



## CALIFORNIA DEPARTMENT OF TAX AND FEE ADMINISTRATION

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EDMUND G. BROWN JR.  
Governor

MARYBEL BATJER  
Secretary, Government Operations Agency

NICOLAS MADUROS  
Director

September 6, 2018

Dear Interested Party:

Enclosed is the Discussion Paper on proposed amendments to Regulation 1503, *Hospitals and other Medical Service Facilities, Institutions and Homes for the Care of Persons*. Staff would like to invite you to discuss the issue and present any additional suggestions or comments. Accordingly, an interested parties meeting is scheduled as follows:

**September 27, 2018**  
**Room 122 at 10:00 a.m.**  
**450 N Street, Sacramento, CA**

If you would like to participate by teleconference, call 1-888-822-7517 and enter access code 5038418. You are also welcome to submit your comments to me at the address or fax number in this letterhead or via email at [Trista.Gonzalez@cdtfa.ca.gov](mailto:Trista.Gonzalez@cdtfa.ca.gov) by October 12, 2018. You should submit written comments including proposed language if you have suggestions you would like considered during this process. Copies of the materials you submit may be provided to other interested parties, therefore, ensure your comments do not contain confidential information. Please feel free to publish this information on your website or distribute it to others that may be interested in attending the meeting or presenting their comments.

If you are interested in other Business Taxes Committee topics refer to the CDTFA webpage at (<http://www.cdtfa.ca.gov/taxes-and-fees/business-taxes-committee.htm>) for copies of discussion papers and calendars of current and prior issues.

Thank you for your consideration. Staff looks forward to your comments and suggestions. Should you have any questions, please feel free to contact Business Taxes Committee staff member Mr. Robert Prasad at 1-916-445-2710, who will be leading the meeting.

Sincerely,

Trista Gonzalez, Chief  
Tax Policy Bureau  
Business Tax and Fee Division

TG:rp  
Enclosures

cc: (all with enclosures)

Mr. Nicolas Maduros (MIC 104)  
Mr. Tad Egawa (MIC 83)  
Ms. Susanne Buehler (MIC 43)  
Mr. Wayne Mashihara (MIC 47)  
Mr. Todd Gilman (MIC 70)  
Mr. Jason Mallet (MIC 25)  
Mr. Kevin Hanks (MIC 49)  
Mr. Robert Tucker (MIC 82)  
Ms. Leslie Ang (MIC 82)  
Mr. Jeff Vest (MIC 85)  
Mr. Bradley Heller (MIC 82)  
Mr. David Levine (MIC 85)  
Ms. Dana Brown (MIC 85)  
Ms. Casey Tichy (MIC 85)  
Mr. Rick Zellmer (MIC 85)  
Mr. Scott Claremon (MIC 82)  
Ms. Kirsten Stark (MIC 50)  
Ms. Lynn Whitaker (MIC 50)  
Mr. Joe Fitz (MIC 67)  
Mr. Marc Alviso (MIC 104)  
Ms. Karina Magana (MIC 47)  
Mr. Bradley Miller (MIC 92)  
Mr. Alfred Buck (MIC 70)  
Mr. Robert Wilke (MIC 50)  
Mr. Robert Prasad (MIC 50)

**DISCUSSION PAPER**  
**Medical Service Facilities**  
**Proposed Amendments to Regulation 1503**

**Issue**

Whether the California Department of Tax and Fee Administration (CDTFA) should amend Regulation 1503, *Hospitals and Other Medical Facilities, Institutions and Homes for the Care of Persons*, to clarify the application of tax to tangible personal property furnished or consumed by medical service facilities in connection with the performance of their services.

General

California imposes sales tax measured by a retailer's gross receipts from the retail sale of tangible personal property in California, unless the sale is specifically exempt or excluded from taxation by statute. While the sales tax is imposed upon the retailer for the privilege of selling tangible personal property at retail in California, the retailer may collect tax reimbursement from the customer if the contract of sale so provides. When sales tax does not apply, use tax is imposed upon the consumer, measured by the price of the property purchased for the storage, use, or other consumption in California, unless the purchase is specifically exempted or excluded from taxation by statute.

