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Excise Tax on Medical Devices Should Not Be Repealed

Industry Lobbyists Distort Tax's Impact

By Paul N. Van de Water

The House may soon vote on a measure to repeal the 2.3-percent excise tax on medical devices that policymakers enacted in 2010 to help pay for health reform. The excise tax is sound, however, and the arguments against the tax don't withstand scrutiny.

- **The tax does not single out the medical device industry for unfair treatment.** The excise tax is one of several new levies on sectors that are gaining business due to health reform. The expansion of health coverage is increasing the demand for medical devices, which could offset the effect of the tax.
- **The tax will not cause manufacturers to shift production overseas.** The tax applies equally to imported and domestically produced devices, and devices produced in the United States for export are tax-exempt. The claim that the tax will lead to production moving overseas thus is a talking point that lacks any foundation.
- **The tax will have little effect on innovation in the medical device industry.** To the contrary, health reform may well spur medical device innovation by promoting more cost-effective ways of delivering care.

Repealing the excise tax would cost $26 billion over the 2015-2024 period.[1] Pay-as-you-go procedures would require Congress to offset the cost of repeal by increasing other taxes or reducing spending, but Congress seems likely to ignore those rules and simply add to the deficit if it proceeds with repeal. Moreover, repealing the tax would encourage efforts to repeal other revenue-raising provisions of health reform, as well, which would either require more painful offsets or further increase the deficit if Congress failed to offset the cost.

The industry's lobbying campaign against the medical device tax is based on misinformation and exaggeration, as a number of industry executives and analysts confirm. For example, Martin

[1] Joint Committee on Taxation (JCT), *Estimated Revenue Effects of Division I of H.R. 4, the "Jobs for America Act,"* Publication JCX-105-14, September 17, 2014. JCT's initial estimate, in March 2010, overestimated the revenue raised by the tax.

Rothenberg, head of a device manufacturer in upstate New York, calls claims that the tax would cause layoffs and outsourcing "nonsense." The tax, he writes, will add little to the price of a new device that his firm is developing. "If our new device proves effective and we market it effectively, this small increase in cost will have zero effect on sales. It would surely not lead us to lay off employees or shift to overseas production."[2] Michael Boyle, founder of a Massachusetts firm that makes diagnostic equipment, insists that the device tax is "not a job killer. It would never stop a responsible manager from hiring people when it's time to grow the business."[3]

The Excise Tax on Medical Devices

Congress carefully designed the Affordable Care Act (ACA) so it will not add to the budget deficit. To help pay for the expansion of health coverage to 27 million uninsured Americans, the ACA either reduces Medicare payments or increases taxes for a range of industries that will benefit from health reform, including hospitals, home health agencies, clinical laboratories, health insurance providers, drug companies, and manufacturers of medical devices. These other industries will very likely seek comparable treatment if Congress repeals the medical device tax. For example, Charles Kahn, president of the Federation of Hospitals, has written:

> [A]ny deal altering the ACA must account for the law's carefully constructed balance of contributions and costs in order to achieve coverage. . . . It is critical that should Congress reopen the ACA to reconsider the contributions of any one health care sector that benefits from ACA's coverage expansion, it should simultaneously address the changed circumstances of hospitals and provide similar relief.[4]

The ACA imposes a 2.3-percent excise tax on the sale of any taxable medical device by the manufacturer or importer of the device starting in 2013. The tax does not apply to eyeglasses, contact lenses, hearing aids, wheelchairs, or any other medical device that the public generally buys at retail for individual use.[5] Sales for further manufacture or for export are also tax-exempt.[6] Because of these exemptions, only about half of the device industry's output is subject to the tax.[7]

The excise tax has now been in effect for two years. The Internal Revenue Service (IRS) published final regulations and additional guidance in December 2012 detailing how the tax is applied.[8] The tax is levied on the wholesale price of a medical device, not the price paid by the end

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[2] Martin Rothenberg, "Numbers show ACA not responsible for layoffs," *Syracuse Post-Standard*, September 25, 2012, http://blog.syracuse.com/opinion/2012/09/numbers_show_aca_not_responsib.html.

[3] Alec MacGillis, "Um, About That Medical Device Tax," *The New Republic*, September 28, 2012.

[4] Charles Kahn, "ACA Fixes Deserve Parity," *FAH Hospital Policy Blog*, October 10, 2013, http://fahpolicy.org/aca-fixes-deserve-parity/.

[5] The excise tax is established by section 1405 of the Health Care and Education Reconciliation Act of 2010 (Public Law 111-152), which effectively substituted for section 9009 of the Patient Protection and Affordable Care Act of 2010 (Public Law 111-148).

