OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18022352
	) CDTFA Case ID: 976743
R. ATKINS	)
	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Malcolm A. Brudigam, Attorney Robert P. Merten III, Attorney Carley A. Roberts, Attorney
For Respondent:	Amanda Jacobs, Tax Counsel III Monica Silva, Tax Counsel IV Jason Parker, Chief of Headquarters Operations

A. KWEE, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, R. Atkins dba Naturally Organic Sleep (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] denying appellant's petition of an August 3, 2016, Notice of Determination (NOD). The NOD is for $29,236.80 in tax, plus accrued interest, for the period January 1, 2013, to March 31, 2014 (liability period).

Office of Tax Appeals (OTA) Administrative Law Judges Andrew J. Kwee, Keith T. Long, and Josh Aldrich held an oral hearing for this matter on October 13, 2020.[2] At the conclusion of the hearing, the record was closed, and this matter was submitted for decision.

[1] Sales taxes were formerly administered by the Board of Equalization (board). Effective July 1, 2017, functions of the board relevant to this case were transferred to CDTFA. (Gov. Code, § 15570.22.) When this opinion refers to acts or events that occurred before July 1, 2017, "CDTFA" shall refer to its predecessor, the board.

[2] The oral hearing was noticed for Sacramento, California, and conducted electronically due to COVID-19.

ISSUES

1. Whether CDTFA timely issued the NOD.
2. Whether appellant made exempt sales of prescription medicines.
3. Whether the doctrine of equitable estoppel applies as to any portion of the liability.

FACTUAL FINDINGS

1. Starting in 2008, and continuing through the liability period, appellant sold all-organic mattresses at retail in this state. Appellant also sold bed frames and accessories. Appellant purchased the mattresses from Eco Mattress Store (supplier) in Illinois for purposes of resale to consumers.
2. Appellant's supplier informed appellant in writing:

> Our research found that prescription mattresses qualify as durable medical equipment and are exempt from sales taxes in every state except IL . . . **(But you should not rely on our statements and check with your state or tax advisor.)** [Emphasis in original.]

3. Appellant's supplier also required appellant to obtain a prescription signed by the customer's physician, osteopath, or chiropractor before the supplier shipped a prescription mattress to the purchaser.[3] The prescription states, in pertinent part: "I authorize the Eco Mattress Store to obtain a prescription mattress, free from toxins or any flame retardant chemicals, for my patient."
4. Appellant did not charge, collect, or remit any sales tax to CDTFA in connection with her sale of prescription mattresses during the liability period. On her sales and use tax returns during the liability period, appellant reported gross sales of $471,166, and claimed deductions of $424,952. Appellant claimed line 10 "Other (clearly explain)" deductions of $420,801 for all of her disallowed claimed exempt sales of prescription mattresses. Appellant also claimed a $4,141 deduction for sales tax included in the

[3] The information from appellant's supplier states: "[B]y law we must have on file a written prescription to a named individual . . . from a physician, osteopath, or chiropractor, before we can ship a prescription toxin free mattress or mattress and foundation set." Appellant also submitted a declaration under penalty of perjury, signed by her husband, stating that appellant "claimed all sales of mattresses to patients with valid prescriptions as exempt sales."

selling price of her $46,214 in reported taxable transactions ($471,166 - $424,952 = $46,214).

5. Appellant incorporated the business as Naturally Organic Sleep, Inc., effective April 1, 2014.

6. On March 9, 2016, CDTFA informed appellant that her account was selected for an audit.[4] This was appellant's first audit.

7. On March 24, 2016, appellant signed a three-month waiver of limitation, giving CDTFA until July 31, 2016, to timely issue an NOD for the liability period.

8. Upon audit, appellant did not provide books or records to support the disallowed claimed exempt sales. Appellant contends she only had documentation for exempt sales made during the third quarter of 2013 (3Q13).[5] Appellant contends she lost her supporting documentation for the other quarters when she incorporated the business on April 1, 2014. Appellant contends that the disallowed sales for the remaining quarters also qualify as exempt sales of prescription mattresses.

