

NO. 39487-1-II

COURT OF APPEALS
FOR THE STATE OF WASHINGTON
DIVISION II

ST. JOSEPH GENERAL HOSPITAL,

Appellant,

vs.

STATE OF WASHINGTON
DEPARTMENT OF REVENUE,

Respondent.

APPELLANT'S REPLY BRIEF

Carla M. DewBerry, WSBA #15746
Roger L. Hillman, WSBA #18643
Jamal N. Whitehead, WSBA #39818
GARVEY SCHUBERT BARER
Attorneys for Appellant

Eighteenth Floor
1191 Second Avenue
Seattle, Washington 98101-2939
(206) 464-3939

TABLE OF CONTENTS

	<u>Page</u>
I. INTRODUCTION.....	1
II. ARGUMENT	3
A. <u>Standard of Review</u>	3
B. <u>Medicare is Responsible for Paying Medicare Covered Charges</u>	3
C. <u>The Court Must Discern Legislative Intent From the Plain Language of RCW 82.04.4297 Because the Statute is Unambiguous</u>	5
1. <i>Dictionary definitions are used in their first and primary sense</i>	5
D. <u>Only If the Court Finds RCW 82.04.4297 Ambiguous Should It Resort to Means Beyond the Plain Language of the Statute to Determine Legislative Intent</u>	7
1. <i>The definition of “instrumentality” used in cases involving tax immunities rooted in the federal Constitution does not apply in circumstances concerning state tax deductions</i>	7
2. <i>The definition advocated for by the department would render other terms within RCW 82.04.4297 superfluous</i>	9
3. <i>The legislative history of RCW 82.04.4297 supports a more expansive reading of the term “instrumentality”</i>	10
4. <i>Subsequent amendments to RCW 82.04.4297 further define what constitutes an “instrumentality”</i>	11

5.	<i>A more expansive reading of the term “instrumentality” will not upset the larger statutory scheme and lead to absurd results</i>	14
E.	<u>Money Collected by St. Joseph on Behalf of Independent Third Party Service Providers is Not Subject to the B&O Tax.</u>	15
1.	<i>Money collected by St. Joseph for services performed by a third party is not the gross income of St. Joseph</i>	16
2.	<i>Even if the Court considers factors beyond who performed the emergency-room services, the revenue still cannot be considered part of St. Joseph’s gross income.</i>	19
F.	<u>The Department’s Pyramid Argument is a Reformulation of the “Cost of Business” Argument, Which this Court has Rejected in this Context</u>	21
G.	<u>St. Joseph is Entitled to an Award of Fees and Costs</u>	22
III.	CONCLUSION.....	23

TABLE OF AUTHORITIES

	<u>Page</u>
 <u>CASES</u>	
<u>City of Spokane ex rel. Wastewater Mgmt. Dep't v. State Dep't of Revenue</u> , 145 Wn.2d 445, 38 P.3d 1010 (2002)	3
<u>City of Tacoma v. William Rogers Co., Inc.</u> , 148 Wn.2d 169, 60 P.3d 79 (2003)	16, 17, 19
<u>Hallauer v. Spectrum Prop., Inc.</u> , 143 Wn.2d 126, 18 P.3d 540 (2001)	15
<u>Heinmiller v. State Dep't of Health</u> , 127 Wn.2d 595, 903 P.2d 433 (1995)	3
<u>Homestreet, Inc. v. State Dep't of Revenue</u> , 166 Wn.2d 444, 210 P.3d 297 (2009)	1, 5, 11
<u>In re Detention of Martin</u> , 163 Wn.2d 501, 182 P.3d 951 (2008)	5
<u>In re Marriage of Barber</u> , 106 Wn. App. 390, 23 P.3d 1106 (2001)	9
<u>Irwin Memorial Blood Bank v. American Nat'l Red Cross</u> , 640 F.2d 1051 (9 th Cir. 1981)	9
<u>McAvoy v. Weber</u> , 198 Wash. 370, 88 P.2d 448 (1939)	9
<u>McCulloch v. Maryland</u> , 17 U.S. 316 (1819)	7
<u>Rho Co., Inc. v. Dep't of Revenue</u> , 113 Wn.2d 561, 782 P.2d 986 (1989)	19
<u>State ex rel. Evergreen Freedom Foundation v. Wash. Educ. Ass'n</u> , 140 Wn.2d 615, 999 P.2d 602 (2000)	11
<u>State ex rel. Macri v. City of Bremerton</u> , 8 Wn.2d 93, 111 P.2d 612 (1941)	23
<u>State v. Roggenkamp</u> , 153 Wn.2d 614, 106 P.3d 196 (2005)	10
<u>State v. Sullivan</u> , 143 Wn.2d 162, 19 P.3d 1012 (2001)	1
<u>Tunstall ex rel. Tunstall v. Bergeson</u> , 141 Wn.2d 201, 5 P.3d 691 (2000)	15

