

Client Update

How Tax Reform and Other Recent Developments Could Impact the Healthcare Industry

Recent developments in Washington are likely to have a significant impact on the healthcare industry. A House/Senate conference committee recently released the final version of the “Tax Cuts and Jobs Act.” The bill has passed both houses of Congress and is expected to be signed by President Trump. But that is not all: a settlement was recently announced resolving important litigation involving subsidies under the Affordable Care Act (“ACA”), and Congress may pass bills that are designed to bolster the ACA exchanges and to delay the implementation of several ACA taxes that have been suspended but are scheduled to go into effect soon. We discuss these developments below and what they may mean for the healthcare industry.

TAX CUTS AND JOBS ACT

Changes in Corporate Taxes and International Taxation

As described in our prior [Client Update](#), the final bill dramatically alters the existing corporate tax framework, particularly as it relates to multinational companies. The bill reduces the corporate tax rate from 35 percent to 21 percent while limiting interest deductibility.

The bill also imposes a one-time repatriation tax on deferred overseas earnings at a rate of 15.5 percent for earnings held in cash and eight percent for earnings held in noncash assets. This repatriation tax is payable over eight years. Going forward, the United States will have a “territorial” tax system in which dividends received by U.S. companies from their foreign subsidiaries will generally be tax-free. However, there will be a minimum tax imposed (at an effective rate of 10.5 percent until 2025 and 13.125 percent thereafter) on the “excess profits” (defined as the overall income in excess of a stated return on tangible depreciable property) of foreign subsidiaries of U.S. companies, whether or not repatriated. The final bill also contains broad anti-base erosion provisions that limit the deductibility of payments from U.S. companies to foreign related parties.

Potential Impact

The final bill is a mixed bag for corporate taxpayers, and there are likely to be winners and losers. On the positive side, the meaningful reduction in the corporate tax rate is beneficial to U.S. healthcare companies. Companies that derive substantially all their revenues from the United States (such as hospitals, managed care and other physician practice businesses) appear to be clear winners. The one-time repatriation tax may also prove beneficial to U.S. healthcare companies if those companies desire to reinvest in the United States the significant stockpile of cash held overseas. That could result in a combination of increased research and development and mergers and acquisition activity.

For companies planning to expand primarily overseas, however, the repatriation tax is likely viewed as a negative since current law would permit the continued deferral of offshore earnings. The other international changes are likely to be of particular interest to multinational healthcare companies. Although the territorial tax is generally positive, the current tax on excess foreign profits is likely to affect existing structures (including intellectual property holding structures) of U.S. parented groups. The broad anti-base erosion rules will significantly affect the tax planning of foreign parented groups with U.S. affiliates. Companies with significant internal cross-border transactions will be most heavily affected.

Elimination of the Individual Mandate

One of the ACA's most controversial provisions was the "individual mandate," a tax on certain people who do not purchase qualified health insurance. The tax was \$695 per person, or 2.5 percent of applicable household income, whichever is higher. The House bill did not address the mandate; the Senate bill proposed to eliminate it. The final bill eliminates the individual mandate beginning in 2019. The Congressional Budget Office ("CBO") estimates that eliminating the mandate will save more than \$300 billion over 10 years, mostly because fewer people will purchase government-subsidized health insurance or Medicaid.

Potential Impact

The individual mandate was developed as a way to address the problem of adverse selection created by the ACA's consumer protection provisions. The ACA requires health insurers to make plans available to everyone at the same price—regardless of health condition (with limited adjustment for age and tobacco use). That creates an incentive for healthy people to forgo purchasing health insurance until they think they need it. When healthy people do not purchase health insurance, the risk pool becomes sicker and the cost of health insurance rises. The mandate was intended to counteract adverse selection by penalizing people for not buying health insurance.

The actual impact of repeal of the mandate is debatable. CBO estimates that without the mandate, the number of people without health insurance would increase by 13 million over the

next decade, and average premiums on the ACA exchanges would rise by 10 percent. But CBO also stated in a blog post that it is currently reworking its analysis of the impact of the mandate. Some economists believe that CBO now recognizes that it has overestimated the impact of the mandate for several reasons including that: (i) the mandate has many exceptions and has not been enforced; (ii) many low-income people are eligible for highly subsidized insurance (either through Medicaid or ACA exchanges), meaning that they have a strong incentive to purchase health insurance without the mandate; and (iii) some healthy people purchase health insurance without regard to the mandate because they are risk adverse. S&P, for example, issued a report estimating that repeal of the mandate would increase the number of uninsured people by only three million to five million over the next decade. Some have also speculated that states may seek to ameliorate the impact of the repeal of the mandate by imposing state-specific mandates.

To the extent repeal of the mandate results in fewer people purchasing plans on ACA exchanges, that will hurt insurers that sell such plans. An increased number of people without insurance will also hurt hospitals, which often treat patients without regard to their ability to pay. Patients who lack insurance typically cannot afford to pay their hospitals, meaning that hospitals have to write off such bills as charity care or bad debt. Similarly, if there are fewer people that are insured, that will translate into reduced demand for prescription drugs and medical devices.

Reduction in Orphan Drug Tax Credit

“Orphan drugs” are drugs that are designed to treat rare diseases that either impact (1) fewer than 200,000 people in the United States or (2) more than 200,000 people in the United States if the cost of developing the drug exceeds anticipated revenue from the drug. The Orphan Drug Act of 1983 provided several incentives to manufacture orphan drugs, including a tax credit in the amount of 50 percent of the cost of human clinical testing.

The House version of the tax bill proposed to eliminate this credit, and the Senate bill included a formula that would have reduced the size of the credit, cutting it approximately in half. The final bill cuts the size of the tax credit from 50 percent to 25 percent. This reduction will go into effect starting in 2018. Congress anticipates that this reduction will save \$32.5 billion over 10 years.

