May 8, 2005

Drug Makers Reap Benefits of Tax Break

By ALEX BERENSON

A new tax break for corporations is allowing the biggest American drug makers to return as much as $75 billion in profits from international havens to the United States while paying a fraction of the normal tax rate.

The break is part of the American Jobs Creation Act, signed into law by President Bush in October, which allows companies a one-year window to return foreign profits to the United States at a 5.25 percent tax rate, compared with the standard 35 percent rate.

Any company with profits in other countries can take advantage of the law, but drug makers have been the biggest beneficiaries because they can move profits overseas relatively easily, independent analysts say.

The money the companies are bringing home has come from many years of using legal loopholes in the tax law to aggressively shelter their profits from United States taxes, tax lawyers say. While the companies' tax returns are private, fragmentary information about their tax payments is buried inside their annual financial statements.

Those figures show that the drug makers have told the Internal Revenue Service for years that their profits come mainly from international sales, even though the prices of medicines are far higher in the United States and almost 60 percent of their sales take place in America.

Representatives of most of the big drug companies declined to comment beyond their annual reports, but in a statement Eli Lilly noted that several factors depressed its United States profits. Pfizer said it was following the intent of the law.

Though the companies stand behind their accounting, financial analysts and tax lawyers say that the drug makers' claim defies reality and that their profits come mostly from sales in the United States. But the I.R.S. lacks the resources to challenge the companies effectively, the analysts and lawyers say. As a result, the six major companies - Pfizer, Johnson & Johnson, Merck, Bristol-Myers Squibb, Wyeth and Lilly - collectively pay a federal tax rate of less than 15 percent on their worldwide profits, with some companies paying much less.

Already, four of the six drug makers have collectively announced plans to return $56 billion in profits to the United States. Two others say they are still considering but could repatriate an additional $18 billion. Had the six companies faced standard federal taxes on those profits, they would have paid $26 billion to the United States. Instead, they will pay less than $4 billion. Chris Senyek, an accounting analyst at Bear Stearns, said drug companies would probably make up about half of all the money repatriated by publicly traded companies.

During this window, returning money to the United States is to the advantage of the companies because they can spend the cash here rather than having to use it overseas as tax laws generally require. Lawmakers have said their main intention for the law was to encourage American companies to build new operations and hire workers. Congress passed the law in response to pressure from the European Union to resolve a long-running trade dispute.

Although the act is intended to create jobs, Pfizer said last month that it would cut its annual costs by $4 billion over the next three years. Pfizer, which will repatriate at least $28 billion under the act, did not say how many jobs it planned to eliminate, but analysts expect the company to shrink its work force by thousands of people. Mr. Senyek said the law would create an insignificant number of jobs because companies can easily work around provisions in
the law meant to stop them from using the money for dividends to shareholders rather than new hiring.

After the break expires, companies will probably go back to stockpiling profits overseas as they wait for another tax holiday in a few years, tax lawyers say.

The major drug makers use a variety of complex but legal tactics to move profits from the United States to low-tax countries like Ireland and Singapore where they have large manufacturing operations, said H. David Rosenbloom, director for the international tax program at New York University Law School.

"The law is complicated, but what's going on is perhaps less complicated," he said. "They're doing everything they can to maximize their profit in Ireland and minimize the profit in the countries where the sales occur."

The government can challenge the way the companies allocate their profits internally. But the companies have usually been able to defeat the I.R.S., Mr. Rosenbloom said.

"There's a limit to what they can do, because these cases are huge. They're very expensive," Mr. Rosenbloom said of the I.R.S.

The companies declined to discuss the specific strategies they use to minimize taxes. But the result of their efforts can be seen in a remarkable set of figures inside their annual financial reports.

Pfizer, the world's largest drug company, said that in 2004 it had only $4.4 billion in pretax profits in the United States, compared with $9.6 billion internationally, though most of its sales came in the United States. The company says that its profit margins on international sales were almost three times as high as on American sales.

Other companies reported similar trends. The biggest imbalance occurred at Eli Lilly, which reported that it had about $200 million in profits from United States sales in 2004, compared with $2.8 billion in profits from sales everywhere else.

Because they report relatively low United States profits, the companies pay little in American taxes compared to their profits. Pfizer reported paying only $1.2 billion in state and federal income taxes in 2004, 9 percent of its worldwide pretax profit. Excluding a one-time payment related to its plans to repatriate money it has sheltered overseas, Lilly reported paying just $37 million in state and federal taxes last year, only 1 percent of its worldwide pretax profit.

In its statement, Lilly said product liability suits, one-time charges related to business restructurings, increased pension expenses and research and development costs all cut into profits here, the company said.

"The intent of this legislation is to encourage companies to invest income earned outside the U.S. in their U.S. operations," Pfizer said in a statement. "That is what Pfizer and more than 300 other U.S.-based companies are doing."

Collectively, the six drug makers paid about $6 billion in federal and state taxes, a fraction of their pretax worldwide profits of $43 billion. Johnson & Johnson accounted for about half the American taxes paid. It garners more than half of its sales from consumer products and medical devices, whose profits are harder to transfer overseas.

The companies' assertions that they are more profitable overseas than in the United States is hard to believe, said Dr. Alan Sager, director of the health reform program at the Boston University School of Health.

Prescription drug prices are far higher in the United States than in other industrialized countries, where prices are generally government-controlled.

In one typical example, a three-month supply of 40-milligram tablets Lipitor, a cholesterol-lowering medicine from Pfizer, costs $305 at Walgreens.com, the Internet site for the largest United States pharmacy. An Internet pharmacy
in Canada lists the same medicine for $174.

"I'm really at a loss to find a reasonable explanation for the phenomenon, a real-world explanation," Dr. Sager said. Outside the United States, "there just doesn't seem to be any place on earth for the high profits to be generated, which leaves us with the extraterrestrial options."

Wall Street analysts who follow the pharmaceutical industry also say most of the drug makers' profits come from the United States.

David Moskowitz, an analyst at Friedman, Billings, Ramsey, estimated that at least 60 percent of the drug industry's worldwide profits come from the United States. Higher American drug prices more than make up for higher marketing costs here, he said. Other analysts estimate that as much as 75 percent of the industry's worldwide profits are generated in the United States.

But companies can hide those profits from the I.R.S. by moving their drug manufacturing overseas, said Martin A. Sullivan, contributing editor of Tax Notes, a nonprofit journal that examines tax issues. Companies transfer drug patents to their own foreign subsidiaries, he said.

The subsidiary then helps pay for research on the drug. If the medicine is approved for sale in the United States, the subsidiary manufactures the drug for a few cents a pill.

The pills are then shipped to the United States, where they are sold to a pharmacy or a wholesale company for several dollars each. But the parent company claims that almost all the profit should go to the subsidiary, not to the parent in the United States.

"Then the name of the game is to have that foreign subsidiary pay as little as possible back to the United States for the rights to all that income," Mr. Sullivan said.

The law will encourage drug makers to become even more aggressive about shifting American profits overseas because the companies will assume that they can lobby Congress for another tax holiday in a few years, said Sheldon Cohen, senior counsel at Morgan, Lewis & Bockius.

"I've always been against tax holidays or amnesties on the basis that if we do this, it tells companies or individuals that we'll do it again," Mr. Cohen said.