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COURT OF APPEALS, DIVISION II
OF THE STATE OF WASHINGTON

EXPRESS SCRIPTS, INC.,

Appellant,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE,

Respondent

ON APPEAL FROM THURSTON COUNTY SUPERIOR COURT
Honorable Mary Sue Wilson and Honorable Christopher Lanese

OPENING BRIEF OF EXPRESS SCRIPTS, INC.

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I. INTRODUCTION

The underlying facts in this appeal are generally not disputed. Based in St. Louis, Missouri, appellant Express Scripts, Inc. ("ESI") is a pharmacy benefit manager ("PBM"). Among other things, a PBM facilitates the sale of prescription drugs by third-party network pharmacies to members of its clients (e.g., health plans, employers, government health programs).

When an individual member of a client (or "plan sponsor") presents a prescription at a local (or mail order) pharmacy, ESI "adjudicates" the claim. As part of the adjudication, performed through its computer network located entirely outside Washington, ESI informs the pharmacy whether the prescription drug is part of the purchaser's plan, the amount to charge for the drug to be dispensed, and the amount of co-payment (if any) to be collected from the purchaser. Under its contract with ESI, the plan sponsor is liable to pay for the cost of all drugs purchased by members (minus the co-pay amount). After the drug is dispensed ESI bills the plan sponsor who pays ESI for the drugs dispensed during the billing period, plus any fees. ESI pays the pharmacies for the drugs that were purchased by the members, less any discounts or fees.[1] More than 95 percent of the funds received by ESI from plan sponsors represented the cost of the drugs that were passed through to the pharmacies. ESI makes its money by retaining the remaining five percent or less of the proceeds from the transaction, *i.e.*, the various fees and discounts, after the pharmacies are paid.

[1] In some cases ESI pays the pharmacies before receiving reimbursement from the plan sponsors.

The Supreme Court held in *Walthew, Warner, Keefe, Arron, Costello and Thompson v. Dep't of Revenue*, 103 Wn.2d 183, 187, 691 P.2d 559 (1984), that "the basis for the [B&O] tax" is the actual "compensation or consideration for the service." In an audit, the respondent Department of Revenue ("DOR") imposed tax on the entire amount ESI received from plan sponsors. But, ESI's actual "compensation or consideration for the service" consists of fees and discounts it receives from plan sponsors and pharmacies for administering the PBM programs, and for managing and processing the claims. The proper measure of B&O tax should exclude the funds paid for the drugs that merely passed through ESI on their way from the plan sponsors to the pharmacies.

The DOR's error is demonstrated by its treatment of credit card processors for B&O tax purposes. A credit card processor, similar to a PBM, provides credit card processing services to merchants (retailers), and banks that contract with merchants, to enable merchants to accept credit cards from customers and receive cash from their bank for the sales. Similar to PBMs, credit card processors charge fees for their services and take discounts for processing every transaction. Pursuant to instructions from DOR, credit card processors and the banks pay B&O tax only on the fees and discounts they receive for processing the transactions, and not on the funds that pass through from their customers to the merchants.

ESI is in the same position as the credit card processors and banks. PBMs sit between the employers (plan sponsors) and the pharmacies in the processing of prescription drugs purchases. Credit card processors and banks sit between customers and merchants in the processing of credit card transactions. PBMs agree to manage the approval of prescription drug sales. Credit card processors agree to approve the sale of goods made with the banks' credit cards presented by the bank's customers, and the banks agree to pay the merchant in cash for the sale.

After a member purchases a prescription drug from a pharmacy, the PBM bills the plan sponsor, collects the funds and pays the pharmacy for the drugs that were dispensed. Credit card processors and the banks do the same thing – they pay the merchants and bill and collect the amount for the goods from customers. Credit card processors and the banks pay B&O tax on the fees and discounts they receive, but ***not*** on the funds received to pay for the goods that were purchased by the customers. PBMs charge fees and discounts to the parties, and DOR requires them to pay B&O tax on these amounts ***plus*** the funds collected from plan sponsors to pay the pharmacies for the cost of the drugs. ***Why the difference?***

Given the stark inconsistency of these positions, DOR's only attempt to distinguish between the two is its remarkable claim—made entirely out of whole cloth—that credit card processing involves loans and PBMs do not. Because there is ***no difference as a matter of substanc****e* between a PBM and a credit card processor, ESI should be taxed the same as a credit card processor.[2]

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[2] Shortly after ESI filed its Notice of Appeal with this Court, DOR memorialized the taxation of credit card processors and merchant banks in a bulletin known as Excise Tax Advisory 3204.2017 (June 26, 2017) ("ETA 3204"). *See* Appendix A, attached. ETA 3204 is an "interpretative or policy statement" under RCW 34.05.230. ETA 3204 *[continued on next page]*

Second, even if ESI were taxable on all funds it received from plan sponsors, the Court must decide the proper tax *classification*. Gross income from services is taxed under the Service B&O tax classification (RCW 82.04.290). Gross income from sales of tangible personal property is taxed under the Wholesaling (RCW 82.04.270) or Retailing (RCW 82.04.250) B&O tax classification. If, as DOR asserts, ESI receives gross income from the cost of the drugs – indisputably tangible personal property and more than 95 percent of ESI's revenues – the more appropriate classification is Wholesaling or Retailing tangible personal property.

The third issue is whether the trial court properly invalidated DOR's 2006 amendment to WAC 458-20-194 ("Rule 194 (2006)") and, if so, to provide an appropriate *remedy* for the rule's invalidation. The trial court determined that Rule 194 (2006) was invalid because it exceeded statutory authority and was arbitrary and capricious, but purported to limit its conclusion to only certain portions of the rule. The court further found that the statutory reach of the B&O tax on service businesses like ESI applied to those businesses that had any "physical presence" in this state.

As far back as 1935 "foreign corporations" – those domiciled outside Washington – performing services and not maintaining a place of business in this state were ***not*** subject to B&O tax. *Id.* In other words, a "foreign" business may be "physically present" and "doing business" in

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confirms that merchant banks and credit card processors pay B&O tax only on the discounts and fees they receive from processing credit card transactions and the amounts merchants are paid in cash for the goods, which may flow through the credit card processors and/or merchant banks, are not taxable gross income of the merchant banks and credit card processors.

Washington, but if that physical presence did not include a place of business in this state, it owed no B&O tax.[3] Nevertheless, after invalidating Rule 194 (2006) the trial court went on to rule that ESI would be "immune" from B&O tax only if it "did not have any physical presence in Washington during the January 2007 through May 2010 period." CP 317 (Order). Again, the court erred. ESI was "immune" from taxation because it did not have a place of business in Washington, hence, ESI was entitled to relief from the tax.[4]

The trial court also erroneously ruled that only "parts" of Rule 194 (2006) were invalid – those that were "inconsistent with the statutory 'physical presence' requirement in the pre-2010 version of RCW 82.04.220." CP 317 (Order).[5] But the trial court never explained how it could achieve such a partial invalidation. The trial court properly found that Rule 194 (2006) exceeded statutory authority and was arbitrary and capricious, and under this rationale the entire rule was invalid. This Court should reverse the trial court's determination that only parts of the rule were invalid.

The final issue is the "estoppel issue." In the audit immediately preceding the period before this Court, DOR provided written instructions

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[3] Subsequent to 1935 the list of activities constituting "doing business" in Washington expanded, but there was no change to the rule that a foreign corporation without a place of business in Washington did not pay B&O on any part of income received for services incidentally rendered in Washington.

[4] The statute underlying Rule 194 – RCW 82.04.460 – was amended by the Legislature effective June 1, 2010. *See* 2010 1st sp.s. c 23 § 108. (A related statute (RCW 82.04.462) was enacted at the same time. *Id.* § 105.) The new and amended statutes made foreign corporations performing services in Washington subject to the B&O tax effective June 1, 2010.

[5] At the time of the 2010 amendments to RCW 82.04.460 the Legislature also amended RCW 82.04.220, which is the statute that imposes the B&O tax. The notes to RCW 82.04.220 also contain a statement of findings and legislative intent. 2010 1st sp.s. c 23 § 101.

to ESI that B&O tax was "not due upon any part of the gross income received for services incidentally rendered to persons in Washington by a person who is not domiciled or does not maintain a place of business in Washington." CP 619-620. In reliance on the written DOR instructions in the prior audit report ESI did not pay B&O tax on its PBM revenues until the B&O tax apportionment law changed on June 1, 2010.

Washington law provides two options for relief to a taxpayer like ESI. The first is common law or equitable estoppel.[6] The other option is grounded in the Washington Taxpayer Rights and Responsibilities Act (*see* RCW 82.32A.002 (known informally as the "Taxpayer Bill of Rights")) enacted in 1991 (c 142). Under the act, "taxpayers of the State of Washington have: . . . [t]he right to rely on specific, official written advice and written tax reporting instructions from the department of revenue to that taxpayer, and to have interest, penalties, and in some instances, tax deficiency assessments waived where the taxpayer has so relied to their proven detriment." RCW 82.32A.020(2) (1991 c 142 § 4).

ESI is entitled to relief under either common law or taxpayer bill of rights statutory estoppel for the audit period prior to the change in law effective June 1, 2010. The trial court ruled for DOR "on the estoppel

[6] A party asserting equitable estoppel against the government must satisfy the following elements: (1) an admission, statement, or act inconsistent with the claim afterwards asserted; (2) action by the other party on the faith of such admission, statement or act; (3) injury to such other party resulting from permitting the first party to contradict or repudiate such admission, statement or act; (4) the application of equitable estoppel is necessary to prevent a manifest injustice; and (5) the application of equitable estoppel would not impair the exercise of governmental functions. *Kramarevcky v. Dep't of Social and Health Services,* 122 Wn.2d 738, 743, 863 P.2d 535 (1993).

issues" (VRP (03/24/17) at 3, lines 14-15), but without offering one word of explanation.[7]

This Court should reverse the trial court "on the estoppel issues." Under common law estoppel, the entire assessment for the period January 1, 2007 through May 31, 2010 (prior to the change in the apportionment law) should be waived. Under RCW 82.32A.020(2) ESI is entitled to a waiver of ***at least*** the interest and penalties that were assessed for this same period under the plain and unambiguous language of the statute. Under the facts of this case, ESI is also entitled to a waiver of the tax itself.

ESI asks this Court to reverse the trial court and order DOR to refund the B&O taxes, interest and penalty ESI overpaid.

II. ASSIGNMENTS OF ERROR AND ISSUES ON APPEAL

A. Assignments of Error.

1. The trial court erred in entering DOR's Interlocutory Order Re APA Rule Challenge (CP 302-357) instead of ESI's Findings of Fact, Conclusions of Law and Order. CP 1396-1417.[8]

2. The trial court erred in concluding that prior to June 1, 2010, the "statutory reach of the B&O tax as applied to service businesses did not cover those businesses that had no physical presence in Washington." CP 310, ¶ 39.

3. The trial court erred by failing to recognize the "place of business" requirement for B&O taxation of service

[7] The record contains five Verbatim Reports of Proceedings ("VRP"), which will be distinguished from each other by reference to the date of proceeding. The above citation came from the transcript of proceedings on March 24, 2017.

[8] Proposed findings of fact, conclusions of law and orders do not become part of the official record in Thurston County Superior Court. A copy of the proposed Findings, Conclusions and Order filed by ESI were filed pursuant to a Notice of Filing on November 16, 2017 (CP 1396), and ESI is citing to the Clerk's Papers page numbers assigned to that Notice.

businesses in the pre-2010 versions of RCW 82.04.220. CP 312-313, ¶ 52.

4. The trial court erred when it found that the DOR "exceeded its statutory authority when it failed to include a 'physical presence' requirement in the 2006 version of Rule 194 consistent with the requirement . . . of the statute." CP 313, ¶ 54.

5. The trial court erred in failing to acknowledge that while the pre-2010 version of RCW 82.04.220 may have included a "physical presence" requirement, it also included a "place of business" requirement for service businesses. CP 314, ¶ 61.

6. The trial court's conclusion that "insufficient apportionment can offend due process and the dormant Commerce Clause" (CP 315, ¶ 1) was error because it was not supported in the record (CP 320-358).

7. The trial court erred when it concluded that at the time of the 2006 amendments to Rule 194 "the statutory reach of the B&O tax did not extend to out-of-state businesses that did not have a physical presence in Washington." CP 316, ¶ 3.

8. The trial court erred in concluding that there were aspects of Rule 194 (2006) that ESI did not challenge. CP 316, ¶ 4.

9. The trial court erred in concluding that (a) prior to the adoption of Rule 194 (2006) "a business that lacked any physical presence in Washington was not subject to the B&O tax under RCW 82.04.220" and (b) "[a]fter the 2006 amendment a business may have been subject to the tax . . . even though that person would not be subject to tax under the statutory 'physical presence' requirement." CP 316, ¶ 5.

10. The trial court erred in concluding that the pre-2010 statutes imposed B&O tax on all businesses having a physical presence in Washington. CP 316, ¶ 6.

11. The trial court erred in concluding that only portions of Rule 194 (2006) were invalid. CP 316, ¶¶ 6, 7.

12. The trial court erred in granting ESI's challenge to Rule 194 (2006) "only with respect to those parts of the Rule . . . that are inconsistent with the statutory 'physical presence' requirement implicitly included in the pre-2010 version of RCW 82.04.220." CP 317, lines 7-10.

