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No. 50348-4-II

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 Christopher Lanese

REPLY BRIEF OF APPELLANT EXPRESS SCRIPTS, INC.

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I. INTRODUCTION

One commits the straw man fallacy when one misrepresents an opponent's position in a way that imputes to it implausible commitments, and then refutes the misrepresentation instead of the opponent's actual view. "Two Forms of the Straw Man" by Robert Talisse and Scott F. Aikin, Vanderbilt University. Argumentation, September 2006, Volume 20, Issue 3, pp. 345-352. The Department's brief is a textbook exercise in avoiding the arguments of Express Scripts, Inc. ("ESI") and instead, creating straw men to knock down.

There are three primary issues in this appeal and the Department has avoided the clear implication of the arguments raised by ESI on each issue. First, what is the ***measure*** of ESI's B&O tax liability? ESI is an independent provider of pharmacy benefit management services and not in the business of selling prescription drugs, either as a principal or an agent of the pharmacies. Consequently, the amounts it receives and passes through to pharmacies that actually sell the drugs do not constitute part of ESI's gross income from its service business.

The second issue is whether the Department (sometimes referred to as "DOR") can modify Washington tax statutes by regulation. It is undisputed that from 1935-2005, DOR regulations stated that any person rendering services in Washington did not have to pay B&O tax on Washington revenues if such person (like ESI) did not maintain a place of business within this state. On January 1, 2006, the Department purported to change the manner in which persons similarly situated to ESI were taxed by amending its rule in the absence of a statutory change. The trial court declared the amended rule invalid because it exceeded statutory authority and was arbitrary and capricious.

On June 1, 2010, the Legislature amended the apportionment statutes to subject those persons without a "place of business" in Washington under prior law to the B&O tax under principles of "economic nexus" and "single factor receipts apportionment." As a result, ESI began to pay B&O tax to Washington on this date in conformance with the new law. Notwithstanding its absence of authority to change the law, the Department erroneously contends ESI was liable for the tax before June 1, 2010, and the trial court agreed.

The third significant issue is whether the Department's written ***instructions*** to ESI, that ESI did not have to pay tax in the course of a prior audit, precluded the Department from assessing tax in the current audit. Principles of estoppel – both common law and statutory (*see* RCW 82.32A.020(2)) – also entitle ESI to relief from the tax for periods prior to June 1, 2010.

The Department chose largely to ignore these clear arguments in the service of erecting and destroying straw men, presumably because it could not adequately address ESI's actual arguments. This Court should reject the Department's arguments and reverse the trial court.

II. ARGUMENT ON REPLY

A. The Measure of ESI's B&O Tax Excludes the Cost of the "Ingredients."

1. The Facts Conclusively Show That the Ingredients Are Not ESI's Costs.

The key facts in this appeal are relatively simple.[1]

ESI is engaged in a service business, namely the pharmacy benefit management service business. It does not sell prescription drugs. Instead, it processes the filling of prescriptions for individuals, pharmacies and plan sponsors by facilitating the payment from the sponsors to the third-party pharmacies. *See* CP 1025-1031.

ESI does not act as an agent for any party in the buying and selling of prescription drugs. ESI never holds title to the drugs. All drugs are purchased, inventoried and sold by the pharmacies. *See* CP 1201. Under ESI's agreement with a plan sponsor, the sponsor is liable to pay for the balance of the cost of the drugs members purchase from pharmacies after any co-pay is applied. *Id.* Under separate agreements with pharmacies, ESI is obligated to pay the pharmacies for the cost of the drugs dispensed to the members, minus any co-payments made by the members. *Id.*

[1] There are some facts in the Department's Brief that this Court should ignore. The Department states that ESI generates "billions of dollars in gross revenue annually" (DOR Brief at 1) and also claims that ESI "and its subsidiaries have created a profitable niche within the prescription drug industry" (*id.* at 27 (citing CP 1328)). Whether ESI "generates" hundreds, thousands, millions, billions or trillions of dollars in annual gross revenue is irrelevant and prejudicial. Moreover, no evidence was presented to the trial court that ESI has "created a profitable niche" in the prescription drug industry. Even if true, the B&O tax is imposed on gross income (RCW 82.04.220) and "is not a tax on either profit or net gain or capital gain or sale." *Budget Rent-A-Car of Washington-Oregon, Inc. v. Department of Revenue*, 81 Wn.2d 171, 173, 500 P.2d 764 (1972) (citing *Young Men's Christian Ass'n v. State*, 62 Wn.2d 504, 383 P.2d 497 (1963).

