CALIFORNIA HOSPITAL ASSOCIATION

Providing Leadership in Health Policy and Advocacy

Ms. Kim DeArte
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450 N Street
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Via Email: CDTFARegulations@cdtfa.ca.gov

Re: Comments on Proposed Revisions to Regulation Sections 1503 and 1591

Dear Ms. DeArte:

Thank you for the opportunity to comment on the California Department of Tax and Fee Administration's (CDTFA) proposed amendments to regulation sections 1503 and 1591. The California Hospital Association (CHA), representing more than 400 hospitals and health systems, strongly opposes the proposed amendments. Our concerns are detailed in the following comments.

CHA also requests a public hearing on this matter and, per the CDTFA's rulemaking protocol, hereby makes the request prior to February 2, 2020, which is before the close of the comment period.

CHA's concerns with the proposed revisions include:

- The changes are contrary to legislative intent.
- The CDTFA should avoid the use of confidential patient medical records to determine taxability.
- The CDTFA cannot subvert the statutory exemption in section 1503 by invoking the "true object" test.
- The "true object" test has been discredited.
- Including a list of property that does not pass to the patient is ill-advised because it is erroneous and subject to change as medical technology advances.
- The CDTFA should replace the effective date of January 1, 2019, with a prospective date so that hospitals can prepare for any finalized changes.

The proposed changes are contrary to legislative intent.

In the proposed revisions, the CDTFA seeks to eliminate an exemption that has been in place for more than 50 years. The background for the existing exemption is much more strongly established than the CDTFA has described in the issue papers, and there have been no changes that would warrant revisiting the exemption language. The longstanding interpretation should prevail, and these sales should remain exempt from tax — as has been the case for more than 50 years.

Historical Context:

Regulation section 1503 reflects longstanding policy and legislative intent that the transactions at issue should be exempt from sales tax. It is our understanding that California Revenue and Tax Code (CRTC) section 6381, enacted in 1943, is a sales tax exemption for sales of tangible personal property to the federal government and its instrumentalities and provides the historic basis for the exemption. CRTC section 6381 (and the related general exemption provided by section 6352, which is based on constitutional considerations) provided the basis for the Medicare Part A exemption set forth in Regulations 1591(f)(2)(A) and 1614(f).

Regulation section 1591(f)(2)(A) provides that the hospital or "medical service facility" is contracting directly with the U.S. government, and sales of tangible personal property related to an insured person's medical care are treated as exempt sales:

> *Medicare Part A. Tax does not apply to the sale of items to a person insured pursuant to Part A of the Medicare Act as such sales are considered exempt sales to the United State Government. Under Part A, the healthcare provider has a contract with the United States Government to provide certain services. Therefore, sales of medicines, devices, appliances, and supplies in which payment is made under Part A qualify as exempt sales to the United States Government.*

Regulation 1503 (through its precursor Board of Equalization Ruling No. 7) originated with the operative date of the Retail Sales Tax Act in 1933. From 1933 to 1970, the rule was that separately stating charges for the tangible personal property was sufficient to establish that a sale of tangible personal property had occurred (i.e., that title to or possession of the tangible personal property had passed for a consideration per CRTC section 6006(a)). In 1970, Regulation 1503 was amended to introduce the administered versus non-administered concept, which narrowed the general rule setting for the circumstances under which a sale would be found to have occurred. The administered versus non-administered concept was discredited and abandoned in 2001. Nothing in the 1970 amendments to Regulation 1503 expressly addresses Medicare Part A transactions. However, the exemption provided in Regulation 1591(f)(2)(A), which was promulgated contemporaneously with the amendments to Regulation 1503, ***does*** expressly address Medicare Part A transactions. Under basic rules of construction and interpretation, the specific controls the general, and the specific exemption for Medicare Part A transactions must be respected.