13. The trial court erred in stating that "'[p]hysical presence' was a statutory requirement under RCW 82.04.220 prior to the 2010 amendment to that statute, and [ESI] will be immune from the Washington [B&O] tax during the tax periods at issue if it can show that it did not have any physical presence in Washington during that January 2007 through May 2010 tax period." CP 317, lines 10-14.

14. The trial court erred in its Letter Ruling of March 2, 2017, where it stated that prior to June 1, 2010, B&O taxation was based on a "physical presence" requirement. CP 722. The court further erred by ruling that, "As a matter of law, during the 2007 through 2010 audit period, Express Scripts had sufficient physical presence with Washington to be subject to tax under Former RCW 82.04.220." *Id.*

15. The trial court erred in entering the Order Granting Department of Revenue's Motion for Partial Summary Judgment Re Physical Presence. CP 723-724.

16. The trial court erred in finding in DOR's "favor on the estoppel issue." VRP (03/24/2017) at 3.

17. The trial court erred in finding in DOR's "favor on the service versus wholesaling [B&O tax classification] issue." VRP (03/24/2017) at 3.

18. The trial court erred in its Letter Ruling dated April 13, 2017, that ESI's business "activity does not satisfy the requirements for pass-through treatment." CP 981.

19. The trial court erred in the same Letter Ruling when it stated that, "The requirements for such treatment are those identified in *Washington Imaging LLC v. Department of Revenue*, 171 Wn.2d 548, 252 P.3d 885 (2011), *William*

Rogers v. City of Tacoma, 148 Wn.2d 169, 60 P.3d 79 (2003), and WAC 458-20-111 (Rule 111)." CP 981.

20. The trial court erred by stating in the same Letter Ruling that, "*First American Title Ins. Co. v. Department of Revenue*, 144 Wn.2d 300, 27 P.3d 604 (2001), does not apply in this case, as First American concerned the 'unique commercial relationship involved in the title insurance business' that is expressly recognized by the applicable statutory scheme" (*id.* at 304 (citing RCW 82.04.050(3)(b)) and that "[t]here is no such unique relationship, recognized by law, in this case." CP 981-982.

21. The trial court erred in granting DOR's motions for summary judgment in its entirety. CP 982.

22. The trial court erred in entering the Order Granting Department of Revenue's Motion for Summary Judgment in Its Entirety. CP 983-985.

23. The trial court erred in dismissing ESI's complaint. CP 985.

B. Issues on Appeal.

1. What is the proper *measure* of B&O tax on ESI's PBM business?

2. Must ESI pay B&O tax on funds received from plan sponsors that were used to pay pharmacies for the prescription drugs dispensed to members?

3. If ESI must pay B&O tax on all proceeds received from plan sponsors, including funds to pay for drugs, is the proper tax classification "service" or "retailing" or "wholesaling"?

4. Was the trial court's invalidation of Rule 194 (2006) proper?

5. Did the trial court properly conclude that ESI was "immune" from B&O tax prior to June 1, 2010, only if it had no "physical presence" in Washington prior to that time?

6. Did the trial court properly determine that only parts of Rule 194 (2006) were invalid?

7. Is DOR estopped from asserting taxes prior to June 1, 2010, because of prior “specific, official, written advice and written tax reporting instructions” from DOR to ESI that ESI relied upon?

8. If DOR is estopped, what part of the assessment – interest, penalty and/or the tax deficiency itself – should be waived?

III. STATEMENT OF THE CASE

A. Background on the Appellant and Taxpayer, ESI.

ESI is a corporation organized under the laws of the state of Delaware with its principal place of business in St. Louis, Missouri. CP 4 (Complaint (“Compl.”) ¶ 1). Its clients (also referred to as “plan sponsors”) include health maintenance organizations, health insurers, third-party administrators, employers, union-sponsored benefit plans, and government health programs. CP 5 (Compl. ¶ 6).

ESI enters into contracts with clients to manage the prescription drug benefits of the clients’ employees or members. CP 5 (Compl. § 7). The services provided by ESI include, but are not limited to, pharmacy network management, claims processing, mail order and specialty mail order pharmaceuticals through ESI affiliates, formulary development, and rebate management. *Id.* ESI contracts with independent third-party retail pharmacies to provide prescription drugs to members. *Id.* ¶ 8. ESI negotiates with the pharmacies to determine the prices at which the pharmacies will provide prescription drugs to members. *Id.* The retail pharmacies use their inventories to fill prescriptions for members. *Id.* ¶ 9.

In a typical prescription drug claim processing transaction, the retail pharmacy will communicate with ESI online and in real-time to process a member's prescription drug claim. CP 7 (Compl. ¶ 16). When a member presents his or her identification card at a network pharmacy, the pharmacist sends the member and prescription information in an industry-standard format through ESI's systems, which process the claim and respond back to the pharmacy. *Id.* This process is called "adjudication" and no portion of the adjudication service is performed in Washington. *Id.* (¶ 16, 17). Instead, adjudication is primarily performed by ESI in Missouri and Texas. *Id.* at ¶ 17.[9]

On a regular, periodic basis ESI invoices its clients for amounts related to the prescription drugs provided by the pharmacies to the clients' members. CP 7 (Compl. ¶ 18). The invoices will include administrative and dispensing fees due under the clients' contracts. *Id.* The clients pay ESI's invoices and the pharmacies are paid for the drugs and dispensing fees, less any co-payment amounts previously paid by the members. *Id.* Payment to the pharmacy will be made either before or after ESI receives

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[9] Adjudication includes the following steps:

- Confirming the member's eligibility for benefits under the applicable health benefit plan and the conditions to or limitations of coverage;
- Performing a concurrent drug utilization review and alerting the pharmacist to possible drug interactions and to reactions or other indications of inappropriate prescription drug usage;
- Updating the member's prescription drug claim record;
- If the claim is accepted, confirming to the pharmacy that it will receive payment for the drug dispensed according to the provider agreement entered into between the retail pharmacy and ESI; and
- Informing the pharmacy of the co-payment amount to be collected from the member based upon the client's plan design and the remaining payable amount due to the pharmacy from the plan.

CP 7 (Compl. ¶ 17).

payment from the client, depending on the timing of the payment received by ESI from its client as required by the contract. CP 7-8 (¶ 18).

ESI is a service provider and it does not sell pharmaceutical products or other tangible personal property. CP 6 (¶ 12). ESI earns revenue from managing the approval of, and reimbursements for, prescription drugs sold to its clients' members through the network of retail pharmacies. *Id.*

The development, management and administration of PBM services are performed primarily from ESI's headquarters in St. Louis, Missouri. CP 8 (Compl. ¶¶ 22, 23). ESI also provides benefit services to members through patient care call centers. *Id.* (¶ 19). Most calls are answered from a call center located in Georgia and overflow call centers are located in other states but none are in Washington. *Id.* (¶ 20). During the period in question, ESI maintained no offices or other places of business in the State of Washington. CP 11 (¶ 41).[10]

B. DOR's Audit of ESI.

The subject audit report was issued on January 25, 2013. CP 11 (Compl. ¶ 40). The audit assessed ESI under Rule 194 (2006) for the period January 1, 2007 through May 31, 2010 (CP 15 (¶ 62) and laws of 2010 1st

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[10] In 2010, ESI had two work-from-home employees located in the State of Washington. CP 11 (Compl. ¶ 42). These employees – a Strategic Planning Director and a Senior Business Analyst – were assigned to ESI offices in St. Louis, Missouri and Bloomington, Minnesota, respectively. CP 11-12 (Compl. ¶ 42). They had no direct contact with clients or members in Washington related to ESI's PBM business in this state. CP 12 (Compl. ¶ 42). Under the definition of "place of business" applicable here, the fact of these two work-from-home employees did not constitute having a place of business in Washington state. Rule 194 (1983) (the term "place of business" means "a location at which regular business of the taxpayer is conducted and which is either owned by the taxpayer or over which the taxpayer exercises legal dominion and control").

sp.s. c 23 §§ 105, 108 (*see* fn. 4, *supra*)), along with two new regulations (WAC 458-20-19401 (WSR 11-19-038, § 458-20-19401, filed 9/12/11, effective 10/13/11) and WAC 458-20-19402 (WSR 12-19-071, § 458-20-19402, filed 9/17/12, effective 10/18/12)), for the remainder of the audit period (June 1, 2010 through December 31, 2010). CP 15 (Compl. ¶ 62). The audit assessed total B&O taxes, interest and penalty in the amount of $18,407,051. *Id.* ¶ 67.

C. ESI's Administrative Appeal to DOR.

ESI filed an appeal of the audit to DOR's Appeals Division. CP 15 (Compl. ¶ 68). Following a hearing, an administrative law judge employed by DOR upheld the audit in a written determination. *Id.* ESI timely petitioned for reconsideration, which was granted in part, and adjustments to the audit report were later made. *Id.* (¶ 69). On December 4, 2014, DOR issued a revised audit to ESI, reducing the total assessment to $14,190,659 (including interest and penalty). CP 16 (¶ 70), *see* CP 651. ESI paid the revised assessment in full on or about January 5, 2015. CP 16 *(*¶ 71). On April 18, 2015, ESI filed this action with the trial court. CP 4-29.

D. DOR's Rule 194 (2006) Rulemaking Proceedings.

DOR amended WAC 458-20-194 effective on January 1, 2006. *See* WSR 05-24-054, § 458-20-194 filed 12/1/05, effective 1/1/06. Rule 194 (2006) was in effect during the January 1, 2007 through May 31, 2010 period of the audit report. ESI's complaint (CP 4-29) challenged DOR's authority to adopt Rule 194 (2006), contending that the rule exceeded statutory authority and was arbitrary and capricious. CP 17-23.

WAC 458-20-194 (sometimes referred to as "Rule 194") and predecessor rules interpreted RCW 82.04.460 and prior iterations of that statute. Subsection (1) of the statute allowed apportionment of the "Service" B&O tax on persons rendering services both within and outside Washington. Apportionment was through either "separate accounting" or "cost of doing business." Rule 194 stated up through December 31, 2005, and consistent with rules adopted by DOR and its predecessor Tax Commission, that no portion of gross income received by a person rendering services in Washington was subject to B&O tax if the services were incidental and the person did not maintain a place of business and was not domiciled in this state.

In 2005, DOR sought to change the way the B&O tax was to apply to foreign corporations that did not maintain a place of business in Washington. At the time, the Legislature had not adopted any substantive amendments to RCW 82.04.460.[11] Nor had the Legislature adopted any recent, substantive amendments to RCW 82.04.220.[12] At the time of the proposed rule amendment, DOR asserted that Rule 194 as last amended in 1983 described apportionment in only "very general terms" and that "[m]ost

[11] The last amendment was made in 2004 to assure apportionment applied to a lower B&O tax rate on boarding homes, which was enacted at the same time, and to also make technical changes to the statute. 2004 c 174 §§ 1, 6.

[12] RCW 82.04.220 was the other statute the trial court found to be important and critical to its ruling. The last amendment to RCW 82.04.220 occurred 45 years earlier. *See* 1961 c 15 § 82.04.220.

of [DOR]'s specific advice on the subject has been by Washington Tax Decisions" that ". . . proved difficult to interpret and apply for taxpayers." AR 5.[13] DOR also stated that an amended rule would ". . . provide specific and consistent guidance on the subject of apportionment under RCW 82.04.460(1), [to] creat[e] more predictable and equitable results for taxpayers." *Id.*

DOR began the rule amendment process on March 2, 2005, by filing a CR-101 Preproposal Statement of Inquiry with the Code Revisor's Office. AR 5. As proposed, the entire existing Rule 194 (1983), being the last previous amendment to Rule 194 (WSR 83-08-026 (Order ET 83-1), § 458-20-194, filed 3/30/83), was deleted (AR 6-8) and in its place an entirely new rule with new language and concepts was substituted (AR 8-17). Gone was the former definition of "place of business" – "a location at which regular business of the taxpayer is conducted" – added when Rule 194 was amended in 1983. In its place, a new definition of what constituted a "place of business" was introduced – "nexus." The proposed rule stated:

> A place of business exists in a state when a taxpayer engages in activities in the state that are sufficient to create nexus. Nexus is that minimum level of business activity or connection with the state of Washington which subjects the business to the taxing jurisdiction of this state. Nexus is created when a taxpayer is engaged in activities in the state, either directly or through a representative, for the purpose of performing a business activity. It is not necessary that a taxpayer have a permanent place of business within a state to create nexus.

AR 9.

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[13] RCW 82.32.410(1) authorizes DOR to "designate certain written determinations as precedents" which "shall be made available for public inspection and shall be published." RCW 82.32.410(1)(b). Determinations are published in the "Washington Tax Decisions."

Thus, the proposed rule deleted the definition of the term "place of business" (AR 8) and also deleted the provision that a person domiciled outside Washington who did not maintain a place of business in this state was not taxable on any part of its gross income when services were incidentally rendered in this state (AR 7). Within months, DOR adopted the amended rule as proposed. AR 107; *see* AR 145-56 (WSR 05-24-054).

