**OFFICE OF TAX APPEALS**

**STATE OF CALIFORNIA**

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| In the Matter of the Appeal of: | ) OTA Case No. 18011881 |
| | ) CDTFA Case No. 910342 |
| **STERILMED, INC.** | ) CDTFA Acct. No. SC OHA 100-970709 |
| | ) |
| | ) Date Issued: May 31, 2019 |
| | ) |

## OPINION

Representing the Parties:

For Appellant: Jacob Bholat, Representative

For Respondent: Mengjun He, Tax Counsel III
Scott Claremon, Tax Counsel IV
Lisa Renati, Supervising Tax Auditor III

M. GEARY, Administrative Law Judge: SterilMed, Inc. (appellant or SterilMed[1]) appeals the California Department of Tax and Fee Administration's (Department's) December 14, 2015 denial of a claim filed by Appellant for refund of $62,951 use tax paid by it in connection with its transfer of medical devices to a California customer during the period July 1, 2010, through December 31, 2012.

Office of Tax Appeals (OTA) Administrative Law Judges Michael F. Geary, Daniel K. Cho, and Linda C. Cheng held an oral hearing for this matter in Los Angeles, California, on February 19, 2019. At the conclusion of the hearing, we closed the record and took the matter under submission.

## ISSUE

Is appellant entitled to a refund of use tax for the period July 1, 2010, through December 31, 2012?

[1] Generally, we will use "SterilMed" when referring specifically to what that entity did or failed to do during the time in question, and we will use "Appellant" when referring to the entity making the arguments in this appeal, which is SterilMed's customer, as explained below.

## FACTUAL FINDINGS

1. A single-use medical device (SUD) is a device that the U.S. Food and Drug Administration (FDA) approved for a single use only.
2. During the relevant times, SterilMed, a Minnesota corporation, was in the business of "reprocessing" SUDs for reuse and held a certificate that required it to collect and remit use tax due in connection with sales of tangible personal property (TPP) to California customers.
3. SUD reprocessors were subject to the same regulatory requirements as SUD manufacturers.
4. During the claim period, SterilMed collected SUDs from its customers after use.[2] It then reprocessed the SUDs in a way that allowed them to be reused. In some cases, the devices could be reprocessed and reused several times after the initial use.
5. The contract that established the relationship between SterilMed and its customers (the contract) appears to be a group purchasing contract that identifies SterilMed as seller or manufacturer, and describes the "product category" as "sterile reprocessing." It states that SterilMed would provide "products and services" described in an attachment to the contract. That attachment was a 314-page list of SUDs, which stated the SUDs' names (e.g., "drill bit cannulated"), the product numbers, and the pricing in several price tiers, which varied depending on a number of factors (e.g., number of SUDs purchased and participation levels within groups of purchasers). Section 6.3 of the contract states that title and risk of loss shall transfer to the customer upon delivery. SterilMed warranted it had good and merchantable title, free of liens and encumbrances, in Section 12.2 of the contract. Section 15.14 of the contract states that the contract constitutes the entire understanding and agreement between the contracting parties. Section 15.20 of the contract states, "In the event of any conflict between this Agreement and any document, instrument or agreement prepared by [SterilMed] …, the terms of this Agreement shall control."
6. During the time in question, SterilMed's website stated that reprocessed SUDs would be returned to the same facility and department that had last used the SUDs.

[2] SterilMed's website indicated that it would reprocess SUDs that were "either opened or expired and unused, or used." For ease of reference, we will refer to them as used.