<u>United Parcel Serv., Inc. v. Dep't of Revenue</u> , 102 Wn.2d 355, 687 P.2d 186 (1984)	9
<u>United States v. City of Spokane</u> , 918 F.2d 84 (9 th Cir. 1990)	8, 9
<u>Walthew v. Dep't of Revenue</u> , 103 Wn.2d 183, 691 P.2d 559 (1984)	17, 21, 22
<u>Walter v. Everett Sch. Dist. No. 24</u> , 195 Wash. 45, 48, 79 P.2d 689 (1938)	19
<u>Wash. Imaging Serv., LLC v. State Dep't of Revenue</u> , __ P.3d __, 2009 WL 4815583 (2009)	2, 3, 16, 18, 19, 22

STATUTES

RCW 34.05.570(3)(d)	3
RCW 4.84.030	23
RCW 82.04.080	17
RCW 82.04.090	17
RCW 82.04.4297	1, 2, 4, 5, 6, 7, 10, 11, 12, 13, 14, 15
RCW 82.04.4311	13, 14, 15

OTHER AUTHORITIES

Washington Appellate Practice Deskbook § 19.7(12) (Wash. State Bar Assoc. 3d ed. 2005)	22
Final Bill Report, Substitute H.B. 302	10
Laws of 2001, 2 nd Spec. Sess., Ch. 23, § 1	12
Laws of 2002, ch. 314, § 2	13
Webster's Third New International Dictionary 1172 (1981)	6

RULES

RAP 14.3	23
RAP 18.1	23

REGULATIONS

WAC 458-20-111.....2, 3, 15, 16, 17, 18, 19

APPENDICES

Appendix 1A-1

I. INTRODUCTION

Not surprisingly, the parties disagree over how the Court should approach the main issues presented on appeal. Each issue, however, can be distilled into a few discrete legal questions. In the case of the Medicare revenue, the Court must decide whether the plain-language meaning of the term “instrumentality” will control in the absence of ambiguity and a statutory definition and whether Medicare patients and Medigap insurers are in fact instruments of the government within the meaning of RCW 82.04.4297’s deduction.

The answer to this first question is plain given that the parties agree that the term is unambiguous and the general rule that absent ambiguity and a statutory definition, a court will apply a dictionary one. Respondent’s Brief at 13. Homestreet, Inc. v. State Dep’t. of Revenue, 166 Wn.2d 444, 451, 210 P.3d 297 (2009); see also State v. Sullivan, 143 Wn.2d 162, 175, 19 P.3d 1012 (2001) (“In the absence of a statutory definition, [a court] will give the term its plain and ordinary meaning ascertained from a standard dictionary.”). Under its plain and ordinary dictionary meaning, an “instrumentality” is a person or an entity used to accomplish the ends of another. Here, Medicare copayments and deductibles along with payments from Medigap insurers are the government’s means—or instrumentality—used to compensate

St. Joseph for a portion of the health and social welfare services it renders to Medicare patients.¹

Accordingly, RCW 82.04.4297 permits St. Joseph to deduct monies received from Medicare patients and Medigap insurers from its gross income subject to the B&O tax as they are acting as instrumentalities of the federal government when paying St. Joseph for rendering Medicare services.

The second issue concerning emergency-room revenue boils down to whether funds paid to St. Joseph, and then passed along to independent emergency-room physicians as payment for rendering services to patients, meet the statutory definition of “gross revenue.” And if not, whether these funds are even subject to the B&O tax in light of the Rule 111 pass-through test.

This Court recently considered this very question in Wash. Imaging Serv., LLC v. State Dep’t of Revenue, ___ P.3d ___, 2009 WL 4815583 (2009) (publication order on December 15, 2009), and held that funds passed along to the actual renderer of a service were not the gross income of the taxpayer passing along the payment and, hence, not subject to the B&O tax in the intermediary’s hands. The income was taxable in the hands of the service provider. The Court need not reach the question of whether such funds

¹ In its opening brief, St. Joseph details the ways in which Medicare uses patient copayments and deductibles and payments from Medigap insurers to reimburse Island for services rendered to Medicare patients.

constitute pass-through payments under Rule 111 if the funds are not considered “gross income” in the first instance.

Consistent with this Court’s decision in Wash. Imaging Serv., the funds passed along by St. Joseph to ER Physicians for rendering their professional medical services are not part of the Hospital’s gross income; consequently, the B&O tax does not apply and Rule 111 does not hold sway.

