

Case No. S241471

In the Supreme Court of the State of California

MICHAEL MCCLAIN, ET AL.,

Plaintiffs and Appellants,

vs.

SAV-ON DRUGS, ET AL.

Defendants and Respondents.

SUPREME COURT
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**THE RETAILER DEFENDANTS' JOINT
ANSWER BRIEF ON THE MERITS**

After a Decision by the Court of Appeal, Second Appellate District,
Division Three, Case Nos. B265011 & B265029

Appeal from a Judgment of Dismissal
Los Angeles Superior Court, Case Nos. BC325272 & BC327216
Honorable John Shepard Wiley

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I.
INTRODUCTION

Plaintiffs—who are consumers, not taxpayers—maintain they have the right to drag the Retailers who sold them certain products into their taxability dispute with the State Board of Equalization (the Board).¹ Relying on *Javor v. State Board of Equalization* (1974) 12 Cal.3d 790 (*Javor*) and Civil Code section 1656.1 Plaintiffs asserted both an equitable cause of action that sought to compel the Retailers to pursue sale tax refund actions on their behalf and order the Board to make the refunds Plaintiffs contend are owed and a contract cause of action that sought to hold the Retailers liable for collecting sales tax reimbursements on transactions Plaintiffs believe are exempt. The causes of action Plaintiffs pled, however, impermissibly demand that a court make the taxability determination with regard to disputed exemption in the first instance.

Although Plaintiffs' causes of action as pled clearly fail under controlling law, this Court granted review to consider a more

¹ On July 1, 2017, responsibility for the administration of the sales tax was transferred to the Department of Tax and Fee Administration. (Gov. Code, §§ 15570, 15570.22.) On January 1, 2018, responsibility for adjudicating tax matters and making of taxability rulings in the first instance will transfer to the Office of Tax Appeals. (Gov. Code, § 15674.) For ease of reference, this brief refers to these functions as being performed by the Board.

nuanced question: “Can a purchaser of products allegedly exempt from sales tax but for which the retailer collected sales tax reimbursement bring an action to compel the retailer to seek a sales tax refund from the State Board of Equalization and remit the proceeds to the purchasers?” As we will explain, the answer to that question also should be a resounding “no.”

There is no dispute that the courts have a very limited role in resolving disputes implicating the tax code and the Board’s decision-making. This is especially true where, as here, a non-taxpayer consumer is the one seeking relief. It is only in those rare circumstances—where no conflict with the tax code exists, taxability is undisputed, and the amount of the refund is so clear that an analogy to a constructive trust remedy can be drawn—that equitable relief benefiting a non-taxpayer can even be contemplated. That is not this case. Here, the Retailers have elected to remit the sales tax reimbursements to the State, the applicability of a tax exemption is at issue, and taxability itself remains in dispute. In these circumstances, where there is no ready analogy to constructive trust, Plaintiffs cannot compel the Retailers to pursue a refund claim on their behalf.

First, although the relief allowed in *Javor* did not conflict with the tax code, the equitable relief contemplated here clearly does so. The code, among other things, provides a statutory safe harbor for taxpayers who remit reimbursements to the State and gives taxpayers the right to decide when to rely on the statutory

presumption of taxability or, alternatively, pursue an exemption. In this case, the Retailers have sought the safe harbor and decided not to pursue an exemption. It is the consumers who are interested in exemptions and dispute the meaning of the Board's regulations. But the Retailers have no dog in that fight; they have paid every penny of the disputed reimbursements to the State. The law therefore does and should leave the Retailers out of Plaintiffs' taxability dispute with the Board. To allow consumers to force the Retailers to pursue refund actions when they occupy a safe harbor and elect not to pursue an exemption conflicts with the code and will do nothing but drive up the cost that retailers charge for the products at issue.

Second, although this Court in *Javor* fashioned a remedy based on constructive trust principles, none of the considerations that drove the constructive trust analysis in *Javor* are present with respect to the taxpayers in this case. To start with, the Retailers are not holding any disputed funds. Thus, unlike in *Javor*, with respect to the taxpayers, there is no identifiable "res." Nor, as in *Javor*, is there an identifiable class of beneficiaries indisputably entitled to the non-existent "res." Here, the amount of the purported refund is in dispute and there is no ready means to identify to whom a refund might be owed. Simply put, the constructive trust analogy as to the Retailers fails in all its particulars.

