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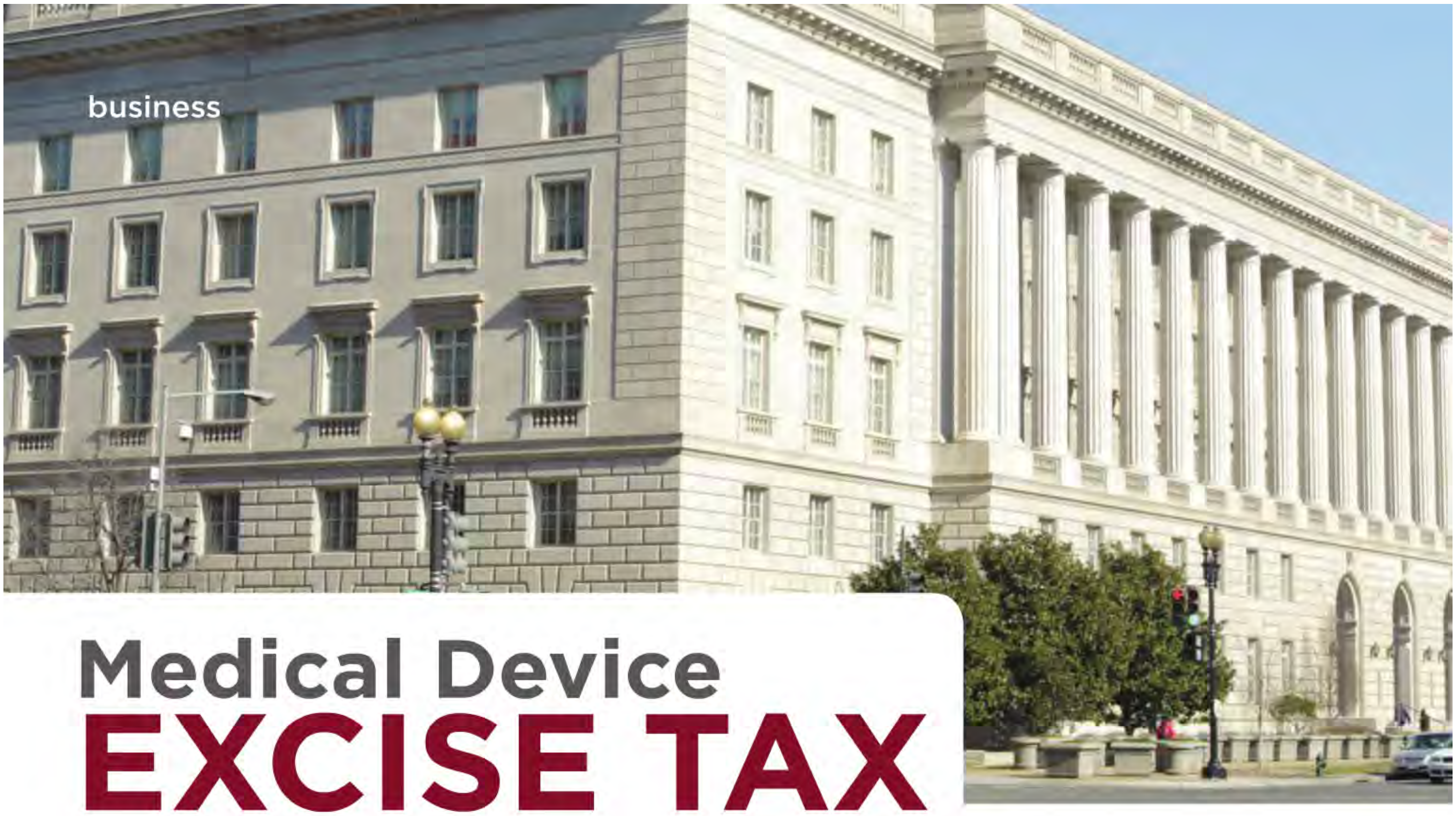

Medical Device EXCISE TAX

Nine months reveal the effects on many small to midsized US companies.

By Kenneth E. Schuckers

On Jan. 1, 2013, the 2.3% medical device excise tax took effect. The tax is on 2.3% of sales as opposed to profits like most U.S. income taxes. For small and midsize companies, the effects have been substantial. Since the tax has now been the law for 9 months, many executives in the medical device industry have been able to see its effects on their companies, as evidenced below.

One executive summed up the effect of the tax on a small business by providing this example. Consider a start-up company that is in a research-and-discovery phase of its life cycle. This business has one commercialized product and has sales of about $1 million and a net profit of $100,000. The company is now paying a 2.3% excise tax on the $1 million of sales, or $23,000. This $23,000 equals 23% of profits. The company also owes $22,250 of federal income taxes on its profits of $100,000, making the total amount paid to the federal government $45,250, or 45.25% of net profit. On top of that, the company will also pay state taxes.

