482 Issued Jan. 13, 1993*, Daily Report for Executives, Jan. 15, 1993, available in LEXIS, Nexis Library, DREXEC File.

¹⁷¹ See, e.g., *Transfer Pricing Regs Should be Withdrawn, Says Wiacek*, Tax Analysts Tax Notes Int'l, Sept. 23, 1992, available in LEXIS, TAXANA Library, TNI File; see also *Pharmaceutical Companies Urge Elimination of Priority Given to CPI Method*, Tax Analysts Tax Notes Int'l, Aug. 26, 1992, available in LEXIS, TAXANA Library, TNI File.

the use of possessions corporations.¹⁷² The drug industry has overwhelmingly been successful in § 482 cases, albeit after protracted litigation. But these cases do illustrate the friction generated between drug industrialists and the IRS with respect to transfers between U.S.-located and foreign manufacturing plants.

G.D. Searle & Co. v. CIR

In *G.D. Searle & Co. v. Commissioner*,¹⁷³ Searle, a U.K. corporation had transferred many of its valuable drug product lines to SCO, a Puerto Rican subsidiary, under § 351 transactions.¹⁷⁴ Searle assisted SCO in packaging, corporate administration, and regulation compliance, and was paid a fee of 3% of SCO's net sales.¹⁷⁵ The IRS sought an allocation of 92% of SCO's gross income to Searle, representing all profits from the transferred intangibles.¹⁷⁶ However, the Court found SCO itself to be a viable entity, and its existence and independent ownership of the patents could not be disregarded for tax purposes.¹⁷⁷ Nonetheless, the Tax Court found that some § 482 allocation was appropriate to instate some semblance of arms-length economics, and so allowed an allocation of 25%.¹⁷⁸

Ciba-Geigy Corp. v. Commissioner

In *Ciba-Geigy Corp. v. Commissioner*,¹⁷⁹ Ciba-Geigy, a Swiss corporation, granted an exclusive license to its U.S. subsidiary to manufacture and sell various herbicides, in return for a 10% royalty. The IRS argued that the 10% royalty was too high, that 6% would be appropriate, and that Ciba-Geigy should be subjected to dividend treatment on the difference.¹⁸⁰ However, petitioner was able to show that other pharmaceutical cor-

¹⁷² As noted above, § 367(d) is not applicable for tax-free transfers of possessions corporations (as, for § 357(d) purposes, possessions corporations are not considered "foreign" corporations). Therefore, § 482 plays a large role in technology transfers to Puerto Rican subsidiaries.

¹⁷³ 88 T.C. 252 (1987).

¹⁷⁴ *Id.* at 341.

¹⁷⁵ *Id.* at 256.

¹⁷⁶ *Id.* at 257.

¹⁷⁷ *Id.* at 370.

¹⁷⁸ *Id.* at 376; Part of the reason for the increased allocation was that the Court disagreed with Searle's "comparable" transaction evidence of similar product royalties of 8-10%, as the Court found that the licenses at bar were substantially more valuable having been approved by the FDA. See DOERNBERG, *supra* note 156, § 8.02. See also D. Kevin Dolan, *Intercompany Transfer Pricing for the Layman*, TAX NOTES, Oct. 8, 1990, at 221, n. 29, which states that some commentators have incorrectly suggested that the 25% figure was arrived at by the court using a § 482 profit-split method.

¹⁷⁹ 85 T.C. 172 (1985).

¹⁸⁰ *Id.* at 174-75.

porations were in fact willing to pay higher royalties for such product rights, and so the Tax Court found that the allocation of the IRS was an abuse of discretion.¹⁸¹

Merck & Co., Inc. v. United States

The U.S. Claims Court recently decided a § 482 transfer pricing case in favor of the taxpayer. In *Merck & Co. v. United States*,¹⁸² the IRS sought a 7% royalty to be allocated from a Puerto Rican subsidiary (Merck, Sharp & Dome Quimica de Puerto Rico — MSDQ) back to the U.S. mainland corporation. Merck & Co. had performed all the R & D on an ingredient called methyldopa, the active ingredient of Aldomet, and had subsequently contributed exclusive rights to the methyldopa patents to MSDQ under a tax-free § 351 transaction.¹⁸³ The IRS attacked Merck on the theory that Merck's benefits in vertical integration, group market planning, and corporate pricing deductions were intangible assets that ought to be reflected in a royalty.¹⁸⁴ The real question at bar was "[h]ow far can a U.S. parent corporation go in managing the affairs of a foreign corporation without subjecting itself to U.S. income tax on a portion of the income of the foreign subsidiary under Section 482?"¹⁸⁵ The Court held that the benefits involved were neither intangible property, nor uncompensated services, and found that a § 482 allocation was inappropriate.¹⁸⁶

