NO. 97247-8

SUPREME COURT OF THE STATE OF WASHINGTON

EXPRESS SCRIPTS, INC.,

Petitioner,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE,

Respondent.

DEPARTMENT OF REVENUE'S ANSWER TO AMICUS CURIAE BRIEF OF COUNCIL ON STATE TAXATION

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I. INTRODUCTION

The Court of Appeals decision below applied settled law to the material facts in the record and does not warrant further review for the reasons set out in the Department's Answer to Petition for Review. Amicus curiae Council on State Taxation (COST) has offered no valid alternative reason for accepting review.

II. ARGUMENT

A. COST's Opposition to Gross Receipts Taxes Does not Present an Issue Warranting Review

Express Scripts has created an immensely successful niche within the prescription drug industry, generating billions of dollars annually from its business activities. The gross income at issue here is an apportioned share of the revenue the company received from its clients under the terms of pharmacy benefit management (PBM) service contracts. Under those contracts, Express Scripts charges its clients an "ingredient cost" plus additional fees for every prescription it processes through its claim adjudication system. Express Scripts reports the entire amount it receives from its clients as gross income on its federal income tax returns. Those amounts are also gross income under the B&O tax code, as the Court of Appeals correctly ruled. *Express Scripts, Inc. v. Dep't of Revenue*, 8 Wn. App. 2d 167, 174-75, 437 P.3d 747 (2019).

Although the amounts at issue in this appeal involve gross income derived from Express Scripts' PBM business activities, it is also true that a business may receive payments that do not represent "gross income," as COST correctly suggests in its amicus brief. *See* Amicus br. at 7 (asserting that amounts received by a "foreign currency exchange" when exchanging dollars for Euros are not "gross income of the business"). Two common examples of "non-income" receipts are borrowed funds and the return of loaned capital. *See C.I.R. v. Tufts*, 461 U.S. 300, 307, 103 S. Ct. 1826, 75 L. Ed. 2d 863 (1983) (gross income does not encompass the receipt of borrowed funds that the recipient is obligated to repay, or the return of those funds to the lender); Det. No. 90-63, 9 WTD 107 at p. 21 (1990) (B&O tax does not apply to the recovery of loaned capital).

But this case does not involve borrowed funds, the recovery of loaned capital, or any other recognized type of "non-income." Rather, Express Scripts is arguing that amounts it receives in exchange for its services and uses to pay its own business expenses should be excluded from the measure of the Washington B&O tax as "pass-through" payments. No authority supports the claim. In fact, the pertinent authority from this Court is entirely contrary. *Washington Imaging Services, LLC v. Dep't of Revenue*, 171 Wn.2d 548, 252 P.3d 885 (2011).

COST does not seriously assert that current law supports Express Scripts' tax refund claim. Rather, COST's principal reason for asking this Court to accept review involves a tax policy argument. The organization is opposed to gross receipts taxes and believes this case presents a vehicle for "minimizing" Washington's gross receipts tax as applied to Express Scripts (and presumably others). Amicus br. at 5.[1] However, COST's arguments about the wisdom of gross receipts taxes in general, and the Washington B&O tax specifically, are misdirected.

As the Court is undoubtedly aware, there are nuanced legal and political reasons why Washington has chosen to employ a gross receipts tax as one of its primary sources of tax revenue. *See generally*, Alfred Harsch, *The Washington Tax System—How It Grew*, 39 Wash. L. Rev. 944, 960-62 (1965) (discussing the development of the B&O tax). This case does not present a suitable vehicle for addressing those reasons or making changes to the state's tax structure. Nor does it present a proper vehicle for creating new or expanded tax exemptions designed to minimize the taxes owed by Express Scripts. As this Court explained long ago, questions involving state tax policy are properly directed to the Legislature "but are not pertinent to

[1] COST's primary complaint involves the fact that the B&O tax applies at each step within the distribution chain involving the sale of products or services. COST asserts that this aspect of the Washington B&O tax, which it refers to as "pyramiding," should be limited by broadly applying "a pass-through exemption." Amicus br. at 5.

judicial inquiry." *City of Tacoma v. Tax Comm'n*, 177 Wash. 604, 617, 33 P.2d 899 (1934). *In accord, Univ. of Wash. v. City of Seattle*, 188 Wn.2d 823, 834, 399 P.3d 519 (2017).