A "sale" means and includes any transfer of title or possession, in any manner or by any means whatsoever, of tangible personal property for a consideration. In general, "gross receipts" mean the total amount of the sale, without any deduction on account of the cost of the materials used, labor, or service cost, or any other expense. It is presumed that all gross receipts are subject to the tax until the contrary is established, and 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 or she accepts a resale certificate from the purchaser. However, gross receipts from sales of any tangible personal property to the United States, including its unincorporated agencies and instrumentalities, are exempted from the sales tax.

Regulation 1501, *Service Enterprises Generally*

Regulation 1501 provides guidance with respect to the application of tax to service enterprises. Regulation 1501 specifies that persons engaged in the business of rendering services are consumers, not retailers, of the tangible personal property which they use incidentally in rendering the service. Accordingly, tax applies to the sale of the property to them. 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.

The basic distinction in determining whether a particular transaction involves a sale of tangible personal property or the transfer of tangible personal property incidental to the performance of a service is one of the true object of the contract; that is, is the real object sought by the buyer the service per se or the property produced by the service. If the true object of the contract is the service per se, the transaction is not subject to tax even though some tangible personal property is transferred. Examples of service enterprises and regulations pertaining thereto are found in regulations which follow Regulation 1501.

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**Background**

Regulation 1503, *Hospitals and Other Medical Facilities, Institutions and Homes for the Care of Persons*

*Historical Application*

Hospitals and other qualified institutions have traditionally been considered service enterprises; they are generally the consumers of property which they incidentally use in rendering service, meaning that the sale to the hospital or qualified institution is a retail sale and not a sale for resale. Accordingly, tax generally applies to the sale of such property by a supplier to the hospital, measured by the “cost” price charged to the hospital. However, under Ruling 7 (the predecessor to Regulation 1503), hospitals and other qualified institutions were classified as retailers of property furnished to patients for a separate charge, including “drugs” and “medicines.” Hospitals could choose to not bill separately for many items commonly furnished to patients, so that the hospitals would be treated as consumers of those items and therefore the tax would be measured by the “cost” price rather than a marked-up retail sale price. While the 1961 adoption of RTC section 6369 (operative January 1, 1962) provided an exemption for medicines, hospitals could still be classified as retailers of certain items that did not qualify for the medicine exemption, such as casts, bandages and non-prescription medications.

Regulation 1503 was amended in 1970, to distinguish between: 1) non-administered property regarded as sold to the patient, such as toothbrushes, combs, and admission kits and 2) property requiring professional administration, such as bandages or castings. Hospitals were considered retailers of the first category, non-administered property, regardless of how they were billed. For the second category, property requiring professional administration, the amendments to Regulation 1503 in 1970 provided that when a charge is made for the property and a separate charge for its administration, the tax applies to the charge for the property (if not otherwise exempt), but not to the charge for its administration. Consequently, a hospital or other qualified institution was considered the retailer of supplies it transferred to its patients if the supply item was “administered” and the institution billed the patient separately for the supply item and for the “administration” service.

In addition, hospitals and other similar institutions were always the consumers of reusable or non-reusable property consumed by the hospital in providing patient service, whether or not the charge for the property was separately itemized on the patient’s bill. In fact, the guidance promulgated by the Board of Equalization at that time indicates that a large portion of the supply items purchased by institutions fall into this category and were always consumed by the institutions, including: q-tips, drapes, scrub brushes, sterile dressings, masks, hair clips, exam gloves, elbow and heel pads, sponges, blankets, towels, sheets, scalpels, table and equipment covers, bottles, basins, sheets, sleeves, lenses, disposable needles, bedpans and urine collectors, birthing pads, and thermometers (See, e.g., Annotation 300.0007.200 (4/30/92)); I/V Containers, Enema Bags and syringes (See, e.g., Annotation 300.0035 (3/2/82)); reusable items and disposable gloves (See, e.g., Annotation 300.0134 (12/27/95)).

In 2001, Regulation 1503 was amended to clarify that hospitals and similar institutions, recharacterized as “medical service facilities,” were the consumers of all property furnished to

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patients and residents, regardless of whether billed as itemized charges or lump sum and without consideration for whether the property is administered by the employees of the facility. Hospitals were considered retailers of tangible personal property intended to be removed by the patient from the medical service facility's premises for the patient's use. Additionally, Regulation 1503 was amended to allow medical service facilities to be the retailer of property furnished if they entered into a contract with the patient to transfer title from the facility to the patient.