Eli Lilly & Co. v. Commissioner

In *Eli Lilly & Co. v. Commissioner*,¹⁸⁷ Lilly U.S. had developed and patented two drugs, Darvon and Darvon N, claimed substantial R & D costs, and then transferred the drug patents, tax free (§ 351), to a Puerto Rican subsidiary.¹⁸⁸ The subsidiary manufactured the drugs, and sold them back to Lilly, who resold them in the U.S.¹⁸⁹ The IRS successfully contested on § 482 grounds.¹⁹⁰

¹⁸¹ See Dolan, *supra* note 177, at 217, n. 14. The Court has also been described as creating a rule of thumb that a license agreement negotiated at arms-length divides net profits between the licensor and licensee at a ratio of 25% to 75%. See Donald Jankowski, et al., *The Transfer of Intangible Property After the Bausch & Lomb Decision: An Economic Perspective*, TAX NOTES, May 8, 1989.

¹⁸² 24 Cl. Ct. 73 (1991).

¹⁸³ Robert Feinschreiber, *Limiting Intangible and Service Allocations*, INT'L TAX J. Summer 1992, at 84.

¹⁸⁴ John E. McDermott, *Claims Court Holds No 482 Change For Group Market Planning and Pricing Policy*, 2 J. INT'L TAX'N 314 (Jan./Feb. 1992).

¹⁸⁵ *Id.*

¹⁸⁶ *Id.* "A taxpayer that does not take the tax laws into consideration when structuring complex transactions not only is naive, but probably is out of business. Accordingly, if the allocation is to be justified, it must be on the 'clearly to reflect income' prong of Section 482." *Merck*, 24 Cl. Ct. at 85.

¹⁸⁷ 84 T.C. 996 (1985), *modified* 856 F.2d 844 (7th Cir. 1988).

¹⁸⁸ Richard J. Driscoll, *Income Shifting for Intangible Property Transferred Abroad*, 14 INT'L TAX J. 165, 175 (1988).

¹⁸⁹ *Id.*

¹⁹⁰ *Id.* See generally James P. Fuller, *Eli Lilly: The Seventh Circuit Partially Reverses the Tax Court*, 17:11 TAX MGMT. INT'L J. 503 (1988).

In *Eli Lilly*, the court resolved the allocation issue by using a profit split method. The court first allocated to the Puerto Rican subsidiary 100% of the manufacturing costs, and to the U.S. corporation 100% of the marketing costs. It then determined a 55% to 45% split of intangible income between the Puerto Rican and U.S. situs, based on the belief that manufacturing skills were somewhat more contributive to the earnings than were marketing efforts.¹⁹¹

Bausch & Lomb

Bausch & Lomb, Inc. v. Commissioner,¹⁹² although not specifically involving a pharmaceutical corporation, is a § 482 case which had profound implications on the drug industry, as it also dealt with transfer of intangible patent rights to an overseas subsidiary. Bausch & Lomb, U.S. granted a nonexclusive license to B & L, Ireland to use patented "spin cast" soft contact lens manufacturing technology.¹⁹³ In return, B & L Ireland agreed to pay a 5% royalty on sales. The IRS contested the characterization of the transaction, arguing that since B & L U.S. was the primary purchaser of B & L Ireland products, B & L Ireland should not earn any return from assumed market risk (and consequently unit transfer prices should be reduced), and further that § 482 should be applied to reallocate a greater royalty to the U.S. corporation.¹⁹⁴ "The Service argued that the transfer price and royalty rate must be analyzed together, asserting that B & L Ireland was little more than a contract manufacturer. Further, the Service implied that the cost plus method is the only proper method for determining the price in this transaction."¹⁹⁵ But the Court dealt with transfer prices and royalty rates separately, stating that each had "independent significance."¹⁹⁶

