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NO. 97247-8

SUPREME COURT OF THE STATE OF WASHINGTON

EXPRESS SCRIPTS, INC,

Petitioner,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE,

Respondent.

ANSWER TO PETITION FOR REVIEW

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I. INTRODUCTION

Express Scripts, Inc. is one of the largest pharmacy benefit management companies in North America, generating billions of dollars in gross revenue annually. It conducted substantial business activity in Washington for many years without paying taxes to the state. That tax-free activity came to an end in January 2013, when the company was assessed for unpaid business and occupation (B&O) taxes it owed for the 2007 through 2010 tax periods. Express Scripts has been fighting that tax assessment ever since.

As relevant here, the company has unsuccessfully litigated three claims. First, it unsuccessfully litigated its claim that it was not subject to B&O tax prior to June 2010 based on its interpretation of a Department of Revenue administrative rule, former WAC 458-20-194, that was partially invalidated by the trial court. Second, it unsuccessfully litigated its claim that most of the amounts it bills and receives from its clients should be treated as "pass-through" payments and excluded from the B&O tax based on this Court's opinion in *First American Title Insurance Co. v. Department of Revenue*, 144 Wn.2d 300, 27 P.3d 604 (2001). And finally, it unsuccessfully litigated its claim that the tax assessment should be waived based on its contention that the Department told the company in "written tax reporting instructions" issued in 2007 that it would not owe

B&O tax on its in-state business activity. The Court of Appeals soundly rejected each of those arguments, and others, in *Express Scripts, Inc. v. Department of Revenue*, No. 50348-4-II (Wn. App. March 26, 2019).

In an effort to continue its fight, Express Scripts argues that the Court of Appeals' opinion conflicts with three decisions of this Court, *Weyerhaeuser Co. v. Department of Revenue*, 106 Wn.2d 557, 723 P.2d 1141 (1986), *First American*, and *Silverstreak, Inc. v. Department of Labor & Industries*, 159 Wn.2d 868, 154 P.3d 891 (2007). There is no conflict. Each of these cases is easily distinguishable. In addition, Express Scripts ignores controlling case law and overlooks the dispositive facts of this case. The Court of Appeals decision applied settled law to the material facts and does not warrant further review under RAP 13.4(b)(1).

Additionally, this appeal does not involve a matter of substantial public interest. Express Scripts simply lays claim to important protections afforded under the Washington Taxpayers' Rights and Responsibilities Act without producing any evidence supporting its claim. That Act provides taxpayers with the right to rely on official written tax reporting instructions from the Department. RCW 82.32A.020(2). But Express Scripts produced no evidence of actual or reasonable reliance. As a result, its claim failed as a matter of law.

II. COUNTERSTATEMENT OF ISSUES

If the Court were to accept review, it would be asked to decide the following three issues:

1. Under the B&O tax statutory scheme, may Express Scripts exclude most of its gross income from taxation as "pass-through" funds, when there is no dispute that Express Scripts did not meet the requirements for excluding such income under *Washington Imaging Services, LLC v. Department of Revenue*, 171 Wn.2d 548, 252 P.3d 885 (2011)?

2. May Express Scripts avoid B&O tax on its in-state business activity based on a partially-invalidated interpretive rule when Express Scripts owed the tax under the controlling tax statutes?

3. Under the Taxpayers' Rights and Responsibilities Act, is Express Scripts entitled to a waiver of the tax assessment based on an audit report issued by the Department in a prior audit when the company offered no evidence to support a claim of detrimental reliance on that prior audit report?

III. COUNTERSTATEMENT OF THE CASE

Express Scripts is one of the world's largest pharmacy benefit management (PBM) companies. CP 1025. Its clients hire Express Scripts to manage the clients' prescription drug benefit programs.

In order to provide cost savings to its clients, Express Scripts directly negotiates with pharmaceutical manufacturers to obtain rebates and other payments tied to the utilization of brand-name drugs, and also directly contracts with retail pharmacies to establish the amount that will be paid for drugs dispensed to plan members. CP 1029; CP 1026. In this respect, Express Scripts acts as a behind-the-scenes middleman within the prescription drug industry, negotiating with manufacturers, retail pharmacies, and plan sponsors to establish the price that can be charged for prescription drugs dispensed to plan members.

