# In the Supreme Court of the State of California

**MICHAEL McCLAIN, et al.,**

**Plaintiffs and Appellants,**

**v.**

**SAV-ON DRUGS, et al.,**

**Defendants and Respondents.**

Case No. S241471

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

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[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.)

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[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.

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[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

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[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

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[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]

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[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

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[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.)

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[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.

The Department has provided other informal guidance about the application of the test strip and lancet exemption. (see 1 AA 208; 2 AA 446-448, 450-452; see also Cal. Bd. of Equalization, Drug Stores, Publication 27 (Oct. 2016) p. 2 at <http://www.boe.ca.gov/pdf/pub27.pdf > [as of Dec. 13, 2017]; Publication 27, Drug Stores (Oct. 2016) at p. 2, <http://www.boe.ca.gov/pdf/pub27.pdf > [as of Dec. 12, 2017].)

To the Department's knowledge, Regulation 1591.1 has never been subject to challenge, and no request for repeal or amendment has been made to the Department.

## PROCEDURAL HISTORY

In 2004 and 2005, in two related cases, the plaintiff customers filed lawsuits on behalf of themselves and others similarly situated, alleging that they purchased skin puncture lancets and glucose test strips from stores owned and operated by defendants Sav-On Drugs; Gavin Herbert Company; Longs Drug Stores Corporation; Longs Drug Stores California, Inc.; Rite Aid Corporation; Walgreen Co.; Target Corporation; Albertson's, Inc.; The Vons Companies, Inc.; Vons Food Services, Inc.; Wal-Mart Stores, Inc.; and CVS Pharmacy, Inc. (collectively, "Retailers"). (*McClain, supra,* 9 Cal.App.5th at p. 690.) Plaintiffs alleged that the Retailers improperly charged them sales tax reimbursement on the sales of these items and requested relief—including a refund of reimbursement paid—under various legal theories. (*Ibid.*; see also 1 AA 214-215; Joint Respondents' Appendix (JRA) 5-17 [complaint]; JRA 22-38 [complaint].)

The parties thereafter engaged in discovery and motion practice, and the trial court made various interim rulings. (See 3 AA 632-691 [docket].) For example, in 2006, the court granted the Retailers' demurrer in part with leave to amend and, in the same order, required the Retailers to file cross-complaints against the Department. (See 1 AA 6 [example cross-

complaint].) In the same 2006 order, the trial court interpreted Regulation 1591.1(b)(5) as exempting lancets and glucose strips only when (1) furnished by a registered pharmacist; (2) for use by a diabetic patient; (3) in accordance with a physician's instructions, and held that if a consumer buys these items off a shelf available to the general public, rather than from the pharmacist, the sale is not tax exempt. (See 1 AA 215, 217.) And in 2008, before denying the Retailers' motion for summary judgment or adjudication (1 AA 248-249), the trial court engaged in further interpretation of the regulation, ruling that there was no blanket presumption that any purchase made at the pharmacy counter satisfied the additional exemption conditions. (1 AA 218-226, 228-229.) Thereafter, the trial court stayed the matter in most respects while the *Loeffler* appeal proceeded. (See 1 AA 252; 3 AA 493; JRA 50, 56.)

In August 2014, some three months after this Court's decision in *Loeffler*, plaintiffs filed the operative Fourth Amended Complaint. Plaintiffs asserted that, as a matter of law, "*all* sales of glucose test strips and skin puncture lancets are exempt from sales tax[.]" (1 AA 70 [FAC ¶ 27], italics added; see also *id.* at 72 [¶ 28].) Plaintiffs alleged claims for (1) breach of contract; (2) violation of the Unfair Competition Law (UCL), Business & Professions Code section 17200; (3) negligence; (4) violation of the California Legal Remedies Act (CLRA), Civil Code section 1770 et seq., and (5) injunctive relief under the legal theory set out in *Javor*. (1 AA 77-89 [¶¶ 44-92].) Only the *Javor* claim named the Department as a defendant; all other claims named only the Retailers. (*Ibid.*) Among other things, plaintiffs alleged that the Retailers breached their contracts by "charging Plaintiffs and the Class members sales tax reimbursement on the glucose test strips or skin puncture lancets when no sales tax was payable."

(1 AA 79 [FAC ¶ 50].)[12] Under the *Javor* claim, plaintiffs sought an order requiring the Retailers to submit a refund request "for all amounts of sales tax the [Retailers] paid on the sale of glucose test strips or skin puncture lancets since the Sales and Use Tax Regulation 1591.1 became effective on March 10, 2000[,]" and requiring the Department to "pay the refunds owed ...." (*Id.* at 83 [¶ 76].)

The trial court sustained the Retailers' and the Department's demurrers without leave to amend, denied plaintiffs' motion to amend their complaint to add constitutional claims, and entered a final judgment of dismissal. (AA 610-614; Reporter's Transcript (RT) (Feb. 24, 2015) 45-46.) It noted that "[w]hat was so unique about the *Javor* circumstance is, 'The Board has admitted it must pay these refunds to retailers.' That's something the Board has certainly not admitted in this case." (RT (Feb. 24, 2015) 4.) In the trial court's view, "[t]his case [was] more like *Loeffler* than *Javor*" because the taxability of the items at issue was "very hotly in dispute[.]" (*Id.* at 5.)

The Court of Appeal affirmed. The court focused primarily on whether plaintiffs had a viable claim under *Javor*. It determined that the "requisite 'unique circumstances'" were not present in this case because the Department "has yet to determine that all of the sales the customers challenge fall within the ambit of Regulation 1591.1's exemption." (*McClain*, *supra*, 9 Cal.App.5th at p. 702.) It followed that "none of the customers' claims—all of which are premised on the unlawful collection of sales tax reimbursement—state a viable cause of action." (*Ibid.*; see also *id.* at pp. 704-705.)

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[12] See also OBM at 35, noting that plaintiffs' "First Cause of Action alleges an implied-in-fact contract that the retailers would not seek tax reimbursement if a transaction was not subject to, or was exempt from, sales tax[.]"

