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STATE OF WASHINGTON

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**COURT OF APPEALS, DIVISION  
OF THE STATE OF WASHINGTON**

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AOL LLC,

Appellant,

v.

WASHINGTON STATE DEPARTMENT OF REVENUE,

Respondent.

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**BRIEF OF RESPONDENT**

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## **I. INTRODUCTION**

For over 70 years, taxpayers, the Department, and courts have applied the requirements of RCW 82.32.150 consistently to require payment of an assessment before a tax refund lawsuit challenging that assessment may be filed in Superior Court. AOL is attempting to create a loophole in Washington's statutory scheme to allow it to substantially bypass this long-standing requirement.<sup>1</sup> The statute, overall statutory scheme, case law, and policy all support the trial court's rejection of AOL's approach. Accordingly, the Department respectfully requests that this Court affirm the trial court's dismissal of AOL's tax refund lawsuit.

## **II. COUNTERSTATEMENT OF ISSUES**

RCW 82.32.150 requires that "[a]ll taxes, penalties, and interest shall be paid in full before any action may be instituted in any court to contest all or any part of such taxes, penalties, or interest." May a taxpayer pay tax for one month of a four-year assessment issued by the Department and still maintain an action in court to contest that part of the assessment, where the identical legal issue in the lawsuit underlies the entire four-year assessment?

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<sup>1</sup> The Appellant AOL, LLC, is apparently the successor to America Online, Inc. The Department refers to "AOL" at all times because the transfer of tax liability from one entity to the next is not an issue in this appeal.

### III. COUNTERSTATEMENT OF THE CASE

#### A. Factual Background

During the period January 1, 1998, through December 31, 2001, AOL was engaged in business as an Internet service provider to paid subscribers who access its online service from locations throughout the world, including Washington. CP 5 (Complaint ¶ 5). To provide that service, AOL contracted with third-party network service providers, which allowed AOL's customers to access AOL's data centers in Virginia from the customers' computers through a system of network access modems and dial-up access numbers integrated with the network service providers' telecommunications networks. *Id.* ¶ 6. AOL describes what it purchased from the network service providers as "managed modem service." *Id.* ¶ 7. Other descriptions would be "dial-up access" or "network" services. The primary tax issue in this case is whether AOL owes sales tax in Washington for its purchase of these managed modem services from the network service providers.

The Department conducted an audit of AOL for the tax period January 1, 1998, through December 31, 2001 (including January 2000), after which the Department issued a tax assessment for unpaid taxes on September 18, 2006. CP 40-41 (Ataman Decl. ¶ 2 & Ex. 1). The assessment imposed \$13,870,886 in taxes due for the four-year period,

plus interest and penalties in the amount of \$5,265,084, for a total due of \$19,135,970. Id., Ex. 1. The penalty was a 5% fee imposed under RCW 82.32.090(2). Id. This fee is referred to by the Department as an “assessment penalty” since it is only issued when the Department issues an assessment. Id. The bulk of the unpaid taxes in the assessment relate to retail sales taxes the Department determined AOL owed on its purchases of managed modem services in Washington. At the time of the assessment, AOL had not included the sales tax for managed modem services on its January 2000 return. CP 6 (Complaint ¶ 9 alleging that AOL filed an amended return on June 18, 2007, adding sales tax on managed modem services).

On December 15, 2006, AOL petitioned the Department to change the assessment pursuant to RCW 82.32.160 and WAC 458-20-100. CP 10-18. For ease of reference and to distinguish this petition from AOL’s later lawsuit in superior court, the Department refers to this petition as the “administrative appeal.” In its administrative appeal, among other issues, AOL challenged the imposition of sales tax on managed modem services over the entire four-year period of the assessment, including January 2000. CP 15. The administrative appeal is still pending, and AOL has not removed the January 2000 period from its petition to the Department. CP 20-23.

On June 18, 2007, over six years after AOL had filed its initial January 2000 return, nine months after having received a four-year assessment including the period January 2000, and six months after filing an administrative appeal of the assessment, AOL filed a purported “amended return” for January 2000. CP 6. Three months later, AOL submitted payment to the Department of \$331,337 for what it asserted was the January 2000 tax and interest due. CP 6. The payment represents 1.7% of the amount due for the four-year assessment. CP 6, 44.

Shortly thereafter, AOL filed the lawsuit that is the subject of this appeal. The lawsuit raises the identical issue raised by AOL in its administrative appeal of the four-year assessment – whether sales tax was due on AOL’s purchase of managed modem services. CP 5-8 , 15. Thus, AOL simultaneously is seeking to pursue tax refunds on the identical factual and legal issue in its administrative appeal and in its refund lawsuit.

**B. Procedure Below**

The Department filed a motion to dismiss or in the alternative to stay proceedings pending outcome of the administrative appeal. CP 24-39. The Department asserted that AOL had not paid any of the January 2000 tax and that even if AOL had paid the tax for that month the case should be dismissed because AOL had not paid the assessment that

included January 2000.<sup>2</sup> CP 29. In the alternative, the Department asked the court to stay proceedings pending outcome of the administrative appeal, which involved identical issues to the lawsuit. Id. The parties agreed to defer the issue of whether AOL had paid the January 2000 tax to allow AOL to conduct discovery, but to proceed on the other issues. CP 323-25.

The trial court agreed with the Department that RCW 82.32.150 requires a taxpayer to pay a full assessment, including interest and penalties, before challenging in Superior Court any period covered by the assessment. CP 436. AOL then filed this appeal.

