

ST 14-05

Tax Type: Sales Tax

Tax Issue: Medicines & Medical Appliance Exemption (Low Rate)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
ANYWHERE, ILLINOIS

THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS

v.

ABC BUSINESS,
Taxpayer

No. XXXX
Account ID XXXX
Letter ID XXXX
XXXX
XXXX
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XXXX
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XXXX
XXXX
XXXX

Period 1/07-5/12
Ted Sherrod
Administrative Law Judge

RECOMMENDATION FOR DISPOSITION

Appearances: Kathleen Lach, Esq. of Arnstein & Lehr LLP for ABC BUSINESS; John Alshuler, Special Assistant Attorney General, for the Illinois Department of Revenue.

Synopsis:

This matter arose by way of requests for an initial review pursuant to 86 Ill. Admin. Code, Ch. I, section 200.175 of the Department’s Notices of Tax Liability for Form EDA-105-R, ROT Audit Report issued June 8, 2011 and December 17, 2012. At issue is whether a specialized compressor device known as a nebulizer used to deliver medications to patients suffering from asthma and other lung disorders qualifies as a “medical appliance” under the provisions of 35 ILCS 120/2-10 of the Retailers’ Occupation Tax Act, 35 ILCS 120/2-10.

A secondary question is whether the taxpayer should be taxed as a pharmacist under the Service Occupation Tax Act, 35 ILCS 115/1 *et seq.* rather than as a retailer subject to the Retailers' Occupation Tax Act, 35 ILCS 120/1 *et seq.* On the basis of the evidence presented at hearing in this matter, it is my recommendation that this matter be decided in favor of the Department. In support of this recommendation, the following "findings of fact" and "conclusions of law" are made.

Findings of Fact:

1. The Department's *prima facie* case, including all jurisdictional elements, was established by the admission into evidence, without objection of the Department's Notices of Tax Liability for Form EDA-105-R, ROT Audit Report covering the tax period January 1, 2007 through May 31, 2012. Transcript ("Tr.") p. 10; Department Exhibit ("Ex.") 1. Following such admission, the Department rested.¹
2. A nebulizer is a small compressor machine used to deliver medications to patients suffering from asthma, COPD, cystic fibrosis and other lung disorders. Tr. pp. 15-18, 20. Its principal function is to break down and dilute medications into an aerosol mist that contains particles small enough to pass through constricted air passages of persons suffering from lung health disorders. *Id.* The medications delivered using a nebulizer widen airways to allow greater flow of oxygen into the lungs and reduce lung inflammation. Tr. pp. 19, 20.
3. Patients having cystic fibrosis and pediatric asthma patients would suffer fatal lung malfunctions without the multiple daily use of a nebulizer to deliver drugs and other

¹ Under applicable statutory and case law, the Department is not required to do anything more to establish its *prima facie* case. See 35 ILCS 120/4, 5; A.R. Barnes & Co. v. Department of Revenue, 173 Ill. App. 3d 826 (1st Dist. 1988).

pharmaceuticals. Tr. pp. 19, 22, 35. Use by such patients varies from two to twelve times a day. Tr. pp. 27, 28. Because 98% of the patients to whom the taxpayer dispenses nebulizers are children, patients in this category constitute at least 98% of the taxpayer's clientele. Tr. p. 49.

4. Nebulizers are frequently used to administer medications in crisis situations when a patient cannot breathe and is losing oxygen levels rapidly. Tr. p. 17.
5. The taxpayer, a corporation registered with the Department to do business in Illinois, is engaged in the business of selling and otherwise providing nebulizers to patients of medical doctors having offices and clinics in the Anywhere metropolitan area. Tr. pp. 35, 51, 54, 59. The taxpayer also provides services related to its nebulizer sales including training in the use of such equipment, equipment repair and customer inquiry assistance. Tr. pp. 25, 30, 39, 40; Taxpayer's Ex. 1, 2, 5, 6.
6. John Doe is the President and principal owner of the taxpayer. Tr. p. 30. The shares of the corporation that he does not own are owned by other members of his family. *Id.*
7. The taxpayer is licensed to engage in the distribution and sale of medical devices by the Taxpayer Commission on Accreditation of Health Organizations. Tr. pp. 45-50.
8. The taxpayer's primary source of income is from the sale of nebulizers. Tr. p. 59.
9. The nebulizers the taxpayer offers are provided to its patients by the taxpayer only when their use is prescribed by a physician. Tr. p. 40.
10. The taxpayer is compensated for 60% of its sales through reimbursements from the State of Illinois Medicaid program. Tr. pp. 48-50. The taxpayer also receives payments from Medicare and from private insurance companies. Tr. pp. 42, 59, 60. Reimbursement

payments received from Medicare and Medicaid do not include Retailers' Occupation Tax. Tr. pp. 42, 67, 68.²

11. No Retailers' Occupation Tax was paid on nebulizer sales made by the taxpayer during the tax period in controversy. Department Ex. 1. The Department's Notices of Tax Liability are based upon its determination that the nebulizers sold by the taxpayer during the tax period in controversy were not "medical appliances" and were therefore taxable at the generally applicable state and local tax rate of 9.75%. Tr. p. 9.
12. Other than the general description of their specific purpose during the hearing, there was no testimony given or documentation offered which would tend to show that the nebulizers sold by the taxpayer substituted for a malfunctioning part of the body.