The court also quickly rejected plaintiffs' takings and due process arguments. It held that "the retailer's initial collection of the [sales tax] reimbursement, it is not a 'taking' because the retailer is not a government entity[,]" and "the Board's subsequent receipt of that money ... is not a 'taking' because" taxes are not takings. (*McClain*, *supra*, 9 Cal.App.5th at p. 703.) Further, the court observed, the Retailer's receipt of sales tax reimbursement "is ostensibly outside the reach of due process because it reflects a contractual arrangement between two private parties[,]" and *Loeffler*, "noted no constitutional impediment to its ruling that left consumers with no direct remedy for a refund ...." (*Id.* at p. 704.) The court refused to address certain of plaintiffs' arguments on the ground that they were raised for the first time in a motion for rehearing—including "that denying them a remedy violates due process because the collection of sales tax reimbursement by retailers effects an 'escheat' to the state ...." (*Id.* at p. 705, fn. 9.)

On June 14, 2016, this Court granted plaintiffs' petition for review. Plaintiffs' petition sought review only as to dismissal of their claims for (1) breach of contract and (2) *Javor* relief. (PFR 16.) Plaintiffs now claim that review encompasses the trial court's denial of their request for leave to amend to allege a constitutional takings claim. (Opening Brief on the Merits (OBM) 5-6.)

## STANDARD OF REVIEW

Where a demurrer has been sustained without leave to amend, the reviewing court determines de novo whether the complaint states facts sufficient to support a cause of action, and whether any defect could be cured by amendment. (*Loeffler*, *supra*, 58 Cal.4th at p. 1100, citing cases.) The court assumes the truth of "properly pleaded or implied factual allegations," but not of "contentions, deductions, or conclusions of law."

(*Ibid.*, citing *Schifando v. City of Los Angeles* (2003) 31 Cal.4th 1074, 1081.) It "may also consider matters subject to judicial notice." (*Yvanova v. New Century Mortgage Co.* (2016) 62 Cal.4th 919, 924.)

## SUMMARY OF ARGUMENT

Consistent with the limits set forth in article XIII, section 32 of the state Constitution, and as provided by statute, a taxpaying retailer that believes it has overpaid sales tax may, post-payment, file a claim for refund with the Department and seek judicial review if that claim is denied. Consumers, in contrast, do not pay sales taxes; accordingly, neither the Constitution nor statute confers on them the right to bring similar sales tax refund claims and actions *against the Department*. And only in very limited circumstances has this Court recognized a consumer claim *against retailers* that may lead to a return of sales tax reimbursement. In *Javor*, where the state taxing entity had established conclusively by rule that a set of sales transactions were subject to a post-sale price adjustment (due to Congressional action), and thus retailers had collected excess sales tax reimbursements, the Court allowed a class of consumers to sue the relevant retailers and join the state taxing entity as a party. (*Javor*, *supra*, 12 Cal.3d at pp. 794, 802.) This arrangement complemented tax code procedures by allowing the superior court to order the retailers to make refund applications to the entity; the entity to respond by paying all sums due into the court; and the court in turn to ensure that the monies were returned to consumers. (*Id.* at p. 802.)

Plaintiffs have no claim under the theory of *Javor*, which requires the taxing entity to have already ascertained that excess sales tax reimbursement has been collected and paid over. The Department has made no such determination for sales taxes paid on the sales of the products at issue in this case. While the plaintiffs seek an unconditional, retroactive

exemption for past sales of glucose testing strips and lancets used in the treatment of diabetes, the Department's regulation—in place since 2000—recognizes only a conditional exemption for these products. And no one has asked the Department to undertake a rulemaking to determine whether an unconditional exemption for the sale of these products would be consistent with the relevant exemption statute.

Expanding *Javor* to allow consumers to routinely dispute how retailers have applied conditional tax exemptions would complicate, not complement, tax code procedures, sharing many of the problems that caused this Court to reject similar Unfair Competition Act and Consumer Legal Remedy Act claims in *Loeffler*. It fails to recognize that retailers may reasonably and appropriately decline to assert or waive exemptions—because, for example, the application of the exemption may be unclear in a given situation, or because the costs of administration and record-keeping required to assert the exemption outweigh its economic benefit. And it would routinely pull the courts, retailers, and the Department into disputes concerning hundreds and perhaps thousands of complex, fact-intensive sales-tax transactions, and interfere with the State's sovereign prerogative to collect taxes, to the detriment of the public. Such an inefficient and disruptive result is not contemplated by the state Constitution's tax-related provisions or the tax code, or required by due process.

Reading *Javor* narrowly forecloses consumer class action refund suits challenging retailers' routine, day-to-day decisions about the application of conditional sales tax exemptions. But the tax system will still operate to the public benefit, as the Legislature intended. The Department will continue to carry out its duty to ensure that the benefits of exemptions reach consumers, by, for example, issuing implementing regulations and guidance. Retailers, operating in a competitive marketplace, will claim exemptions. And consumers may take advantage of a variety of options to

influence the application of sales tax exemptions, which may involve exercising their purchasing power, requesting the Department to take formal or informal action, or seeking a change in law.

Plaintiffs claim, in a cursory fashion, that this longstanding system violates their due process rights, because they are not afforded the same protest and refund rights as taxpayers. But consumers who pay sales tax reimbursement are not taxpayers. Granted, the Legislature in many instances intends that consumers benefit from sales tax exemptions. But the benefit so conferred on consumers is an indirect one that does not implicate the Due Process Clause.

## ARGUMENT

### I. *JAVOR* SHOULD NOT BE EXTENDED TO ALLOW CONSUMERS TO CHALLENGE THE ROUTINE APPLICATION OF TAX EXEMPTIONS

#### A. The "Unique Circumstances" of *Javor*—Most Importantly, That Sales Tax Overpayment Was Definitively Established—Are Not Present in This Case

In *Javor v. State Board of Equalization* (1974) 12 Cal.3d 790, this Court recognized the viability of an extra-statutory consumer-initiated class action claim seeking the return of sales tax reimbursement in the "unique circumstances" there presented. (*Id.* at p. 802.) The necessary circumstances are not present in this case.