#### **IV. SUMMARY OF ARGUMENT**

AOL incorrectly argues that it may pay only a small portion of an assessment because it is seeking a refund of only that portion of the tax assessed. This novel approach to the Washington tax refund statutes ignores statutory language and case law, is inconsistent with the statutory scheme as a whole, and leads to absurd results. AOL's reliance on California law is misplaced as California's taxing scheme is altogether

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<sup>2</sup> The Department asserts AOL has not paid the January 2000 tax because, by statute, the Department is required to apply all taxpayer payments first to penalties and interest, and then to tax, regardless of a taxpayer's instructions. RCW 82.32.080. The Department's rules make clear that payments are applied to penalties and interest on an entire assessment before being applied to the underlying tax. WAC 458-20-228(8). CP 42. Applying these rules, AOL's payment of \$331,377.32 merely reduced the outstanding interest and penalties from the assessment to \$5,741,200. CP 42.

different from Washington's. Finally, AOL is required to meet the prerequisites for filing a tax refund claim and not merely to meet the "spirit" of those requirements. In any event, payment of 1.7% of a tax assessment complies with neither the letter nor the spirit of the law.

## V. ARGUMENT

Washington's tax refund statutes require full payment of an assessment before challenging "any part of" that assessment. The language of the statute and the statutory scheme as a whole make clear that once an assessment has been issued by the Department, the assessment becomes the "tax" that must be paid in full before suing in superior court. AOL's proposed new approach is inconsistent with the statutory scheme and would lead to absurd results, allowing taxpayers to ignore the prepayment requirement. Confirming the language and overall scheme of the statute, Washington cases repeatedly confirm the principle that an assessment must be paid in full before bringing a tax refund lawsuit. AOL's argument that it need meet only the "spirit" of RCW 82.32.150 is similarly inconsistent with the plain language of the statute and every court case interpreting the statute.

**A. Statutory Language And Case Law Establish That AOL Must Pay An Assessment In Full Before Suing In Superior Court For A Refund**

Washington's tax refund statute requires that "all taxes, penalties and interest shall be paid in full" before a taxpayer may sue in superior court for "all or any part of such taxes, penalties or interest." RCW 82.32.150. This "pay first, litigate later" rule ensures the efficient collection of taxes. The plain meaning of the statute, in the context of the overall statutory scheme, shows that the "tax" referred to in RCW 82.32.150 is an entire assessment once an assessment has been issued by the Department. AOL's contrary interpretation conflicts with the chapter's other administrative provisions and is inconsistent with Washington's statutory scheme for challenging Washington taxes.

**1. The "pay first, litigate later" rule in Washington ensures the efficient collection of tax.**

Unquestionably, "taxes are the life-blood of government." Bull v. United States, 295 U.S. 247, 259, 55 S. Ct. 695, 79 L. Ed. 1421 (1935). Thus, one way that many states and the federal government ensure the efficient collection of taxes is by requiring the payment of a tax before allowing litigation regarding that tax. RCW 82.32.150, .180; Roon v. King County, 24 Wn.2d 519, 528, 166 P.2d 165 (1946). Courts have recognized the importance of this requirement for over a hundred years.

“The prompt payment of taxes is always important to the public welfare. . . . The idea that every taxpayer is entitled to the delays of litigation is unreason.” Springer v. United States, 102 U.S. 586, 594, 26 L. Ed. 253 (1880). “Any delay in the proceedings of the officer, upon whom the duty is devolved of collecting the taxes, may derange the operations of government, and thereby cause serious detriment to the public.” Dows v. City of Chicago, 78 U.S. 108, 20 L. Ed. 65 (1870); see also Peters v. Sjolholm, 95 Wn.2d 871, 885, 631 P.2d 937 (1981) (Brachtenbach, C.J., concurring)(“The government has a strong interest in the efficient collection of taxes which has long been recognized by the judiciary.”) The special status of tax collection is also reflected in the courts’ recognition that, while due process concerns generally require pre-deprivation notice and opportunity to be heard, for tax purposes it is sufficient to provide only a post-deprivation opportunity for refunds. E.g., Peters, 95 Wn.2d at 876-77.

The pay first, litigate later rule ensures the efficient collection of taxes in numerous ways. It prevents the government from bearing the risk that a losing taxpayer will be unable or unwilling to pay the judgment against it. The taxpayer bears no such risk since presumably the government will have sufficient funds to pay a judgment if the taxpayer prevails. The rule prevents an interruption in revenue from taxpayers that

delay payment while litigating a tax. The rule also removes leverage that taxpayers may otherwise have to encourage the state to settle litigation merely to obtain funds necessary for governmental functions. The rule also allows the state to avoid the cost of collection procedures for taxpayers that seek redress in the courts.

AOL's interpretation of Washington's pay first, litigate later requirement threatens to undermine these important policies. While not all of the reasons for the rule are affected in AOL's particular case, this Court's opinion will be applicable to all taxpayers, many of whom are less financially solvent or less scrupulous than AOL. In contrast, the trial court's ruling is consistent with legislative intent, the statutory language and the statutory scheme as a whole.

**2. The statute requires full payment of an assessment before bringing a lawsuit.**

Requiring full payment of an assessment before allowing a challenge to a tax period covered by the assessment gives full effect to the words "or any part of" in the statute and is consistent with the overall statutory scheme.

**a. Full payment of an assessment before bringing a tax refund lawsuit gives effect to all words in the statute.**

Under RCW 82.32.150, “[a]ll taxes, penalties, and interest shall be paid in full before any action may be instituted in any court to contest all or any part of such taxes, penalties, or interest.” In interpreting statutes, the court’s primary goal is “to discern and implement the intent of the legislature.” Lakemont Ridge Homeowners Ass’n v. Lakemont Ridge Ltd. Partnership, 156 Wn.2d 696, 698, 131 P.3d 905 (2006). In doing so, the court looks to the plain meaning of the language and ensures that “all the language is given effect, with no portion rendered meaningless or superfluous.” Id. Similarly, the court seeks to harmonize statutory provisions and construe the statute as a whole. Id. If there is any ambiguity in the statute requiring AOL to pay all of a tax before challenging any part of the tax, it should be construed strictly against the taxpayer. Cf. Lacey Nursing Center, Inc. v. Dep’t of Revenue, 128 Wn.2d 40, 49-50, 905 P.2d 338 (1995).<sup>3</sup>

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<sup>3</sup> The Lacey Nursing case did not involve RCW 82.32.150, but a closely related statute, RCW 82.32.180. RCW 82.32.180 sets forth the prerequisites for filing a tax refund lawsuit, implicitly incorporating RCW 82.32.150 by stating that a taxpayer must pay “any tax as required.” Lacey Nursing applied the rule that a statute conferring a credit, refund or deduction should be applied strictly in holding that a taxpayer must meet all of the requirements of RCW 82.32.180 before filing suit in superior court. Id. at 53, 55. Similarly, RCW 82.32.150 should be applied strictly.