During the 2007 through 2010 audit period, Express Scripts engaged in substantial business activities in Washington. The company had 58 Washington clients, including the Washington State Health Care Authority, King County, and the Seattle Mariners. CP 1036. In addition, Express Scripts had several full-time employees who lived and worked in Washington. CP 491; CP 1039. It sent other employees into the state on a regular basis to meet with clients. CP 491. Express Scripts concedes that its in-state visits were important and helped it maintain good relationships with its clients. CP 1385-86.

A. Department's Audit of Express Scripts

Although Express Scripts had several employees who resided in Washington, and regularly sent other employees into the state to meet with

clients, it did not begin filing Washington excise tax returns until June 2010. The Department became aware of Express Scripts' in-state business activities following an audit of ESI Mail Pharmacy, Inc., a subsidiary of Express Scripts. CP 588-89. ESI Mail Pharmacy made retail sales of prescription drugs through the mail to Washington buyers and was assessed for unpaid B&O tax under the "retailing" classification. CP 585.

ESI Mail Pharmacy appealed the tax assessment to the Washington Board of Tax Appeals. CP 588. Discovery in that appeal revealed that ESI Mail Pharmacy's parent, Express Scripts, had significant nexus-creating contacts with the State. CP 588-89. Based on that information, the Department scheduled an audit of Express Scripts. CP 589.

At the conclusion of the audit, the Department determined that roughly two percent of Express Scripts' gross income from its PBM services had been derived from Washington business activities during 2007 through 2010, resulting in a tax assessment of $11,794,092 plus interest and penalties. CP 1130. Express Scripts paid the assessed amounts and sued for a refund under RCW 82.32.180. CP 4. Express Scripts also sought to invalidate a Department interpretive rule, former WAC 458-20-194 (2006), that it claimed was inconsistent with RCW 82.04.460. CP 17-23. RCW 82.04.460 is the statute that authorizes apportionment of gross income derived from interstate commerce.

B. Procedural History

The various claims asserted by Express Scripts were segregated into two proceedings. CP 303. In the APA rule challenge, Express Scripts argued that the Department exceeded its authority by amending WAC 458-20-194 in 2006 to change its interpretation of the term "place of business" without any change having been made to RCW 82.04.460. CP 37. Express Scripts also claimed that if the 2006 version of Rule 194 were invalidated, it would owe no B&O tax for the 2007 through May 2010 tax periods because it lacked an in-state "place of business"—which the company asserted was a requirement for *imposing* the tax. CP 33.

The trial court rejected Express Scripts' assertion that B&O tax applied only when a service provider maintained a "place of business" in the state, explaining that RCW 82.04.460 authorized apportionment of a taxpayer's income but does not impose the tax. CP 308. Rather, the B&O tax is imposed by RCW 82.04.220; and imposition of the tax has never been tied to whether a taxpayer had a "place of business" in the state. *Id.*

Although the trial court rejected Express Scripts' premise that RCW 82.04.460 imposed the B&O tax, it nevertheless invalidated a portion of Rule 194 that it concluded was inconsistent with RCW 82.04.220. Specifically, the court found that the amended Rule's discussion of "nexus" in subsection (2)(a) was inconsistent with an

implied physical presence nexus requirement in the pre-2010 version of RCW 82.04.220. CP 312-13. The pertinent rule language stated: "Nexus is created when a taxpayer is engaged in activities in the state, either directly or through a representative, for the purposes of performing a business activity." WAC 458-20-194(2)(a) (2006). The court invalidated that section of the rule because it "failed to include a 'physical presence' requirement . . . consistent with the requirement the Court has found to be part of the statute." CP 313.

The trial court's conclusion that the pre-2010 version of RCW 82.04.220 included an implied physical presence requirement did not impact the ultimate resolution of Express Scripts' tax refund claim because the undisputed evidence established that Express Scripts had a substantial physical presence in Washington during the tax period. *See* CP 722 (letter ruling regarding physical presence). Thus, Express Scripts met the implied nexus requirement the trial court added to the statute. The case then proceeded to the tax refund phase.[1]

In that second phase, the trial court granted summary judgment to the Department on all of the various claims Express Scripts raised in its complaint, including its claim that most of its gross income was exempt

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[1] The trial court's decision to invalidate Rule 194's discussion of "nexus" based on an implied "physical presence" statutory standard proved to be harmless. As a result, the Department did not appeal that ruling.

from B&O tax as "pass-through" payments under the holding in *First American Title Insurance Company v. Department of Revenue*, 144 Wn.2d 300, 27 P.3d 604 (2001). CP 981. The trial court also rejected Express Scripts' claims for relief under the doctrine of equitable estoppel and under the Taxpayers' Rights and Responsibilities Act. CP 948-49.

