

FILED  
Court of Appeals  
Division II  
State of Washington  
2/12/2018 4:21 PM

NO. 50348-4-II

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

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EXPRESS SCRIPTS, INC.,

Appellant,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE,

Respondent.

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**BRIEF OF RESPONDENT**

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## I. INTRODUCTION

Express Scripts, Inc. is one of the largest pharmacy benefit management companies in North America, generating billions of dollars in gross revenue annually. Since at least 2001, Express Scripts has been providing pharmacy benefit management (PBM) services in Washington for numerous corporate clients and government entities. In this appeal, Express Scripts raises a wide assortment of arguments for why it should be allowed to avoid paying business and occupation (B&O) tax on 95% or more of its gross income. All of its arguments fail.

The B&O tax is imposed “for the act or privilege of engaging in business activities” in the state and is measured by the “value of products, gross proceeds of sales, or gross income of the business, as the case may be.” RCW 82.04.220(1). “Gross income of the business” is defined as “the value proceeding or accruing by reason of the transaction of the business engaged in” without any deduction for the cost of tangible property being sold, the cost of materials used, or any other expense incurred in operating the business. RCW 82.04.080(1). These statutes advance the Legislature’s intent “to impose the business and occupation tax upon virtually all business activities carried on within the state.” *Simpson Inv. Co. v. Dep’t of Revenue*, 141 Wn.2d 139, 149, 3 P.3d 741 (2000).

Another important B&O tax statute applicable in this case is RCW 82.04.460(1), which allows apportionment of gross income derived from service activity that is taxable in more than one state. Whether a taxpayer has the right to apportion its service income is mainly a matter of constitutional law. As a result, RCW 82.04.460(1) must be construed in light of established constitutional requirements.

Express Scripts misconstrues these key B&O tax statutes. It argues that the terms “gross income of the business” in RCW 82.04.080(1) should be narrowly applied to permit it to exclude “ingredient costs” that it receives from its PBM clients and reports as gross income on its financial statements and federal income tax returns. It also argues that RCW 82.04.460(1), prior to being amended in 2010, did more than simply authorize apportionment of service income. According to Express Scripts, the pre-2010 version of RCW 82.04.460(1) limited the *imposition* of the B&O tax to businesses that maintained a permanent “place of business” in the state. Express Scripts contends that it had no established place of business in Washington during the tax periods at issue and, therefore, was not subject to B&O tax under its proffered reading of the statute.

The trial court correctly rejected these and other arguments, finding them to be inconsistent with established law. This Court should affirm.

## II. STATEMENT OF THE ISSUES

1. Did the Department correctly conclude that Express Scripts was not entitled to exclude from gross income the “ingredient costs” it receives from its clients and reports as gross income on its financial statements and federal tax returns?

2. Did the Department correctly impose B&O tax under the “service and other” tax classification in RCW 82.04.290(2) when Express Scripts undisputedly provides PBM *services* to its clients and does not sell tangible personal property?

3. Did the trial court, in addressing a challenge under the Administrative Procedure Act to the 2006 version of WAC 458-20-194, correctly reject Express Scripts’ claim that former RCW 82.04.460(1) “imposed” B&O tax on service providers and its claim that the Rule was inconsistent with that statute?

4. Should this Court address Express Scripts’ contention that the Department miscalculated the company’s apportionment factor when Express Scripts did not raise the issue below?

5. Did the trial court correctly reject Express Scripts’ contention that some or all of the assessed tax, interest and penalty should be waived as a result of a statement made in a prior audit of an Express Scripts subsidiary?

### III. STATEMENT OF THE CASE

#### A. Express Scripts Engaged in Substantial Business Activities Within Washington During the Audit Period.

Express Scripts was founded in 1986 and is headquartered in St. Louis, Missouri. CP 1026. The company has grown into one of the largest pharmacy benefit management (PBM) companies in North America. CP 1025. Its clients include health maintenance organizations, health insurers, third-party administrators, government and private employers, union-sponsored benefit plans, and government health programs. *Id.* These clients (commonly referred to as “plan sponsors”) hire Express Scripts to manage the clients’ prescription drug benefit programs. This management activity includes: (1) working with drug manufacturers, pharmacists and physicians to increase efficiency in the prescription drug distribution chain; (2) managing costs associated with providing prescription drug benefits to members and employees of its clients’ health benefit plans; and (3) improving “health outcomes and satisfaction” of plan members. *Id.*

In order to provide cost savings to its clients, Express Scripts negotiates with pharmaceutical manufacturers to obtain rebates and other payments tied to the utilization of brand-name drugs, and also contracts with retail pharmacies throughout the United States to establish the amount that will be paid for drugs dispensed to plan members. CP 1029

(discussing rebates); CP 1026 (discussing pharmacy network). In this respect, PBMs like Express Scripts act as behind-the-scenes middlemen in the prescription drug industry, negotiating with manufacturers, retailers, and plan sponsors to establish the policies and procedures for fulfilling prescription drug orders—including the prices charged for prescription drugs dispensed to plan members.