In order to give effect to all of the words in RCW 82.32.150, a taxpayer must be required to pay the full amount of an assessment once the Department has issued an assessment.<sup>4</sup> An “assessment” is a determination by the Department of a tax liability for a defined period. RCW 82.32.050. As noted by AOL, an assessment can cover a transaction, a month, or one or more years. App. Br. at 6. There is no question that in this case, the tax for January 2000 is a “part of” the four-year assessment. Accordingly, AOL should not be permitted to file an action in court regarding that month because it is only a “part of” the taxes, penalties and interest assessed against AOL. If a taxpayer that has been issued a four-year assessment can pay taxes for only one month of the four years before filing an action in superior court, the statute’s use of the words “all or any part of” such taxes would not be given full meaning. The taxpayer could determine for itself what “part of” any tax it wished to pay and then seek a refund for only that amount. Additional evidence that the legislature intended to include assessments when it required payment of “all taxes, penalties and interest” is that the term “taxes, penalties and interest” is consistently used elsewhere in the statute when addressing assessments. E.g., RCW 82.32.050(3); RCW 82.32.100(2).

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<sup>4</sup> The Department agrees that where a monthly reporting period is not covered by an assessment, a taxpayer may pay a single month and file an action in superior court for a refund of the taxes paid for that month.

AOL argues that the statute's meaning is plain from its language, yet AOL's own interpretation of the statute belies its claim. AOL claims that the statute plainly requires, "the payment of all the taxes due with the return all or part of which taxes is being contested." App. Br. at 5. Yet the statute makes no reference to all taxes in a "return" being paid, just as it makes no explicit reference to an "assessment." Indeed, reading the "plain meaning" of the statute in isolation and in a strict, wooden manner would require AOL to pay all taxes it currently owes, not just the assessment -- a result AOL argues is absurd.<sup>5</sup> App. Br. at 10.

AOL also argues that the term "assessment" in the second sentence of RCW 82.32.150 shows that the Legislature did not intend the term "taxes, penalties and interest" to refer to assessments. App. Br. at 14-15. The use of "assessment" in the second sentence merely reflects the difference in purpose of the two sentences. The first sentence applies to all court actions in which a taxpayer seeks a refund. Thus, the language must encompass voluntary reporting and payment as well as assessments. The second sentence addresses injunctions, which by their nature can only

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<sup>5</sup> The Department does not interpret RCW 82.32.150 to require a taxpayer to pay all current taxes owing before filing a refund lawsuit because requiring an assessment to be paid in full is more consistent with the overall statutory scheme, as set forth in more detail below. Nevertheless, a truly literal "plain meaning" reading of the statute in isolation could require this result, which would not necessarily be absurd. See Bull HN Information Sys. v. Dep't of Revenue, 916 P.2d 1109 (Ariz. Ct. App. 1995) (interpreting statute that requires payment of "past, current and accruing" property taxes before commencing tax refund action).

apply to prevent the Department from assessing a tax or collecting an assessed tax. It would be nonsensical for a taxpayer to sue for an injunction ordering itself not to pay a tax voluntarily.

**b. Requiring full payment of an assessment is consistent with the statutory scheme.**

Rather than requiring AOL to pay all of its outstanding taxes, the Court should construe RCW 82.32.150 in the context of the entire statutory tax scheme and the methods the Legislature has set aside for challenging such taxes. As the United States Supreme Court reasoned when holding that a taxpayer must pay the full amount of an income tax assessment, “[w]e are not here concerned with a single sentence in an isolated statute, but rather with a jurisdictional provision which is a keystone in a carefully articulated and quite complicated structure of tax laws.” Flora v. United States, 362 U.S. 145, 157, 80 S. Ct. 630, 4 L. Ed. 2d 623 (1960). Washington also has a carefully articulated and sometimes complicated structure of tax statutes, including provisions for reporting, paying, assessing and disputing taxes. AOL’s proposed approach is incongruous with nearly every aspect of Washington’s taxing statutes.

Washington taxpayers generally pay taxes on a self-reporting, monthly basis as set forth in RCW 82.32.045(1). That statute, however, begins with the instruction, “[e]xcept as otherwise provided in this

chapter, payments [and reporting] of the taxes imposed” are due on a monthly basis. Id. One of the exceptions to monthly reporting and payment “otherwise provided” for in the chapter is where the Department assesses taxes. This occurs when it “appears that a tax or penalty has been paid less than that properly due.”<sup>6</sup> RCW 82.32.050(1). In contrast to the monthly reporting period set forth at RCW 82.32.045(1), the time period of an assessment can and generally does include multiple years. RCW 82.32.050(3). Thus, once the Department issues an assessment, the time periods covered by the assessment are no longer covered by RCW 82.32.045(1) but by the assessment statute, RCW 82.32.050, “as otherwise provided by this chapter.”

This reading follows the regular course of tax reporting and payment clearly envisioned by the statutory framework. Taxpayers generally self-report and pay their taxes along with monthly reports. RCW 82.32.045(1). If the Department audits a taxpayer and determines that the monthly reports understated the taxpayer’s actual tax liability, it

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<sup>6</sup> In addition to assessments, other circumstances reflect a reporting and payment obligation on other than a monthly basis. For example, pursuant to RCW 82.32.045(2), the Department allows small businesses to report on a quarterly or annual basis. Washington State Department of Revenue, 2007 Business Tax Guide, at 5, found at <http://dor.wa.gov/Docs/Pubs/ExciseTax/FilTaxReturn/BusTaxGuide08.pdf>. Other examples include when a business takes over another business and is subject to successorship liability, the entire tax then owed by the predecessor is immediately due. RCW 82.32.140. Other taxes are due on a one-time basis only, such as when a Washington resident who purchased a car in Oregon and then used the car in Washington is subject to use tax payable within 16-45 days. WAC 458-20-178.

issues an assessment. RCW 82.32.090(2). Similarly, if a taxpayer fails to file any monthly reports, the Department may issue an assessment. RCW 82.32.100. In either case, the time period covered by the assessment is limited only by RCW 82.32.100(3). Once the assessment has been issued, the statutory scheme makes no provision for, and does not suggest any reason a taxpayer might have for, filing an amended return for any month covered by the assessment.