[6] The excise tax is one of several manufacturers' excise taxes included in subtitle D, chapter 32, of the Internal Revenue Code. Section 4221 of the Code provides that sales for further manufacture or export are exempt from these excises.

[7] Jane G. Gravelle, *The Medical Device Excise Tax: Economic Analysis*, Congressional Research Service, January 9, 2015, p. 12, http://fas.org/sgp/crs/misc/R43342.pdf.

[8] Internal Revenue Service, *Treasury Decision 9604, Taxable Medical Devices*, December 27, 2012, http://www.irs.gov/irb/2012-52_IRB/ar10.html; *Notice 2012-77, Interim Guidance and Request for Comments; Medical Device*

user, so the effective tax rate is actually less than 2.3 percent of the final price. For example, in those instances where the manufacturer is also the distributor of the device, the wholesale price is generally assumed to be 75 percent of the actual selling price.

Lawmakers initially considered a higher tax, but the medical device industry succeeded during the health reform debate in halving the amount of revenue that a fee or tax on devices would raise. Since the excise tax was enacted, lobbyists for the industry have been pressing for its delay or repeal. The House voted to repeal the tax in 2012 and 2014, and the Senate in 2013 approved a non-binding resolution supporting repeal.

Medical devices encompass an extremely wide range of products, such as surgical gloves, dental instruments, coronary stents, artificial knees and hips, defibrillators, cardiac pacemakers, irradiation equipment, and advanced imaging technology. The U.S. medical device industry has estimated total sales of $130 billion to $170 billion a year.[9] A few large firms account for the lion's share of this revenue. For example, Johnson and Johnson's worldwide sales of medical devices and diagnostics totaled $28 billion in 2014; the firm had total sales (on both medical devices and other products) of $74 billion, on which it earned profits of $16 billion.[10] Medtronic had $17 billion in sales and $3 billion in profits during its 2014 fiscal year.[11] The 19 largest U.S. firms account for fully half of total sales among firms that manufacture medical supplies and equipment, and the top 58 firms account for about three-quarters of sales.[12]

Tax Will Not Shift Employment Offshore

Despite claims to the contrary, the excise tax creates no incentive whatsoever for medical device manufacturers to move production overseas. The tax applies to imported as well as domestically produced devices. Thus, sales of medical devices in the United States are equally subject to the tax whether they are produced here or abroad, and the tax does not make imported devices any more attractive to domestic purchasers.

In addition, devices produced in the United States for export are exempt from the tax, so it does not reduce the competitiveness of U.S.-made devices in international markets. Making a tax-free sale for export is straightforward, and the administrative burden of securing an exemption is small. The device manufacturer and the U.S. exporter register with the IRS (foreign purchasers of articles for export need not register), and the U.S. exporter simply provides its registration number to the manufacturer and certifies that the devices will be exported.[13]

Excise Tax; Manufacturers Excise Taxes; Constructive Sale Price; Deposit Penalties, December 27, 2012, http://www.irs.gov/irb/2012-52_IRB/ar16.html.

9 Gravelle, p. 11.

10 *Johnson & Johnson Reports 2014 Fourth-Quarter and Full-Year Results,* January 20, 2015, http://files.shareholder.com/downloads/JNJ/3973170543x0x803978/63CB6D49-A780-4BDF-8682-7C3AC794DEE1/JNJ_News_2015_1_20_Financial_Releases.pdf.

11 Medtronic, Inc., *2014 Integrated Performance Report,* p. 8.

12 Gravelle, p. 10.

13 Internal Revenue Service, "Notice of Proposed Rulemaking: Taxable Medical Devices," *Federal Register*, February 7, 2012, p. 6033, http://www.gpo.gov/fdsys/pkg/FR-2012-02-07/pdf/2012-2493.pdf.

A much-cited 2011 study financed by AdvaMed, an industry trade association, alleged that the tax would cause 10 percent of device manufacturing to move offshore, leading to the loss of 43,000 U.S. jobs.[14] Analysis by Bloomberg Government, however, found that the study "is not credible." Its assumptions, Bloomberg concluded, "conflict with economic research, overstate companies' incentives to move jobs offshore, and ignore the positive effect of new demand created by the [health reform] law."[15] AdvaMed has subsequently commissioned other studies and surveys, some with even higher job-loss numbers, but these are not credible either. As *The Washington Post* editorial board has written, "Surveys of executives asked to evaluate a tax on their own industry and anecdotal accounts aren't compelling."[16]

A careful economic analysis by the Congressional Research Service (CRS) finds that the medical device tax will have, at most, only a tiny effect on employment. "The tax should have no effect on production location decisions," CRS says, "since both domestically manufactured and imported medical devices are subject to the excise tax." Depending on the extent to which consumers reduce their demand for medical devices in response to an increase in their price, CRS estimates that the drop in employment in the device industry could range from 47 workers (0.01 percent of industry jobs) to 1,200 workers (0.2 percent of jobs).

