

Medical Device Manufacturer Profits

Background

The Patient Protection and Affordable Care Act (ACA) mandates a 2.3 percent excise tax on the sale of any taxable medical device by the manufacturer, producer or importer. Eye glasses, contact lenses, hearing aids and other medical devices “generally purchased by the general public at retail for individual use” are exempt from the excise tax.^{1 2} Companies have been paying the tax quarterly since January 2013.³ The tax is one of a number of mechanisms that fund the expansion of health insurance coverage under the ACA.

The Advanced Medical Technology Association (AdvaMed), a trade group representing the medical device industry, has been actively lobbying for repeal of the medical device tax since it was passed. It has led a coalition of device makers, venture capitalists and physicians to press the case against the tax, citing job loss and impact on research and development.⁴

While legislative attempts have so far failed, the industry won a significant symbolic victory when 79 Senators voted for repeal as an amendment to a nonbinding budget resolution in March 2013.⁵

Repeal of the medical device excise tax, at a cost of more than \$29 billion over 10 years, may well embolden other stakeholders to try to unwind other ACA revenue provisions.⁶ The insurance industry, for example, is pressing for repeal of an annual fee assessed by the ACA to help fund the law’s coverage expansion.

Research and Findings

Consumers Union analyzed financial data from device manufacturers’ filings with the Securities and Exchange Commission and investor reports to assess the effect of the excise tax on the major manufacturers. Other research has found that large medical device makers will pay the lion’s share of the tax—by one estimate 86 percent—compared to smaller companies.⁷ Our research shows that large, publicly held companies are highly profitable and appear able to absorb the tax without the

significant financial impact to their bottom line or the types of large-scale layoffs opponents of the tax suggest.

We chose American medical device companies for research by cross referencing an industry analysis of top companies with the Forbes list of major device manufacturers by revenue. While different organizations may yield slightly different lists of “top” companies depending on the metrics used, we wanted to identify businesses broadly acknowledged as “leading companies.” (See methodology section below for more detail.)

We looked at companies’ operating profits, where available; otherwise net income or net earnings as measures of profits. The findings are displayed in the table below.

MEDICAL DEVICE COMPANIES PROFITS, AND ESTIMATED EXCISE TAX

N/A= Not Available	FY 2012 (In Millions)		
Company	Excise tax estimate (where available)	Company's operating profit, net earnings (relevant division where possible)	Profits after subtracting company's tax estimate (used companies' highest estimate where available)
Abbott Laboratories	N/A	902 (Vascular division)	N/A
Allergan, Inc.	N/A	1,103	N/A
Baxter International, Inc.	N/A	2,326	N/A
Becton, Dickinson and Co.	40-50	1,162 (Medical division)	1,112
Boston Scientific Corp.	80	-3,868	-3,948
Cardinal Health, Inc.	N/A	332 (Medical division)	N/A
CareFusion Corp.	15-20	293	273
CR Bard, Inc.	40	530	490
Danaher Corp.	N/A	861 (Life sciences division)	N/A
General Electric Co.	100-150	2,920 (Health care division)	2,770
Intuitive Surgical Inc.	N/A	657	N/A
Johnson & Johnson	200-300	7,187 (Device division)	6,887
Medtronic, Inc.	125-175	3,617	3,442
St. Jude Medical Inc.	62	752	690
Stryker Corp.	150	1,298	1,148
Varian Medical Systems, Inc.	N/A	427	N/A
Zimmer Holdings, Inc.	40-50	755	705
3M Co.	N/A	1,646 (Health care division)	N/A

SOURCES: (see below)

We found that all but one of the top 18 companies we researched were profitable (see table above). Using the manufacturers' own estimates of what they will pay for the device tax (where available) compared to net income, the tax will account for a relatively small portion of profits for most companies. Even for Boston Scientific, the one company that did experience a loss in 2012, the device tax accounted for just a small portion of the loss, suggesting that the device tax will be a minor factor in the profitability of large companies. In fact, Boston Scientific's stock is up 96 percent since device manufacturers began paying the tax.⁸

Past Profitability of Device Manufacturers

In recent years the net income for American and European publicly held medical technology companies experienced double-digit increases while growth in the general economy has been significantly weaker. In 2011, the latest year available, net income increased by 14 percent. This was the third consecutive year public companies had experienced double-digit growth.⁹

Within the sector, many large device manufacturers have been particularly successful. In 2012, for example, Abbott, a manufacturer of coronary and vascular devices, reports producing a 20.3 percent total shareholder return, compared to 10.2 percent for the Dow Jones Industrial Average and 16.0 percent for the Standard & Poor 500 Index.¹⁰

Zimmer Holdings, which markets orthopedic, reconstructive, spinal trauma devices and dental implants, had net earnings of \$755 million.¹¹ Zimmer boasts in its annual report that progress in its "value creation agenda supported double-digit growth in adjusted earnings per share for 2012."¹² It is important to note that manufacturers have experienced substantial compound growth in recent years. For example, Zimmer's adjusted earning per share¹³ for 2012 increased 10.4 percent over 2011.

