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Fiscal Fact

The ACA Medical Device Tax: Bad Policy in Need of Repeal

By

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Introduction

On March 21, the Senate voted 79 to 20 to pass a nonbinding budget amendment encouraging the repeal of the Affordable Care Act's medical device excise tax. This is a 2.3 percent tax on total sales of taxable medical devices by medical device manufacturers that went into effect on January 1, 2013. Like other excise taxes, this tax is harmful and will create distortions in the medical device industry, likely leading to higher health care prices for consumer, lower employment, and less innovation. Additionally, the tax is complex and creates additional compliance costs for firms. These consequences argue for the permanent repeal of the tax.

The Medical Device Tax

How does this tax work?

The medical device tax operates like a typical excise tax, which increases the per-unit price of a good. However, unlike common excise taxes such as the flat per-unit taxes on cigarettes and alcohol, this tax is a percent of the sales price. This 2.3 percent tax is levied on the manufacturer or importer before a taxable medical device is sent to the wholesaler or hospital.

Purpose of this Tax

Introduced in the Affordable Care Act, the medical device tax is predicted to raise \$3.2 billion dollars each year on average for the next ten years.¹ Proponents of the tax have also argued that the tax will act like the

¹ Joint Committee on Taxation, *Estimated Revenue Effects of the Amendment in the Nature of a Substitute to H.R. 4872, The "Reconciliation Act of 2010"* (Mar. 20, 2010), <http://www.jct.gov/publications.html?func=startdown&id=3672>.

windfall profits tax of the 1980s and recapture the excess gains that medical device manufacturers are expected to receive from the ACA.²

What is a Taxable Device?

Taxable medical devices are defined as any device “intended for use in the diagnosis of disease or other conditions, or in the cure, mitigation, treatment, or prevention of disease in man or other animals . . . or intended to affect the structure or function of the body of man.”³ For instance, the tax would be levied on devices such as pacemakers and defibrillators.

However, this tax also has what is called a retail exemption. This provision exempts goods from the excise tax that are commonly purchased directly by the general public—not through their insurance at the hospital—for individual use. Exempted goods include: eyeglasses, contact lenses, and hearing aids.⁴ The IRS and FDA also have the ability to set additional exemptions as they see fit.

This tax also exempts any medical devices from taxation that are sold and exported overseas.

Implications of the Medical Device Tax

While the intentions of the medical device excise tax are to raise revenue and reduce excess profits manufacturers may enjoy as a result of the ACA, the tax, like any excise tax, will increase the cost of the product on which it is levied. This calls into question the logic of this excise tax and its purpose in the Affordable Care Act. If it does in fact raise consumer prices, which seems likely, it contradicts the original purpose of the ACA, which was to lower healthcare prices.

Additionally, since producers have to pay the tax whether they make a profit or not,⁵ the tax will adversely affect innovation, employment, and competition in the same way the windfall profits tax of the 1980s depressed domestic oil production.⁶

² Center for Budget and Policy Priorities, Paul N. Van de Water, *Excise Tax on Medical Devices Should Not Be Repealed, Industry Lobbyists Distort Tax's Impact* (Mar. 2013), <http://www.cbpp.org/files/2-14-12health.pdf>.

³ Annette B. Smith, *Preparing for the Medical Device Excise Tax*, THE TAX ADVISOR (July 1, 2012), <http://wwwaicpaorg/publications/taxadviser/2012/july/pages/clinic-story-03.aspx>.

⁴ Diana Furchtgott-Roth & Harold Furchtgott-Roth, *Employment Effects of the New Excise Tax on the Medical Device Industry* (Sept. 2011), <http://wwwchiorg/uploadedFiles/Industry at a glance/090711EmploymentEffectofTaxonMedicalDeviceIndustryFINALpdf>.

⁵ *Id.*

Increased Costs for the Consumer

In the short term, manufacturers will try to pass the tax on to consumers in the form of higher prices. In fact, earlier this year, some hospitals expressed alarm that medical device manufacturers are beginning to bill them for the cost of the excise tax.⁷

Burden on the Medical Device Industry

However, the market power of hospitals could undercut the ability of device manufacturers to pass on much of the cost of this tax in the long run. One hospital supply association was recently quoted as saying it “will continue to monitor the device marketplace for evidence of cost-shifting onto hospitals, and encourage our hospital partners not to enter into contracts that bill them for the device tax.”⁸

This illustrates the fact that much of the prices of goods in the health care industry are determined by the relative bargaining power of buyer and sellers.⁹ Often prices are set by contracts and negotiated between two parties. If the medical device industry is highly competitive (many sellers), or if hospitals have significant bargaining power (few buyers), it is unlikely that medical manufacturers can pass the entire tax on to hospitals or consumers. With 80 percent of the industry comprised of small firms with fewer than fifty employees,¹⁰ the industry likely lacks bargaining power and the effects on business could be great.