In 1983, changes were made to federal regulations to specify how billing statements to the federal government under Part A were to be formatted. This formatting change occurred due to congressional action requiring that Medicare Part A reimbursement be based on a per-procedure approach derived from diagnostic-related groups for cost control purposes. Given the Board of Equalization's (BOE) lack of regulatory response to the 1983 changes, the implication is that the BOE did not view the changes as substantive with respect to the application of the Medicare Part A exemption. The non-authoritative annotations published beginning in the late 1980s, suggesting that the formatting change may affect the availability of the Medicare Part A exemption, are not persuasive in light of the BOE's lack of regulatory action — and because these non-authoritative annotations were discredited by the 2001 amendments to Regulation 1503.

In 2001, the BOE abandoned the administered versus non-administered concept and further narrowed the general rules under which a sale of tangible personal property would be found to exist. The formal issue paper for the 2001 amendments expressly states that the Medicare Part A exemption would continue to be available if (1) the transactions were properly structured or (2) as an additional option, a title passage clause was used to establish the sale.

The Medicare Part A exemption rule established in 1970 was effectively unchanged by the 2001 amendments because the title passage approach was expressly presented as an additional option (not an exclusive means) in the issue paper. Other accompanying issue papers noted that hospitals were not structuring these transactions in a way that would effectuate the exemption. The formal issue paper clarified that the charges for the tangible personal property should be separately stated, or the agreements should specify that title passes to the patient.

The CDTFA should avoid the use of confidential patient medical records to determine taxability.

The proposed amendments to section 1503 will implicate the administered versus non-administered regulatory system prior to 2001 and previously abandoned by the BOE. ***In order to determine the economic reality of a transaction, the CDTFA auditors will need to review confidential patient medical records and have a detailed understanding of medical procedures and the associated medical products and supplies.***

In the past, the BOE chose not to enact regulatory processes that required its auditors to review individual patient medical records — both because it did not want its auditors reviewing confidential medical records and because state tax auditors and administrators do not have the requisite training or medical knowledge to perform such review. Even if the CDTFA would allow the records to be redacted to omit the patients' names, auditors will still need specialized medical knowledge to conduct reviews of the records and comply with the requirements of the Health Insurance Portability and Accountability Act (HIPAA) of 1996. There is no indication in the proposed revisions that the CDTFA anticipates additional costs related to obtaining the necessary training to perform these medical record reviews, suggesting additional training will not be provided. Further, there is no discussion of what standards will be applied, and how the auditors will be instructed, to evaluate patient records.

CHA urges CDTFA to avoid the use of patient medical records due to concerns about confidentiality and auditors' lack of the requisite knowledge to perform these reviews.

The CDTFA cannot subvert the statutory exemption in section 1503 by invoking the "true object" test.

The Informative Digest/Policy Statement Overview that accompanied the Notice of Proposed Amendments offers a lengthy explanation of the application of the "true object" test. In Regulation section 1503, however, the "true object" test is irrelevant. This point is implicitly recognized in the second full paragraph of the discussion of Regulation section 1501 on page 5 of the notice, where it states:

> *If, in addition to rendering services, they regularly sell tangible personal property to consumers, then they are retailers with respect to those sales, and they must obtain permits, file returns and remit tax measured by such sales. If their purchases of tangible personal property are predominantly for consumption rather than for resale, they should not give resale certificates covering such purchases, but should follow the procedure prescribed in Regulation 1701, Tax-Paid Purchases Resold, to be credited for taxes paid at the time of purchase.*

In scenarios where the "true object" test is raised, there is a key difference from the scenario raised by section 1503. Here — importantly — pursuant to a specific clause in the contract between the parties, title to the tangible personal property used for the patient transfers to the patient for consideration. This is a "sale" as defined in CRTC section 6006. Although service is also provided, there is a specific contractual transfer of title of the tangible personal property to the patient for consideration.

When the contract directs the intent of the parties — i.e., the transfer of tangible personal property from the hospital to the patient — no "true object" analysis is needed, and the "true object" test becomes irrelevant.

In the past, the BOE/CDTFA has not provided guidance for situations where contractual terms for the transfer (sale) of tangible personal property were re-characterized as a service. *On the contrary, all available guidance is where service transactions were deemed to be sales of tangible personal property.* The CDTFA now reverses course and states the "true object" test requires a different result.

The "true object" test has been discredited.

