SUBJECT: Exempting surplus inventory of drug distributors from property taxation

COMMITTEE: Local Government Ways and Means — committee substitute recommend

VOTE: 5 ayes — Hill, Hamilton, Laubenberg, Puente, Quintanilla

0 nays

2 absent — Elkins, Uresti

WITNESSES: For — Donald King, Cardinal Health, Inc.

Against — None

BACKGROUND: Tax Code, sec. 23.12 governs the appraisal of inventory for property taxation purposes.

Tax Code sec. 151.313 exempts certain health care supplies from sales and use taxes. Subsec. (c) defines a product as a drug or medicine if it is required to be labeled with a "Drug Facts" panel in accordance with regulations of the federal Food and Drug Administration or:

- is intended for the treatment of disease, illness, or pain;
- is not an appliance or device; and
- is not a food.

DIGEST: CSHB 3016 would require a chief appraiser to exclude the value of "drug supplies held in surplus" from the market value of a wholesale pharmaceutical distributor's inventory.

Drugs held in surplus would be those that are in excess of the amount held for market purposes. This would be defined as drugs owned by a wholesale distributor for less than 60 days for response to public health or emergency demands. The definition would include drugs or medicine exempted from sales and use taxes under Tax Code, sec. 151.313.

The definition of wholesale distributor would exclude pharmaceutical drug manufacturers, retail pharmaceuticals, and chain pharmacies.

In calculating the number of days that drug supplies held in surplus were held in inventory, a wholesale distributor would subtract the average days of inventory held to meet normal customer demand from the wholesaler's total pharmaceutical drug inventory.

The bill would take effect January 1, 2006.

SUPPORTERS SAY:

CSHB 3016 would provide more equitable treatment of wholesale drug distributors for property tax purposes. The bill would exempt the market value of drugs held in inventory to satisfy requirements that excess inventory be available in case of emergency. Because this inventory is held for public health rather than typical business purposes, it is unfair to force distributors to pay taxes on this inventory.

Currently, wholesale drug distributors, which sell medicine to health care providers, are required through contracts with hospitals and other clients to carry surplus inventory in excess of market demand. These agreements ensure that additional inventory of certain vital drugs and medicines would immediately be available in case of a public health emergency. Following the 9/11 attacks, these types of agreements are increasingly common, leading to larger taxable inventories for wholesale drug distributors. Distributors realize profit margins as low as 1 percent on many of these items, requiring huge sales volumes in order to pay off taxes on inventory that serves a marginal business interest for a company.

Because wholesale drug distributors are having a difficult time affording taxation of excess inventory, the state could experience several problems unless the valuation of this property is reformed. Because many of these distributors have warehouses across the country, some wholesalers could transfer their inventory out of state. This could cost the state jobs and tax revenue on non-surplus drug inventory. It also could leave hospitals without a nearby source of medicine in case of emergency, a particular problem if security concerns required the cessation of overland or air traffic.

If hospitals or tax-exempt health care providers chose to stock inventories of these drugs in-house, Texas would lose tax revenue on non-surplus drugs that would be allowed under this bill. Further, many hospitals likely would resist managing the large inventories required to address emergency public health considerations.

CSHB 3016 would address all of these concerns, maintaining a balance between the emergency needs of health care providers and the revenue needs of local taxing units. The bill would not exempt all drug and medicine inventory from taxation, only that determined to be in excess of market demand based on a standard industry calculation specified in statute. Pharmaceutical manufacturers, retail pharmacies, and chain pharmacies would not qualify for this exemption, only wholesalers whose primary market participation was the distribution of drugs.

OPPONENTS SAY:

CSHB 3016 would reduce tax revenue to local governments that levy ad valorem taxes on the inventory of drug distributors when many are struggling to pay for the services they provide. According to the Comptroller's Office, there are about 750 wholesale drug distributors throughout the state, and local governments currently can levy taxes on the entire inventory of these distributors. While CSHB 3016 may not exempt the surplus inventory of all these businesses, the revenue loss to many local governments could be significant.

Drug distributors should not receive an exemption on their excess surplus even if it was held for public health reasons. The distributors will sell this product eventually, and providing an exemption for it would ignore this fact. If an emergency occurred, a distributor would realize profit on product upon which taxes were not levied. Surplus agreements are negotiated between distributors and health care providers, and the state should not get involved in this issue.

NOTES:

As introduced, HB 3016 would not have exempted pharmaceutical drug manufacturers, retail pharmacies, or chain pharmacies from its provisions. The bill would have exempted from taxation drugs located in the state for less than 60 days as of January 1.