For many growing businesses, this is a staggering amount of income that could be used to grow the business through research and development, as well as expansions. Some medical device manufacturing companies even have to take out a bank loan to pay these taxes, putting them further behind in trying to grow the business.

Furthermore, business investors, such as venture capital funds and private equity funds, generally look very closely at the return on investment. These types of negative pressures on a business cause investment firms to think twice before investing in this industry segment. Ultimately, this disproportionate amount of tax is discouraging start-ups and the innovations that they can contribute to the U.S. economy.

Adding to this, another business owner states that medical device companies in the U.S. are forced to be reactionary. Business owners are now sharpening their pencils to look at the real return on investment of manufacturing in the U.S. versus manufacturing abroad. In order for his family business to survive, he has sent the manufacturing for many of his products overseas. Decisions like this are costing valuable skills and high-paying jobs for U.S. citizens.

Another small business owner says that when looking at the return on investment of producing in the U.S., the owner should not only look at the 2.3% excise tax on sales, but also the massive administrative costs of tracking products that may be subject to the tax, and the administrative costs of the Patient Protection and Affordable Care Act, commonly referred to as the Affordable Care Act (ACA) or Obamacare. For those companies that have the ability to move overseas, it is now becoming a relatively easy business decision to do so.

Learning New Rules

One of the administrative burdens that small and midsized medical device manufacturers struggle with is the compliance of analyzing and completing the quarterly Form 720 – Quarterly Federal Excise Return. For example, many of these companies have one internal accountant that is responsible for reconciling cash, budgeting, paying invoices, payroll, preparing, and filing property and income taxes, coordinating with their auditing firm, etc. These accountants are stretched extremely thin to the point that many struggle to keep up with new and complex laws such as the medical device excise tax. Most of these companies never had to complete an excise tax form prior Jan. 1, 2013.

Many small and midsize company executives are not aware of or familiar with the retail exception, which applies to retail products consumed by the public – such as eyeglasses, contact lenses, and hearing aids, as well as Internet and telephone purchases of medical devices. Companies that are aware of this exception, and that have additional funds to spend, are now hiring expert tax advisors and attorneys to provide detailed analysis of the company's products to determine which are taxable. Fees for these services can range from a few thousand dollars up to several hundred thousand dollars, depending on the size and products of the company.

Other companies that do not have that luxury in their budgets are forced to figure these rules themselves, as their tax and auditing firms are, in many instances, bookkeepers that may not be very knowledgeable about this law in order to provide proper advice to their one or two clients in the medical device industry.

During a recent Southeast Medical Device Association conference in Atlanta, Ga., many business owners of small and midsized companies were polled about their knowledge of the tax and the retail exception. The responses were across the board – from not even knowing about this new tax; believing they were not subject to the tax; believing everything they produce is taxable; and not knowing a retail exemption exists. The result is that it appears some companies are paying too much tax while others are paying too little or not paying at all.

Dealing with New Cost

Another complex business issue faced by medical device manufacturers is the ability, or lack of ability, to pass on the tax to the consumers, which are generally doctors and hospitals. According to many medical device executives, this is a complex dilemma. The medical device manufacturing executive really has three choices when it comes to paying this tax: to pay the tax and not pass it on to customers to ensure longer-term business relationships; attempt to pass the tax on and potentially lose customers; or attempt to pass the tax on and have the customer refuse to pay it, thereby creating additional accounting issues relating to higher bad-debt expenses. Currently, many manufacturers have long-term price contracts in place with their customers, and the tax cannot be passed on for contracts in place prior to Jan. 1, 2013. In addition, many customers are highly aware of the tax and have informed the manufacturers that they will not pay the tax if a line item shows up on their invoice. To make matters worse, some customers have told executives they will take their business elsewhere if the tax is passed onto them.

The Obama administration states that the tax will be good for the industry as many new patients will be able to buy these devices through increased health care access. The medical device industry makes the argument that many of the products are targeted at older adults that are already on Medicare or other health insurance. While this may be true for some, other medical manufacturers provide products to most of the population. There will likely be some winners and some losers to the Obama administration's position.

When asked, many business owners who were originally optimistic that the tax would be repealed are now skeptical of its repeal. There is significant bipartisan support for repeal in both the House and Senate. However, proponents of the tax argue that repealing the tax will increase federal debt. The supporters of the tax state that the ACA will more than offset the cost of the tax by increasing the number of patients, which will increase demand for medical devices, which will increase profits for medical device manufacturers. During the week of Sept. 23, 2013, the debate on this issue was intense as supporters of a repeal attempted to attach it to a bill to keep the government running. On Oct. 1, 2013, the U.S. government could not reach an agreement on the budget, which resulted in a partial government shutdown. According to recent articles and news releases, the Obama administration is not in favor of the repeal. Proponents and supporters of the medical excise tax will be closely watching the outcome of the debate in Washington. **tmd**

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