Under Washington law, a service provider is liable for the state B&O tax on its "gross income of the business," defined to mean the "value proceeding or accruing by reason of the transaction of the business engaged in and includes . . . compensation for the rendition of services" without deduction for any costs of doing business. RCW 82.04.080. "[T]he basis for the tax" is the "[c]ompensation or consideration for the service." *Walthew, Warner, Keefe, Arron, Costello and Thompson v. Dep't of Revenue*, 103 Wn.2d 183, 186-87, 691 P.2d 559 (1984). ESI's "value proceeding or accruing" or "compensation for the rendition of services" is reflected in the fees, discounts and other emoluments it actually receives "by reason of" the PBM "business engaged in."

The funds received from plan sponsors to pay pharmacies for the prescription drugs the pharmacies dispense and sell to the sponsors' members are not part of ESI's "consideration for the service." Nonetheless, the Department seeks to impute the costs of the prescription drugs sold by the pharmacies (*i.e.*, the "ingredient costs") to ESI as part of its compensation for the rendition of pharmacy benefit management services. The unarticulated assumption in DOR's argument is that the drugs are ESI's costs that must be included in the measure of its B&O tax.

The Supreme Court has ruled that where a "business acts only as a pass-through for funds, the pass-through funds are not included as income." *First American Title Insurance Company v. Dep't of Revenue*, 144 Wn.2d 300, 305, 27 P.3d 604 (2001). ESI is merely acting as a pass-through for the cost of prescription drugs sold by the pharmacies to the plan sponsors (and ultimately to the plan members). The pharmacies pay B&O tax on their gross proceeds from sales, but funds that merely pass through ESI on their way to the pharmacies are not ESI's taxable revenues.

2. *First American* Controls, Not Rule 111 or Agency.

The Department's first straw man is an argument that the only way a taxpayer may eliminate amounts recorded for financial accounting purposes from its computation of B&O tax is under Rule 111 in the presence of an agency relationship. The Department spends at least four pages of its brief discussing Rule 111 cases (*see* DOR Brief at 16-19) even though there is no agency relationship and ESI has never purported to rely on Rule 111. The Department's argument that Rule 111 is exclusive is belied by *First American* where the court held that "[w]here the business acts only as a pass-through for funds, the pass-through funds are not included as income." 144 Wn.2d at 305. It did so without mentioning Rule 111 once, and where the facts were clear that there was no agency relationship.

None of the Department's attempts to minimize this inconvenient fact are availing. The Department first tries to avoid the implications of *First American* by stating that the case "did not involve pass-through payments" (DOR Brief at 20) when a critical factor in the case was that the funds to pay for the title insurance passed through UTCs (underwritten title companies). 144 Wn.2d at 302 ("the UTCs collected the premiums from the consumers, retained a portion . . . for abstracting services, and . . . [t]he remaining portion was remitted to First American . . . for title insurance"). Obviously, the Department's statement is untrue. Like the UTCs, ESI also acts as a pass-through for the sponsor's responsibility to pay the cost of the prescription drugs sold by the pharmacies.

Second, DOR argued that "the UTCs were not a party in the litigation." DOR Brief at 21. While this may be true it is also true that the treatment of the UTCs was critical to the holding of the court. How else could one interpret the penultimate point in the decision, that "the UTCs merely act as a pass-through entity for the proportional value of the product contributed by the insurer, . . . which is the value of the insurance policy?" *First American*, 144 Wn.2d at 305-06.

Third, the Department argues that the holding is not "helpful" to ESI because the court in *First American* allowed pass-through treatment only if it finds "a business arrangement with another entity to perform 'components' of a bundled transaction." DOR Brief at 21. In actuality, the court recognized First American and the UTCs as separate business entities, just as ESI, the pharmacies and plan sponsors are separate business entities:

> In this case . . . the proceeds of the business arrangement, described in the contracts between First American and the UTCs, recognizes the activities of the title insurer and the UTCs as separate business services. [Footnote omitted.]

144 Wn.2d at 304. In the related footnote the court also went on to state:

> The Department argues the relationship between First American and the various UTCs is that of a principal to its agents. ***We do not rely on principles of agency*** to determine the result in these unique circumstances because the statutory scheme dictates a different result.

Id. n.1 (emphasis added).