Other statutory language shows that the Legislature intended an assessment to be the controlling unit of tax for administrative provisions once it has been issued. For example, the Legislature allows taxpayers to seek Departmental review of assessments. RCW 82.32.160; see also RCW 82.32.100 (allowing appeal of an “assessment,” rather than using the term “tax” or “monthly tax,” where the Department has assessed tax due to a taxpayer’s failure to file returns); RCW 82.32.090(2) (determining whether taxpayer has substantially underpaid tax based on total period of time covered by Department’s examination rather than monthly reporting periods). The Legislature also requires that a taxpayer’s payment must first apply to penalties and interest before being applied to the underlying tax without regard to any direction of the taxpayer. RCW 82.32.080. The Department’s rules establish that a

taxpayer must pay all penalties and interest on an assessment before paying any of the underlying taxes.<sup>7</sup> WAC 458-20-228(8).

In contrast to the Legislature's statutory scheme recognizing an assessment as the controlling unit of tax for administrative purposes, there is no statutory provision authorizing or addressing amended returns. See generally RCW 82.32.<sup>8</sup> Such statutory and administrative provisions conflict with AOL's attempted procedure of ignoring the assessment and its related administrative provisions and seeking to pay an amended, monthly return as if the assessment had never happened.

**c. AOL's interpretation conflicts with the statutory scheme.**

Likewise, there are numerous ways in which AOL's proposed interpretation of the statute will cause conflicts with the statutory scheme. For example, various penalties may apply when the Department issues an assessment or warrant.<sup>9</sup> E.g., RCW 82.32.090(2) (assessment penalty that

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<sup>7</sup> Because of the mandate to apply payments to penalties and interest first under RCW 82.32.080 and WAC 458-20-228(8), the Department believes that AOL has not in fact paid the tax for January 2000. CP 8-9. AOL disagrees and the parties have postponed resolution of that issue pending discovery. CP 323-25. Accordingly, it is not at issue in this appeal. Nevertheless, the difficulties in determining whether AOL has in fact paid the "tax, penalties and interest" demonstrate how AOL's proposed interpretation conflicts with the statutory scheme.

<sup>8</sup> The Department does not mean to suggest that amended returns are not authorized under any circumstance. Nevertheless, in determining the Legislature's intent regarding what "tax" must be paid before suing in superior court, it is significant that the Legislature not once referred to an "amended return."

<sup>9</sup> A warrant is a document filed in superior court by the Department for unpaid taxes that operates as the equivalent of a lien. RCW 82.32.210.

varies depending on whether taxpayer pays assessment by due date stated in assessment); RCW 82.32.090(3) (warrant penalty of 10% but not less than \$10); RCW 82.32.090(4) (5% penalty for being unregistered); RCW 82.32.105 (waiver or cancellation of penalties). RCW 82.32.150 requires payment of all “taxes, penalties and interest” before a lawsuit may be filed to contest “all or any part of such taxes, penalties and interest.” Under the statutory scheme confirmed by the trial court decision, a court can easily determine whether all the “taxes, penalties and interest” have been paid because the amount is stated on the face of the assessment.

AOL’s approach, on the other hand, leads to a confusing morass of questions to which the statute gives no answers. The court would have to determine what portion, if any, of the assessment penalty or other penalty to allocate to the single month that a taxpayer opts to pay. The court may have to determine whether the taxpayer’s calculation of tax for the month is accurate, a task made more difficult by the fact that assessments typically do not list figures for each month of the assessment but rather for each year. See e.g. CP 44 (assessment issued to AOL in this case). If the court simply accepts a taxpayer’s self-reporting of the tax for one month, the court will have to decide whether the 5% assessment penalty applies to the taxpayer’s declared number or to try to determine the penalty based on the amount of tax in the assessment. The court would have corresponding

difficulties in determining the amount of tax to which interest would apply. The court would also be faced with the incongruous task of applying an “assessment penalty” to what AOL asserts is merely an amended return. On the other hand, failing to apply the penalty would allow a taxpayer to avoid paying the “penalties” that the Legislature has specifically mandated be paid. These difficulties and contradictions demonstrate that AOL’s interpretation does not harmonize the prepayment requirement with the overall statutory scheme.<sup>10</sup>

AOL’s interpretation would also do violence to the Legislature’s scheme of providing alternative avenues for review of a taxpayer’s objection to particular taxes. Washington’s statutory tax scheme provides two distinct means of seeking review: superior court review that requires prior payment and prepayment review at the Department and the Board of

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<sup>10</sup> AOL’s own actions in this case demonstrate the pitfalls of removing a monthly reporting period from an assessment. Penalties and interest were assessed against AOL for the four-year assessment, including January 2000. CP 41-42, 44. If AOL’s amended return and payment is treated as simply a monthly return completely divorced from the assessment, AOL’s return and payment would be over seven years late, and subject to its own penalties and interest. For example, RCW 82.32.090(1) would impose an additional 25% penalty on AOL for filing a tax report in June 2007 and remitting payment in September 2007. Yet AOL has not alleged that it paid any penalty for the January 2000 tax period. CP 6 (Amended Complaint ¶ 10). The 25% penalty would be in addition to any penalties imposed in the assessment, essentially penalizing AOL’s payment for January 2000 twice. RCW 82.32.090(7). By stipulation of the parties, whether AOL has paid the tax, interest and penalties for January 2000 is not at issue in this appeal. Nevertheless, the potential double penalty that would result demonstrates the incongruity of AOL’s approach.

