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NO. 98533-2
[Court of Appeals Div. II No. 52349-3-II]

SUPREME COURT
OF THE STATE OF WASHINGTON

ARUP Laboratories, Inc.,

Appellant,

v.

State of Washington, Department of Revenue,

Respondent.

PETITION FOR REVIEW

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A. IDENTITY OF PETITIONER

ARUP[1] Laboratories, Inc. ("ARUP"), the Petitioner, is a non-profit entity located and organized in the State of Utah. ARUP performs pathology services on human tissue and fluids that it receives from around country, including Washington. ARUP seeks this Court's review of the decision reached in Court of Appeals, Div. II, NO. 52349-3-II.

B. COURT OF APPEALS DECISION

ARUP appeals the Division II's decision in its entirety except the section "I – Legal Principles" at A-00005 through A-000006. A copy of the decision is in the Appendix at A-000002 through A-000019. A copy of the order denying petitioner's motion for reconsideration is in the Appendix at A-000020.

C. ISSUES PRESENTED FOR REVIEW

1. Did Division II err when it failed to apply WAC 458-20-19402(303)(b) and applied WAC 458-20-19402(303)(c) instead?
2. Did Division II err with its ruling, rendering WAC 458-20-19402(303) violative of the due process clause?
3. Did Division II err when it found that ARUP is not an arm of the state?[2]

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[1] Pronounced A–R–U–P.

[2] Because Division II failed to find that ARUP was not an arm of the state, such failure rendered moot ARUP's arguments that as an arm of the State of Utah, (1) that ARUP is not a "person" in RCW 82.04.030, (2) failing to exclude ARUP from tax deprived ARUP of the full faith and credit of law, and (3) that Washington's requirement to pay the tax to sue in court

D. STATEMENT OF THE CASE

Procedural background

ARUP sued for a refund in the Thurston County Superior Court. ARUP argued that (1) WAC 458-20-19402(303)(b) sourced ARUP's income to Utah; (2) that if that rule did not apply, then ARUP was an arm of the State of Utah which meant that (a) it was not a taxable "person" under RCW 82.04.030, and (b) that it was entitled to full faith and credit and should be taxed like other state-funded schools; (3) the rule violated the United States Commerce Clause; and (4) Washington tax procedure deprived ARUP of sovereign immunity.

The court concluded that DOR's rule did not apply because ARUP's laboratory services did not relate to tangible personal property. Report of Proceedings (RP) at 40 and 41. The court stated that although ARUP is closely affiliated with "the Utah state institution," ARUP is a "person" for purposes of the B&O tax. RP at 40. The court also found that the four-prong commerce clause test[3] had been satisfied, so there was no impermissible discrimination. RP at 41. Finally, it held sovereign immunity did not apply because ARUP is a non-profit "person" and not an arm of Utah. RP at 41. ARUP appealed to the Court of Appeals.

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deprives ARUP's sovereign immunity. Should this Court reverse Div. II on the question of whether ARUP is an arm of the State of Utah, then this matter should be remanded back to further determine these other legal questions that depends on the arm-of-the-state question.

[3] *See Complete Auto Transit, Inc. v. Brady*, 430 U. S. 274, 279, 97 S.Ct. 1076, 1079, 51 L.Ed.2d 326 (1977) (*Complete Auto*)

Division II heard the matter and upheld the trial court result. Division II reviewed RCW 82.04.462(3)(b)(i) and concluded that its function was to determine what the legislature meant when it sourced the revenue to the location "where the customer benefitted" from ARUP's service. Op. at 12. Because the legislature did not define "benefit," Division II relied on a dictionary definition of "benefit."[4] Using that definition, Division II concluded that the customer benefitted from the service where the medical personnel used the test results to treat their patients. Op at 13.

Division II did not rely on Rule 19402(303)(b) to allocate the benefit of the service to where the tangible personal property was used or to be used. It reasoned that Rule 19402(303)(b) intended "to facilitate the use and enjoyment of the property." Op at 14. Thus, because the tissue and fluids were simply stored and not returned to the customer, the property was not used or enjoyed.

Division II also rejected ARUP's claim that it was solely managed and controlled by the University of Utah Medical School, making it an arm of the state. This conclusion allowed Division II to reject ARUP's position that RCW 82.04.030 excluded ARUP from the definition of "person." It found that (1) ARUP is a non-profit that is expressly included in the definition of "person"[5] and (2) it was not an arm of the State of Utah because there were

[4] "The advantage or privilege something gives; the helpful or useful effect something has." Black's Law Dictionary (11th ed. 2019). Op at 13.
[5] Op 6

differences between ARUP's facts and the facts in the two cases that ARUP relied upon (that found nonprofit healthcare organizations were arms of the State of Washington). Op at 6-9. Consequently, Division II did not address whether ARUP was entitled to the full faith and credit or the sovereign immunity protections.[6] Division II did not address whether DOR's application of Rule 19402(303) violated the Commerce Clause under *Complete Auto*.

Factual background

The University formed ARUP to attract large samples of human tissue or fluids to enhance its educational work in pathology research. CP at 173-174. The Utah Med School used ARUP to increase substantially the number samples, knowing that more samples would also mean more unique samples of novel diseases or abnormal occurrences that its faculty could study. *Id.* ARUP's efforts aid in the school's retention and attraction of highly regarded pathologists. *Id.*

Utah statutorily created and controls the University of Utah ("University").[7] The Utah Med School is statutorily part of the University.[8] The University is a "component unit"[9] of Utah. ARUP's budget is approved by either the University's president or the University's vice president for health sciences. CP at 250-251. When a "separate

[6] Op 1, footnote 1
[7] UT Code, 53B-2-101
[8] UT Code, 53B-17-Part 9
[9] "Component unit" is a financial accounting term. Amendment of GASB Statement No. 14. CP at 665.

entity," ARUP in this case, has a significant relationship with a government entity, the University is required to report ARUP's financials as a component unit of the state. The significant relationship exists if ARUP "raises and holds economic resources for the direct benefit of a governmental unit" under GASB.[10] The University's 2017 Audit Report from the State Auditor provides that the University has such a relationship and is treated as a "component unit" of Utah.[11] CP at 295. Further, ARUP is also treated as a "component unit" of the University.[12] CP at 362. ARUP is a component unit of the University and the University is a component unit of Utah. GASB financial reporting confirms that ARUP raises and holds economic resources for the direct benefit of the University, and the University raises and holds economic resources for the direct benefit of Utah.

The University incorporated ARUP and it is ARUP's sole voting member.[13] CP at 425. According to the ARUP 2017 Annual Financial Report (audit performed by independent auditors, Deloitte & Touche), both the Congressional Joint Committee on Taxation and the IRS ruled that ARUP has been an "integral part of the State of Utah" since its

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[10] *Id.*

[11] University of Utah 2017 Financial Report. See caption *Report on the Financial Statements.*

[12] ARUP 2017 Annual Financial Report. *See* paragraph 1 "Significant Accounting Policies", subparagraph "Organization". According to the subparagraph "Basis of Accounting" in that same paragraph, ARUP's audit was done in accordance with GASB.

[13] Art. III., § 3.1, Restated By-Laws (2009)

formation in 1984."[14] CP at 363. To comply fully with the IRS letter ruling,[15] the University reincorporated Associated Regional and University Pathologists, Inc. under the Utah Revised Nonprofit Corporation Act, creating ARUP Laboratories, Inc. CP at 443-447 (see Art. IV, CP at 444-445).

The University controls ARUP. The University is the sole member of ARUP. ARUP's "management and direction" is controlled by the Board of Directors appointed by the University. A majority of the board members "shall be appointed from officers, employees, and trustees of the University". CP at 445.

ARUP's staff exceeds 3,000 employees of which at least 80 are medical directors. CP at 149. These medical directors are Utah Med School faculty members who are employed by the University; ARUP reimburses the University for their wages. *Id.* Any liability for ARUP's actions is divided into two categories. The State of Utah covers the clinical staff (the about 80 or so medical directors who are part of the University faculty) from a state fund. CP at 253. ARUP covers the

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[14] ARUP 2017 Annual Financial Report, (see caption "Taxes:"),
[15] Associated represented to the IRS that it would amend its articles and by-laws to meet the requirements of IRC § 115. See fourth full paragraph on CP at 580.

IRC § 115 provides:

> Gross income does not include—
>
> (1) income derived from … the exercise of any essential governmental function and accruing to a State or any political subdivision thereof ….

general medical liability for the technical staff (the people who prepare slides, physically perform lab tests, and conduct other testing processes). *Ibid.*

ARUP's activities are testing the pathology of tissue and fluids to evaluate what anomalies are present, and it receives some of the samples from Washington. Once the customer collected the samples, they would have the same transported to ARUP in Utah by air. CP at 78-79. ARUP performed all testing activities in its Utah laboratories; no testing activities occurred in Washington. CP at 126-127.