The Tax Court found that B & L Ireland did take on some market risk, as B & L, U.S. was not required to purchase all of B & L, Ireland's inventory.¹⁹⁷ However, the Court noted that the royalty rate provided was far too low, and required the royalty rate to be 20% of sales, (a rate of return of 27% of B & L Ireland's investment), stating, "Using our best judgment, we find that at arm's length B & L Ireland would have been willing to invest in the lens production facility even if required to share approximately 50 percent of the profits therefrom with B & L as consideration for use of its intangibles."¹⁹⁸ This 15% increase, based on a 50:50 profit split, has been described as a precursor to the super-

¹⁹¹ Dolan, *supra* note 177, at 220-21.

¹⁹² 92 T.C. 524, 525 (1989), *aff'd*, 933 F.2d 1084 (2d Cir. 1991).

¹⁹³ *Bausch & Lomb, Inc. v. Commissioner*, 933 F.2d 1084, 1087 (2d Cir. 1991).

¹⁹⁴ Dolan, *supra* note 177 at 218-19.

¹⁹⁵ *Tax Court Upholds Bausch & Lomb's Transfer Prices to Irish Subsidiary, But Royalty Rate is Increased from Five to Twenty Percent*, TAX NOTES, April 3, 1989.

¹⁹⁶ *Id.*

¹⁹⁷ *Id.*

¹⁹⁸ *Bausch & Lomb, Inc. v. Commissioner*, 92 T.C. 524, 611 (1989), *aff'd*, 933 F.2d 1084 (2d Cir. 1991).

royalty provisions of the Tax Reform Act of 1986, requiring that royalties be "commensurate with income."¹⁹⁹

Bausch & Lomb ended up the clear winner of this case, owing only \$2.5 million of the \$17 million potentially in dispute.²⁰⁰ As to the transfer pricing issue, the Tax Court simply found comparable prices in the industry, and looked no further, which was a fatal blow to the IRS's contract manufacturing pricing theory.²⁰¹ But the pro-taxpayer B & L result served to strengthen the IRS's resolve to push for periodic adjustments of royalty rates.²⁰² Largely because of this, pharmaceutical royalty arrangements are today at risk of periodic adjustment.

Although, as mentioned, the pharmaceutical companies have been largely successful in their battles with the IRS over § 482 allocations, it's clear that this section's complexity, volatility, and uncertainty make tax planning and transfers of intangibles difficult. As can be seen, the IRS largely has a free hand to contest sale prices, licenses and royalty agreements between related taxpayers. This can be especially difficult for drug company tax planners when dealing with new drug patents, where the ultimate market is not always immediately apparent, and any attempt at valuation (for royalty/price purposes) would be sheer speculation. The pro-litigation stance of the IRS (with respect to § 482) also makes the conducting of an international business dealing in intangibles (such as drug patents) more risky than other multinational ventures, as advantageous transfers between related companies tend to result in lengthy court disputes.

INTERNATIONAL COMPETITIVENESS ISSUES OF THE ORPHAN DRUG ACT, § 28

The Orphan Drug Act of 1983²⁰³ was designed to provide an additional incentive to drug companies to conduct research on drugs to fight rare diseases, where the limited market might not otherwise be sufficient to drive such R & D expenditures.²⁰⁴ the Act tends to be extremely beneficial to U.S. pharmaceutical companies to the detriment of foreign drug interests (and, perhaps, consumers).

¹⁹⁹ Lawrence P. Shanda, *Royalties and Super-royalties*, 67 TAXES NOTES 576, 577-78 (1989); However, critics note that the B&L decision is inconsistent with results suggested by the then proposed White Paper. Jankowski, *supra* note 180; See also Daniel J. Frisch, & Thomas Horst, *Bausch & Lomb and the White Paper*, 43 TAX NOTES, 725 (May 8, 1989), which suggests that the White Paper royalty would be approximately 34%.

²⁰⁰ Kathleen Mathews, *Tax Court's Bausch & Lomb Decision Deals Another Blow to IRS' Transfer Pricing Theories*, TAX NOTES, April 3, 1989.

