M e m o r a n d u m

425.0142.010

To: Mr. Robert Roos
Oakland District Auditing – CH

Date: October 5, 1995

From: John L. Waid
Senior Staff Counsel

Subject: Purchase of Durable Medical Equipment
Out-Patient Pharmacy Sales

I am responding to your memorandum to the Legal Division dated July 21, 1995. You indicate that the district is currently auditing X---------- and two issues have arisen both of which appear to involve opinion letters of mine. You provide the following background information as to the taxpayers' general mode of operations:

"[S]ince January 1, 1988, the taxpayer has purchased non-inventoried expense items for resale, issuing [resale certificates]. The basis for this was that X---------- ['the Health Plan'] purchased the goods for resale to X----------['the Hospitals'] and X---------- ['the Medical Group']. Each is a separate legal entity. In most cases, the goods were ordered directly by [the Hospitals, the Health Plan, and the Medical Group], and the goods were delivered by the vendor directly to the user entity. The bills were sent to and paid by [the Health Plan]. The procedure has been approved by the Principal Tax Auditor. On February 15, 1995, the taxpayer was advised that [the Health Plan] must cease issuing a resale certificate for purchases of property which it knows at the time of purchase that it will be used by itself rather than resold to other entities."

A. Durable Medical Equipment ("DME").

You attached to your memorandum a copy of my letter dated January 26, 1995 to X---------- of the X---------, stating that, based on the facts as she recounted them, the Health Plan could not issue resale certificates for the purchase of the items described on the certificates. In the letter, I stated that the items described on the certificates were "articles and supplies required for the operation of Medical Clinics and Hospitals and all support facilities." Second, under the facts she supplied, it appeared that the X---------- member was selling the medical items at issue therein directly to the patient whom the Health Plan then reimbursed for the expense thereof. You describe the taxpayer's position as follows:

"The taxpayer takes issue with Mr. Waid's statement that the X---------- members are selling goods directly to the patient. The taxpayer contends that they retain title to the DME that is purchased from the X---------- members, and that the patient is seldom reimbursed for purchases from a X---------- member. If the patient has DME coverage, [Health Plan] pays the vendor directly almost one hundred percent of the time. The standard ... plan does not include DME coverage. DME coverage is optional."

You attached a copy of the optional DME coverage plan. It describes the coverage of DME as follows:

"Durable Medical Equipment, including oxygen dispensing equipment (and oxygen), used during a covered stay in a hospital or Skilled Nursing Facility is provided at no charge. When prescribed by a Physician, medically necessary durable medical equipment for use in the home is provided without charge. Health Plan, at its option, will decide whether to rent or purchase the equipment. The Member must return the equipment to Health Plan or pay Health Plan the fair market price when it is no longer prescribed .... "

The Plan defines DME, limitations' and exclusions, and says this about the role of Medicare:

"Members with Medicare or Part B of Medicare will be provided durable medical equipment covered under this provision by Medicare at no charge. However, benefits otherwise provided under this provision are reduced by any benefit a Member is eligible for under Medicare."

Health Plan's description of its operation is somewhat ambiguous and could be construed to mean that, whether or not the patient has the optional DME coverage, Health Plan purchases the prescribed DME and provides it to the patient at no charge. The facts as X---------- recites them make it appear, however, that the Health Plan does not supply DME to its members unless they have the optional DME coverage. In that event, the Health Plan generally purchases the DME from the X---------- member directly and retains title thereto. Health Plan then provides the DME to the patient at no charge, and the patient must either return the DME to the Health Plan or pay the latter the equipment's fair market price when "it is no longer prescribed." If the patient has Medicare B as well as Health Plan coverage, though, the member sells the DME directly to the patient, and Medicare reimburses the X-------- member. In that case, the Health Plan covers the co-payment.

The conclusion in my letter is thus correct as regards the use of resale certificates although the facts as stated there are somewhat different than those set forth herein. It now appears that when the Health Plan purchases the DME it does so for its own consumption. You indicate that the taxpayer maintains that it retains title to the DME. The Plan provides that the Health Plan provides the equipment to the patient free 6f charge and is also responsible for the repair and replacement of it. The Plan does indicate that there are circumstances under which the DME might eventually be sold to the patient, but such sales seem to occur, if at all, after the Health Plan makes use of the DME. (See., e.g., Kirk v. Johnson (1940) 37 Cal.App.2d 224.) We

thus conclude that the Health Plan may not purchase the DME ex tax for resale but that the sales to it are subject to sales or use tax.

B. Annotation 425.0142.

The taxpayer questions our opinion as expressed in my letter to X---------- dated January 8, 1993, regarding out-patient transfers of medicines to HMO members when the transferor is a pharmacy owned by the HMO and the member pays nothing or a small co-payment. In that letter, we concluded that such transfers were retail sales of the medicine for which the pharmacy was paid by the insurance division of the HMO. The letter was subsequently annotated as Annotation 425.0142. You indicate that, during a prior audit, the taxpayer received an oral opinion from the Legal Division contrary to the annotation that such transfers were consumptive uses by the HMO with any co-payment received being an additional premium. This would mean that the HMO's purchase of the containers for the medicines did not qualify for the Section 6464 exemption.

The facts, as you state them, are that the Health Plan purchases the medicines and containers free of tax for resale. The property is delivered directly to the entity which ordered them. Previous correspondence with you regarding this taxpayer indicates that the Health Plan acts as a medical insurer for the Hospitals (and also the Medical Group which is not concerned with this aspect of the problem). The pharmacies then transfer the medicines (which term includes for the purpose of this discussion medical items excluded from the definition of medicine under Regulation 1591(c) (2)) to their patients who are billed for the items but payment is made by the Health Plan. In all likelihood, the Hospitals treat themselves as the retailers of the medicines for the purposes of Regulation 1503.

The annotation sets forth the rule that, under Regulation 1591(n) and (o), a medical insurer is not the retailer of any property transferred to patients under its insurance plan merely because it supplies the money for the transfer. The January 8, 1993 letter, upon which the annotation is based, recognizes that, while the insurer can be the retailer if it sells tangible personal property on its own account, it is not made the retailer of medical items merely because its insurance programs provide the money which the patient uses to purchase them. You indicate that here both the Health Plan and the Hospitals operate outpatient pharmacies. Pharmacies are retailers required to obtain seller's permits. (Annot. 410.0250 (11/9/71).) Based on the facts you supply, then, we conclude that each is likely the retailer of items sold through its own pharmacies. The Hospitals' gross receipts are made up of the money they receive from the Health Plan plus the patients' co-payments.

The role of the Health Plan is a little more murky, and it would require additional facts to render a definitive opinion. If the Health Plan purchases the items tax-free by issuing its vendors resale certificates and bills its patients for the full amount, then it would be the retailer of the items sold with the measure of tax being the amount billed even though it subsequently reimbursed the patient for the amount billed. In that case, both the Hospitals and the Health Plan could buy drug containers ex tax. (Reg. 1589 (b) (1) (C) .) If, however, Health Plan buys the medical items it dispenses through its own pharmacies and does not bill the patients for such

transfers, it would be the consumer of those items (as well as the containers) with no tax due at the time of the transfer to the patient.

JLW:sr

Cc: Mr. William D. Dunn – MIC:49
Mr. Dennis Fox – MIC:40