No. 97247-8

SUPREME COURT OF THE STATE OF WASHINGTON

EXPRESS SCRIPTS, INC.,

Petitioner,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE,

Respondent.

MEMORANDUM OF AMICUS CURIAE COUNCIL ON STATE TAXATION IN SUPPORT OF PETITION FOR REVIEW

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I. IDENTITY AND INTEREST OF AMICUS CURIAE

The Council On State Taxation ("COST") is a nonprofit trade association based in Washington, D.C. COST was organized in 1969 as an advisory committee to the Council of State Chambers of Commerce. Today, COST has an independent membership of approximately 550 of the largest multistate corporations engaged in interstate and international commerce, many of which do business in Washington. COST members represent the part of the nation's business sector that is most directly affected by state taxation of interstate and international business operations. COST's mission is, and has always been, to preserve and promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities. COST members employ a substantial number of Washingtonians, own extensive property in Washington, and conduct substantial business in Washington.

COST is interested in this case because the Court of Appeal's decision exacerbates the impact of the tax pyramiding that occurs when multiple businesses are engaged in facilitating the same or related transactions. COST's position is that the negative impact of gross receipts tax pyramiding can be minimized by a proper interpretation of "gross income of the business" and the economic realities of a transaction when certain funds are passed through (or paid) to clients.

Furthermore, the protection of taxpayers' rights in tax matters is of paramount importance to COST. Recently, several COST members have informed COST of audit techniques utilized by the Department that fail to rely on its own "specific, official written advice." COST has approached the Department regarding these issues, stressing the requirements of the Taxpayer Bill of Rights in RCW 82.32A.020. COST has an interest in the Court taking this opportunity to delineate the rights conferred to taxpayers under RCW 82.32A.020.

Given the concerns of COST members with gross receipts taxes and the fair administration of taxes under the states' taxpayer bill of rights laws, COST brings an important perspective to this case highlighting the need for this Court to overturn the Court of Appeals' decision.

As amicus, COST has participated in numerous significant federal and state tax cases over almost 50 years, including several high-profile tax cases in Washington, including in *Tesoro Ref. & Mktg. Co. v. Dep't of Revenue*, 173 Wn.2d 551, 269 P.3d 1013 (2012); *Avnet, Inc. v. Dep't of Revenue*, 187 Wn.2d 44, 384 P.3d 571 (2016); and *Lowe's Home Ctrs., LLC v. Dep't of Revenue*, No. 96383-5 (Wash. argued May 30, 2019) (decision pending).

In this memorandum, COST will underscore the importance of this Court's review of the Court of Appeals' decision to disallow the exclusion

of pass-through funds (from Express Scripts, Inc.'s ("ESI")) from the Washington Business and Occupation (B&O) tax base.

II. STATEMENT OF ISSUES PRESENTED FOR REVIEW

COST adopts the Statement of Issues as framed by the Petitioner ESI.

III. STATEMENT OF THE CASE

COST adopts the Statement of the Case presented by Petitioner ESI. In addition, COST would specifically highlight that of the receipts ESI collected from its clients, approximately 95 percent were transferred to the third-party pharmacies that supplied the drugs. *See* Pet. 5, *citing* CP 756.

IV. ARGUMENT

A. Review is required to limit pyramiding of the B&O tax to only that resulting from a proper interpretation of the meaning of "gross income of the business."

In January 2007, COST and the Tax Foundation jointly released a study on gross receipts taxes, providing a review of the history of gross receipts taxes and their performance.[1] As indicated in the Gross Receipts

[1] *See* John L. Mikesell, *Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance*, January 2007, available a: https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/other-state-tax-studies-articles-reports/gross-receipts-taxes-in-state-government-finances-study.pdf (hereinafter referred to as "Gross Receipts Tax Study").

Tax Study, one of the biggest concerns with gross receipts taxes is the absence of economic neutrality. As stated in the study:

> A gross receipts tax interferes with private market decisions. Its pyramiding creates a haphazard pattern of incentives and disincentives for business operations. Most significantly, it establishes artificial incentive for vertical integration and discrimination against contracting work with independent suppliers and the advantages of scale and specialization that production by independent firms can bring.[2]

COST recognizes that the B&O tax, which is a gross receipts tax, pyramids. However, that pyramiding impact should be kept to a minimum by properly interpreting the meaning of "gross income of the business."

