OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 20056171
	) CDTFA Case IDs 085-056; 085-054; 085-055
POMONA VALLEY COMMUNITY HOSPITAL, LTD	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Brian Nisenholtz, Representative Stan Pincura, Representative
For Respondent:	Jarrett Noble, Tax Counsel III Randy Suazo, Hearing Representative Scott Claremon, Tax Counsel IV
For Office of Tax Appeals:	Deborah Cumins, Business Taxes Specialist III

S. BROWN, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6901, Pomona Valley Community Hospital, LTD (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] partially denying appellant's claims for refund for the periods July 1, 2008, through June 30, 2011; July 1, 2011, through December 31, 2012; and July 1, 2008, through December 31, 2012.

Office of Tax Appeals (OTA) Administrative Law Judges Andrew Wong, Josh Lambert, and Suzanne B. Brown held an oral hearing for this matter on April 21, 2021.[2] At the conclusion of the hearing, the record was closed and this matter was submitted for decision.

[1] Sales and use taxes were formerly administered by the State Board of Equalization (BOE). In 2017, functions of BOE relevant to this case were transferred to CDTFA. (Gov. Code, § 15570.22.) For ease of reference, when this Opinion refers to acts or events that occurred before July 1, 2017, "CDTFA" shall refer to BOE; and when this Opinion refers to acts or events that occurred on or after July 1, 2017, "CDTFA" shall refer to CDTFA.

[2] The hearing was conducted electronically with the agreement of the parties.

ISSUES

1. Whether two purchases of software from 3M should be regarded as errors for the purpose of computing the percentage of use tax paid to vendors in error.
2. Whether the purchase of the EsophyX device for use in California was exempt from use tax.

FACTUAL FINDINGS

1. Appellant operates eight hospital facilities in eastern Los Angeles and western San Bernardino counties, providing inpatient and outpatient health care services.
2. Appellant filed a total of three claims for refund of overpayments of use tax paid to vendors with respect to purchases of medicines and fixed assets. Appellant also claimed refunds for use tax that appellant reported on returns.[3] The claims were dated October 26, 2011 (for the period July 1, 2008, through June 30, 2011), February 1, 2013 (for the period July 1, 2011, through December 31, 2012), and November 4, 2015 (for the period July 1, 2008, through December 31, 2012). Each of the claims showed the amounts of overpayment as $1 or such other amounts as may be established.
3. On or about September 17, 2012, appellant's representative contacted 3M regarding appellant's purchases of software from 3M in the amounts of $57,961 on March 22, 2010, and $96,597 on April 21, 2010. In response to that inquiry, 3M indicated that the software had been transmitted electronically and thus the use tax appellant had paid should be credited back to appellant. On September 24, 2012, 3M issued credit memos to appellant for the erroneously collected use tax.
4. In response to appellant's claims for refund, CDTFA held a pre-audit conference with appellant on January 15, 2013. CDTFA also conducted an audit of appellant for the period July 1, 2008, through December 31, 2012.
5. To establish the amounts of claimed overpayments of use tax paid to vendors and use tax reported to CDTFA, appellant established 2010 as a test period. For that test period, appellant reviewed all amounts of use tax paid to vendors and use tax accrued and paid to

[3] Some of the transactions included in appellant's claims represented alleged overpayments of sales tax. CDTFA removed these transactions from consideration for refund, and they are not at issue in this appeal.

CDTFA. Appellant established two separate percentages of error and applied each percentage to the relevant base to compute the claimed overpayments.[4]

6. In appellant's test of use tax paid to vendors, the questioned items included the two purchases of software from 3M in the amounts of $57,961 on March 22, 2010, and $96,597 on April 21, 2010, for which appellant had paid use tax to the vendor. Appellant included those two transactions as errors in its computation of a percentage of overpayment of use tax to vendors.

7. In June 2010, appellant made a tax-paid purchase of the EsophyX System in the amount of $20,400 from vendor Endogastric Solutions. The EsophyX System is used to fuse gastrointestinal tissue for treatment of gastroesophageal reflux disease, which occurs when stomach acid flows back into the tube connecting the mouth and stomach. The EsophyX System consisted of an EsophyX device, an endoscopic surgical instrument used to deploy fasteners, and fasteners, akin to skin sutures. The EsophyX device is a disposable instrument packaged and sold with fasteners as one unit and used for one surgical procedure. The EsophyX device can be reloaded with additional fasteners during the same procedure, but it is not sterilized and reused in a separate procedure. While the device is sold along with the fasteners as one unit, it is not sold preloaded or prefilled with the fasteners.