The Court of Appeals, like the trial court, rejected all of Express Scripts' varied legal arguments. In relevant part, the Court explained that Express Scripts did not meet the requirements this Court established for excluding pass-through payments from gross income, and rejected Express Scripts' claim that *First American* established an alternative means of achieving that tax benefit. Slip op. at 4-9. The Court also explained that Express Scripts owed the assessed B&O tax under the controlling tax statutes and that its partially-successful rule challenge did not entitle the company to a refund. Slip op. at 14. Finally, the Court explained that Express Scripts could not avail itself of the protections of the Taxpayers' Rights and Responsibilities Act because the company offered no evidence that it actually or reasonably relied on audit instructions the Department gave in 2007 when it audited the mail order pharmacy activities conducted by ESI Mail Pharmacy. Slip op. at 16-18.

IV. REASONS WHY THE COURT SHOULD DENY REVIEW

Express Scripts contends that the Court of Appeals opinion is contrary to three opinions of this Court, and contends that the issues it unsuccessfully argued below involve matters of substantial public importance. The contentions are baseless. This Court should deny review.

A. The Court of Appeals Correctly Rejected Express Scripts' "Alternative" Pass-Through Claim

The core features of the B&O tax are well-established. *Washington Imaging*, 171 Wn.2d at 555-56. The tax is imposed "for the act or privilege of engaging in business activities" and is measured by the "value of products, gross proceeds of sales, or gross income of the business, as the case may be." RCW 82.04.220(1). It is a gross receipts tax, not a net income tax. Accordingly, taxpayers may not deduct costs of doing business unless an express exemption or deduction applies. RCW 82.04.080; *Dot Foods, Inc. v. Dep't of Revenue*, 185 Wn.2d 239, 245, 372 P.3d 747 (2016).

Although the B&O tax applies broadly, it is well established that gross income of the business does not include amounts "that merely 'pass through' a business in its capacity as an agent." *Washington Imaging*, 171 Wn.2d at 560 (quoting *City of Tacoma v. Wm. Rogers Co. Inc.*, 148 Wn.2d 169, 175, 60 P.3d 79 (2002)). For instance, the collection of a licensing fee

by an auto dealer acting as an agent for the licensing agency is not taxable gross income of the auto dealer. *Wm. Rogers*, 148 Wn.2d at 176.

WAC 458-20-111 (Rule 111) represents the Department's longstanding interpretation of RCW 82.04.080 with respect to payments received by an agent. That Rule describes how to distinguish business expenses, which may not be deducted from a taxpayer's gross income, from "non-income" amounts that are excluded from gross income because they are received by a taxpayer acting solely in its capacity as an agent.

Payments received by a taxpayer can qualify for exclusion from taxation only when the payments are customary reimbursements for advances made by the taxpayer to procure a service for the client and the taxpayer is not liable for the advances or payments it made to third parties other than as an agent of the client. *Washington Imaging*, 171 Wn.2d at 561-62. Regarding agency, the taxpayer must prove both that the payment received from the client was made pursuant to an agency relationship and that the taxpayer's liability to pay the funds to a third party constituted solely agent liability. *Wm. Rogers*, 148 Wn.2d at 177-78. If the taxpayer independently assumes any liability to the third party, the payments it receives are not excluded from taxation even if the taxpayer uses the payments to pay costs related to its services. *Id.* at 178 (citing *Walthew,*

Warner, Keefe, Arron, Costello & Thompson v. Dep't of Revenue, 103 Wn.2d 183, 189, 691 P.2d 559 (1984)) .

