OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	OTA Case No. 18042986
	CDTFA Case ID: 812466
SPECIALIZED ORTHOPEDIC SOLUTIONS, INC.,	
dba SOS Medical	

OPINION

Representing the Parties:

For Appellant:	Marcus Allen Frishman, Representative Mark Cummins, Representative
For Respondent:	Amanda Jacobs, Attorney Chad Bacchus, Attorney Randolph (Randy) Suazo, Hearing Representative
For Office of Tax Appeals:	Corin Saxton, Attorney

J. ALDRICH, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Specialized Orthopedic Solutions, Inc., dba SOS Medical (appellant) appeals respondent California Department of Tax and Fee Administration's (CDTFA)[1] decisions to partially deny appellant's petition for redetermination with respect to a Notice of Determination (NOD) that CDTFA timely issued on April 10, 2014, for the period July 1, 2010, through June 30, 2013 (liability period).[2] The NOD is for tax of $208,427.86, plus applicable interest. CDTFA's Decision and Recommendation (D&R) issued on September 21, 2016, called for a reaudit. Pursuant to the reaudit, CDTFA reduced the deficiency measure by $7,023, resulting in a corresponding reduction to the tax and applicable interest. Subsequently, appellant

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

[2] The NOD was timely issued because appellant filed its returns on an annual basis, and the NOD was issued within three years of the last day of the calendar month following each of the one-year periods at issue. (R&TC, § 6487(b).)

submitted an untimely request for reconsideration (RFR) to CDTFA. In response, CDTFA issued a Supplemental Decision on March 16, 2018, recommending no additional adjustments.

Office of Tax Appeals (OTA) Administrative Law Judges Michael F. Geary, Richard Tay, and Josh Aldrich held an oral hearing for this matter in Cerritos, California, on September 14, 2023. At the conclusion of the oral hearing, the record was closed and this matter was submitted on the oral hearing record pursuant to California Code of Regulations, title 18, (Regulation) section 30209(b).[3]

ISSUE

Whether further adjustments to the determined measure of tax are warranted.

FACTUAL FINDINGS

1. Appellant sells and leases prosthetics, orthotics, and other medical supplies. Appellant purchases durable medical equipment (DME) ex-tax (i.e., without the payment of tax or tax reimbursement) and sells or rents the DME to its customers to whom the DME has been prescribed.
2. On September 12, 2013, CDTFA began an audit of appellant's business for the liability period.
3. During the liability period, appellant claimed all sales and leases as exempt sales of medicine. CDTFA examined appellant's claimed exempt sales on an actual basis (i.e., each transaction was examined using appellant's records).
4. CDTFA disallowed claimed exempt sales and leases of pneumatic compression devices, heat and cold therapy devices, and DME used with such devices, such as wraps, tubes, or

[3] At the beginning of the hearing, appellant objected to OTA's August 8, 2023 Prehearing Order denying appellant's subpoena request. OTA took appellant's objection under submission. During the hearing, appellant clarified that it did not dispute the audit methodology and that the issue before OTA was legal in nature; that is, whether the products at issue are exempt from tax. Such a legal determination does not require the presence of the original auditor. Accordingly, OTA overruled appellant's objection. After the record closed, appellant submitted an untimely additional brief. To the extent that appellant raises new issues or arguments in its untimely additional brief, OTA declines to consider or address them. (Cal. Code Regs., tit. 18, §§ 30213(a)(7), 30412.)

blankets.[4] CDTFA disallowed the claimed exempt sales and leases because it concluded that the items did not fall under the definition of medicine according to Regulation section 1591. During the audit, CDTFA noted that Regulation section 1591(b)(5) states prosthetic devices that do not qualify as exempt medicine include, but are not limited to, air compression pumps and pneumatic garments. Further, CDTFA noted that its Sales and Use Tax Annotations (annotations) specify that compression devices do not qualify as exempt medicine, citing to the following annotations: 425.0022.700 (10/15/96), which concluded that cold compression therapy units do not qualify as medicine; 425.0883.200 (03/02/95), which concluded that anti-embolism stockings qualify as exempt prosthetic devices if they are worn on the patient and they operate separately from a compression system, whereas a system that provides compression therapy which is comprised of a compression sleeve, pump, and tubing connecting the sleeve and the pump is not exempt medicine; and 425.0170 (10/14/93), which concludes that air compression pumps and pneumatic garments do not qualify as exempt prosthetic devices because they are not fully worn on the body.

