

In the Supreme Court of the State of California

SUPREME COURT

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MICHAEL McCLAIN, et al.,

Plaintiffs and Appellants,

v.

SAV-ON DRUGS, et al.,

Defendants and Respondents.

Case No. S241471 Deputy

Second Appellate District, Div. Eight, Case Nos. B265011 and B265029
Los Angeles County Superior Court, Case Nos. BC325272 and BC327216
John Shepard Wiley, Judge

**RESPONDENT CALIFORNIA DEPARTMENT
OF TAX AND FEE ADMINISTRATION'S
ANSWER BRIEF ON THE MERITS**

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ISSUES PRESENTED

The issues presented, as stated in plaintiffs' petition for review, are as follows:

1. Does the Court of Appeal's opinion *de facto* overrule this Court's opinions in *Loeffler v. Target Corp.* (2014) 58 Cal.4th 108 and *Javor v. [State Bd. of Equalization]* (1974) 12 Cal.3d 790 by creating prerequisites to pursuing a *Javor* remedy which are by definition impossible to fulfill, not only for the three million California diabetics in this action, but for all California consumers regarding any sales tax issue?

2. In rewriting the presumption in California Civil Code § 1656.1 from "rebuttable" to "irrebuttable," does the Court of Appeal cause California's sales tax scheme to violate this Court's direct holding in *National Ice & Cold Storage Co. v. Pacific Fruit Express Co.* (1938) 11 Cal.2d 283, and by escheating money with no recourse, to violate the United States Constitution's Due Process and Takings Clauses?

(Petition for Review (PFR) 1.)

As stated in the petition:

[Plaintiffs] are limiting this Petition to two of their causes of action: (1) the Fifth Cause of Action against all defendants for the equitable remedy devised by this court in *Javor ...*, and (2) the First Cause of Action against the retailer defendants for breach of the contractual agreement required by Civil Code § 1656.1 in order for retailers to collect sales tax reimbursement from their customers. In addition, [plaintiffs] seek review of the Court of Appeal's decision not to reverse the trial court's denial of leave [to] amend (which amendment was identified to the trial court as being to allege a constitutional Takings Clause claim).

(PFR 16.)

INTRODUCTION

Litigation over the imposition of taxes can disrupt and delay the State's collection of revenues necessary to carry out its core government functions. To ensure an orderly and workable tax system, California's Constitution (in article XIII, sections 32 and 33) limits taxpayers to post-payment refund claims, prohibits court action that would prevent or enjoin the collection of taxes, and vests power over tax procedure in the Legislature. The Legislature in turn has created a system in which sales tax—a tax on the privilege of selling tangible personal property—is the responsibility of retailers. Under this system, retailers and not consumers are the taxpayers, and they are given certain responsibilities and rights particular to that status. Retailers operate in a complex system where sales are presumed to be taxable; retailers bear the burden of proving up sales tax exemptions (and keeping records necessary to do so); and exemptions are construed in favor of taxability. Retailers must decide whether and in what circumstances to claim exemptions. And only retailers, as taxpayers, may dispute the imposition of a sales tax, by paying under protest, filing an administrative claim, and exhausting their remedies before seeking judicial review.

The Legislature has not ignored consumers in this system, recognizing that sales taxes are reflected in the price of goods—whether retailers choose to absorb the tax, or instead collect sales tax reimbursement (as a matter of contract), which retailers must pay over to the State. The Legislature has, for example, enacted a number of exemptions from sales tax designed to serve the public interest, including, as is relevant to this case, a conditional exemption for prescription medications. The system relies primarily on market forces to deliver the benefits of sales tax exemptions to consumers. While imperfect, the market does in general cause retailers to claim exemptions where they apply and can be claimed in a cost-effective

manner—because every retailer has an incentive to offer goods at the lowest price.