Tax Appeals. RCW 82.03.190; RCW 82.32.160 - .180.<sup>11</sup> AOL's proposed interpretation would allow taxpayers to circumvent this statutory scheme and sue in superior court despite paying only a fraction of an assessment.

The United States Supreme Court sought to avoid disruption of a similar system adopted by Congress for review of taxes, determining that a taxpayer must pay the full assessment of an income tax before suing for a refund. Flora v. United States, 362 U.S. 145, 80 S. Ct. 630, 4 L. Ed. 2d 623 (1960). Just as in the present case, the taxpayer in Flora sought to pay a portion of an assessment and sue for a refund of only that portion. Id. at 147. The statute at issue in Flora gave jurisdiction to a district court for “[a]ny civil action against the United States for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or any penalty claimed to have been collected without authority or any sum alleged to have been excessive or in any manner wrongfully collected . . . .” Id. at 148-49. Among the reasons the Court gave for determining that Congress meant this statute to require payment

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<sup>11</sup> RCW 82.32.160 allows administrative appeals of tax assessments, and RCW 82.32.170 allows administrative appeals for a tax refund request. In this case, AOL chose to appeal its assessment to the Department. CP 13. Departmental decisions under either of these sections may be appealed to the Board of Tax Appeals under RCW 82.03.190. In appeals from Departmental decisions under RCW 82.32.160, appeal may be made to the Board of Tax Appeals without payment of the tax that had been assessed.

of a full assessment before filing suit in district court was the creation of a dual system by Congress: “The result is a system in which there is one tribunal for prepayment litigation and another for post-payment litigation, with no room contemplated for a hybrid of the type proposed by petitioner.” Id. at 164. The Court rejected the taxpayer’s attempt to subvert this congressionally created system, reasoning:

[A] suit for recovery of but a part of assessment would determine the legality of the balance by operation of the principle of collateral estoppel. With respect to this unpaid portion, the taxpayer would be securing what is in effect – even though not technically – a declaratory judgment. The frustration of congressional intent which petitioner asks us to endorse could hardly be more glaring.

Id. at 165.

Similarly, in the present case, AOL’s proposed interpretation would essentially allow a taxpayer to circumvent the carefully constructed statutory scheme and permit taxpayers to sue in superior court despite not having paid the full amount of tax.

**d. Requiring AOL to pay the full assessment against it does not conflict with RCW 82.32.160.**

AOL asserts that the Department’s interpretation of RCW 82.32.150 would conflict with RCW 82.32.160 because in order to bring a lawsuit, a taxpayer would be forced to pay an assessment while

simultaneously seeking administrative review of the assessment, which could change the assessed amount. There is no conflict.

The taxpayer has received an assessment from the Department that is not conditional. RCW 82.32.050(1) (authorizing Department to assess taxes which shall become due and payable within 30 days or within such further time as the Department provides); CP 44 (notice of assessment stating, "This is your Tax Assessment"). Assessed "taxes are presumed to be just and legal, and the burden rests upon one assailing the tax to show its invalidity." Ford Motor Co. v. City of Seattle, Executive Services Dep't, 160 Wn.2d 32, 41, 156 P.3d 185 (2007).

While the assessment may not be considered "final" in the sense that AOL has asked the Department to review the assessment, nothing prevents AOL from paying that assessment and pursuing its action in superior court. In that circumstance, if the administrative appeal results in a change in the amount of the assessment, AOL would either be issued a refund or an additional assessment. As set forth above, the Legislature established two different options for resolving taxpayer disputes, one that requires prepayment and one that does not. RCW 82.32.150-.180. The requirement that AOL pay the full assessment despite having administratively appealed the assessment is not the result of a statutory conflict; it is the result of AOL simultaneously pursuing both avenues for

relief.<sup>12</sup> The statutory scheme does not prevent AOL from doing so, but it does not allow AOL to avoid the requirements of one appeal avenue simply because it is pursuing the second avenue as well.

Finally, AOL turns to California case law to support its theory that the assessment issued by the Department and appealed by AOL to the Department need not be paid before challenging in court a tax period covered by the assessment. App. Br. at 16-17 (discussing City National Corp. v. Franchise Tax Board, 146 Cal. App. 4th 1040, 1045, 53 Cal. Rptr. 3d 411 (2007)). In City National, the court held that a taxpayer need not pay “proposed” assessments before bringing a tax refund lawsuit for previously reported and paid taxes. City National, 146 Cal. App. 4th at 1046. Unlike the present case, the taxpayer in City National had reported and paid the tax and then sought a refund administratively before being issued a notice of proposed assessment by the California Franchise Tax Board (FTB) for those tax periods. Id. at 1043. Also, unlike the present case, the proposed assessment issued by the FTB and covering the tax period of the amended returns dealt with entirely different legal issues from those for which the taxpayer sought a refund. Id. The taxpayer

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<sup>12</sup> AOL claims that the Department’s position would accelerate the due date of the assessment contrary to RCW 82.32.160. App. Br. at 16. It is not the Department that has required AOL to pay its assessment despite having filed an administrative appeal, but AOL’s decision to pursue a superior court appeal while its administrative review is pending.

therefore was not seeking to avoid the consequences of the notice of assessment when it paid the taxes.

Moreover, California courts are faced with a very different statutory scheme than Washington's. In both California and Washington, a taxpayer's self-reported taxes are subject to review and additional assessment if deficiencies are discovered. RCW 82.32.050; Cal. Rev. & Tax. Code §19032 (West 2008). In Washington, the Department is authorized to issue an assessment for the unpaid taxes, which amount "shall become due and shall be paid within thirty days from the date of the notice, or within such further time as the department may provide." RCW 82.32.050(1). In contrast, the California Franchise Tax Board (FTB) is initially authorized only to "examine [the return] and . . . determine the correct amount of tax." Cal Rev. & Tax. Code §19032 (West 2008). After such examination, the FTB may issue a notice to the taxpayer regarding any deficiencies and proposing an assessment of additional taxes. Cal. Rev. & Tax. Code §19033; City National, 146 Cal. App. 4th at 1045. Only if the taxpayer does not object to the proposed assessment does the deficiency become an assessment. Cal. Rev. & Tax. Code §19042 (West 2008). California's statutory scheme further differs from Washington's in requiring exhaustion of administrative remedies. Cal. Rev. & Tax. Code §19382 (West 2008).

