NORTH CAROLINA GENERAL ASSEMBLY

LEGISLATIVE FISCAL NOTE

Replaces earlier note on same bill.

Only effective date has been changed; no change in fiscal impact.

BILL NUMBER: S.B. 864 Senate Finance Proposed Committee Substitute Lab Testing Lab Testing Facility Sales Tax
Facility Sales Tax

SHORT TITLE: Lab Testing Facility Sales Tax

SPONSORS:

FISCAL IMPACT

Yes (X) **No ( )** **No Estimate Available ( )**

	FY 1999-00	FY 2000-01	FY 2001-02	FY 2002-03	FY 2003-04
REVENUES					
General Fund	**0**	**(2.3)**	**(2.4)**	**(2.5)**	**(2.7)**
Local Government	**0**	**(1.5)**	**(1.6)**	**(1.7)**	**(1.8)**

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: Department of Revenue, Sales Tax Division, and Local Governments.

EFFECTIVE DATE: Section 2 of this act is effective when it becomes law. The remainder of this act becomes effective July 1, 2000, and applies to sales made on or after that date.

BILL SUMMARY: The bill lowers the sales tax to 1% on many of the chemicals, test kits, and supplies used in laboratory testing. To qualify for the exemption the business must be certified by the federal Health Care Finance Administration (HCFA) as a moderate or highly complex laboratory. The lab must also be "primarily engaged in providing medical, analytic or diagnostic services, including bodily fluid analysis, generally to the medical profession or to employers, or to patients on referral from a medical professional or employer". The bill defines this type of business as a medical laboratory testing company. The revenue from the 1% tax is retained by the state. The entire 2% local sales tax on laboratory testing supplies is repealed.

BACKGROUND: The legislation lowers to 1% the sales tax charged on the following items that are used or consumed in the clinical laboratory testing business: medical products, medical accessories, reagents, chemicals, test kits, consumable lab supplies, and other similar tangible personal property not including machinery and equipment.

The special tax treatment only applies to companies that met both of two sets of qualifications. First, they must be certified by HCFA as a moderately or highly complex laboratory. Second, laboratory services, as defined in the bill, must be their primary business. Both the bill drafting attorney and industry representatives believe this definition includes only those companies that are laboratory service companies.

According to HCFA, there are 1,506 laboratories in North Carolina that are certified as moderately or highly complex. Most of these laboratories are in hospitals or a doctor's office. Because the primary business of these facilities (hospitals and doctors offices) is not laboratory testing, they would not qualify for the special tax treatment in the bill. Based on a list of all 1506 HCFA certified laboratories, Fiscal Research identified 80 facilities that may be stand alone laboratory testing businesses. These laboratories appear to be operated by approximately 44 companies. Fiscal Research, in conjunction with KPMG Accounting in Greensboro, surveyed these facilities to determine if they met the qualifications listed in the bill. Companies that qualified were asked to supply information about their medical supply and equipment expenditures. Of those surveyed, 15 responded or 34%. Two of these respondents indicated that they did not meet the qualifying criteria in the bill.

One of the responding companies the Laboratory Corporation of America or LabCorp, provided extensive information about their expenditures, purchases, and the company as a whole. According to the organization's filings with the Security and Exchange Commission, LabCorp is the largest independent clinical laboratory company in the United States, based on 1998 net revenue. The company is headquartered in Burlington, NC, and offers more than 2,000 different clinical laboratory tests. LabCorp current maintains 25 regional testing facilities. The company reports 1998 net sales of $1.6126 billion, with a gross profit of $563.4 million, and net earnings of $68.8 million. Because of the level of detail provided by LabCorp, and their dominant market share, much of the analysis is based on their information.

ASSUMPTIONS AND METHODOLOGY: Because of the unique structure of laboratory data, the estimates in this note are divided into three parts that reflect the three data segments available. Section 1 reflects the data provided by LabCorp, while Section 2 includes the estimates associated with the 12 other companies that responded to the survey and qualified for the exemption. Section 3 provides total loss estimates, including assumed losses associated with companies who did not respond to the survey. The data included in the note reflects only information provided by laboratory companies directly. No data from the Department of Revenue is used in this analysis.