Express Scripts' legal arguments all fail under current law. If COST believes that Washington's tax laws should be changed to benefit Express Scripts and others within the PBM industry, its arguments should be addressed to the Legislature. *City of Tacoma, supra.* The Legislature is capable of balancing the financial benefit to companies like Express Scripts against the countervailing cost to the State's ability to fund government, and can craft statutory exemptions or deductions designed to best achieve the desired goal. Asking this Court to step in and make those tax policy decisions in order to "minimize" Washington's gross receipts tax is not an issue warranting review under RAP 13.4(b).

B. COST's Discussion of "Federal Precedent" is Unavailing

COST also asserts that review should be granted to address whether Washington should "follow federal precedent" pertaining to the recognition of gross income. Amicus br. at 6. Specifically, COST argues that this Court should follow the analysis and holding of *Commissioner of Internal Revenue v. Indianapolis Power & Light Company*, 493 U.S. 203, 110 S. Ct. 589, 107 L. Ed. 2d 591 (1990). Amicus br. at 7-8. That case involved customer deposits received by a power utility "to assure payment of future

bills for electric service." *C.I.R. v. Indianapolis Power & Light Co.*, 493 U.S. at 204. Under established federal tax principles, customer deposits are not treated as gross income at the time of receipt unless they constitute "advance payments" for goods or services. *Id.* at 207. Applying that principle to the specific facts in the record, the Supreme Court ruled that the customer deposits received by Indianapolis Power & Light were not gross income when received because the utility was obligated to repay those amounts to customers that fulfilled their obligations to make timely payment for utility services. *Id.* at 209.

The present case does not involve the tax treatment of refundable customer deposits. Consequently, *Indianapolis Power & Light* has no direct bearing on the outcome of this litigation.[2] More importantly, the holding in *Indianapolis Power & Light* is of absolutely no help to Express Scripts. The amounts that Express Scripts seeks to exclude from the Washington B&O tax represent payments for services it performed for its clients. Express Scripts is under no obligation to return any of those payments to its clients. Rather, it has complete dominion over those payments and can use them for its own business purposes, including the payment of its own business expenses.

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[2] The issue addressed in *Indianapolis Power & Light* is unlikely to ever reach this Court unless the Department of Revenue were to assert that B&O tax is owed on refundable customer deposits, which would be a change from its historic practice.

COST was apparently misinformed as to the nature of the payments Express Scripts received from its clients, believing that the company "does not ultimately control the pass-through funds it receives from its clients and immediately transfers to pharmacies." Amicus br. at 9. The claim is untrue.

The payments COST refers to as "pass-through funds" represent consideration Express Scripts actually received for performing services under the terms of its contracts with its PBM clients. Those services are summarized in its contract with King County and includes claims processing, pharmacy network contracting and management, formulary development and management, rebate management and administration, trend management, and clinical program development. CP 1269.

The services Express Scripts performs for plan sponsors are independent from its contractual obligations with retail pharmacies. In its dealings with retail pharmacies, Express Scripts acts as a principal and expressly "assume[s] the credit risk" pertaining to the payments it is obligated to make for the cost of dispensed drugs. CP 1297. In short, Express Scripts' business activity includes overseeing all aspects of its clients' drug benefit programs, including the obligation to contract with and pay pharmacies for drugs dispensed to plan members.

A large part of the consideration Express Scripts receives from its clients is roughly equivalent to the amount it has independently contracted

to pay to retail pharmacies for the cost of drugs dispensed to plan members. *See* CP 756 (diagram showing $45 "Ingredient costs" received from client and $44 "Ingredient costs" paid to retail pharmacy). This is by design. An essential aspect of Express Scripts' business model is to deal directly with retail pharmacies on its own behalf and not as an agent of its clients. It does this so it can generate and retain the difference between what it charges its clients and what it pays network pharmacies, without any agency or fiduciary obligation to disclose the "spread" to its clients. *See* Brittany Hoffman-Eubanks, *The Role of Pharmacy Benefit Managers in American Health Care: Pharmacy Concerns and Perspectives: Part 1*, Pharmacy Times (Nov. 14, 2017) (PBMs like Express Scripts negotiate separate contracts with network pharmacies and plan sponsors "with neither typically being privy to the other's contract").[3]

Importantly, Express Scripts accounts for the total amount it receives from its clients as gross revenue on its accounting records. CP 1275. And it reports the total amount as gross revenue on its audited financial statements. CP 1297. In short, Express Scripts has determined that the amounts it bills and receives from its clients for "ingredient costs" must

[3] Available online at <https://www.pharmacytimes.com/news/the-role-of-pharmacy-benefit-mangers-in-american-health-care-pharmacy-concerns-and-perspectives-part-1> (last viewed August 2, 2019).

be recognized as gross income in accordance with generally accepted accounting principles. *Id.*[4]

Consistent with the financial accounting treatment discussed above, Express Scripts also includes the total amount it receives from its clients as gross income on line 1 of its federal income tax return. CP 1301.