Potential Impact

Reduction of the development tax credit will make orphan drug development more costly. However, it seems unlikely that a reduction in the tax credit would result in the development of significantly fewer orphan drugs because there are many other incentives that promote orphan development:

- Seven years of marketing exclusivity. This period is highly lucrative because there are no competitors in the market during this time period.

- The FDA typically requires less data for orphan drug applications. In many cases, the FDA will approve a new drug application for an orphan drug based on one controlled clinical trial, as opposed to two or three for a non-orphan drug.
- FDA's rare disease program provides support to the sponsors of orphan drugs.
- Orphan drugs are exempt from a program which requires certain drugs to be sold to government-supported hospitals and clinics at a discount.

Short-term Increase in Medical Expense Deduction

Under current law, taxpayers are entitled to a deduction for the cost of healthcare that exceeds 10 percent of adjusted gross income. The House bill proposed repealing this deduction; the Senate bill did not. The final bill would make the deduction more generous for two years by lowering the expense threshold to 7.5 percent of adjusted gross income.

Potential impact: The medical expense deduction is often used by people over 50 who incur significant long-term care expenses that are not covered by Medicare, Medicaid or private insurers. Many raised concerns that the House bill would make it much more difficult for such people to afford long-term care. That would harm providers of long term care. The final bill, by contrast, improves the status quo. Indeed, it creates incentives to front-load qualifying care into the next two years (to the extent that is feasible).

Potential Impact on Medicare and Medicaid

The final bill does not alter spending levels for Medicare or Medicaid. But the bill could nevertheless indirectly impact both programs. CBO estimates that passing the bill will automatically trigger a \$25 billion cut in Medicare in 2018 as a result of reduced government revenue. Congressional Republicans have pledged to undo this automatic cut. It is uncertain, however, whether they will have the political support to do so. The final bill also significantly limits the deductibility of state and local taxes (capping deductions at \$10,000). That means that taxpayers in high-tax states, such as California and New York, will lose the benefit of federal subsidies for state taxes. State governments may now face pressure to lower taxes. If that happens, states may seek to reduce Medicaid spending to keep budgets in balance.

OTHER RECENT HEALTHCARE DEVELOPMENTS

Potential Resolution of Lawsuit Involving Cost Sharing Reductions

Cost sharing reductions ("CSRs") are provided to insurers to cover many out-of-pocket medical expenses incurred by people making between 100 percent and 250 percent of the federal poverty level who purchase "silver" plans on the ACA exchanges. In 2014, House Republicans filed suit against the Obama Administration, claiming that payment of CSRs was unconstitutional because there had never been a Congressional appropriation of CSR funding. In 2016, a federal

district judge agreed with House Republicans, but the ruling was appealed. In October 2017, President Trump—relying on this ruling—terminated CSR funding. On December 15, the parties to the litigation filed a proposed settlement with the appellate court that is assigned to the case. If the settlement is approved, the lower court’s injunction that prohibited CSR payment would be vacated.

It is unknown what will happen next. This settlement does not require the Trump Administration to reinstate the CSRs. But Vice President Pence and Senate Majority Leader McConnell have told Senator Collins that in return for her support of the tax bill, Congress would pass a bill co-authored by Senators Alexander and Murray. This bill would appropriate CSR funding through 2019. This bill would also allow everyone to purchase “catastrophic” health insurance plans (low premiums, high deductibles) on the ACA exchanges. While the Alexander-Murray bill originally had bipartisan support in the Senate, Senate Democrats now say that they may not support the bill because they are opposed to the individual mandate repeal. Some conservative House Republicans have also expressed opposition to this bill.

Potential Impact

CBO has previously estimated that cutting off CSRs would cause the cost of “silver” plans to rise by about 20% because insurers are required to bear the cost of CSRs even if Congress does not fund the subsidies. Were that to happen, some people would likely purchase cheaper “bronze” plans with higher deductibles (for which CSRs are not available) or will stop purchasing health insurance altogether.

To date, those dire scenarios do not appear to have materialized. Insurers have raised rates in many states as a result of the CSR cutoff, but consumers who purchase subsidized plans are largely shielded from rate increases because the subsidies increase along with premiums. Nevertheless, restoration of CSRs could have an impact on the ACA exchanges. This additional funding may counteract to some extent any increase in premiums that results from people declining to buy health insurance once the mandate is repealed.

Congressional Debates Regarding Suspended ACA Taxes

The ACA imposed three taxes that were subsequently suspended, but are scheduled to go back into effect in the coming years:

- The 2.3 percent excise tax on medical devices. This tax will come into effect on January 1, 2018. The medical device industry has made postponement of this tax a top priority.
- The “Health Insurance Tax,” which is a tax on the cost of health insurance plans which is estimated to add 3 percent to the cost of health insurance premiums. This tax will come into effect on January 1, 2018. The healthcare insurance industry has been lobbying to postpone this tax.

- The “Cadillac tax,” which is a 40 percent excise tax on the cost of certain high-price health insurance plans. This tax will come into effect in 2020. Postponement of the tax is a high priority for unions and Democrats who receive union support because unions often negotiate for generous health insurance plans. Those plans would be subject to the Cadillac tax if it ever came into effect. Republicans too dislike the Cadillac tax but appear to want to use its postponement as leverage to accomplish other policy objectives.

Potential Impact

It seems likely that Congress will postpone implementation of these taxes at some point because there is strong opposition from industry and members of both parties in Congress (which is why these taxes have been repeatedly postponed). The main question is when Congress will reach consensus on how to fund postponement of these taxes.

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