Third, although the remedy crafted in *Javor* did not raise constitutional concerns, enfranchising non-taxpayer consumers

to force the Retailers to pursue an exemption to benefit those consumers would raise serious constitutional issues. The California Constitution authorizes the Legislature—and only the Legislature—to decide how refund claims are pursued. And the Legislature did not give non-taxpayer consumers the right to pursue refund claims themselves or the ability to compel taxpayer-retailers to file refund lawsuits. To the contrary, the Legislature gave the Retailers a safe harbor and the right to elect whether to pursue an exemption. These constitutional concerns should be avoided, not invited, and no *Javor*-type remedy should be considered for that reason as well.

Fourth, in *Javor*, this Court felt compelled to craft a remedy because the consumers had no other avenue to obtain relief. That compulsion is not present in this case either. Here, the statutory scheme already provides for the resolution of taxability questions without forcing the Retailers into the middle of Plaintiffs' dispute with the Board. A consumer can petition the Board under Government Code section 11340.6 to repeal, amend, or enact a regulation, thereby empowering the Board to address a taxability dispute created by a particular regulation. Similarly, Government Code section 11350 permits a consumer to file a declaratory relief action to determine whether a regulation conflicts with a statute or the constitution. And the statutory refund procedures apply equally to use tax. For purchases subject to use tax, the consumer is the

taxpayer and thus is free to litigate a taxability dispute with the Board under established administrative procedures.²

Finally, Plaintiffs' breach of contract claim (framed under section 1656.1) triggers precisely the same conflicts with the tax code and the California Constitution as Plaintiffs' flawed effort to obtain equitable relief against the Retailers. Plaintiffs cannot use that section to circumvent the fundamental statutory and administrative obstacles that foreclose the relief they seek on the allegations they advance. There likewise is no need, for the reasons noted, to disrupt established law by dramatically expanding section 1656.1 to provide the relief Plaintiffs seek.

In sum, the Retailers do not belong in this lawsuit and there is no basis on which *Javor* can or should be expanded and extended to force them to file a refund action. Nor should section 1656.1 be judicially redrafted in an effort to accomplish that result. The existing law preserves the proper roles for the Legislature and the courts and avoids conflicts with the provisions of the tax code and the California Constitution. This Court should maintain that balance and affirm the result reached by the Court of Appeal.

² The existence of such established avenues for resolving their alleged wrongs eliminates Plaintiffs' assertions that the tax code is unconstitutional and the remittance of sales tax an escheat to the State by virtue of the safe harbor provision of Revenue and Tax Code section 6901.5.

II. RELEVANT BACKGROUND

As the Court of Appeal recognized here, and as this Court has recognized before, any relief provided to a non-taxpayer in a case like this must be consistent with the tax code. Here, this Court's inquiry must take account of the provisions of the Sales and Use Tax Law, applicable regulations, and the conduct of the Board and the retailer-taxpayers in relation to both.

A. California's Sales And Use Tax Law

California's Sales and Use Tax Law is set forth in division two, part one, of the Revenue and Taxation Code (beginning with Revenue and Taxation Code section 6001, et seq.).³ Although division two covers two distinct taxes—sales tax and use tax—which are imposed on different categories of persons for different reasons, many of the relevant provisions—including those concerning exemptions and how refunds are to be obtained—apply to both taxes.

³ Unless otherwise stated, all subsequent statutory citations are to the Revenue and Taxation Code.

1. Sales Tax

“Sales tax” is imposed on the “gross receipts” of all retailers doing business within the state “[f]or the privilege of selling tangible personal property at retail” (§ 6051.) It is “presumed that all gross receipts are subject to the tax until the contrary is established” and it is the retailer’s burden to prove otherwise. (§ 6091.) Although the retailer is the taxpayer, retailers are permitted, but not required, to collect “reimbursements” from their customers. (Civ. Code, § 1656.1.) Retailers who elect to collect reimbursements from customers are afforded a statutory safe harbor that relieves them of any obligation vis-à-vis the reimbursements as long as they remit the reimbursements to the Board. (§ 6901.5.)