E. Judicial Review of ESI's Challenge to Rule 194 (2006).

ESI alleged that Rule 194 (2006) exceeded statutory authority by declaring that a "place of business exists in a state when a taxpayer engages in activities in the state that are sufficient to create nexus" and that it was "not necessary that a taxpayer have a permanent place of business within a state to create nexus." WAC 458-20-194(2)(a) (2006); *see* CP 19 (Compl. § 88). ESI also alleged that Rule 194 (2006) represented an unlawful attempt to disregard decades – going back to 1935 – of DOR administrative interpretation, without any substantive change to the underlying statute, RCW 82.04.460(1). *Id.* (¶ 90).

The trial court's review of Rule 194 (2006) proceeded as the first issue taken up in ESI's complaint. An APA hearing was held on February 19, 2016 (*see* VRP 02/19/16), and the trial court announced its decision on June 10, 2016 (VRP 06/10/16), ruling that Rule 194 (2006) exceeded statutory authority and was invalid (VRP (06/10/16) at 23, lines 8-10). The court also ruled that the rule was "invalidated on its face based upon the arbitrary-and-capricious standard." *Id.* at 30, lines 2-3. The parties were asked, in light of the court's ruling that invalidated the rule, whether portions of Rule 194

(2006) "can survive." *Id.* at 33, lines 20-21. A decision on this question was deferred, leaving unresolved the full "scope of the ruling." *Id.* at 34, lines 13-15. Instead, the court directed ESI to draft the findings and conclusions required under the APA. *Id.* ¶ 34, lines 10-11; *see* RCW 34.05.574(1).

ESI filed proposed findings and conclusions with the trial court. CP 1396-1417. DOR opposed ESI's version and filed its own findings and conclusions. CP 191-253, 254-272. ESI objected to DOR's proposed findings and conclusions (CP 273-279), which DOR labelled "Interlocutory Order Re APA Rule Challenge" ("Order"). Later, DOR submitted a revised Order. CP 285-301. On July 15, 2016, the trial court entered DOR's revised Order with additional changes. CP 302-358.

The trial court concluded that "prior to the 2010 amendment to RCW 82.04.220 the Legislature had chosen not to reach as far as it could, and in 2010 it amended RCW 82.04.460 and RCW 82.04.220 to impose a tax that basically parallel[ed] the constitutional reach." CP 313, ¶ 53. The court also concluded that DOR "exceeded its statutory authority when it failed to include a 'physical presence' requirement in the 2006 version of Rule 194 consistent with the requirement the Court has found to be part of the statute." *Id.* The trial court went on to rule that Rule 194 (2006) was arbitrary and capricious and that the "amendments dealing with who is subject to the tax were not the result of a rational decision-maker." CP 315, ¶¶ 55-63. The trial court's findings and conclusions ended with the following "Order":

> Express Scripts' challenge to the 2006 amendment to WAC 458-20-194 is granted only with respect to those parts of the Rule discussed above that are inconsistent with the statutory "physical presence"

> requirement implicitly included in the pre-2010 version of RCW 82.04.220. Physical presence was a statutory requirement under RCW 82.04.220 prior to the 2010 amendment to that statute, and Express Scripts will be immune from the Washington tax during the tax periods at issue if it can show that it did not have any physical presence in Washington during that January 2007 through May 2010 period.

CP 317.

F. Facts Pertinent to "The Measure of Tax Issue."

ESI performs a variety of services, including claims processing for covered drugs dispensed by pharmacies. An exhibit in the record helps explain the process. CP 756 is Exhibit D to the Declaration of George C. Mastrodonato (Appendix B attached) and is a diagram of a typical "retail" network transaction and how ESI interacts with its client and the network pharmacy. In this example ESI (shown in the middle of the page) bills the client after a client's member fills a prescription, ESI receives payment from the client, and then ESI pays the pharmacy. The cost of the drug (known as the "ingredient cost") constitutes the majority of the cost of the transaction, accounting for over 95 percent of the funds that change hands. In the example, the "ingredient cost" is $45 and ESI charges its client $38 including fees ($3) after reducing the amount due for the member's co-payment ($10) to the pharmacy. ESI pays the pharmacy $36 after the co-payment is applied. ESI bills the client for the "ingredient cost" and this amount passes through ESI from the client to the pharmacy. Thus, the pharmacy payments ESI received from clients were passed through to the network pharmacies to pay the amounts owed to the pharmacies for the prescription drugs dispensed to the clients' members with only $2 being retained by ESI.

G. Facts Pertinent to Credit Card Transactions

In credit card transactions, merchant banks issue credit cards to individuals. CP 814 (lines 1-2). The banks have separate agreements with merchants in which the merchants agree to accept the credit cards issued by the banks as payment for goods and services. *Id.* (lines 19-21). When a purchaser presents the credit card to a merchant, the merchant receives electronic authorization from the credit card processor for the individual's purchase, and the bank pays the merchant for the individual's purchase, less an administrative or transaction fee ("discount"). CP 815-816. The bank is wholly liable to the merchant regardless whether the individual pays the bank (consistent with the individual's legal obligation to do so when presented a bill at the end of the billing cycle). CP 818-819.

The entire amount the bank receives from the individual to pay the credit card purchase is not subject to B&O as gross income, because it is not value proceeding or accruing to the bank even though the bank is liable for the payment to the merchant. CP 818. Instead, the only portion of revenue received by the bank from the individual that is subject to B&O tax is the transaction fee retained by the bank and paid for the service of administering the transaction, even though the bank records the entire amount received from the individual as revenue. *Id.* The application of B&O tax to this transaction is confirmed by ETA 3204 (App. A).

H. Facts Pertinent to "The Estoppel Issue."

DOR audited ESI for the period January 1, 2001 through December 31, 2006, and a report was issued on December 12, 2007. CP 11 (Compl. ¶ 38). The prior audit report reflected DOR's review of both ESI's PBM business and mail order pharmacy business. CP 618-622. After the report had been issued and ESI had filed an administrative appeal to DOR, ESI clarified that the pharmacy mail order business was not conducted by ESI but by an affiliate company, ESI Mail Pharmacy Services, Inc. ("ESI Mail Pharmacy"). CP 624 (Barrett Decl., Ex. 8). In response DOR reissued or "transferred" the ***tax assessment liability*** to ESI Mail Pharmacy. CP 626, 628 (Barrett Decl., Exs. 9, 10). The written prior audit report (CP 618-622 (Barrett Decl., Ex. 7)) remained the same and was never withdrawn, amended, corrected or modified. That audit stated:

> Express Scripts also receives a dispensing fee for the costs of providing the pharmacy benefit service. WAC 458-20-194 explains the application of various business and occupation taxes to persons doing business inside and outside of Washington State. Tax is not due upon any part of the gross income received for services incidentally rendered to persons in Washington by a person who is not domiciled or does not maintain a place of business in Washington. Because Express Scripts does not have physical presence in the state and all of the activities associated with this fee occur outside of Washington, none of this fee would be subject to the B&O tax.

CP 619-620. The prior audit report further stated that, "The instructions provided in this report . . . constitute 'specific written instructions' within the meaning of RCW 82.32.090."[14] Consistent with DOR's "specific,

[14] RCW 82.32.090(5) imposes a ten percent (10%) penalty for disregarding "specific written instructions as to reporting or tax liabilities." "Specific written instructions" are present "when the department has informed the taxpayer in writing of the taxpayer's tax obligations." *Id.* A variation of the term "specific written instructions" also appears in *[continued on next page]*

official written advice and written tax reporting instructions" in the prior audit report, ESI did not report or pay B&O tax on revenues from its PBM business from January 1, 2007 through May 31, 2010.

DOR audited ESI again for the current period (January 1, 2007 through December 31, 2010) and issued a new report on January 25, 2013. CP 11 (Compl. ¶ 40). During all periods covered by the prior audit and current audit, ESI conducted its PBM business in substantially the same manner, operating primarily from ESI's headquarters in St. Louis, Missouri with no offices or other places of business in Washington. *Id.* (¶ 41). ESI only performed "incidental" services in Washington such as occasional in-person meeting with clients and occasional audits of network pharmacies (usually lasting approximately two to three hours each).

IV. ARGUMENT

A. Standard of Review.

1. Under the APA.

ESI's challenge to Rule 194 (2006) arose under the APA. This rule is reviewed under the standard set forth in RCW 34.05.570. *See Wash. Indep. Tel. Ass'n v. Telecomm. Ratepayers Ass'n for Cost-Based & Equitable Rates*, 75 Wn. App. 356, 880 P.2d 50 (1994). "A rule is invalid if it (1) violates constitutional provisions; (2) exceeds the agency's statutory authority; (3) was adopted without compliance to statutory rule-making procedures; or (4) is arbitrary and capricious in that it could not have been

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RCW 82.32A.020(2) ("taxpayers of the state of Washington have: . . . [t]he right to rely on specific, official written advice and written tax reporting instructions from the department of revenue to that taxpayer").

the product of a rational decision maker." *Wash. Indep. Tel. Ass'n v. Wash. Util. & Trans. Comm'n*, 110 Wn. App. 147, 155, 39 P.3d 342 (2002) (citing RCW 34.05.570(2)(c); *Neah Bay Chamber of Commerce v. Dep't of Fisheries*, 119 Wn.2d 464, 469, 832 P.2d 1310 (1992)). "A court must declare an administrative rule invalid if it finds that the 'rule exceeds the statutory authority of the agency.' " *Swinomish Indian Tribal Cmty. v. Dep't of Ecology*, 178 Wn.2d 571, 580, 311 P.3d 6 (2013) (quoting RCW 34.05.570(2)(c)).

The extent of an agency's rulemaking authority is a question of law that courts review de novo. *Armstrong v. State*, 91 Wn. App. 530, 536, 958 P.2d 1010 (1998) (citing *Local 2916, IAFF v. Pub. Employment Relations Comm'n*, 128 Wn.2d 375, 379, 907 P.2d 1204 (1995)). An administrative rule "must be written within the framework and policy of the applicable statute[]." *Dep't of Labor & Indus. v. Gongyin*, 154 Wn.2d 38, 50, 109 P.3d 816 (2005). " 'Administrative rules or regulations cannot amend or change legislative enactments.' " *Dep't of Ecology v. Campbell & Gwinn, LLC*, 146 Wn.2d 1, 19, 43 P.3d 4 (2002) (quoting *Dep't of Ecology v. Theodoratus*, 135 Wn.2d 582, 600, 957 P.2d 1241 (1998)). "Rules that are not consistent with the statutes that they implement are invalid." *Swinomish*, 178 Wn.2d at 581 (citing *Bostain v. Food Express, Inc.*, 159 Wn.2d 700, 715, 153 P.3d 846 (2007)).

2. For Summary Judgment Proceedings.

Before the trial court, DOR filed two summary judgment motions, one a motion for partial summary judgment to affirm ESI had a "physical presence" in Washington (CP 467-489), and a second motion for summary judgment on all remaining issues (CP 359-360). The trial court granted DOR's motions in their entirety.

Appellate courts "review summary judgment orders de novo, considering the evidence and all reasonable inferences from the evidence in the light most favorable to the nonmoving party." *Keck v. Collins*, 184 Wn.2d 358, 370, 357 P.3d 1080 (2015) (citing *Folsom v. Burger King*, 135 Wn.2d 658, 663, 958 P.2d 301 (1998)). "Summary judgment is appropriate only when no genuine issue exists as to any material fact [footnote omitted] and the moving party is entitled to summary judgment as a matter of law." *Keck, supra* (citing *Scrivener v. Clark Coll.*, 181 Wn.2d 439, 444, 334 P.3d 541 (2014)). "A material fact is one that affects the outcome of the litigation." *Owen v. Burlington N. Santa Fe R.R. Co.,* 153 Wn.2d 780, 789, 108 P.3d 1220 (2005).

3. Interpretation of Tax Statutes

Former RCW 82.04.460(1), RCW 82.04.080 (definition of "gross income of the business") and 82.04.090 (definition of "value proceeding or accruing") are taxing statutes, which determine the amount of B&O tax. Under rules of statutory construction, "If any doubt exists as to the meaning of a taxation statute, the statute must be construed most strongly against the taxing power and in favor of the taxpayer." *Ski Acres v. Kittitas County*¸ 118 Wn.2d 852, 857, 827 P.2d 1000 (1992) (citing *Puyallup v. Pacific Northwest Bell Tel. Co.,* 98 Wn.2d 443, 448, 656 P.2d 1035 (1982); *Vita Food Prods., Inc. v. State*, 91 Wn.2d 132, 134, 587 P.2d 535 (1978)); *Dep't* *of Revenue v. Hoppe*, 82 Wn.2d 549, 552, 512 P.2d 1094 (1973); *see Gould v. Gould*, 245 U.S. 151, 38 S.Ct. 53, 62 L.Ed. 211 (1917).

B. The Fees and Discounts Received By ESI Were Its Actual "Compensation or Consideration" for Performing PBM Services, and This Was ESI's "Gross Income" Subject to B&O Tax.

The payments from clients for the "ingredients," which ESI passed through to the pharmacies, were not "value proceeding or accruing" (RCW 82.04.090) to ESI. The actual "compensation or consideration" received for the PBM services provided to clients was reflected in the fees, discounts, and other amounts retained by ESI for the services, and these amounts were the measure of ESI's B&O tax. *See Walthew*, 103 Wn.2d at 187.