²⁰¹ *Id.*

²⁰² Kathleen Mathews, *Lainoff and Triplett Respond to Public Comments on Section 482 White Paper*, 43 TAX NOTES, 647 (May, 1989); See also Lee A. Sheppard, *Triplett Criticizes Tax Court's Reasoning in Bausch & Lomb*, 43 TAX NOTES, 951 (May 22, 1989); "The *Bausch & Lomb* case is 'a great illustration' of why periodic adjustments are needed", Mathews, *supra* note 200 (quoting Steven R. Lainoff, Associate Chief Counsel (International)).

²⁰³ Public Law 97-414, 96 Stat. 2049.

²⁰⁴ See Carolyn H. Asbury, *The Orphan Drug Act; The First 7 Years*, 265 JAMA 893 (1991).

The I.R.C. § 28 gives a 50% research expense tax credit to companies who invest in developing medications (so called "orphan" drugs) for "rare" diseases. A "rare disease" is defined as one affecting fewer than 200,000 persons in the U.S.²⁰⁵ It was expected that with such a small market, corporations would not expend time and money researching these diseases unless government action sweetened the rewards available.

While not explicitly touted as a U.S. sourced company benefit, § 28(d)(3) contains severe limits on foreign testing. No credit will be allowed for any testing done outside of the U.S. unless (i) there is an insufficient U.S. population with the disease, or (ii) testing is done outside the U.S. by a U.S. person, or under the auspices of the FDA.²⁰⁶

The Orphan Drug Act also grants a monopoly of seven years before the FDA will grant approval of a competing product.²⁰⁷ Orphan drug status is granted to products by the FDA for companies who create qualifying medicines, based on newly clarified regulations.²⁰⁸ However, high price concerns have recently made Congress rethink this incentive. Opponents of the Act argue that it allows drug corporations to take advantage of many of the nation's ailing children.²⁰⁹ In a bill proposed by Senators Kassebaum and Metzenbaum, a \$200 million dollar cap on sales would have been set, after which orphan drug benefits would terminate.²¹⁰

It would terminate the 7-year monopoly when a drug reaches \$200 million in sales and allow other drug companies to seek FDA approval of a competitive drug. It will not stop the sale of the first drug, but subject it to price competition. a \$200 million sales trigger will more than cover the cost of research and development and provide the necessary incentive for companies to continue working on such drugs.²¹¹

²⁰⁵ I.R.C. § 28(d)(1)(A) (1988). The Code also allows the credit where the disease affects more than 200,000 U.S. persons if there is no reasonable expectation of recouping R&D expenses out of U.S. sales. I.R.C. § 28(d)(1)(B) (1988).

²⁰⁶ I.R.C. § 28(d)(3)(A) (1988).

²⁰⁷ Asbury, *supra* note 204.

²⁰⁸ The new FDA regulations, effective January 28, 1993, clarify what degree of difference is required between existing orphan drugs and newer developments seeking orphan status — generally denying the status to similar drugs unless "clinical superiority" can be demonstrated. *FDA Publishes Orphan Drug Regulations*, PR Newswire, Jan. 4, 1994, available in LEXIS, Nexis Library, PRNEWS File; *U.S. FDA Sets New Rule for "Orphan" Drug Marketing*, Reuters, Jan. 4, 1993, available in LEXIS, Nexis Library, FINRPT File; This differentiation has already been criticized as a disincentive to orphan drug development. *FDA Draws Heat on Orphan Drug Rules*, CHEM. WEEK, Jan. 20, 1993 at 37.

²⁰⁹ *End Abuse of the Law on "Orphan" Drugs*, ST. PETERSBURG TIMES, June 24, 1992, at 11A.

²¹⁰ *Orphan Drug Revenue Cap Proposed*, INVESTOR, INC: PORFOLIO LETTER, June 29, 1992 at 3; David Brown, *Senate to Reconsider Market Shelter for "Orphan" Drugs*, WASH. POST, June 17, 1992, § 1, at A3; *Orphan Drugs: Senate Cmte to Vote on Amendment Today*, Health Line, June 17, 1992, available in LEXIS, Nexis Library, HLTLNE File.

²¹¹ *Anticompetitive Abuse of the Orphan Drug Act: Invitation to High Prices*, S. 2060, S. Hrg. 102-615, 102d Cong., 2d Sess., 4 (1992) (Statement of Sen. Metzenbaum); A House version of the bill H.R. 3930 would have set a cap at \$150 million.