After ARUP completed the testing, ARUP stored the samples in its Utah facilities, securely protecting the samples from contamination or spoilage. CP at 83-84. Samples are not returned to Washington. CP at 136. In some cases, the samples must be retested. CP at 83-84. Once ARUP completes the testing, it then securely sends the results to its customer's location through the internet and the customer typically accesses the information through computer equipment. CP at 67-68; 136.

As part of the testing functions, ARUP has medical students and Utah Med School residents performing pathology activities at ARUP; they work under the supervision of "full pathologists or certified pathologists, board-certified pathologists." CP at 127-128.

From its activities, it receives income from Washington customers. The issue is whether this income is taxable in Washington.

E. WHY THE CASE SHOULD BE ACCEPTED FOR REVIEW

The Court should review this case because (1) whether Rule 19402(303)(b) applies to ARUP is intellectually disputed, as the Division II decision was not unanimous–there was a dissent, and (2) the matter should be clearly resolved. The Court should also review this case because Division II's application of Rule 19402(303) violates the due process clause. Finally, the Court should review this case because the decision draws previously non-existent lines as when an entity is acting as an arm of the state. These reasons have substantial public interest that should be determined by this Court.

Rule 19402(303)(b) should have been followed.

ARUP is taxable on its apportionable income under the Washington Business and Occupations tax ("B&O tax" or "gross receipts tax"). RCW 82.04.209(2), 82.04.460, and 82.04.462. The question in this case is to determine how much of ARUP's income is sourced to Washington for purposes of the apportionment formula. The statute sources the receipts to the place where the customer receives the benefit of the service. The legislature granted DOR the authority to determine how to source income for purposes of apportionment. RCW 82.04.462(2). ARUP argues that none of it is sourced to Washington, because Rule 19402(303)(b)(ii) sources the gross receipts to the state where the benefit of the service is received and that location is *"where the tangible personal property is located or intended/expected to be located."* Rule

19402(303)(b)(iii)(D) expressly includes "testing tangible personal property." There is no dispute that the tissue and fluid are tangible personal property, Utah is where the property is located, and Utah is where the testing occurs.

Division II, however, refused to apply that rule, instead looking to RCW 82.04.462, noting that the statute requires sourcing the gross receipts to the location where the customer receives the benefit. The statute delegates rule-writing authority to DOR to determine the sourcing rules. In that regard, DOR sourced the receipts from services related to personal property to the location of the property when tested. However, Division II determined that the customer benefits from the service where the customer reviews the test results, not where the property was located when tested. Then, it resorted to Rule 19402(303)(c)'s sourcing rule which sources revenue to where the customer's related business activities occur.[16] By its own terms, that section of the rule only applies when the services are not related to real property or tangible personal property. ARUP's services were related to tangible personal property regardless of where the customer reviewed the test results.

Division II reconciled the Rule 19402(303)(b) with the statute by looking at the rule's examples to conclude that the testing the rule had in

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[16] Practically speaking, the test results do not belong to the customer; they belong to the patient who pays for the pathology testing through insurance or out of pocket. The medical facility acquires the testing for the patient's benefit, not its own benefit. So, to source it to where the customer conducts business is a weak attribution of where the benefit is received.

mind was testing of property that the customer could use and enjoy after the testing was done. Because ARUP did not return the samples to Washington, Division II found that the rule did not apply to ARUP. To reach that conclusion, Division II had to engage in strained reasoning.

Judge Maxa found Rule 19402(303)(b) clear on its face that the receipts should be sourced to Utah, and that he did not agree with the majority's attempt to explain why it did not apply. Op at 18. He notes that DOR wrote the rule and it should be bound to follow it.[17] *Ibid.*

Consequently, this Court should review Division II's refusal to apply Rule 19402(303)(b). The review should determine why the literal application of the rule to a taxpayer's facts should be subject to divining a different outcome from general guidelines provided in the examples. Examples only serve as a general guide to determine the application of the rule. Rule 19402(302). If there was any ambiguity in the rule, then examples might aid in the interpretation; however, when the rule is clear on its face, the court should not look to examples to create ambiguity. The decision not only affects ARUP, but it also creates ambiguity for businesses that fall under Rule 19402(303)(a), (b), and (c). Division II should have applied Rule 19402(303)(b) as written, respected the

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[17] In a case when a state agency tried to change its prior interpretation, this court said: "If contractors and subcontractors cannot rely on the consistency of clear department interpretations in effect at the time they enter into a contract, they are left to guess at the meaning of regulations. Thus, the result the Department urges us to reach would be not only manifestly unjust but unconstitutional." *Silverstreak, Inc. v. Dep't of Labor & Indus.*, 159 Wn.2d 868, 890, 154 P.3d 891, 903 (2007).

legislature's delegation to DOR to write appropriate rules, and refrained from adding limiting concepts to the rule that DOR could have easily provided at the time the rule was adopted.

A Due Process violation results from Division II's decision.

ARUP moved for reconsideration, which was denied without an answer from DOR or benefit of argument. ARUP argued that Division II's interpretation rendered Rule 19402(303) invalid under the due process clause. The location of where the taxpayer's customer receives the benefit of the service is vague. As Judge Maxa noted in his dissent, how do you decide that? "RCW 82.04.462(3)(b)(i) provides no assistance in resolving this issue." Op at 17.

Likely recognizing that vagueness, DOR attempted to provide surrogate objective standards to determine where the customer benefits from the service. DOR chose to use a cascading approach. When the services relate to real property, then the revenue is sourced to the location of the real property. When the services relate to personal property, then the receipts are sourced to the location of the personal property. And finally, if the services are related to neither, then the revenue is sourced to the location of the customer.

By resorting to using Rule 19402(303)(c), Division II has created an unaccountable tax liability problem for service vendors. The federal and state due process clauses are violated when a taxpayer's tax liability is determined by third parties that the taxpayer does not control. *Dot Foods, Inc. v. Dep't of Revenue*, 166 Wn.2d 912, 215 P.3d 185 (2009). In *Dot*

Foods, the taxpayer was an out-of-state business that sold consumer and non-consumer products through agents (the statute referred to such agents as "direct seller representatives"). This Court described the taxpayer's position:

> Dot's argument is based on the premise that it has no control over any downstream sales of its products once it sells through DTI [the direct seller representative] to a purchaser. Put another way, if a person buys one of Dot's products and then turns around and sells it to a permanent retail establishment, this is beyond Dot's control. Dot asserts that, in such a situation, Dot does not lose its tax-exempt status.

Dot Foods, 922-923.

Based on these facts, the Court concluded that looking to others' actions to determine the taxpayer's tax status violated the due process clauses of both the state and federal constitutions. First, it found an amicus brief helpful and agreed with the analysis:

> Melaleuca, Inc., in its amicus brief, presents an argument that reinforces Dot's reading of the statute's language:
>
> > [A] proper interpretation of all of the words in the statute makes it understandable that the Legislature only imposed restrictions on sales activities to the extent that the direct sales company could have some control over them. This is not only logical, it is undoubtedly required by the Due Process Clauses of both the United States and the Washington Constitutions. U.S. Const., Amend. XIV, § 1; Wash. Const., Art. I, § 3. A state cannot impose taxes on someone based upon the actions of another person, who is not the seller's agent, and whose actions are beyond the tax payer's [sic] control.
>
> Amicus Curiae Br. of Melaleuca, Inc., at 11.

Dot Foods, 923. This Court agreed with Melaleuca's due process analysis:

> We agree with this analysis. Under the statutory provision, the Department cannot hold Dot responsible for taxes on sales it essentially has nothing to do with. The statute's plain language pertains to a requirement that an out-of-state seller "[m]akes sales in this state exclusively to or thorough [sic] a direct seller's representative." RCW 82.04.423(1)(d). The statute's language does not pertain, however, to some downstream purchaser of a product after the out-of-state seller has made its final sale to or through its direct seller's representative. The tax or tax exemption under the terms of the statute focuses on the seller's transaction with the seller's product, not on what some purchaser opts to do with the product after the transaction with Dot is completed. Applied here, Dot's sales through DTI are the final sales as far as the transaction concerns Dot; if Dot's final sale customer later resells the product or a byproduct of that product to a permanent retail establishment, such a transaction has no effect on Dot's tax status.

Ibid.