In fact, health reform will likely benefit the medical device industry and boost its sales. By extending health coverage to a projected 27 million more Americans, or by nearly 10 percent, the Affordable Care Act will increase the demand for medical devices and the revenue of device manufacturers. As the industry notes, older patients, who use a disproportionate number of medical devices, already have coverage through Medicare. However, the substantial expansion of health coverage will increase the number of elective medical procedures performed on those who were previously uninsured and, in turn, the use of medical devices. A study by Wells Fargo Securities finds that health reform will increase device sales by 3.6 percent cumulatively through 2022. This increase, the study concludes, "will be sufficient to offset" the tax.[17]

Tax Will Have Little Effect on Innovation

"Innovation and research would be minimally affected" by the tax, CRS finds, despite industry lobbyists' claims to the contrary. "The effects on small as well as large firms will likely be minimal," CRS writes, "because the tax is expected to be passed on in price and the decrease in demand would be negligible."[18]

The consulting firm PricewaterhouseCoopers has identified five pillars of medical technology innovation: financial incentives, human and physical resources, a favorable regulatory climate,

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[14] Diana Furchtgott-Roth and Harold Furchtgott-Roth, *Employment Effects of the New Excise Tax on the Medical Device Industry,* Advanced Medical Technology Association, July 2011, http://advamed.org/res.download/290.

[15] Christopher Flavelle, "How Much Will the Medical Device Tax Hurt?," *BloombergBusinessweek*, March 22, 2012, http://www.businessweek.com/printer/articles/14874-how-much-will-the-medical-device-tax-hurt.

[16] Washington Post Editorial Board, "Bipartisan efforts to repeal the medical device tax are galling," *The Washington Post*, January 29, 2015.

[17] Wells Fargo Securities, *Healthcare Coverage Expansion: A Short in the Arm for MedTech*," April 1, 2013, http://www.elsevierbi.com/~/media/Supporting%20Documents/The%20Gray%20Sheet/39/15/WellsFargo_benefits_Of_NewInsured_vs_DeviceTax_Impact_Report.pdf.

[18] Gravelle, p. 19.

demanding and price-insensitive patients, and a supportive investment community.[19] Each pillar comprises more than a dozen separate factors, and the tax rate is just one of the many factors affecting financial incentives.

Staff of AdvaMed, the trade association, have similarly identified a range of factors that, they say, threaten innovation in medical technology, including a reduced supply of venture capital, slower growth of demand, movement of clinical trials outside the United States, increased difficulty in achieving insurance coverage for new devices, and new health care payment methods that discourage adoption of new technology.[20] The medical device tax has a negligible effect on demand and no effect at all on the other factors.

To the contrary, health reform may well spur medical-device innovation by promoting more cost-effective ways of delivering care. As PricewaterhouseCoopers observes, "Government pressure to lower healthcare costs could . . . forc[e] developed nations to turn to innovative technology to achieve better results at lower costs."[21]

Tax Will Have Minimal Effect on Consumers

"The effect [of the excise tax] on the price of health care," CRS says, "will most likely be negligible because of the small size of the tax and the small share of health care spending attributable to medical devices."[22] Spending on taxable medical devices represents less than 1 percent of total personal health expenditures, so a small increase in their price would have an almost imperceptible effect on health care costs and health insurance premiums.

Taking all of its provisions into account, including the device tax, the Congressional Budget Office (CBO) expects health reform to modestly *reduce* the cost of health insurance. CBO estimates that the ACA will reduce premiums for employers with more than 50 workers — which account for 70 percent of the total insurance market — by up to 3 percent by 2016. For small employers, the estimated change in premiums ranges from an increase of 1 percent to a reduction of 2 percent.[23]

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[19] PricewaterhouseCoopers (PwC), *Medical Technology Innovation Scorecard: The Race for Global Leadership,* January 2011.

[20] Stephen Ubl and David Nexon, "How to Restore the Innovation Ecosystem for Medical Technology," *Health Affairs Blog*, February 10, 2015, http://healthaffairs.org/blog/2015/02/10/how-to-restore-the-innovation-ecosystem-for-medical-technology/.

[21] PwC, p. 12.

[22] Gravelle, p. ii.

[23] Congressional Budget Office, *An Analysis of Health Insurance Premiums Under the Patient Protection and Affordable Care Act,* November 30, 2009, http://www.cbo.gov/ftpdocs/107xx/doc10781/11-30-Premiums.pdf.