The Legislature has also created an administrative agency, the California Department of Tax and Fee Administration (formerly the Board of Equalization), charged with assuring the integrity of the sales tax system and following statutory procedures for the orderly administration of the tax laws.¹ As contemplated by the Legislature, the Department takes an active role to increase the likelihood that the benefits of exemptions reach consumers—as the circumstances of this case well illustrate. Among other things, the Department issues regulations to facilitate the use of statutory exemptions (here, extending the conditional exemption for insulin and insulin syringes to glucose test strips and lancets used in the treatment of diabetes); responds to consumer complaints; conducts investigations of market practices (here, conducting a survey of drug stores’ use of the regulatory exemption); communicates directly with retailers to clarify any confusion (here, among other things, sending out a staff letter explaining the regulation to thousands of stores); and issues informal guidance to educate both consumers and retailers (here, for example, producing publications containing plain-language explanations of the exemption).

Plaintiffs—consumers who believe that all sales of glucose blood testing strips and lancets should be *unconditionally* tax exempt—object that defendant retailers in some circumstances collected sales tax

¹ The Taxpayer Transparency and Fairness Act of 2017 created the CDTFA and transferred to it most of the Board of Equalization’s tax-related duties, powers, and responsibilities. (Assem. Bill No. 102 (2017-2018 Reg. Sess.) § 1; Gov. Code, § 15570.22.) References to the “Board of Equalization” in the sales tax laws “shall be deemed to refer to the department [of Tax and Fee Administration].” (Gov. Code, § 15570.24, subd. (a).) For simplicity, this brief will refer to CDTFA and the predecessor Board as the “Department.”

reimbursement for these products, and seek refunds of sales tax reimbursement paid on a class of transactions now reaching back more than a decade. Recognizing that this cause of action has no basis in the tax code, plaintiffs assert that they are entitled to pursue a consumer claim against retailers that could lead to a return of sales tax reimbursement under the authority of *Javor v. State Board of Equalization* (1974) 12 Cal.3d 758.

They are not. In *Javor*, this Court fashioned an equitable remedy consistent with and complementary to tax code procedures. There, the taxing entity had already conclusively determined that defendant auto retailers had paid excess sales tax due to a retroactive change in federal law in a set of defined transactions, and that the retailers had therefore collected excess sales tax reimbursement from a defined set of auto buyers. Some retailers had not of their own accord sought refunds, even though the taxing entity was holding funds for this purpose. The Court in these circumstances recognized an extra-statutory cause of action to correct an incentive problem: although by law the auto retailers were unambiguously entitled to receive refunds, they could not retain the benefit, but were required to pass the refund back to the auto buyers who had paid sales tax reimbursement.

Nothing in *Javor*, however, suggests that it is appropriate for courts to determine in the first instance complex questions of taxability. In this case, as the trial court noted and the Court of Appeal reiterated, the proper application of the Department's conditional exemption for glucose test strips and lancets to a wide variety of factually different transactions "was 'very hotly in dispute.'" (*McClain v. Sav-On Drugs* (2017) 9 Cal.App.5th 684, 691.) As the Legislature has provided, such taxability questions must first be presented to the Department, the expert administrative agency, for resolution, subject to judicial review. And if, as appears to be the case here, a consumer seeks a change in tax policy that has been set by statute, and

there is a question about the Department's legal authority to make the change requested, the consumer's remedy lies with the Legislature.

The trial court properly dismissed plaintiffs' sales tax reimbursement refund claim without leave to amend. The judgment below in this respect should be affirmed.²

STATUTORY AND REGULATORY BACKGROUND

I. THE LEGISLATURE HAS CHARGED THE DEPARTMENT WITH ADMINISTERING AND ENFORCING THE STATE'S SALES TAX SYSTEM

Article XIII, section 32 of the State Constitution vests in the Legislature the authority to "pass all laws necessary to carry out the provisions of this article ["Revenue and Taxation"]." Under the tax system created by our Legislature, "all tangible personalty sold or utilized in California is taxed once for the support of the state government." (*Woosley v. State of Cal.* (1992) 3 Cal.4th 758, 771, quotation and citation omitted.) The use tax (Rev. & Tax Code, § 6201 et seq.), imposed on the consumer, "complements" the sales tax (§ 6051 et seq.), imposed on the retailer.³ (*Woolsey, supra*, 3 Cal.4th at p. 771.) Both are set at the same rate, and transactions covered by the sales tax are exempt from the use tax; as a result, a sale or use "is taxed once for the support of the state government." (*Ibid.*, quotation and citation omitted; see also § 6401.)