An industry report by Ernst and Young notes that the rate of growth in the device industry overall is "certainly impressive in today's challenging economic climate."¹⁴

PRICING THAT HELPS DRIVE PROFITABILITY

The device industry has a well-earned reputation for generating high profits with high prices. A recent exposé by Steven Brill in *Time Magazine* highlighted the case of a neurostimulator used to treat back pain, with a list price of approximately \$19,000. *Time* estimates that if the neurostimulator earns the company-wide profit margin over and above the cost of producing its product, Medtronic will receive approximately four times what the device costs to manufacture.¹⁵ A recent *New York Times* piece found that hospitals routinely pay \$4,500-\$7,500 for hip implants that cost \$350 to manufacturer.¹⁶

The device industry has benefited from fragmented and complex payment structures that have traditionally placed payers (e.g. insurers and self insured businesses) at an arms length from the negotiating process with manufacturers. For example, surgeons have typically selected implantable devices for their patients, the hospital pays for the device and the insurer that pays the hospital has little leverage over the price of devices.¹⁷

Conflicts of interest further skew the marketplace for devices, creating incentives for physicians to use specific devices for their own financial gain. The device industry in recent years has seen high-profile scandals involving improper financial payments paid to surgeons in order to influence the procurement of devices by hospitals or health systems.¹⁸

The lack of price transparency for medical devices is a significant factor driving high medical device prices. Hospitals have difficulty getting information on devices because comparable information across manufacturers is often not available publicly.¹⁹ Device companies put confidentiality clauses into their contracts with hospitals or group purchasing organizations in order to keep the terms of the contract private. At least one company was successfully sued to keep a purchaser from sharing pricing information.²⁰ The lack of transparency in turn harms the ability of hospitals and organizations that purchase on behalf of hospitals (known as group purchasing organizations) to meaningfully shop for competitive prices. Research indicates a wide variation in the price paid for the same devices. For example, a Government Accountability Office report on prices for implantable devices found differences of six to nearly nine thousand dollars between the lowest and highest price that hospitals reported paying for a particular automated implantable cardioverter defibrillator (AICD) model.²¹

Differences between Large and Small Manufacturers

Unlike the pharmaceutical industry, the device industry is characterized by a large number of smaller device companies. These companies tend to have fewer staff and smaller products lines. Cash flow for small device companies may depend much more heavily on the success of an individual product than it would at a larger company.²² Smaller companies may therefore be legitimately more sensitive to the impact of the device tax.

Since the current excise tax is applicable to all firms without respect to profits, firms that could be affected include those that are not or are barely profitable. This would disproportionately impact smaller startup companies that have small profits or have yet to post profits that might be limited by the tax.

According to Ernst and Young, while the leading US companies have logged record profits in recent years, smaller US device companies have not prospered as robustly. Net income for the 30 US commercial device leaders increased by an average of 22

percent in 2011. In contrast, net income averaged -186 percent for the rest of the device industry.²³

It is important to note that excise or sales taxes generally do not consider the profitability of the entities being taxed. However, if Congress is intent on protecting smaller or less profitable companies, they should do so without exempting profitable and/or large companies.

Conclusion

There are three reasons the medical device excise tax added by the ACA should not be repealed.

1. SHARED CONTRIBUTION AND BENEFIT

The ACA includes many revenue raisers to fund the expansion of health insurance to the uninsured including, for example, an excise tax on employer based so-called “Cadillac” health plans and the medical device excise tax. In addition, other stakeholders contribute to the funding of the law in a variety of ways. For example, hospitals will take Medicare payment reductions and drug companies must provide discounts to Medicare beneficiaries in the Medicare prescription drug coverage gap known as the donut hole. The principle of broadly shared contribution among stakeholders to the funding of the ACA may be at risk if individual stakeholders are exempted from their responsibilities toward the funding of the law.

2. INCREASED DEMAND FROM NEWLY & BETTER INSURED CONSUMERS

All these stakeholders will benefit from the law because millions of new, paying customers will enter the system due to the coverage expansion. The Congressional Budget Office estimates that the law will ultimately expand insured coverage by more than 27 million, which means the demand for—and the ability to pay for—medical devices is likely to expand significantly in the coming years. In addition, the ACA requirement that insurance cover “essential benefits” means many more consumers will have more comprehensive coverage of services these companies provide.²⁴

Thus, the tax opponents’ arguments about inability to pay or mass layoffs seem to be totally unsupportable in light of the enormous benefits that will accrue to the medical device industry as a result of the various reforms in the ACA.

3. PROFITABILITY OF THE INDUSTRY

Our analysis of top device manufacturers who will pay most of the tax shows that most of them are highly profitable and capable of absorbing the costs of the device tax without affecting research and development or causing the types of large-scale layoffs opponents of the tax suggest. And information from the industry itself indicates the same. For example, one industry survey of over 3,000 device companies noted that only 11 percent of North American companies surveyed indicated they actually would reduce staffing to adjust to the tax.²⁵

In light of the prevalence of often extraordinary profits earned by the device industry overall, it is difficult to argue that the medical device industry should be exempted from helping fund the ACA. For the reasons outlined above, policy makers should leave the device tax as is, or at the very least consider a more targeted approach to altering the tax.

APPENDIX

METHODOLOGY

To determine the top United States medical device companies, we consulted an online list, Forbes' "The World's Biggest Public Companies," which uses a methodology for assessing the top companies in the world that involves analyzing four metrics: sales, profits, assets and market value.²⁶ From that list, we selected American based medical device companies and American companies with medical device divisions of significance by consulting an online list published in late 2012, "Top 40 Medical Device Companies," by *Medical Device and Diagnostic Industry*, which ordered the companies "by trailing 12-month (TTM) revenues."²⁷

Next, we determined how much the companies would have to pay due to the new tax. From the list that we had compiled of top medical device companies, we searched for those that had made their estimated medical device excise tax figures publicly available, either to the media or in their SEC filings. Thus, we used the information that companies had themselves provided to assess the impact of the medical device excise tax. An exception is St. Jude Medical, Inc., for which we used an estimate provided to the media by a Piper Jaffray analyst.

Then, we estimated how the new tax would affect the companies' profits. We searched 2012 Annual Reports and SEC filings to determine the overall profit of each company, whether expressed as net earnings or net income or operating income in the report. Then, we subtracted the company's estimated medical device tax payment from those profits to estimate the impact of device on an annual basis (the tax actually took effect in 2013).

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