COST offers no discussion of these undisputed facts, and makes no meaningful effort to explain why the outcome of this litigation would be different if Washington followed "federal precedent" pertaining to the recognition of gross income. Under both Washington law and federal law, the amounts Express Scripts receives from its clients for performing PBM services is gross income. Moreover, COST's unsupported claim that Express Scripts lacks "complete dominion" over those amounts is simply not true. *See* Amicus br. at 9. Express Scripts is under no obligation to refund the payments to clients. Rather, it has the unfettered right to use the income to pay its own business expenses—including expenses pertaining to its obligation to pay retail pharmacies for drugs dispensed to plan member.

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[4] One of the primary "indicators of gross revenue" under generally accepted accounting principles is whether the business receiving the payment "is the primary obligor in the arrangement." CP 763. "Representations (written or otherwise) made by a company during marketing and the terms of the sales contract generally will provide evidence as to whether the company . . . is responsible for fulfilling the ordered product or service." *Id.* Here, Express Scripts' public statements and its contracts with plan sponsors clearly demonstrate that Express Scripts is responsible for fulfilling all aspects of its PBM services, including contracting with and paying pharmacies for the prescription drugs dispensed to plan members.

See CP 1297 (Express Scripts records the "ingredient cost" paid to network pharmacies as a "cost of revenue" at the time the claim is processed). Further review by this Court to confirm the undisputed and undeniable facts in the record is simply not warranted.

C. COST's Arguments Regarding the Taxpayers' Rights and Responsibility Act Misstate the Record and Provide No Basis for Discretionary Review

COST also suggests that review is warranted to address what it perceives as the Court of Appeals' failure to properly apply the Taxpayers' Rights and Responsibilities Act. Amicus br. at 10. The argument is meritless.

Without providing any citation to the record, COST claims that "ESI relied upon the Department's 2007 written audit report as well as WAC 458-20-194." *Id.* However, the claim is incorrect as a matter of established fact. As the Court of Appeals explained in the unpublished portion of its opinion, Express Scripts offered *no evidence* that it relied on the 2007 audit report issued at the conclusion of the Department's audit of Express Scripts' subsidiary, ESI Mail Pharmacy. Slip op. at 16. And evidence in the record contradicted any claim of reasonable reliance. *See id.* at 17 (discussing evidence that undercuts ESI's reliance claim "for five reasons"). Finally, Express Scripts clearly was not relying on WAC 458-20-194 because it

challenged that administrative rule under the APA. *See* slip. op. at 9-12 (facts pertaining to APA rule challenge).

The facts in this case provide important context to the legal issues addressed by the Court of Appeals. COST simply ignores the facts in the record when it baldly asserts that Express Scripts "relied" on prior written advice. Consequently, its claim that review is necessary to "reinforce the protections provided under Washington's Taxpayer Bill of Rights" is based on a false premise. The protections afforded to taxpayers under the Taxpayers' Rights and Responsibility Act are not "eviscerated" or "rendered moot" by a court decision holding that a taxpayer has failed to offer proof supporting its claim. COST's unfounded rhetoric does not raise an issue worthy of this Court's review.

III. CONCLUSION

Neither Express Scripts nor COST has asserted any viable reason why the Court of Appeals decision below warrants this Court's review. Accordingly, the petition should be denied.

RESPECTFULLY SUBMITTED this 14th day of August, 2019.

ROBERT W. FERGUSON
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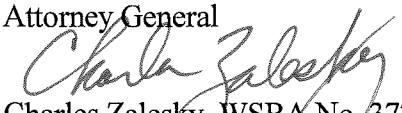

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DATED this 14th day of August, 2019, at Tumwater, WA.

Katelyn Johnson, Legal Assistant

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