Conclusions of Law:

This case involves the application of section 2-10 of the Illinois Retailers' Occupation Tax Act, 35 ILCS 120/2-10 ("section 120/2-10") to nebulizers the taxpayer sold and provided to patients presenting prescriptions for such devices from physicians having practices or clinics in Illinois during the period January 2007 through May 2012. Section 120/2-10 provides in pertinent part:

Unless otherwise provided in this Section, the tax imposed by this Act is at the rate of 6.25% of either the selling price or the fair market value, if any, of tangible personal property ...

With respect to ... prescription and nonprescription medicines, drugs, medical appliances ... and insulin, urine testing materials, syringes, and needles used by diabetics, for human use, the tax is imposed at the rate of 1%. (Emphasis supplied)

35 ILCS 120/2-10

² While the record contains no evidence whether Medicare and Medicaid reimbursements were included in the tax base used to arrive at the Department's assessment, it is assumed that these amounts were not taxed. The Department has previously opined that no tax is due on payments made directly to vendors by Medicare, Medicaid or the Illinois Department of Healthcare and Family Services. See General Information Letter No. ST 11-0074 (September 13, 2011).

The taxpayer filed its returns without reporting or paying any tax on its nebulizer sales presumably based upon its assumption that section 120/2-10 provides a complete exemption for medical appliances. Department Ex. 1. However, medical appliances are not completely exempt under Illinois law, but are taxable at a reduced tax rate. *Id.* Accordingly even if the provision noted above pertaining to medical appliances is applicable in this case, as the taxpayer contends, the taxpayer would remain liable for a portion of the tax due on the nebulizers it sold during the tax period in controversy.

The Department established its presumptively correct *prima facie* case when it introduced the Notices of Tax Liability at issue into the record.³ The burden of going forward and rebutting the Department's presumptively correct determination then shifted to the taxpayer. A.R. Barnes & Co. v. Department of Revenue, 173 Ill. App. 3d 826 (1st Dist. 1988); Central Furniture Mart v. Johnson, 157 Ill. App. 3d 907 (1st Dist. 1987); Vitale v. Illinois Department of Revenue, 118 Ill. App. 3d 210 (3d Dist. 1983). A taxpayer can overcome the Department's *prima facie* case only by producing competent evidence closely identified with the taxpayer's books and records. *Id.*

Section 120/2-10 noted above, which taxes medical appliances at the rate of 1%, does not define the term "medical appliances." It only provides that they must be for human use. However, the Department has adopted a regulation that defines this term. The applicable regulation interpreting this statutory section is 86 Ill. Admin. Code, ch. I, section 130.310(c) which, as in effect for the period at issue, provides in relevant part as follows:

(c) Medicines and Medical Appliances

³ Pursuant to 35 ILCS 120/4, the Department's Notice of Tax Liability is entitled to a presumption of correctness. See Balla v. Department of Revenue, 96 Ill. App. 3d 293 (1981), wherein the Illinois Appellate Court states the following: "The Illinois legislature, in order to aid the Department in meeting its burden of proof ..., has provided that the findings of the Department concerning the correct amount of tax due are prima facie correct." Balla, supra at 295.

(2) A medical appliance is an item that is intended by its manufacturer for use in directly substituting for a malfunctioning part of the human body. These items may be prescribed by licensed health care professionals for use by a patient, purchased by health care professionals for the use of patients, or purchased directly by individuals. Purchases of medical appliances by lessors that will be leased to others for human use also qualify for exemption. Included in the exemption as medical appliances are such items as artificial limbs, dental prostheses and orthodontic braces, crutches and orthopedic braces, wheelchairs, heart pacemakers, and dialysis machines (including the dialyzer). Corrective medical appliances such as hearing aids, eyeglasses and contact lenses qualify for exemption. Diagnostic equipment shall not be deemed a medical appliance, except as provided in Section 130.310(d). Other medical tools, devices and equipment such as x-ray machines, laboratory equipment, and surgical instruments that may be used in the treatment of patients but that do not directly substitute for a malfunctioning part of the human body do not qualify as exempt medical appliances. Sometimes a kit of items is sold so the purchaser can use the kit items to perform treatment upon himself or herself. The kit will contain paraphernalia and sometimes medicines. An example is a kit sold for the removal of ear wax. Because the paraphernalia hardware is for treatment, it generally does not qualify as a medical appliance. However, the Department will consider the selling price of the entire kit to be taxable at the reduced rate when the value of the medicines in the kit is more than half of the total selling price of the kit.