1. *First American* is Controlling Authority.

In *First American Title Insurance Company v. Department of Revenue*, 144 Wn.2d 300, 27 P.3d 604 (2001), the Supreme Court addressed the definition of "value preceding or accruing" (RCW 82.04.090), holding that "[w]here the business acts only as a pass-through for funds, the pass-through funds are not included as income." *Id.* at 305. In *First American*, consumers purchased preliminary title reports and title insurance from an underwritten title company ("UTC") where the UTC provided the abstracting process and a title insurer (First American) provided the insurance policy. In the transaction, the UTC collected the entire amount of the consideration from the consumer, retained a portion for the abstracting service and paid B&O tax on this latter amount. The UTC remitted the remainder of the consideration to First American (the title insurance company) which paid the B&O tax on the proceeds it received.[15] DOR assessed First American on the entire amount of consideration (including the amount retained by the UTC). The court held that First American did not receive value on such amounts because the UTC acted as a pass-through entity even though it constituted a separate service provider generating business for its own account. *Id.* at 305. In so holding, the Supreme Court affirmed this Court's determination that the substance of the taxpayer's business controls, and the "facts show that the substance of the [title] insurer's business is to provide, sell, and be compensated for insurance ***only***." *First American Title Ins. Co. v. Department of Revenue*, 98 Wn. App. 882, 887, 991 P.2d 120 (2000) (court's emphasis).

The substance of ESI's business is to provide, sell, and be compensated for PBM services. This compensation includes ***only*** the various fees and discounts ESI charges and retains, just as First American was compensated ***only*** for insurance.[16] Here, ESI should be subject to B&O tax on the PBM services it provides and sells, but not on the prescription

[15] Likewise in this case, the Washington pharmacies pay B&O taxes on the entire amount of the pharmacy payments from ESI, as well as any copayments collected.

[16] In *First American*, DOR argued that "if First American pays tax on only 10 percent, it will be deducting expenses contrary to the legislature's definition of 'gross proceeds' of sales." 98 Wn. App. at 887-888. The court rejected this argument, stating "First American [is] paying tax on all that it provided and sold." *Id.* at 888. DOR's inclusion of the outsized funds for payment to pharmacies in this case mirrors DOR's unsuccessful argument in *First American*. Specifically, DOR will claim that by not paying tax on the pass-through "ingredient cost" ESI is effectively taking a deduction from "gross income." But, under *First American* the tax is to be paid only on income for the services that are provided and sold. The "service" here is taxed through the revenues from fees and discounts, not from the pass-through "ingredient cost."

drugs – the "ingredient cost" it pays to the pharmacies and recovers from clients – that it does not provide or sell.

In this case, the trial court held that *First American* did "not apply in this case" because "*First American* concerned the 'unique commercial relationship involved in the title insurance business' that is expressly recognized by the applicable statutory scheme" and "[t]here is no such unique relationship, recognized by law, in this case." CP 981-82 (citing 144 Wn.2d at 304 and RCW 82.04.050(3)(b)). While the Supreme Court referenced a "unique commercial relationship," it also recognized the more general principle of tax law that where a "business acts only as a pass-through for funds, the pass-through funds are not included as income." 144 Wn.2d at 304-305. The fact that this is a universal principle of the B&O tax is demonstrated by the way credit card processors and merchant banks are allowed to exclude from the measure of B&O tax payments to the merchants. For the same reason expressed in *First American*, credit card processing companies are not subject to B&O tax on amounts passed through to merchants (i.e., it is not value proceeding or accruing to the business activity). *See* ETA 3204 (App. A, attached); *see also* CP 817-818, 820 (Mastro Decl., Ex. G at 39-40, 42).

The situation with ESI and the credit card processor is directly analogous. CP 827-828 (Mastro Decl., Ex. G at 49-50). A member fills a prescription at a pharmacy and ESI adjudicates the claim (*i.e.*, authorizes the purchase). CP 822 at 44. The pharmacy is paid for the cost of the prescription drug sold to the member (less the amount of copayment, if any, received from the member) pursuant to ESI's contract with the pharmacy. CP 822-823 at 44-45. ESI bills its client for the prescriptions filled by the members at the pharmacies pursuant to ESI's contract with the client. *Id.* As with the bank paying the merchant in the credit card transaction, the amount ESI receives from its client is not the same as that which it pays to the pharmacy. *Id.* In fact, the only material difference between the PBM transaction and the credit card transaction is that there is no upfront payment to the merchant by the individual in the credit card transaction like there may be with the copayment in the sale of the prescription drugs to the member by the pharmacy. CP 825 at 47. Consequently, PBMs should be taxed in the same manner as credit card processors as required by *First American.*

2. The Trial Court's Reliance on *Washington Imaging, William Rogers,* and Rule 111 Was Misplaced.

In addition to rejecting ESI's reliance on *First American,* the trial court ruled that ESI did "not satisfy the requirements for pass-through treatment" as set out in *Washington Imaging*, *supra* (171 Wn.2d 548), *William Rogers, supra* (148 Wn.2d 169), and WAC 458-20-111 ("Rule 111"). Neither of these cases nor the rule alter the conclusion that ESI is not taxable on the pass-through pharmacy payments.

Washington Imaging's business was "providing medical imaging services," which involved a report that included "both the technical and the professional components" and patients were "not aware of the arrangements" between Washington Imaging and a hospital, in which one involved creating the image and the other reading the image. *Wash. Imaging,* 171 Wn.2d at

552-53. In the PBM situation the plan sponsor is fully aware that it will get billed for the prescription drug purchases of its members and the pharmacies are fully aware that they will be paid by the PBM less any co-pay amount received previously, because their contracts expressly stated these facts. *See* CP 709-710. In ESI's situation it merely facilitates the payment from the plan sponsors to the pharmacies, unlike Washington Imaging, which was providing full "medical imaging services." 171 Wn.2d at 552.

Washington Imaging did at one point state that the only way for a taxpayer to obtain "pass through" tax treatment (*i.e.*, exclude the revenues from gross income) would be if Rule 111 (WAC 458-20-111) applied. 171 Wn.2d at 561 (stating Rule 111 applies when the taxpayer is "acting solely as an agent" in making payments to a third party). This language, however, was not necessary to the decision and therefore constitutes only dicta and not binding on this Court. *Protect the Peninsula's Future v. City of Port Angeles*, 175 Wn. App. 201, 215, 304 P.3d 918 (Div. II 2013) ("Dicta is not binding authority"). In this case, as in the case of the credit card processing companies, the payments made to pharmacies from the funds received from plan sponsors do not constitute gross income in the ***first instance***, irrespective of Rule 111.

As stated in *Walthew*, "the statute's 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)." 103 Wn.2d at 188. ESI collects payments from its clients to compensate for the PBM services it provides, and to pay the pharmacies for the drugs they dispense to the client's members. Only funds collected to compensate for the costs in the first category constitute consideration for services rendered by ESI. Funds collected to compensate for the cost of drugs dispensed to members relate to retail sales of the drugs by pharmacies. The latter are not includable in ESI's gross income, and hence, not subject to B&O tax – irrespective of whether they meet the test for pass-through payment under Rule 111.

C. If ESI is Subject to B&O Tax On All Income Received From Clients, the Service Tax is the Wrong Classification.

DOR contends that ESI is not in the business of purchasing and reselling prescription drugs. CP 578-579 (DOR Brief at 23-24). This fact was confirmed by the Board of Tax Appeals in *Wellpartner Inc. v. Department of Revenue*, Docket No. 10-228 (2011) at 21:

> It is generally understood that a stand-alone pharmacy benefit manager (PBM) does not purchase prescription drugs from its network pharmacies. … Instead, the network pharmacy makes sales of prescription drugs to patients that order and receive those drugs.[17]

This issue is not in dispute, but DOR still fails to grasp that its argument to include the pharmacy payments as gross receipts of ESI ***treats*** ESI as if it were selling prescription drugs. As previously stated, amounts are treated as gross receipts only if value is accrued or received from a transaction. Because ESI is not in the business of selling prescription drugs, DOR's argument that ESI accrues or receives value from the sale of prescription drugs cannot be correct. CP 566-568 (DOR Brief at 11-13). ***In***

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[17] As the sellers of prescription drugs, the pharmacies pay Retailing B&O tax on the gross proceeds of their sales.

other words, DOR should not be allowed to assert on the one hand that ESI receives gross receipts from the sale of prescription drugs while denying that ESI sells prescription drugs. If DOR continues to take the counterfactual position that ESI receives gross receipts from the sale of prescription drugs, DOR should be required to follow this reasoning and impose the tax under a classification for sales of prescription drugs rather than as a service provider.[18] DOR's arguments in this regard are akin to Alice in Wonderland believing numerous contrary ideas at once.

This Court should not permit DOR to "have its cake and eat it too" to maximize the B&O tax without regard to logic or internal consistency.[19] If ESI is to be taxed on the "ingredient" – which is indisputably an article of tangible personal property – and 95 percent of the income ESI receives is from this source, the proper tax classification is Wholesaling or Retailing.[20]

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[18] Indeed, the DOR auditors themselves early in the audit process questioned whether the pharmacy payments received by ESI from clients should be taxed under the "Wholesaling" B&O tax classification instead of the "Service" category. "The more I look at the records, the more I wonder if we need to treat the amounts [ESI] receive[d] from clients . . . as wholesaling. It just doesn't seem like service and the pharmacies are making the retail sales." CP 815 (Mastro Decl., Ex. H (email dated June 21, 2012)). The auditor got it right – the monies used to pay the pharmacies, more than 95% of the total, were not for any service rendered by ESI.

[19] To make it clear beyond any doubt, ESI's position is that the Service classification with the exclusion of the pharmacy payments (or "ingredient costs") from gross receipts is the proper measure of ESI's B&O tax.

[20] Since the pharmacies pay Retailing B&O tax on their sales of prescription drugs to members, the more appropriate category for ESI's tax would be Wholesaling.

D. The Trial Court Properly Invalidated Rule 194 (2006), But Improperly Invalidated Only Portions of the Rule. The Trial Court's Attempt to Salvage the Rule's Apportionment Formula Must Fail Because the Formula Assumes the Validity of the Portion of the Rule Invalidated by the Court.

The adoption of Rule 194 (2006) created at least two problems. First, the rule reinterpreted RCW 82.04.460(1) to replace a "place of business" standard with "nexus" but there was no legislative change or amendment to the statute that would have caused DOR to adopt a new rule. Second, in 2010 the Legislature rewrote and reenacted RCW 82.04.460. *See* 2010 1st sp.s. c 23 § 108. Effective June 1, 2010, the Legislature replaced the "place of business" standard with "economic nexus," which established minimum nexus thresholds for B&O taxation of apportionable business activities. *See* 2010 1st sp.s. c 23 §§ 101-112. RCW 82.04.460 eventually imposed the Service B&O tax based on "nexus," but not until the Legislature acted in 2010.

The adoption of Rule 194 (2006) was legislation through rulemaking by a state agency, purporting to allow DOR the power to levy a tax that was not imposed by the Legislature under former RCW 82.04.460(1). DOR also acted arbitrarily and capriciously when it discarded not only the existing statute, but decades of its own prior rulemaking for the sole purpose of generating additional taxes for the state treasury. This Court should follow the trial court's lead and declare Rule 194 (2006) invalid. But unlike the trial court, this Court should also order DOR to refund the B&O taxes ESI paid under the invalid and unlawful regulation.

1. The Historical Record Shows That ESI Was Not Taxable On Its PBM Revenues Prior to June 1, 2010.

RCW 82.04.460's predecessor was enacted in 1939 (c 225 § 4). The 1939 act required that "[a]ny person engaged in the business of rendering services both within and without this state shall, for the purposes of computing B&O tax liability . . . apportion to this state that portion of . . . gross income which is derived from services rendered within this state." 1939 c 225 § 4. Apportionment of tax liability was by either "separate accounting methods" or "that proportion of . . . total income which the cost of doing business within the state bears to the total cost of doing business both within and without the state." *Id.* The 1939 act was amended two years later. 1941 c 178 § 5. The 1941 amendment required taxpayers seeking to apportion tax liability to also maintain "places of business" both within and outside Washington.[21]

[21] From 1941 until 2010, the statute was amended several more times. Even before the 1939 act came into existence, DOR's predecessor agency (the "Tax Commission") adopted "Rules and Regulations Relating To The Revenue Act of 1935." CP 93. Rule 199 – titled "Doing Business Within and Without the State" – stated that the "Service and Other Business Activities" B&O tax did not apply when the services were rendered incidentally within the state by persons not construed to be "doing business within the state." CP 94-95. Rule 199 also stated:

> . . . it will be presumed that ***foreign corporations, or other persons whose residence or principal place of business is located without the state, are doing business within the state if they do any of the following acts:***
>
> 1. Maintain an office or established place of business within the state from which they—
>
> . . .
>
> (c) ***render services*** . . . .

CP 94 (emphasis added). The Tax Commission's 1935 Rule 199 conclusively refutes the trial court's conclusion that, prior to June 1, 2010, the "statutory reach of the B&O tax as applied to service businesses did not cover those businesses that had no physical presence in Washington" (CP 310, ¶ 39) because service businesses with a place of business in the state were subject to the tax.