² The Department addresses plaintiffs' sales tax reimbursement refund claim (Fifth Cause of Action), which names the Department and a set of retailers as defendants. Plaintiffs did not name the Department as a defendant to their breach of contract claim (First Cause of Action); the Department therefore leaves the briefing on the viability of this claim largely to retailer defendants.

³ All references are to the Revenue & Taxation Code unless otherwise specified.

The Department is responsible for the administration and enforcement of the sales and use tax programs. (§ 7051; *Ontario Community Foundation, Inc. v. State Bd. of Equalization* (1984) 35 Cal.3d 811, 816.) Among other things, it “may prescribe, adopt, and enforce rules and regulations” and determine “the extent to which any ruling or regulation shall be applied without retroactive effect” (§ 7051.) In addition, the Department issues less formal guidance for the use of retailers and consumers, through, for example, tax code annotations (see Cal. Code Regs., tit. 18, § 5700) and guidance documents.⁴ It rules on taxpayer claims for refunds (§ 6901 et seq.), conducts investigations and audits (§ 7054), and fields and responds to calls and emails from the public (see *Loeffler, supra*, 58 Cal.4th at p. 1123). Along with the general and important interest of the State in raising revenues, the Department has ““a vital interest in the integrity”” of the sales and use tax system. (*Id.* at p. 1114, quoting *Javor, supra*, 12 Cal.3d at p. 800.)

II. THE RETAILER IS THE TAXPAYER

“The central principle of the sales tax is that retail sellers are subject to a tax on their ‘gross receipts’ derived from retail ‘sale’ of tangible personal property.” (*Loeffler, supra*, 58 Cal.4th at p. 1105, quoting § 6051.) More specifically, sales tax is a tax on the ““privilege of conducting a retail business[,]” not a tax on the property sold. (*City of Pomona v. State Bd. of Equalization* (1959) 53 Cal.2d 305, 309, quoting *Livingston Rock and Gravel Co. v. De Salvo* (1955) 136 Cal.App.2d 156, 160.) Thus, “[t]he

⁴ A variety of publications are available on the Department’s website: <<https://www.cdtfa.ca.gov/formspubs/pubs.htm>>.

retailer is the taxpayer, *not* the consumer.” (*Loeffler, supra*, 58 Cal.4th at p. 1104, italics in original.)⁵

For purposes of determining gross receipts subject to tax, a retailer may opt to simply absorb the cost of paying sales tax (*Loeffler, supra*, 58 Cal.4th at pp. 1103, 1117; § 6012), sell the product as “tax included,” and adjust the sales price of the product, as it would for any other business expense, such as property taxes or permit fees. Alternatively, as is more common, a retailer may—but is not required to—obtain separate reimbursement from the consumer for the retailer’s sales tax liability at the time of sale and as a matter of contract. (*Loeffler, supra*, 58 Cal.4th at pp. 1108-1109; § 6012; Civ. Code, § 1656.1; Cal. Code Regs., tit. 18, § 1700.) In that case, gross receipts exclude sales tax reimbursement. (§ 6012.) Separately noting sales tax and collecting sales tax reimbursement “merely avoids payment by the retailer of a tax on the amount of the tax.” (*Western Lithograph Co. v. State Bd. of Equalization* (1938) 11 Cal.2d 156, 164.)

In its dealings with the Department, the retailer is entitled to a presumption that the parties to a sales transaction agreed to an additional sales tax reimbursement charge (in contrast to a tax-included total charge) if the retailer follows prescribed protocols in its dealings with consumers (§ 6012)—for example, if “[s]ales tax reimbursement is shown on the sales check or other proof of sale[.]” (Civ. Code, § 1656.1, subd. (a)(2); Cal. Code Regs., tit. 18, § 1700, subd. (a)(2)(B) [same].) While the additional charge paid by consumers is sometimes referred to as “sales tax,” this is a misnomer; consumers are in fact paying sales tax reimbursement. (See *Loeffler, supra*, 58 Cal.4th at p. 1135 (dis. opn. of Liu, J.); see also *id.* at pp.