8. During the audit, CDTFA contacted the vendor, 3M, regarding the two software purchases mentioned above. The vendor stated that it had issued credit memos for the erroneously collected use tax on September 24, 2012, shortly after appellant's representative had contacted the vendor to inquire about whether the software had been transmitted electronically. In the audit workpapers, CDTFA states that it treated these two purchases from 3M as non-recurring and unusual transactions. CDTFA concluded that, since the use tax had been refunded to appellant prior to any contact by CDTFA, the two transactions should not be regarded as errors in the test period and should be excluded from the computation of the percentage of overpayment to be applied to the remainder of the claim period.

[4] Appellant also conducted an actual review of purchases of certain fixed assets. All of those claimed overpayments established on an actual basis have been resolved.

9. On September 25, 2017, CDTFA issued a Report of Field Audit-Revised,[5] which reflected an overpayment of tax of $327,754.52, measured by $3,598,174.[6] In that revised audit, CDTFA established percentages of overpayment of 12.49 percent for use tax paid to vendors and 35.62 percent for use tax accrued and paid to CDTFA. Those percentages were used to establish the amounts of claimed overpayments of use tax for the periods July 1, 2008, through December 31, 2009, and January 1, 2011, through December 31, 2012.

10. Appellant disputed the audited amount of the refund and requested an appeals conference pursuant to CDTFA's internal appeals process. On January 22, 2019, CDTFA issued a Decision which ordered a reaudit. As relevant here, the Decision concluded that the 3M purchases should not be included as errors in the computation of the percentage of overpayment of use tax to vendors. The Decision also concluded that appellant's purchase of the EsophyX System from Endogastric Solutions for use in California was exempt from use tax because the product contains both exempt (i.e., fasteners) and taxable (i.e., EsophyX device) items within each unit purchased.

11. On February 21, 2019, CDTFA[7] filed a Request for Reconsideration (RFR), disputing the finding in the Decision that appellant's purchase of the EsophyX System and use in California qualified as exempt use of medicines.

12. On May 3, 2019, appellant filed an RFR disputing the Decision's conclusion that the 3M purchases should not be included as errors in the computation of the percentage of overpayment of use tax to vendors.

13. On September 16, 2019, CDTFA issued a Supplemental Decision, ordering a reaudit to apportion the purchase price of the EsophyX System between exempt and non-exempt amounts and to make other adjustments regarding appellant's exempt purchase of

[5] This superseded the original Report of Field Audit dated April 15, 2016.

[6] CDTFA found overstatements of reported taxable measure of: $3,551,293 (use tax erroneously accrued or erroneously paid to vendors); $769,914 (tax-paid purchases resold of soda and disposable food containers sold with meals); $122,627 (exempt sales of meals on wheels); $101,438 (tax-paid purchases resold of cups sold with meals; and $165,131 (erroneously accrued use tax or use tax paid to vendors on purchases of fixed assets). It also found understatements of reported taxable measure of $86,200 (difference between sales tax accrued and reported; $376,637 (ex-tax purchases of fixed assets); and $649,393 (ex-tax purchases of consumable supplies).

[7] CDTFA's Business Tax and Fee Division conducted the audit and filed the February 21, 2019, Request for Reconsideration. CDTFA's Legal Division, Appeals Bureau, conducted the appeals conference and issued the Decision and Supplemental Decision in this matter.

medicines for use in California. The Supplemental Decision continued to find that the two purchases from 3M should not be considered errors for purposes of computing the percentage of overpayment of use tax to vendors.

14. CDTFA conducted a second revised audit, in which it computed percentages of overpayment of 12.60 percent for use tax paid to vendors and 37.62 percent for use tax accrued and paid to CDTFA. In the second revised audit, the overstatement of reported taxable measure was increased from $3,598,174 to $3,779,165.

15. In an April 2, 2020, letter to appellant, CDTFA stated that the additional overpayment of tax should have been $16,590. However, because of errors in entering local and county tax information into CDTFA's computer system, CDTFA had refunded to appellant the amount of $30,494. The letter stated that a Notice of Erroneous Refund would be issued to appellant for $13,904 ($30,494 - $16,590).

16. This timely appeal followed.

DISCUSSION

Use tax applies to the storage, use, or other consumption of tangible personal property 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 tangible personal property 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.)