In 1945, the Tax Commission issued a new set of Rules. CP 97. Former Rule 199 was now codified in "Rule 194." Rule 194 (1945) continued the same approach with respect to nondomiciliary persons taxable under the Service B&O tax.[22] In 1970, DOR adopted the modern version of Rule 194 known as WAC 458-20-194 ("Rule 194 (1970)"). Order ET 70-3, filed 5/29/70, effective 7/1/70. Among other provisions, Rule 194 (1970) restated the statute and once again affirmed that service businesses do not pay tax on any part of gross income received for services incidentally rendered in this state by a person who does not maintain a place of business in this state and is not domiciled here. WAC 458-20-194 was next amended in 1983. WSR 83-08-026 (Order ET 83-1, filed March 30, 1983) ("Rule 194 (1983)"). The 1983 amendment made two changes to Rule 194 (1970): (1) the words "inside" and "outside" were substituted for "within" and "without," respectively; and (2) a definition of the term "place of business" was added for "purposes of apportionment under RCW 82.04.460 and this rule."[23]

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[22] Rule 194 (1945) stated in part:

> When the business involves a transaction taxable under the classification of "Service and Other Business Activities," . . . the tax does not apply upon any part of the gross income received for services incidentally rendered to persons in this state by a person who does not maintain a place of business in this state and who is not domiciled herein.

CP 98.

[23] Former RCW 82.04.460(1) did not contain a definition of the term "place of business." The term was defined in 1983 to mean:

> . . . a location at which regular business of the taxpayer is conducted and which is either owned by the taxpayer or over which the taxpayer exercises legal dominion and control. The term does not include locations or facilities at which the taxpayer acquires merely transient lodging nor does it include mere telephone number listings or telephone answering machines. *[continued on next page]*

Thus, beginning in 1935 when the Revenue Act was first enacted, agency rules stated that no portion of gross income was subject to B&O tax if a foreign corporation did not maintain a place of business in this state. Ten years later (in 1945) the rule reaffirmed that service businesses not domiciled in Washington and performing only incidental service in this state were not subject to tax. The Legislature amended RCW 82.04.460 numerous times over the course of 75 years and did not enact any law or amendment that changed this interpretation until 2010. The Legislature's decision not to change DOR's longstanding interpretation indicated a legislative acquiescence in that interpretation. *Manor v. Nestle Food Co.*, 131 Wn.2d 439, 445, n.2, 932 P.2d 628 (1997) ("The Legislature's failure to amend a statute interpreted by administrative regulation constitutes legislative acquiescence in the agency's interpretation of the statute").

The Legislature acted in 2010 to change the prior statute, but the change in the text effected that year only confirms that the Legislature recognized the need to make such a change, in order to adopt the broader, "nexus" approach.[24] The Legislature understood the then-current law to be that foreign corporations, even if they were "physically present" in Washington, were not subject to B&O tax if they did not have a Washington "place of business" even though they earned "significant income" from Washington, as well as "significant benefits and

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Rule 194 (1983), *supra*. The 1970 and 1983 versions of Rule 194 are reflected at CP 59-60.

[24] DOR has not explained why the Legislature's action in amending the statute was not a nullity if the DOR had the authority to change the place of business requirement by administrative rule.

opportunities provided by the state." 2010 1st sp.s. c 23 § 1. The stated intention of the Legislature in enacting the 2010 bill was "to extend" the B&O tax "to these companies" "to ensure that they pay their fair share of the cost of services that this state renders and the infrastructure it provides." *Id.*; *see G-P Gypsum Corp. v. Dep't of Revenue*, 169 Wn.2d 304, 310, 237 P.3d 256 (2010) ("an enacted statement of legislative purpose is included in a plain reading of a statute").

In 2010 the only way for the Legislature to expand "the statutory reach of the B&O tax as applied to service businesses" was to tax those service businesses that were not taxable because they had no place of business in Washington. This is so because service businesses ***with*** a place of business in this state were already taxable on an apportioned basis, and had been since 1935. Ultimately, even the trial court came to this same conclusion, acknowledging that "'place of business' for purposes of apportionment was defined by reference to having a physical location" and because the term "'place of business' is defined [in Rule 194 (1983)] and nowhere else" and because Rule 194 (1983) defined a "qualifying circumstance where the tax does not apply, there is only one reasonable interpretation of Rule 194 at the time – that the B&O tax did not apply where services were incidentally rendered by persons who did not maintain a physical location in Washington." CP 311, ¶ 47.

The trial court also properly found that, "The U.S. Constitution sets the limit on what is the permissible constitutional reach of a tax," a "state cannot tax beyond what the constitution permits" and "the standard for measuring whether a tax reaches too far" was the nexus standard in Rule 194 (2006). CP 312, ¶ 50. Although Rule 194 (2006) and its description of "nexus" was "consistent with established constitutional law," the trial court found "that the 2006 amendment expanded the reach of who is subject to the B&O tax," by defining "'place of business' by reference to 'nexus' (not physical presence) and by removing the 'place of business' requirement that had been included in . . . the prior Rule." *Id.*, ¶ 51. The trial court also correctly concluded that "RCW 82.04.220 as it existed at the time did not support that change" to Rule 194 (1983) and "the 2006 amendment to Rule 194 exceeded the 'physical presence' [place of business] requirement in the pre-2010 version of the statute." CP 312-313, ¶ 52. Read in context, the Legislature's reference to "physical presence" in the 2010 statement of intent, and the trial court's use of the term "physical location" in interpreting that law, meant that these terms were being used synonymous with the term "place of business" – the historical term in Rule 194 that distinguished between which service businesses were taxable, and which were not.

2. *WSHA v. DOH* is On Point; Rule 194 (2006) Exceeded Statutory Authority and Was Arbitrary and Capricious.

The Supreme Court's decision in *Washington State Hospital Ass'n v. Dep't of Health*, 183 Wn.2d 590, 353 P.3d 1285 (2015) ("*WSHA*"), is on point. In *WSHA* the association challenged a rule promulgated by the state Department of Health ("DOH") that significantly expanded the types of hospital ownership changes that required approval under the certificate of need ("CON") program (*see* chapter 70.38 RCW). The trial court declared DOH's new rule invalid on the basis that DOH exceeded its statutory authority. *Id.* at 594. The Supreme Court granted direct review and affirmed. *Id.* at 592, 597.

What DOR did with Rule 194 was precisely what DOH did with respect to the CON rule – interpret the underlying statute far too broadly. The decision in this case should be the same as in *WSHA*: DOR exceeded its scope of authority in promulgating Rule 194 (2006), because it expanded the meaning of the term "place of business" used in RCW 82.04.460(1) in a manner that was not consistent with the statute. *See WSHA,* 183 Wn.2d at 597. This Court should uphold the trial court and rule that DOR exceeded its scope of authority because, in adopting Rule 194 (2006) DOR expanded the meaning of the term "place of business" in a manner that was inconsistent with the statute.

This Court should also uphold the invalidation of Rule 194 (2006) on the alternative ground that DOR's unsupported change in interpretation was arbitrary and capricious because it disregarded, misapplied and misrepresented the facts and existing law at the time.[25] Prior to June 1, 2010, there was no ambiguity in RCW 82.04.460(1). DOR's sweeping expansion of taxation was, therefore, arbitrary, capricious and invalid for

[25]"An agency action is arbitrary and capricious if it is willful and unreasoning and taken without regard to the attending facts or circumstances." *Puget Sound Harvesters Ass'n. v. Dep't of Fish & Wildlife,* 157 Wn. App. 935, 945, 239 P.3d 1140 (2010). "The reviewing court must consider the relevant portions of the rulemaking file [footnote omitted] and the agency's explanations for adopting the rule as part of its review." *Id.* (citing *Wash. Indep. Tel. Ass'n. v. Wash. Util. & Transp. Comm'n*, 148 Wn.2d 887, 905, 64 P.3d 606 (2003)). "The court must scrutinize the record to determine if the result was reached through a process of reason, not whether the result was itself reasonable in the judgment of the court." *Neah Bay Chamber of Commerce v. Dep't of Fisheries*, 119 Wn.2d at 474. "The agency must also respond to any interested party who requests the reasons for overruling considerations urged against the adoption of a specific regulation." *Id.* (citing RCW 34.05.355(2)).

the reasons set out in ESI's brief to the trial court. *See* CP 50-55. ESI will not repeat those arguments here, but they are incorporated by this reference. *See* Appendix C attached, for excerpts from that brief.

In summary, for 70 years DOR had consistently interpreted RCW 82.04.460(1), through Rules 199 and 194, as imposing no B&O tax on persons rendering services in Washington who did not maintain a place of business in this state. If DOR had concerns over the scope or coverage of RCW 82.04.460(1) and the B&O tax liability of persons rendering services in Washington from outside the state, it should have taken its concerns to the Legislature. *See Dot Foods, Inc. v. Dep't of Revenue*, 166 Wn.2d 912, 921, 215 P.3d 185 (2009) ("the more appropriate method to change the interpretation or application of a statute is by amendment or revision of the statute, rather than a new agency interpretation"). DOR exceeded statutory authority and acted arbitrarily and capriciously in 2005 by amending a rule to correct a problem it perceived with RCW 82.04.460(1) that only the Legislature could correct.

3. "Physical Presence" Was Not the Standard Under Rule 194 (1983)'s Definition of "Place of Business." Nor Was "Physical Presence" the Standard for Apportionment of the Service B&O Tax.

While RCW 82.04.460(1) itself did not define the term "place of business" Rule 194 added a definition in 1983: "a location at which regular business of the taxpayer is conducted and which is either owned by the taxpayer or over which the taxpayer exercises legal dominion and control." CP 59-60; WSR 83-08-026 (Order ET 83-1) § 458-20-194, filed 3/30/83).

This definition went on to exclude temporary facilities – which serves to further underscore that the DOR's interpretation of "physical presence" as "nexus" in Rule 194 (2006) was more expansive than the "place of business" standard that should be applied in this case.

An administrative rule "must be written within the framework and policy of the applicable statute[]" and an administrative rule cannot amend or change legislative enactments. *Dep't of Labor & Indus. v. Gongyin*, 154 Wn.2d 38, 50, 109 P.3d 816 (2005); *see also Swinomish*, 178 Wn.2d at 580 ("Rules that are not consistent with the statutes that they implement are invalid"). As the trial court concluded in its Order, the concept of nexus is more expansive than maintaining a place of business. If DOR's interpretation of "physical presence" were accepted, the Court would be inserting a definition of "place of business" beyond what former RCW 82.04.460(1) allowed, and would therefore be arbitrary and capricious. Accordingly, DOR's expansive interpretation of the term "physical presence" should be rejected. DOR failed to make any factual showing that ESI maintained a place of business in Washington during the period January 1, 2007 through May 31, 2010, and the only proof DOR offered was evidence of nexus, which was not the standard.[26]

[26] In support of its "physical presence" argument, DOR also cited to numerous cases for the proposition that "physical presence" was the standard. *See* CP 475-477 (DOR Motion at 9-11) (citing *Lamtec Corp. v. Dep't of Revenue*, 170 Wn.2d 838, 246 P.3d 788 (2011); *Standard Pressed Steel Co. v. Dep't of Revenue*, 419 U.S. 560, 95 S.Ct. 706, 42 L.Ed. 2d 719 (1975); *Space Age Fuels, Inc. v. State*, 178 Wn. App. 756, 315 P.3d 604 (2013))). However, all of these cases involved sales of tangible personal property, i.e., ***goods***, not services. *E.g.*, *Lamtec* (insulation and vapor barrier products); *Standard Pressed Steel* (fasteners used in the aerospace industry); *Space Age Fuels* (fuel). *[continued on next page]*

DOR's actions in this case reflect its view that the Legislature did not act fast enough in 2006 to change the State's policy to that preferred by DOR, and therefore, it amended the rule to impermissibly substitute its judgment for that of the Legislature. This Court should insist that determinations of Washington tax policy be made by its elected legislature and not have unelected bureaucrats at DOR impose their policy choices by administrative fiat.

4. Rule 194 (2006) Was Properly Invalidated By the Trial Court, But the Court Erred By Assuming the Validity of a Part of the Rule It Had Invalidated.

The trial court invalidated Rule 194 (2006) under RCW 34.05.570(2)(c). *See* Appendix D for VRP (06/10/16) at page 21, line 25 through page 22, line 10. The trial court actually questioned the scope of its ruling, asking whether there are "portions of the rule that can survive in light of my ruling?" VRP (06/10/16) at 33, lines 20-21. Thus, whether any part of Rule 194 (2006) "survived" was left to another day, and the court never ruled on the full scope of the invalidation. That day has come.