Plaintiff Javor sought to represent a class of consumers who had purchased new vehicles and paid sales tax reimbursement. (*Javor*, *supra*, 12 Cal.3d at pp. 792-793.) Because of a change in federal law, consumers received refunds of federal excise taxes charged on the purchased vehicles. (*Id.* at pp. 792, 794.) State sales tax (and thus sales tax reimbursement) had been calculated based on the vehicles' sales price plus federal excise tax. (*Id.* at pp. 792, 793-794.) Plaintiffs' complaint noted that the agency had

promulgated a rule specifically providing that in the event of a repayment of federal excise tax, "taxable gross receipts of the retailer will be reduced accordingly" and "sales tax will be refunded to the retailer provided he also repays to the consumer the amount collected from him as sales tax reimbursement." (*Id.* at p. 794.) "The refund of the federal tax ... effected a *pro tanto* reduction of the total sales price, thereby giving rise to the claim that a greater sales tax had in fact been paid by the above purchasers than was eventually found to be due." (*Id.* at pp. 792-793.) Plaintiff alleged that "Defendant retailers are under no statutory obligation to claim any refunds from the Board for the benefit of plaintiff and have no financial interest in doing so" and "Defendant Board is under no statutory obligation to voluntarily refund said taxes to plaintiffs and has no financial interest in doing so." (*Id.* at p. 795.)[13]

The Court first noted that there was no dispute that the complaint "contain[ed] the necessary elements of a class action." (*Javor*, *supra*, 12 Cal.3d at p. 796.)[14] Among other things, "[t]he exact amount of this sales tax overage can be easily ascertained from the books and records of the retailers" and the consumers affected were identifiable. (*Id.* at p. 797.) And it rejected any argument that consumers' return-of-reimbursement claim was categorically barred due to their non-taxpayer status, the fact that monies had already been paid over to the agency, or the lack of any explicit statutory remedy for consumers. (*Id.* at pp. 797-800.)

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[13] Some retailers did file claims for refund. (*Javor v. State Bd. of Equalization* (1977) 73 Cal.App.3d 939, 948, disapproved on other grounds in *Woosley*, *supra*, 3 Cal.4th at p. 792.)

[14] Compare *Blue Chip Stamps v. Superior Court* (1976) 18 Cal.3d 381, 383-384 (dismissing class action portion of case seeking return of sales tax reimbursements based on theory that trading stamp company failed to comply with prescribed method for calculation of sales tax set out in Regulation 1671).

In recognizing a claim, the Court focused on the fact that the Department had already conclusively determined that it was holding excessive sales tax payments. In addition to the agency's regulation prescribing how repayments of federal excise taxes would work a retroactive reduction in sales price, and therefore sales taxes (*Javor*, *supra*, 12 Cal.3d at p. 794), the Court noted that an agency notice to auto dealers "announced: 'The California sales tax charged on the federal tax included in the sale price, and subsequently refunded to the customer is subject to refund, *provided the dealer returns the amount of the sales tax refund to the customer from whom it was collected.*' (Original italics.)" (*Id.* at p. 801.) Further, an agency news release informed vehicle purchasers that "'the refund of sales tax may be obtained through the dealer from whom the vehicle was purchased by presenting to the dealer evidence of the refund of the Federal tax. The dealer will file a claim with the State Board of Equalization.'" (*Ibid.*) "The Board has admitted that it must pay these refunds to retailers. All that plaintiffs seek in this action is to compel defendant retailers to make refund applications to the Board and in turn to require the Board to respond to these applications by paying into court all sums, if any, due defendant retailers." (*Id.* at p. 802; see also *Loeffler*, *supra*, 58 Cal.4th at p. 1133 [taxability not in dispute in *Javor*].)

The Court held that

> under the unique circumstances of this case a customer, who has erroneously paid an excessive sales tax reimbursement to his retailer who has in turn paid this money to the Board, may join the Board as a party to his suit for recovery against the retailer in order to require the Board in response to the refund application from the retailers to pay the refund owed the retailers into court or provide proof to the court that the retailer had already claimed and received a refund from the Board.

(*Javor*, *supra*, 12 Cal.3d at p. 802, fn. omitted.) Under these circumstances, the court-ordered remedy for consumers was "entirely consonant with the

statutory procedures ...." (*Ibid.*, see also *id.* at p. 800, citing § 6054.5 [repealed] and *Decorative Carpets, Inc. v. State Bd. of Equalization* (1962) 58 Cal.2d 252, 256 [recognizing agency's duty to see that customers who paid sales tax reimbursement eventually obtain any refund of sales tax made to the retailer].)

To summarize, the *Javor* Court recognized an equitable remedy because the agency in the first instance had conclusively determined that excess sales tax had been paid due to a change in how sales tax was calculated (and thus excess sales tax reimbursement had also been collected). (See *Loeffler*, *supra*, 58 Cal.4th at p. 1128 [consumers may not "*require* the Board to ascertain whether excess reimbursement charges have been made"].) The Court in *Javor* stepped in only to correct an "incentive" problem; some percentage of retailers had failed to submit claims to the Department for refunds clearly due, because they would not be entitled to retain the benefits of their efforts. (*Javor*, *supra*, 12 Cal.3d at p. 801; *Loeffler*, *supra*, 58 Cal.4th at p. 1115 [discussing *Javor*].)

In sharp contrast, in this case, there has been no Department determination that the Retailers have paid excess sales tax relating to sales of glucose test strips and lancets. Plaintiffs attempt to fit their claim into the mold of *Javor* by alleging that, before they filed their complaint, "it already had been determined by the Legislature and by the [Department] that all sales of glucose test strips and skin puncture lancets are exempt from sales tax[.]" (1 AA 70 [¶ 27].) But courts are not required to accept legal assertions on demurrer. And the assertion is unsupported. As noted above, the exemption set forth in section 6369, subdivision (e) by its terms applies only to "[i]nsulin and insulin syringes" and, further, has conditions on its application. And while Regulation 1591.1, subdivision (b)(5) extended the interpretation of section 6369, subdivision (e) to reach glucose test strips and lancets, it retains the statutory conditions on the exemption's

application. As the trial court correctly determined, and the Court of Appeal reiterated, this case is unlike *Javor* "because the taxability of lancets and test strips" in various types of sales transactions "was 'very hotly in dispute.'" (*McClain*, *supra*, 9 Cal.App.5th at p. 691; see also pp. 24-26, *ante* (summarizing trial court ruling).) Nothing in *Javor* "suggest[s] that a question concerning the applicability of the tax code to a particular type of transaction should be resolved in a consumer action." (*Loeffler*, *supra*, 58 Cal.4th at p. 1133.)