CDTFA may refund any amount, penalty, or interest that has been paid more than once or has been illegally collected or computed. (R&TC, § 6901.) A retailer engaged in business in this state is required to collect the applicable use tax from the purchaser at the time of the sale of property to be used in this state and give the purchaser a receipt therefor. (R&TC, § 6203(a); Cal. Code Regs., tit. 18, § 1684(a).) When CDTFA ascertains that a retailer has collected use tax from a customer in excess of the amount required to be collected, or has collected from a customer an amount which was not tax but was represented by the retailer to the customer as being use tax, no refund of such amount is to be made to the retailer even though the retailer has paid the amounts so collected to the state. (R&TC, § 6901; Cal. Code Regs., tit. 18, § 1684(h).) Instead, any overpayment of use tax must be credited or refunded to the purchaser who made the overpayment. (*Ibid*.) A taxpayer who claims a refund bears the burden of establishing its

entitlement thereto. (*Honeywell, Inc. v. State Bd. of Equalization* (1982) 128 Cal.App.3d 739, 744-745.)

Issue 1: Whether two purchases of software from 3M should be regarded as errors for the purpose of computing the percentage of use tax paid to vendors in error.

CDTFA's Audit Manual (Audit Manual)[8] states that an audit made on a test basis is one in which the transactions of only a part of the audit period are examined in detail. The balance of the period is adjusted on the basis of the findings in the test period. This basis assumes that the differences disclosed in the test period, which are audited in detail, will occur in the same proportion in the balance of the audit period. (Audit Manual, § 0405.20.) In CDTFA's audit tests, if taxable sales of a non-recurring nature are disclosed, those sales are to be excluded from the calculation of the percentage of error. Then, all sales of a similar nature are to be examined for the entire audit period and handled separately from the understatement established using a percentage of error. (Audit Manual, § 0405.20(e).)

The Audit Manual clarifies that underpayments and overpayments must be treated equally when reviewing a taxpayer's records. Sampling and projection techniques may be used by taxpayers to determine the amount of overpayment of tax liability using criteria similar to the techniques used by auditors to establish underpayments or overpayments. (Audit Manual, § 0401.05.)

In this matter, appellant conducted a test of use tax payments to vendors for the year 2010, computed a percentage of overpayment, and applied that percentage to use tax payments to vendors in the remainder of the claim period. CDTFA accepted appellant's selection of the year 2010 as a test period. Appellant identified several erroneous payments of use tax to vendors, including the two purchases of software from 3M in March and April 2010. There is no dispute that the vendor collected use tax from appellant in excess of the amount required to be collected.

During the audit, in its review of the claim for refund, CDTFA contacted 3M and found that 3M had issued credit memos for the erroneously collected use tax shortly after appellant had contacted 3M to verify that the software had been transmitted electronically. CDTFA concluded that, since the use tax had been refunded to appellant prior to any contact by CDTFA, the two

[8] CDTFA's Audit Manual summarizes CDTFA's audit policies and procedures. It is a useful resource that OTA may look to for guidance in interpreting the law; however, it is not binding legal authority. We refer to the Audit Manual here because it establishes that CDTFA has a defined procedure for addressing tests conducted in audits.

transactions should not be regarded as errors in the test period and should be excluded from the computation of the percentage of overpayment to be applied to the remainder of the claim period.

Appellant argues that for purposes of computing the percent of overpayment, the purchases from 3M should remain in the test as errors. Appellant asserts that the errors were similar to erroneously claimed sales for resale for which the purchaser pays the tax after receiving an "XYZ" letter[9] during an audit. Typically, in that event, the erroneously claimed nontaxable sale for resale is considered an error for the purpose of establishing a percentage of error. (See Audit Manual, § 0405.20(j).) Appellant states that, in essence, its representative had acted as the auditor, conducting its own investigation. On that basis, appellant asserts that the refund of the use tax had not been made until appellant's representative contacted 3M and, thus, the purchases should remain as errors in the test.

Further, appellant argues that a refund should be governed by the refund claim period, not the audit period, and contends that the use tax was not refunded by the vendor during the applicable claim period. Appellant states that when it received the refund from 3M in September 2012, appellant had filed a claim for refund only for the period July 1, 2008, through June 30, 2011. Appellant notes that it did not file a claim for refund for the period July 1, 2011, through December 31, 2012, until February 1, 2013.

Relying on Audit Manual section 1302.25, CDTFA argues that any sampled transactions that are subsequently debited or credited due to a discount, return, bad debt, or refund should be considered a non-error. CDTFA also points to the fact that the auditor had completed a form CDTFA-472, an audit sampling plan, which included a specific reference to Audit Manual section 1302.25. The audit sampling plan stated "if a sample unit is an error, but the transaction is corrected within the audit period, the sample unit will be considered a non-error." CDTFA notes that appellant had refused to sign the audit sampling plan and that the information and methods documented in this form are not binding on either the taxpayer or CDTFA staff. (See Audit Manual, § 1302.05.) Nevertheless, it concludes that there is no reason to depart from the guidance in the form. CDTFA contends that since the erroneously collected use tax was refunded by 3M before the end of the audit period, the two purchases should not be regarded as errors for the purpose of the test.