7. Beginning on March 4, 2013 (after the claim period), SterilMed changed its inventory and allotment processes to allow a customer up to 30 days to order the SUDs last used by the customer, after which time those SUDs would be put into inventory available to all customers. SterilMed notified its customers regarding the change, but it did not seek any customer's approval, and there is no evidence the parties to the written contract sought to modify it to reflect the change.
8. During the claim period, the typical chain of possession of the SUDs from use to reuse was as follows: (1) SterilMed's customer used the SUD and soon thereafter, cleaned it and deposited it into customized shipping containers provided by SterilMed; (2) SterilMed determined which SUDs were eligible for reprocessing, disposed of those that were not, and labeled the SUDs for identification (by facility and department); (3) SterilMed reprocessed, relabeled, and repackaged the SUDs for reuse; (4) SterilMed sent its customers regular emails to identify the inventory of SUDs that were available for reuse; (5) customers submitted a "purchase order" for the SUDs they wanted to reuse; (6) the sterile and repackaged SUDs were shipped to the facilities from which they had been collected, where they were placed in inventory and, eventually, reused.
9. SterilMed did not reprocess every SUD collected by it. If SterilMed could not reprocess an SUD for reuse, SterilMed would dispose of it. SterilMed was not required to obtain its customer's permission to destroy an SUD.
10. There was no requirement that customers order any reprocessed SUDs.
11. SterilMed charged its California customers for each delivered SUD and collected use tax in connection with each transaction measured by the charge to the customer. If a customer did not order a reprocessed SUD, SterilMed did not charge the customer.
12. SterilMed thus collected $62,951 in use tax from a California customer, Daughters of Charity Health Systems (DCHS), during the claim period, and remitted those funds to the state.
13. DCHS decided to request a refund of the use tax paid. Because SterilMed remitted the use tax, it agreed to allow DCHS to file the claim in SterilMed's name.
14. In a December 23, 2015 email to Mr. Bholat, SterilMed stated that it does not join in or oppose his arguments on behalf of DCHS and that SterilMed considered itself the manufacturer of the reprocessed SUDs per FDA regulations and/or guidance.

15. On October 28, 2013, DCHS filed a timely claim in SterilMed's name for refund of the $62,951 in use tax remitted by SterilMed during the claim period.

16. By letter dated December 14, 2015, the Department denied the claim for refund. This timely appeal followed.

## DISCUSSION

California imposes sales tax on all a retailer's retail sales of TPP in this state, unless the sale is exempt or excluded from tax. (Rev. & Tax. Code (R&TC), § 6051.) The sales tax is imposed upon retailers for the privilege of selling TPP at retail in this state (R&TC, § 6051), although the retailer may collect sales tax reimbursement from the purchaser if the contract of sale so provides (Civ. Code, § 1656.1(a)). Sales tax is measured by a retailer's gross receipts, and all gross receipts are presumed taxable until proven otherwise, unless the retailer timely and in good faith takes from the purchaser a certificate to the effect that the property is purchased for resale. (R&TC, §§ 6051, 6091, 6092; Cal. Code Regs., tit. 18, § 1668(a).)

When sales tax does not apply, use tax applies to the storage, use, or other consumption of TPP purchased from any retailer for storage, use, or other consumption in this state, measured by the sales price, unless that use is specifically exempted or excluded by statute. (R&TC, §§ 6201, 6401.) It is presumed that TPP sold by any person for delivery in this state is sold for storage, use, or other consumption in this state until the contrary is established. (R&TC, § 6241.) Generally, use tax is owed by the person using or storing the property in this state. (R&TC, § 6202(a).) However, retailers engaged in business in this state have an obligation to collect use tax from the purchaser on sales of property for use, storage, or other consumption in this state. (R&TC, § 6203(a).) A retailer who is not engaged in business in this state may apply for a Certificate of Registration – Use Tax. (Cal. Code Regs., tit. 18, § 1684(e).) Holders of such certificates are required to collect tax from purchasers and pay the tax to the Department in the same manner as retailers engaged in business in this state. (*Ibid*.; see also *B & D Litho, Inc.* (Board Memorandum Opinion) 5/31/2001.)