II. ARGUMENT

A. Standard of Review.

In as much as this appeal concerns only questions of law and statutory interpretation, the lower court’s conclusions are subject to de novo review. City of Spokane ex rel. Wastewater Mgmt. Dep’t v. State Dep’t of Revenue, 145 Wn.2d 445, 451, 38 P.3d 1010 (2002). The Board of Tax Appeals did not enter findings of fact, so the “substantial evidence” standard does not apply on appellate review. Heinmiller v. State Dep’t of Health, 127 Wn.2d 595, 609-10, 903 P.2d 433 (1995). Instead, this Court must grant relief from the BTA’s order if it finds the agency erroneously interpreted or applied the law. Wastewater Mgmt. Dep’t, 145 Wn.2d at 451; RCW 34.05.570(3)(d).

B. Medicare is Responsible for Paying Medicare Covered Charges.

The Department characterizes the Medicare system as one in which Medicare is actually paying for services. In reality, private insurance

companies and patients make interim payments as instrumentalities of the Medicare program, subject to a year-end true-up process conducted by a third-party actor.

To be sure, Medicare is contractually bound to pay St. Joseph for its costs incurred in caring for Medicare patients; however, Medicare relies on third parties to administer the Medicare program and to make Medicare payments. Medicare compensation is complex and the law establishes various ways in which Medigap insurers and Medicare patients are integrated into the Medicare-coverage system. For example, Medicare patients can enroll in a Medicare HMO or a competitive health plan, in which the HMO/insurance plan makes payments for services rendered to the Medicare patient (the Department concedes that such payments are not taxable). In this way, the government relies on a series of third parties acting between the government and healthcare providers to pay St. Joseph.

The Department claims that St. Joseph's argument concerning third parties as Medicare instrumentalities is ridiculous because, by analogy, all highly-regulated entities would then be government agents. However, it is not the fact that these third-party actors operate in a highly regulated environment that makes them instrumentalities of the government. It is the fact that they discharge a governmental function that defines them as instrumentalities of the government within the meaning of RCW 82.04.4297.

C. **The Court Must Discern Legislative Intent From the Plain Language of RCW 82.04.4297 Because the Statute is Unambiguous.**

It is axiomatic that “where statutory language is plain and unambiguous, courts will not construe the statute but will glean the legislative intent from the words of the statute itself, regardless of contrary interpretation by an administrative agency.” Homestreet, 166 Wn.2d at 451-52. This is true even where the court believes the legislature intended something else but failed to express it adequately. Id. at 455; see also In re Detention of Martin, 163 Wn.2d 501, 509, 182 P.3d 951 (2008).

The parties agree that RCW 82.04.4297 is unambiguous (see Respondent’s Brief at 13), but rather than confront the ordinary dictionary meaning of “instrumentality,” the Department ignores the dictionary definition of the term and instead resorts to tools of statutory construction and interpretation, which are used only when a statute’s meaning is ambiguous. The Court should not consider legislative history or other tools of statutory construction because the scope of the deduction is best discerned from its plain language and a dictionary.

1. Dictionary definitions are used in their first and primary sense.

A single term often describes a number of similar, yet distinguishable, situations. Such is true of the term “instrumentality.” Each dictionary definition cited by Appellant and Respondent define an instrumentality as an

entity acting as an intermediary. Each dictionary definition also defines instrumentality to include an entity which is a functional part of another entity. The Department argues that only the second type of instrumentality is contemplated by RCW 82.04.4297, there is no authority supporting the notion that a court should resort exclusively to a secondary or subsidiary meaning for a term while ignoring the first and most accepted entry found in the dictionary.

As St. Joseph indicates, the word “intermediary” is included in the first entry for the “instrumentality” found in each respective dictionary, save for the definition found in Webster’s Third New International Dictionary. The first entry found in Webster’s, however, only strengthens St. Joseph’s argument. Under Webster’s, instrumentality in its first sense means “the quality or state of being instrumental: a condition of serving as an intermediary, the agreement was reached through the [instrumentality] of the governor.” Webster’s Third New International Dictionary 1172 (1981). Although Medigap insurers and Medicare patients are clearly instrumental to the adjudication of Medicare claims, Medicare bears ultimate responsibility for compensating St. Joseph for healthcare services rendered to Medicare patients. Medicare uses Medicare beneficiaries and Medigap insurers as instrumentalities (*i.e.*, intermediaries) to accomplish this end.

The court should decline the Department's invitation to bypass the clear and logical application of the primary definition of "instrumentality" in favor of its second, third, or fourth meaning.

D. Only If the Court Finds RCW 82.04.4297 Ambiguous Should It Resort to Means Beyond the Plain Language of the Statute to Determine Legislative Intent.

Because RCW 82.04.4297 is clear on its face, the Court need not adopt the definition of "instrumentality" found in inapposite case law or the one cobbled together by the Department from the legislative history or the structure of the statute's chapter.

Even if the statute were ambiguous, however, the legislative history of the deduction, subsequent amendments thereto, and the rules of construction all favor St. Joseph's definition of the term "instrumentality." In the event that the Court looks past the language of the statute, it will find little support for the Department's contentions.

1. The definition of "instrumentality" used in cases involving tax immunities rooted in the federal Constitution does not apply in circumstances concerning state tax deductions.