In short, the court rejected the argument that agency was the controlling factor, which necessarily means Rule 111 is not controlling authority under the Supreme Court's decisions. The Department attempted to make the same argument to the court in *First American* as it has here; namely, that agency and Rule 111 are the exclusive ways that a taxpayer may eliminate amounts recorded for financial accounting purposes from its computation of B&O tax. This court should reject it just as the *First American* court did.[2]

3. *Wash. Imaging* and *Wm. Rogers* Are Inapplicable

The Department says the "controlling authorities with respect to pass-through payments" is *Washington Imaging Services, LLC v. Dep't of Revenue*, 171 Wn.2d 548, 252 P.3d 885 (2011) and *City of Tacoma v. Wm. Rogers Co., Inc.*, 148 Wn.2d 169, 60 P.3d 79 (2002). DOR Brief at 23. Reliance on these cases does nothing more than reinforce the Department's Rule 111 straw man argument.

Washington Imaging ("Imaging") was a medical imaging company that retained another entity, Overlake Imaging Associates and its radiologists, to interpret the images created by Imaging. 171 Wn.2d at 551. After it was paid by insurers and patients for imaging services, Imaging paid Overlake a percentage of net receipts. *Id.* While patients were aware that the images were "interpreted by a physician, they [did] not know of Overlake's

[2] The Department also creates a straw man in arguing that the B&O tax applies unless a specific exemption exists. DOR Brief at 14 (citing *Dot Foods, Inc. v. Dep't of Revenue*, 185 Wn.2d 239, 245, 372 P.3d 747 (2016), *cert. denied*, 137 S. Ct. 2156 (2017)). Of course, ESI is not arguing that it owes no tax based upon an ***exemption***; tax does not apply because the gross receipts of separate taxpayers are ***excluded*** from the taxable B&O tax base in this first place. Further, as noted in ESI's opening brief, because the issue is the interpretation of tax imposition statutes, any doubt as to their meaning is given in favor of ESI and against the Department. *See First American*, 144 Wn.2d at 303 (citing *Duwamish Warehouse Co. v. Hoppe*, 102 Wn.2d 249, 254, 684 P.2d 703 (1984)).

involvement or of the contractual arrangements between" the two parties. *Id.* The issue was whether Imaging must pay B&O tax on the entire amount received from patients and insurers, or this amount less payments to Overlake. *Id.* The court held that the former was the correct measure of Imaging's B&O tax, in part because the report consisted of two components (technical and medical) and both were essential to the service (a written report that assisted physicians in treating patients) that Imaging provided. *Id.* at 552-53. In other words, the professional component (interpretation of the image by a radiologist) was a ***cost*** of Imaging's business. The Court stated:

> . . . "the business engaged in" [by Imaging] is the business of providing medical imaging services, which involves a "product" that is a report with both technical and professional components. Both of these components, creation . . . and interpretation of the image, are necessary to medical imaging services, the business in which Washington Imaging is engaged.

Id. at 556.

To the contrary in this case, the provision of pharmacy benefit management services is not required for the sale of prescription drugs. While ESI's services facilitate a more efficient transaction between pharmacies and ***their*** customers, the sale of prescription drugs continues to this day in the absence of such services. Thus, the holding of *Wash. Imaging* does not apply because the facts here demonstrate the absence of an integrated transaction.

Wm. Rogers (148 Wn.2d 169) also has no bearing on this case. In *Wm. Rogers*, the court concluded that the wages paid by a temporary staffing agency were its costs rather than those of the independent companies who contracted with the staffing agency for the labor of the employees. The court based its decision on the fact that the agency "functioned as the actual employer of its temporary workers" including "withholding payroll taxes and filing the employer's state and federal tax returns." *Id.* at 172-73. The taxpayer also provided the employees paid holidays and sick days, and the taxpayer's handbook even stated, "[y]ou remain our employee no matter where we assign you to work." *Id.* at 173. In this case, the prescription drugs are not ESI's costs – they are the costs of the pharmacies. That the funds from the plan sponsors are paid to ESI first and then ESI pays the pharmacies is merely a function of the unique, three-party, pharmacy benefit management arrangement between ESI, sponsors and pharmacies. Indeed, *First American* recognized a "unique commercial relationship" (144 Wn.2d at 304) between the title company and UTCs and the situation here between the three parties is also a "unique commercial relationship."

4. The Credit Card Example is Analogous, Indeed, *Identical* to the PBM Situation and the B&O Tax Implications Should Be the Same.