One concern is that the tax could reduce the incentive for medical manufacturers to innovate. As was suggested above, an excise tax is levied on a business whether it makes profits or not. As a result, firms will take on fewer risks and less research and development.¹¹ Take the example by Henry I. Miller of the Hoover Institute: a small company with total sales of medical devices of \$2 million is liable for a \$46,000 tax. However, after accounting for R&D and other expenses, total profit on those sales may only be \$75,000. This is the same as an effective corporate income tax of 60 percent.¹² Since firms are profit maximizing, they will undertake less R&D on the margin to remain profitable, likely having an industry-wide effect on innovation.

These cost pressures could reduce competition and create consolidation in the market. Firms that are entering the market will have a harder time becoming profitable with the additional cost of this excise tax. In

⁶ David I. Meiselman, *The Oil Excise Tax: Another Government Windfall*, Tax Foundation Tax Review, Vol. XL, No. 9 (Oct. 1979), <http://taxfoundation.org/article/tax-review-oil-excise-tax-another-government-windfall>.

⁷ Michael Cohn, *Medical Device Makers Shift Excise Tax Cost to Hospitals*, ACCOUNTING TODAY (Jan. 25, 2013), <http://www.accountingtoday.com/news/Medical-Device-Makers-Shift-Excise-Tax-Cost-Hospitals-65455-1.html>.

⁸ *Id.*

⁹ Michael E. Porter & Elizabeth Olmsted Teisberg, *Redefining Competition in Healthcare*, HARVARD BUSINESS REVIEW, <http://hbr.org/web/extras/insight-center/health-care/redefining-competition-in-health-care>.

¹⁰ Medical Device Manufacturers Association, *Broad Coalition Urges Congressional Leaders to Repeal Medical Device Tax*, July 18, 2011, <http://www.medicaldevices.org/node/1039>.

¹¹ See Meiselman, *supra* note 6.

¹² Henry I. Miller, *ObamaCare's Medical Device Tax Will Cost Innovation and Jobs*, FORBES, Dec. 17, 2012, <http://www.forbes.com/sites/henrymiller/2012/12/17/obamacare-medical-device-tax-will-cost-innovation-and-jobs/>.

turn, this would give an advantage to larger, more established firms, reducing the competitiveness of the industry and providing another means by which medical device prices could rise.

Another concern is that in the face of higher costs and lower demand, firms may decide to hire fewer workers. An analysis by Diana and Harold Furchtgott-Roth estimated that employment losses could total 45,000 workers nationwide due to the additional cost of the excise tax.¹³ These jobs would either be completely eliminated or relocated overseas.

Additional Costs

Complexity

Like any tax, the medical device tax comes with compliance costs. Even the IRS has admitted that “the medical device industry will likely face some implementation issues when the medical device excise tax goes into effect on January 1, 2013.”¹⁴ Just three months into its implementation, firms are still having trouble complying with the tax due to its complexity and are likely overpaying.¹⁵

One issue regarding complexity is how firms calculate the actual sales price of taxable medical devices. There are cases in which vertically integrated manufacturers sell directly to hospitals rather than through wholesalers. This requires them to create an artificial wholesale price upon which to apply the tax.

Ultimately, the complexity of the tax places an additional, disproportionate administrative burden on smaller firms. Smaller firms, in the process of compliance, need to expend a greater percentage of their resources on administration than a bigger company.¹⁶ For many medical device firms, adding one more person in the tax department likely means not adding one more scientist in the R&D laboratory.

Other Concerns

Sound tax policy dictates that taxes be transparent to those that pay them, a requirement this tax fails to meet. Like any excise tax, the portion of the tax that is passed to consumers is embedded in the price. And because people typically pay for their medical care through insurance, they may not notice a difference in price even though they are paying a tax. People should easily be able to understand how much tax they are paying. The medical device tax makes it nearly impossible for consumers to do so. Even more, the retail exemption exacerbates the situation by ensuring that the only products on which the tax is levied are those products not directly purchased by the consumer.

¹³ See Furchtgott-Roth & Furchtgott-Roth, *supra* note 4.

¹⁴ Internal Revenue Service, *Taxable Medical Devices*, Final Regulations (Dec. 7, 2012), http://www.kslaw.com/library/publication/HH121012_FinalRule.pdf.

¹⁵ Kyle Pomerleau, *Obamacare Medical Device Still Baffling Business*, TAX FOUNDATION TAX POLICY BLOG, Mar. 20, 2013, <http://taxfoundation.org/blog/obamacare-medical-device-tax-still-baffling-business>.

¹⁶ J. Scott Moody, *The Impact of Tax Complexity on Small Businesses*, TAX FOUNDATION SPECIAL BRIEF (Sept. 2000), <http://taxfoundation.org/article/impact-tax-complexity-small-business>.

Conclusion

The medical device excise tax, like any excise tax, will have an adverse effect on the medical device industry, consumers, and the economy. However, the exact effect of the tax could vary based on how the medical device industry is structured. To some degree, this tax will result in higher health care costs, which undermines the objective of the ACA. It is also likely that this tax will adversely affect employment, innovation, and competition in the medical device industry, especially among small firms with slim margins. Finally, the tax is complex and opaque, while targeting just one industry, making it overall bad tax policy that should be repealed.

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