86 Ill Admin. Code, Ch. I, section 130.310.⁴

In the case at hand, the taxpayer sold and provided the nebulizers at issue in this case to patients pursuant to prescriptions from physicians authorizing the use of these devices in the treatment of asthma and other lung disorders. Tr. pp. 35, 40, 51, 54, 59. As noted above, medical devices used for the treatment of patients do not fall within the definition of the term “medical appliance” contained in this regulation because the regulation expressly states that “[o]ther medical tools...that may be used in the treatment of patients but do not directly substitute for a malfunctioning part of the human body do not qualify as exempt medical appliances.” Moreover,

⁴ Effective in 2010, the Department revised section 130.310 from one that addressed food, drugs and medical appliances to one that addressed only the types of property that would (or would not) be considered food subject to tax at the low rate. 34 Ill. Reg. 12935, 12946-71 (issue 36) (September 3, 2010)(effective August 19, 2010). It removed the medicine and medical appliance subsections that were previously included within section 130.310, and substantially rewrote those subsections within a newly numbered regulation section 130.311, bearing the heading, “Drugs, Medicines, Medical Appliances and Grooming and Hygiene Products.” 86 Ill. Admin. Code, ch. I, section 130.311(2010); 34 Ill. Reg. 12963-71.

a perusal of regulation 130.310(c) noted above indicates that neither the nebulizer at issue nor any similar device is expressly mentioned in this regulation as falling within the Department's definition of a "medical appliance." The failure to specifically enumerate either the nebulizer or any other device used for a similar purpose in the list of items that qualify for the reduced tax rate as "medical appliances" is additional and persuasive evidence that this device is not the type of item contemplated by section 120/2-10 or the regulation defining the term "medical appliances" noted above for taxation at the low rate.

Furthermore, notwithstanding the foregoing, the taxpayer introduced no evidence nor offered any expert opinion that the nebulizers at issue substitute for any malfunctioning human systems or body organs which is a prerequisite to coming within the definition of "medical appliances" under the aforementioned regulation. Although testimony was offered to explain what a nebulizer device is and how it is used, there was no statement, medical conclusion or other indicative evidence that would establish a direct or inferential qualification of nebulizers under this criteria of the regulation. As a consequence, the taxpayer has not overcome the presumption of correctness with respect to the Department's classification of the nebulizers at issue as taxable at the high rate. Accordingly the taxpayer's attempt to qualify the taxpayer's nebulizers as a medical appliance must be denied.

Taxpayer's right to be taxed under the Service Occupation Tax

The taxpayer also contends that it should be taxed as a pharmacist under the Service Occupation Tax Act because, like a pharmacist, it is licensed to dispense medical devices to patients pursuant to prescriptions it receives from physicians. Tr. pp. 53-74; Taxpayer's Brief pp. 6, 7. The Service Occupation Tax ("SOT") Act, 35 ILCS 115/1 *et seq.*, is a tax on persons making sales of a service. The SOT is intended to place service providers on a tax parity with

retailers to the extent they transfer tangible personal property to the ultimate consumer as an incident to the sale of service. A.R. Barnes & Co., *supra* at 829. The SOT is a tax on the cost to service providers (servicemen) of tangible personal property transferred as an incident to such sale. Hagerty v. General Motors Corp., 59 Ill. 2d 52, 55 (1974).

Regulation 130.2035 (86 Ill. Admin. Code section 130.2035), which makes the SOT applicable to certain prescription sales is only applicable to registered pharmacists and druggists that are licensed to practice pharmacy. The taxpayer, by its own admission, is not owned or operated by a registered pharmacist or druggist licensed to practice this profession. Tr. p. 51. Accordingly, the application of the tax methodology used by pharmacists to the taxpayer is not authorized by the Department's regulations.

Moreover, as a general rule, the Retailers' Occupation Tax ("ROT") applies to all sales at retail unless the taxpayer produces evidence in the form of books and records to show that the sales are not subject to ROT. H.D., Ltd. v. Department of Revenue, 297 Ill. App. 3rd 26, 34 (2d Dist. 1998). Section 4 of the Retailers' Occupation Tax Act provides that the certified copy of the notice of tax liability issued by the Department "shall be prima facie proof of the correctness of the amount of tax due, as shown therein." 35 ILCS 120/4. Once the Department has established its *prima facie* case by submitting the notice of tax liability into evidence, the burden shifts to the taxpayer to overcome this presumption of validity. A.R. Barnes & Co., *supra* at 832. To prove its case, a taxpayer must present more than its testimony denying the accuracy of the Department's assessment. Mel-Park Drugs, Inc. v. Department of Revenue, 218 Ill. App. 3d 203, 217 (1st Dist. 1991). The taxpayer must present sufficient documentary evidence to support its claim. *Id.*

In the instant case, the only evidence in the record to support the taxpayer's claim that it is entitled to be taxed under the SOT is testimony by its accountant, Robert Lloyd, a certified public accountant, giving reasons why he believes the taxpayer should be taxed under the SOT. Tr. pp. 53-74. Since this testimony is not corroborated by any documentary evidence, it is insufficient to rebut the Department's *prima facie* correct determination that the taxpayer was properly taxed under the Retailers' Occupation Tax Act.

WHEREFORE, for the reasons stated above, it is my recommendation that the Department's Notices of Tax Liability at issue in this case be upheld.

Ted Sherrod
Administrative Law Judge

Date: November 18, 2013