The Department has not determined—by rule, in the context of a refund action, or otherwise—that the exemption for glucose test strips and lancets is unconditional, that the Department is therefore holding excess sales tax, and that all that the Retailers need to do is to submit administrative claims, in which case all tax paid during the limitations period for the privilege of selling these products would automatically be refunded. In these circumstances, there can be no *Javor*-type remedy.[15]

### B. Extending *Javor* to Disputes Over Conditional Tax Exemptions Would Undermine Statutory Sales Tax Procedures and Lead to Unworkable Results

Plaintiffs seek to litigate their claim that the Retailers failed to maximize their assertion of the conditional sales tax exemptions for test strips and lancets, and to obtain a refund of sales tax reimbursement for a large set of past transactions. As the Court repeatedly observed in *Loeffler*, however, any judicially created consumer remedy relating to sales tax reimbursement is appropriate only if it would not undermine the procedures

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[15] It may be that *Javor*-type relief could be obtained in other situations where a question of taxability has been conclusively resolved by the Legislature (by statute) or by the Department (by final agency action), leaving no issues of application for the courts. But those circumstances are not presented by this case.

set out in the tax code. (58 Cal.4th at pp. 1101, 1112, 1114-1115.)[16] For a number of reasons, including but not limited to the following, allowing this type of claim to proceed would be in conflict with the tax code and fundamental principles of administrative law, and would lead to unworkable results.

Recognizing the right of consumers to file court actions asserting that retailers have underutilized a sales tax exemption runs afoul of the rule that any "'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." (*Loeffler*, *supra*, 58 Cal.4th at p. 1100; see also *id.* at p. 1123 [review of statute and implementing regulations "confirms that the Board is the entity responsible for determining in the first instance whether transactions, in their nearly infinite variety, are taxable and how much tax is due"].) In *Loeffler*, the Court held that an Unfair Competition Law or Consumer Legal Remedies Act claim that "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" was precluded. (*Id.* at p. 1100; see also *id.* at p. 1104 [noting that "it would be inconsistent with th[e sales tax] scheme to permit the consumer to initiate a consumer action such as plaintiffs' requiring a court to resolve, outside the searching regulatory scheme established by the tax code, whether a sale was taxable or exempt, and for the court to interfere in the statutory system"].) These claims could not proceed because "it is the Board that 'ascertains' whether a retailer has charged excess reimbursement on a sale and that a retailer may either

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[16] See also *Woosley*, *supra*, 3 Cal.4th at p. 792 (courts may not "expand[] the methods for seeking tax refunds expressly provided by the Legislature").

refund excesses to consumers or remit them to the Board" and "[i]t is the Board that is the entity charged with assuring the 'integrity of the sales tax' following statutory procedures assuring the 'orderly administration of the tax laws.'" (*Id.* at p. 1123, quoting *Decorative Carpets*, *supra*, 58 Cal.2d at p. 255, and citing *Javor*, *supra*, 12 Cal.3d at pp. 798, 800.)

The result can be no different for a consumer-initiated claim questioning taxability that relies instead on *Javor*, because the underlying defects are the same. As this Court observed, "[t]he taxability question lies at the center of the Board's function and authority." (*Loeffler*, *supra*, 58 Cal.4th at p. 1127.) "The Legislature has subjected such questions to an administrative exhaustion requirement precisely to obtain the benefit of the Board's expertise, permit it to correct mistakes, and save judicial resources." (*Ibid.*) Permitting consumer claims based on disputes over taxability would "forfeit[] these benefits." (*Ibid.*) Further, the Legislature has ensured that taxpayers "cannot obtain a declaratory judgment ... without first exhausting administrative remedies by making a claim for refund" and "it would be anomalous if persons not subject to the tax were in a better position than taxpayers to secure judicial review of the question whether a certain transaction is subject to the sales tax or is exempt." (*Id.* at pp. 1127-1128.)[17]

Relatedly, allowing taxability questions to be heard in the courts in the first instance on consumer-initiated claims could result in a crush of litigation, to the detriment of the judiciary, the Department, and ultimately

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[17] Intruding on this agency function would in turn override the Legislature's constitutional authority under sections 32 and 33, presenting separation of powers concerns. (See *Marine Forests Society v. California Coastal Com.* (2005) 36 Cal.4th 1, 46 [separation of powers doctrine precludes a branch of government from "impermissibly intrud[ing] or infring[ing] upon" the "'core zone' of" another branch's functions].)

the public. (See *Loeffler*, *supra*, 58 Cal.4th at p. 1130 ["independent consumer claims ... could form a huge volume of litigation over all the fine points of tax law as applied to millions of daily commercial transactions in this state"].) Here, plaintiffs would have the courts determine whether sales of glucose test strips and lancets in a variety of complex and diverse factual circumstances—sold off the shelves or rather from a controlled space; by a licensed pharmacy or a registered pharmacist; with or without written proof of being under a doctor's care—should be exempt. Indeed, in this case, the parties and the Department had engaged in extensive motion practice and discovery, and the trial court had issued a ruling applying the exemption to a variety of circumstances presented by the named plaintiffs, before the *Loeffler* litigation provided an opportunity to reassess whether this case presented cognizable claims. (See *ante* at p. 25.) If these types of claims are allowed, we can expect similar, wide-ranging litigation—for example, about the proper taxing of alterations for new versus pre-worn clothing (Cal. Code Regs., tit. 18, § 1524 subd. (b)(1)(A); see *Duffy v. St. Bd. Of Equalization* (1984) 152 Cal.App.3d 1156); or sales of various types of goods from vending machines (Cal. Code Regs., tit. 18, § 1574); or the sales of food in an almost unlimited combination of circumstances. (Cal. Code Regs., tit. 18, § 1602.) Even a "to-go" coffee case might be revived using a *Javor*-based claim. Such a result should be rejected as "undermining the 'orderly administration of the tax laws.'" (*Loeffler*, *supra*, 58 Cal.4th at p. 1130, quoting *Decorative Carpets*, *supra*, 58 Cal.2d at p. 255.)