A gross receipts tax is akin to a "turnover tax" because every time a product is sold or transferred to a different owner gross receipts are added to the tax base. Thus, the tax base is often larger than a state's gross domestic product because both the final value of a product and the value of transactions leading up to the that final production are subject to the tax. Washington's B&O tax—a true gross receipts tax—is no exception. The Gross Receipts Tax Study points out that in 2005, Washington's $474.8 million B&O tax base was 177 percent greater than the State's $268.5 million gross domestic product.[3] Under these circumstances, it is important for the State to limit the pyramiding of tax to

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[2] *Id.* at p. 1.
[3] *Id.* at p. 7.

the absolute minimum threshold required by the B&O tax statute to avoid the detrimental impact of excessive and unfair double taxation on the state's economy.

The Court of Appeal's decision exacerbates the issue of pyramiding and will result in an unfounded expansion of Washington's B&O tax base that will occur in connection with ESI's business model. ESI's situation is particularly egregious since approximately 95 percent of its receipts are being passed through to the third-party pharmacy suppliers. Review and reversal of the Court of Appeals' decision will not reduce the "legitimate" State B&O tax base. Rather, such a decision would be consistent with past State precedent, which applied a pass-through exception for funds that a business, such as ESI, passes through to their clients.[4] This minimizes the imposition of the gross receipts tax, making the tax more economically neutral by not penalizing businesses that elect not to self-administer pharmacy programs and instead use a business, such as ESI, that is specialized in administering those programs.

[4] See *First American Title Insurance Co. v. Department of Revenue*, 144 Wn.2d 300, 27 P.3d 604 (2001), and *Weyerhaeuser Co. v. Dep't of Revenue*, 106 Wn.2d 557, 723 P.2d 1141 (1986) – both cases addressing "pass-through" funds and the "economic realities" of a transaction.

B. Washington should follow federal precedent, which requires a taxpayer to have "complete dominion" over receipts before characterizing such receipts as income.

The parties agree that the tax is measured by the "gross income of the business." RCW 82.04.220(1). *See*, Answer to Pet. 9. Furthermore, RCW 82.04.080 defines "gross income of the business" to mean "the value proceeding or accruing by reason of the transaction of the business engaged in and includes gross proceeds of sales, [and] compensation for the rendition of services." "Compensation or consideration for the service is thus the basis for the tax." *Walthew, Warner, Keefe, Arron, Costello and Thompson v. Dep't of Revenue*, 103 Wn.2d 183, 187, 691 P.2d 559 (1984). Furthermore, "nothing in the statute refers to exceptions on the basis of agency and liability." *Walthew*, 103 Wn.2d at 187-88. Notwithstanding this, the Court of Appeals limited its analysis to "amounts that 'merely pass through' a business in its capacity as an agent", because, in its opinion, "the only way funds qualify for 'pass-through' treatment is under WAC 458-20-111 (Rule 111)" which requires agency. *Express Scripts, Inc. v. Department of Revenue*, 8 Wash.App.2d 167, 172, 437 P.3d 747, 749 (2019) (citing *Washington Imaging Services v. Washington State Department of Revenue,* 171 Wn.2d 548, 559-560, 252 P.3d 885 (2011)).

Not all receipts are "gross income of the business" if they do not satisfy Rule 111. For example, a foreign currency exchange that receives dollars in exchange for Euros does not measure its tax by all the dollars it receives. Similarly, in *First American Title Insurance Co. v. Department of Revenue*, 144 Wn.2d 300, 27 P.3d 604 (2001), this Court did "not rely on principles of agency to determine the result in these unique circumstances because the statutory scheme dictates a different result," 144 Wn.2d 300 at note 1, and lawyers and not their clients are the only ones in privity of contract with those providing litigation support services, yet this Court in *Washington Imaging Services,* 171 Wn.2d 548, did not overrule *Walthew,* 103 Wn.2d 183. Rule 111 cannot be the exclusive means by which a taxpayer shows that certain receipts are not its "gross income of the business."