The Department itself does not even believe its straw man that Rule 111 is exclusive, as demonstrated by the credit card interpretive statement, Excise Tax Advisory (ETA) 3204 (*see* ESI's Opening Brief, Appendix A). In defining "gross income" of "Processors" in the credit card industry,[3] the Department states:

> For business and occupation (B&O) tax purposes, the transaction/ relationship between a merchant and the Merchant Bank and Processor

[3] A "'Processor' . . . provides credit card processing services to a merchant, pursuant to contracts with the Merchant Bank and the merchant." ETA 3204 at 1.

> 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.

ETA 3204 at 2-3.

"Example 1" in the bulletin (at 3) discusses the above arrangement, including the netting of fees, without regard to agency or Rule 111 whatsoever, and without any of these parties paying B&O tax on the funds passing through to pay the merchant for the cost of the goods sold to the customer. The Department's argument that the creation of an agency arrangement under Rule 111 is a prerequisite to excluding funds as a pass-through is contradicted not only by *First American*, but by the Department's own ETA 3204, since the sole basis for taxing only the fees and Merchant Discount is RCW 82.04.080(1)'s definition of "gross income of the business."

The Department tries to obscure the impact of ETA 3204 by addressing the last paragraph of the section, "Gross Income of Processors" and "Example 2" out of context. In context, it provides:

> 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.

ETA 3204 at 3 (emphasis added).

It is clear this "limited situation" is an ***exception***, not the general rule, as implied, ***if not outright stated***, by the Department (DOR Brief at 24-25).

In lieu of the weakness of this argument, the Department creates another straw man by arguing that ESI's credit card example is not supported by evidence or analysis. DOR Brief at 23. Even if ETA 3204 were not sufficient evidence of the Department's position in itself (and it is), ESI relied on the testimony of the Department's own auditor, Susan Barrett, who testified under oath of her familiarity with both ***PBMs and credit card transactions***.

Ms. Barrett stated she had "special expertise" in "bank audits" (CP 809 at lines 4-7) and she previously audited a "credit card company" (*id.* at lines 8-13, 15-17). She is also the only person in the Department who fields questions from other employees on "banks and financial institutions." CP 810 at lines 6-25. Ms. Barrett testified extensively about the credit card industry, how it operates and how it compares to the PBM business. CP 812-828. After establishing her expertise, she agreed that credit card and pharmacy transactions were ***analogous situations*** and that "a bank is being ***treated differently*** than a PBM." CP 827, line 23 through CP 828, line 1 (emphasis added).

Nonetheless, in yet another attempt to obscure the clarity of ESI's arguments and the undisputed evidence presented to the trial court, the Department argues that ESI "completely misunderstands the point" of ETA 3204 and proceeds to lecture ESI and the Court how "processing credit card transactions is a highly regulated function within the banking industry that is entirely and fundamentally distinct from the PMB services" performed by ESI. DOR Brief at 23-24. Of course, unlike ESI, the Department provided no evidence in support of this naked assertion. Neither is the credit card analogy "entirely inapt" (*id.* at 25) unless "inapt" is synonymous with "destructive of the straw man."

In the case of the pharmacy benefit manager the revenues received to pay for the ingredients sold by the pharmacies are taxable gross revenues. But, in the case of credit card processing the funds received by the Processor or Merchant Bank to pay the merchant for the cost of the goods sold to the customers are not gross revenues. As ESI has asked previously, why the difference? From an economic perspective the situations are not just analogous, but ***identical***.[4]

The Department attempts to explain the disparity by arguing that the amounts paid to the merchants are "funds the ***issuing bank*** forwards to the merchant in settlement of the cardholder's debt obligation to the merchant."

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[4] Footnote 5 of the Department's brief notes that banks do not record the entire amount of a payment of debt as revenue because the portion representing the return of capital is not revenue as the return of loaned property. Tellingly, the Department has not been able to distinguish (either at trial or in its brief) how ESI's advance of funds to pay the pharmacy on behalf of its client is anything other than a "loan" or that the client's repayment of the drug cost is anything other than a "return of capital."

DOR Brief at 25 (emphasis in original). Well, are not the payments to the pharmacies funds a pharmacy benefit manager forwards to the pharmacy in settlement of the plan sponsor's debt obligations to pay for the balance of the drug dispensed to the member by the pharmacy? The answer, of course, is "yes."