Following the *Dot Foods* logic in this case, if the gross receipts are sourced to the location where the medical provider used the reports to make the diagnosis, then ARUP would be compelled to follow every location where that report was used for a patient's medical treatment to determine where to source its apportionable receipts. If a Washington cancer patient received the diagnosis in Spokane and then took the report and went to the University of Texas' MD Anderson Cancer Center in Houston, TX, then ARUP should split the receipts between Washington and Texas. If the patient then took his/her pathology reports to the Mayo Clinic in Minnesota, then ARUP should split the receipts among

Washington, Texas, and Minnesota. How would ARUP know where the patient and his/her doctors are using the reports? Further, how would ARUP assign value of the use of reports to each state? By the number of days the report was in the state? By amount of medical fees charged? Sourcing receipts on this basis would be required by Division II's opinion, and it is too vague to be enforceable. ARUP's tax circumstances would be totally out of its control and totally dependent, on where the patient and his/her doctors used the pathology reports. Using an objective marker like the place where the testing occurs is in ARUP's control, and the benefit of the service is not dependent upon third-parties.

When a statute (in this case, a rule) is capable of two different interpretations, one constitutional and the other unconstitutional, the court should adopt the constitutional interpretation. ("It is a well settled rule that, where a statute is open to two constructions, one of which will render it constitutional, and the other unconstitutional, the former construction, and not the latter, is to be adopted. *Poolman v. Langdon*, 94 Wn. 448, 162 Pac. 578 (1917). *State ex rel. Campbell v. Case*, 182 Wn. 334, 47 P. (2d) 24 (1935)." *Gruen v. Tax Com*, 35 Wn.2d 1, 6, 211 P.2d 651, 655 (1949); "Where a statute is susceptible to more than one interpretation, it is our duty to adopt a construction sustaining its constitutionality if at all possible." *Spokane v. Vaux*, 83 Wn.2d 126, 129-30, 516 P.2d 209 (1973);

State ex rel. Morgan v. Kinnear, 80 Wn.2d 400, 402, 494 P.2d 1362 (1972); "And, where a statute is susceptible of several interpretations, some of which may render it unconstitutional, the court, without doing violence to the legislative purpose, will adopt a construction which will sustain its constitutionality if at all possible to do so." *State v. Dixon*, 78 Wn.2d 796, 479 P.2d 931 (1971); *George v. Day*, 69 Wn.2d 836, 420 P.2d 677 (1966); and *Tembruell v. Seattle*, 64 Wn.2d 503, 392 P.2d 453 (1964).

This Court should review the constitutional effect of Division II's decision to determine whether it violates ARUP's due process protections by holding that ARUP's tax status is established by third-party actors that ARUP does not control.

Arm of the State

ARUP argued that it was not a "person" under RCW 82.04.030. The B&O tax chapter uses that definition to determine to whom to apply the B&O tax. The statute does not include "state" although it includes virtually every other kind of entity. If ARUP is an arm of Utah, then ARUP is the State of Utah and should be excluded from the definition of person. If ARUP is an arm of the state, then other relief is possible under WAC 458-20-167, the Commerce Clause, and sovereign immunity. Because Division II did not find that ARUP was an arm of the state, it did not reach these other questions.

ARUP relied on *Hontz v. State*, 105 Wn.2d 302, 714 P.2d 1176 (1986) and *Hyde v. University of Washington Medical Center*, 186 Wn. App. 926, 347 P.3d 918 (2015). The *Hyde* court looked at Association of University Physicians' ("UWP") articles of incorporation, bylaws, and operating agreement with the university, how it was owned, managed, and operated, how its income was distributed, and whether the UWP faculty would be deemed employees and agents of the University of Washington for professional liability purposes in determining UWP's status as an arm of the state.[18] Because the University of Washington operated and managed UWP, the court concluded that UWP was an arm of the state.

Division II did not find these cases persuasive, because there were factual differences in those cases and in ARUP's situation. It found a key difference was that "Liability of the medical directors is covered under the University's plan, but liability for ARUP's employees are covered under its own insurance plan. The key facts that the court relied on in *Hontz* to determine that Harborview was an arm of the State of Washington are missing here." Op at 7. It concedes, however, that ARUP's nonprofit status does not determine if ARUP is an arm of the state: "In that case, the court determined that Associated Students of the UW, a separate nonprofit corporation, was an arm and agency of the UW. *Good*, 86 Wn.2d at 97 [*Good v. Associated Students of Univ. of Wash.*, 86 Wn.2d 94, 542 P.2d 762 (1975)]. It was an arm and agency of the UW because it was subject to the

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[18] *Hyde* at 931.

ultimate control by the UW Board of Regents. *Good*, 86 Wn.2d at 98." Op at 8-9.

Division II's distinctions are without a difference. As in *Good*, ARUP's board is totally and ultimately controlled by the University. Utah created and controls the University of Utah, having statutorily created the school. The Utah Med School is a school within the University of Utah. The University of Utah created ARUP and is ARUP's sole voting member. ARUP's Board of Directors is appointed by the University and a majority of the board members are appointed from officers, employees, and trustees of the University. The Board of Directors consists of ten members of which three must consist of (a) a representative appointed by the President of the University of Utah; (b) the Chairman of the University of Utah Department of Pathology; and (3) the President of ARUP who is a faculty member employed by the University. ARUP's purpose is to further the educational opportunities for the University of Utah. Thus, it is without question that the University manages and controls ARUP.

Division II believes that the state must also bear financial liability for an entity that claims to be an arm of the state. In this case, the financial connection between ARUP and the state is substantial. The University president or vice president for health services approves ARUP's budget. All revenue is used by the University as it sees fit. In that regard, ARUP is able to use the revenue to cover its budget and any revenue not spent belongs to the University.

Division II believed that ARUP's responsibility for the technical and other employees and the state's responsibility for the clinical (the pathologists) was a meaningful and significant difference. That difference is based on a false assumption. It assumes that the revenue belongs to someone other than the University. There is no evidence in the record that ARUP could spend the revenue in ways other than what the University-approved budget allowed. The University controlled whether the non-professional employees would be paid from operating receipts or from the state treasury. Regardless of which, all were paid from resources owned and controlled by the state. Whether ARUP paid for some liability with operating receipts or the University paid for liability with state funds is irrelevant. In both circumstances, the state used its resources to pay all liability. This statement is confirmed by the financial accounting that required that ARUP's financials be reported as a component part of the University's financial accounting.

ARUP's facts show stronger control by the University than in *Hyde*. In *Hyde*, the UWP was controlled by the UW Medicine Board, and none of the board members need come from the UW Board of Regents. ARUP's Board includes a majority of University employees, officers, and trustees. Various factors should be weighed to evaluate whether the state exercises the requisite control and management. It is not enough to find some factual differences as Division II did.

This Court should review the Division II decision to determine whether taxpayers must have identical facts to *Hyde* or if the court must weight all the factors to determine the presence or absence of management,

control, and operation. There are many entities that carry out government functions, and this Court should take this opportunity to explain clearly when an entity is an arm of the state.

F. CONCLUSION

Division II committed error (1) when it found that Rule 19402(303)(b) did not apply, (2) when it approved an application of Rule 19402 that rendered it violative of the due process clause, and (3) when it failed to find that ARUP was an arm of the state. This Court should accept review to answer these important legal questions.

RESPECTFULLY SUBMITTED this day of May, 2020.

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CERTIFICATE OF SERVICE

The undersigned certifies under the penalty of perjury under the laws of the State of Washington that I am now and at all times herein mentioned a resident of the State of Washington, over the age of eighteen years, not a party to or interested in the above-entitled action, and competent to be a witness herein.

On the date given below, I caused to be served the foregoing document on the following persons and in the manner listed below:

Ms. Kelly Owings Mr. Joshua Weissman Assistant Attorney General Office of the Attorney General 7141 Cleanwater Lane SW P.O. Box 40123 Olympia, WA 98504-0123 kellyo2@atg.wa.gov joshuaw@atg.wa.gov CarrieP@Atg.wa.gov kyleeni@atg.wa.gov REVOlyFF@atg.wa.gov	[ ] Via Hand delivery [X] Via U.S. Mail, 1st Class, Postage Prepaid [ ] Via Overnight Delivery [ ] Via Facsimile [X] Via Email per E-Service Agreement

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

DATED at Tacoma, Washington this 14th day of May, 2020.

Cindy Rochelle

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APPENDIX

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Washington State
Court of Appeals
Division Two

April 14, 2020

IN THE COURT OF APPEALS OF THE STATE OF WASHINGTON

DIVISION II

ARUP LABORATORIES, INC., FORMERLY KNOW AS ASSOCIATED GENERAL AND UNIVERSITY PATHOLOGISTS, INC., Appellant, v. STATE OF WASHINGTON DEPARTMENT OF REVENUE, Respondent.	No. 52349-3-II ORDER GRANTING RESPONDENT'S RECONSIDERATION AND AMENDING OPINION

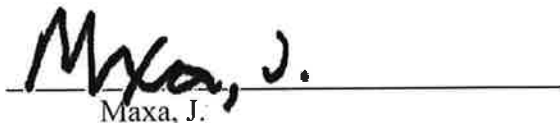
Respondent, Department of Revenue, moves this court to reconsider its February 11, 2020 opinion as to footnote 8. Appellant, Arup Laboratories Inc., agreed to Respondent's motion in its response. After consideration, we grant Respondent's motion and amend the opinion in part as follows: On page 13, we remove footnote 8 in its entirety.