Regardless of the terms in the contracts at issue, the "true object" test is not an adequate test to make a distinction between a sale of a service and a sale of tangible personal property. As discussed in Hellerstein's State Taxation treatise, there is "no sound principle of tax policy" and "no sound analytical basis" for using the "true object" test.[1] Further, Hellerstein's case studies note there are "literally hundreds of cases" that try to employ the "true object" test,[2] and such an analysis is "unrelated to any intellectually defensible principle of tax or economic policy."[3]

As stated above, the "true object" test is not an instructive inquiry and should not form the basis for the CDTFA's proposed amendments. The existing regulation contains provisions that date back to the 1970s and represent more than 50 years of guidance to taxpayers. The taxpayer community does not claim that the existing regulation is ambiguous or unclear and does not support these changes.

The CDTFA's proposed regulatory language includes a list of property that, according to the CDTFA, does not pass to the patient. The inclusion of this language is ill-advised because it is erroneous and is subject to change as medical technology advances.

The proposed amendments to section 1503, subdivision (b)(2)(C)2., include a list of property titles that, according to the CDFA, do not pass to a patient. The CDTFA should not include this list in the regulation. While we do not believe any amendments to section 1503 are necessary, we propose that — if amendments are made — instead of listing property the possession or control of which the CDTFA asserts does not pass to patient, the regulation should be based on the distinction between disposable (one-time use) and non-disposable (multi-use) property.

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[1] WALTER HELLERSTEIN ET AL., STATE TAXATION ¶12.06[2] (3rd ed. 2019)

[2] WALTER HELLERSTEIN ET AL., STATE AND LOCAL TAXATION: CASES AND MATERIALS, p.628 (9th ed. 2009)

[3] See HELLERSTEIN, supra at ¶12.06[2].

If an item is disposable and used for only one patient, and the agreement between the hospital and the patient includes a title clause, then the item should be treated as purchased for resale. Conversely, if the item is for non-disposable (multi-use) and used in the care of more than one patient, then the hospital is the consumer, regardless of title clause. Below, we propose alternative language for section 1503, subdivision (b)(2)(C)2., that builds on the language already proposed by the CDTFA, with our additions bolded.

> *2. On and after January 1, 2019, except for property of which possession, title or control does not pass to the resident or patient or other customer, a medical service facility is the retailer of property furnished in connection with its medical services, if its contract with the resident or patient or other customer specifically provides that title to the subject tangible personal property passes to the resident or patient or other customer. When a medical service facility sells tangible personal property to the resident or patient or other customer, the medical services facility may purchase such property for resale, and tax applies to the charge by the medical services facility unless its sale is otherwise exempt from tax. Medical service facilities are consumers of property of which possession, title, or control does not pass to the resident, patient or other customer when the property is used for multiple patients.* ***When the use of the property is for a single patient and disposed of after the one-time use, the items may be purchased for resale if title to the property passes to the patient as provided above.***

We suggest deleting the second paragraph, which includes the list, proposed by CDTFA. Medical technology and techniques continue to advance at an ever-quickening pace. As a result, the property listed by the CDTFA may not have the same function or mean the same thing in five, 10, or 20 years, and taxpayers would be better served by not including a list as currently proposed.

The CDTFA should replace the effective date of January 1, 2019, with a prospective date so that hospitals can prepare for the finalized changes.

Even though the informal regulatory process introduced language with an effective date of January 1, 2019, that informal process continued throughout 2019. Assuming no significant issues arise — and assuming these changes do not exceed the $50 million threshold that would require the agency to complete a significant economic impact assessment — hospitals will be forced to retroactively retract resale certificates, update reporting procedures, and establish new compliance processes. This is a significant burden on hospitals, and **CHA urges the CDTFA to consider the ramifications of assuming a January 1, 2019, effective date.**

Thank you for your review and consideration of the comments presented. Please do not hesitate to contact me with any questions you may have about CHA's comments. As always, we stand prepared to discuss the amendments proposed by the CDTFA and their impact on our member hospitals.

Sincerely,

Ryan Witz
Vice President, Health Care Finance Initiatives
California Hospital Association