In fact, the only basis upon which the Department has been able to distinguish the pharmacy benefit management situation from a credit card transaction is that ingredient costs are included in the reporting of pharmacy benefit managers for financial statement and (consequently) federal income tax purposes while analogous amounts are not reported by credit card companies. Once again, the Department has made an unstated assumption that financial statements and federal income tax returns are determinative for B&O purposes, regardless of the economic realities of a transaction.[5] Of course, the Department does not, and cannot, state this assumption because it is contrary to Washington law.[6]

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[5] *Weyerhaeuser v. Dep't of Revenue*, 106 Wn.2d 557, 568, 723 P.2d 1141 (1986) (courts look at the "economic realities" of a transaction to determine its taxability).

[6] *See, e.g., Discount Tire Company of Washington, Inc. v. Department of Revenue,* 121 Wn. App. 513, 528, n.12, 85 P.3d 400 (2004) (rejecting the Department's argument that the standards set forth in Financial Accounting Standards Board Technical Bulletin 90-1, regarding the treatment of certain receipts should be determinative for B&O purposes); *Weyerhaeuser*, 106 Wn.2d at 564-65 (rejecting the Department's attempt to "impute" interest to a real estate sales contract when no actual interest was charged ("Weyerhaeuser's accountants, pursuant ***to generally accepted accounting principles***, internally computed an interest component at the prevailing rate, segregated that interest, and placed the interest proceeds in a separate account [as] Weyerhaeuser ***had to comply with these accounting principles pursuant to the requirements of the New York Stock Exchange and the Securities and Exchange Commission***") (emphasis added)). In a separate part of the same *Weyerhaeuser* decision, the court rejected the Department's argument that Weyerhaeuser "actually received" a tax credit regardless that the credit was claimed on the face of the company's ***federal tax return***. *Id.* at 568.

More damning to its obsequious argument is the fact that the Department does not follow its devotion to its unstated assumption all the way through. The ingredient costs are recorded on ESI's books for financial accounting purposes as revenue and then deducted as "costs of ***goods*** sold" (known as "COGS" in the accounting world). *See* CP 1301 (line 2). They are not recorded as "cost of ***services*** sold" or any other description for that matter. If financial statement and/or federal tax reporting were determinative, then the ingredient costs must be reported as "goods" regardless of the economic realities of the transaction, such that ESI should be taxed under the Retailing (RCW 82.04.250) or Wholesaling (RCW 82.04.270) B&O tax classification, not the Service classification. In short, for purposes of ***measuring*** the B&O tax, DOR purports that financial statements and federal tax returns are determinative, but when it comes to ***classification,*** they are not.

In summary, none of the Department's straw men alter the fact that the ingredients are the costs of the pharmacies (who pay B&O tax on these amounts) and not the costs of ESI. Consequently, the ingredient costs do not constitute gross income from engaging in a pharmacy benefit management business, and therefore are not subject to B&O tax.

B. The Trial Court Properly Determined that Rule 194 (2006) Exceeded Statutory Authority and Was Arbitrary and Capricious.

With respect to Rule 194, the sole issue is whether, before June 1, 2010, Washington chose to extend its apportionment to the full limits permitted by the United States Constitution. The answer is "no" and the trial court explicitly acknowledged this fact:

> The Legislature defines and controls the reach of the Washington B&O tax subject to constitutional limits. Although the Legislature cannot impose tax beyond what the state and federal constitutions allow, the Legislature can certainly choose not to tax to the full extent of what would be constitutionally permissible. The Court concludes 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 parallels the constitutional reach.***[7]

Former Rule 194 (all versions and iterations back to 1935) provided that B&O tax did ***not*** apply when a service provider domiciled outside Washington did not maintain a place of business in this state. This position was reflected at the time in Rule 194 (1983):

> When 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.

As such, the Department's attempt to broaden the scope of the tax through the adoption of Rule 194 (2006) was invalid. During all years former Rule 194 was in effect, the underlying statute, RCW 82.04.460(1), did not undergo any substantive amendment. "The Legislature's failure to amend a statute interpreted by administrative regulation constitutes legislative acquiescence in the agency's interpretation of the statute." *Manor v. Nestle Food Co.*, 131 Wn.2d 439, 445, n.2, 932 P.2d 628 (1997). The Legislature acquiesced in the Department's interpretation of RCW

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[7] CP 313 (Findings of Fact ("FF") 53) (emphasis added); *see* CP 309-313 (FF 34-52).

82.04.460(1) prior to 2006 – and its companion statute, RCW 82.04.220, as found by the trial court – by its failure to amend. "[W]here a statute has been left unchanged by the legislature for a significant period of time, 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." *Dot Foods, Inc. v. Dep't of Revenue*, 166 Wn.2d 912, 921, 215 P.3d 185 (2009). Then, in 2010, the Legislature did precisely that – it amended and revised the statute. 2010 1st sp.s. c 23 § 108.