We do not amend any other portion of this opinion or the result. Accordingly, it is

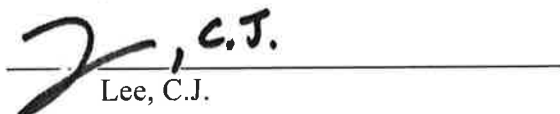
SO ORDERED.

Melnick, J.

We concur:



Maxa, J.



Lee, C.J.

Filed
Washington State
Court of Appeals
Division Two

February 11, 2020

IN THE COURT OF APPEALS OF THE STATE OF WASHINGTON

DIVISION II

ARUP LABORATORIES, INC., FORMERLY KNOW AS ASSOCIATED GENERAL AND UNIVERSITY PATHOLOGISTS, INC., Appellant, v. STATE OF WASHINGTON DEPARTMENT OF REVENUE, Respondent.	No. 52349-3-II PUBLISHED OPINION

MELNICK, J. — ARUP Laboratories, Inc. appeals the trial court's determination that it is subject to Washington Business and Occupation (B&O) taxes for income derived from the testing of bodily fluid and tissue samples in Utah that it received from Washington medical providers. ARUP argues that it is excluded from paying B&O taxes because only "persons" are subject to the B&O tax and states are excluded from the applicable statutory definition of "persons." ARUP argues it is an "arm of the State of Utah and is therefore the State of Utah." For those reasons, ARUP argues it is not subject to the tax. ARUP also argues that if we determine that it is a "person" under the statute, the revenue from its Washington sales should be attributed to Utah rather than Washington.[1] We affirm.

[1] ARUP also makes various constitutional arguments that depend on us concluding it is an arm of the State of Utah. Based on our resolution of this issue, we need not address these arguments.

FACTS

ARUP is a pathology laboratory located in Utah. It receives bodily fluid and tissue samples from medical providers in all 50 states and performs tests on the samples. Medical providers ship the samples to Utah. The samples are not returned to the customer. The test results are sent securely through the internet. ARUP contracts with hospitals, clinics, and laboratories to provide testing services. ARUP occasionally sends one or more employees to Washington to train in specimen collection and transportation, and to encourage providers to use ARUP.

ARUP is a nonprofit corporation created by the Department of Pathology of the University of Utah School of Medicine.[2] The University of Utah (University)[3] is part of Utah's higher education system under Utah Code. ARUP's bylaws and articles of incorporation both state that the purpose of ARUP is to serve the University's educational and charitable purposes, and its income accrues to the State of Utah or the University to further those purposes.

ARUP is a component unit of the University, and the University is a component unit of the State of Utah.[4] The University makes changes to and approves the final budget of ARUP. The president of the University determines how much of the profit is payable and distributed to the University.

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[2] It is incorporated pursuant to the Utah Revised Nonprofit Corporation Act (U.C.A) 1953 §16-6a-101.

[3] When referring to the University of Utah, it includes the University of Utah School of Medicine.

[4] A "component unit" is a financial accounting term used by the Government Accounting Standards Board to describe a legally separate entity like a nonprofit that is financially accountable to the government entity or whose relationship with the entity are such that exclusion would cause the entity's financial statements to be misleading or incomplete.

The University is the sole member of ARUP.[5] The Board of Directors, who control the management and direction of ARUP, consists of ten members, three of whom are representatives appointed by the president of the University, the chairman of the University Department of Pathology, and the president of ARUP. The majority of directors "shall be employees, officers, or trustees of the University of Utah." Clerk's Papers (CP) at 427. The remaining board members are non-University community members. Approximately 80 faculty members of the University oversee ARUP's laboratories, which employs roughly 3,000 technicians and support staff who are employees of ARUP but not the University. Approximately 15-20 medical students from the University work under supervision at ARUP.

ARUP maintains its own bank accounts and is not financially dependent on the University. It does not receive funding from the State of Utah. ARUP has historically paid settlements and judgments out of its own funds. ARUP's Chief Financial Officer (CFO) explained that there has never been a need for the State or the University to pay judgments because ARUP has always been capable of meeting the obligations, however, it is "conceivable that if ARUP . . . could not meet the obligation, that the university would . . . or the State of Utah." CP at 234.

ARUP filed an action against the Department of Revenue (DOR) seeking the refund of $713,920.19 in B&O taxes for the tax period from January 2013 to December 2016.[6] Both parties

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[5] Utah nonprofits have members, which is the equivalent of a shareholder in a for-profit corporation.

[6] ARUP challenged an assessment of B&O taxes during the tax period January 2008 through December 2011 before the Board of Tax Appeals. *Associated Reg'l & Univ. Pathologists v. Dep't of Revenue*, No. 13-124, 2016 WL 3262421, at *3 (Wash. Bd. of Tax Appeals May 6, 2016). It used the same arguments that it makes here, and the board determined that the DOR had properly apportioned ARUP's income to Washington. *Associated Reg'l & Univ. Pathologists*, 2016 WL 3262421, at 5. ARUP did not appeal.

moved for summary judgment. The trial court denied ARUP's motion for summary judgment and granted DOR's motion for summary judgment. ARUP appeals.

ANALYSIS

I. Legal Principles

We review an order granting summary judgment de novo, performing the same inquiry as the trial court. *Aba Sheikh v. Choe*, 156 Wn.2d 441, 447, 128 P.3d 574 (2006). "Summary judgment is appropriate only if the pleadings, affidavits, depositions, and admissions on file demonstrate the absence of any genuine issues of material fact and that the moving party is entitled to judgment as a matter of law." *Sheehan v. Cent. Puget Sound Reg'l Transit Auth.*, 155 Wn.2d 790, 797, 123 P.3d 88 (2005).

We also review questions of statutory interpretation de novo. *Bostain v. Food Express, Inc.*, 159 Wn.2d 700, 708, 153 P.3d 846 (2007). The "fundamental objective" of statutory interpretation "is to ascertain and carry out the Legislature's intent." *Dept. of Ecology v. Campbell & Gwinn, LLC*, 146 Wn.2d 1, 9, 43 P.3d 4 (2002). Where a "statute's meaning is plain on its face, then the court must give effect to that plain meaning as an expression of legislative intent." *Campbell & Gwinn*, 146 Wn.2d at 9-10. Such plain meaning "is discerned from all that the Legislature has said in the statute and related statutes which disclose legislative intent about the provision in question." *Campbell & Gwinn*, 146 Wn.2d at 11. If "the statute remains susceptible to more than one reasonable meaning" after such inquiry, it is ambiguous and we must "resort to aids to construction, including legislative history." *Campbell & Gwinn*, 146 Wn.2d at 12.

The rules of statutory construction also apply to the interpretation of administrative regulations adopted pursuant to statutory authority. *Cannon v. Dep't of Licensing*, 147 Wn.2d 41, 56, 50 P.3d 627 (2002). In this context, appellate courts "interpret[ ] a WAC provision to ascertain

and give effect to its underlying policy and intent." *Cannon*, 147 Wn.2d at 56. "Rules and regulations are to be given a rational, sensible interpretation," and courts will not consider them "ambiguous simply because different interpretations are conceivable." *Cannon*, 147 Wn.2d at 56-57. As with statutes, courts do not generally apply canons of construction to unambiguous administrative regulations. *Cannon*, 147 Wn.2d at 57. Courts should, however, "avoid a literal reading of a provision if it would result in unlikely, absurd, or strained consequences." *Cannon*, 147 Wn.2d at 57.

"As a rule, '[a] definition which declares what a term "means" . . . excludes any meaning that is not stated.'" *Colautti v. Franklin*, 439 U.S. 379, 392 n.10, 99 S. Ct. 675, 58 L. Ed. 2d 596 (1979) (quoting 2A C. SANDS, STATUTES AND STATUTORY CONSTRUCTION § 47.07 (4th ed. 1978)); *State v. Leek*, 26 Wn. App. 651, 655, 614 P.2d 209 (1980).

II. ARUP IS A PERSON UNDER B&O STATUTE

ARUP contends that it is an "arm of Utah"; therefore, it is the State of Utah. It further argues that because only persons, and not states, are subject to the B&O tax, ARUP is not subject to the tax. Br. of Appellant at 21. We disagree with ARUP.

Washington's B&O tax is "extremely broad." *Steven Klein, Inc. v. Dep't of Revenue*, 183 Wn.2d 889, 896, 357 P.3d 59 (2015). Under RCW 82.04.220(1), "There is levied and collected from every person that has a substantial nexus with this state . . . a tax for the act or privilege of engaging in business activities." Thus, the "'legislature intended to impose the [B&O] tax upon virtually all business activities carried on within the state.'" *Steven Klein, Inc.*, 183 Wn.2d at 896 (internal quotation marks omitted) (quoting *Simpson Inv. Co. v. Dep't of Revenue*, 141 Wn.2d 139, 149, 3 P.3d 741 (2000)).