California Code of Regulations, title 18, section (Regulation or Reg.) 1524 states that tax applies to sales to consumers by manufacturers, producers, processors, and fabricators of TPP the sale of which is not otherwise exempted. Similarly, "[t]ax applies to charges for producing, fabricating, processing, printing, or imprinting of tangible personal property for a consideration for consumers who furnish either directly or indirectly the materials used in the producing,

fabricating, processing, printing or imprinting." (Reg. 1526(a).) However, tax usually does not apply to such charges when the operation merely repairs or reconditions TPP "to refit it for the use for which it was originally produced." (Reg. 1526(b).) If the process of reconditioning TPP involves comingling of similar TPP delivered to the processor such that the customer receives reconditioned property which may not be the identical property delivered to the reconditioner, tax applies to the amount charged by the reconditioner for reconditioned property. (Reg. 1546(c)(5); see *Continental Water Conditioning Co.* v. *State Board of Equalization* (1989) 207 Cal.App.3d 783.)

Appellant argues that it is entitled to a refund of the use tax remitted because SterilMed was not a retailer of the SUDs. It contends SterilMed is a service provider, and that SterilMed's customers hire SterilMed to recondition SUDs to allow additional use. Appellant acknowledges that the analysis and outcome might be different for charges made after March 2013, but it argues that for the claim period, SterilMed reconditioned property belonging to a customer and returned that same property to the same customer when the work was completed.

The relationship between SterilMed and its customers is legally defined by the contract. The only contract provided by the parties (appellant's Exhibit 1 and the Department's Exhibit D) appears, for the most part, to be a group purchasing contract. We find nothing in the contract that refers specifically to the process of retrieval, reprocessing and return of SUDs that is described elsewhere in the evidence. Specifically, we find no contract term that required SterilMed to return reprocessed SUDs to the last user. To the extent commingling occurred during the audit period, Regulation 1546(c)(5) and the *Continental Water Conditioning Co*. case, *supra*, would control, tax would apply, and the Department's denial of the claim for refund should be sustained. The evidence does not establish that there was no commingling. At best, it establishes that SterilMed promoted itself on its website by promising to return SUDs to the last user. Nevertheless, we will examine the evidence to determine whether a different result would follow if there had been no commingling.

There is no dispute that SterilMed took possession of the SUDs after their customers' first use. Once used, the SUDs were medical waste and of no value to the customer, except to the extent that SterilMed could make them available for another use at a cost substantially less

than a new SUD.[3] The customer deposited the used SUDs in a SterilMed container. SterilMed sorted the contents of its containers, disposed of those not deemed suitable for reprocessing, and marked those that were suitable for reprocessing to identify and track the SUDs. SterilMed then reprocessed the SUDs and held them in its inventory until a customer ordered SUDs for reuse or SterilMed otherwise disposed of them.

Although not specifically stated in the contract, SterilMed's customers allowed SterilMed to take the used SUDs and reprocess them. The circumstances indicate that this was a transfer of ownership. It was either a sale by the customer to SterilMed, the consideration being SterilMed's assumption of the disposal obligation[4] and its promise to make reprocessed SUDs available to the customer, or, the customer simply gave the SUDs to SterilMed by disposing of it in containers controlled by SterilMed.

There is substantial evidence that SterilMed took title to the SUDs when it took possession at a customer's facility. First, SterilMed had complete control of the SUDs once the customer deposited them into the containers after use. It was not required by the contract or otherwise to reprocess or return any particular SUD to the customer. While SterilMed's business model depended on its ability to successfully reprocess the SUDs for reuse by its customers, and the customer's willingness to pay for the opportunity to reuse the SUD, SterilMed evaluated the products and determined which ones were eligible for reprocessing. Mr. Bholat stated that the customer might also have some input into whether a device was eligible for reprocessing if, for example, it did not want to reuse the device more than three times. But that did not limit SterilMed's discretion. It merely informed SterilMed in advance that the customer would not reuse the SUD. It did not control what SterilMed did with it. Only SterilMed decided what to do with a SUD once it took possession of it. SterilMed could reprocess it or it could dispose of it; it could return it to the last user for a charge or it could sell it to another user; and it was not required to obtain consent from anyone.[5]

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[3] Mr. Bholat argued that the cost of a SterilMed reprocessed SUD was only a small fraction of the cost of a new SUD.

