

Memorandum

To : Honorable Judy Chu, Ph.D., Chair
Honorable Betty T. Yee, Vice Chairwoman
Honorable Bill Leonard, Board Member, Second District
Honorable Michelle Steel, Board Member, Third District
Honorable John Chiang, State Controller

Date : May 13, 2008

From : Todd C. Gilman, Chief 
Taxpayers' Rights and Equal Employment Opportunity Division

Subject : **Follow-up to March 18, 2008 Business Taxpayers' Bill of Rights Hearings - Hospital Claims for Refunds**

At the March 18, 2008 Business Taxpayers' Bill of Rights Hearing, Mr. Clayton Hale, Mr. Bob Wood and Ms. Diane Buaas, all representing Contract Management Strategies, Inc. (CMS), discussed specific issues their firm encounters in representing hospitals that seek refunds of sales tax reimbursement paid to vendors on purchases of medical items that are exempt from tax pursuant to the provisions of Regulation 1591. As a result of the issues presented by the CMS representatives, the Members of the Board requested that staff investigate and report their findings at the May 2008 Board Meeting.

Attached for your consideration is a memorandum from Mr. Jeffrey L. McGuire, Chief, Tax Policy Division. The memorandum:

- Provides a description of the procedures currently in use by the Sales and Use Tax Department to process claims for refund received from hospitals and their vendors.
- Describes the status of the refund claim cited by CMS in their presentation on March 18, 2008.
- Responds to CMS' comments regarding audit procedures.
- Lists a number of issues related to the application of tax to sales of tangible personal property to hospitals and the filing of claims for refund by hospitals in cases where tax reimbursement was paid on items not subject to tax.
- Describes current efforts to revise Publication 45, *Tax Tips for Hospitals*.

Mr. McGuire states that staff is working to identify potential administrative changes to reduce the time required for staff to refund overpaid tax to hospitals; and that staff is also researching possible legislative and regulatory solutions to ease the administrative burden of tax compliance within this industry.

I appreciate the representatives of CMS bringing these issues to our attention, and I have urged the Sales and Use Tax Department to work with CMS and other interested parties in finding solutions to address the issues.

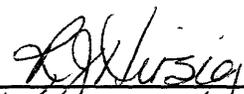
This matter will be presented to the Board at its May 29, 2008 meeting. I hope the attached memorandum is helpful and adequately responds to your request. If you wish additional information, please contact Mr. McGuire at 916-445-1825.

TCG:ls

Attachment

Hospital Memo to Members 5-13-08.doc

Approved:


 Ramon J. Hirsig
Executive Director

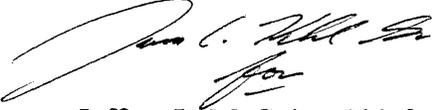
cc (all with attachment):

- Ms. Marcy Jo Mandel, Deputy State Controller
- Mr. Steve Shea, Board Member's Office, Fourth District (MIC 72)
- Mr. Alan LoFaso, Board Member's Office, First District (MIC 71)
- Ms. Margaret Pennington, Board Member's Office, Second District (MIC 78)
- Mr. Erik Caldwell, Board Member's Office, Third District
- Mr. Ramon J. Hirsig (MIC 73)
- Ms. Kristine Cazadd (MIC 83)
- Ms. Diane Olson (MIC 80)
- Ms. Randie L. Henry (MIC 43)
- Mr. David Gau (MIC 63)
- Ms. Elizabeth Houser (MIC 69)
- Mr. Jeffrey L. McGuire (MIC 92)
- Mr. James C. Kuhl, Sr. (MIC 44)

Memorandum

To : Mr. Todd C. Gilman, Chief
Taxpayers' Rights and Equal Employment Office (MIC 70)

Date: May 8, 2008


From : Jeffrey L. McGuire, Chief
Tax Policy Division (MIC 92)

Subject : **Hospital Claims for Refunds**

At the March 18, 2008 Taxpayers' Bill of Rights Hearings, Mr. Clayton Hale, Mr. Bob Wood and Ms. Diane Buaas, all representing Contract Management Strategies, Inc. (CMS), discussed specific issues their firm encounters in representing hospitals that seek refunds of sales tax reimbursement paid to vendors on purchases of medical items that are exempt from tax pursuant to the provisions of Regulation 1591. As a result of the issues presented by the CMS representatives, the Members of the Board requested that staff investigate and report their findings at the Sacramento May 28 – 29, 2008 Board Meeting.

The specific claim for refund in question by CMS relates to Owens & Minor Distribution Inc., SR OHB 097-955387, and actually consists of 34 individual claims for refund totaling \$1,984,343 covering the period January 1, 2002, through December 31, 2005. These claims, which were filed beginning in July 2004 through January 2006, were forwarded to the district office for investigation. District staff investigated the claims for refund and recommended a refund of \$1,827,907.25 in tax plus \$244,195.52 in interest, for a total of \$2,072,102.77. Since the claims for refund exceed \$50,000, the refunds must be approved by the Members of the Board. This consolidated refund is on the agenda for the May 28, 2008 Board Meeting.