Considering the significant redundancy between ESI's receipts and those of the pharmacies, this Court should consider analogies under the federal Internal Revenue Code which rely on "gross income." The U.S. Supreme Court has determined that receipts similar to those being collected by ESI were not gross income for federal income tax purposes. *See Comm'r v. Indianapolis Power & Light Co.*, 493 U.S. 203 (1990) and *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426 (1955). While Washington's B&O tax does not specifically conform to the federal

Internal Revenue Code nor generally rely on federal income tax principles, these federal cases are instructive as to when a receipt is gross income.

The taxpayer in *Comm'r v. Indianapolis Power & Light Co.* was a regulated utility that collected deposits from certain residential customers. *Id.* at 204. Customer deposits were held from six to 12 months as collateral in case a customer was unable to pay his or her electric bill. *Id.* If, however, the deposits were not used within that timeframe, then the customer was entitled to either a refund or to request the deposit be applied against future bills. *Id.* at 204-05. While recognizing the taxpayer enjoyed receipt of these deposits, the Court ultimately determined that, because the taxpayer was required to refund the deposits where a customer stayed current with all electric bills, the taxpayer lacked "complete dominion" over these receipts. *Id.* at 209, *citing Glenshaw Glass Co.*, at 431. Lacking such dominion, the Court determined that it was not proper to classify these deposits as gross income because these deposits did not represent an "accession" to the economic wealth of the taxpayer. The question of whether these deposits constituted income turned "upon the nature of the rights and obligations that [the taxpayer] assumed when the deposits were made" rather than by querying whether the taxpayer "derives some economic benefit from receipt of these deposits." *Id.*

Similar to the taxpayer in *Indianapolis Power & Light Co.*, ESI does not ultimately control the pass-through funds it receives from its clients and immediately transfers to pharmacies. These payments are made in accordance with agreements between ESI and the pharmacies, and ESI and the plan sponsors; thus, ESI is contractually bound to the immediate transfer of the funds to the pharmacies.

Like Indianapolis Power & Light, although ESI may "derive... some economic benefit from receipt" of the pass-through funds (by, for example, being able to earn interest on these monies), ESI ultimately lacked complete dominion over the receipts required to be transferred to the pharmacies. And it is this dominion that matters most for federal income tax purposes and that should matter most for determining what constitutes gross income for Washington's B&O tax purposes. *See Walthew, Warner, Keefe, Arron, Costello and Thompson v. Dep't of Revenue*, 103 Wn.2d 183, 187, 691 P.2d 559 (1984) ("compensation" is the basis for the B&O tax). Without dominion as a limiting principle to "compensation" the B&O tax base can pyramid out of control.

Thus, this Court should grant review to determine whether the federal authority on pass-through funds, as well as the authority cited by ESI, is persuasive in overturning the Court of Appeals' decision.

C. Without review of the Court of Appeals' decision, the Washington Taxpayer Bill of Rights will be effectively eviscerated.

The Washington Legislature gave Washington taxpayers certain rights with the passage of RCW 82.32A.020, commonly known as the Washington Taxpayer Bill of Rights, including "[t]he right to rely on specific, official written advice."

Here, ESI relied upon the Department's 2007 written audit report as well as WAC 458-20-194, both of which constitute "specific, official written advice" of the Department. Nevertheless, the Court of Appeals denied ESI a remedy even though ESI's filing position was based upon its reliance on that written advice. Pursuant to the Taxpayer Bill of Rights, ESI has a statutory right to do so. RCW 82.32A.020(2). If this Court fails to review the Court of Appeal's decision and to reinforce the protections provided under Washington's Taxpayer Bill of Rights, those protections will effectively be rendered moot.

Amicus urges the Court to grant Appellant's Petition and to use this case to address the intent of the Washington Taxpayer Bill of Rights.

V. CONCLUSION

For the foregoing reasons, *Amicus* respectfully requests that the Court grant Appellant's Petition for Review.

Respectfully submitted.

DATED: July 22, 2019.

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CERTIFICATE OF SERVICE

Today I electronically filed the foregoing document via the Washington State Appellate Courts' Secure Portal, which will automatically cause such filing to be served on counsel for all other parties in this matter via the Court's e-filing platform.

I certify under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct.

DATED: July 22, 2019, at Seattle, Washington.

s/ Betty Kawagoe
Betty Kawagoe
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