2. Use Tax

“Use tax” in contrast, is not imposed on retailers but on “[e]very person storing, using, or otherwise consuming in [California] tangible personal property” that is purchased from any retailer. (§ 6202.) While the use tax is imposed on all tangible personal property stored or used within the state, a person’s liability for use tax is extinguished by a receipt demonstrating that the item was purchased from a retailer engaged in business in California or one who is authorized by the Board to collect use tax. (*Ibid.*) Thus, for purposes of use tax, the consumer is deemed the taxpayer. (*Ibid.*)

3. Exemptions From Sales And Use Tax

An entire chapter of the Sales and Use Tax Law is devoted to various exemptions taxpayers are permitted to claim. (§§ 6351-6423.) As this Court noted in *Loeffler v. Target* (2014) 58 Cal.4th 1081 (*Loeffler*), the “law of exemptions is comprehensive, governing every imaginable type of sales transactions.”⁴ (*Id.* at p. 1105.) All sales and uses are presumed taxable unless the retailer proves otherwise. (§ 6091 [“it shall be presumed that all gross receipts are subject to the tax until the contrary is established. The burden of proving that a sale of tangible personal property is not a sale at retail is upon the person who makes the sale unless he takes from the purchaser a certificate to the effect that the property is purchased for resale”]; § 6202 [similar provision for use tax].) If a taxpayer wants to claim an exemption for a particular sale or use, then it is the taxpayer’s burden to establish that an exemption applies. This construct is intended to help “the proper administration” of the Sales and Use Tax Law and to prevent tax evasion. (*Loeffler, supra*, 58 Cal.4th at p. 1107.)

⁴ “One article in the exemption chapter includes 79 provisions exempting particular types of transactions from sales and use taxation—including, for example, relatively straightforward exemptions for poultry litter (§ 6358.2), to much more complicated and fact-specific exemptions for some sales of food or medicine (§§ 6359, 6369) or for gross receipts from food stamp sales (§ 6373), to some quite arcane exemptions. (See § 6366.5 [sales of endangered species].)” (*Loeffler, supra*, 58 Cal.4th at p. 1105.)

4. Deficiency Determinations And Taxpayer Refund Claims

Persons subject to either sales or use tax are required to file returns and make payments on a quarterly basis. (§§ 6451-6459.) The tax code provides, however, that persons who purchase items subject to “qualified use tax” (which is defined to mean use tax due on purchases of certain individual items with a sales price of less than one thousand dollars), may elect to pay the qualified use tax they owe on an annual basis as part of their annual income tax return. (§ 6452.1, subd. (d); § 6452.2.)

To the extent the Board is not satisfied with a return or the amount of tax paid on its own initiative, the Board may audit the taxpayer, make deficiency determinations, and impose penalties on the taxpayer for underpayment of tax. (§ 7054 [audits]; § 6481 [deficiency determinations]; §§ 6484-6485 [penalties].) If a deficiency determination is made, the taxpayer is permitted to challenge the determination by filing an administrative petition with the Board. (§§ 6561-6564 [petitions for redetermination of deficiency and process for having a hearing on the same].)

On the flip side, to the extent the taxpayer believes the taxpayer has overpaid the amount of tax due, the taxpayer is permitted, but not required, to file refund claims with the Board. (§ 6901.) The filing of an administrative refund claim is a necessary prerequisite to maintaining a refund lawsuit [§ 6932], and the failure

to file a timely refund claim waives the right to recover any overpaid amounts [§ 6905]. The tax code makes clear, however, that *only* the taxpayer is permitted to file a refund claim or sue in court to seek a refund. (§ 6937.)

Irrespective of how a taxability dispute arises, be it through a deficiency determination or a refund claim, under the administrative procedures established by the tax code “it is for the Board in the first instance to interpret and administer an intensely detailed and fact-specific sales tax system governing an enormous universe of transactions.” (*Loeffler, supra*, 58 Cal.4th at p. 1103.) In that regard, court involvement is limited to review of the Board’s administrative determinations. (*Ibid.* [“Administrative procedures must be exhausted before the taxpayer may resort to court.”].)

5. Non-Taxpayer Lawsuits To Recoup Reimbursements

By legislative design, the tax code does not provide a mechanism for non-taxpayer consumers to pursue refund actions or file suit against the retailers who collected reimbursements. Given this statutory limitation, courts should tread cautiously before providing non-taxpayers with relief. In both *Javor* and *Loeffler*, this Court exercised that caution in determining whether a non-taxpayer lawsuit could proceed.