Recognizing such claims would fail to acknowledge that taxpayers legitimately may waive the right to claim a sales tax refund or elect not to attempt to invoke a particular sales tax exemption—particularly a complex

and conditional one. (*Loeffler*, *supra*, 58 Cal.4th at p. 1129.)[18] "Given the taxpayer's burden of proof, the fact that retail sales are presumed to be subject to the sales tax, and the fact that a retailer is not required to seek a refund but rather will be deemed to have waived the right to refund if a timely claim is not filed (§ 6905), it would not be unreasonable if the retailer's tax payment to some extent erred on the side of considering sales taxable." (*Id.* at p. 1129; see also *ibid.* [noting that taxpayer may determine its records are inadequate or that it is not likely to carry its burden of proof]; *id.* at p. 1141 (dis. opn. of Liu, J.) [retailer may choose not to seek refund "if it believes the administrative costs outweigh the benefits"].)

Finally, the uncertainty caused by the possibility of a multiplicity of large-scale consumer class actions that dispute sales tax practices otherwise settled as between taxpaying retailers and the Department could severely undermine the predictability of the State's sales tax revenues. In this case, for example, the Fourth Amended Complaint calls into question all sales taxes remitted on the transactions occurring at Retailers' stores for the time period that can be reached on actions originally filed in 2004 and 2005. Allowing such claims would undermine the fundamental purpose of Section 32: to "avoid unnecessary disruption of public services that are dependent on that revenue." (*Loeffler*, *supra*, 58 Cal.4th at p. 1101.)

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[18] Plaintiffs have at no point alleged that the Retailers (in collecting sales tax reimbursement on sales of glucose test strips and lancets) or the Department (in accepting retailers' remittance of sales tax) have acted in bad faith, nor could they. They summarily allege in their contract-based claim that the Retailers breached the "implied covenant of good faith and fair dealing[,]" but this is based only on the Retailers' asserted failure to assert the conditional exemptions. (1 AA 78-79 [¶¶ 49-50].) The viability of the contract claim has been briefed by defendant Retailers. The Department notes only that it would be surprising if retailers routinely committed to consumers that they have advanced every colorable application of every relevant sales tax exemption.

Plaintiffs' arguments for extension of *Javor* to the circumstances of this case must be rejected.

## II. THE SALES TAX SYSTEM, BY DESIGN AND IN OPERATION, ENSURES THAT CONSUMERS BENEFIT FROM TAX EXEMPTIONS

While the sales tax system as constructed by the Legislature does not allow consumers to file sales tax reimbursement refund actions, the system is designed to ensure that, in general, the benefits of tax exemptions flow to consumers as a class (though not necessarily in a perfect manner, or in every possible transaction). As noted, as a general proposition, retailers have an incentive to claim exemptions so they may gain an advantage in the marketplace by offering consumers goods at a lower total cost.[19] In addition, the Department takes an active role in ensuring that exemptions are reasonably employed by retailers, as part of its responsibilities to ensure the integrity of the tax system. The Department's actions concerning the conditional exemption for test strips and lancets is illustrative. As discussed above (see *ante* at pp. 22-23), it enacted a regulation that extended the conditional exemption for insulin and insulin syringes to test strips and lancets—products not noted in the text of the statute. Learning that there might be confusion about how the regulation should be applied, the Department surveyed retailers and then sent a clarifying letter to thousands of stores throughout the State to foster its application. And as recently as 2016, it published a plain-language guidance document

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[19] A business may choose not to collect sales tax reimbursement from its consumers, pay the sales tax under protest, and then seek a refund—which the retailer may then retain. (See *Purdue Frederick Co. v. State Bd. of Equalization* (1990) 218 Cal.App.3d 1021 [manufacturer/ retailer of antiseptic scrub used on patients and staff entitled to refund based on scope of the sales tax exemption for sales of medicines to health facilities].)

explaining how to take advantage of the exemption, available to consumers and retailers alike on the Intranet. (See *ante* at p. 24)

Consumers, too, may influence the application of tax exemptions. Among informal options, a consumer may approach the retailer and ask that the retailer apply the exemption to the consumer's transaction, or ask how the consumer might structure the transaction to take advantage of the exemption.[20] If retailers are applying the same exemption differently, a consumer may choose to purchase the item from a retailer that takes a more liberal view of the exemption, or that absorbs its sales tax obligation in a way that results in lower total costs to its customers.[21] And if the consumer believes that the retailer is making, or has made, an error in determining whether sales tax is due, or the amount owed, the customer may bring that error to the retailer's attention and—if the retailer has not already remitted

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[20] CVS, for example, asserts that while it adds sales tax reimbursement to the sales of glucose test strips and lancets "directly off the shelf on the open sales floor[,]" it also "sells some glucose test strips and skin puncture lancets through its registered pharmacists. These products are sold from a 'controlled' space. For products sold in this matter, it is CVS's policy and practice not to pay sales tax to the [Department] and not to collect sales tax reimbursements from customers who provide the required documentation of a 'physician's instructions' per Regulation 1591.1." (1 AA 15-15 [CVS Cross-Complaint, ¶¶ 8-9].)

[21] It "'is freshman-year economics that higher prices mean lower demand, and that consumers are sensitive to the full price that they must pay, not just the portion of the price that will stay in the seller's coffers.'" (*Sanchez v. Aerovias De Mexico, S.A. de C.V.* (9th Cir. 2010) 590 F.3d 1027, 1030, quoting *Buck v. American Airlines, Inc.* (1st Cir. 2007) 476 F.3d 29, 36.)

the sum to the Department—request a refund of sales tax reimbursement from the retailer.[22]

Customers also may ask the Department to take action. "[C]onsumers who believe they have been charged excess reimbursement ... may complain to the Board, which may in turn initiate an audit." (*Loeffler*, *supra*, 58 Cal.4th at p. 1104; §7054 [Department has power to audit taxpayers and require them to file reports relating to their sales].) The Department's customer service representatives field a large volume of calls and e-mails from the public, and information from customers could cause the Department to conduct an audit to determine whether the retailer has collected or is collecting excess sales tax reimbursement. (See *Loeffler*, *supra*, 58 Cal.4th at p. 1123.) The Department can order a retailer to stop collecting any excess sales tax reimbursement. And it can require a retailer to return already collected excess sales tax reimbursement to those consumers who paid it, provided they can be identified. (*Id.* at pp. 1117-1119 [discussing *Decorative Carpets, supra*, 58 Cal.2d 252 and § 6901.5].)