The differences in the two statutes make the City National case inapposite here. Unlike Washington statutes, California statutes specifically identify the initial calculation by the FTB as a “proposed” assessment, and the FTB is not authorized to “assess” a tax at that stage of proceedings. City National’s conclusion that the taxpayer need not pay the “proposed” assessment is thus firmly rooted in the wording of California’s statute. AOL incorrectly seeks to uproot this analysis and apply it to Washington’s statute, which authorizes the Department to “assess” taxpayers upon finding a deficiency. RCW 82.32.050. Given the Department’s statutory authority to “assess,” the statement in RCW 82.32.160, addressing administrative appeals, that an assessment shall become “final” if no objection is made within 30 days is best understood as “final” in the sense that no further administrative appeal can be taken.

The City National opinion also is bolstered by California’s requirement that a taxpayer exhaust administrative remedies. California taxpayers may sue only after having been denied a refund by the FTB. Cal. Rev. & Tax. Code §19382 (West 2008). Thus, it would be difficult for taxpayers to avoid the requirements of California’s statutory scheme by using the strategy employed by AOL. AOL filed an amended return for January 2000 after having already received an assessment covering January 2000. Yet if AOL were required to exhaust administrative

remedies, the entire assessment would likely become ripe for a suit in court before the amended return, thus making the amended return moot. Indeed, the reason that the City National court was even faced with the issue it addressed is that the taxpayer filed amended returns for four years, paid taxes in full for those four years, and filed claims for refunds administratively. Id. at 1043. Only after these events did the FTB issue proposed assessments to the taxpayer. Id. Consequently, the issue of the refund claims based on the amended returns became ripe for suit in court before the FTB had taken action on the proposed assessments.

Washington has no corresponding exhaustion of remedies requirement in the tax context. Transplanting the City National conclusion into Washington's statutory scheme would allow taxpayers to file an amended return at any time after an assessment had been issued and appealed administratively, and immediately could seek court review of the amended return, crippling the prepayment requirement with no additional risk to the taxpayer of losing its right to appeal the assessment.

**3. Case law establishes that a taxpayer must pay a full assessment before suing for a tax period covered by the assessment.**

Just as a harmonious reading of Washington's taxing scheme mandates, Washington cases applying RCW 82.32.150 have required taxpayers to pay an entire assessment before bringing a tax refund lawsuit.

Kirkland v. Dep't of Revenue, 45 Wn. App. 720, 727 P.2d 254 (1986); Morrison-Knudsen Co. v. Dep't of Revenue, 6 Wn. App. 306, 493 P.2d 802 (1972). While those cases did not address the specific fact pattern here, the language in the opinions is consistent with the statutory scheme. Moreover, the result in the Kirkland case is inconsistent with AOL's proposed interpretation.

In Kirkland, the Department had assessed excise taxes for the period between January 1, 1971, and October 1, 1975. Id. at 721. Thus, just as here, the assessment covered numerous monthly "reporting periods." The Department obtained partial payment from the taxpayer of approximately 1/3 of the outstanding assessment. Id. at 722.

Nevertheless, the court applied the provisions of RCW 82.32.150 to hold that, as a matter of law, the taxpayer's refund lawsuit should be dismissed because "there was no material issue of fact as to whether Kirkland had fully paid the tax assessment . . . ." Id. at 723-24. Despite the partial payment by the taxpayer of the assessment, the court did not allow the refund lawsuit to continue with respect to some of the tax periods but dismissed the entire action. The court ruled that because the taxpayer had failed to challenge the assessment administratively, the taxpayer's "only remedy is to challenge the assessment in a refund action under RCW 82.32.150." Id. at 723 (emphasis added). Thus, the court gave full effect

to the statutory language that “all taxes, penalties, and interest” must be paid before seeking refund of “any part” of the taxes.

Likewise, AOL has failed to pay the full assessment against it, and the trial court’s ruling should be affirmed. The dictates of RCW 82.32.150 apply with even greater force here. While the taxpayer in Kirkland paid approximately one-third of the outstanding tax assessment, AOL has paid only 1.7% of its tax assessment.

**4. AOL’s proposed interpretation leads to absurd results.**

If AOL’s proposed interpretation were adopted by this court, the prepayment requirement of RCW 82.32.150 would cease to have any meaningful impact. Courts avoid construing a statute to achieve absurd results. Glaubach v. Regence Blueshield, 149 Wn.2d 827, 833, 74 P.3d 115 (2003). Moreover, it is presumed that the Legislature does not indulge in vain and useless acts and that some significant purpose or object is implicit in every legislative enactment. Kelleher v. Ephrata School Dist. No. 165, 56 Wn.2d 866, 873, 355 P.2d 989 (1960).

One needs look no further than the present case to observe this result. AOL was assessed over \$19 million for a four-year period. Instead of paying the assessment and challenging it in court, AOL chose to pay what it alleges is one month of the assessment and sue for that part of the assessment only. AOL hints that this does not create a conflict because

AOL is only suing for a refund of one month, stating that a judgment on the merits in this lawsuit is not res judicata with respect to other tax periods. App. Br. at 8 n.7. AOL does not mention that a judgment on the merits can result in collateral estoppel or a published appellate opinion resolving the issues. See Kalama Chemical Inc. v. State, 102 Wn. App. 577, 579, 9 P.3d 230 (2000), review denied, 143 Wn.2d 1006 (2001), cert. denied, 533 U.S. 931 (2001); Flora v. United States, 362 U.S. at 165.