Washington's B&O tax applies to "every person" engaging in business activities within the state. RCW 82.04.220(1). "'Person' or 'company', herein used interchangeably, means any individual, . . . corporation, . . . whether mutual, cooperative, fraternal, nonprofit, or otherwise and the United States or any instrumentality thereof." RCW 82.04.030.

ARUP agrees with DOR that as a nonprofit, it falls within the statutory definition of "person" under the B&O statute. However, ARUP also argues that because it is an arm of the State of Utah, it is excluded from the definition. ARUP argues that "states" are excluded from the definition of "person." ARUP's argument ignores the undisputed, material fact that the University chose to organize ARUP as a nonprofit corporation, and it was not created as an agency of the State of Utah.

The definition of "person" neither includes nor excludes "states." RCW 82.04.220(1). ARUP argues that because the definition declares what "person" means, under *Colautti*, "it 'excludes any meaning that is not stated.'" 439 U.S. at 392 n.10 (quoting 2A C. SANDS, STATUTES AND STATUTORY CONSTRUCTION § 47.07). ARUP's reasoning means that a state is not a person subject to the B&O tax.

ARUP relies on two cases to support its argument that it is an arm of the State of Utah. Both cases are distinguishable from the present situation because they involve different factual situations and different statutes.

In the first case, *Hontz v. State*, 105 Wn.2d 302, 714 P.2d 1176 (1986), multiple individuals sued Harborview Medical Center and other defendants, alleging that they had been deprived of their civil rights under 42 U.S.C. § 1983. Section 1983 does not define "person," but the Supreme Court has held that "person" does not include a state. *Edgar v. State*, 92 Wn.2d 217, 222, 595 P.2d 534 (1979), *cert. denied*, 444 U.S. 1077 (1980). The State is not suable under section 1983. *Hontz*,

105 Wn.2d at 309. The uncontroverted evidence showed that the University of Washington (UW), a state agency, operated and managed Harborview, and that UW employed all of Harborview's employees. A fund held by the state treasurer paid claims against Harborview. *Hontz*, 105 Wn.2d at 310. The suit was "in legal effect a suit against the State" and could not be maintained. *Hontz*, 105 Wn.2d at 310.

Here, during the relevant tax period, ARUP's Board of Directors, who control the management and direction of ARUP, consisted of ten members, a majority of whom were employees, officers or trustees of the University. However, the employees of ARUP are not all employees of the University. Only approximately 80 faculty members of the University oversee the laboratories. The laboratories are staffed by roughly 3,000 technicians and support staff who are employees of ARUP, not the University.

In regard to liability, ARUP has historically paid settlements and judgments out of its own funds. ARUP's CFO explained that there has never been a need for the state or the University to pay judgments because ARUP has always been capable of meeting the obligations, however, it is "conceivable that if ARUP . . . could not meet the obligation, that the university would . . . or the State of Utah." CP at 234. There is no evidence in ARUP's articles of incorporation, bylaws, or other parts of the record that the University or the State of Utah would be liable for any judgment against ARUP. Liability of the medical directors is covered under the University's plan, but liability for ARUP's employees are covered under its own insurance plan. The key facts that the court relied on in *Hontz* to determine that Harborview was an arm of the State of Washington are missing here.

ARUP also relies on *Hyde v. University of Washington Medical Center*, 186 Wn. App. 926, 347 P.3d 918 (2015), where the court determined that the Association of University Physicians

(UWP), a nonprofit corporation created by the UW School of Medicine, was an arm of the State of Washington. The court reversed an order denying summary judgment under the tort claim statute, RCW 4.92.100 and .110. *Hyde*, 186 Wn. App. at 937. The court determined that the UW School of Medicine, a state agency, controlled UWP. UWP was created to serve the purposes of the UW School of Medicine. *Hyde*, 186 Wn. App. at 927. UWP provided physician services in hospitals owned and operated by the UW. UWP's members are UW faculty members. *Hyde*, 186 Wn. App. at 929.

The court also looked at several factors. First, the articles of incorporation, bylaws and operating agreement demonstrated that UWP was a nonprofit corporation created for the benefit of the UW School of Medicine. Its principal and income were devoted exclusively to that purpose. *Hyde*, 186 Wn. App. at 931. Second, a board of trustees managed and directed UWP. The board consisted of the chair of each department at the UW School of Medicine and a minority of community members appointed by the dean of the medical school. *Hyde*, 186 Wn. App. at 931. When UWP is dissolved, all of its remaining assets would go to the UW. *Hyde*, 186 Wn. App. at 931. Third, all UWP physicians were UW faculty members and employees. They were agents of UW for professional liability purposes. *Hyde*, 186 Wn. App. at 933-34. The court emphasized the liability aspect in making its determination.

Finally, the court stated that UWP's status as a separate non-profit corporation did not preclude it from being considered an arm of the state. *Hyde*, 186 Wn. App. at 934. The court relied on *Good v. Associated Students of the University of Washington*, 86 Wn.2d 94, 97, 542 P.2d 762 (1975). In that case, the court determined that Associated Students of the UW, a separate nonprofit corporation, was an arm and agency of the UW. *Good*, 86 Wn.2d at 97. It was an arm

and agency of the UW because it was subject to the ultimate control by the UW Board of Regents. *Good*, 86 Wn.2d at 98.

Here, ARUP's bylaws and articles of incorporation both state that the purpose of ARUP is to serve the University's educational and charitable purposes, and its income accrues to the State of Utah or the University to further those purposes. The University is the sole voting member of ARUP. The composition of ARUP's Board of Directors is similar to that of UWP. However, in regard to the day-to-day operation of ARUP, the majority of employees of ARUP are not employees of the University. In regard to liability, ARUP pays settlements and judgments out of its own funds.

Many of the factors relied on in *Hyde* and *Hontz* are not present in this case. Unlike there, ARUP, and not the State of Utah, is responsible for liability in the case of legal actions. Unlike there, ARUP has employees who are not employees of the state. We conclude that ARUP is not an arm of the state, like Harborview in *Hyde* or UWP in *Hontz*. ARUP is a person subject to the B&O tax.

III. ARUPs Washington Revenue

ARUP contends that the samples it tests are tangible personal property for tax purposes; therefore, the benefit of the service is located where the tangible personal property is located or "where the place of principal use occurs." Br of Appellant at 14 (quoting WAC 458-20-19402(303)(b)). It cites the fact that "testing of the tangible personal property" is included as part of a non-exclusive list of services that relate to tangible personal property under WAC 458-20-19402(303)(b). Br. of Appellant at 14. Therefore, ARUP argues the revenue from testing samples in Utah that are sent by Washington customers should be attributed to Utah.

DOR contends that the regulation must be read in the context of RCW 82.04.462 because WAC 458-20-19402 was promulgated to help taxpayers assess where the benefit of the service is received. It argues that in promulgating the regulation, DOR intended the "testing of tangible personal property" example to "describe services where the benefit the customer receives is the use or enjoyment of the [property] being tested." Br. for Resp't at 26. Therefore, the benefit of the service is the information received from the testing services, not the sample itself. We agree with DOR.

A. Legal Principles

Washington imposes the B&O tax "for the act or privilege of engaging in business activities" here. RCW 82.04.220; *Lamtec Corp. v. Dep't of Revenue*, 170 Wn.2d 838, 843, 246 P.3d 788 (2011). The statute requires "every person" who has a substantial nexus with this state and who conducts activities here "with the object of gain, benefit, or advantage to the taxpayer or to another person or class, directly or indirectly" to pay a percentage of the gross receipts of the resulting sales. RCW 82.04.220; RCW 82.04.140; *Lamtec*, 170 Wn.2d at 843.

To determine the amount of B&O tax owed, DOR uses an apportionment formula.[7] One of the important parts of the formula is "the total gross income of the business of the taxpayer attributable to [Washington] during the tax year from engaging in an apportionable activity."

[7] The DOR explained how the apportionment formula works as follows: "Single factor apportionment formula" multiplies a person's "apportionable income" by its "receipts factor." RCW 82.04.462(1). The "receipts factor" is a fraction where the numerator is the gross income of the business attributed to Washington during the tax year, and the denominator is the total gross income of the business worldwide during the tax year. RCW 82.04.462(3)(a). To determine the numerator of the receipts factor, i.e., the amount of gross income to attribute to Washington, the legislature provides that the "gross income of the business generated from each apportionable activity is attributable to the state . . . [w]here the customer received the benefit of the taxpayer's service." Br. of Resp't at 17 (quoting RCW 82.04.462(3)(b)(i)).