The Court of Appeals held that Express Scripts did not meet the elements necessary under Rule 111 to qualify for the pass-through exclusion on the amounts it used to pay pharmacies for the drugs they dispensed because the company undertook the obligation to pay the pharmacies on its own accord and not as an agent. Slip op. at 6. The Court further explained that Express Scripts "ascribes undue weight to the *First American* court's use of the term 'pass-through'" because that case did not involve a genuine pass-through issue and the term was used in passing without providing "any standards to be applied in future cases." *Id.* It logically follows that the use of the term in *First American* was dictum and did not "create an alternative means of achieving pass-through status for B&O tax purposes." *Id.* at 7.

B. The Opinion of the Court of Appeals is not in Conflict with *First American* or *Weyerhaeuser*

Express Scripts concedes that it is not entitled to exclude any of its gross income under a standard pass-through theory. Instead, the company argues that it is entitled to the benefit of the exclusion based on its reading of *First American.* It also argues in its Petition for Review that it is entitled to a pass-through exclusion based on its reading of *Weyerhaeuser*

v. Department of Revenue, 106 Wn.2d 557, 723 P.2d 1141 (1986).[2] But neither of those cases involved a claim that amounts received from clients should qualify as pass-through payments. Consequently, there is no conflict between the holdings in those cases and the Court of Appeals' rejection of Express Scripts' pass-through argument in this case.

1. There is no conflict with *First American*.

As support for its alternative "pass-through" theory, Express Scripts relied below on *First American*. As noted above, however, that case did not involve a dispute over pass-through payments. Instead, it involved the allocation of taxable receipts between entities engaged in different aspects of a bundled sale of title insurance. *First American*, 144 Wn.2d at 303. The holding in *First American* is not applicable in this appeal, as the Court of Appeals correctly held. Slip op. at 6-7.

First American involved a title insurance business (First American) that operated in association with various "underwritten title companies" (UTCs). The UTCs would "sell a bundled package to consumers in a single transaction." *First American*, 144 Wn.2d at 304. The bundled package consisted of title insurance provided by First American and title abstracting services provided by the UTCs. *Id.* Under the terms of the parties' contracts, the UTCs collected the total fee from the consumers,

[2] Express Scripts' argument pertaining to *Weyerhaeuser* is new.

retained the portion pertaining to its title abstracting service, and remitted the remaining portion to First American for providing title insurance. *Id.* at 302. From these facts, this Court held that the amounts paid by consumers for the bundled service should be allocated in the manner provided in the contracts entered into between First American and the UTCs. *Id.* at 305.

The pass-through concept was briefly addressed at the end of the opinion with respect to the B&O tax treatment of the UTCs. *Id.* at 305. However, the UTCs were not a party in the litigation, and the amounts paid by consumers to the UTCs never "passed through" First American. Consequently, this Court's brief mention of the pass-through exclusion had no bearing on First American. Rather, the Court's analysis pertaining to First American involved the allocation of receipts between entities engaged in "two components" of a single transaction. *Id.* at 305 n.3.

First American is not helpful to Express Scripts because no evidence or argument suggests that it has entered into a business arrangement with another entity to perform "components" of a bundled transaction. To the contrary, Express Scripts is "solely responsible" for the PBM services it provides to its clients. CP 1297. It is not performing those services in conjunction with another entity, and there is no agreement pertaining to the allocation of fees between Express Scripts and another

entity. Thus, none of the facts that informed this Court's decision in *First American* are present here.

Moreover, nothing in *First American* suggests that the Court intended to establish an "alternative" method by which a taxpayer could exclude amounts from the B&O tax as "pass-through" payments. *First American* has certainly never been cited for that proposition. And cases decided before and after *First American* have emphasized that treating income as merely passing through a taxpayer in its capacity as an agent can apply only when specific elements are met, including proof of a true agency relationship. *See, e.g., Walthew*, 103 Wn.2d at 189 (law firm was "acting solely as agent for the client in advancing the type of litigation expense involved here"); *Washington Imaging*, 171 Wn.2d at 566 (taxpayer "fails to show that it is in an agency relationship with its patients"). Had the Court in *First American* intended to announce an alternative means of achieving the tax benefit of pass-through treatment, it would have made that intent clear.

First American is easily distinguishable from the facts of this case, and it did not modify Washington law pertaining to the pass-through exclusion. The controlling authorities with respect to pass-through payments are discussed and analyzed in *Washington Imaging*, and the Court of Appeals decision is entirely consistent with those authorities.