[4] A used SUD was medical waste. It was no longer an asset to the customer. It was a liability in that disposal of medical waste was (and remains) strictly regulated. (See Health & Saf. Code, div. 104, pt. 14.)

[5] Appellant argues that SterilMed returned processed SUDs to the last user until it changed its business practices after the claim period. However, the contract did not require that, and we have no testimony or other evidence that this invariably occurred. Furthermore, when SterilMed changed its business practices, it simply sent a letter to customers telling them about the change.

Just as SterilMed assumed complete control of the SUDs, it is equally clear that the customer relinquished all control. While we do not have the benefit of testimony or other evidence from SterilMed or its customers on the issue, it is reasonable to infer that SterilMed's customers did not want to retain title to, and therefore responsibility for, the SUDs that were no longer in its possession. As we note, above, the SUDs were medical waste and more a liability than an asset. What the customers wanted was an opportunity to acquire a number and type of reprocessed SUDs at least equal to the number and type of its own SUDs that SterilMed reprocessed.

The fact that the contract does not specifically state that the customers were transferring title to SterilMed is immaterial. The contract is silent on much of what occurred here. As stated earlier, the contract has the appearance of a standard group purchasing contract for goods and services, and it says nothing about the process by which the customers delivered the used SUDs to SterilMed. Mr. Bholat explained that his client, or rather, the purchasing group of which his client was a member, prepared the contract, which is sufficiently generic to cover many different situations. Nevertheless, as we have already explained, there is other evidence that establishes that SterilMed had possession of and title to the SUDs when it reprocessed them.

Appellant's reliance on Regulation 1526(b) is misplaced. As explained above, SterilMed's role is distinguishable from the role of a service provider that is paid to recondition property. When an owner of TPP hires someone to return the TPP to "new" condition, there is a clear understanding that the owner is agreeing to pay for the service and retrieve his or her TPP (or identical TPP left by someone else) when the work is done. At hearing, appellant made it clear that SterilMed first reprocessed the SUDs and then informed the customers that they were available for reuse; but the customers were not required to order reprocessed SUDs. In other words, SterilMed did the work but did not require the customer to pay for the service or retrieve SUDs.

Appellant also overstates the effect of SterilMed's representations on its website that the customer gets back SUDs last used by the customer. First, the contracting parties' rights and obligations are determined by reference to the contract. Section 15.14 of the contract states that it constitutes the entire understanding and agreement between the contracting parties. Section 15.20 of the contract states, "In the event of any conflict between this Agreement and any document, instrument or agreement prepared by [SterilMed] …, the terms of this Agreement

shall control." Second, and as already noted, the contract did not require SterilMed to return SUDs to the last user. On the contrary, and as basically conceded by appellant, the parties intended the contract to be generic, and it did not have to be modified when SterilMed abandoned its preferred practice of returning SUDs to the last user, what SterilMed referred to as a "closed loop," and instead moved SUDs to its open sales inventory if the last user did not submit a purchase order within 30 days. SterilMed simply sent a notice to its customers informing them of the change. There is no evidence that the process for transferring the used SUDs to SterilMed was handled differently after the change.

Finally, although we do not give great weight to these matters, it at least appears that the FDA views SUD reprocessors as having the same responsibilities as the original manufacturers in some regards, such as labeling,[6] and SterilMed considers itself the manufacturer of the reprocessed SUDs according to FDA regulations and/or guidance. Based on the evidence, we find that SterilMed had possession of and title to the SUDs when it reprocessed them, that SterilMed then sold the SUDs back to its customers. On that basis, we conclude that use tax was due in connection with the subject transactions.

## HOLDING

Appellant is not entitled to a refund of use tax for the period July 1, 2010, through December 31, 2012.

