STATE OF CALIFORNIA

545.0019

STATE BOARD OF EQUALIZATION
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May 23, 1988

Mr. R--- J. ---
Director
F--- and A---
XXXX --- Avenue, Suite XXX
---, CA XXXXX

Dear Mr. F---:

On February 16, 1988, you met with senior staff of the State Board of Equalization here in Sacramento to discuss application of the sales tax under our Regulation 1503, "Hospitals, Institutions and Homes for the Care of Persons." In particular, you sought to clarify issues raised by your earlier correspondence with this office. The two letters which we discussed were Ms. Vickie B. Owen's letter to you of March 27, 1985 and Mr. Robert J. Stipe's letter to you of May 1, 1986.

Under our Regulation 1503 sales to institutions of tangible personal property for which the institution makes a separate charge are sales for resale, and tax does not apply with respect thereto. During our meeting on February 16, we discussed application of these rules in the context of "noncharge-based hospital reimbursement," and we also discussed the relationship between the status of the institutions as the retailer or consumer of items furnished to patients and the tax-paid purchases resold deduction permitted by Revenue and Taxation Code Section 6012 and our Regulation 1701.

Noncharge-based reimbursement may be distinguished from charge-based reimbursement as follows. Charge-based reimbursement occurs when the charge to the individual patient or the patient's insurer is based upon services provided to that particular patient and property utilized in serving that particular patient. In other words, the more service provided to the patient and the more property used in serving that patient, the higher the billing. Charge-based reimbursement is cost related on a patient by patient basis.

Noncharge-based reimbursement occurs where the charge made by the institution is based on the procedure performed (for example, the diagnostic related group (DRG) procedure utilized under Medicare A), a capitated rate (a fee per patient served or per patient subject to service), a per diem rate, etc. The essence of noncharge-based reimbursement is that the cost incurred in terms of services and property provided to an individual patient is not directly reflected in the charge made by the institution for the services and property provided to that patient.

To illustrate the difference between the two concepts, consider a situation where the instititution and the insurer have negotiated a simple discount procedure. The insurer agrees to pay (say) 60% of the billing for services and property provided to the individual patient. This is a charge-based reimbursement system, even though there is a discount feature, because the gross charge made with respect to a particular patient is dependent upon services and the property provided to that patient.

Regulation 1503 provides in relevant part as follows:

> "Tax applies to sales to institutions of tangible personal property for which a separate charge is not made to patients, residents, nurses, doctors and others, …Sales to institutions of tangible personal property for which the institution makes a separate charge are sales for resale and tax does not apply with respect thereto."

The rule adopted by the regulation is a rule dependent upon the presence of absence of a "separate charge". This conclusion may appear to be inconsistent with the rule stated in Ms. Owens letter to you of March 27, 1985. We believe that Ms. Owen's conclusion was based upon the unstated assumption that where fees are noncharge-based, there is no separate charge made for items provided. This unstated assumption appears not to be the universal practice.

How does the tax-paid purchases resold deduction fit with this analysis? The concept of retailer versus consumer is always complementary with the concept of tax-paid purchases resold deduction. In other words, if under Regulation 1503 the institution is regarded as selling nonadministered property (or administered property for which both a charge for the property and a separate administration fee is made), then a tax-paid purchases resold deduction is permissible where there is a tax-paid inventory. If for any reason the sale transaction itself is exempt, as for example where payment is made by the United States, the tax-paid purchases resold deduction is nevertheless permissible. The tax-paid purchases resold deduction is complementary with "sale," not just with "taxable sale". If under Regulation 1503 the institution is regarded as not selling the property utilized in treating the patient, then a tax-paid purchases resold deduction is never permissible, because there is no resale.

How, then, does Regulation 1503 apply? Mr. Stipe, in his letter of May 1, 1986, suggested that in determining whether a separate charge is made we would employ a two-tier analysis in first looking to the billing rendered to the patient and then looking to the billing issued to the insurer if no billing were issued to the patient. See attached. We see no basis for altering that conclusion at this time.

We would conclude that a sale occurs if the billing is itemized, notwithstanding the fact that the actual payment made to the hospital might be a greater or lesser amount based upon the negotiated DRG rate, or capitated rater, or per diem rate. In situations where the hospital is treated as a retailer, actual required payment may be less than the itemized bill. This difference, normally

referred to as the "contract allowance," is in the nature of a discount. The measure of tax with respect to items regarded as sold would not be the actual invoiced amount but would be the invoiced amount adjusted for the contractual allowance. The contractual allowance is in no way a bad debt to be taken later but is a discount for sales and use tax purposes to be taken as an adjustment at the time of the transaction.

We note that the very existence of a "contract allowance" implies that there has been a billing to the insurer in excess of actual reimbursement. It would seem that it may not make a great deal of difference from a tax burden point of view as to whether hospitals are consumers or sellers in the noncharge-based (other than Medicare Part A) situations, since there may be little difference between "cost" to the hospital on the one hand, and "separate charge less contract allowance" billed to the insurer on the other hand.

In summary, whether the billing is charge-based or noncharge-based, if the billing to the patient were itemized, then the hospital would be a seller. If the billing were lump sum, the hospital would be a consumer. If there were no billing to the patient, then we look to the billing to the insurer. If that billing were itemized, the hospital would be a retailer. If that billing were lump sum, the hospital would be a consumer.

Very truly yours,

Gary J. Jugum
Assistant Chief Counsel

GJJ:sr

bc: Mr. Glenn A Bystrom
Mr. William D. Dunn
Mr. Donald J. Hennessy
Mr. E. L. Sorensen, Jr.
Mr. Robert J. Stipe