⁵ This approach is sometimes referred to as a “vendor tax.” Due & Mikesell, *Sales Taxation, State and Local Structure and Administration* (2nd ed. 1994) p. 28 [discussing States’ differing approaches].

1108-1109.) The sales tax relationship at all times remains “between the retailer only and the state; and is a direct obligation of the former.” (*Id.* at p. 1104, quoting *Livingston Rock & Gravel Co., supra*, 136 Cal.App.2d at p. 160.)

By statute, collection of sales tax reimbursement cannot result in a retailer windfall. Retailers must timely remit to the Department all sales tax reimbursement collected, or be subject to a penalty of 40 percent of the amount due. (§ 6597, subd. (a)(1).) Further, when sales tax reimbursement is “computed upon an amount that is not taxable or is in excess of the taxable amount and is actually paid by the customer” to the retailer, the retailer cannot retain it, but must either return the reimbursement to the customer or remit it to the Department. (§ 6901.5; see also *Loeffler, supra*, 58 Cal.4th at pp. 1117-1120 [discussing history and function of § 6901.5]; Cal. Code Regs., tit. 18, § 1700, subd. (b)(2).)

III. TAXPAYERS MAY PURSUE SALES TAX REFUNDS IN THE MANNER PROVIDED BY THE LEGISLATURE

Article XIII, section 32 provides that a taxpayer may challenge the imposition of a tax only after first paying the tax and then seeking a refund, and only “in such manner as may be provided by the Legislature.”⁶ (See *State Bd. of Equalization v. Superior Court* (1985) 39 Cal.3d 633, 638-639 [“the sole legal avenue for resolving tax disputes is a postpayment refund action”].) This “strict legislative control” over methods for obtaining a tax refund reflects the government’s need to “engage in fiscal planning based

⁶ Article XIII, section 32 states: “No legal or equitable process shall issue in any proceeding in any court against this State or any officer thereof to prevent or enjoin the collection of any tax. After payment of a tax claimed to be illegal, an action may be maintained to recover the tax paid, with interest, in such manner as may be provided by the Legislature.” (Cal. Const., art. XIII, § 32.)

on expected tax revenues.” (*Woosley, supra*, 3 Cal.4th at p. 789.) Section 32 “allow[s] revenue collection to continue during litigation so that essential public services dependent on the funds are not unnecessarily interrupted.” (*Pacific Gas & Elec. Co. v. State Bd. of Equalization* (1980) 27 Cal.3d 277, 283, citing *Modern Barber Colleges, Inc. v. Cal. Employment Stabilization Com.* (1948) 31 Cal.2d 720, 726.) The drafters recognized that “[a]ny delay in the proceedings of the officers, upon whom the duty is devolved of collecting the taxes, may derange the operations of government, and thereby cause serious detriment to the public.” (*Ibid.*, quotation and citation omitted.) By the force of section 32, courts are precluded from “expanding the methods for seeking tax refunds expressly provided by the Legislature.” (*Woosley, supra*, 3 Cal.4th at p. 792.)⁷

Exercising its powers under section 32, the Legislature enacted a comprehensive administrative scheme “to resolve ... tax questions and to govern disputes between the taxpayer and the [Department].” (*Loeffler, supra*, 58 Cal.4th at p. 1103.) Under this system, any taxpayer may challenge the imposition of sales tax by paying the tax and then filing an administrative claim for refund with the Department. (§ 6901 et seq.) Claims must be filed within the deadlines set by statute. (§ 6932 [“No suit or proceeding shall be maintained in any court for the recovery of any amount alleged to have been erroneously or illegally determined or collected unless a claim for refund or credit has been duly filed pursuant to Article 1 (commencing with Section 6901).”].) Administrative exhaustion