[6] As Mr. Bholat explained at the hearing, SterilMed duplicated the original manufacturer's label information.

## DISPOSITION

We sustain the Department's denial of appellant's claim for refund.

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Michael F. Geary
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Michael F. Geary
Administrative Law Judge

I concur:

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Daniel K. Cho
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Daniel K. Cho
Administrative Law Judge

Concurring opinion of Linda C. Cheng, writing separately:

I concur with the majority holding but write separately to clarify the basis of my conclusion. In support of its position that its contract with SterilMed pertaining to the reprocessed devices is one of service, Daughters of Charity Health Systems (DCHS) references two annotations,[7] one of which describes the transaction that took place here. Annotation 515.0016.200 provides that when a medical equipment company has a contract with a hospital to store, clean, maintain, inspect, deliver, and retrieve medical equipment owned by the hospital, there is no transfer of tangible personal property to the hospital when providing such services. In such instances, the medical equipment company is providing a nontaxable service to the hospital. This is because the true object of the contract is the service per se, rather than the property. (Cal. Code Regs., tit. 18, § 1501.) Certainly, if hospitals elected to sterilize and reprocess the used devices themselves, they would not be deemed to sell the devices back to themselves.

In the instant appeal, however, DCHS fails to show that the contract at issue is one for cleaning services rather than a sale of reprocessed devices. The applicable burden of proof here is by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(c); *Appeal of Estate of Gillespie*, 2018-OTA-052P, at p. 4.) That is, appellant must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Concrete Pipe and Products of California, Inc. v. Construction Laborers Pension Trust for Southern California* (1993) 508 U.S. 602, 622.) To satisfy its burden of proof, a taxpayer must prove both (1) the tax assessment is incorrect, and (2) the proper amount of the tax. (*Paine v. State Bd. of Equalization* (1982) 137 Cal.App.3d 438, 442; *Honeywell, Inc. v. State Bd. of Equalization* (1982) 128 Cal.App.3d 739, 744.) DCHS has not proven, by a preponderance of the evidence, that the California Department of Tax and Fee Administration's determination that the subject transactions are taxable is incorrect.

For support, DCHS points to Section 2.0 of the contract which states that SterilMed agrees to provide "the products and services" described in the attached exhibit, contending that the reprocessed devices fall within the "services" rather than "products" portion of the contract. However, nowhere in the contract or the attached exhibit is the distinction made between devices that are reprocessed (or serviced) versus those that are sold. To the extent that the written

[7] Annotations do not have the force or effect of law. (Cal. Code Regs., tit. 18, § 5700, subds. (a)(1), (c)(2).)

contract is ambiguous or imperfect, we can look to extrinsic evidence for clarification. (Code Civ. Proc., § 1856, subds. (b), (e).) DCHS's reliance on SterilMed's FAQ webpage and historical website information to support its contention that it retained title to the reprocessed devices is unpersuasive. While it is compelling as a marketing tool that "SterilMed guarantees that the same device collected at [the hospital's] facility are [sic] returned to [the hospital]" and "every device is returned to its owner," this evidence does not speak to the issue of title ownership or retention.

In fact, when queried whether DCHS removed the reprocessed devices from its product inventory after being collected by SterilMed, appellant's representative admitted he did not know the answer. Likewise, no answer was given to the question whether SterilMed added the reprocessed devices to its sales inventory and claimed the cost of goods sold on its tax returns. Had appellant been able to answer these factual questions in the negative, arguably it might have shown that it was more likely than not that DCHS retained title to the reprocessed devices such that the contract was for cleaning services rather than sales of reprocessed tangible personal property. As tenuous as the circumstantial evidence of title transfer from DCHS to SterliMed is (i.e., inferred from the contract), appellant simply has not met its burden to show, by a preponderance of the evidence, that DCHS retained title to the reprocessed devices.

On these grounds, I concur with the majority holding.

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Linda C. Cheng
Administrative Law Judge