This legislation was initially approved by a Senate Committee in July of 1992.²¹² However, drug analysts disagreed with this move, and believed that few companies would invest the R & D required if such a cap was placed on the incentive.²¹³ Further, loss of such an incentive which favored U.S. corporations was sure to affect the international competitiveness of U.S. firms. Pharmaceutical lobbyists and several sympathetic senators were able to defeat this bill, for the time being, by keeping the legislation from coming before a vote of the full Senate.²¹⁴ In the OBRA '93 Act, § 13111(b) retroactively amended IRC § 28 and extended the Orphan Drug Act Credit (which had expired June 30, 1992) unchanged through December 31, 1994.²¹⁵

A RISING TAX RATE - GENERAL COMPETITIVENESS ISSUE

The president of the Pharmaceutical Manufacturing Association has suggested that other countries with interests in promoting their pharmaceutical firms' development have reduced their corporate tax rates (for such firms) to match that of the U.S. or below.²¹⁶ He thus emphasized the need for a stable tax economy, and suggested that a rate increase would be short-sighted.²¹⁷ However, with the recent increase of the U.S. corporate rate to 35%,²¹⁸ it appears that this will be but another challenge to be faced by this industry.

²¹² *New Rules for "Orphan" Drug Marketing*, Pharmaceutical Bus. News, Jan. 8, 1993, available in LEXIS, Nexis Library, PBNWS File.

²¹³ INVESTOR, INC.; PORTFOLIO LETTER, *supra* note 209. It appears that the \$200,000,000 sales cap is a somewhat arbitrary amount, and it's not clear that this cap will cover the costs for a drug's development in every situation, let alone induce many pharmaceutical corporations to undertake the research involved. Perhaps a cap on a specific drug's net profits, rather than sales, would have been a more sensible approach.

²¹⁴ DRAKE & UHLMAN, *supra* note 36, at 43; *Metzenbaum to Retire in 1994*, Health Legislation and Regulation, July 7, 1993, available in LEXIS, Nexis Library, OMNI File. But the controversy is far from over. "The bill's principal sponsors, Senators Nancy Kassebaum (R. Kans.) and Howard Metzenbaum (D. Ohio), have informed IBA that they intend to get this bill enacted in the 103rd Congress." Reginal Rhein, *Five Biotech Bills Signed Into Law, New Congress Ponders Many More*, Biotechnology Newswatch, Jan. 4, 1993, available in LEXIS, Nexis Library, OMNI File. And new proposals are beginning to surface. In the hopes of circumventing more severe bills such as the \$200 million cap proposal, Biotechnology Industry Organization (BIO) recently proposed cutting the marketing exclusivity years for orphan drug status from seven to five years, and allowing the FDA to cut off orphan status if the patient population increased beyond 200,000 Americans. Reginal Rhein, *BIO Circulates Orphan Drug Proposal on Capitol Hill*, Biotechnology Newswatch, July 5, 1993, available in LEXIS, Nexis Library, OMNI File. However, this proposal has met with lukewarm enthusiasm in Congress. *Id.*

²¹⁵ *A Tax Bill Boedeker, A Guide to the 1993 Tax Law*, *supra* note 116, at 876.

²¹⁶ Mossinghoff, *supra* note 18; *But of New Law May Harm U.S. Investments Overseas, Mixed Impact on Investment in U.S. Likely*, Int'l Trade Reporter, April 1, 1987, available in LEXIS, Nexis Library, INTRAD File.

²¹⁷ Mossinghoff, *supra* note 18.

²¹⁸ Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13221 (Increases the corporate rate to 35% for tax years from January 1, 1993).

CONCLUSION

At its base level, the opinion of Senator Pryor and his supporters has appeal. They reason: "We are giving these companies all these tax credits and incentives, and are getting nothing in return." When one considers that the people hardest hit are America's aged, Pryor's platform becomes quite a sympathetic one — and one with political appeal.²¹⁹

But this idea is based on narrow reasoning, and implementation would bring forth numerous undesired consequences.²²⁰ It is not quite clear what these "advocates of change" hope to accomplish. In answer to the question "What do we get in return," it should be realized that pharmaceutical companies provide America with one of its most recession-proof industries, they hire a significant number of employees, find cures for many diseases, and pay a large portion of U.S. taxes. But it must also be realized that the ethical drug industry is a business, and like any business, the companies are in it to make a profit. If they cannot make a profit here, they will likely move elsewhere.