The question of whether Medicare patients and Medigap insurers are performing sufficient secondary or derivative government functions to insulate money paid to the Hospital from state taxation under McCulloch v. Maryland, 17 U.S. 316 (1819), is a far different question from whether these entities are making payments to St. Joseph as instrumentalities of the

government within the meaning of a specific Washington tax statute. Yet the Department ignores this distinction in its discussion of inapposite case law, which addresses the power of the States to tax the federal government.

For instance, in the primary case cited by the Department, United States v. City of Spokane, 918 F.2d 84 (9th Cir. 1990), the Ninth Circuit frames the issue presented as whether the Red Cross, a private entity, is sufficiently aligned with the federal government so as to become an instrumentality thereof fully immune under the federal Constitution from state taxation. The Court held that the Red Cross was an “instrumentality” of the federal government for purposes of evaluating whether the state could tax monies raised by the Red Cross in the first instance.

The definition used by the Ninth Circuit to assess the Red Cross’s tax immunity, however, cannot be ported over to this dispute because this case does not concern constitutional limits on state taxation; rather, it concerns whether the Washington Legislature carved out a specific tax deduction for monies received from persons or entities acting in place of the government. Indeed, the Ninth Circuit explicitly rejected the argument that the meaning of “instrumentality” for intergovernmental tax immunity purposes could be equated to the meaning of a government “instrumentality” in other contexts. Id. at 88. As the court explained, it is a “fallacy that a word which has a meaning in one context must have the selfsame meaning when transplanted to an entirely different context.” Id.

The legal effect of the word “instrumentality” varies depending on the context in which it has been examined. Compare City of Spokane, 918 F.2d 84 (holding that the Red Cross is a government instrumentality immune from local taxation), with Irwin Memorial Blood Bank v. American Nat’l Red Cross, 640 F.2d 1051 (9th Cir. 1981) (holding that the Red Cross is *not* a government instrumentality for purposes of the Freedom of Information Act). Since the question at bar is whether Washington created by legislative action a tax deduction for certain monies received by the Hospital,² the language of the statute must control the scope of the deduction, not the case law cited by the Department.

2. *The definition advocated for by the department would render other terms within RCW 82.04.4297 superfluous.*

The Legislature is presumed not to have used superfluous words and courts “are bound to accord meaning, if possible, to every word in a statute.” In re Marriage of Barber, 106 Wn. App. 390, 394-395, 23 P.3d 1106 (2001). “Statutes are to be construed, wherever possible, so that no clause, sentence or word shall be superfluous, void, or insignificant.” United Parcel Serv., Inc. v. Dep’t of Revenue, 102 Wn.2d 355, 361, 687 P.2d 186 (1984). Courts

² The Department’s discussion of McAvoy v. Weber, 198 Wash. 370, 88 P.2d 448 (1939)—the only Washington authority cited by the Department on this score—is similarly distinguishable. In McAvoy, the court considered the term instrumentality in the context of private citizens suing out a writ of garnishment against a government-owned corporation, not whether the corporation was an instrumentality within the meaning of a specific statute-based tax deduction.

may not rewrite or delete the plain language of an unambiguous statute.

State v. Roggenkamp, 153 Wn.2d 614, 632, 106 P.3d 196 (2005).

RCW 82.04.4297 carves out a deduction from the B&O tax for monies received from the “United States or any instrumentality thereof,” but the deduction also extends to amounts received from the “state of Washington or any ... political subdivision thereof.” The Legislature’s choice to refer to both government instrumentalities and political subdivisions (within the same statute) was deliberate and meaningful, and clearly establishes that these terms have separate meaning.

Placed in the context of the current dispute, it becomes clear that the Legislature intended the scope of the deduction to extend beyond monies received from political subdivisions and to include payments from those entities acting in the government’s stead.

3. The legislative history of RCW 82.04.4297 supports a more expansive reading of the term “instrumentality.”

The plain language of RCW 82.04.4297 proves that the Legislature intended a more expansive reading of the term than what was suggested by the Department. The only legislative history cited by the Department concerning the creation of the deduction is the 1979 Session Law and the Final Bill Report accompanying the legislation. Respondent’s Brief at 14-15. The Bill Report described the new deduction as one for “[a]mounts received from the United States or any governmental unit...” Final Bill Report,

Substitute H.B. 302. From this language, the Department concludes that “the deduction applies only to governmental payments.” Respondent’s Brief at 19. The final version of the law ultimately passed by the Legislature, however, provided that the deduction applies to amounts received from the United States or any instrumentality thereof or from the State of Washington or any Municipal corporation or political subdivision. Thus, the statute allows a deduction for not only payments received from governmental units, but payments from instrumentalities or intermediaries thereof as well.