The Department's long-winded and irrelevant explanation of the scope of the Commerce Clause (*see* DOR Brief at 31-34) does not alter the fact that the Legislature chose not to tax to the full extent permissible under the U.S. Constitution until 2010. Neither does the Department's desperate assertion that ESI waived any arguments with respect to the invalidity of Rule 194 under the arbitrary and capricious standard.[8] Finally, the Department's assertion that its announced "interpretation" acts to change duly enacted statutes constitutes a breathtaking appropriation of democratic authority onto itself. DOR Brief at 33-34.[9] The courts, and not administrative agencies, are the ultimate arbiters

[8] In the first place, the trial court held that Rule 194 (2006) ***was*** arbitrary and capricious, and therefore ESI is not required to challenge the court's decision in that regard. VRP 27 (06/10/16) at lines 17-19. Furthermore, even if ESI had the burden of assigning error on this point, the Department's position is wrong. In both cases cited by the Department, *Building Indus. Ass'n of Washington v. McCarthy*, 152 Wn. App. 720, 746, n. 11, 218 P.3d 196 (2009); *Holland v. City of Tacoma*, 90 Wn. App. 533, 538, 954 P.2d 290 (1998), the appellate court considered issues had been abandoned where only general references to arguments were made in the absence of any reasoned argument. Because the Department wishes to avoid discussing ESI's reasoned argument, it has constructed yet another straw man to distract this Court.

[9] The argument is all the more breathtaking given the Department purports to have had this so-called "interpretation" beginning in 1987, *(footnote continued on next page)*

of statutory interpretation. *Senate Repub. Campaign Comm. v. Pub. Disclosure Comm'n*, 133 Wn.2d 229, 241, 943 P.2d 1358 (1997). While courts may defer to an agency's interpretation of the law when it involves an area in which the agency has special expertise, courts are not bound by an agency's determinations. *Cashmere Valley Bank v. Dep't of Revenue*, 181 Wn.2d 622, 635-36, 334 P.3d 1100 (2014). This is true even though RCW 82.32.410 uses the word "precedent" to refer to departmental determinations. *See, e.g., Tacoma Subaru Inc. d/b/a The New Tacoma Nissan Subaru v. Dep't of Revenue,* Wash. Bd. Tax. App., 2004 WL 3363839, at *1 n.1 (2004) (indicating the Department's determinations are binding on the Department, not the Board of Tax Appeals). To accept DOR's arguments otherwise would adopt "an undesirable, if not dangerous, public policy" of allowing a departmental determination to "usurp the basic and traditional judicial function of the courts in the interpretation of tax statutes enacted by the legislature." *Rusan's, Inc. v. State*, 78 Wn.2d 601, 607, 478 P.2d 724 (1970) (explaining why neither a taxpayer nor government may stipulate to the meaning of a tax statute).

C. The Trial Court's Invalidation of Rule 194 (2006) Results In a Tax Refund Owed to ESI.

Because Rule 194 (2006) exceeded statutory authority and was arbitrary and capricious, the entire rule is invalid for periods prior to June 1, 2010. *See Washington State Hospital Ass'n v. Dep't of Health*, 183 Wn.2d 590, 353 P.3d 1285 (2015) (invalidating entire rule adopted by agency);

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an interpretation directly contrary to former Rule 194 that had been in place for decades. The Department would have this Court believe it took almost 20 more years to amend Rule 194 to conform it to the "new" interpretation.

Swinomish Indian Tribal Cmty. v. Dep't of Ecology, 178 Wn.2d 571, 311 P.3d 6 (2013) (striking down the entirety 2006 amendments to 13 new or amended rules promulgated by Department of Ecology on the ground that the rules exceeded the agency's statutory authority). When a rule is declared invalid, the aggrieved party is entitled to a remedy. In this case, that remedy is a tax refund during the period when the rule was in effect and applied to ESI (January 1, 2007 through May 31, 2010).

Once again, the Department resorts to the construction of straw men to avoid the clear implications of the law. First, contrary to the law, the Department states that the trial court's ruling that held ESI's challenge to Rule 194 (2006) was "granted 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." DOR Brief at 37 (citing CP 317). However, the trial court did not explain with specificity what "parts of the Rule" were declared invalid. This is not unsurprising since RCW 34.05.570(2)(c) allows a court to declare "the rule" invalid, not "parts" of "the rule." A contrary statute allowing courts to declare parts of rules invalid would wreak havoc on agencies, citizens and the courts because it would lead to endless disputes and further litigation.