5. In reaching these conclusions, CDTFA examined the manufacturer's product descriptions. According to the descriptions, the "Cold Therapy Units, NanoTherms, Protherms, and VascuTherm, and their parts are considered compression devices."[5] CDTFA then considered whether the items were permanently implanted articles under Regulation section 1591(b)(2), or whether the items were artificial limbs pursuant to Regulation section 1591(b)(3), but concluded these subdivisions were inapplicable to the disallowed items. The disallowed items, collectively referred to as the items at issue, are described in evidence as follows:

[4] The pneumatic compression devices and heat and cold therapy devices consist of a motorized or electronic unit not worn on the body, which is connected through a series of accessories (i.e., tubes to a wrap or blanket) worn on the affected area of the body. Pneumatic compression devices apply intermittent, sustained, and graduated compression to the body in order to provide pain relief and prevent the formation of blood clots. Heat and cold therapy devices provide heat or cold, or alternating heat and cold, to the body in order to provide pain relief or to reduce swelling.

[5] CDTFA's D&R states "according to [appellant], all of the equipment it sold and leased is capable of providing both pneumatic compression and heat and cold therapy, and that its VascuTherm [device] is also capable of providing 'DVT prophylaxis,' which is a specific form of compression therapy used to assist in preventing the formation of deep vein blood clot."

a. The "cold therapy unit" is a motorized device that will continuously circulate cold water through DME to cool the extremity and provide pain relief and reduce swelling.
b. The "heat/cold unit" is a motorized device that will continuously circulate cold or hot water through DME to cool or heat the extremity and provide pain relief and reduce swelling.
c. The IceMan cold therapy cooler is a device that will continuously circulate cold water through DME to cool the extremity to reduce the need for post-operative pain medications, reduce swelling, and facilitate rehabilitation.
d. The "manual cold therapy unit" is manually operated devices and delivers continuous cold therapy through DME to the extremity.
e. NanoTherm is an electronic heating and cooling system that provides precisely controlled fluid temperature for cooling and heating through DME to the extremity.
f. Pro Thermo is a device that delivers heat, cold, contrasting heat and cold, and/or compression through a DME to the extremity.
g. VascuTherm is a device that delivers heat, cold, contrasting heat and cold, and/or compression through DME to the extremity.
h. The disallowed DME included the following: NanoTherm medium shoulder wrap is a cold therapy blanket; knee full nonsterile; "cold therapy blanket shoulder"; "nonsterile hip temperature therapy blanket"; standard knee wrap NanoTherm; "temp. therapy wrap with knee blanket"; "mini wrap"; "standard hip wrap"; and wrap knee standard half leg unfilled.[6]

6. CDTFA also disallowed a single $55 sale of electrodes. The electrodes consist of small pads that are attached to the patient, and a wire connected to an electrotherapy stimulation device which is not worn on the body. Electrodes apply electrical stimulation to the targeted area to provide pain relief. CDTFA disallowed the electrode sale based on Regulation section 1591(c)(2).

[6] OTA notes that the audit workpapers scheduled three sales or leases of an item described as "phantom nano," and the record is unclear as to exact nature of this DME.

7. On March 27, 2014, CDTFA completed an audit report for the liability period, in which CDTFA identified a $2,269,515 deficiency measure for disallowed claimed exempt sales of medicine.
8. On April 10, 2014, CDTFA issued the NOD to appellant and appellant filed a timely petition for redetermination.
9. By memorandum dated February 24, 2016, CDTFA recommended the measure be reduced by $6,348 for "dummy rentals", which were inventory management entries, and not taxable sales or leases. By email dated August 16, 2016, CDTFA recommended the measure be reduced by $675 for foam abductors, which CDTFA found to be exempt medicine.
10. CDTFA issued the D&R on September 21, 2016, recommending the deficiency measure be reduced by $7,023, from $2,269,515 to $2,262,492.
11. In accordance with the D&R, CDTFA issued a reaudit report on February 22, 2017, reducing the deficiency measure to $2,262,491.[7]
12. Appellant filed an untimely RFR on September 18, 2017, and CDTFA issued a Supplemental Decision on March 16, 2018, recommending no additional adjustments.
13. This timely appeal followed.