⁷ See also *Loeffler, supra*, 58 Cal.4th at p. 1102 (section 32 “vests power over tax procedure in the Legislature, and limits or governs the authority of the courts over tax collection disputes”); *Western Oil & Gas Assn. v. State Bd. of Equalization* (1987) 44 Cal.3d 208, 213 (section 32 “broadly limits in the first instance the power of the courts to intervene in tax collection matters”).

thus is a prerequisite to judicial review. (*Ibid.*) If the Department denies a timely claim for refund, the taxpayer may within 90 days bring an action in court for a refund of sales tax. (§ 6933.) Any failure to act within the deadlines set by statute results in the waiver of a refund claim. (*Ibid.*)

The Legislature has provided no general tax-related refund remedy for any person other than a taxpayer.⁸

IV. THE PRESUMPTION OF TAXABILITY AND STATUTORY SALES TAX EXEMPTIONS

In general, “it is *presumed* that all ‘gross receipts’” for the sale of tangible personal property “are subject to the sales tax unless the contrary is established by the retailer.” (*Loeffler, supra*, 58 Cal.4th at p. 1107, italics in original, citing § 6091.) The presumption ensures the proper administration of the sales tax law and prevents its evasion. (*Ibid.*)

While a calculation of sales tax owed based on gross receipts may appear straightforward, in fact “a complex system of statutes and regulations minutely controls tax liability.” (*Loeffler, supra*, 58 Cal.4th at p. 1104.) For example, “an entire chapter of the sales and use tax law is devoted to exemptions.” (*Id.* at p. 1105, citing § 6351 et seq.; see also Cal. Code Regs., tit. 18, § 1581 et seq.) The exemption statutes and their implementing regulations cover a wide variety of sales, and apply in varied ways, depending on the factual circumstances of the transaction. (See

⁸ The Legislature has provided consumers direct relief in specific circumstances. For example, in 1993, the Legislature enacted Senate Bill No. 263 to create a comprehensive legislative scheme for distributing refunds of transaction and use taxes, where the tax had been declared to be unconstitutional and the revenues had been impounded by the levying agency. (§§ 7275-7279.6 (Stats. 1993, ch. 1060, § 2); see also *Kuykendall v. State Bd. of Equalization* (1994) 22 Cal.App.4th 1194 [upholding Legislature’s refund scheme against constitutional challenge], discussed *post* at p. 48.)

Loeffler, supra, 58 Cal.4th at pp. 1105-1106; see also *id.* at 1106 [discussing how exemptions might apply to “to-go” coffee.] “[W]hether a particular sale is subject to or exempt from sales tax, is exceedingly closely regulated, complex, and highly technical.” (*Loeffler, supra*, 58 Cal.4th at p. 1103.) A retailer must support any exemption claim by adequate records and bears the burden of proof. (*Id.* at p. 1107.) In addition, and in general, exemptions are construed liberally in favor of the taxing authority and strictly against the taxpayer. (*Beatrice Co. v. State Bd. of Equalization* (1993) 6 Cal.4th 767, 775.)

V. CONDITIONAL SALES TAX EXEMPTION FOR GLUCOSE TEST STRIPS AND LANCETS

For well over half a century, the Legislature has conditionally exempted medicines from sales tax if they are (1) “prescribed” by an “authorized” person; and (2) “dispensed on prescription filled by a registered pharmacist” (§ 6369, subd. (a)(1); Stats. 1961, ch. 866, § 1, p. 2273; Cal. Code Regs., tit. 18, § 1591.) In 1981, the Legislature amended section 6369 to further provide that “[i]nsulin and insulin syringes furnished by a registered pharmacist to a person for treatment of diabetes as directed by a physician shall be deemed to be dispensed on prescription within the meaning of this section.” (§ 6369, subd. (e); Stats. 1981, ch. 1530, § 1, pp. 5954-5955; see also Cal. Code Regs., tit. 18, § 1591.1, subd. (b)(5).)⁹

⁹ The cited regulation provides: “‘Insulin’ and ‘insulin syringes’ furnished by a pharmacist to a person for treatment of diabetes as directed by a physician shall be deemed to be dispensed on prescription within the meaning of Revenue and Taxation Code section 6369(e). As such, the sale or use of insulin and insulin syringes furnished by a pharmacist to a person for treatment of diabetes, as directed by a physician, is exempt from tax.”