9. On May 5, 2016, appellant signed a six-month waiver of limitation; the waiver indicated that CDTFA had until January 31, 2017, to timely issue an NOD for the liability period.

10. CDTFA accepted $93,054 of the claimed deductions as exempt sales in interstate commerce and disallowed all the remaining claimed deductions of $327,747 ($420,801 - $93,054 = $327,747). It is undisputed that the disallowed measure is $327,747, and that this represents disallowed sales of mattresses being claimed as exempt sales of medicines.[6]

[4] CDTFA concurrently audited the corporation's account for the period April 1, 2014, through September 30, 2015. We do not further discuss the audit of the corporation because it is not at issue in this appeal.

[5] CDTFA accepted this documentation and projected the amount of allowed exempt sales in interstate commerce for 3Q13 to the remainder of the liability period and allowed 22.11% of appellant's claimed "other" deductions on this basis.

[6] CDTFA initially disallowed the entire $420,801 in claimed exempt sales of prescription medicines. During the audit process, appellant alternatively claimed that some of the disallowed sales were exempt sales in interstate commerce. Based on a review of the documentation, CDTFA accepted 22.11 percent (here, $93,054) of the disallowed sales on this basis. The parties do not dispute this percentage allocation.

11. CDTFA issued the NOD to appellant on August 3, 2016, for the liability disclosed by audit, which appellant petitioned. CDTFA denied the petition in a decision dated September 27, 2017. This timely appeal followed.[7]

12. On appeal, appellant submitted a declaration under penalty of perjury, from her husband, H. Atkins, stating that appellant sold the mattresses claimed as exempt pursuant to valid prescriptions. H. Atkins further declared that he called CDTFA in 2008 and was orally advised that sales of mattresses made pursuant to a valid prescription are exempt from sales tax.

DISCUSSION

Issue 1: Whether CDTFA timely issued the NOD.

R&TC section 6487 generally provides for a three-year statute of limitations for CDTFA to issue an NOD. (R&TC, § 6487(a).) As an exception, the statute of limitations is eight years in the case a failure to file a return, and it is tolled indefinitely in the case of fraud. (*Ibid*.) Furthermore, when a taxpayer timely consents in writing to an extension of the statute of limitations (waiver of limitation), the NOD may be mailed at any time prior to the expiration of the period agreed upon. (R&TC, § 6488.) In the case of a waiver of limitation, the time period to file a claim for refund is also extended for the same time period as the statute of limitations for CDTFA to issue an NOD. (R&TC, § 6902(b).) In the instant case, there is no dispute that appellant timely executed two waivers of limitation, which collectively extended the statute of limitations to January 31, 2017. There is also no dispute that CDTFA issued the NOD prior to this date, on August 3, 2016. Therefore, we find that CDTFA timely issued the NOD within the meaning of R&TC section 6487.

Appellant separately challenges the validity of the NOD on the basis that the waivers of limitation are invalid. Appellant contends that the two waivers of limitation are not valid (and thus, the NOD is invalid) because CDTFA failed to obtain a supervisor's approval before presenting the waivers to appellant for signature. CDTFA promulgated California Code of Regulations, title 18, section (Regulation) 1698.5 which provides, in pertinent part:

[7] In its decision, CDTFA denied the petition on the basis that mattresses do not qualify as medicines. CDTFA's decision did not address as an issue whether the mattresses were sold pursuant to a valid prescription. On appeal, CDTFA disputes both whether the mattresses: (1) qualify as medicines and (2) were sold or furnished in an exempt manner. (See R&TC, § 6369(a); Cal. Code Regs., tit. 18, § 1591(d)(1).)

> (b) . . . This regulation provides taxpayers and Board staff with the necessary procedures and guidance to facilitate the efficient and timely completion of an audit . . . ¶ (3) Supervisory approval of the circumstances which necessitated the request for the waiver will be documented in the audit before the waiver is presented to the taxpayer for signature.

(Cal. Code Regs., tit. 18, § 1698.5(b)(3).) Here, CDTFA did not submit direct documentary evidence of such supervisor approval. CDTFA did submit as an exhibit its audit work papers (AWPs), and the AWPs do not appear to contain direct documentary evidence of such supervisory approval.