DISCUSSION

California imposes a sales tax on a retailer's gross receipts from the retail sale of tangible personal property in this state unless the sale is specifically exempt from taxation by statute. (R&TC, §§ 6021, 6051.) A "lease" or "rental" is a granting of possession of tangible personal property by a lessor to a lessee for a consideration. (R&TC, §§ 6006.1, 6006.3.) Generally, a lease of tangible personal property is a continuing sale and purchase for the duration of the lease, and tax is due on the rentals payable.[8] (R&TC, §§ 6006.1, 6010.1; Cal. Code Regs., tit. 18, § 1660(b)(2), (c)(1).)

In the case of an appeal under the Sales and Use Tax Law, CDTFA has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Talavera*,

[7] The $1 difference between the measure in the D&R and the reaudit appears to be an immaterial arithmetic error in appellant's favor.

[8] Although not applicable here, a retailer may make an irrevocable election to pay use tax measured by his or her purchase price instead of paying tax on the rentals. (Cal. Code Regs., tit. 18, § 1660(b)(1), (c).)

2020-OTA-022P.) Once that burden is met, the taxpayer must prove: (1) that the tax assessment is incorrect, and (2) the proper amount of the tax. (*Appeal of AMG Care Collective*, 2020-OTA-173P.) Here, appellant does not dispute that it sold the contested items for the amounts determined; rather, the sole dispute is whether those sales were exempt. A taxpayer bears the burden of proving entitlement to an exemption or exclusion. (*Appeal of Owens-Brockway Glass Container, Inc.*, 2019-OTA-158P; *Standard Oil Co. v. State Bd. of Equalization* (1974) 39 Cal.App.3d 765, 769.) Thus, OTA must decide whether the evidence establishes that appellant correctly claimed the exemptions.

Generally, medicines are exempt from tax when sold or furnished by a health facility for treatment of any person pursuant to the order of a licensed physician, dentist, or podiatrist. (R&TC, § 6369(a)(3); Cal. Code Regs., tit. 18, § 1591(d)(3).) Tax also does not apply to the sale or use of medicines prescribed for the treatment of a human being by a person authorized to prescribe the medicines and dispensed on a prescription filled by a registered pharmacist in accordance with law. (R&TC, § 6369(a)(1); Cal. Code Regs., tit. 18, § 1591(d)(1).)[9]

"Medicines" means any substance or preparation intended for use by external or internal application to the human body in the diagnosis, cure, mitigation, treatment, or prevention of disease and commonly recognized as a substance or preparation intended for that use. (R&TC, § 6369(b).) Regulation section 1591(a)(9)(B), (b)(1) interprets and implements R&TC section 6369(b), and it provides an illustrative list of "preparations and similar substances,"[10] such as drugs, antibiotics, aspirin, baby lotion, oil and powder, enema preparations, hydrogen peroxide, lubricating jelly, medicated skin creams, oral contraceptives, vaccines, and other items of that nature. "Medicines" also means orthotic devices designed to be worn on the person of the user, such as a brace, support, or correction for the body structure. (R&TC, § 6369(c)(3)(A); Cal. Code Regs., tit. 18, § 1591(b)(4).)[11] If any part of the orthotic device is not worn on the

[9] For those transactions deemed sales or leases of medicine, the record is unclear as to whether CDTFA accepted these sales of medicine as exempt on the basis of subdivision (d)(1) or subdivision (d)(3) of Regulation section 1591. In any event, it is undisputed that the transactions at issue are nontaxable if they are found to be sales or leases of medicines.

[10] Thus, although R&TC section 6369(b) refers to "any substance or preparation," Regulation section 1591(b)(1) refers to "preparations and similar substances."

[11] Orthotic devices furnished pursuant to a written order of a physician by medical device retailers are deemed to be dispensed on a prescription within the meaning of Regulation section 1591(d)(1), and do not need to be furnished by a pharmacist for purposes of this regulation.

person, the device is not a medicine. (Cal. Code Regs., tit. 18, § 1591(b)(4).) "Medicines" does not include articles that are in the nature of splints, bandages, pads, compresses, 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); Cal. Code Regs., tit. 18, § 1591(c)(2).)