2. There is no conflict with *Weyerhaeuser*.

Weyerhaeuser is also distinguishable and cannot fairly be read as creating an alternative means of excluding any of Express Scripts' income from taxation. Consequently, the Court of Appeals' opinion rejecting Express Scripts' pass-through argument is not in conflict with this Court's decision in *Weyerhaeuser*.

The *Weyerhaeuser* opinion involved three unrelated excise tax issues. *Weyerhaeuser*, 106 Wn.2d at 558-59. Express Scripts relies on the portion of the opinion addressing the construction and application of the pollution control facility tax credit allowed under RCW 82.34.060(2). That statute generally allows for a state tax credit equal to two percent of the cost of a qualifying pollution control facility. *Weyerhaeuser*, 106 Wn.2d at 567 (discussing RCW 82.34.060(2)). However, the amount of the credit is reduced by the total amount of any federal investment credit "actually received by the taxpayer." *Id.* (quoting RCW 82.34.060(2)(d)).

In construing the plain language of that "credit reduction" provision, this Court explained that a federal tax credit must be "actually received" by the taxpayer for the reduction to apply. *Id.* at 568. The facts in the record established that Weyerhaeuser never actually received the "extra 1%" federal investment tax credit at issue because that credit had been contributed by Weyerhaeuser to an employee stock ownership plan.

Id. at 567. Contributing the "extra 1%" federal tax credit to an employee stock ownership plan resulted in "an immediate pass-through" of the credit to employees of the company. *Id.* at 568.

Express Scripts argues that *Weyerhaeuser* holds that the "economic reality" of a business arrangement can create a tax-free "pass-through" of funds when the initial recipient of the funds received "no profit." Pet. at 8. But that is a gross misstatement of this Court's holding. Rather, the Court found legal support for its holding from the "intent of the Legislature in creating the limitations on state tax credits in RCW 82.34.060." *Weyerhaeuser*, 106 Wn.2d at 568. That legislative intent was to prevent a "double benefit to entities for a single pollution control facility." *Id.* That purpose was not impeded under the facts presented because "Weyerhaeuser's 1 percent federal tax credit in return for a 1 percent contribution to an [employee stock ownership plan] does not result in a double benefit to the corporation." *Id.* at 568-69.

The Court of Appeals decision in this case is not in conflict with *Weyerhaeuser* for at least three reasons. First, this Court in *Weyerhaeuser* was addressing a specific tax statute, RCW 82.34.060, that is not at issue in this appeal. Thus, *Weyerhaeuser* is not directly on point.

Second, the facts in *Weyerhaeuser* are distinct from the facts in this appeal. Specifically, the gross income Express Scripts seeks to exclude

from the B&O tax was "actually received" from its clients for performing contracted services. CP 1273-74. Not only were the payments actually received, they were (1) recorded as gross income on Express Scripts' accounting records, (2) treated as gross income by Express Scripts on its audited financial statements, and (3) included as gross income on its federal income tax return. *See* CP 564-65 and portions of the record cited therein. Thus, Express Scripts seeks to exclude amounts it actually received and treated as gross income under generally accepted accounting rules and the federal tax code. The holding in *Weyerhaeuser* provides no support for such an unprincipled application of the state's B&O tax laws to Express Scripts' PBM business activities.

Finally, like *First American*, nothing in *Weyerhaeuser* suggests that this Court was creating an "alternative" pass-through concept. Express Scripts simply reads into *Weyerhaeuser* a legal proposition that has no support in the law. The Court of Appeals did not err by rejecting Express Scripts' novel and unprincipled analysis. Review should be denied.

C. There is no Conflict with *Silverstreak*

Express Scripts' reliance on *Silverstreak* is also misplaced. Pet. at 9-13. That case involved a group of plaintiffs that established all of the facts necessary to invoke the doctrine of equitable estoppel against a state agency. *Silverstreak*, 159 Wn.2d at 887. That case did not rest on the

proposition that an agency is "bound by its own interpretive rule unless and until the rule is repealed by a valid replacement or the Legislature changed the law." Pet. at 10. Rather, *Silverstreak* involved a successful equitable estoppel claim where all elements were met. By contrast, Express Scripts met none of the required elements. Slip op. at 19.