In addition, any "interested person" may petition the Department to adopt a new regulation, or to amend or repeal an existing regulation. (Gov. Code, § 11340.6.) Where no regulation covers a specific type of sale or item, a consumer may request the Department to adopt a new regulation to address taxability in those circumstances. (*Ibid.*; see also *Loeffler*, *supra*, 58 Cal.4th at p. 1127.) Where there is a relevant regulation, but its application is unclear, the consumer may petition the Department to amend the regulation to clarify its interpretation. (*Ibid.*) And where there is a regulation that the consumer believes is inconsistent with statute, he or she

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[22] Granted, retailers are likely to engage in such a discussion only where the sale is unusual in some respect and/or the sales tax at issue is significant.

may petition the Department to repeal that regulation. (*Ibid.*) Once a petition is filed pursuant to Government Code section 11340.6, the Department must act on it, stating the basis for its action in writing, and, if the petition is granted in whole or in part, schedule a public hearing on the matter pursuant to the California Administrative Procedures Act. (Gov. Code, § 11340.7.) (In this case, plaintiffs never sought to avail themselves of any of these procedures to test their view that the conditional statutory exemption in section 6369, subdivision (e) for insulin and insulin syringes should (and could) be extended without conditions to test strips and lancets.) And where there is already a regulation in place, if a consumer believes it to be inconsistent with the tax code, he or she may file a declaratory relief action against the Department challenging the regulation. (Gov. Code, § 11350, subd. (b)(1).)

And, of course, consumers may make their case for additional or expanded sales tax exemptions to the Legislature. In this case, the Legislature at various points has considered and made progress toward a statutory tax exemption expressly addressing glucose test strips and lancets, but, to date, no such exemption has been signed into law. (See, e.g., *ante* at pp. 22-23 [noting Sen. Bill No. 2049 (Reg. Sess. 1995-1996)]).[23] Notable among the Legislature's efforts is Assembly Bill No. 1916 (2001-2002 Reg. Sess.), which sought to codify Regulation 1591.1(b)(5) and, in addition, to remove the requirement that the exempt products be furnished by a registered pharmacist—an effort that met with the Governor's veto. (Assem. Bill No. 1916 (2001-2002 Reg. Sess.) § 1; Department's Motion

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[23] See also Assem. Bill No. 2587 (Reg. Sess. 1999-2000); Assem. Bill No. 249 (Reg. Sess. 2001-2002); Assem. Bill No. 857 (Reg. Sess. 2007-2008); and Sen. Bill No. 655 (Reg. Sess. 2009-2010). The text and history of these bills are available at <http://www.leginfo.ca.gov/bilinfo.html> [as of Dec. 12, 2017].

for Judicial Notice; see also 2 AA 464-471 [select history for Assem. Bill No. 1916].)[24] In his veto message, then-Governor Gray Davis explained: "I am sympathetic to those who have a legitimate medical need for lancets and glucose test strips and whose medical treatment is under the supervision of a medical doctor. However, those persons may already purchase these products from a pharmacist without paying sales tax on these products."[25]

The Legislature is free to revisit the issue at any time, and has the ultimate constitutional prerogative and responsibility to set the State's tax policy. (See Cal. Const., art. XIII, § 33; *Hoogasian Flowers v. State Bd. of Equalization* (1994) 23 Cal.App.4th 1264, 1270 [power of Legislature in area of taxation is "paramount"].)

## III. DECLINING TO EXTEND *JAVOR* TO CONSUMER-INITIATED ACTIONS CHALLENGING THE APPLICATION OF CONDITIONAL SALES TAX EXEMPTIONS DOES NOT VIOLATE DUE PROCESS

Plaintiffs advance two summary due process arguments, one grounded in a theory of escheat, and the other in a theory of tax. Both must be rejected.

"Both the federal and state Constitutions compel the government to afford persons due process before depriving them of any property interest." (*Today's Fresh Start, Inc. v. Los Angeles County Office of Educ.* (2013) 57 Cal.4th 197, 212, citing U.S. Const., 14th Amend., Cal. Const., art. I, § 7,

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[24] The legislative history for Assem. Bill No. 1916 is available at <http://www.leginfo.ca.gov/cgi-bin/postquery?bill_number=ab_1916&sess=0102&house=B&author=matthews> [as of Dec. 12, 2017]. The Department's predecessor supported the bill. (2 AA 454-455, 457-459, 469-470.)

[25] The veto message is available at < http://www.leginfo.ca.gov/pub/01-02/bill/asm/ab_1901-1950/ab_1916_vt_20020918.html> [as of Dec. 12, 2017].

subd. (a).) In light of the "virtually identical language" of the federal and state Due Process clauses, this Court has "treated the state clause's prescriptions as substantially overlapping those of the federal Constitution." (*Today's Fresh Start, supra,* 57 Cal.4th at p. 212.) Where, as in this case, the Due Process "Clause is invoked in a novel context" a court must "begin the inquiry with a determination of the precise nature of the private interest" that is purportedly threatened by government action. (*Lehr v. Robertson* (1983) 463 U.S. 248, 256.)

Plaintiffs first assert that section 6901.5 reflects "a statutory recognition that customers are the rightful owners of excess sales tax reimbursement" (OBM 30)—just as bank depositors are the owners of the monies in their accounts—and failure to recognize a consumer cause of action to claim their property works an unconstitutional "permanent escheat." (OBM 30-33; see OMB 30-31, discussing *State of Cal. v. Savings Union Bank and Trust Co.* (1921) 186 Cal. 294 [bank deposits could not escheat to State without judicial process.)[26] In fact, section 6901.5, as summarized by this Court in *Loeffler*, merely provides that "[w]hen it is 'ascertained' (§ 6901.5) whether through a Board audit or deficiency determination or a refund proceeding, that a retailer miscalculated its sales tax and charged consumers an erroneous reimbursement amount, the retailer has a choice whether to make a refund to consumers or instead, to remit the amount to the Board." (58 Cal.4th at p. 1103.) Rather than

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[26] "'Escheat' ... means the vesting in the state of title to property the whereabouts of whose owner is unknown or whose owner is unknown or which a known owner has refused to accept ...." (Code Civ. Proc., § 1300, subd. (c).) California's general escheat statute, the Unclaimed Property Law, Code of Civil Procedure section 1500 et seq., applies to unclaimed money or other unclaimed property. The law carries out the "intent of the Legislature that property owners be reunited with their property." (Code Civ. Proc., § 1501.5, subd. (c).)

creating or recognizing a vested property interest held by consumers, section 6901.5 ensures as a matter of equity that retailers do not in any circumstance retain and profit from monies collected from consumers as sales tax reimbursement with the representation and understanding that they would be paid over to the State. (*Id.* at p. 1119; see also *id.* at pp. 1111, 1117, 1118 [characterizing consumers' interest as "equitable" in nature].)