If DOR's interpretation of "physical presence" as a synonym for nexus is correct, the Order is not internally consistent. In paragraph 46 of the Order, the trial court stated that the reach of the B&O tax under the "pre-2006 rule [was] consistent with the Court's understanding of the scope of

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ESI, on the other hand, does not sell goods, but performs ***services*** in support of its PBM business. Indeed, DOR's longstanding position is that the taxation of interstate sales of goods is treated differently than taxation of revenue from multistate service activities. Determination No. 01-188, 21 WTD 289, 292-93 (2002). This interpretation was reflected in DOR's audit of ESI for a prior period (2001-2006) where the auditor's written report addressed a dispensing fee received by ESI and instructed that this fee was ***not*** subject to B&O tax under Rule 194 (1983). CP 62-63.

the statute [former RCW 82.04.460(1)] in effect at the time." CP 206 (Order at 10, ¶ 46, lines 20-21). That statute explained "that the tax does not apply when services are incidentally rendered by persons who do not maintain a place of business in Washington." *Id.*, lines 21-23. In the next paragraph of the Order, the trial court further explained its understanding of the former statute and rule:

> As acknowledged in the same rule . . . "***place of business***" for purposes of apportionment was defined by reference to having a ***physical location***. Because the term "***place of business***" is defined there and nowhere else, and [the Rule] defines a qualifying circumstance where the tax does not apply, [and] there is only one reasonable interpretation of Rule 194 at the time—that the B&O tax did not apply where services were incidentally rendered by persons who did not maintain a ***physical location*** in Washington. This is the Court's reading of the pre-2006 version of Rule 194.

CP 206-207 (Order at 10-11, ¶ 47) (emphasis added).

The trial court fully understood that a "place of business" and a "physical location" were synonymous and that was the statutory standard for imposing B&O tax on persons located outside the state of Washington, who performed only incidental services in this state, and who did not maintain a "place of business" or "physical location" in this state prior to June 1, 2010. Later, in finding Rule 194 (2006) invalid as "expand[ing] the reach of who is subject to the B&O tax" the trial court found that DOR "expanded the reach of the B&O tax by defining 'place of business' by reference to 'nexus' (not ***physical presence***) and by removing the 'place of business' requirement that had been included in . . . the prior rule." CP 208 (Order at 12, ¶ 51, lines 3-6) (emphasis added). In the next paragraph, the trial court concluded that, "RCW 82.04.220 as it existed at the time did not support that change to the Rule." CP 208 (Order at 12, ¶ 52, lines 8-9).

Given these statements in the Order, DOR's assertion that taxation was based on an "implied statutory nexus limitation" in the statute is astonishing. *See* CP 528, 536. Taxation was based on the ***express*** statutory language, limiting the imposition of the Service B&O tax to out-of-state entities with a "place of business" in Washington. Indeed, former RCW 82.04.460(1) did not use the word "physical presence," which is equivalent to the constitutional standard for nexus as set forth in *Quill Corp. v. North Dakota*, 504 U.S. 298, 112 S.Ct. 1904, 119 L.Ed. 2d 91 (1992), and other precedents, but instead used the term "place of business."

Moreover, the concept of "implied physical presence" is nowhere to be found in either former RCW 82.04.460(1) or any version of Rule 194 dating back to 1935. The prior statute and regulation provided that the B&O tax did not apply to any part of gross income received for services incidentally rendered to persons in this state by a business that does not maintain a place of business in this state and who is not domiciled here.

Furthermore, Rule 194 did not address the scope of taxation under RCW 82.04.220. Instead, it addressed taxation, as the trial court earlier found, under RCW 82.04.460(1). Under that latter statute, Rule 194 until the 2006 amendment, stated that, "[w]hen the business involves a transaction taxable under the classification Service and Other Business Activities, the tax does not apply upon any part of the gross income received for services incidentally rendered to persons in this state by a person who does not maintain a place of business in this state and who is not domiciled herein." CP 98. The trial court reaffirmed this principle in its ruling, nevertheless, the Order broadened the scope of the ruling by stating that ESI was taxable if it had a mere or "implied" physical presence in Washington.

So why did the trial court ultimately presume to invalidate only "portions of the rule?" VRP (06/10/16) at 33, line 20. The apparent reason it was important for some portion of the rule to "survive" (*id.* at line 21) was so the court could save the new apportionment formula included in the rule. But that formula was based on the concept of "nexus" or "physical presence," which had been declared invalid by the court earlier in its ruling.

The trial court's attempt to salvage Rule 194 (2006)'s apportionment formula must fail, because that formula assumed the validity of a portion of the rule that itself had been declared invalid by the court. This Court should reverse the last substantive paragraph of the Order. CP-317, lines 7-13. Consistent with the rest of the ruling, the standard for determining whether ESI was subject to tax during the period January 1, 2007 through May 31, 2010, was whether it had a ***place of business*** in Washington during this period. DOR presented no evidence that ESI had a place of business in Washington during this period; in fact, ESI did not have a place of business in Washington during this period.

E. ESI Properly Apportioned Zero Gross Income to Washington for Periods Prior to June 1, 2010.

The apportionment of gross revenues for service businesses was governed by former RCW 82.04.460(1) for periods prior to June 1, 2010. The methods for apportionment were set out in the statute:

> Where such apportionment cannot be accurately made by ***separate accounting*** methods, the taxpayer shall apportion to this state that proportion of his total income which the ***cost of doing business*** within the state bears to the total ***cost of doing business*** both within and without the state. (Emphasis added.)

ESI correctly apportioned ***zero gross income*** to Washington prior to June 1, 2010. It had no place of business in Washington contributing in any way to the provision of PBM services.

Even if ESI were required to apportion and pay tax on income prior to June 1, 2010, rather than applying the statutory method of apportionment (separate accounting or cost) DOR used the purported cost formula outlined in the invalid Rule 194 (2006). Specifically, DOR assigned $0 property costs to Washington, $68,998 in employee costs, and an incredible $208,925,891 in other "Costs Assigned by Formula" for 2007. CP 1308 (2nd Zalesky Decl., Ex. 6). It defies any semblance of logic or reality to believe that ***over $200 million*** in costs can be attributed to Washington "by formula" when ESI had no Washington facilities and minimal payroll costs in this state. DOR's "cost apportionment" for the period January 1, 2007 through May 31, 2010, was a mockery of actual apportionment under the "cost" or "separate accounting" methods of former RCW 82.04.460(1), the statute in effect during this period of time. A proper application of ***either*** separate accounting ***or*** cost would have attributed virtually 100% of the costs for rendering ESI's services to states outside Washington. And, the revenues attributable to Washington under the proper formula, and resulting tax, would be substantially less.

F. ESI is Entitled to a Waiver of the Tax, Interest and Penalties Assessed For the Period January 1, 2007 through May 31, 2010.

1. Relief Is Appropriate Under the Taxpayer Bill of Rights.

RCW 82.32A.020(2) provides:

> [T]axpayers of the state of Washington have: … [t]he right to rely on specific, official written advice and written tax reporting instructions from the department of revenue to that taxpayer, and to have interest, penalties, and in some instances, tax deficiency assessments waived where the taxpayer has so relied to their proven detriment[.]

The prior audit report stated that, "The instructions provided in this report . . . constitute 'specific written instructions' within the meaning of RCW 82.32.090." RCW 82.32.090(5) imposes a ten percent (10%) penalty for disregarding "specific written instructions as to reporting or tax liabilities." "Specific written instructions" are present "when the department has informed the taxpayer in writing of the taxpayer's tax obligations." *Id.*

The prior audit report instructed ESI that the dispensing fee (and by implication the other fees ESI receives for conducting its PBM business) was not subject to B&O tax pursuant to Rule 194. CP 619-620. Consistent with DOR's "specific, official written advice and written tax reporting instructions" (CP 648) in the prior audit report, ESI did not report or pay B&O tax on revenues from its PBM business from January 1, 2007 through May 31, 2010. Following the legislative changes to B&O apportionment that were enacted effective June 1, 2010, ESI began reporting and paying B&O

tax on its PBM business for the remainder of the current audit period (*i.e.*, from June 1, 2010 through December 31, 2010).[27] Under the plain and unambiguous terms of RCW 82.32A.020(2), the interest and penalties should be waived. It would be appropriate in this case to also waive the tax given the obvious reliance on the prior audit report's written instructions by ESI.

DOR did not even attempt to dispute ESI's qualification for relief under RCW 82.32A.020(2), but only claimed that ESI did not meet the common law elements of equitable estoppel. *See* CP 568-569 (DOR Brief at 13-20). In so doing, DOR missed the obvious point that RCW 82.32A.020(2) provides a separate cause of action from equitable estoppel. *See Potter v. Washington State Patrol*, 165 Wn.2d 67, 196 P.3d 691 (2008) (the enactment of a statutory remedy where a common law remedy already existed did not abrogate the common law remedy unless the legislature clearly expressed its intent to do so). *Id.* at 79. In the absence of such intent, the common law remedy and the statutory remedy are independent, separate remedies. *Id.*[28]

In this case, the doctrine of equitable estoppel was part of Washington common law applicable to taxpayers for decades prior to the enactment of RCW 82.32A.020(2). *See Kitsap Mason Dairymen's Ass'n v.*

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[27] ESI reported and paid taxes on the fees it received and retained. It did not report or pay taxes on the pass through "ingredient" amounts.

[28] To the extent that the Board of Tax Appeals decision in *Fun Group, Inc. v. Dep't of Revenue*, 2016 WL 6810347 (Wash. Bd. Tax. App., Docket 13-206 (August 24, 2016)) asserts that RCW 82.32A.020(2) "narrowed" the common law remedy of equitable estoppel (*see* page 6, ¶ 5), its decision is contrary to both *Potter* and common sense in that the Board would be asserting that by enacting a ***taxpayer bill of rights,*** the Legislature intended to make it more difficult for taxpayers where they were given inaccurate tax information and instruction, when a bill of rights is commonly understood to afford greater protections to a class of persons.

Tax Comm'n, 77 Wn.2d 812, 467 P.2d 312 (1970); *Wasem's Inc. v. State*, 63 Wn.2d 67, 385 P.2d 530 (1963); *Bennett v. Grays Harbor County*, 15 Wn.2d 331, 130 P.2d 1041 (1942). RCW 82.32A.020(2) created a separate, independent remedy under the circumstances set forth in the statute.[29] DOR's assertions that ESI does not satisfy the elements for common law equitable estoppel are irrelevant because ESI satisfies the elements of RCW 82.32A.020(2) and is entitled to relief as a statutory right.

2. ESI is Also Entitled to Relief Under Common Law Equitable Estoppel.

Estoppel is grounded in the principle "that a party should be held to a representation made or position assumed where inequitable consequences would otherwise result to another party who has justifiably and in good faith relied thereon." *Wilson v. Westinghouse Elec. Corp.*, 85 Wn.2d 78, 81, 530 P.2d 298 (1975). DOR should be held to the representations it made to ESI, which had long ago closed its books on tax years 2007-2010 by the time it had paid the tax assessment in early 2015. CP 16 (Compl. ¶ 71). This was inequitable because ESI had "justifiably and in good faith" relied on the instructions in the prior audit.

A party asserting equitable estoppel against the government must satisfy five elements. *See* n. 6, *supra*, and *Kramarevcky*, 122 Wn.2d at 743. There is little doubt that all of the elements were satisfied here:

[29] Indeed, had the Legislature expressed an intent to make the statutory remedy exclusive, it would be the common law of equitable estoppel, and not RCW 82.32A.020(2), that would be abrogated.

(1) The prior audit report, stating that ESI was not subject to tax on its PBM income is inconsistent with DOR's later claim that such income was taxable;

(2) ESI did not file B&O tax returns or pay taxes based upon the statements in the prior audit report;

(3) ESI was injured in the form of an assessment in the paid amount of $14 million where it could have modified its contracts or otherwise changed its business practices (including no longer providing PBM services to Washington clients) as a result of DOR's repudiation of the prior audit report;

(4) It would be manifestly unjust to permit DOR to retain this overpayment; and

(5) Government functions would not be impaired by the application of equitable estoppel. The State of Washington operates under a nearly $80 billion biennial budget ($94 billion if the transportation budget and capital budget are included). CP 741 (Mastro Decl. Ex. C ("A Citizen's Guide to the Washington State Budget") at 2). By comparison, the potential refund of something less than $14 million is a proverbial drop in the state budget bucket.

Common law estoppel is based upon the ***facts*** related to the nature of DOR's statements to ESI and ESI's actions in reliance thereon, and given those facts DOR should be estopped.[30]

---

[30] Before the trial court DOR argued that its specific, written instructions to ESI in the prior audit were based on the auditor's mistaken belief that ESI "did not have any physical presence in the state and the dispensing service occurred entirely outside the state." CP 559 (DOR Brief at 4, lines 1-2). But, in that report the auditor wrote that B&O tax was not owed on "any part of the gross income received for services incidentally rendered to persons in Washington by a person who is not domiciled or does not maintain a ***place of business*** in Washington." CP 619-621 (emphasis added). DOR also argued that RCW 82.32A.020(2) did not apply because the audit instructions were given to ESI Mail Pharmacy, a wholly owned subsidiary of ESI. CP 569 (DOR Brief at 14, lines 11-23). This is contrary to the uncontroverted evidence showing that the report was issued to **"Express Scripts, Inc. Registration Number 602 632 306."** CP 618 (bold included in original). (This heading appears at the top of ***each page*** of the prior audit. *Id.* at pages 2-5. CP 618-622) DOR further asserted that it was unaware of ESI's PBM business—a claim directly refuted by the express language of the prior audit report, stating that ESI's business was "pharmacy benefit management services" including "retail pharmacy claims processing formulary management and home delivery pharmacy services." *[continued on next page]*

V. CONCLUSION

The Court should impose B&O tax on ESI, using a proper measure of revenue, and which excludes funds received from clients that are used to pay pharmacies. If all funds are taxable, then the proper B&O tax classification is something other than Service, namely Wholesaling. ESI is also entitled to relief from the DOR tax assessment for the period January 1, 2007 through May 31, 2010, because of estoppel or because Rule 194 (2006) was invalid. ESI asks the Court to reverse the trial court on one or more of these issues.