Javor involved a consumer's attempt to obtain a refund from the Board of sales tax reimbursements to which the Board was indisputably not entitled. (*Javor, supra*, 12 Cal.3d at pp. 792-793.) In that case, Congress's retroactive repeal of an excise tax imposed on the sale of new cars and accessories reduced the total vehicle price on which sales tax had previously been imposed. (*Ibid.*) The retroactive reduction meant the Board had collected excess sales tax. (*Ibid.*) Recognizing this, the Board adopted procedures by which retailers could secure refunds on condition that the retailers passed on the refund to their customers who had paid sales tax reimbursements. (*Id.* at p. 794.) Tellingly, the Board admitted it would order the refunds if the retailers applied for them. (*Ibid.*)

Many retailers did not, however, pursue refund claims, because they had no incentive to do so. As a result, the *Javor* plaintiff brought a putative class action on behalf of all purchasers of new motor vehicles and accessories in California to compel the retailers to seek, and the Board to issue, refunds. (*Javor, supra*, 12 Cal.3d at p. 793.) Although the retailers who sold the vehicles and accessories were named as defendants, they were never served and were not involved in the case. (*Id.* at p. 793, fn.2 ["The record discloses that the Board is the only defendant either served with summons or appearing in the action"].) This Court fashioned a remedy nonetheless. (*Id.* at pp. 801-802.)

It began by recognizing "that the Board's liability to refund taxes erroneously collected . . . is governed by statute . . .

and the orderly administration of the tax laws requires adherence to the statutory procedures and precludes imposing on [the Board] the burden of making refunds to the taxpayers' customers." (*Javor, supra*, 12 Cal.3d at p. 798.) Because of the unique factual circumstances, this Court allowed the suit to proceed—as it was unwilling to leave the Board with the excess revenue that rightfully belonged to the purchasers. (*Id.* at pp. 800-802.) Relying on the equitable principles of restitution and unjust enrichment, this Court decided it was appropriate to permit the named plaintiff to pursue a class action which nominally would “compel” the retailers (who had not been served and did not participate in the case) to file refund claims to avoid the unjust enrichment that would otherwise result. (*Ibid.*)

In crafting this remedy, this Court drew heavily on both its earlier decision in *Decorative Carpets, Inc. v. State Board of Equalization* (1962) 58 Cal.2d 252 (*Decorative Carpets*) and Civil Code section 2224 (upon which *Decorative Carpets* relied). As this Court explained, section 2224 codifies the constructive trust principle that “[o]ne who gains a thing by fraud, accident, mistake [is] an involuntary trustee of the thing gained, for the benefit of the person who would otherwise have had it.” (*Javor, supra*, 12 Cal.3d at p. 798, quoting Civ. Code, § 2224.) Relying on constructive trust principles, *Decorative Carpets* upheld the Board’s refusal to refund sales tax overpayment to a retailer unless the retailer demonstrated that it would return the money to the consumers who paid reimbursements. (*Ibid.*) To support that

holding, the *Decorative Carpets* Court explained that the Board “had a vital interest in the integrity of the sales tax and might therefore ‘insist as a condition of refunding overpayments to [the retailer] that it discharge its trust obligations to its customers.’” (*Ibid.*, quoting *Decorative Carpets*, *supra*, 58 Cal.2d at p. 255.) In *Javor*, this Court went further, noting that “[t]he integrity of the sales tax requires not only that the retailers not be unjustly enriched, but also that the state not be similarly unjustly enriched” and thus allowed the plaintiff’s lawsuit to proceed. (*Javor*, *supra*, 12 Cal.3d at p. 802, internal citation omitted.)

For its part, *Loeffler* stood on a very different footing and generated a different result. The plaintiffs there wanted to hold Target, a retailer who had remitted the disputed sales tax collections to the Board, liable for allegedly charging sales tax reimbursements on transactions the plaintiffs argued were not taxable. (*Loeffler*, *supra*, 58 Cal.4th at pp. 1092-1093.) They asserted Target’s conduct violated the Unfair Competition Law (UCL), Consumer Legal Remedies Act (CLRA), and the common law because Target misrepresented to the general public that Target had a legal right to collect tax reimbursement on sales of hot coffee “to go.” (*Ibid.*)