[9] XYZ letters are CDTFA-approved letters sent to a seller's customers when the seller has claimed the transaction as a nontaxable sale for resale; the XYZ letters inquire as to the disposition of property the customer has purchased. (Cal. Code Regs., tit. 18, § 1668(f).)

The purpose of an audit sampling plan is to have agreement between the parties before the sampling begins. (Audit Manual, § 1302.05.) Given that appellant did not sign the audit sampling plan, we do not consider the plan to be controlling regarding how we should treat the errors at issue. To that extent, we find unconvincing CDTFA's position regarding the audit sampling plan.

The purpose of projecting errors from a test period is to establish a percentage of the tested transactions that is representative of the taxpayer's actual business operations during the remainder of the audit period or claim period. Hence, we find that the key question is whether the type of error identified in the 3M purchases was likely to occur again in the remainder of the claim period. On this issue, use of a test basis assumes that the differences disclosed in the test period, which are audited in detail, will occur in the same proportion in the balance of the audit period. (Audit Manual, § 0405.20.) If that is not the case, then there is no basis to include the two purchases as errors for the purpose of computing a percentage of overpayment of use tax.

Here, the amounts of these two software purchases from 3M were $57,961 and $96,597. The parties agree that appellant is not due a refund of use tax with respect to these two transactions because 3M already credited the tax to appellant's account. Therefore, we consider what the evidence shows regarding the likelihood that during the remainder of the claim period, appellant made other purchases of software, that the software related to those other purchases was delivered electronically, and that the vendors erroneously collected use tax on those purchases.

We have reviewed each of the purchases that appellant identified as transactions for which it paid use tax to vendors in error. Appellant identified several purchases of electronically transmitted software updates, software maintenance contracts, and software support, all of which were purchased during the 2010 test period.[10] The amounts of overpaid taxable measure for two of those purchases (from McKesson) are $3,348 and $4,021. The measures of the remaining overpayments range from $48 to $1,170. Clearly, none of those purchases are for a complete software program. Moreover, the amounts of the purchases are only a fraction of the cost of the computer programs purchased from 3M. Accordingly, the evidence indicates these purchases of software updates, maintenance contracts, and software support are not similar to the purchases

[10] Appellant made purchases from BD diagnostics (1 purchase), Cerner (5 purchases), McKesson (2 purchases), MZI Healthcare (9 purchases), and Noble Systems (12 purchases).

from 3M. Hence, the evidence does not show that purchases similar to the 3M transactions reoccurred during the test period.

In addition, we note that on Schedule 12D-2b of the audit workpapers, the comments state that the auditor treated these two purchases from 3M as non-recurring and unusual transactions; the date of that schedule is May 5, 2016. Accordingly, appellant was put on notice that CDTFA considered the purchases of software from 3M to be non-recurring. However, appellant has not provided evidence of other purchases of software during the remainder of the claim period for which appellant erroneously paid use tax to the vendor.[11] Given the lack of any evidence of additional erroneous payments of use tax on software programs during the remainder of the claim period, we have no basis to conclude that similar errors occurred during that period.

In light of all of the above, we find that the evidence fails to establish that the purchases of electronically transmitted software from 3M, for which appellant erroneously paid use tax to its vendor, were likely recurring transactions.[12] Consequently, we find that the purchases from 3M should not be regarded as errors for the purpose of computing a percentage of overpayment of use tax.

Issue 2: Whether the purchase of the EsophyX device for use in California was exempt from use tax.

R&TC section 6369 provides a tax exemption for sales and use of medicines, when those medicines are prescribed and sold or furnished under specified conditions for the treatment of a human being. R&TC section 6369(c)(2) and California Code of Regulations, title 18, (Regulation) section 1591(b)(2) explain that the term "medicines" also includes any "article . . . 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," including sutures, regardless of whether they are permanently implanted. In contrast, surgical instruments and devices are excluded from the definition of medicines for sales and use tax purposes, and thus sales and use of those items

[11] In response to the OTA panel's questions at hearing about whether these types of purchases were recurring errors, appellant stated that it frequently makes software purchases for which its payment of tax is incorrect; however, appellant indicated that these examples are not in evidence because they occurred after the period at issue in this appeal.