Additionally, even if this Court were to accept Express Scripts' overly-simplistic description of the holding in *Silverstreak*, that holding would not apply here. Express Scripts seeks to bind the Department to *Express Scripts'* reading of a pre-2006 version of Rule 194. Pet. at 11. But Express Scripts' proposed interpretation is untethered from the statutes upon which the B&O tax is imposed and measured, as the Court of Appeals correctly held. Slip op. at 14-15.[3] In short, Express Scripts owes the B&O tax at issue as a matter of statutory law, not because of any change the Department made to Rule 194. There is no conflict.

D. Express Scripts' Unsuccessful Attempt to Obtain Relief Under RCW 82.32A is Not an Issue of Substantial Public Importance

The Washington Taxpayers' Rights and Responsibility Act (codified in RCW 82.32A) details the rights and obligations that apply to

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[3] Express Scripts' proposed interpretation of the pre-2006 version of Rule 194—which Express Scripts contends exempted service providers from the B&O tax unless the service provider had a brick-and-mortar "place of business" in Washington—is also inconsistent with established case law. *See Smith v. State*, 64 Wn.2d 323, 391 P.2d 718 (1964) (out-of-state tugboat company with no place of business in the state was nonetheless subject to B&O tax on a portion of its service income).

the taxpaying public. As relevant here, the Act provides that taxpayers have the right to rely on "specific, official written advice and written tax reporting instructions" from the Department, and to have "interest, penalties, and in some instances, tax deficiency assessments waived where the taxpayer has so relied to their proven detriment." RCW 82.32A.020(2).

Express Scripts claims that it relied to its proven detriment on an audit report the Department issued in 2007. Pet. at 14. According to Express Scripts, that 2007 audit report "instructed" the company that its "PBM revenues were not subject to B&O tax under Rule 194." Pet. at 14. However, the 2007 audit report said no such thing. Express Scripts simply reads an audit report discussing the business activities of ESI Mail Pharmacy—a company that makes mail-order sales of prescription drugs—as if it somehow excused Express Scripts from paying B&O tax on its in-state PBM service activities. Nothing in the language or context of that audit report supports Express Scripts' purported interpretation.

Additionally, as the Court of Appeals correctly explained, Express Scripts offered no evidence to support its purported "reliance." Slip op. at 17 n.7. And the actual evidence in the record "undercuts ESI's reliance claim for five reasons." Slip op. at 17. The most probative of those "five reasons" is the fact that "there was no implication in the prior audit that ESI's PBM activities were not subject to the B&O tax." *Id.* Additionally,

as Express Scripts admits in its Petition, the company could find no employees willing to testify that the company "relied" on the 2007 audit report as its basis for failing to file B&O tax returns. Pet. at 15 n.5.[4]

RCW 82.32A.020(2) does not permit tax, interest, or penalties to be waived based on a taxpayer's misinterpretation of written audit instructions. Express Scripts' purported decision to interpret the prior audit report as implicitly carving out its PBM service activities from the reach of the B&O tax was not reasonable, and does not entitle the company to relief under RCW 82.32A.020(2). Moreover, in light of the total lack of evidence supporting the company's detrimental reliance claim, there is no issue of substantial public importance that warrants this Court's review.

V. CONCLUSION

For the foregoing reasons, the decision of the Court of Appeals does not merit this Court's review. The petition should be denied.

RESPECTFULLY SUBMITTED this 21st day of June, 2019.

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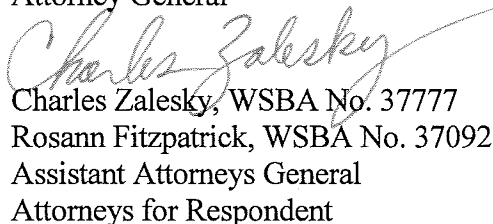

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[4] The one employee that did testify, Express Scripts' tax director, was unaware of any facts suggesting that the company had relied on the 2007 audit report. CP 943-45.

PROOF OF SERVICE

I certify that on June 24, 2019, I electronically filed this document with the Clerk of the Court using the Washington State Appellate Courts' e-file portal, which will send notification of such filing to all counsel of record at the following:

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

DATED this 21st day of June, 2019, at Tumwater, WA.

Jamie Falter, Legal Assistant

ATTORNEY GENERAL'S OFFICE - REVENUE & FINANCE DIVISION

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