Because of the competitive nature of the world pharmaceutical industry, the U.S. drug companies need the benefits they are given. This is because other countries give tax breaks and offer tax sparing opportunities to European and Japanese multinationals that the U.S. companies cannot take advantage of (as a matter of U.S. law), and also because of the high degree of speculation involved in drug research. While the Treasury Department has in the past opined that companies tend not to be overly influenced by tax factors when deciding whether to relocate research operations overseas, it is possible that enough adverse tax law may change the drug industry's perspective. When it offered this opinion, the Treasury Department was speaking only about the R & D expense allocation regulations. The inherent tax costs were found not to be a location-determining factor, as foreign start-up costs tended to be too prohibitive to permit a move solely to protect a credit which accounted for only an estimated 1% of U.S. research expenses.²²¹ But if one adds to that a higher corporate tax rate, a loss of use of the § 936 Possessions Tax Credit, restrictive transfer pricing regulations, a limiting of applicability of the Orphan Drug Act, and less favorable patent laws and FDA regulations, tax havens, such as Ireland, suddenly become more appealing. It is therefore possible that the Treasury may

²¹⁹ This is especially true since, although prescription drugs account for only 5¢ of every dollar, it is the 5¢ most likely to be paid directly by consumers, a.k.a. constituents. "[O]nly 5 percent of hospital costs are paid out-of-pocket in the United States. However, over 70 percent of prescription drug costs in the United States are paid out-of-pocket." A STATUS REPORT: ACCESSIBILITY AND AFFORDABILITY OF PRESCRIPTION DRUGS FOR OLDER AMERICANS, *supra* note 29, at 1. "People don't like drug companies. They are far more attuned to the price of a drug than to the cost of a hospital room because most people don't pay for a hospital room but many pay for drugs out of pocket." Kathleen Day, *The Drug Industry's Response; Lobbyists Tackling Rising Criticism*, WASH. POST, Feb. 20, 1993, at C-1 (quoting drug analyst Marc O. Mayer).

²²⁰ Such as fewer drug innovations, a loss of jobs, and the possible emigration of some portions of the industry.

²²¹ *But cf.* ARTHUR ANDERSEN & CO., *supra* note 72.

have to rethink its position. President Clinton and Senator Pryor may be about to “kill the goose that lays the golden eggs.”²²²

However, the drug companies ought to be prepared to compromise somewhat, as their bargaining chips are quickly being knocked off the table. It is possible that a give-away of one benefit in exchange for preserving another may be in their best interests in the future. Perhaps, a counter proposal to Clinton’s R & D - Royalty Plan, with, for example, an 80% R & D credit in exchange for some percentage (i.e. 20%) of active royalties being placed into the passive limitation “basket,” would have been acceptable. And it probably would have been prudent for the drug industry to whole-heartedly back a position such as Congressman Rostenkowski’s relatively minor 15% Possessions Credit reduction bill, rather than have protested all limitations. Following the expiration of the temporary OBRA ’93 expense allocation provisions, the industry should proffer some form of counter-proposal that the Clinton administration might agree to accept. Claiming “loss of dollars means loss of research” tends to fall on deaf ears, as the public and many Congressmen appear only to have a vague idea of what biomedical research is all about.²²³

²²² “[T]he international competitiveness of U.S. companies in high technology industries is influenced by a variety of provisions of the Code. While the R&D allocation rules may disadvantage U.S. companies relative to their foreign competitors, other provisions of the Code . . . may offset this disadvantage.” *Tax Pamphlet*, *supra* note 55. Yet while it appears that one can attack any one advantage given to this industry without making it unprofitable for them to do business here, it’s not clear that the threshold won’t be met when politicians attack various Code sections successively, as has now been proposed . . . (Note: this “killing the goose” language was first argued in 1991 during the debate of Senator Pryor’s unsuccessful “Prescription Drug Cost Containment Act.” Pryor still questions this assertion. *Pharmaceutical Industry, Good Medicine for Madison Avenue*, 138 CONG. REC. S. 7529, 7530, 102d Cong., 2d Sess. (daily ed., March 26, 1992) (statement of Sen. Pryor)).

²²³ See *supra* note 11.