*Current Application*

Regulation 1503 describes when a medical service facility is a retailer or a consumer of tangible personal property that it uses or furnishes to its patients in connection with the provision of medical services. Subdivision (b)(1) of Regulation 1503 provides the general rule that medical service facilities are service providers to their patients and residents and are the consumers of tangible personal property furnished to those patients and residents in connection with those services. Therefore, unless specifically exempted, sales of tangible personal property to medical service facilities are generally taxable sales and the furnishing of the property to patients and residents are not retail sales. This general rule applies regardless of how the medical service facility bills for the treatment of the patient, resident or customer; that is, whether the medical service facility itemizes and separately bills for such items, or uses a lump sum method of billing for each particular medical service.

However, subdivision (b)(2) provides that if the property is furnished to a patient or resident with the intent that the patient or resident remove the property from the premises of the medical service facility for their own use, then a medical service facility is the retailer of tangible personal property for which it makes a separately itemized charge. Examples of these items include crutches or a wheelchair provided upon release from the medical service facility.

Subdivision (b)(2) also provides that a medical service facility is the retailer of any property furnished in connection with its medical services if its contract with the resident, patient or other customer specifically provides that title to the property passes to the resident, patient or other customer. When the contract has a provision passing title to the subject property to the resident, 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.

Regulations 1591, Medicines and Medical Devices, and 1614, Sales to the United States and Its Instrumentalities

Regulations 1591 and 1614 provide that 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 States. Regulation 1591 further explains that 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.

**Discussion**

As stated in the Formal Issue Paper presented to the Board of Equalization with regard to the

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prior amendments:

It is clear that hospitals are primarily service providers. . . . Staff believes the abolishment of the regulatory distinction between administered and non-administered medical supply items would help to ensure that hospitals are taxed based on the true object of the contract, which would be as the provider of the services to their patients, rather than on distinctions such as “administered” versus “non-administered” and itemized billing versus lump-sum billing.

[¶] . . . [¶]

Amending Regulation 1503 to abolish the distinction between administered and non-administered medical supply items will simplify sales and use tax reporting for hospitals and medical service facilities as well as for their suppliers, reducing the need for complex accounting records to distinguish between taxable and nontaxable supply purchases.

Acknowledging that a medical service facility cannot take advantage of the exemption for sales to the United States Government under Medicare Part A when it is a consumer, the prior amendments to Regulation 1503 provided that medical service facilities are retailers of property furnished in connection with their medical services if an explicit clause in the contract between the facility and the patient, resident, or customer transfers title to those items to the patient, resident, or customer. It also states:

However, the exemption for sales to the federal government, under Medicare Part A, does not apply unless the hospital is selling tangible personal property to the United States. This exemption would not apply when a medical service facility acts as a consumer. Nevertheless, current industry practice, as found in recent hospital audits, is that hospitals are not structuring their transactions to be sales to the United States, and that they are thus not claiming exempt government sales. Additionally, medical service facilities will still have the option to be a retailer under the proposed regulation by including an explicit clause in the contract between the facility and the patient transferring title to medical supply items to the patient.

Current Industry Practice

When Regulation 1503 was amended in 2001, as industry practice, hospitals and medical service facilities were not structuring their transactions to be sales to the United States, and accordingly, they were not claiming exempt government sales. Recently, staff has noted a trend with medical service facilities including a title provision in their admission agreements, in which a patient eligible for Medicare Part A acknowledges that title to all tangible medical-related products and devices provided to the patient or consumed while providing services to the patient while in the hospital, vests in the patient. Such facilities are subsequently filing claims for refund on the grounds that they are entitled to claim a tax-paid purchases resold deduction for those items as tax had been paid or accrued and reported at the time of purchase and such items sold to patients covered under Medicare Part A are exempt sales to the United States Government.