CDTFA contends that the requisite documentary evidence may be inferred based on the involvement of supervisory staff, which is documented in the audit.[8] On this contention, CDTFA primarily relies on a March 18, 2016 letter from the District Principal Auditor (one of the auditor's supervisors), addressed to the appellant, and stating that it was necessary to issue an estimated billing because CDTFA was unable to contact appellant to discuss the audit or investigation. CDTFA contends this is sufficient evidence of supervisor approval of the need for a waiver, because the letter was sent before appellant was asked to sign the waiver. Alternatively, CDTFA contends that there is no provision in the law which would invalidate an otherwise valid waiver of limitation due to CDTFA's failure to follow Regulation 1698.5.

CDTFA is bound to follow its own regulations. (See *Newco Leasing, Inc., et al. v. State Bd. of Equalization* (1983) 143 Cal.App.3d 120, 124; *Appeal of Talavera*, 2020-OTA-022P; *Appeal of Micelle Laboratories*, 2020-OTA-290P.) Regulation 1698.5 implements R&TC sections 7053 and 7054 which govern the requirement of a taxpayer to maintain books and records, and the authority of CDTFA to examine those books and records, respectively. (Cal. Code Regs., tit. 18, § 1698.5 [reference notes].) The regulation's reference notes are consistent with CDTFA's stated intent for adopting Regulation 1698.5:

> The proposed regulation will implement, interpret, and make specific [R&TC section] 7053, which requires sellers, retailers, and consumers to maintain sales and use tax records in such form as [CDTFA] may require and section 7054, which authorizes [CDTFA] to examine records, property, and persons, and conduct investigations to verify the accuracy of returns and accurately ascertain sales and use tax liabilities.

[8] This is a new contention that CDTFA raised during the oral hearing. In response, appellant asserted during the hearing that the available documentation is insufficient to satisfy the requirements of the regulation.

(Register 2010, No. 3.)[9] The stated intent is also consistent with subdivision (b), which states the purpose of Regulation 1698.5: "this regulation provides taxpayers and [CDTFA] staff with the necessary procedures and guidance to facilitate the efficient and timely completion of an audit." (Cal. Code Regs., tit. 18, § 1698.5(b).) In summary, Regulation 1698.5 sets forth CDTFA's audit policies and procedures.

OTA does not have jurisdiction to determine whether an appellant is entitled to a remedy for CDTFA's alleged violation of any substantive or procedural right, unless the violation affects the adequacy of a notice, the validity of an action from which a timely appeal was made, or the amount at issue in the appeal. (Cal. Code Regs., tit. 18, § 30104(d).) As such, OTA lacks authority to enforce an alleged violation of CDTFA audit policies and procedures such as those set forth in Regulation 1698.5, unless a violation thereof impacts the adequacy of the NOD, the validity of CDTFA's decision, or the amount at issue. (Cal. Code Regs., tit. 18, § 30104(d).) Regulation 1698.5 does not interpret or implement R&TC sections 6487 or 6488, pertaining to the statute of limitations and waivers of limitation, respectively, nor does it cite either section as a reference or authority for its promulgation. Moreover, Regulation 1698.5, Audit Procedures, neither cites to nor authorizes any enforcement mechanism with respect to either the responsibilities imposed on taxpayers or on CDTFA.

Even if Regulation 1698.5 did interpret the waiver requirements of R&TC section 6488, there is no remedy which OTA or CDTFA is legally authorized to provide with respect to the auditor's alleged failure to document obtaining a supervisor's approval prior to presenting appellant with a waiver of limitation for signature. To the contrary, Regulation 1698.5(b) provides that: "[a] waiver of limitation that is signed by the taxpayer prior to the statute expiration date extends the period in which a [NOD] may be issued." It is undisputed that appellant signed the waivers prior to the statute expiration date. As such, we find that there is no remedy which OTA may provide with respect to an alleged failure of CDTFA to follow its own audit policies and procedures in Regulation 1698.5, such as the requirement to involve a supervisor during the waiver process. (See Cal. Code Regs., tit. 18, § 30104(d).)