The Department would render the difference between the Bill and the plain language of the statute meaningless, but “[w]hen words in a statute are plain and unambiguous, this Court is required to assume the Legislature meant what it said and apply the statute as written.” State ex rel. Evergreen Freedom Found. v. Wash. Educ. Ass’n, 140 Wn.2d 615, 631, 999 P.2d 602 (2000); Homestreet, 166 Wn.2d at 452. Here, the Legislature clearly and unambiguously included payments from the U.S. government and instrumentalities thereof, and not merely payments from governmental units, in the plain language of the statute. Thus, the language as written is the beginning and end of the Legislature’s intent.

4. *Subsequent amendments to RCW 82.04.4297 further define what constitutes an “instrumentality.”*

In 2001, the Legislature took the unusual step of codifying in RCW 82.04.4297 an explanation of what the section always meant. The 2001

legislation makes plain that the deduction under RCW 82.04.4297 always applied to monies received from the government and from entities or persons making payment on the government's behalf as instrumentalities thereof. See Appendix 1 (Timeline of Amendments to RCW 82.04.4297). The 2001 amendment added language to RCW 82.04.4297 to clarify that amounts received from the U.S. government included "amounts received from" managed-care organizations or other entities under contract to manage healthcare benefits under the Medicare statute. The Legislature added an explanation of the meaning of RCW 82.04.4297; the clarifying language was as follows:

The legislature finds that the deduction under the business and occupation tax statutes for compensation from public entities for health or social welfare services was intended to provide government with greater purchasing power when government provides financial support for the provision of health or social welfare services to benefited classes of persons.

The legislature further finds that the objective of these changes is again to extend the purchasing power of scarce government health care resources, but that this objective would be thwarted to a significant degree if the business and occupation tax deduction were lost by health or social welfare organizations solely on account of their participation in managed care for government-funded health programs. In keeping with the original purpose of the health or social welfare deduction, it is desirable to ensure that compensation received from government sources through contractual managed care programs also be deductible.

Laws of 2001, 2nd Spec. Sess., Ch. 23, § 1 (emphasis added).

A subsequent amendment followed in 2002, eliminating a deduction for Medicare deductibles and copayments received from patients, but allowing a retroactive refund back to 1998 for amounts received “as compensation for healthcare services covered under the federal Medicare program.” Laws of 2002, Ch. 314, § 2 (codified at RCW 82.04.4311). The Legislature stated that this retroactive amendment was necessary to put to rest the dispute between hospitals and the Department, explaining that “it would be inconsistent with the government function [of providing subsidized healthcare benefits because of age, disability or lack of income] to tax amounts received by a . . . nonprofit hospital . . . when the amounts are paid under a health service program subsidized by federal or state government. Further, the tax status of these amounts should not depend on whether the amounts are received directly from the qualifying program or through a managed care organization.” *Id.*

In these subsequent changes to RCW 82.04.4297, the Legislature has clearly stated that (1) the purpose of the deduction under RCW 82.04.4297 has always been to provide the government with greater purchasing power of health or social welfare services, and (2) the Legislature intended for the deduction to extend to all monies received under a health plan for the aged, sick, or poor (such as Medicare) even if the government only subsidizes the plan and does not pay 100-percent of the plan’s costs.

The Department places great import upon the 2002 enactment of RCW 82.04.4311, which beginning in 2002, excluded from tax-deductible income amounts received from patients as copayments and deductibles. While it is true that patient copayments and deductibles ceased to be deductible beginning in 2002, the change did not take effect until after the tax period in dispute here.

Moreover, the Department's argument on this score is logically inconsistent. It asks on the one hand, "why would the Legislature amend RCW 82.04.4297 in 2001 to include a deduction for Medicare payments received from government intermediaries if that right already existed?" While on the other hand, it asks us not to consider why the Legislature would have removed a deduction for patient copayments and deductibles if that deduction did not already exist. These competing arguments cannot be reconciled under the Department's theories concerning the recent amendments to RCW 82.04.4297.

5. *A more expansive reading of the term "instrumentality" will not upset the larger statutory scheme and lead to absurd results.*

The Department's concern about absurd results is overblown. First, the notion that the Legislature created two separate statutory deductions dealing with Medicare copayments and deductibles paid by patients is not so "absurd" as to warrant rewriting the words of the statute and ignoring the plain language as written.

Second, to the extent that a conflict exists between RCWs 82.04.4297 and .4311, the Court has developed additional cannon's of construction to deal with the wording found in competing statutes. See, e.g., Tunstall ex rel. Tunstall v. Bergeson, 141 Wn.2d 201, 211, 5 P.3d 691 (2000) (“Another well-established principle of statutory construction provides that apparently conflicting statutes must be reconciled to give effect to each of them.”); Hallauer v. Spectrum Prop., Inc., 143 Wn.2d 126, 146, 18 P.3d 540 (2001) (“If the statutes irreconcilably conflict, the more specific statute will prevail, unless there is legislative intent that the more general statute controls.”). Thus, despite the Department's argument, taxpayers and the Department are not lost if the statutes are somehow deemed “incongruous” as the Department argues.