This Court again noted the difficulties with allowing non-taxpayers to insert themselves into California’s carefully-crafted taxation and tax refund statutory schemes. (*Loeffler*, *supra*, 58 Cal.4th at pp. 1100-1101.) Those schemes provide no direct right of action for consumers to obtain tax refunds and the California

Constitution, in article XIII, section 32, prohibits courts from expanding the methods for obtaining tax refunds beyond those provided by the Legislature. (*Woosley v. State of California* (1992) 3 Cal.4th 758, 789 (*Woosley*) [“The California Constitution expressly provides that actions for tax refunds must be brought in the manner prescribed by the Legislature”].) With that backdrop, this Court held that the plaintiffs’ UCL and CLRA claims were barred because they conflicted with the tax code and the comprehensive taxation and refund scheme the Legislature had crafted. (*Loeffler, supra*, 58 Cal.4th at p. 1100.)

As a threshold matter, this Court found that the consumers’ claims improperly invaded the Board’s core function. That is, taxability determinations are “committed in the first instance to the Board, subject to judicial review under the restrictions and pursuant to the procedures provided by the tax code.” (*Loeffler, supra*, 58 Cal.4th at p. 1100.) Applying that principle to the UCL and CLRA claims, this Court concluded that because the plaintiffs’ lawsuit would have conflicted with the Board’s exclusive jurisdiction to make taxability determinations, it was subject to dismissal:

The clear basis of plaintiffs’ action – that Target represented that it properly was charging and in fact charged sales tax reimbursement on a sale that plaintiffs believe the tax code exempted from taxation – requires resolution of a sales tax law question, that is, whether Target’s sales of hot coffee to go to plaintiffs were subject to sales tax or fell

within an exemption. That question, which we may characterize as the “taxability” question, is committed in the first instance to the Board, subject to judicial review under the restrictions and pursuant to the procedures provided by the tax code. A UCL or CLRA cause of action such as plaintiffs’ cannot be reconciled with the primary decision making role that the tax code vests in the Board with respect to tax issues. . . . *For these reasons, the tax code precludes claims such as plaintiffs’.*

(*Loeffler, supra*, 58 Cal.4th at p. 1100, italics added.)

This Court was careful to distinguish the consumer claims brought against Target (which conflicted the procedures set forth in tax code), from the equitable relief sought in *Javor* (which did not). The equitable relief sought in *Javor*, which would have allowed the non-taxpayer consumer “to compel the retailer/taxpayer to seek a refund from the Board,” was permissible because it “invoke[d], rather than avoid[ed], tax code procedures.” (*Loeffler, supra*, 58 Cal.4th at p. 1101.) In keeping with *Javor*, this Court observed that “any remedy must be constrained by and not *inconsistent* with the tax code” and “carefully identif[y] an appropriate means to vindicate a consumer interest in a refund of a reimbursement charge *without* embracing procedures that were inconsistent with the tax code or disregarded the central function of the Board.” (*Id.* at p. 1133, original italics.) The *Loeffler* plaintiffs’ claims, in contrast, did no such thing. (*Ibid.*)

B. Plaintiffs Press Their Dispute Over The Taxability Of Glucose Test Strips And Skin Puncture Lancets By Suing The Retailers, Who Join The Board Of Equalization

This lawsuit, like *Javor* and *Loeffler*, was brought by non-taxpayer consumers attempting to obtain a sales tax refund. It concerns a dispute between Plaintiffs and the Board over the taxability of glucose test strips and skin puncture lancets. There is no provision in the tax code that expressly exempts glucose test strips and skin puncture lancets from sales and use tax. Rather, the dispute between Plaintiffs and the Board concerns the correct interpretation of section 6369 and Sales and Use Tax Regulation 1591.1 (a sales and use tax regulation adopted by the Board that interprets the scope of section 6369).

Section 6369, entitled “Medicines,” provides for an exemption “from the taxes imposed by the [Sales and Use Tax Law] for the gross receipts from the sale . . . and the storage, use, or other consumption” of medicines prescribed or furnished for certain uses. (§ 6369.) As relevant to this case, section 6369, subdivision (a)(1), exempts from sales and use tax medicine “[p]rescribed for the treatment of a human being by a person authorized to prescribe the medicines, and dispensed on prescription filled by a registered pharmacist in accordance with law.” (§ 6369, subd. (a)(1).)

Regulation 1591.1 is entitled “Specific Medical Devices, Appliances, and Related Supplies” extends section 6369 to