Appellant primarily argues that the sales of the items at issue should be allowed as tax exempt sales of medicine on two bases. First, appellant argues that its products constitute a substance or preparation pursuant to R&TC section 6369(b) and Regulation section 1591(a)(9)(B). Specifically, appellant argues that its products are a medical treatment, a medical product, or a medicine that have the same effects on the body (i.e., reducing swelling and lowering the risk of blood clots) that prescription medicines, steroids, lubricants, or menthol, would provide. Second, appellant argues that its products constitute orthotic devices pursuant to R&TC section 6369(c)(3)(A) and Regulation section 1591(b)(4). Specifically, appellant argues that its products are braces that immobilize the limb and provide compression and heat/cold therapy.[12] Appellant concedes that its "braces"[13] are connected to a power unit that is plugged into a wall, but appellant argues that this should not exclude the lease or sale of the brace from being tax exempt. In addition to appellant's primary arguments, it also argues that the annotations relied upon by CDTFA are not law, are not enforceable, and are a "scam."[14]

CDTFA argues that exemptions from tax are to be strictly construed against the taxpayer to avoid enlarging or extending the concession of tax beyond the plain meaning of the language used in granting it. (*Associated Beverage Company v. State Bd. of Equalization* (1990) 224 Cal.App.3d 196, p 211). CDTFA notes that R&TC section 6369(b) and Regulation section 1591(c)(2) exclude from the definition of medicines those articles that are in the nature of splints, bandages, pads, compresses, supports, dressings, instruments, apparatus, contrivances,

[12] Appellant argues that all of the disallowed products at issue here are VascuTherm devices, which provide both compression and heat/cold therapy. However, the description of items scheduled in the audit working papers and the literature appellant provided upon audit indicates that the transactions CDTFA disallowed involved products other than VascuTherm. Therefore, OTA finds this assertion lacks merit.

[13] The audit working papers do not characterize any of the DME as "braces", but instead refer to them as "wraps" and "blankets."

[14] To the extent that appellant made other arguments, OTA has considered them and rejected them or otherwise found them to be inapplicable to the analysis. For example, appellant argues that all the products were furnished pursuant to a prescription, which CDTFA does not appear to dispute.

appliances, devices, or other mechanical, electronic, optical, or physical equipment or article or the component parts and accessories thereof. CDTFA argues that, for over 30 years, its position has been that compression and hot/cold therapeutic products are not medicines within the meaning of R&TC 6369(a). In support, CDTFA cites to the following annotations: 425.0022.700 (10/15/96), which concludes that cold compression therapy units do not qualify as medicine; 425.0170 (10/14/93), which concludes that air compression pumps and pneumatic garments do not qualify as exempt prosthetic devices because they are not fully worn on the body; 425.0292 (08/01/89), which concludes that continuous passive motion pads and hypothermia blankets, which are used in conjunction with hot/ice machines, to promote post-operative healing are subject to tax because they do not qualify as orthotic devices; 425.0293 (04/06/88), which concludes that Cryomat and Cryopak (i.e., reusable liquid filled therapeutic ice products) are not medicines because no ingredient or comparable component of Cryomat or Cryopak are absorbed by the body; 425.0512 (03/22/93), which concludes, in pertinent part, that pneumatic compression units or accessories, alternating pressure pads and pumps are excluded from the definition of medicine, and as such are subject to tax; 425.0883.200 (03/02/95), which concludes that anti-embolism stockings qualify as exempt prosthetic devices if they are worn on the patient and they operate separately from a compression system, whereas a system that provides compression therapy which is comprised of a compression sleeve, pump, and tubing connecting the sleeve and the pump is not exempt medicine; and 425.1000 (05/20/93), which concludes that Wright Linear Pumps, which are used to reduce swelling compression is an appliance, device, or article within the meaning of Regulation section 1591(c), and are subject to tax. In sum, CDTFA argues that the items at issue are excluded from the definition of exempt medicine.

With respect to appellant's first argument, that its products constitute a substance or preparation pursuant to R&TC section 6369(b) and Regulation section 1591(a)(9)(B), preparations and similar substances is defined in Regulation section 1591(b)(1), which includes a non-exhaustive list of items as follows:

> [D]rugs such as penicillin, and other antibiotics, "dangerous drugs" (drugs that require dispensing only on prescription); alcohol (70% solution) and isopropyl; aspirin; baby lotion, oil, and powder; enema preparations; hydrogen peroxide; lubricating jelly; medicated skin creams; oral contraceptives; measles and other types of vaccines; topical creams and ointments; and sterile nonpyrogenic distilled water. Preparations and

> similar substances applied to the human body in the diagnosis, cure, mitigation, treatment, or prevention of disease qualify as medicines.