Of course, once it has been conclusively ascertained through the processes established in the tax code that a retailer has paid excess sales tax, consumers who paid sales tax reimbursement to that retailer and have not received a refund may assert the equitable cause of action recognized in *Javor*. (See discussion, *ante*, at pp. 30-34.) The Department will ensure that refunded tax payments are in turn passed back to the consumers who paid sales tax reimbursement. (*Javor*, *supra*, 12 Cal.3d at p. 802; see Cal. Code Regs., tit. 18, § 1700, subd. (b).) And while plaintiffs complain that the decision below "effectively abolish[ed]" such a claim by imposing impossible prerequisites (OBM 28-32), the Department is not requesting that this Court disapprove *Javor* or impose any preconditions to asserting *Javor*-type relief beyond what are set out in that case and discussed in *Loeffler* and in the previous sections of this brief.

As an alternative to their theory of escheat, plaintiffs summarily contend that they should be entitled to the same due process afforded to taxpaying retailers. (OBM 33-35.) Plaintiffs state that they too must be provided with "'meaningful backward-looking relief'" to challenge the taxpaying retailers' decision not to claim the conditional sales tax exemption for all sales of glucose test strips and lancets, and to seek a refund of sales tax reimbursement paid over by the retailers to the State, even though the Legislature (in section 6901.5) did not provide for this remedy. (OBM at pp. 33-35.) Due process does not require this result.

Due process requires a State to provide *taxpayers* with (1) "a fair opportunity to challenge the accuracy and legal validity of their tax obligation," and (2) a "clear and certain remedy[.]" (*McKesson Corp. v. Division of Alcoholic Beverages and Tobacco* (1990) 496 U.S. 18, 39, internal quotation, citation omitted]; see also *River Garden Retirement Home v. Franchise Tax Bd.* (2010) 186 Cal.App.4th 922, 937-939 [discussing *McKesson*].) States have considerable flexibility in structuring that remedy. They may, for example, require taxpayers to pay the contested tax as a precondition to contesting its validity—as California does. (*Reich v. Collins* (1994) 513 U.S. 106, 110-111; see also *McKesson*, 496 U.S. at p. 45 [State may "provide by statute that refunds will be available only to those taxpayers paying under protest"].)[27] If the taxpayer prevails, the State may, consistent with due process, award a refund to the taxpayer or provide some other adequate retroactive relief. (*Harper v. Virginia Dept. of Taxation* (1993) 509 U.S. 86, 101.) And by statute, California provides such relief—to taxpayers.

Plaintiff consumers, however, are not taxpayers under the sales tax laws of this State. The Legislature consistently has defined retailers, not consumers, as taxpayers, from the first enactment of state sales tax in 1933 (*De Aryan v. Akers* (1939) 12 Cal.2d 781, 783) to the present day (*Loeffler*, *supra*, 58 Cal.4th at p. 1003). And, as the U.S. Supreme Court observed in another context, "[a]s a rule, a nontaxpayer may not sue for a refund of

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[27] States are afforded this flexibility in recognition of the fact that "[a]llowing taxpayers to litigate their tax liabilities prior to payment might threaten a government's financial security, both by creating unpredictable interim revenue shortfalls against which the State cannot easily prepare, and by making the ultimate collection of validly imposed taxes more difficult." (*McKesson*, *supra*, 496 U.S. at p. 37; see also *Pacific Gas & Elec. Co. supra*, 27 Cal.3d at p. 283 [similar].)

taxes paid by another." (*Montana v. Crow Tribe of Indians* (1998) 523 U.S. 696, 713).[28]

Plaintiffs suggest that the Court may simply reject the Legislature's decision to make retailers—and not consumers—the payers of sales tax, because "the courts are not bound by the California Legislature's self-motivated characterization ...." (OBM 35, citing *Diamond Nat. Corp. v. State Bd. of Equalization* (1976) 425 U.S. 268.) But beyond this assertion, plaintiffs provide no analysis or argument in support of their request, and the Court may reject it on this ground alone. (See *People v. Stanley* (1995) 10 Cal.4th 764, 793 [court may treat issue as waived when general assertion is unsupported by specific argument and citation of authorities].) In any event, there is no basis to disturb the Legislature's considered and settled decision to place the incidence of the State's tax on retailers. Responding to *Diamond National*—which held that the legal incidence of California sales tax fell on a national bank as purchaser, and the bank was exempt from taxes—the Legislature in 1978 made a number of changes to the tax code. The changes, summarized in *Loeffler*, clarify and reinforce the Legislature's original intent that retailers, not consumers, are the sales tax taxpayers. (*Loeffler*, *supra*, 58 Cal.4th at pp. 1116-1117 [discussing repeal of §§ 6052, 6053, and 6054.5 and addition of Civ. Code, § 1656.1].)[29]

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[28] In *Montana v. Crow Tribe of Indians*, the Tribe sought to recover monies paid to Montana and its counties by a non-Indian mineral lessee pursuant to a state severance and gross proceeds tax on coal, during a period of time before the tax was enjoined in a Tribe-initiated lawsuit. (523 U.S. at pp. 700, 702.) The Court declined to order restitution (*id.* at p. 700), beginning its analysis with the observation that the Tribe had no right to seek a refund for taxes paid by the lessee. (*Id.* at p. 713.)

[29] The Department notes that after the 1978 amendments, the Ninth Circuit held that under federal law, and in the context of inter-governmental tax immunity, the incidence of California's sales tax was considered to be

(continued...)