In summary, we find that the alleged violation of the audit policies and procedures set forth in Regulation 1698.5 does not affect the adequacy or timeliness of the NOD, because the

[9] The California Regulatory Notice Register is maintained by the Office of Administrative Law. See www.oal.ca.gov/wp-content/uploads/sites/166/2017/05/3z-2010.pdf.

waiver is legally complete and valid. There is no argument or evidence that CDTFA's decision or the amount at issue are otherwise impacted. As such, we find that an auditor's alleged failure to obtain supervisor approval prior to presenting a waiver of limitation to a taxpayer for signature has no impact on the validity of the waiver, once signed by the taxpayer. Based on all the above, we need not address whether CDTFA sufficiently documented supervisor approval as required by Regulation 1698.5.[10]

Issue 2: Whether appellant made exempt sales of prescription medicines.

California imposes sales tax measured by a retailer's gross receipts from the retail sale of tangible personal property in this state unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, § 6051.) All of a retailer's gross receipts are presumed subject to tax until the contrary is established. (R&TC, § 6091.) The courts have concluded that statutes granting exemption from taxation must be reasonably, but nevertheless strictly, construed against the taxpayer. The taxpayer has the burden of showing that s/he qualifies for the exemption. An exemption will not be inferred from doubtful statutory language; the statute must be construed liberally in favor of the taxing authority, and strictly against the claimed exemption. (*Standard Oil Co. v. State Bd. of Equalization* (1974) 39 Cal.App.3d 766.)

The law exempts from tax the sale of medicines, when those medicines are prescribed and sold or furnished under one of six specified conditions. (R&TC, § 6369(a)(1)-(6).) Only two of those conditions are at issue or otherwise relevant to the instant appeal. The first pertinent condition is when the medicines are furnished by a licensed physician, dentist, optometrist, or podiatrist to his or her own patient for the treatment of the patient. (R&TC, § 6369(a)(2).) The second specified condition is the sale of medicines prescribed for the treatment of a human being by a person authorized to prescribe the medicines and dispensed on prescription filled by a registered pharmacist. (R&TC, § 6369(a)(1).)

For purposes of this exemption, medicines are defined as "any substance or preparation intended for use by external or internal application to the human body in the diagnosis, cure,

[10] At the oral hearing, CDTFA contended that it sufficiently documented supervisor approval. Based on our finding that supervisor approval has no impact on the validity of waivers signed by the taxpayer, we need not address appellant's contention that CDTFA has the burden of proving that CDTFA sufficiently documented supervisor approval in the audit file.

mitigation, treatment, or prevention of disease and commonly recognized as a substance or preparation intended for that use." (R&TC, § 6369(b).) Notwithstanding the above definition of medicines, the law specifically provides that the following six items will qualify as medicines for purposes of the sales and use tax exemption:

> (1) Sutures, whether or not permanently implanted.
>
> (2) Bone screws, bone pins, pacemakers, and other articles, other than dentures, permanently implanted in the human body to assist the functioning of any natural organ, artery, vein, or limb and which remain or dissolve in the body.
>
> (3) (A) Orthotic devices, other than orthodontic devices, designed to be worn on the person of the user as a brace, support, or correction for the body structure, and replacement parts for these devices . . . ¶
>
> (4) Prosthetic devices, and replacement parts for those devices, designed to be worn on or in the person of the user to replace or assist the functioning of a natural part of the human body . . .
>
> (5) Artificial limbs and eyes, or their replacement parts, for human beings.
>
> (6) Programmable drug infusion devices to be worn on or implanted in the human body.

(R&TC, § 6369(c).) The law goes on to specifically exclude from the definition of medicines any "[a]rticles that are in the nature of . . . supports, dressings, instruments, apparatus, contrivances, appliances, devices, or other mechanical, electronic, optical, or physical equipment or article or the component parts and accessories thereof." (R&TC, § 6369(b)(2).) Regulation 1591 interprets and implements this section, and further clarifies that arch supports, cervical pillows, and hospital beds are excluded from the definition of medicines within the meaning of R&TC section 6369(b)(2).[11] (Cal. Code Regs., tit. 18, § 1591(c)(2).)