The enumerated items found in Regulation section 1591(b)(1) are typically applied to the body via injection, inhalation, ingestion, or topical application, and the therapeutic effect of those medicines is the result of the administration of the substance or preparation. (See Cal. Code Regs., tit. 18, § 1591(a)(1).) The enumerated items appear to be largely chemical or biological in nature, whereas the items at issue here are not. The items at issue tend to operate through principles of physics such as thermodynamics, pneumatics, or hydraulics. Although the intended effect of appellant's devices, in some instances, is similar to that of the substances listed in Regulation section 1591(b)(1), the physical properties of appellant's devices are readily distinguishable from that of the preparations and similar substances listed therein. For example, ibuprofen and the VascuTherm device could both reduce swelling. Ibuprofen, however, is likely to be taken orally or applied topically and, in either case, the body would absorb or metabolize the ibuprofen to reduce swelling. In contrast, the VascuTherm device, in conjunction with the necessary DME, provides compression together with temperature control to achieve the same or similar goal. (See annotation 425.0481(01/11/93).) Further, Regulation section 1591 has separate analyses pertaining to devices and DME similar to the ones at issues, which can be found in Regulation section 1591(b)(4) and Regulation section 1591(c)(2). Accordingly, OTA finds that the products at issue here do not constitute medicines on these bases.

Regarding appellant's argument that its products constitute orthotic devices pursuant to R&TC section 6369(c)(3)(A) and Regulation section 1591(b)(4), it is undisputed that appellant's products are not fully worn on the person. Therefore, appellant's argument fails because Regulation section 1591(b)(4) expressly states that if any part of the orthotic device is not worn on the person, the device is not a medicine for purposes of this regulation.

OTA now turns to appellant's assertion that CDTFA's sales and use tax annotations are not law, are not enforceable, and are a "scam." Annotations are not binding on taxpayers, CDTFA, or OTA. (*Appeal of Martinez Steel Corporation*, 2020-OTA-074P.) Annotations are "digests of opinions written by the legal staff of [CDTFA] which are evidentiary of administrative interpretations made by [CDTFA] in the normal course of its administration of the Sales and Use Tax Law." (*Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1, 15 (*Yamaha*).) Pursuant to *Yamaha*, the "annotations have substantial precedential

effect within [CDTFA]" and the "interpretation represented in [the] annotations is certainly entitled to some consideration by [OTA]." (*Ibid*.) Here, OTA finds that the above referenced annotations are entitled to weight because those annotations address items substantially similar to the disallowed items at issue here, and the annotations further interpret Regulation section 1591, which CDTFA promulgated and administers.[15] Further, OTA notes that CDTFA's interpretation of such devices has remained consistent from 1988 through the present. These annotations support OTA's interpretation that the items at issue are not medicine within the meaning of Regulation section 1591(b)(1) and are not exempt orthotic devices within the meaning of Regulation section 1591(b)(4).

In sum, the transactions at issue here involve devices or associated DME, and devices and appliances are generally excluded from the exemption from tax on the sale or use of medicines. (R&TC, § 6369(b)(2); Cal. Code Regs., tit. 18, § 1591(c)(2).) Accordingly, appellant has not shown that any of the disallowed transactions constitute nontaxable sales or leases of medicines or orthotics; therefore, OTA finds that the transactions at issue are taxable.

[15] See annotations 425.0022.700 (10/15/96); 425.0170 (10/14/93); 425.0292 (08/01/89); 425.0293 (04/06/88); 425.0512 (03/22/93); 425.0883.200 (03/02/95); 425.1000 (05/20/93); and 425.0481(01/11/93).

HOLDING

No further adjustments to the determined measure of tax are warranted.

DISPOSITION

Sustain CDTFA's decision to reduce the deficiency measure by $7,023, from $2,269,515 to $2,262,491, and to otherwise deny appellant's petition for redetermination.

DocuSigned by:
Josh Aldrich
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Josh Aldrich
Administrative Law Judge

We concur:

DocuSigned by:
Michael F. Geary
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Michael F. Geary
Administrative Law Judge

DocuSigned by:
Richard Tay
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Richard Tay
Administrative Law Judge

Date Issued: 12/14/2023