Any sales-tax related due process right for consumers must thus find its source elsewhere. The only California case to address this issue held that consumers do not have a free-standing, extra-statutory due process right to seek refunds of sales tax reimbursement. (*Kuykendall v. State Bd. of Equalization* (1994) 22 Cal.App.4th 1194, 1211-1215.) *Kuykendall* involved a local sales tax held by this Court to be unconstitutional. In response, the Legislature passed a special law to allow consumers (who were without any statutory refund remedy) to obtain a refund if they could demonstrate through proper documentation that they had made at least $5,000 in purchases that were subject to the tax. (*Id.* at pp. 1199-1201.) The court rejected the argument that consumers who were excluded from the refund statute (either because they spent less than $5,000 or did not have proper documentation) were deprived of due process. (*Id.* at p. 1214.) It held that the Legislature had "great latitude" in designing a refund scheme, and observed that plaintiffs had no "vested right to direct refunds for claims under $5,000." (*Id.* at pp. 1213-1214.)

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(...continued)
on the federal government as purchaser. (*U.S. v. Cal. State Bd. of Equalization* (9th Cir. 1981) 650 F.2d 1127, 1132 [holding sales tax unconstitutional as applied to leases of tangible personal property to the United States], affirmed without opinion in *Cal. State Bd. of Equalization v. U.S.* (1982) 456 U.S. 901.) More recently, the U.S. Supreme Court has relied on the state legislature's use of "dispositive language" concerning the incidence of a state tax and the "'fair interpretation'" of the state taxing statute as written and applied. (*Wagnon v. Prairie Band Potawatomi Nation* (2005) 546 U.S. 95, 102-103, quoting *Cal. Bd. of Equalization v. Chemehuevi Tribe* (1985) 474 U.S. 9, 11 (per curiam); see also *id.* at p. 103 [citing cases]; *id.* at pp. 102-105 [holding that language and fair interpretation of state statute established that incidence of fuel tax was on non-Indian distributor, even though distributor was entitled to pass tax to customer gas station owned by tribe]; *Oklahoma Tax Com. v. Chickasaw Nation* (1995) 515 U.S. 450, 460 [State is "generally is free to amend its law to shift the tax's legal incidence"].)

Plaintiffs in this case, similarly, have no cognizable due process right to seek refunds of sale tax reimbursement from the State. Granted, consumers are economically affected by sales taxes. They pay "the aggregate of the list price and the amount of tax reimbursement" which constitutes "the actual purchase price of the commodity." (*De Aryan, supra* 12 Cal.2d at p. 786.) And, when the Legislature enacts exemptions, consumers (or particular types of consumers) as a class may expect to benefit. But such effects and benefits to consumers are indirect. The Due Process Clause "does not apply to the indirect adverse effects of governmental action." (*O'Bannon v. Town Court Nursing Center* (1980) 447 U.S. 773, 789; c.f., *South Carolina v. Regan* (1984) 465 U.S. 367, 394, fn. 11 (concur. opn. of O'Connor, J.) [though taxes "inevitably have a pecuniary impact on nontaxpayers" .... "indirect impacts of a tax, no matter how detrimental, generally do not invade any interest cognizable under the Due Process Clause"]; see also *People ex rel. Franchise Tax Bd. v. Superior Court* (1985) 164 Cal.App.3d 526, 547-548 [insurance company that sold annuities had no due process right to interfere with Franchise Tax Board's actions to enforce change in law affecting annuities' taxability; "the seller of the investment annuity policies was not deprived of a property interest cognizable under the due process clause"].)[30] And the Due Process Clause "does not protect everything that might be described as a 'benefit': 'To have a property interest in a benefit, a person clearly must have more than an abstract need or desire' and 'more than a unilateral expectation of it. He must, instead, have a legitimate claim of entitlement to it.'" (*Town of Castle Rock, Colo. v. Gonzales* (2005) 545 U.S. 748, 756, quoting *Bd. of*

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[30] *People ex rel. Franchise Tax Bd. v. Superior Court* was disapproved of on another ground in *Dana Point Safe Harbor Collective v. Superior Court* (2010) 51 Cal.4th 1, 11, fn. 6.

*Regents of State Colleges v. Roth* (1972) 408 U.S. 564, 577.) In the sales tax system as designed by the Legislature, while consumers have some ability to affect how sales tax exemptions operate in the marketplace (see pp. 40-42, *ante*), they have no entitlement to file direct claims for sales tax reimbursement refunds.

Plaintiffs have failed to establish that due process is implicated in the circumstances of this case.[31]

## CONCLUSION

For the foregoing reasons, the decision of the Court of Appeal should be affirmed.

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[31] Any claim that the State has taken consumers' property without just compensation would suffer from these same defects. And, more to the point, a State's exercise of its taxing power, standing alone, does not implicate the Takings Clause. (*Koontz v. St. Johns River Water Management Dist.* (2013) __ U.S. __, 133 S.Ct. 2586, 2600-2601 [collecting cases]; see also *Houck v. Little River Drainage Dist.* (1915) 239 U.S. 254, 264 ["the power of taxation should not be confused with the power of eminent domain"].) Plaintiffs' argument that the trial court erred in refusing to grant them leave to plead such a claim (OBM 43-46) thus is without merit.

Dated: December 13, 2017

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## CERTIFICATE OF COMPLIANCE

I certify that the attached **Respondent California Department of Tax and Fee Administration's Answer Brief on the Merits** uses a 13 point Times New Roman font and contains 12,499 words.

Dated: December 13, 2017

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## DECLARATION OF SERVICE BY U.S. MAIL

Case Name: **Michael McClain, et al. v. Sav-On Drugs, et al.**
Case No.: S241471

I declare:

I am employed in the Office of the Attorney General, which is the office of a member of the California State Bar, at which member's direction this service is made. I am 18 years of age or older and not a party to this matter. I am familiar with the business practice at the Office of the Attorney General for collection and processing of correspondence for mailing with the United States Postal Service. In accordance with that practice, correspondence placed in the internal mail collection system at the Office of the Attorney General is deposited with the United States Postal Service with postage thereon fully prepaid that same day in the ordinary course of business.

On December 13, 2017, I served the attached **ANSWER BRIEF ON THE MERITS, MOTION FOR JUDICIAL NOTICE and PROPOSED ORDER** by placing a true copy thereof enclosed in a sealed envelope in the internal mail collection system at the Office of the Attorney General at 455 Golden Gate Avenue, Suite 11000, San Francisco, CA 94102-7004, addressed as follows:

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I declare under penalty of perjury under the laws of the State of California the foregoing is true and correct and that this declaration was executed on December 13, 2017, at San Francisco, California.

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