RESPECTFULLY SUBMITTED this 4th day of December, 2017.

CARNEY BADLEY SPELLMAN, P.S.

By ______________________
George C. Mastrodonato WSBA #7483
Michael B. King, WSBA #14405
Attorneys for Plaintiff Express Scripts, Inc.

CP 619 (Barrett Decl., Ex. 7 at 2) Even if DOR's factual claims are treated as somehow raising a genuine issue of fact, this only means that the trial court should have held an evidentiary hearing, and this Court, if it is persuaded that there are such genuine issues (which as shown by the prior written audit instructions there are not) should vacate and remand for such a hearing.

CERTIFICATE OF SERVICE

The undersigned certifies under penalty of perjury under the laws of the State of Washington that I am an employee at Carney Badley Spellman, P.S., over the age of 18 years, not a party to nor interested in the above-entitled action, and competent to be a witness herein. On the date stated below, I caused to be served a true and correct copy of the foregoing document on the below-listed attorney(s) of record by the method(s) noted:

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DATED this 4th day of December, 2017.

Patti Saiden

Patti Saiden, Legal Assistant

APPENDICES

Appendix A: Excise Tax Advisory 3204.2017 (June 26, 2017)

Appendix B: Clerk's Papers Page 756 –
Diagram of "Retail Network Transaction"

Appendix C: Excerpt From ESI's Brief at CP 50-55

Appendix D: Verbatim Report of Proceedings (6/10/16) pages 21-23

APPENDIX A

Department of Revenue Washington State

Excise Tax Advisory

Excise Tax Advisories are interpretive statements authorized by RCW 34.05.230.

ETA 3204.2017 | Issue Date: June 26, 2017

Credit Card Processors

Purpose

This Excise Tax Advisory (ETA) describes how a credit card processor ("Processor") should measure, for B&O tax purposes, its gross income from processing credit card transactions.

Definitions

For purposes of this ETA, the following definitions apply:

A "**Merchant Bank**" is a bank that contracts with a merchant, enabling the merchant to accept a Card Association-branded credit card and receive cash proceeds from the sale.

An "**Issuing Bank**" is a bank that issues Card Association-branded credit cards to consumers.

A "**Processor**" generally provides credit card processing services to a merchant, pursuant to contracts with the Merchant Bank and the merchant.

"**Card Association**" means an association that manages the rules and practices involved in processing credit card transactions.

"**Merchant Discount**" means the total fee a merchant must pay for the processing of credit card transactions. For example, a merchant might agree to pay under a Merchant Agreement a flat 3% Merchant Discount fee. In this scenario, the merchant will receive $97 on a credit card sale of a $100 product. The $3 the merchant does not receive is the Merchant Discount.

"**Interchange Fee**" is a fee the Issuing Bank is entitled to retain as compensation for its role in issuing credit to a cardholder and advancing proceeds to settle a credit card transaction.

"**Merchant Agreement**" means the documents that govern the services provided by a Processor/Merchant Bank to a merchant and the related fees.

"**Sponsorship Agreement**" is a contract that governs the rights and obligations of the Processor and the Merchant Bank with respect to the Merchant Bank's sponsorship of the Processor's use of the Card Associations' networks and the processing services provided to merchants.

Overview of Credit Card Processing System

A merchant seeking to accept a Card Association-branded credit card as payment for goods or services must contract with a Merchant Bank, and often a Processor, to participate in the Card Association's payment system network. Because a Processor typically cannot participate in a Card Association network on its own, it enters into the Merchant Agreement jointly with the Merchant Bank. The Merchant Bank and the Processor also execute a separate Sponsorship Agreement that governs their relationship.

Other parties involved in processing a credit card transaction are not part of the Merchant Agreement. They also earn fees on each completed transaction. The Interchange Fee is the largest of these fees. The Card Associations set the Interchange Fees and periodically revise the rates based on a number of factors that influence the supply and demand for the credit card products marketed by its financial institution members.

Merchant Banks and sponsored Processors are free to independently negotiate the Merchant Discount they charge merchants for credit card processing services. Most commonly, the merchant is charged a fixed Merchant Discount rate for every card transaction, or for specified categories of card transactions. Alternatively, the Merchant Discount may be charged on a "cost plus" basis. Under a cost plus arrangement, the amount a merchant is charged equals the total of Interchange Fees determined on each card transaction and other incidental fees or charges, plus a specified mark-up.

The Card Associations' operating rules, which are binding on the participating banks and their sponsored Processors, specify that the Interchange Fee is a liability of the Merchant Bank to the Issuing Bank. The Merchant Bank is free to require a Processor to assume liability for Interchange Fees as a condition of the Sponsorship Agreement. Although the Processor charges the merchant the Merchant Discount on the front end, fees charged by other parties involved in processing the credit card transaction are netted out of funds distributed to the Processor.

Under a less common business model, the Merchant Bank (or, alternatively, another entity that markets credit card processing services to merchants) simply pays the Processor for services the Processor performs solely as an agent of the Merchant Bank (or the other entity).

Gross Income of Processors

For business and occupation (B&O) tax purposes, the transaction/relationship between a merchant and the Merchant Bank and Processor creates tax consequences separate from the transactions/relationships that generate Interchange Fees and other fees resulting from the processing of a credit card transaction. While the activities of the parties processing a credit card transaction are related, the activities and responsibilities of the Processor differ from those of the other parties, including the Issuing Banks. Accordingly, each party must be taxed based on the gross income of its respective business.

Per RCW 82.04.080(1), gross income of the business means the value proceeding or accruing to the taxpayer by reason of the transaction of the business engaged in without deduction for any expense whatsoever paid or accrued. Under the Merchant Agreement, the Processor is legally entitled to the Merchant Discount charged to the merchant. The Merchant Discount is consideration that accrues to the Processor, thus representing gross income, notwithstanding that fees charged by other parties may be netted out before the Processor receives payment. Consequently, **the Merchant Discount amount is gross income to the Processor subject to tax under the service and other business activities B&O classification.**

Note, in the limited situations where both the practices of the parties and the contractual documents establish that a Merchant Bank (or, alternatively, another entity that markets processing services to merchants) pays the Processor fees for services the Processor performs solely as an agent of the Merchant Bank (or the other entity), the fees are the measure of the Processor's gross income for B&O tax purposes. Under this arrangement, the Merchant Discount is gross income to the Merchant Bank (or the other entity). The Department will presume a Processor is not performing services solely as an agent unless both the contractual documents and the parties' practices indicate otherwise.

Examples

The following examples identify a number of facts and then state conclusions. These examples should only be used as a general guide. The tax results of other situations must be determined after a review of all the facts and circumstances.

Example 1

Merchant X enters into a Merchant Agreement with Processor Y and Merchant Bank Z. The arrangement enables Merchant X to make certain credit card sales to customers and receive cash from the transactions. The Merchant Agreement charges Merchant X a Merchant Discount equal to 3% of the amount of each transaction. The difference between the purchase price and Merchant Discount on each transaction is deposited into an account designated by Merchant X.

On a sale of a $100 product, Merchant X receives $97 from the transaction. Pursuant to their Sponsorship Agreement, Merchant Bank Z and Processor Y receive $0.10 and $0.70, respectively, from the same transaction after deductions of $2.20 in other fees, such as Interchange and Card Association fees. The Department will presume Processor Y's gross income from the transaction is $3, the amount of the Merchant Discount.

Example 2

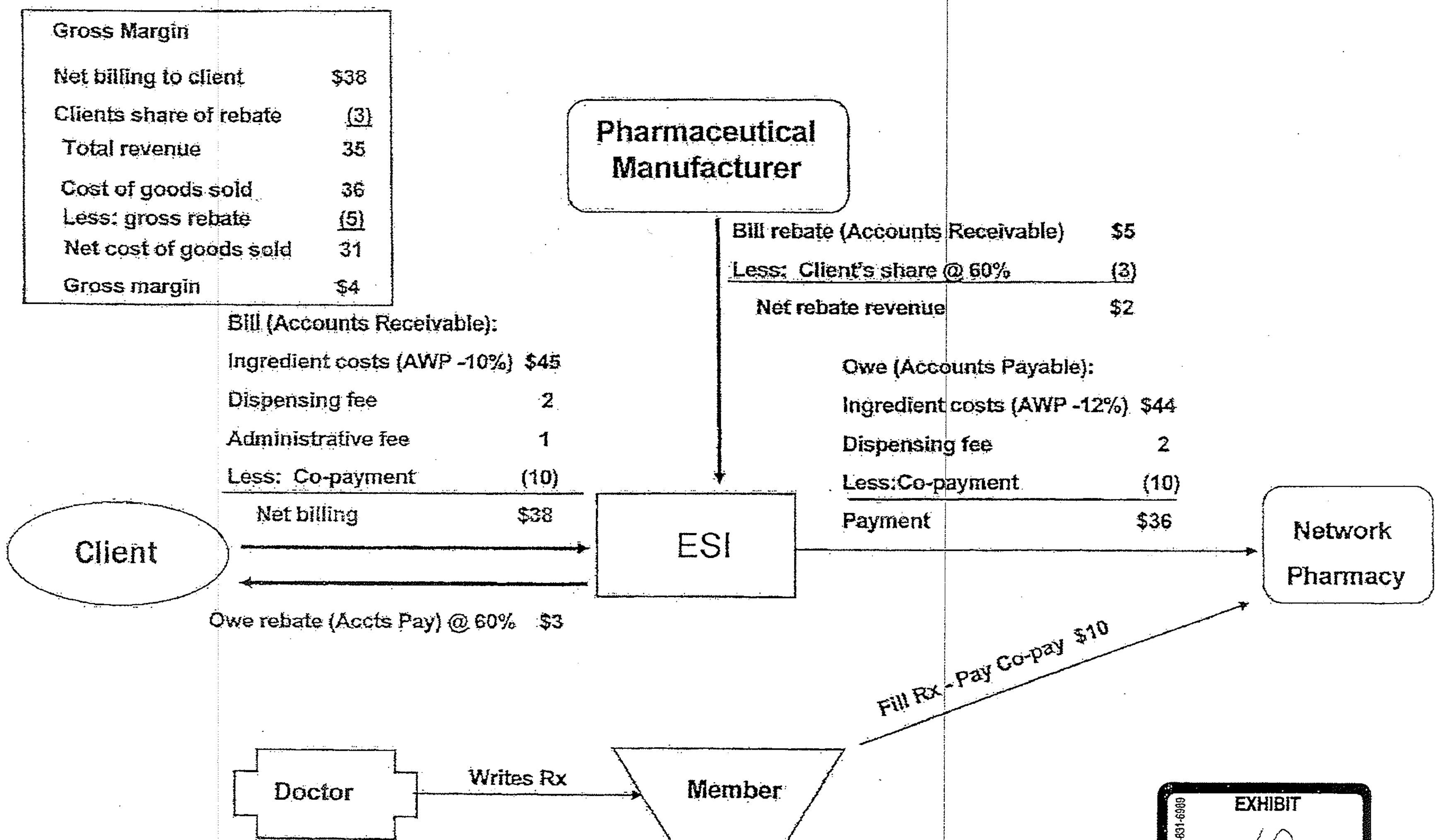
Under a Merchant Agreement between Merchant Bank A and Merchant C, Merchant Bank A agrees to process Merchant C's credit card transactions in exchange for a Merchant Discount equal to 3% of the amount of each transaction. Under a separate services agreement between Merchant Bank A and Processor B, Processor B will process Merchant C's credit card transactions. In exchange for the processing services, the services agreement entitles Processor B to a fee from Merchant Bank A. As provided in the services agreement, Processor B performs the services solely as an agent of Merchant Bank A without undertaking any liability of Merchant Bank A to either Merchant C or any other party.

Because the terms of the contracts and the practices of the parties indicate Processor B is acting solely as an agent of Merchant Bank A, Processor B's gross income from these services is the fees it earns from Merchant Bank A under their services/agency agreement. Merchant Bank A's gross income from its processing services is the 3% Merchant Discount required by its Merchant Agreement with Merchant C.

*****

APPENDIX B

Retail Network Transaction - Brand AWP = $50



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APPENDIX C

The purpose of RCW 82.04.460(1) was to apply B&O tax to persons "rendering services . . . and maintaining place of business both within and without this state which contribute to the rendition of such services." Rule 194, as originally adopted in 1970 and for 35 years thereafter, interpreted RCW 82.04.460(1) to cover not only persons maintaining places of business both within and outside Washington, but the rule covered two additional situations: (1) out of state persons rendering services in Washington but not maintaining a place of business in this state; and (2) persons with a place of business in Washington who rendered services outside this state but did not maintain a place of business outside Washington. *See* n. 19, *supra*. The key factor was a place of business. Rule 194 (2006)'s interpretation of "nexus" to mean "place of business" departs from the plain meaning of that latter term. *See WSHA*, 183 Wn.2d at 597. This Court should rule that the Department exceeded its scope of authority by promulgating Rule 194 (2006), because it expanded the meaning of the term "place of business" (RCW 82.04.460(1)) in a manner that was not consistent with the statute. *Id.*

C. The Court Should Invalidate Rule 194 (2006) on the Alternative Ground that the Department Acted Arbitrarily and Capriciously.