Therefore, the outcome of this lawsuit, were it permitted to go forward, would not merely resolve one month of AOL's tax liability but would have significant, if not conclusive, impact on the remaining 47 months of the assessment. If allowed to go forward, AOL will be permitted to effectively challenge its entire assessment after having paid only a tiny portion of the assessment. Paraphrasing the United States Supreme Court in Flora, the frustration of legislative intent could hardly be more glaring. 362 U.S. at 165.

AOL's interpretation also would allow taxpayers to avoid the payment of penalties before filing suit, as required by RCW 82.32.150. An assessment issued with assessment penalties or even penalties for willfully evading tax imposed under RCW 82.32.090(6) would simply be ignored under AOL's approach. A taxpayer receiving such an assessment could simply file an amended return for one month, asserting whatever tax

it claimed was due, and file a refund lawsuit for the one month without ever having paid the penalty.<sup>13</sup> Under AOL's approach, the taxpayer could proceed with the lawsuit because it had paid "all the taxes due with the return all or part of which taxes is being contested." App. Br. at 5. Such a result makes a mockery of the statute and clear legislative intent.

Taxpayers less scrupulous than AOL could circumvent the statute even more blatantly. Under AOL's proposed new interpretation, nothing would prevent a taxpayer that has been issued a four-year assessment from filing an "amended return" for a month covered by the assessment showing additional taxes due of \$1. The taxpayer could pay the \$1 and sue for a refund of the \$1, arguing as the legal basis the same issue as that addressed in the assessment.

Similarly, not all taxpayers are as financially solvent or responsible as AOL. In requiring prepayment of taxes before bringing a lawsuit, the legislature assured efficient tax collection and uninterrupted revenue. See Tyler Pipe Indus., Inc. v. Dep't of Revenue, 96 Wn.2d 785, 797, 638 P.2d 1213 (1982) (applying policy to reverse injunction against tax collection). Yet under AOL's proposal, a near-bankrupt taxpayer could pay a tiny

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<sup>13</sup> AOL's argument is silent on whether an "amended return" would be subject to any scrutiny before a taxpayer is allowed to pay the alleged amount due on the amended return and file a refund lawsuit. Nevertheless, the import of its argument seems to be that the court can ignore the assessment entirely. Therefore, even if an "amended return" ignores penalties or substantially understates the tax liability in comparison to an assessment, under AOL's approach the taxpayer will still be permitted to file a lawsuit.

portion of a tax assessment and pursue a refund action in court, knowing that if it lost the case it would not be able to pay the entire tax bill due to bankruptcy. Such results are ones the tax refund statutes were designed to prevent.

Accordingly, the Department respectfully requests that the Court of Appeals affirm the trial court's order dismissing the case without prejudice.

**5. AOL misconstrues the Department's arguments.**

AOL claims that the Department's position is inconsistent with its past practice, but AOL misconstrues the Department's stated position. App. Br. at 9. As stated in the Department's brief to the superior court (and noted in AOL's reply), RCW 82.32.150 requires full payment of an assessment, interest and penalties, before filing a tax refund lawsuit for tax periods covered by the assessment. CP 32, 372-73, 426. AOL argues that the Department has historically not objected when a taxpayer seeks a refund when there is a pending administrative appeal. App. Br. at 9. The issue is not whether there is a pending administrative appeal, but whether a taxpayer seeks a refund of taxes paid for a time period already covered by an assessment.<sup>14</sup> The Department does not and has not asserted that a

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<sup>14</sup> AOL repeatedly attempts to cast this case as the Department objecting to AOL's pursuit of simultaneous administrative appeal and a tax refund lawsuit in superior court. The Department did move, in the alternative, for a stay of trial court proceedings

taxpayer must pay all outstanding assessments before filing a tax refund lawsuit in superior court. AOL does not even allege that any of the cited cases involved a tax refund lawsuit in Superior Court for the same tax period covered by an unpaid assessment at the time of filing. App. Br. at 9. Accordingly, the cases do not demonstrate any inconsistency.

**6. AOL's reliance on California case law is misplaced.**

AOL urges this Court to look to California courts' interpretation of California's Unemployment Insurance Code in declaring that only a portion of an assessment need be paid before challenging a tax period covered by the assessment. App. Br. at 12-13. This Court's task, however, is not to interpret California's unemployment insurance statute, but Washington's excise tax statutes. The cases cited do not advance AOL's argument, and the two states' statutes and statutory schemes differ significantly.<sup>15</sup>

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pending administrative review, but the pending administrative review was not the basis upon which the trial court dismissed this action. AOL's administrative appeal has no effect on whether it is required to pay an assessment before bringing a tax refund lawsuit.

<sup>15</sup> AOL's citation to the federal rule allowing a refund after paying sales tax on a single transaction is also inapposite. As the treatise cited by AOL explains, "In general, if a tax is one over which the Tax Court has jurisdiction (e.g., income, gift, and estate tax), the *Flora* rule applies and the taxpayer must make full payment of an assessed tax . . . . Transactional taxes, as well as most excise taxes . . . do not fall within the Tax Court's jurisdiction, and so the taxpayer has no opportunity for prepayment judicial review." Michael I. Saltzman, *IRS Practice and Procedure* §11.06[4] (RIA 2008). Washington's tax scheme, on the other hand, allows prepayment review for excise taxes. RCW 82.03.190 (prepayment review at Board of Tax Appeals).

AOL claims that the court in Dep't of Calif., Veterans of Foreign Wars of U.S. v. Kunz, 269 P.2d 882 (Cal. Ct. App. 1954), allowed a taxpayer to sue for taxes paid for one reporting period despite having been assessed for multiple periods. App. Br. at 12. A close reading of that case reveals that the court allowed the taxpayer to sue for a refund of an entire assessment after paying the entire assessment, where there were also other assessments outstanding. Id. at 884 (“Although payment under protest and claim of refund seems to be the only manner in which an employment unit could institute a court action as to the legality of an assessment[,] respondents do not indicate any provision of the statute which prevents the application of such procedure to one separate assessment only.”) (citations omitted)). The later California case cited by AOL describes Kunz as involving the refund of a reporting period despite multiple assessments being outstanding. App. Br. at 13 (citing Masi v. Nagle, 5 Cal. App. 4th 608, 7 Cal. Rptr. 2d 423 (1992)). The Masi court did not claim that the reporting period was covered by any of the outstanding assessments and noted that the Kunz court did not consider whether the total liability was one assessment. 5 Cal. App. 4th at 613. The Kunz case is therefore entirely consistent with RCW 82.32.150’s requirement that an assessment be paid in full before suing in superior court for a time period covered by the assessment.