RCW 82.04.462(3)(a). The statute explains that a taxpayer's "apportionable activity is attributable to the state . . . [w]here the customer received the benefit of the taxpayer's service." RCW 82.04.462(3)(b)(i). Customer is defined as the "person or entity to whom the taxpayer makes a sale or renders services or from whom the taxpayer otherwise receives gross income of the business." RCW 82.04.462(3)(b)(viii).

Guidance on "where the taxpayer's customer receives the benefit of the service" is provided in WAC 458-20-19402. The parties refer to this regulation as "Rule 19402." The regulation states in relevant part:

> (303) Benefit of the service explained. . . . This subsection explains the framework for determining where the benefit of a service is received.
>
> . . . .
>
> (b) If the taxpayer's service relates to tangible personal property, then the benefit is received where the tangible personal property is located or intended/expected to be located.
>
> (i) Tangible personal property is generally treated as located where the place of principal use occurs . . .
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> . . . .
>
> (iii) The following is a nonexclusive list of services that relate to tangible personal property:
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> . . . .
>
> (C) Inspections of the tangible personal property;
> (D) Testing of the tangible personal property;
>
> . . . .
>
> (c) If the taxpayer's service does not relate to real or tangible personal property, the service is provided to a customer engaged in business, and the service relates to the customer's business activities, then the benefit is received where the customer's related business activities occur.
>
> . . . .
>
> (d) If the taxpayer's service does not relate to real or tangible personal property, is either provided to a customer not engaged in business or unrelated to the customer's business activities; and:
>
> . . . .

> (iii) If (d)(i) and (ii) of this subsection do not apply, the benefit of the service is received where the customer resides. The following is a nonexclusive list of services whose benefit is received at the customer's residence:
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> . . . .
>
> (D) Blood tests (not blood drawing).

WAC 458-20-19402.

B. Where is the benefit of ARUP's service received?

ARUP argues that if we determine that it is subject to the B&O tax, the regulations require that the income from Washington customers be apportioned to Utah in the apportionment formula. DOR argues that the income should be apportioned to Washington. We agree with DOR.

At issue is the interpretation of RCW 82.04.462(3)(b)(i) which reads, in pertinent part, "apportionable activity is attributable to the state . . . [w]here the customer received the benefit of the taxpayer's service." A person earning "apportionable income" that is taxable both in Washington and another state must apportion to Washington the amount that person derived from business activities performed within Washington. "Apportionable income" means gross income of the business generated from engaging in activities falling within the "services" classification under the B&O tax classification. RCW 82.04.460(4)(a); RCW 82.04.290. ARUP does not dispute that it earned "apportionable income," which is the laboratory services provided to Washington customers. However, neither the statute nor any regulation defines "benefit."

"An undefined term is 'given its plain and ordinary meaning unless a contrary legislative intent is indicated.'" *State v. Donaghe*, 172 Wn.2d 253, 262, 256 P.3d 1171 (2011) (quoting *Ravenscroft v. Wash. Water Power Co.*, 136 Wn.2d 911, 920-21, 969 P.2d 75 (1998)). To determine the plain meaning of an undefined term, we may look to the dictionary. *HomeStreet, Inc. v. Dep't of Revenue*, 166 Wn.2d 444, 451, 210 P.3d 297 (2009). Black's Law Dictionary

defines benefit as "The advantage or privilege something gives; the helpful or useful effect something has." Black's Law Dictionary (11th ed. 2019).

To determine to which state the income ARUP received from its Washington customers should be apportioned, we must determine where ARUP's customers receive the helpful or useful effect of its services. ARUP's services assist medical providers in diagnosing their patients. The medical providers cannot diagnose their patients until they receive the results of the tests they ordered from ARUP. Therefore, we agree with DOR and conclude that the benefit is received where the medical provider is located, which is in Washington.

This interpretation is consistent with the legislature's intent in creating the B&O tax as well as the 2010 changes to the apportionment method. "'[T]he legislature intended to impose the [B&O] tax upon virtually all business activities carried on within the state,' and to 'leave practically no business and commerce free of . . . tax.'" *Simpson Inv. Co.*, 141 Wn.2d at 149 (citation omitted) (quoting *Time Oil Co. v. State*, 79 Wn.2d 143, 146, 483 P.2d 628 (1971) and *Budget Rent-A-Car of Wash.-Or., Inc. v. Dep't of Revenue*, 81 Wn.2d 171, 175, 500 P.2d 764 (1972)). Additionally, the legislature changed to a single factor apportionment formula specifically to reach entities like ARUP.[8] "The express purpose of the change in the law was to

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[8] The apportionment formula determines how much tax a company that does business in multiple states has to pay to Washington. The previous and more traditional method of apportionment was a three-factor apportionment. When the three factor apportionment formula was applied to the income of a company that was located outside of Washington and that provided a service (as opposed to product manufacturing) to a Washington customer, the income from that service was normally apportioned to the state where the company was located. This means that there was very little (or no) tax paid by the company to Washington. A single factor apportionment formula, on the other hand, apportions the income of the company to where the benefit of the services is received, rather than where the company providing the services is located. With this method, more tax is paid to Washington where the income originated. *See* Giles Sutton et al., *The Increasingly Complex Apportionment Rules for Service-Based Business: Basic Issues* (pt. 1), J. MULTISTATE TAX'N & INCENTIVES, Oct. 2007, at 24, 26, 2007 WL 3201540, *2.

require businesses 'earn(ing) significant income from Washington residents from providing services' to 'pay their fair share of the cost of services that this state renders and the infrastructure it provides.'" WAC 458-20-19402 (quoting LAWS OF 2010, 1st spec. sess., ch. 23, § 101). Because ARUP earns a significant amount of income from serving Washington residents, specifically medical providers located in Washington, we conclude that the legislature intended to tax out-of-state entities like ARUP.

C. Do ARUPs Services Relate to Tangible Personal Property?

ARUP argues that we must look to WAC 458-20-19402, to determine where the benefit is received. It argues that the specimen samples are tangible personal property for tax purposes; therefore, the benefit of the service is located where the tangible personal property is located or "where the place of principal use occurs." Br of Appellant at 14.

DOR argues that both RCW 82.04.462 and WAC 458-20-19402 confirm that the benefit of the service from ARUP is received in Washington and the revenue should be apportioned to Washington. We agree with DOR.

The regulation and the statute can be read consistent with each other. Section 303(b) of the regulation applies when "the taxpayer's service relates to tangible personal property," and is meant to describe services where the benefit that the customer receives is in the use or enjoyment of the property. The regulation gives detailed examples of services, including testing, that are related to tangible personal property. WAC 458-20-19402(304)(b). All of the examples describe the use of widgets, tools and equipment. The services related to these items of property facilitate the use and enjoyment of the property. Unlike testing of tools and widgets, the purpose of the service provided by ARUP is to provide the results of the testing, rather than the use and enjoyment

of the property. For this reason, the samples are not sent back to the customers after the testing is complete, but reports on the results are sent to the medical providers.

Section 303(c) of the regulation applies when "the taxpayer's service does not relate to real or tangible personal property." WAC 458-20-19402(303)(c). This section includes the services that "involve" the use of tangible personal property, but the benefit received is the result produced by the service, not the use or enjoyment of the property. The benefit received from ARUPs services is the result, not the use or enjoyment of the specimens.

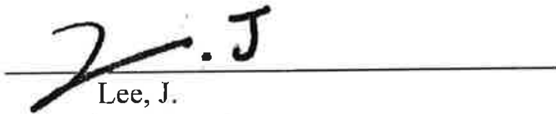
This characterization of ARUP's services is also consistent with section 303(d), which applies "[i]f the taxpayer's service does not relate to real or tangible personal property [and] is either provided to a customer not engaged in business or unrelated to the customer's business activities." WAC 458-20-19402(303)(d). Included under this section in a "nonexclusive list of services whose benefit is received at the customer's residence," is "Blood tests (not blood drawing)." WAC 458-20-19402(303)(d).

Blood testing is listed as a part of a category of service that "does not relate to real or tangible personal property," for customers not engaged in business. WAC 458-20-19402(303)(d). It should be similarly considered for customers engaged in business. The purpose of conducting blood tests is to receive results, whether or not the customer is a medical provider in the business of diagnosing patients or an individual seeking test results. We therefore determine that the benefit of ARUP's services to Washington customers should be attributed to Washington under both RCW 82.04.462 and WAC 458-20-19402(303)(c).

We affirm.

Melnick, J.

I concur:



Lee, J.

MAXA, C.J. (dissenting in part) – I agree with the majority opinion that ARUP Laboratories, Inc. is a "person" for purposes of the Washington Business and Occupation (B&O) tax. But I disagree that ARUP is subject to Washington B&O taxes for income derived from testing in Utah of bodily fluid and tissue samples received from Washington customers.