This Court should also invalidate Rule 194 (2006) on the alternative ground that the Department's unsupported change in interpretation was arbitrary and capricious. "An agency action is arbitrary and capricious if it is willful and unreasoning and taken without regarding to the attending facts or circumstances." *Puget Sound Harvesters Ass'n. v. Dep't of Fish & Wildlife,* 157 Wn. App. 935, 945, 239 P.3d 1140 (2010). "The reviewing court must consider the relevant portions of the rulemaking file [footnote omitted] and the agency's explanations for adopting the rule as part of its review." *Id.* (citing *Wash. Indep. Tel. Ass'n. v. Wash. Utils. & Transp. Comm'n*, 148 Wn.2d 887, 906, 64 P.3d 606 (2003)). "The court must scrutinize the record to determine if the result was reached through a process of reason, not whether the result was itself reasonable in the judgment of the court." *Neah Bay Chamber of Commerce*

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v. Dep't of Fisheries, 119 Wn.2d 464, 474, 832 P.2d 1310 (1992). "The agency must also respond to any interested party who requests the reasons for overruling considerations urged against the adoption of a specific regulation." *Id.* (citing RCW 34.05.355(2)).

Here, the Department acted arbitrarily and capriciously in adopting Rule 194 (2006) because it disregarded, misapplied and misrepresented the facts and existing law at the time. Prior to 2010 when RCW 82.04.460(1) was amended by the legislature, there was no ambiguity in the statute. The Department's sweeping expansion of taxation was, therefore, arbitrary, capricious and invalid for the following additional reasons:

- RCW 34.05.325(6)(a)(i) required the Department to identify in a Concise Explanatory Statement ("CES") "the agency's reasons for adopting the rule."[24] The ***primary*** reason identified in the CES for adopting Rule 194 (2006) was that RCW 82.04.460(1) "provides only limited guidance on how to apportion gross income." AR 125. The CES went on to state:

> "Separate accounting" is not defined, and the statute does not describe how or when apportionment can be accurately made by separate accounting methods. The statute does not describe what costs of doing business are within the state and what costs of doing business are without the state. These issues are not addressed in detail by existing department rules. To date, the department has addressed most apportionment issues through published determinations or in audits. By adopting the amended rule, the department will help insure taxpayers receive uniform treatment under a method previewed by the public with an opportunity for notice and comment. AR 125.

If the Department attempted to merely provide "greater guidance" in the areas of cost or separate accounting than what already appeared in Rule 194 (1983), Rule 194 (2006) may arguably be valid. But, nowhere in any of these statements is it disclosed that the Department intended to substitute "nexus" for "place of business." Nor was it made clear that persons domiciled outside Washington, having no place of business in this state, and who previously

[24] The CES is found in the record at AR 125-137.

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did not pay B&O taxes to Washington under RCW 82.04.460(1) and Rule 194 (1983), would now be subject to a tax.

- The CES included a "summary of comments received and Department of Revenue response." AR 127-137. One comment and response addressed "nexus":

> Some comments questioned whether nexus as described in the proposed rule must include a "physical presence." The department believes the proposed rule as written accurately reflects ***federal law.***

AR 128 (emphasis added).[25] Whether or not the Department's rule was consistent with federal law is irrelevant. The proposed rule was contrary to ***state law*** and, therefore, it was invalid.

- The CES also stated that "one comment suggested that the Department should have estimated revenues that might be generated by the rule change." AR 132. This indicated that at least one person thought the rule would increase revenues to the state treasury, but the Department deflected the question by stating that:

> . . . it is not the goal of RCW 82.04.460(1), or the Department in implementing it, to minimize or maximize revenues. The correct level of tax is that which is incidental to what measures Washington activity in a way that is fair. That incidental level is unknown. This is why this CBA does not focus on revenues, but on the measurement of benefits in terms of how well the methodologies measure Washington state activity, the equity of methodologies, and the measure of costs in terms of cost of compliance to the taxpayer and the Department of Revenue. AR 132.

There are several things wrong with this response. First, by structuring the new rule in the manner that it did, the Department had to be well-aware that the rule would "maximize"

---

[25] The Department made a similar statement at the public meeting (held on April 7, 2005) on the proposed rule:

> The draft provides examples of when taxpayers do or do not have nexus, with Washington or other states, for the purposes of the draft rule.
>
> ***The nexus discussion is consistent with existing department publications and determinations.*** The department's existing position on, quote, ***maintaining a place of business***, unquote, ***in which phrase is tied to nexus*** under Washington standards, is incorporated in the draft.

AR 233 (transcript of public hearing) (emphasis added).

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not "minimize" revenues. After all, a whole new class of out-of-state businesses not previously subject to B&O tax would become taxable. Second, the correct level of tax is ***not*** "what measures Washington activity in a way that is fair." Fairness should not be the Department's concern. Instead, the tax is imposed on what ***the legislature says should be taxed***, not what the Department perceives is "fair." Finally, the last statement quoted above makes absolutely no sense and can only be characterized as bureaucratic gobbledygook.

- The record contains a file memorandum dated November 30, 2005 (*see* AR 59-62), which states that, absent the Department's 2005 proposal to amend Rule 194, the "only other alternative would be for the legislature to amend the statute." AR 60. The memo even acknowledged that, "The legislature has had several proposals relating to apportionment before it recently, but none have passed." *Id.* The memo concluded that "[w]hile a legislative solution may [be] the best in the long run, in the meantime, both taxpayers and the Department need a fair method of apportionment that can be consistently applied." *Id.* In other words, the Department admitted it was acting in place of the legislature. The Department's actions violated RCW 34.05.328(1)(b). This statute requires that an agency "analyze alternatives to rulemaking" including the possible alternative of not adopting the proposed rule. In lieu of adopting a rule that was inconsistent with RCW 82.04.460(1), the Department should have sought a legislative amendment that would have provided the changes in the statute that the Department was seeking with the adoption of Rule 194 (2006). In fact, the legislature did make changes to the statute consistent with some of the provisions of Rule 194 (2006) but not until 2010.

- The above memo (AR 59-62) contained one final, notable statement: "There are no known conflicts between the proposed rule and either federal ***or state law***." AR 61 (emphasis added). This statement was false because the proposed rule conflicted with state law in RCW 82.04.460(1).

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• The record also contains a "Cost Benefit Analysis" ("CBA") (AR 63-105) presumably prepared by the Department but the author and his or her qualifications to perform a cost benefit analysis are not disclosed. The CBA included various cost apportionment options and attempted to measure "the extent to which the various apportionment methodologies result in different tax treatment for firms that are similar." AR 64. However, it does not appear the CBA examined the situation of an out-of-state business, performing services in Washington, with no place of business in this state, and who was not previously subject to B&O tax.[26] The CBA was thus incomplete.[27]

• The record includes another memorandum dated December 1, 2005 (AR 139-143), to the "agency head as required by RCW 34.05.325." AR 139. This memo correctly stated that the statute "was enacted in 1939 in response to" a U.S. Supreme Court decision that "held income earned from rendering services in and out-of-state . . . must be apportioned" and the statute "has remained in substantially the same form ever since." AR 139; *see Gwin, White & Prince, Inc. v. Henneford*, 305 U.S. 434, 59 S.Ct. 325, 83 L.Ed. 272 (1939). After quoting RCW 82.04.460(1), this memo then discusses the "[t]wo statutory methods" of apportionment: "(1) separate accounting; and (2) a formulary apportionment based on the ratio of in-state costs of doing business to total costs of doing business." AR 140. Once again, the Department failed to address — or even mention — the requirement of maintaining a place of business within Washington.

---

[26] ESI's "service" B&O tax liability on its PBM business in the prior audit was zero ($0.00) (*see* Appendix at A4-A5) but in the subject Audit, tax was assessed and paid as follows:

2007	$ 2,852,263
2008	3,504,838
2009	2,652,817
2010	2,784,174
TOTAL	$11,794,092

See Appendix at A8. The Audit added interest and penalty to the above amount. *Id.*

[27] One person commenting on the proposed rule prepared an extensive written critique of the CBA. *See* AR 504-525. This commenter contended that the CBA did not comply with RCW 34.05.328. AR 504. This person also accurately stated that the proposed rule "does not merely clarify but instead significantly alters the Department's longstanding practices with respect to the administration of a statute that has not been amended." AR 507, n. 4.

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In summary, for 35 years the Department had consistently interpreted RCW 82.04.460(1) through Rule 194, as imposing no B&O tax on persons rendering services in Washington who did not maintain a place of business in this state. The statute remained largely unchanged for an even longer period of time, since 1941. If the Department had concerns over the scope or coverage of RCW 82.04.460(1) on the B&O tax liability of persons rendering services in Washington from outside the state, it should have taken its concerns to the legislature (as it apparently did in 2010). *See Dot Foods*, 166 Wn.2d at 921 ("the more appropriate method to change the interpretation or application of a statute is by amendment or revision of the statute, rather than a new agency interpretation"). The Department acted arbitrarily and capriciously in 2005 by amending a rule to correct a problem it perceived with RCW 82.04.460(1) that only the legislature could correct.

VI. CONCLUSION

The Department of Revenue lacked statutory authority to amend and expand RCW 82.04.460(1) through Rule 194 (2006), and acted arbitrarily and capriciously in adopting that rule. The changes it sought could not be accomplished by agency fiat but were for the legislature to consider and enact by statute, as it did in 2010. The Department acted beyond is authority when it adopted Rule 194 (2006) and this conclusion is confirmed by the Supreme Court's recent decision in *WSHA*. The Department had the power to implement RCW 82.04.460 but it had no power to change or expand this statute to achieve its own policy objectives. This Court should hold that Rule 194 (2006) was arbitrary, capricious, contrary to law, and invalid and order a refund of the B&O taxes, interest and penalty ESI paid for the period January 1, 2007 through May 31, 2010, based on this ultra vires regulation.

[Signature on Next Page]

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APPENDIX D

amendments affirmatively imposed or enacted new language and at the same time repealed language from the existing rule. Both of those actions, the affirmative providing of new language and the repeal of existing language, is part of the rule that is challenged and part of the rule-making action that the court is evaluating. So the three paragraphs I just referenced were repealed by the 2006 amendments and a new paragraph as well as a lot of other material was added, but the paragraph that I have focussed on and the parties have focussed on is subsection (2)(a) of the new rule, and that was entitled "Place of business -- minimum presence necessary for tax. The following discussion of nexus applies only to gross income from activities subject to apportionment under this rule. A place of business exists in a state when a taxpayer engages in activities in the state that are sufficient to create nexus. Nexus is that minimum level of business activity or connection with the state of Washington which subjects the business to the taxing jurisdiction of the state. Nexus is created when a taxpayer is engaged in activities in the state, either directly or through a representative, for the purpose of performing a business activity. It is not necessary that a taxpayer have a permanent place of business within a state to create nexus."

So after reviewing the 2006 rule language and the rule amendments, which as I said, are effected through the promulgation of new language and the repeal of old language, I have reached the following conclusion, and that is that the 2006 rule amendment effected the following changes: It certainly broadened the application of apportionment and modified apportionment methods, but it also from the court's perspective changed the way it articulated whether a business was subject to the B&O tax, and I find that in so doing it expanded the reach of the tax, and I find that it did that as a result of two parts of the rule, first by defining place of business by reference to nexus, not physical location -- this was a new concept that wasn't in the prior rule so it was a new way of defining the place of business concept -- second, by removing the place of business requirement from the paragraph I've referred to as paragraph six, the agency effectively repealed that part of the prior rule that defined to whom the tax did not apply. So from the court's perspective the combined effect of these two rules is to change who is subject to B&O tax on the businesses who are subject to the services category. And so before the rule a business whose services were incidentally rendered in Washington but did not maintain a physical location in Washington was not subject to the tax. After the rule amendment that person may have been subject to the tax under the application of a different concept.

So after having determined that the amended rule expanded the scope of who is subject to the tax as I've just described, I'm ultimately concluding that the B&O tax at the time of the 2006 rule-making under the statute did not authorize this change because the 2006 rule changed who was subject to the B&O tax beyond what the statute at the time authorized. I'm finding that the rule exceeded the statutory authority and as a result the 2006 rule was invalid, the portions that I've highlighted.

Now, I've talked a bit about the intent sections of the 2010 legislation, and I want to take a moment to talk about the relationship between the constitution and the statute and the rule, and the constitution definitely sets the limit on what's a permissible constitutional reach of a tax. The state can't tax beyond what the constitution permits. And it's undisputed that the standard for measuring whether a tax reaches too far is generally the nexus standard.

Now, the legislature imposes a tax by imposing the tax by way of a statute, imposes and authorizes the tax, and then the rule by the agency implements the tax that's authorized by the legislature. Some of the Department of Revenue's arguments suggests to the court if the constitution would allow the tax articulated in the 2006

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Superior Court Case Number:	15-2-00693-0

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