[12] Since the transactions were non-recurring, it would have been appropriate for CDTFA to remove them from the test, for purposes of computing the percentage of overpayment, regardless of whether the vendor had already refunded the use tax before the audit was conducted.

are not exempt from tax. (R&TC, § 6369(b)(2); Cal. Code Regs., tit. 18, § 1591(c)(2).) Exemptions from tax are strictly construed against the taxpayer. (*H. J. Heinz Co. v. State Board of Equalization* (1962) 209 Cal.App.2d 1, 4.) The party claiming an exemption bears the burden of showing that it clearly comes within the terms authorizing exemption. (*Ibid.*)

There is no dispute that the fasteners, akin to sutures, qualify as "medicines" for sales and use tax purposes under R&TC section 6369 and Regulation section 1591. The question on appeal is whether the EsophyX device, a surgical instrument that deploys the fasteners, also meets the definition of "medicines" under that exemption. Appellant contends that the EsophyX device qualifies as a medicine because it is sold prepackaged with the fasteners. In support of its position, appellant points to CDTFA Sales and Use Tax Annotation (Annotation)[13] 425.0853 (6/11/1991) (Am. 2002–3), which states that disposable staplers and staples qualify as medicines because they are sold and used as a unit, and their sales are exempt from tax.

With exceptions (under Regulation section 1591(b)) not applicable here, R&TC section 6369 and Regulation section 1591 specifically exclude "instruments" and "devices" from the definition of medicines for sales and use tax purposes. (R&TC, § 6369(b)(2); Cal. Code Regs., tit. 18, § 1591(c)(2).) As one exception, the law specifically provides that certain non-returnable and non-reusable *needles* pre-attached to a suture are regarded as a part of the suture for purposes of this exemption. (Cal. Code. Regs., tit. 18, § 1591(b)(2).) There is otherwise no specific statutory or regulatory inclusion in the definition of medicine for other types of disposable medical equipment or instruments attached to a suture. Consequently, to the extent that Annotation 425.0853 relies on a distinction between disposable versus durable in analyzing whether a stapler meets this exemption's definition of "medicines," we give little weight to this annotation's analysis of whether disposable staplers qualify as medicines under R&TC section 6369 and Regulation section 1591.

In contrast, other legal guidance is consistent with the regulatory language that surgical instruments and devices, when not shipped preloaded with sutures, are excluded from the

[13] Annotations are not binding authority and do not have the force or effect of law. (Cal. Code Regs., tit. 18, § 5700(a)(1); *Appeal of Martinez Steel Corporation*, 2020-OTA-074P.) However, OTA may give some consideration to annotations and will independently determine the appropriate weight to afford an annotation. (*Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1, 15 (*Yamaha*); *Appeal of Martinez Steel Corporation*, *supra*.) The weight given to an annotation in a particular case will depend upon "the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control." (*Yamaha*, *supra*, 19 Cal.4th at pp. 14-15, quoting *Skidmore v. Swift & Co.* (1944) 323 U.S. 134, 140.)

definition of medicines. For example, regarding an endoscopic stapling system that delivered tacks permanently implanted in the body, when the delivery system was not shipped preloaded, the tacks qualify as sutures under Regulation section 1591, but the rest of the delivery system is excluded from the regulation's definition of "medicines." (Annotation 425.0607 (6/5/96).)

We note that there appears to be no dispute that the exemption for sales and use of containers, pursuant to R&TC section 6364 and Regulation section 1589, is not applicable here. When a skin stapler is sold pre-filled and is not reusable, and the contents of the stapler meet Regulation section 1591's definition of "medicines," the cartridge containing the staplers constitutes a container sold with contents. (R&TC, § 6364(a); Cal Code Regs., tit. 18 § 1589(b)(1)(A); Annotation 425.0926 (9/25/95).) In contrast, while the EsophyX device is sold prepackaged with the fasteners, it is not prefilled and does not contain the fasteners within the device, and therefore is not acting as a container.

For the above reasons, we find that the purchase of the EsophyX device for use in California was not exempt from use tax.

HOLDINGS

1. The purchases of software from 3M should not be regarded as errors for the purpose of computing the percentage of use tax paid to vendors in error.
2. The purchase of the EsophyX device for use in California was not exempt from use tax.

DISPOSITION

CDTFA's actions partially denying appellant's claims for refund for the periods July 1, 2008, through June 30, 2011, July 1, 2011, through December 31, 2012, and July 1, 2008, through December 31, 2012, are sustained.

DocuSigned by:
Suzanne B. Brown
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Suzanne B. Brown
Administrative Law Judge

We concur:

DocuSigned by:
Josh Lambert
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Josh Lambert
Administrative Law Judge

DocuSigned by:
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Andrew Wong
Administrative Law Judge

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