The issue presented here is whether organic mattresses are "medicines" as defined above. Mattresses do not meet the general definition of medicines, which only includes a "substance or preparation intended for use by external or internal application to the human body" for the treatment of a disease. (R&TC, § 6369(b).) This definition is limited to items such as prescription drugs approved by the United States Food and Drug Administration (FDA), and

[11] R&TC section 7051 grants CDTFA the authority to prescribe, adopt, and enforce rules and regulations relating to the administration and enforcement of the Sales and Use Tax Law. The courts have concluded that the legislative delegation in R&TC section 7051 is proper even though it confers some degree of discretion on CDTFA. (*Henry's Restaurants of Pomona, Inc. v. State Bd. of Equalization* (1973) 30 Cal.App.3d 1009, 1020.)

other substances or preparations for application to the human body which are commonly recognized for use in the diagnosis, cure, mitigation, treatment or prevention of disease. (See Cal. Code Regs., tit. 18, § 1591(a)(9)(A)&(B).) CDTFA has historically interpreted "commonly recognized" as a medicine to mean: (1) general acceptance as indicated by the greater weight of opinion in the medical community, as may be documented by medical journals or authoritative scientific publications or pronouncements from authoritative regulatory institutions; or (2) constitutional, statutory, or controlling case law establishing that the substance or preparation in question is a medicine as a matter of law. (See, e.g., Business Taxes Law Guide Annotation (Annotation) 425.0053.100 (11/17/08).)[12] We agree with this interpretation.

Here, appellant did not submit documentary evidence to support her position that her mattresses were commonly recognized as medicines in the medical community, applicable regulatory institutions, or otherwise as a matter of law. Furthermore, appellant concedes that the mattresses were not approved by the FDA to diagnose, cure, mitigate or treat any disease. As such, we conclude that the mattresses are not medicines within the meaning of R&TC section 6369.

Having failed to meet the definition of a medicine, a mattress can only qualify as an exempt product for purposes of this tax exemption if the mattress falls within one of the six specifically included items in R&TC section 6369(b)(1)-(6). For these purposes, a mattress is not a suture (item one), permanently implanted in the human body (item two), an orthotic device worn on the body (item three), a prosthetic device used to replace a natural part of the human body (item four), an artificial limb (item five), or a programmable drug infusion device (item six). Therefore, we find that sales of mattresses do not qualify for the prescription medicine exemption set forth in R&TC section 6369. Furthermore, our finding is consistent with Regulation 1591, which clarifies that sales of items such as arch supports, pillows, and beds do not qualify for the exemption. (Cal. Code Regs., tit. 18, § 1591(c)(2).) In summary, the mattresses do not meet the statutory definition of a medicine. Furthermore, the mattresses do not

[12] Annotations do not have the force or effect of law; however, OTA may apply its own independent judgement in determining the weight to afford an annotation, and such annotations may be entitled to great weight. (*Appeal of Praxair, Inc*., 2019-OTA-301P; *Appeal of Martinez Steel Corporation*, 2020-OTA-074P.)

meet one of the six specifically included items for purposes of this exemption.[13] Therefore, appellant failed to establish that she made any exempt sales of prescription mattresses.

Issue 3: Whether the doctrine of equitable estoppel applies as to any portion of the liability.

R&TC section 6596 provides for relief of taxes, interest, and penalties under certain circumstances where a taxpayer's failure to timely pay the tax is due to reasonable reliance on written advice provided by CDTFA (or, prior to July 1, 2017, the board). (R&TC, §§ 20, 6596(a).) Here, it is undisputed that R&TC section 6596 does not authorize relief of the tax liability because appellant failed to obtain written advice from CDTFA advising appellant that sales of prescription mattresses are exempt from tax in this state. Instead, appellant requests relief from the liability on equitable grounds due to her alleged reliance on oral advice provided by CDTFA to her husband.