RCW 82.04.462(3)(b)(i) states that income for B&O tax purposes is attributable to the state where "the customer received the benefit of the taxpayer's service." But for a service like the testing of bodily fluid and tissue samples, it is unclear where the benefit of the testing is received. Is the benefit received in Utah, where the samples are used to perform testing and the usable results are obtained, especially since the samples are not returned to Washington? Or is the benefit received in Washington, where the test results are used in diagnosis and treatment? RCW 82.04.462(3)(b)(i) provides no assistance in resolving this issue.

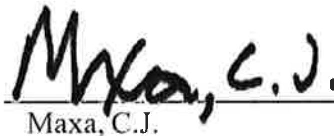
However, the Department of Revenue (DOR) adopted WAC 458-20-19402 (Rule 19402), which in subsection (303) "explains the framework for determining where the benefit of a service is received." Subsection (303)(b) states, "If the taxpayer's service relates to tangible personal property, then the benefit is received where the tangible personal property is located or intended/expected to be located." Subsection (303)(b)(i) states, "Tangible personal property is generally treated as located where the place of principal use occurs."

Here, the bodily fluid and tissue samples clearly are tangible personal property. And there is no question that the samples are located and will remain located in Utah and that Utah is the place the samples are used. DOR emphasizes that the test *results* are sent to Washington and used in Washington. But the *samples* clearly remain in and are used in Utah. Therefore, subsection (303)(b)(i) suggests that the benefit of ARUP's testing was received in Utah.

Further, there is no question that subsection (303)(b) of Rule 19402 applies here. Subsection (303)(b)(iii) provides a "nonexclusive list of services that relate to tangible personal property." This list includes "(D) Testing of tangible personal property." ARUP's testing of bodily fluid and tissue samples unequivocally constitutes the "[t]esting of tangible personal property."

Both DOR and the majority opinion try to explain away subsection (303)(b), but I believe that their attempts are unsuccessful. Subsections (303)(b) and (303)(b)(i) could not be more clear: (1) testing of tangible property is a service that relates to tangible personal property, (2) for such service the benefit is received where the tangible property is located, and (3) tangible personal property is located where the principal use occurs. DOR drafted and adopted this regulation, and DOR cannot now claim that we should not follow its provisions.

I would hold that ARUP is not subject to Washington's B&O taxes for income derived from testing in Utah of bodily fluid and tissue samples received from Washington customers.



Maxa, C.J.

Filed
Washington State
Court of Appeals
Division Two

March 9, 2020

IN THE COURT OF APPEALS OF THE STATE OF WASHINGTON

DIVISION II

ARUP LABORATORIES, INC., FORMERLY KNOW AS ASSOCIATED GENERAL AND UNIVERSITY PATHOLOGISTS, INC., Appellant, v. STATE OF WASHINGTON DEPARTMENT OF REVENUE, Respondent.	No. 52349-3-II ORDER DENYING APPELLANT'S MOTION FOR RECONSIDERATION

Appellant, ARUP Laboratories, Inc., moves for reconsideration of this court's February 11, 2020 opinion in the above-entitled matter. After consideration, we deny the motion. Accordingly, it is

SO ORDERED.

Panel: JJ. Maxa, Lee, Melnick.

FOR THE COURT:

Melnick, J.

COURT OF APPEALS
THE STATE OF WASHINGTON
DIVISION II

ARUP Laboratories, Inc. Appellant, v. State of Washington, Department of Revenue Respondent.	NO. 52349-3-II MOTION FOR RECONSIDERATION

1. IDENTITY OF THE MOVING PARTY

ARUP Laboratories, Inc. ("ARUP") is the Appellant in the above-captioned matter.

2. STATEMENT OF RELIEF SOUGHT

ARUP requests that this court reconsider its published decision issued on February 11, 2020 that held that Rule 19402(303)(b) only applies if the testing services are related to tangible personal property are "[t]he services related to these items of property facilitate the use and enjoyment of the property." Slip Op., p. 14. The "use and enjoyment" of the property is irrelevant for purposes of sourcing the apportionable receipts; only the location or intended/expected location of the tangible personal property is relevant for sourcing purposes. For the reasons that follow, the court should reconsider its decision and source ARUP's

apportionable receipts to the location where the tissue, blood, bone, and other personal property is located when tested.

3. FACTS RELEVANT TO MOTION

This court heard ARUP's appeal from the Thurston County Superior Court where the parties filed cross motions for summary judgment. The court denied ARUP's motion and granted the motion of Washington State, Department of Revenue ("DOR"). This court upheld the trial court's decision to grant DOR's motion for summary judgment.

The parties looked to WAC 458-20-19402 ("Rule 19402") for guidance to source apportionable receipts. That rule explains the sourcing location where the customer benefits from the service:

> (303) Benefit of the service explained. The first two steps (subsection (301)(a)(i) and (ii) of this rule) used to attribute apportionable receipts to a state are based on where the taxpayer's customer receives the benefit of the service. This subsection explains the framework for determining where the benefit of a service is received.

Rule 19402(303).

ARUP relied on the portion of that rule that sourced the apportionable receipts from testing tangible personal property to the location where the tangible personal property "is located or intended/expected to be located." Rule 19402(303)(b)(i), (ii), and (iii)(D). DOR refused to apply Rule 19402(b)(i), (ii) and (iii)(D), but instead relied

on Rule 19402(303)(c) of the rule that sourced to where ARUP's customer resides on the basis that the testing services did not relate to tangible personal property.

There is no factual dispute that the tangible personal property is located in Utah when the property is tested, and such property remains in Utah. The pathology test results and interpretation by a licensed pathologist are transferred through the internet to a medical provider.

This court agreed with the DOR, finding that Rule 19402(c) applied, stating first, "The medical providers cannot diagnose their patients until they receive the results of the tests they ordered from ARUP." Slip Op., p. 13. Then this court concluded "Therefore, we agree with DOR and conclude that *the benefit is received where the medical provider is located*, which is Washington." *Ibid.* (Italics supplied.) Consequently, following this court's analysis, ARUP is required to source its apportionable receipts to the location where the medical provider uses the test results to diagnose the patients.

4. GROUNDS FOR RELIEF

The court's conclusion creates due process issues that renders the court's decision constitutionally suspect. It creates a constitutionally significant issue because ARUP does not know how to source its apportionable receipts when it is paid for services and the pathology test

results are used in more than one state by the patient. Under the court's interpretation of Rule 19402(303)(b), ARUP's reporting Washington State tax reporting obligations are *not* determined by its conduct, but it is determined by conduct of others over whom ARUP has no control.

Courts should avoid interpretations that create constitutional error.

5. ARGUMENT

The federal and state due process clauses are violated when a taxpayer's tax liability is determined by third parties that the taxpayer does not control. *Dot Foods, Inc. v. Dep't of Revenue*, 166 Wn.2d 912, 215 P.3d 185 (2009). In *Dot Foods*, the taxpayer was an out-of-state business that sold consumer and non-consumer products through agents (the statute referred to such agents as "direct seller representatives"). Pursuant to RCW 82.04.423(1), the statute exempted the taxpayer from the B&O tax on its sales into Washington on sales made by or through a direct seller representative.

The DOR contended that the statute should be construed to require the products sold could never be resold by anyone, including downstream resellers, from a permanent retail establishment. It revised its rule to accommodate that construction. Thus, if the products were sold to a consumer under circumstances that the goods could never be sold in a permanent retail establishment through the chain of downstream

distribution, then the sale was exempt. Door-to-door sales to a consumer would likely meet that construction.

In this case, the taxpayer sold product to resellers that did not resell from a permanent retail establishment but still claimed the exemption. It did so even though some products that it sold to its buyers were resold to other downstream resellers who eventually distributed the products from permanent retail establishments. According to the DOR interpretation, that downstream sale disqualified the taxpayer from the exemption. The Washington Supreme Court's describe the taxpayer's position:

> Dot's argument is based on the premise that it has no control over any downstream sales of its products once it sells through DTI [the direct seller representative] to a purchaser. Put another way, if a person buys one of Dot's products and then turns around and sells it to a permanent retail establishment, this is beyond Dot's control. Dot asserts that, in such a situation, Dot does not lose its tax-exempt status.

Dot Foods, Inc. v. Dep't of Revenue, 166 Wn.2d 912, 922-23, 215 P.3d 185, 190 (2009).

Based on these facts, the Court concluded that looking to others' actions to determine the taxpayer's tax status violated the due process clauses under both the state and federal constitutions. First, it cited from an amicus brief that explained the problem and then agreed with the amicus brief analysis:

Melaleuca, Inc., in its amicus brief, presents an argument that reinforces Dot's reading of the statute's language:

> [A] proper interpretation of all of the words in the statute makes it understandable that the Legislature only imposed restrictions on sales activities to the extent that the direct sales company could have some control over them. This is not only logical, it is undoubtedly required by the Due Process Clauses of both the United States and the Washington Constitutions. U.S. Const., Amend. XIV, § 1; Wash. Const., Art. I, § 3. A state cannot impose taxes on someone based upon the actions of another person, who is not the seller's agent, and whose actions are beyond the tax payer's [sic] control.