Finally, since the limits found in RCW 82.04.4311's did not take effect until after the tax period in question, the conflict with RCW 82.04.4297 described by the Department was not yet ripe and could not possibly lead to an absurd result when .4297 was the only statute in effect.

E. Money Collected by St. Joseph on behalf of Independent Third Party Service Providers is Not Subject to the B&O Tax.

At the onset, the Court must first consider whether money collected by St. Joseph for services rendered by independent third parties constitutes “gross income” before addressing whether that income is exempt as Rule 111

“pass-through” payments. The Department overlooks this threshold issue and urges the Court to fast-forward with its analysis, but if the money in question does not even constitute gross income, the court need not consider the exemption because the money is not subject to the B&O tax in the first instance. Wash. Imaging Serv., LLC v. State Dep’t of Revenue, ___ P.3d ___, 2009 WL 4815583, 7 n. 4 (2009) (publication order December 15, 2009) (“Because we have determined that the funds that [the taxpayer] forwards to [a third party service provider] do not constitute gross income, we need not address whether these payments constitute pass-through payments under Rule 111.”); see also City of Tacoma v. William Rogers Co., Inc., 148 Wn.2d 169, 184, 60 P.3d 79 (2003) (Sanders, J., dissenting).

1. Money collected by St. Joseph for services performed by a third party is not the gross income of St. Joseph.

Over the past 30 years, Washington courts have been consistent in their decisions concerning whether money received by a taxpayer for services rendered by a third party to the taxpayer’s customers are considered the gross income of the taxpayer. The majority of the seven published cases that have dealt with the issue have addressed it in the context of Rule 111, but the analysis in two cases and the dissent within a third, do not apply the Rule 111 exemption or discount the importance of its agency and liability focus when answering the gross-income question. These non-Rule 111 cases are not a genus apart from the others, but rather recognize that the exemption analysis

is mooted if the funds in question are not the gross income of the taxpayer to begin with.

In the first case, Walthew v. Dep't of Revenue, 103 Wn.2d 183, 691 P.2d 559 (1984), the Washington Supreme Court compared Rule 111's agency and liability requirements to RCW 82.04.080 (the statute defining "gross income"), and held that "[n]othing in [RCW 82.04.080] refers to exceptions on the basis of agency and liability." 103 Wn.2d at 187-88. The court continued, "[t]he obvious intent [is] to tax only gross income which is 'compensation for the rendition of services' (RCW 82.04.080) or 'consideration ... actually received or accrued' (RCW 82.04.090)." Id. at 188. Thus, the court did address the issue of whether the funds constituted "gross income" within the meaning of RCW 82.04.080. The court recognized the baseline principle that "[c]ompensation or consideration for the service is thus the basis for the [B&O] tax." Id. at 187.

The dissent in William Rogers, reached a similar conclusion, explaining that the B&O tax may only be imposed on compensation or consideration received by the taxpayer for services rendered by the taxpayer. 148 Wn.2d at 185 (citing Walthew). Rule 111 and whether the taxpayer establishes an agency relationship pursuant to that rule is therefore relevant only in determining whether the taxpayer or some third party actually rendered the services for which compensation was received. Id. at 185-87.

Finally, in Wash. Imaging, this Court held that revenue collected by a taxpayer is not considered part of the taxpayer's gross income subject to the B&O tax if the money collected was not payment for services rendered by the taxpayer, and was instead forwarded on to those who actually rendered service. 2009 WL 4815583 at 7. The court did not apply Rule 111's tripartite test in deciding the issue of gross income. Id. at 7 n. 4.

Thus, as these cases make clear, the Department may only impose the B&O tax on compensation or consideration received and retained by St. Joseph for services rendered by St. Joseph. Id. It is clear that St. Joseph did not perform the services in question here because: (1) St. Joseph does not have a license to practice medicine, (2) St. Joseph contracted with ER Physicians for the sole purpose of obtaining emergency-room services for its patients, and (3) ER Physicians did, in fact, perform the emergency-room services for which compensation was received.³

Funds collected by St. Joseph for services rendered by ER Physicians are, for this reason, not properly included as St. Joseph's gross income and, hence, not subject to the B&O tax irrespective of whether they meet the test for pass-through payments under Rule 111.

³ St. Joseph retained nearly a third of the money it collected from patients receiving emergency-room services from ER Physicians as compensation for administrative support the Hospital provided to the emergency-room doctors. St. Joseph does not dispute that these funds are subject to the B&O tax.