As the Kunz and Masi cases also make clear, the statute at issue in those cases required exhaustion of administrative remedies. The court therefore did not address the concerns raised in Flora about preserving the legislative scheme of alternative avenues of relief. As explained above, requiring administrative review would also alleviate the possibility of a taxpayer filing an amended return on an existing assessment in order to avoid the consequences of the assessment, since the amended return would also have to go through administrative review. Accordingly, court interpretations of California's Unemployment Insurance Code, even if their holdings are accurately set forth by AOL, are unhelpful in this case.

**B. AOL Must Comply With RCW 82.32.150 To Maintain Its Tax Refund Lawsuit**

The statutory prerequisites for filing a tax refund lawsuit must be fully met before a tax refund lawsuit may be brought in superior court. RCW 82.32.150, .180; Lacey Nursing Center, Inc. v. Dep't of Revenue, 128 Wn.2d 40, 49-50, 905 P.2d 338 (1995). The plain language of the statute dictates full compliance, not compliance with the "spirit" of the statute, as AOL argues. Even if the statute left any room for doubt, the Washington Supreme Court has stated: "The right to bring excise tax refund suits against the state must be exercised in the manner provided by statute." Lacey Nursing Center, 128 Wn.2d at 52. As noted above, Lacey

Nursing Center held that RCW 82.32.180 should be strictly applied before a taxpayer can maintain a tax refund lawsuit. Id. at 49-52. For over 70 years, other Washington cases have applied and upheld the requirement under RCW 82.32.150 that a taxpayer pay all of a tax before seeking a refund of all or part of the tax. See Kirkland, 45 Wn. App. at 723-24; Shutt v. Moore, 26 Wn. App. 450, 456 n.4, 613 P.2d 1188 (1980); Weber v. School Dist. No. 7 of Yakima County, 185 Wash. 697, 703, 56 P.2d 707 (1936).

Nevertheless, AOL asserts that it need only comply with the “spirit” of the statute, arguing that article IV, section 6 of the Washington Constitution controls.<sup>16</sup> App. Br. at 18. AOL ignores article II, section 26 of the Washington constitution: “The legislature shall direct by law, in what manner, and in what courts, suits may be brought against the state.” This constitutional provision was the basis for the Washington Supreme Court’s reasoning in Lacey Nursing. 128 Wn.2d at 52. The plain meaning of the statute and unequivocal caselaw dictate that AOL comply fully with the requirements of RCW 82.32.150.

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<sup>16</sup> Although the Department entitled its motion to dismiss as one for lack of subject matter jurisdiction, the trial court’s ruling did not specify this as the reason for dismissal. See RP 6-7 (Department noting that even if issue not considered one of subject matter jurisdiction, AOL’s lawsuit should be dismissed for failing to satisfy RCW 82.32.150). Whether RCW 82.32.150 relates to subject matter jurisdiction or is otherwise a statutory prerequisite for filing a lawsuit may be an interesting academic debate, but the outcome in the present case is clear: if AOL has not satisfied RCW 82.32.150 and .180, the case must be dismissed.

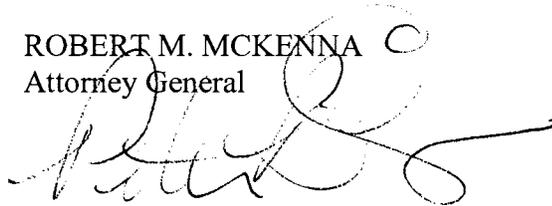
Even if AOL were required to satisfy only the “spirit” of the tax refund statutes, the Department respectfully submits that paying only 1.7% of an assessment before bringing a lawsuit, while simultaneously pursuing administrative appeals, is exactly the opposite of complying with the spirit of RCW 82.32.150. Simply put, AOL is attempting to create a loophole in Washington’s prepayment requirement. Thus, the Department respectfully requests that the trial court decision be affirmed.

## VI. CONCLUSION

Washington’s statutory taxing scheme and case law establish that when an assessment has been issued, a taxpayer must pay the entire assessment, which includes interest and penalties, in order to bring a tax refund lawsuit for any part of the assessment. We respectfully submit that the Court should uphold this long-standing principle and affirm the trial court’s dismissal without prejudice of AOL’s lawsuit.

RESPECTFULLY SUBMITTED this 16th day of June, 2008.

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NO. 37353-0-II

**COURT OF APPEALS, DIVISION II  
OF THE STATE OF WASHINGTON**

AOL, LLC, f/k/a AMERICA ONLINE,  
INC.,

Appellant,

v.

WASHINGTON STATE  
DEPARTMENT OF REVENUE,

Respondent.

FILED  
COURT OF APPEALS  
DIVISION II  
08 JUN 16 PM 4:25  
STATE OF WASHINGTON  
BY SMX  
DEPUTY

DECLARATION OF  
MAILING

Jessica Pagnotta, states and declares as follows:

I am a citizen of the United States of America and over 18 years of age and I am competent to testify to the matters set forth herein. On June 16, 2008, I provided a true and correct copy of the Brief of Respondent and of this Declaration of Mailing to be sent electronically via email to SEdwards@perkinscoie.com and GBarton@perkinscoie.com, and by U.S. Mail, postage prepaid via Consolidated Mail Service, to:

Scott M. Edwards  
Gregg D. Barton  
Perkins Coie  
1201 Third Avenue Suite 4800  
Seattle, WA 98101-3099

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<sup>1</sup>  
**ORIGINAL**

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

Executed this 16<sup>th</sup> day of June, 2008, in Tumwater, Washington.

  
\_\_\_\_\_  
JESSICA PAGNOTTA  
Office Assistant