Perspective

The First Thirty-Days of the Excise Tax: Battle Lines Are Being Drawn

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GPO's and hospitals are pushing back on device companies looking to "shift the burden" of the excise tax.

Introduction

The medical device tax, which came into effect on January 31, 2012, is a controversial part of the Obama administration's plan for financing the Affordable Care Act (ACA). Based on IRS regulations released in December, a medical device company's first payments resulting from the 2.3% excise tax — applicable on sales from January 1 to January 15 — were due at the end of January. Looking back at the first thirty days since the tax took effect, it looks like medical device companies, group purchasing organizations, hospitals and lobbyists (representing device companies and hospitals) are drawing the battle lines.

Device Company's Position

Device companies have been arguing that the new tax, which applies to sales rather than profits, is unfair. The device industry feels that although hospitals and drug companies face new costs, both will benefit from a large number of newly insured patients entering the healthcare system. However, device companies feel that most of the patients who need devices are older and already covered by Medicare. Industry lobbyists argue "this theory that there's going to be a windfall of new patients for device makers just doesn't hold water". They add, the tax will not "pay for itself" in the form of new customers who can afford better healthcare, as defenders of the law propose.
As medical device companies prepared for the pending excise tax, many either looked to cut costs (ex: product development programs, R&D, headcount) and/or raise prices in an effort to help offset the impact of the tax.

- Virtually every major orthopedic company reduced headcount in 2011 and/or 2012 — with more reductions expected. Stryker confirmed that it would lay off 1,000 employees in part to brace itself for the tax. Medtronic cut 500 positions last summer — and is expected to reduce headcount by an additional 500 by the end of 2013. Smith & Nephew announced in February, 2012 that it would reduce its global work force by 7% over the next three years — and on January 31st, reported the elimination of 100 jobs in Memphis, TN and Andover, MA, as it cuts expenses in an effort to offset tax hikes.

- Other companies attempted to “shift the burden” of the excise tax to hospital customers — either through price increases and/or “invoice surcharges”.

In January, 2013, the *Wall Street Journal (WSJ)* acquired letters sent from nine different medical device companies to hospitals related to the excise tax. The WSJ reported that one maker of cardiac surgical tools wrote the following to a hospital: “As a result of this (ACA) law, we will be forced to charge the 2.3% federal medical device excise tax to you”.

The *WSJ* also confirmed that other companies have quietly added new surcharges — or warned hospitals of price increases to cover the new tax on device sales. One small company added a new surcharge — labeled as a “medical device adjustment” — on invoices for its radiology supplies.

A large medical device company’s CEO put the price increase issue in perspective by saying “the medical device tax is not what is driving up product prices, but instead the significant increases in utilities, rising gasoline prices and higher healthcare costs”. The CEO added, “We have seen unemployment insurance taxes increasing, along with other state and local taxes including property taxes. Our employees need raises. We will have price increases but those increases will not include the 2.3% tax”.

MedTech Lobbying Groups Position

The President and CEO of the Advanced Medical Technology Association (AdvaMed) stated “every dollar spent on this (ACA) tax is a dollar taken away from medical innovation and job creation. This tax is already resulting in layoffs, reduced investments in R&D and delays in significant capital improvements. We urge Congress to act swiftly and repeal this job-killing, innovation destroying, anti-competitive tax”.
The President of the Medical Device Manufacturers Association (ADMA) added “instead of investing in new medical technologies or creating new jobs, innovators across the US wrote a check to the IRS (in January)”.

Advamed and ADMA have continuously warned of declines in innovation, layoffs and off-shoring from device companies as a result of the excise tax. The two MedTech industry advocates estimate that the excise tax will cost medical device companies about $194MM *per month*. Medtronic said it expected the tax to cost them $125MM to $175MM *per year* — and take funding away from other possible investments. Stryker will pay approximately $100MM related to the excise tax *this year*. Congressional budget forecasters estimate the excise tax will generate $29B for the government’s health-care overhaul *by 2022*.

Hospitals and GPO’s Position

The Healthcare Supply Chain Association (HSCA), a trade organization that represents 15 group purchasing organizations (GPO’s), confirmed that some medical device companies are adding a line to their invoices that passes on the cost of the excise tax to its customers.

The President of the HSCA stated: “Medical device manufacturers should be on notice that passing the device tax on is not acceptable. GPO’s are effective at limiting these attempts but it appears medical device manufacturers are trying to work around the GPO’s by creating a new line item on their billing statements to hospitals. We think this practice should stop immediately…….now that the new tax is being implemented, it should be the responsibility of the medical device companies to pay it and not pass it on to others”.