Amicus Curiae Br. of Melaleuca, Inc., at 11.

Dot Foods, Inc. v. Dep't of Revenue, at 923, 190. Second, it went to agree with the due process analysis:

> We agree with this analysis. Under the statutory provision, the Department cannot hold Dot responsible for taxes on sales it essentially has nothing to do with. The statute's plain language pertains to a requirement that an out-of-state seller "[m]akes sales in this state exclusively to or thorough [sic] a direct seller's representative." RCW 82.04.423(1)(d). The statute's language does not pertain, however, to some downstream purchaser of a product after the out-of-state seller has made its final sale to or through its direct seller's representative. The tax or tax exemption under the terms of the statute focuses on the seller's transaction with the seller's product, not on what some purchaser opts to do with the product after the transaction with Dot is completed. Applied here, Dot's sales through DTI are the final sales as far as the transaction concerns Dot; if Dot's final sale customer later resells the product or a byproduct of that product to a permanent retail establishment, such a transaction has no effect on Dot's tax status.

Ibid.

Following the *Dot Foods* logic in this case, if the gross receipts are sourced to the location where the medical provider used the reports to

make the diagnosis, then ARUP would be compelled to follow every location where that report was used for a patient's medical treatment to determine where to source its apportionable receipts. This is precisely the type of tax administration that the Court said violates a taxpayer's due process rights.

ARUP notes that the court could find *Dot Foods* actually supports the court's conclusion. Like *Dot Foods*, the court could look at the sale to ARUP's customer and conclude that the sale was to the customer's location. That approach would be intellectually flawed, because Rule 19402(303) and this court's interpretation are not based on a "sale" by the taxpayer as in *Dot Foods*. Rather, they are based on the location(s) where the customer benefits from the taxpayer's service. Thus, the court must focus on where the customer benefits from the service, not where the first sale occurred.

The constitutional question focuses upon whether the taxpayer's taxation depends upon *actions* others that are not controlled by the taxpayer. In the case of *Dot Foods*, the critical actions were subsequent sales of the product. In this case, according to this court's interpretation of Rule 19402(303)(b), the determinative actions are where the medical provider uses the test results to diagnose the patient. The test results, like subsequent sales, can occur in different places and times. It is a false

premise to assume that the test results are used in only one location. They can be used in one or more locations besides Washington.

To illustrate this point, assume that a patient seeks help for chronic lethargy symptoms at his/her general practitioner's office. The laboratory draws the patient's blood and the blood is sent to ARUP for pathology tests. ARUP tests the blood, an ARUP pathologist interprets the test results, and has the opinion that the patient has a particularly rare form of leukemia. The test results and pathologist's opinion are then transmitted to the patient's medical provider at the Washington drop-in clinic. Because of the rare form of the disease, the medical provider refers the patient to the MD Anderson Cancer Center at the University of Texas in Houston, TX. The patient visits medical providers at the MD Anderson Cancer Center, accompanied with the test results, the pathologist's opinion, and other medical records provided by the Washington medical provider. The MD Anderson Cancer Center medical providers evaluate the tests, the pathologist's opinion, and the other medical records of the Washington medical provider to determine the best way to treat the patient's rare form of leukemia.

In this fact pattern, ARUP's test results are used in both Washington and Texas. Under the court's rationale, the place where the medical provider makes the diagnosis for treatment is where the benefit of

the service occurs ("The medical providers cannot diagnose their patients until receive the results of the tests they ordered from ARUP.... Therefore, we agree with DOR and conclude that the benefit is received where the medical provider is located, which is Washington.") Under this common hypothetical, the benefit has occurred in both Washington and Texas.

Use of the test results in more than one state presents two reporting problems. First, how would ARUP allocate the apportionable receipts between Washington and Texas? The amount of time the Washington medical providers spent with the patient divided by the total time the Washington and Texas medical providers spent treating the patient? The amount of fees the Washington medical providers charged divided by total fees? Neither the statute nor the rule answers that question.

Second, once the test report is sent to the patient (who incidentally owns the medical information, not the medical providers who ordered the test) and the patient takes the test report to various medical providers for second opinions or otherwise aid in the diagnosis or treatment, ARUP has no idea where the benefit of the service is enjoyed. Neither the original medical provider who ordered the test nor the patient sends updates to ARUP to let it know where the report has been used for diagnostic purposes. The court's decision creates due process issues when applied to

ARUP and taxpayers like ARUP whose services do not necessarily benefit the buyer at one location.

These potential due process complexities do not exist when the apportionable receipts are sourced to the location where the tangible personal property "is located or intended/expected to be located." This is true, because the testing of tangible personal property occurs in one location where ARUP does the testing. And this is where the DOR defined the location of the benefit of the testing service in Rule 19402(303). Utilization of the report for treatment purposes can happen in more than one location, creating the due process problem.

When a statute is capable two different interpretations, one constitutional and the other unconstitutional, the court should adopt the constitutional interpretation. ("It is a well settled rule that, where a statute is open to two constructions, one of which will render it constitutional, and the other unconstitutional, the former construction, and not the latter, is to be adopted. *Poolman v. Langdon*, 94 Wash. 448, 162 Pac. 578. *State ex rel. Campbell v. Case*, 182 Wash. 334, 47 P. (2d) 24." *Gruen v. Tax Com*, 35 Wn.2d 1, 6, 211 P.2d 651, 655 (1949); "Where a statute is susceptible to more than one interpretation, it is our duty to adopt a construction sustaining its constitutionality if at all possible." *Spokane v. Vaux*, 83 Wn.2d 126, 129-30, 516 P.2d 209 (1973); *State ex rel. Morgan v. Kinnear*,

80 Wn.2d 400, 402, 494 P.2d 1362 (1972); and "And, where a statute is susceptible of several interpretations, some of which may render it unconstitutional, the court, without doing violence to the legislative purpose, will adopt a construction which will sustain its constitutionality if at all possible to do so." *State v. Dixon*, 78 Wn.2d 796, 479 P.2d 931 (1971); *George v. Day*, 69 Wn.2d 836, 420 P.2d 677 (1966); and *Tembruell v. Seattle*, 64 Wn.2d 503, 392 P.2d 453 (1964)).

Here, the court has two interpretations. One that is constitutionally firm (source the apportionable receipts to one location where the tangible personal property is tested) or one that is constitutionally suspect (source apportionable receipts to locations where the medical provider utilizes the test results, activity over which ARUP has no control or knowledge). The court should select the interpretation that avoids due process violations.

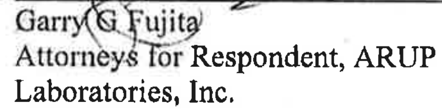
6. CONCLUSION

The court faced two interpretations of Rule 19402(303)(b). It could (1) construe that rule section to apply as written to "where the tangible personal property is located or intended/expected to be located" or (2) construe the rule to only apply when "[t]he services related to these items of property [widgets, tools and equipment] facilitate the use and enjoyment of the property." Slip Op., p. 14. The court's decision to choose the second interpretation renders Rule 19402(303)(c) violative of

the due process clauses of the federal and state constitutions. It raises constitutional issues because it determines ARUP's tax-reporting obligations by what others --- over whom ARUP has no control --- do with the test results. As the Washington Supreme Court has said, courts should avoid interpretations that would render a law unconstitutional, and the court should reconsider its decision.

DATED this 2nd day of March, 2020.

EISENHOWER CARLSON PLLC

By: 

Garry G Fujita
Attorneys for Respondent, ARUP Laboratories, Inc.

PROOF OF SERVICE

I certify that I served a copy of this document, in the manner indicated below, on the following:

Ms. Kelly Owings Mr. Joshua Weissman Assistant Attorney General Office of the Attorney General 7141 Cleanwater Lane SW P.O. Box 40123 Olympia, WA 98504-0123 kellyo2@atg.wa.gov joshuaw@atg.wa.gov CarrieP@Atg.wa.gov kyleeni@atg.wa.gov REVOlyFF@atg.wa.gov	[ ] Via Hand delivery [X] Via U.S. Mail, 1st Class, Postage Prepaid [ ] Via Overnight Delivery [ ] Via Facsimile [X] Via Email per E-Service Agreement

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

DATED at Tacoma, Washington this 2nd day of March, 2020.

Cindy C. Rochelle, Legal Assistant

EISENHOWER CARLSON PLLC

May 14, 2020 - 10:27 AM

Filing Motion for Discretionary Review of Court of Appeals

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