Second, even if the trial court had the authority and intent to invalidate "parts" of the rule, the Department's Order created out of thin air a requirement that the "pre-2010 version of RCW 82.04.220" must "implicitly" have had a "statutory physical presence requirement." DOR Brief at 37 (citing CP 37). The law at the time (RCW 82.04.460(1)) required a "place of business" in Washington in order for an out-of-state service provider to be taxable, and there is no reference anywhere in the law to an "implied physical presence requirement." *See* DOR Brief at 37 (citing CP 313 FF 54).

Without discussion of how the newly created "implied physical presence requirement" does so, the Department then claims that "those aspects of the Rule involving the mechanics of apportionment" remain valid. DOR Brief at 40 (citing CP 17-23). While not defined, presumably the Department refers to the apportionment formula in the invalid rule that was applied to ESI for the period January 1, 2007 through May 31, 2010, and created nearly the entirety of the assessment.

Even if ESI had a place of business in Washington as required under the prior law, former RCW 82.04.460(1) would have required ESI to apportion its gross income by "separate accounting" or by apportioning "to this state that proportion of his total income which the cost of doing business with the state bears to the total cost of doing business both within and without the state." Thus, the formula required calculation of ***costs of doing business*** within and outside this state. The evidence in the record is that ESI had $68,998 in employee costs in Washington during tax year 2007, and no property or facility costs. CP 1308. All other costs were incurred by ESI outside Washington.

The Department was unsatisfied with the assessment resulting from the use of ESI's actual costs by separate accounting. Instead, DOR "assigned" costs "By Formula" as set forth in the invalid Rule 194 (2006) ***in excess of $200 million!*** Incredibly, as set forth in footnote 7 in DOR's Brief (at 42), the Department simply determined that ESI's Washington

income was equal to 2.035% of its total income and applied that same percentage (2.035%) to ESI's total costs to determine Washington costs, regardless of the amount of ESI's ***actual*** costs in this state. *See* CP 1308. The determination by DOR that income equals costs is absurd on its face. Income and costs are separate variables, and apportioning income using gross receipts was a clear violation of former RCW 82.04.460(1) because before June 1, 2010, the statute apportioned income based on costs.

In apportioning income using gross receipts, the Department once again substituted its judgment for the prerogatives of the Legislature. In ***2010,*** the Legislature adopted apportionment based on gross receipts (*i.e.*, "single factor receipts apportionment" (*see* RCW 82.04.462 and WAC 458-20-19402). Rule 194 (2006) attempted to disguise single factor receipts apportionment as cost apportionment. Therefore, even if the trial court had the authority to invalidate only a portion of Rule 194 (2006) (which it did not), it should still have invalidated the "apportionment formula" since the rule also constitutes an attempt by the Department to usurp the legislature.[10]

[10] To avoid this argument, the Department constructs yet another straw man, asserting that this Court should not address this issue because "the issue was not raised in [ESI's] complaint or in any motion it filed with the trial court." DOR Brief at 41. In the first place, ESI did not file any motion on the merits with the trial court; the two motions were summary judgment motions filed by the Department to which ESI responded. *See* CP 359-360, 467-489, 556-581. Second, in response to the Department's motions, ESI argued that the apportionment under Rule 194 (2006) was invalid. *See* CP 906-909, in particular, CP 908, line 18 through CP 909, line 3. Finally, to the extent that the Department relies on any absence of argument in ESI's Complaint, RCW 82.32.180 provides that a trial is conducted "***de novo and without the necessity of any pleadings other than the notice of appeal***. At trial, the burden shall rest upon the taxpayer to prove that the tax as paid by the taxpayer is incorrect, either in whole or in part, and to establish the correct amount of the tax" (emphasis added).

D. ESI Should Be Granted Relief Under Either Statutory or Common Law Estoppel.

The trial court, when it convened the summary judgment hearing, informed "counsel at the outset what I am interested in hearing and what I am not interested in hearing." VRP (03/24/17) at 3, lines 12-13. The court then immediately ruled, without any discussion or explanation, "in the Department's favor on the estoppel issues." *Id.* lines 14-15. Had it examined the estoppel issue, it would have found another independent basis for ruling in favor of ESI.