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Staff's Proposed Amendments

The application of tax should be based on the economic reality of a transaction, rather than on the way a transaction is billed or the inclusion of a title clause in a medical service facility's admission agreement. Medical service facilities are primarily service providers. They generally do not sell the tangible personal property they use or furnish in the provision of medical services to their patients. Rather, a medical service facility is the consumer of tangible personal property used or furnished in connection with the performance of its services. This is reflected in both past industry practices and the history of Regulation 1503 described above. The recent trend of medical service providers including a title transfer clause only in contracts with Medicare Part A patients does not reflect the economic reality of these transactions and creates an artificial distinction with identical transactions involving non-Medicare patients.

In addition, as noted above, medical service facilities are often claiming that they are the retailer of *all* tangible personal property furnished to a patient or *consumed by the facility*. As a result, medical service facilities now claim that they are the retailer of tangible personal property that they were always the consumer of under the prior amendment. The purpose of adding the title transfer clause exception in 2001 was to maintain medical service facilities' ability to take advantage of the exemption for sales to the United States Government, not to expand the scope of the exemption to tangible personal property that had always been considered to be self-consumed by medical service facilities.

Accordingly, since there is no statutory distinction between patients and residents who are or are not insured pursuant to Medicare Part A staff proposes amendments to Regulation 1503, subdivision (b)(1), as shown in Exhibit 1, to clarify that the medical service facilities are service providers to their patients and residents, which include patients and residents insured pursuant to Medicare Part A.

Staff also proposes amendments to Regulation 1503 subdivision (b)(2), in proposed subparagraph (A), to further clarify that subparagraph (A) only applies when the property is furnished to a person other than a patient or resident. In other words, it does not apply when property is furnished to a patient or resident insured under Medicare Part A.

Additionally, staff also recommends adding subparagraph designations (A), (B), and (C) to subdivision (b)(2), for ease of understanding the conditions under which a medical service facility is a retailer of tangible personal property. Staff also proposes an amendment to the paragraph to be designated as subparagraph (C) making that provision become inoperative after December 31, 2018, to clarify that medical service facilities cannot be the retailer of tangible personal property consumed in the provision of service to a resident, patient or other customer by including a title transfer clause in the contract with the resident, patient or other customer. The application of tax should reflect the economic reality of these transactions, without artificial distinction between identical transactions involving non-Medicare and Medicare patients.

*Non-substantive revision*

While reviewing the rulemaking files for Regulation 1503, staff noted that the final text of the February 15, 2001, amendments to Regulation 1503 submitted and approved by the Office of

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Administrative Law included double underline font, strikeout, and brackets ([]) to show a proposed change with respect to the operative date added in subdivision (b)(1). While brackets are not specifically included or excluded as a uniform method to clearly indicate changes to regulations, there was not a written description with the final text that the brackets were used to show text added following the public hearing. As a result, brackets were inadvertently included in the official text of the regulation. Staff proposes to delete the brackets, as they were never intended to be part of the regulation.

Finally, staff recommends clarifying that the provisions of the tax exemption in subdivision (b)(3) apply to human whole blood or blood plasma for use in transfusions. This eliminates any potential confusion that animal blood may qualify.

**Summary**

Staff welcomes any comments, suggestions, and input from interested parties on this issue. Staff also invites and encourages those who are interested to participate in the September 27, 2018 interested parties meeting. If you plan to attend via teleconference, please let staff know and an agenda or other material(s) for the meeting will be emailed to you in the morning on the day of the meeting. The deadline for interested parties to provide written responses regarding this discussion paper is October 12, 2018.

Prepared by the Tax Policy Bureau, Business Tax and Fee Division.

Current as of September 6, 2018

Reg 1503 IDP.docx



**1503. Hospitals and Other Medical Service Facilities, Institutions and Homes for the Care of Persons.**

(a) Meals.

(1) There are exempt from sales and use tax the sale of meals and food products to and the use of meals and food products by the following institutions when furnished or served to and consumed by their residents or patients:

(A) A health facility as defined in section 1250 of the Health and Safety Code, which holds the license required pursuant to section 1253, or is exempt from the license requirement pursuant to subdivision (a) of section 1270, or is operated by the United States.

(B) A community care facility as defined in section 1502 of the Health and Safety Code, which holds the license required by section 1508, or is a residential facility selected by a licensee pursuant to section 1506 and exclusively used for the reception and care of persons placed by such licensee, or is exempt from the license requirement pursuant to subdivision (f) of section 1505, or is operated by the United States.

