



Chlorofluorocarbon (CFC) Taxes at Distributor Inc.

For more than a decade, WRI's Sustainable Enterprise Program (SEP) has harnessed the power of business to create profitable solutions to environment and development challenges. BELL, a project of SEP, is focused on working with managers and academics to make companies more competitive by approaching social and environmental challenges as unmet market needs that provide business growth opportunities through entrepreneurship, innovation, and organizational change.

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Introduction

Distributor Inc. was one of the largest independent chemical distributors in the United States. Distributor purchased chemicals in large quantities from chemical companies, repackaged them in smaller quantities from chemical companies, repackaged them in smaller quantities, and shipped those smaller units to small- and medium- sized businesses that used them. Distributor Inc. did not manufacture any chemicals on its own.

Chlorofluorocarbons (CFCs)

One chemical that Distributor shipped was freon. The company bought freon from chemical manufacturers and sold it to firms that used it in manufacturing processes. Freon was one of several chlorofluorocarbons (CFCs) with wide commercial use. In the mid-1980s, convincing scientific evidence indicated that increased levels of CFCs in the atmosphere were decreasing stratospheric ozone concentrations. The "ozone layer" of the atmosphere absorbs ultraviolet light from the sun. Ultraviolet light has been linked to skin cancer and cataracts in humans, and a number of other health problems in animals and plants. Declining stratospheric ozone concentrations allow more ultraviolet light through, which could lead to costly social effects worldwide.

Increased CFC levels in the atmosphere were attributed to freon leakage and evaporation from individually owned appliances and commercial equipment. Consequently, a phase out of manufacture and use was called for by the 1987 Montreal Protocol on Substances that Deplete the Ozone Layer. The Protocol, and subsequent Amendments, set ambitious goals to reduce CFC production, but allowed individual governments the freedom to determine how they would meet those targets.

In 1990, the United States began taxing CFC manufacture (and providing tax incentives for recycling) under the federal Fluorocarbon Tax (IRC §4681). For freon, the tax was initially set at \$1.37/pound (which is almost equal to the pretax wholesale price of the product). The tax was paid by the freon manufacturer, then the cost was passed on to Distributor Inc., which in turn passed the cost on to its customers. The legislation also stipulated that the tax would increase incrementally each year.

Reaction to the Tax

As was common for many businesses, Distributor's accounting system did not have the ability to separate a wholesale unit cost into different components (e.g., product "cost" exclusive of product "tax"). Typically, when Distributor received a shipment from a producer, it recorded the shipment identification number, substance identity, unit cost, and total number of units. Then, different accounting systems added various information to the wholesale cost as each value-added step was completed (e.g., repacking, invoicing for transport). Output from each of these systems was used to generate financial accounting reports, managerial accounting reports, and tax return data.

Distributor's customers who used freon were unhappy with the increase in price. Some customers were (unfairly) suspicious that Distributor had used the tax increase as an opportunity to quietly increase its profit margins for freon. These customers demanded a breakdown of non-tax product cost and product tax on Distributor invoices.

Distributor's executives were concerned that its business would be affected by the Fluorocarbon Tax, even though the company did not explicitly have to pay the tax.

Case Questions and Assignment

Be prepared to discuss: a) from a policy perspective, what economic effect was probably expected from implementing this pass-through tax, b) what is the likely impact of the Fluorocarbon Tax on Distributor's customer relationships, c) how is the Fluorocarbon Tax likely to impact Distributor's cost accounting results, d) what other impacts may the tax have on Distributor, and e) is this tax unique, or are there other taxes or regulatory instruments that pose analogous problems for business.