2. *Even if the Court considers factors beyond who performed the emergency-room services, the revenue still cannot be considered part of St. Joseph's gross income.*

Even if the Court considers the agency and liability questions as the Department urges, it is clear that St. Joseph merely collects the emergency-room revenue and is liable to ER Physicians for payment solely as its agent. First, the contract between the parties appoints St. Joseph as the collection agent for ER Physicians. There is ample evidence to support a finding that an agency relationship exists. “The standard definition of agency should be used in analyzing Rule 111...” Rho Co., Inc. v. Dep’t of Revenue, 113 Wn.2d 561, 573, 782 P.2d 986 (1989) which is defined as follows:

“Agency is the relationship which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act.”

William Rogers, 148 Wn.2d at 190 (quoting Walter v. Everett Sch. Dist. No. 24, 195 Wash. 45, 48, 79 P.2d 689 (1938)).

In this case, the contract is the manifestation of St. Joseph’s consent to act as ER Physicians collection agent. In addition, St. Joseph acts at ER Physicians direction in as much as the Hospital bills and collects only the amounts billed by ER Physicians. Moreover, this Court has already held that a collection-agency relationship will suffice in analyzing the agency issue raised by “pass-through” payments. Wash. Imaging, 2009 WL 4815583 at

7 n.3 (“[S]ituations in which the taxpayer is the agent of the payee ... may also constitute pass-through payments.”).

As for compensation, the contract between the parties states as follows:

It is recognized that the intent of this Agreement is to provide compensation to [ER Physicians] at a level which is consistent with the Hospital’s collection of professional components charged by [ER Physicians] and which recognizes the administrative and clinical functions inherent in the Emergency Department Management.

BTA Doc. 411, ER Contract (¶ 6.4) (emphasis added). So while it is true that the money collected by St. Joseph and passed along to ER Physicians is compensation for services billed by ER Physicians, the amount paid is not divorced from the actual amounts received.

The Department makes it appear that St. Joseph pays ER Physicians a flat salary regardless of whether ER Physicians bills or performs services. This is not the case. St. Joseph collects funds from patients and passes them along to ER Physicians only to the extent that ER Physicians performs services and generates charges for the Hospital to collect.

Accordingly, the funds St. Joseph ultimately pays to ER Physicians for ER Physicians professional services are not costs to St. Joseph for services that St. Joseph renders; rather, these funds are used to pay for professional services rendered by ER Physicians, which the Hospital merely collects and passes through to the actual service provider.

F. **The Department's Pyramid Argument is a Reformulation of the "Cost of Business" Argument, Which this Court has Rejected in this Context.**

The Department argues that “[g]iven the pyramiding nature of the B&O tax, generally if the taxpayer bills a client and receives money for these services, the money should be included as gross income [of the taxpayer’s] regardless of the fact that the taxpayer may have to pay the third party for the services, because this is a cost to the taxpayer that cannot be deducted.” Respondent’s Brief at 28 (emphasis added). But this claim is nothing more than a return to the same tired “cost of doing business” argument that Washington courts have roundly rejected in cases where the taxpayer is unable to render the services for which compensation is received.

For example, in Walthew and Wash. Imaging Serv., the Department argued that businesses were subject to the B&O tax on services they did not provide if some third party rendered services that were otherwise “necessary to [the] business, not merely incidental costs.” Walthew, 103 Wn.2d at 187. The Department argued that these so-called “cost of doing business” expenses were taxable in part because “the nature of the tax on gross income is pyramidal with all costs accumulating.” Id.

The court in Walthew held flatly, “We disagree with the Department’s analysis,” explaining that the funds that flowed to the taxpayer to pay the costs of third parties who provided services necessary for the operation of the taxpayer’s business were not part of the taxpayer’s gross

income if the taxpayer could not provide the service and was liable for payment to the third party as its agent. 103 Wn.2d at 188-89; see Wash. Imaging, 2009 WL 4815583 at 6 (citing Waltheu).

Here, St. Joseph did not, nor could it, perform emergency-room physician services for its patients. As a matter of law, St. Joseph cannot be deemed to have rendered this service simply because it is one “necessary to its business” because the services were in fact performed by an independent third party, not St. Joseph. And since the Hospital does not retain compensation for these services—passing it along instead to the actual service provider—money collected for emergency-room services cannot be deemed part of the Hospital’s “gross income.”

In any event, the pyramid structure of the B&O tax has no application here because only one transaction involving two components occurred—St. Joseph collected payment and then passed a portion of the funds along to ER Physicians for the services it rendered to the patients. There simply is not a sequential set of transactions upon which to apply the tax pyramid as described by the Department.

G. St. Joseph is Entitled to an Award of Fees and Costs.

The argument for fees should be as succinct as possible, so that it does not detract from the underlying merits of the appeal. Washington Appellate Practice Deskbook § 19.7(12) (Wash. State Bar Assoc. 3d ed. 2005). RAP 18.1 requires that the party requesting fees “devote a section of

its opening brief to the request for the fees or expenses.” To the extent that the Court finds an award of fees is warranted, the procedural requirements of RAP 18.1 are met because St. Joseph included a request for fees in its opening brief.