As presented, CMS expressed concern with the length of time between when their client hospital pays sales tax reimbursement to a vendor and when the sales tax is actually refunded by the Board. CMS provided an example where client hospitals submitted claims for refund to a particular vendor several years ago and the vendor has yet to receive a refund of the tax. CMS also noted that vendors receive inconsistent advice from Board staff regarding the application of tax to specific medical products. Additionally, claims for refund by CMS client hospitals for use tax paid to the vendor were rejected by the vendor as the vendor alleges they were advised by Board staff that since the applicable tax is a use tax, the vendor is not required to address the claim for refund. The final issue presented pertains to the use of statistical sampling in conducting an audit of a hospital and the exclusion of credit items from the sample.

Currently, when the Audit Determination and Refund Section (ADRS) receives a claim for refund from a taxpayer, the claim for refund is handled by ADRS unless the taxpayer has an audit in process, another claim from the same taxpayer has previously been forwarded to the

district office, or the claim amount is significant. Typically, ADRS handles approximately one-third of the claims filed by hospitals and vendors filing claims on behalf of their client hospitals.

In a situation where the claim for refund is forwarded to the district office, the claim is assigned to a field auditor for investigation. When a district office receives numerous claims on a continuous basis for the same vendor, the district office generally handles a group of claims at one time rather than process each of them individually. Therefore, some claims from medical supply vendors may be held for a period of time before the individual claim is investigated. There is generally a lapse of time between when the vendor files the claim for refund and when staff approves the claim. Due to the circumstances involved, some refund cases may extend over a year before the taxpayer's refund is granted by the Board.

In response to CMS' concerns, staff examined the issues related to the application of tax to sales of tangible personal property to hospitals and the filing of claims for refund by hospitals in cases where tax reimbursement was paid on exempt items. Some of the early issues disclosed are:

- 1) The taxability of many of the items sold depends on how the items are used by the hospital. For example, medicated soaps are exempt if used on the patient, but are taxable if used in restrooms. There are also numerous items that may qualify for "mixed use." Since claims for refund for sales tax must be filed by the vendor, verification of "use" by the hospital is necessary and can be problematic in the timely processing refund claims.
- 2) Hospitals generally do not provide exemption certificates at the time of the transaction or blanket certificates for use on a going-forward basis so that liability for the tax is not shifted to them but remains with the retailer. Vendors know some of the more common items subject to tax, and collect tax reimbursement accordingly.
- 3) Each hospital files a claim for refund with their vendors often long after the items are used. The vendors, in turn, pass on the claims to the Board. This results in the Board receiving multiple claims from each vendor at any given time on an ongoing basis.
- 4) Approximately two-thirds of the claims are forwarded to the appropriate district office for investigation. Since the vendors are merely a pass-through for the tax to the hospital, considerable time is spent securing documentation from the vendors.
- 5) In a situation where the vendor collected sales tax reimbursement and filed a claim for refund on behalf of the hospital, the claim is generally scheduled on an actual basis as the use of statistical sampling would not adequately identify the customers to whom the refunds are due.
- 6) The number of medical items in question are numerous and their names as well as their nature are constantly changing.
- 7) Combination packages or kits sold by vendors consist of taxable and exempt items sold in a single package for a single price. For example, a kit may include a stent (a tube inserted into an artery to help keep it open) that is exempt from tax, and also include a stent delivery device that is subject to tax. In such a situation, although the kit is sold for a single price, the portion of the selling price representing the sale of the stent is exempt from tax while the portion of the selling price representing the

delivery device is taxable. Vendor accounting software does not allow for taxing a percentage of the selling price; therefore, vendors generally charge tax on the entire selling price from the sale of the kit and seek to get the exempt percentage refunded from the Board. This shifts much of the verification responsibility onto Board staff.

Due to the issues noted above, staff is revising Publication 45, *Tax Tips for Hospitals*, to add a new section regarding the proper method of filing claims for refund. This will advise hospitals seeking a refund of sales tax reimbursement paid to the vendor to file the claim for refund directly with the vendor rather than filing the claim with the Board. Inclusion of this information in this publication should prevent periods from expiring due to delays in properly filing a claim for refund with the vendor.

Information will also be included in Publication 45 encouraging hospitals to issue exemption certificates to their vendors when purchasing items the hospital knows to be exempt from tax. This practice will alleviate the need for the hospital to later file a claim for refund for tax erroneously paid on exempt items.

In addition, staff is reviewing administrative changes and work flow processes that may assist in reducing the time required for staff to process claims for refund. Staff is also researching possible legislative and regulatory solutions to ease the administrative burden of tax compliance within this industry.

If you have any questions or concerns regarding any of the above issues, please contact me or Mr. James C. Kuhl, Sr., Supervisor, Audit and Information Section, via email or telephone at (916) 324-2916.

JLM:bem

cc: Ms. Randie Henry (MIC 43)
Ms. Freda Orendt (MIC 47)
Ms. Stephen Rudd (MIC 46)
Mr. Joseph Young (MIC 49)
Ms. Kelly Reilly (MIC 47)
Mr. James C. Kuhl, Sr. (MIC 44)
Mr. Steven Sisti (MIC 39)
Ms. Trista Gonzalez (MIC 44)
Ms. Sandy McCaleb (MIC 43)
Ms. MaryAnn Hay (MIC 47)
Mr. Mike Loretta (MIC 46)
Mr. Larry Bergkamp (MIC 92)
Ms. Mariflor Jimenez (MIC 49)
Ms. Laureen Simpson (MIC 70)
Mr. Todd MacMurray (MIC 44)
Mr. Bradley Miller (MIC 44)
Mr. Rick Mattson (MIC 44)