(C) A residential care facility for the elderly, as defined in Section 1569.2 of the Health and Safety Code, that holds the license required by Section 1569.10 of the Health and Safety Code or is exempt from the license requirements pursuant to Section 1569.145 of the Health and Safety Code, or is operated by the United States.

(D) Any house, retirement home or similar establishment supplying board and room for a flat monthly rate and serving as a principal residence exclusively for persons 62 years of age or older, and any housing that primarily serves older persons and that is financed by state or federal programs. For purposes of this regulation, the term "exclusively" is defined to mean that no more than four persons under 62 years of age are in residence during any calendar quarter.

(E) An alcoholism or drug abuse recovery or treatment facility, as defined in section 11834.02 of the Health and Safety Code, which holds the license required by section 11834.30 of the Health and Safety Code.

(2) "Meals," for purposes of this subdivision, include any of the following:

(A) Carbonated beverages furnished or served as part of the meals.

(B) Food provided to the patient or resident by way of enteral feeding, Total Parenteral Nutrition (also called TPN), and Intradialytic Parenteral Nutrition (also called IDPN), as each is defined in Regulation 1591, provided these forms of nutrition are furnished or served to and consumed by a resident or patient of an institution specified in this subdivision (a).

(C) Nonreusable items that become components of the meals. These include straws, paper napkins, and plastic eating utensils. These also include bags and tubing, as well as filters, locks, tape, clamps, and connectors which are integral to the tubing, each of which is used to dispense enteral feeding as meals to the patient or resident including: gastrostomy tubes (also called G tubes) which are used to deliver the nutrition directly into the stomach; jejunostomy tubes (also called J tubes) which are used to deliver the nutrition directly into the intestinal tract; and nasogastric tubes (also called NG tubes) which are used to deliver the nutrition directly through the nasal passage to the stomach. Needles, syringes, cannulas, bags, and tubing, as well as filters, locks, tape, clamps, and connectors which are integral to the tubing, used to dispense TPN or IDPN as meals to the patient or resident are also regarded as components of those meals provided each of these items is used primarily to dispense the TPN or IDPN.

(b) General.

(1) Sales to Medical Service Facilities. "Medical service facilities" for purposes of this subdivision are those institutions specified in subdivision (a) of this regulation as well as surgery centers and similar medical service facilities whether patients are accepted for periods of less than or more than twenty-four hours. For example, dialysis centers, AIDS centers, and cancer centers are medical service facilities. ~~Operative April 1, 2001, e~~xcept as provided in subdivisions (b)(2) of this regulation, medical service facilities are service providers to their patients and residents, [including patients and residents insured pursuant to Part A of the Medicare Act](#), and are the consumers of tangible personal property furnished in connection with those services, whether separately itemizing charges for the services and for the tangible personal property or billing in lump sum, and sales of that tangible personal property to the medical service facilities are taxable retail sales unless specifically exempted.

(2) Sales by Medical Service Facilities. When a medical service facility is the retailer of property furnished, tax applies to its charge for that property unless the sale is exempt from tax.

(A) A medical service facility is the retailer of property furnished ~~for a charge~~ to persons other than residents and patients [for a charge](#).

(B) A medical service facility is the retailer of tangible personal property for which it makes a separately itemized charge if the property is furnished to a patient or resident with the intent that the patient or resident remove the property from the premises of the medical service facility for use by the patient or resident. Examples of such items include crutches or a wheelchair provided upon release from the medical service facility and discharge kits for new mothers (which might include formula, diapers, etc.).

(C) [Prior to January 1, 2019, n](#)otwithstanding subdivision (b)(1) of this regulation, a medical service facility is the retailer of any property furnished in connection with its medical services if its contract with the medical service facility's 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 the contract has a provision

passing title to the subject 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.

(3) Laboratory Charges. Laboratory charges, such as charges for blood-counts, are not taxable. Tax does not apply with respect to purchases, sales or donations of [human](#) whole blood or blood plasma for use in transfusions.

Note: Authority cited: Section 7051, Revenue and Taxation Code. Reference: Sections [33](#), 6006, 6007, 6015, 6016, 6051, 6359 and 6363.6, Revenue and Taxation Code.