As for the substantive claim of fees, RCW 4.84.030 entitles St. Joseph to its attorney fees as the prevailing party before the Superior Court, should this Court reverse the lower court’s order. As for St. Joseph’s fees on appeal, even in the absence of express statutory authority or contract, the Court may award fees on equitable grounds as it sees fit. See, e.g., State ex rel. Macri v. City of Bremerton, 8 Wn.2d 93, 111 P.2d 612 (1941).

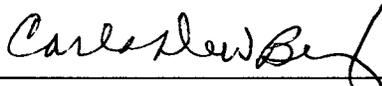
The Department concedes that if St. Joseph prevails on appeal, St. Joseph is entitled to appellate costs under RAP 14.3.

III. CONCLUSION

St. Joseph respectfully requests the Court to reverse the Board of Tax Appeals’ final decision, and the Superior Court order affirming that decision and remand for entry of judgment in St. Joseph’s favor for the refund sought plus pre-judgment interest, court costs, and applicable attorney’s fees, if any. St. Joseph also asks for an award of any applicable appellate costs and attorney’s fees under RAP 14.3 and RAP 18.1.

DATED this 31st day of January, 2010.

GARVEY SCHUBERT BARER

By 
Carla M. DewBerry, WSBA #15746
Roger L. Hillman, WSBA #18643
Jamal N. Whitehead, WSBA #39818
Attorneys for Appellant St. Joseph General
Hospital

CERTIFICATE OF SERVICE

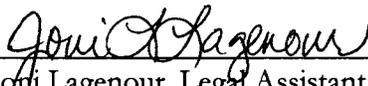
I, Joni Lagenour, certify under penalty of perjury under the laws of the State of Washington that I caused the original of the foregoing APPELLANT'S REPLY BRIEF to be filed with the Washington State Court of Appeals, Division Two, by U.S. Mail, on February 1, 2010, at the address listed below:

Clerk/Administrator
Washington State Court of Appeals,
Division Two
950 Broadway, Suite 300
Tacoma, WA 98402-4454

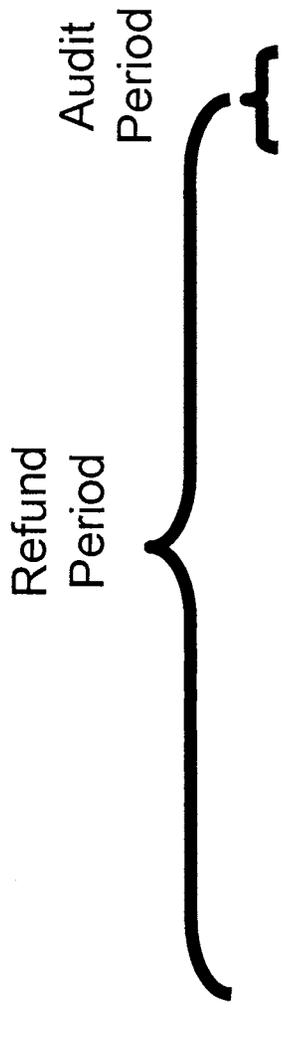
I further certify under penalty of perjury under the laws of the State of Washington that I caused a copy of the foregoing APPELLANT'S REPLY BRIEF to be served, via U.S. Mail and e-mail, on February 1, 2010, on the Attorneys for Respondent listed below:

Peter Gonick, AAG
David Hankins, AAG
AG Office – Revenue Division
7141 Cleanwater Drive S.W.
P.O. Box 40123
Olympia, WA 98504-0123
PeterG@ATG.WA.GOV
David.Hankins@atg.wa.gov

Dated at Seattle, Washington, this 1st day of February, 2010.



Joni Lagenour, Legal Assistant



1980

RCW 82.04.430(16) adopted.

Deduction allowed from payments from US or instrumentality

1988

RCW 82.04.430(16) recodified at .4297 and following added:

Deduction allowed from payments from US or instrumentality “. . . except deductions are not allowed under this section for amounts that are received under an employee benefit plan.”

1997

2000

2001

RCW .4297 amended by adding the following:

“For purposes of this section, ‘amounts received from’ includes amounts received . . . from a managed care organization or other entity that is under contract to manage health care benefits for the federal Medicare program . . . to the extent that these amounts are received as compensation for health care services within the scope of benefits covered by the pertinent government health care program.”

2002

RCW .4297 amended and .4311 adopted and refund/waiver established.

.4297 now provides – Deduction allowed for payments from US or instrumentalities . . . “except deductions are not allowed under this section for amounts that are received under an employee benefit plan.” (*Back to 1988.*)

.4311 now provides – Deduction allowed amounts received as “compensation for health care services covered under the federal Medicare program . . . The deduction authorized by this section does not apply to amounts received from patient copayments or patient deductibles.”

2006

Refund/waiver authorized from 1998 forward.