Group purchasing organization Novation recently scolded medical device makers who attempt to pass on the burden of the 2.3% sales tax on to their customers, asking the industry “to take responsibility for its share of the cost of healthcare reform”. Novation reported that several medical device manufacturers attempted to bill hospitals for the tax, and the GPO “is taking a firm stance with suppliers who are trying to pass along their medical device excise tax obligations on to the hospitals”. Although hospitals admit that it is difficult to spot cases where device companies raise prices to cover the tax without explaining it on invoices, a Novation senior executive further warned that companies seen baking in the cost of the tax would feel “a very swift and vocal objection in the marketplace”.

A contract manager at Beth Israel Deaconess Medical Center in Boston, MA “noticed a new 2.3% surcharge — labeled as a ‘medical device adjustment’ — in a bill for radiology supplies sold by a small company”. Tampa General Hospital received a bill in January tacking $5.73 on to the cost of a $249 throat device to cover the tax. A number of procurement managers at other hospitals have confirmed that they are seeing the charges attached to certain commodity items — especially those sold by smaller manufacturers.

Some hospitals are also warning device vendors that they won’t budge on price due to multi-year contracts that include fixed prices. The VP of Supply Chain Management at a major health network offered, “if out of nowhere, you come back with a 2.5% price increase, we’re just not going to honor it”.

Hospital Lobbying Group’s Position

Hospitals have further argued that, because they had already agreed to give up $155 billion in the form of Medicare-payment cuts over ten years to help pay for the health law, other sectors should also pay their fair share. “American hospitals have already lived up to their shared financial responsibility for national healthcare reform, and now face mounting budgetary strain as they continue to deliver affordable and effective patient care with fewer dollars”. The American Hospital Association has been lobbying the Internal Revenue Service to draft rules preventing device makers from deceptively passing off the tax on their members.

An Industry Expert's Position

Industry experts believe that the HSCA's accusations are designed to discourage device companies from attempting to use the tax as leverage in negotiations with GPO's. The publisher of Kalorama Information, a healthcare research and publishing firm, opined that "it's an unsurprising part of negotiations that will occur between GPO's and med device companies for a long time, with the tax adding just a bit more friction……..this is a warning shot across the bow saying don't come to us — GPO's representing hospitals — and ask us to consider the excise tax you are facing in price negotiations".

What We Can Expect Looking Forward

Despite best efforts from industry and medical device lobbyists, especially AdvaMed and AMDA, MedTech experts have expressed **pessimism that the excise tax repeal efforts will work**. Many feel that if President Obama and Congress address overall tax reform sometime during 2013, then that opportunity may be the device industry's last, best effort to have the excise tax appealed.

With a device tax very likely to remain in place, it will **clearly add to a manufacturer's cost at a time when demand for medical devices has softened and hospitals have more skillfully negotiated price reductions**. Medical device companies will continue to closely manage (or further reduce) costs, implement (or announce new) head count reductions and make every attempt to "net" small price increases (and make "mix" more meaningful when signing new contracts with new, more costly products) in an effort to offset the excise tax and other cost increases.

- The headcount reduction issue was reinforced by a recent AdvaMed survey. Based on feedback from 81 of its roughly 350 members, 62% of those surveyed said they are planning layoffs or reduced hiring to help offset the tax. **AdvaMed forecasts up to 43,000 more jobs will be cut over the next 5 years because of the tax.** Since last year, over 7,000 jobs have already been eliminated.

At between 4% and 5.5% of sales, R&D remains one of the smallest expenses for the major and mid-major publicly-traded orthopedic companies. Innovation had already been underwhelming in the last 5 years, with little in the way of disruptive, new technologies. With low, single-digit sales growth projected for hips, knees and spine, **R&D has been an area of underinvestment in orthopedics. Given the 2.3% excise tax, it will likely remain that way**. Innovation will continue to be negatively impacted. A Wells Fargo Securities Equity Research, published on January 15, 2013, offered the following about the ACA impact on MedTech utilization:

- Recent studies show an increase of utilization due to healthcare coverage
- Most uninsured are below 65 years old
- Device utilization is lower in non-elderly (<65 years old) and uninsured (although the uninsured account for 18% of total non-elderly population in the US, the

uninsured account for a median of 1.8% of procedures among the non-elderly in the categories considered, including hips, knees and spine)

Wells Fargo Securities Equity Research concluded the ACA impact on MedTech utilization is likely small. The analysis also suggested that **the benefit from the ACA will not outweigh the cost of the 2.3% excise tax in most major device categories (including hips and knees), with the possible exception of spine (and only in a more optimistic scenario)**.

The battle lines are being drawn. Here’s hoping the device companies can continue to overcome the challenges!

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