<u>Section 1: LabCorp Information:</u>

According to documents provided by LabCorp, the organization's North Carolina laboratories spent $50.67 million and $46.89 million on reagents and other chemicals in 1997 and 1998. This estimate assumes that 90% of all laboratory supply expenses were associated with reagents and other chemicals. LabCorp officials believe a 5% growth rate in this type of expenditure is appropriate. When questioned about using a 5% growth rate in light of the increased output anticipated by the bill, company representatives stated that "this additional work is not expected to greatly increase lab supply costs." They cite more favorable contracts with vendors, reducing waste, increased efficiency (by the company manufacturing its own reagents), and the low per unit cost associated with many of the more routine tests which will be handled by the North Carolina facilities.

Assuming the 5% growth rate is appropriate, reagent and chemical purchases by the North Carolina portions of LabCorp will be:

	1999	**2000**	**2001**	**2002**	**2003**	**2004**
Reagents & Other Chemicals	42,733,800	44,870,490	47,114,015	49,469,715	51,943,201	54,540,361

Under current law a 6% sales tax applies to these purchases. The tax liability associated with these estimates, once adjusted for the fiscal year basis are:

	1999-00	**2000-01**	**2001-02**	**2002-03**	**2003-04**
Reagents & Other Chemicals	43,802,145	45,992,252	48,291,865	50,706,458	53,241,781
Sales Tax (6%)	2,628,129	2,759,535	2,897,512	3,042,387	3,194,507

The bill repeals the 2% local tax. It also reduces the state tax from 4% to 1%. The fiscal loss associated with these changes and LabCorp's purchases is as follows:

	1999-00	2000-01	2001-02	2002-03	2003-04
State Loss	(1,314,065)	(1,379,768)	(1,448,756)	(1,521,194)	(1,597,254)
Local Loss	(876,043)	(919,845)	(965,837)	(1,014,129)	(1,064,836)

Section 2: Other Laboratory Companies:

The 12 non-LabCorp companies that responded to the survey reported annual laboratory supply purchases of $20,348,831. Assuming the 6% sales tax currently applies, the total revenue associated with these purchases is $1,220,930. Under the bill, the 2% local tax is repealed and the 4% state tax is reduced to 3%. Assuming supply purchases grow by 5%, the potential revenue impact is as follows:

	1999-00	2000-01	2001-02	2002-03	2003-04
State Loss	$610,465	$640,988	$673,038	$706,690	$742,024
Local Loss	$406,977	$427,326	$448,692	$471,126	$494,683

Section 3: Total Losses

As mentioned previously, survey respondents are assumed to account for 87.5% of the qualifying market. Assuming the survey results apply to the remaining 12.5%, the fiscal loss associated with this portion of the bill is as follows:

	1999-00	2000-01	2001-02	2002-03	2003-04
State Loss					
LabCorp	(1,314,065)	(1,379,768)	(1,448,756)	(1,521,194)	(1,597,254)
Survey Respondents	($610,465)	($640,988)	($673,038)	($706,690)	($742,024)
Others	(274,933)	(288,679)	(303,113)	(318,269)	(334,183)
TOTAL STATE LOSS	**(2,199,462)**	**(2,309,435)**	**(2,424,907)**	**(2,546,152)**	**(2,673,460)**
Local Loss					
LabCorp	(876,043)	(919,845)	(965,837)	(1,014,129)	(1,064,836)
Survey Respondents	(406,977)	(427,326)	(448,692)	(471,126)	(494,683)
Others	(183,289)	(192,453)	(202,076)	(212,179)	(222,788)
TOTAL LOCAL LOSS	**(1,466,308)**	**(1,539,623)**	**(1,616,605)**	**(1,697,435)**	**(1,782,307)**

The fiscal loss shown in the chart on page one reflects the adjustment needed for the July 1, 2000 effective date.

Note: Because doctor offices would not qualify for the special tax treatment they are not included in the fiscal estimate. However, some physicians may create a separate subsidiary business to take advantage of the tax treatment afforded laboratory-testing companies. Therefore, the actual cost associated with the bill may increase in future years. In addition, some hospitals may also decide to create separate structures for their laboratory business. Because non-profit hospitals already receive a sales tax refund, the only loss associated with the transformation of the hospital laboratories would be the interest the state receives on the sales tax money before it is refunded to the hospitals. Thus, any potential loss in this area would be insignificant.

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