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BILL



ANALYSIS

Telephone: (517) 373-5383  
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House Bill 5678 (as reported without amendment)  
Sponsor: Representative Kenneth Horn  
House Committee: Tax Policy  
Senate Committee: Finance

Date Completed: 11-26-12

### **RATIONALE**

Some concerns have been raised about Michigan's sales tax exemption for prescription drugs, which is found in both the State Constitution and the General Sales Tax Act. The Constitution states that the sales tax cannot be collected on the sale of "prescription drugs for human use". Before the Act was amended in 2004, the statutory exemption also referred to sales of prescription drugs for human use. The current statute, however, exempts sales of "drugs for human use that can *only* be legally dispensed by prescription" (emphasis added). Evidently, this language is causing some confusion in situations involving drugs that can be both prescribed and sold over the counter (OTC). For example, a consumer can buy OTC products containing ibuprofen, which are packaged and labeled for individual sale and are subject to the sales tax. At the same time, a physician can write a prescription for ibuprofen, which pharmacies can buy in bulk and use to fill prescriptions. Although ibuprofen might be prescribed, it is not a drug that can *only* be dispensed by prescription. Therefore, pharmacists are supposed to collect the sales tax in these situations; apparently, however, some pharmacists are not aware of this requirement until they are audited.

In addition, collecting the sales tax on prescribed drugs that have an OTC counterpart evidently can be especially confusing or problematic in situations involving third-party contracts, such as those used by some employers. If a consumer is responsible for only a co-payment and pays the sales tax only on that portion, and the pharmacist bills a pharmacy benefits manager for the balance, it is not

clear whether the employer or the third party is responsible for paying the tax on that amount. Apparently, the pharmacy itself sometimes resorts to paying the sales tax, which becomes a business expense.

To address this situation, it has been suggested that the statutory exemption should be extended to drugs that are dispensed pursuant to a prescription even if they also can be purchased over the counter.

### **CONTENT**

**The bill would amend the General Sales Tax Act to provide a tax exemption for the sale of over-the-counter drugs pursuant to a prescription.**

Currently, the sales tax does not apply to sales of drugs for human use that can only be legally dispensed by prescription. The bill, instead, would exempt the sale of a prescription drug for human use, and an over-the-counter drug for human use pursuant to a prescription.

The bill would define "prescription" and "prescription drug" as those terms are defined in Part 177 of the Public Health Code.

(The Code defines "prescription" as an order by a prescriber (e.g., a licensed dentist, physician, or podiatrist) to fill, compound, or dispense a drug or device written and signed; written or created in an electronic format, signed, and transmitted by facsimile; or transmitted electronically or by other means of communication.

"Prescription drug" means one or more of the following:

- A drug dispensed pursuant to a prescription.
- A drug bearing the Federal legend "CAUTION: federal law prohibits dispensing without prescription" or "Rx only".
- A drug designated by the Michigan Board of Pharmacy as a drug that may only be dispensed pursuant to a prescription.)

MCL 205.54g

## **BACKGROUND**

Article IX, Section 8 of the State Constitution provides, "No sales tax or use tax shall be charged or collected...on the sale or use of prescription drugs for human use." Accordingly, both the Use Tax Act and the General Sales Tax Act contain an exemption for the sale of prescription drugs. Previously, the exemption in each Act applied to purchases or sales of "a prescription drug for human use". In 2004, numerous amendments were made to both statutes to authorize Michigan's participation in the Streamlined Sales Tax Project. At the same time, the language exempting sales or purchases of prescription drugs was amended. Each Act now exempts sales of "drugs for human use that can only be legally dispensed by prescription".

These amendments responded to a 2004 decision of Michigan Court of Appeals concerning the exemption in the Use Tax Act (*Birchwood Manor, Inc. v Commissioner of Revenue*, 261 Mich App 248). Three nursing homes had challenged the Revenue Commissioner's assessment of the use tax on their purchase of over-the-counter drugs that were dispensed by licensed pharmacists pursuant to prescriptions written by physicians. The Court of Appeals held that the OTC drugs were exempt from the use tax under the exemption for purchases of "a prescription drug for human use".

The Court stated, "Though the statutory provision appears to broaden the tax exemption contained in the Constitution, the Michigan Legislature has the right to further define and expand the definition of 'prescription drug' in order to implement the constitutional mandate. Furthermore, if the

Legislature wished to exempt only those drugs that can be purchased only with a doctor's prescription, it could have easily said so in the statute."

The Court pointed out that this holding had additional support in the Public Health Code's definition of "prescription drug", which includes a "drug dispensed pursuant to a prescription".

## **ARGUMENTS**

*(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)*

### **Supporting Argument**

The 2004 change in the sales tax amendment for prescription drugs has generated confusion and cost for pharmacies. Until they are audited, some pharmacies are not aware that they are supposed to collect the sales tax on prescription drugs that also can be purchased over the counter. Even if they do know about this requirement and attempt to comply, they run into complications when a customer pays only a co-payment and a third party is responsible for the balance. It is difficult for pharmacists to know how much sales tax they are supposed to collect and from whom, and whether they must pay it themselves as a cost of doing business if they cannot collect the tax from a third party.

The bill would resolve these issues by extending the sales tax exemption to OTC drugs sold pursuant to a prescription, and adopting the definition of "prescription drug" found in the Public Health Code. While the definition refers to drugs bearing the Federal legend and other designated drugs, it also includes drugs "dispensed pursuant to a prescription". That portion of the definition makes no distinction based on the nature of the drug—whether it also can be sold OTC or can only be sold pursuant to a prescription. Since the Constitution mandates the exemption for "prescription drugs" but does not define that term, this amendment would bring clarity to the law and provide consistency within the statutes.

**Response:** The bill would take a step in the right direction by exempting prescribed OTC drugs from the sales tax, but nonprescription OTC drugs should be exempt as well. These products offer an

increasingly significant health care option for millions of Americans. Many workers are covered by employer-supported health insurance but face higher co-payments with fewer benefits, and some providers refuse to cover a prescription drug if a safe, effective OTC alternative is available. Also, in addition to treating the symptoms of common ailments, OTC products can help prevent chronic conditions and save costs. Smoking cessation treatments, for example, can save medical expenses and lost earnings, but might cost several hundred dollars. Not having to pay the sales tax on this amount could provide the incentive a smoker needs to make the purchase. Although the State would lose sales tax revenue, taxpayers could see savings individually and through the reduced costs of public health care.

### **Opposing Argument**

The bill could cost the State approximately \$10.0 million annually, according to the Department of Treasury, and should not be enacted without a commensurate expenditure reduction. If pharmacies do not have an effective system to collect the sales tax on prescribed OTC drugs, and end up paying the tax themselves, they have the option to pass on the cost to their customers.

Legislative Analyst: Suzanne Lowe

### **FISCAL IMPACT**

The bill would reduce State revenue to both the General Fund and the School Aid Fund, as well as revenue to local units. The Department of Treasury estimates that the bill would reduce revenue by approximately \$10.0 million per year, with \$7.3 million of the reduction affecting the School Aid Fund, \$1.7 million of the reduction affecting General Fund revenue, and the remaining \$1.0 million affecting local units through constitutional revenue sharing.

Fiscal Analyst: David Zin

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.