As a general matter, equitable powers can only be exercised by a court of general jurisdiction. (See *Standard Oil Co. v. State Bd. of Equalization*, *supra*.) As an administrative agency, we lack constitutional authority to exercise judicial powers. (Cal. Const., Art. 6, § 1.) Under limited circumstances where doing so is otherwise consistent with the law, a non-constitutional administrative agency may exercise equitable estoppel without violating Article 3, Section 3.5 of the California Constitution, which provides that an administrative agency may not refuse to enforce a statute. (*Lentz v. McMahon* (1989) 49 Cal.3d. 393, 402-403.) Thus, for example, the California Supreme Court has concluded that a statute authorizing an administrative agency to "fairly and equitably" construe the law conferred authority on that agency to apply the doctrine of equitable estoppel during an administrative hearing. (*Ibid*.)

In the instant appeal, the fact remains that OTA is an administrative agency and we have no authority under the California Constitution to decline to enforce the clear and unambiguous provisions of R&TC section 6596, which explicitly requires written advice, under conditions set

[13] Although appellant failed to submit any signed prescriptions, the blank prescription form that appellant submitted authorized a physician, osteopath, or chiropractor to sign the prescription. Based on our finding that mattresses do not qualify as medicines for purposes of the exemption, we need not address any further issues, such as whether appellant otherwise sold the mattresses in an exempt manner, or whether a prescription signed by an osteopath or chiropractor is a valid prescription, for purposes of the exemption in R&TC section 6369. Appellant also contends CDTFA has the burden to prove appellant's mattresses were not "[f]urnished by a licensed physician and surgeon, dentist, or podiatrist to his or her own patient for the treatment of the patient" in order to qualify for exemption, because CDTFA's decision did not dispute that appellant met the statutory requirement that medicines must be furnished in an exempt manner. Based on our finding that mattresses are not medicines for purposes of the exemption in R&TC section 6369, we need not address this contention.

forth therein, in order to grant relief of taxes. (Cal. Const., Art. 3, § 3.5.) Under these facts, applying the doctrine of equitable estoppel to grant relief under circumstances where we are explicitly barred by statute from granting such relief would directly contravene the clear language of R&TC section 6596. As such, we conclude that OTA lacks authority to apply the doctrine of equitable estoppel to grant relief of taxes based on written or oral advice, regardless of whether the elements of equitable estoppel were met. Furthermore, we cannot create an exemption that is not authorized by law. (See *Market Street Railway Co. v. State Bd. of Equalization* (1955) 137 Cal.App.2d 87, 96-97.) Therefore, we find that even if appellant relied on oral advice from an employee of CDTFA or the board, OTA lacks authority, in law or equity, to grant relief of the taxes on this basis unless specifically provided for by R&TC section 6596.[14] As indicated above, R&TC section 6596 is inapplicable because there was no written advice. Therefore, we find no basis for relief of all or any portion of the taxes, or interest accrued thereon, at issue in this appeal.

[14] Appellant cites *Appeal of John M. Sedillo*, 2018-OTA-101P, for the proposition that OTA has equitable powers. This case did not conclude that OTA has equitable powers because it concluded the taxpayer's equitable estoppel claim was without merit. Furthermore, that case did not involve a scenario where, as here, OTA is barred by statute from providing the relief requested. Here, R&TC section 6596 requires written advice from CDTFA and it is undisputed that there is no written advice.

HOLDINGS

1. CDTFA timely issued the NOD.
2. Appellant's retail sales of organic mattresses do not qualify as exempt sales of prescription medicines.
3. The doctrine of equitable estoppel is inapplicable for purposes of granting relief of taxes based on reliance on oral advice.

DISPOSITION

CDTFA's action in denying the petition is sustained.

DocuSigned by:
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Andrew J. Kwee
Administrative Law Judge

We concur:

DocuSigned by:
Josh Aldrich
48745BB806914B4...
Josh Aldrich
Administrative Law Judge

DocuSigned by:
DC88A60D8C3E442...
Keith T. Long
Administrative Law Judge

Date Issued: 11/18/2020