In 2000, the Department by formal regulation extended the conditional exemption for insulin and insulin syringes to glucose test strips and lancets sold under similar conditions. (Cal. Code Regs. tit. 18, § 1591.1, subd. (b)(5); see also 1 Appellants' Appendix (AA) 197-206 [Final Statement of Reasons].)¹⁰ Regulation 1591.1(b)(5) provides in relevant part:

Glucose test strips and skin puncture lancets *furnished by a registered pharmacist that are used by a diabetic patient to determine his or her own blood sugar level and the necessity for and amount of insulin and/or other diabetic control medication needed to treat the disease in accordance with a physician's instructions ...* are not subject to sale or use tax pursuant to subsection (e) of Revenue and Taxation Code section 6369.

(Italics added.) The Final Statement of Reasons justified the extension as follows: “Based on evidence supplied by industry, the [agency] concluded that these items were so integrated with the operation of insulin and insulin syringes (the syringes cannot be used until the patient has first tested his blood sugar using the lancets and test strips) that the Legislature intended that their sales be exempt from tax as part and parcel of the exemption for sales of insulin syringes under section 6369(e).” (1 AA 200; see also *id.* at 203.) Two commenters objected that the conditional exemption for glucose test strips and lancets was not authorized by statute, one noting that the

¹⁰ Regulation 1591.1, subdivision (b)(5) overrode the previous interpretation contained in Annotation 425.0462. (See *Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1, 7-8 [tax regulations entitled to greater weight than tax annotations].) Annotation 425.0462 provided that “[s]ince the statute does not mention ‘related supplies’, test devices such as glucose monitors and glucose test strips do not qualify for the exemption.” The Department’s tax annotations related to prescription medicines and medical devices are available at <<http://www.boe.ca.gov/lawguides/business/current/btlg/vol2/suta/425-0000.html>> [as of Dec. 12, 2017].

Legislature previously had considered but failed to enact such an exemption. (1 AA 202-203; see also Sen. Bill No. 2049 (Reg. Sess. 1995-1996) [proposing to expand existing statutory exemption to test strips and lancets sold by registered pharmacist].)¹¹ Another commenter “requested that the exemption be extended to *all* uses of test strips, etc., which the [agency] rejected on the ground it was beyond the scope of the statute.” (1 AA 203, italics added.)

The Department and its staff have provided additional guidance on the meaning and application of the conditional exemption for glucose test strips and lancets. For example, in 2003, after conducting a phone survey of pharmacy practices and concluding that there were “inconsistencies” in how Regulation 1591.1 was being applied to these products, agency staff sent a guidance letter to California drug stores. (1 AA 210 [letter from C. Paliani, Program Planning Manager]; see also 1 AA 3 [Fourth Amended Complaint (FAC) ¶ 6, noting that Paliani letter was sent to “almost 13,000” pharmacy retailers].) The letter stated that the required “physician instructions” “need not come up to the level of a ‘prescription[,]’” but that a copy must be provided to the pharmacist. Further, the letter stated:

If your inventory of glucose test strips and skin puncture lancets are kept in a secure location (controlled) and a registered pharmacist dispenses the items to the customer, no tax would be due. However, if your customers are able to remove the items directly off the shelf and pay for them at your store’s registers, without a pharmacist’s intervention, the sales are subject to tax.

(1 AA 210.)

¹¹ The history of Senate Bill No. 2049 is available at <http://www.leginfo.ca.gov/cgi-bin/postquery?bill_number=sb_2049&sess=9596&house=B&author=senators_leslie,_ayala,_craven,_and_mello> [as of Dec. 12, 2017]. See the Department’s Motion for Judicial Notice, filed together with this answer.