With regard to the Taxpayer Rights and Responsibilities Act (Chapter 82.32A RCW, commonly known as the Taxpayer Bill of Rights) and statutory estoppel (RCW 82.32A.020(2)), the Department asserts, without citing any authority, that recourse to statutory estoppel requires "actual evidence" of "reliance." DOR Brief at 44.[11] In fact, the Department's words -- "actual evidence" of "reliance" – are not in the statute. The statute actually states that a taxpayer has the "right to ***rely*** on specific, official written advice and written tax reporting instructions from the department … to that taxpayer." RCW 82.32A.020(2) (emphasis added). Since there is no definition of the word "rely" in the statute, the common dictionary definition is to be used to determine the plain meaning of the term. *State v. A.M.R.*, 147 Wn.2d 91, 94, 51 P.3d 790 (2002). The word "rely" means "to have confidence, trust" and "to look to for support

[11] The Department does not address ESI's argument that it is incongruous for a supposedly taxpayer-friendly "bill of rights" standard to impose a heretofore undefined and apparently testimonial standard of proof.

or aid, depend." Webster's New World Dictionary at 1134 (3rd Coll. Ed. (1994)).

The undisputed facts demonstrate that the Department issued a written report to ESI for the previous audit period (2001-2006) stating that ESI's pharmacy management benefit service revenues were not subject to B&O tax per Rule 194 (1983). CP 619-620. This prior audit even stated that the "instructions provided in this report . . . constitute 'specific written instructions.'" CP 619. Consistent with these written instructions in the audit report, ESI did not report revenues or pay B&O tax for the new audit period (2007-2010) through May 31, 2010. CP 641-49. The prior report constituted "specific, official written advice and written tax reporting instructions from the department." RCW 82.32A.020(2). The record reflects that ESI followed the instructions in the prior audit report because ESI did not pay tax on its pharmacy benefit management revenues. This demonstrated that ESI had "confidence" and "trust" in the report, which "supported" its B&O tax reporting from June 1, 2007 through May 31, 2010. ESI thus "relied" on the audit report within the plain meaning of the statute, and therefore that ESI is entitled "to have interest, penalties, and . . . [the] tax deficiency . . . waived." *Id.*

Further, even if there were an issue regarding the evidence demonstrating reliance on the audit report, this would indicate there are facts in dispute. This issue was determined on summary judgment with absolutely no analysis by the trial court. Since the Department has admitted that ESI claims reliance on the instructions provided by the Department, the proper procedural step would be to remand for an evidentiary hearing if the Department's standard were accepted.

Likewise, the Department's assertion that RCW 82.32A.020(5) imposes additional duties upon a taxpayer to always seek written clarification if it is uncertain about its tax reporting obligations beggars belief given that a bill of rights is supposed to benefit taxpayers, not impose additional duties on them. More importantly, ESI was not and has not been uncertain about its B&O tax reporting obligations after the 2001-2006 audit was completed. The audit report was clear and unambiguous and, as the record reflects, ESI followed the Department's instructions up until the law changed effective June 1, 2010. The Department's attempts to argue that its 2001-2006 audit report was given to Express Scripts Mail Pharmacy, Inc., not ESI, is contrary to the facts in the record, which reflects the audit instructions were given to "**Express Scripts, Inc. Registration No. 602 632 306**." CP 618-622 (bold in original). In short, DOR creates more straw men to avoid the real facts in this case.

Finally, the Department's arguments regarding ESI's compliance with the elements of common law estoppel (DOR Brief at 46-47) are just another way of saying the Department disbelieves them. Once again, the issue was decided on summary judgment with the trial court merely ruling "in the Department's favor on the estoppel issues." If the Department is disputing facts, which now appears to be the case, this Court should remand back to the trial court for an evidentiary hearing, if the Court does not otherwise find in ESI's favor.

III. CONCLUSION

While the Department tells the Court that ESI's "concerns over the measure of the B&O tax should be directed to the Legislature" (DOR Brief at 27-28) this is unnecessary since the existing statutes and common law demonstrate that ESI is entitled to the relief its seeks. Directing ESI "to the Legislature" is also quite rich, given that the Department purported to arrogate to itself the right to act as the Legislature in promulgating Rule 194 (2006) which the trial court has already declared invalid.

Further, even if the Court were to agree with the Department on the issue of the measure of the B&O tax, ESI is still entitled to partial relief for the audit period prior to June 1, 2010, because that part of the tax assessment was based on an invalid regulation (Rule 194 (2006)) and because principles of statutory (RCW 82.32A.020(2)) and common law estoppel grant ESI relief.

RESPECTFULLY SUBMITTED this 13th day of April, 2018.

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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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