Express Scripts offers a “full range of [PBM] services to [its] clients,” including benefit plan design and consultation, drug formulary management, retail pharmacy management, and claims processing. CP 1025-26. To better serve its clients, Express Scripts has assembled a network of more than 60,000 retail pharmacies located throughout the United States, which enables plan members to fill prescriptions conveniently at multiple locations. *Id.*

During the 2007 through 2010 audit period, Express Scripts engaged in substantial business activities in Washington. The company had 58 Washington clients, including the Washington State Health Care Authority, King County, and the Seattle Mariners. CP 1036. In addition, Express Scripts had several full-time employees located in Washington. CP 491; CP 1039, 1041-042. It sent other employees into the state on a regular basis to meet with clients, CP 491, or to conduct audits of retail pharmacies. CP 1097-1100. Express Scripts concedes that its in-state visits

were important and helped it maintain good relationships with its clients.

CP 1385-386.

**B. Department's Audit of Express Scripts.**

Although Express Scripts had several employees who resided in Washington, and regularly sent other employees into the state to meet with clients or conduct audits of retail pharmacies, it did not begin filing Washington excise tax returns until June 2010. The Department became aware of Express Scripts' in-state business activities following an audit of its corporate subsidiary, ESI Mail Pharmacy, Inc., covering the 2001 through 2006 tax periods. CP 588-89. ESI Mail Pharmacy made retail sales of prescription drugs through the mail to Washington buyers and was assessed for unpaid B&O tax under the retailing tax classification. CP 585.

ESI Mail Pharmacy appealed the Department's audit assessment to the Washington Board of Tax Appeals. Through discovery in that appeal, the Department learned that ESI Mail Pharmacy's parent, Express Scripts, had a number of Washington clients and had sent employees into the state to solicit new business or to meet with existing customers. *Id.*; CP 1114-18. Based on this information, the Department scheduled an audit of Express Scripts. CP 589; CP 632.

At the conclusion of the audit, the Department determined that roughly two percent of Express Scripts' gross income from its PBM

services had been derived from Washington business activities during 2007 through 2010, resulting in a tax assessment of \$11,794,092 plus interest and penalties. CP 1130. Express Scripts paid the assessed amounts and sued for a refund under RCW 82.32.180. CP 4. Express Scripts also sought to invalidate a Department administrative rule, former WAC 458-20-194, that it claimed was inconsistent with former RCW 82.04.460(1). CP 17-23.

**C. Procedural History.**

The various claims asserted by Express Scripts were segregated into two proceedings, a rule challenge under the Administrative Procedure Act, RCW 34.05, and a tax refund action under RCW 82.32.180. CP 303. In the APA rule challenge, Express Scripts argued that the Department exceeded its statutory authority by amending WAC 458-20-194 in 2006 “without any change to the underlying statute, RCW 82.04.460(1).” CP 37. Express Scripts also argued that the Department acted arbitrarily and capriciously by changing “its longstanding interpretation of ‘place of business’ to mean ‘nexus’ in Rule 194 (2006).” *Id.*

The trial court rejected Express Scripts’ assertion that the 2006 rule amendment was inconsistent with former RCW 82.04.460(1). CP 308. The court explained that “RCW 82.04.460, both the version in effect when the 2006 rule was enacted and as amended in 2010, does not itself establish

whether a taxpayer is subject to the B&O tax. Other statutes expressly impose the tax, specifically RCW 82.04.220 and RCW 82.04.290.” *Id.* (FOF 30). Accordingly, the trial court rejected Express Scripts’ premise that former RCW 82.04.460(1) limited the *imposition* of the B&O tax to service businesses that maintained a “place of business” in Washington. Instead, the court found that RCW 82.04.220 “established as a matter of state law that the B&O tax applies to the service industry and that Express Scripts’ business activity falls within this statute.” CP 309 (FOF 36).

Although the trial court rejected Express Scripts’ argument, it nonetheless concluded that the 2006 amendment to Rule 194 was inconsistent with RCW 82.04.220, the statute that imposes the B&O tax. CP 310-13 (FOF 39-54). Specifically, the court found that the amended Rule’s discussion of “nexus” was inconsistent with an implied “physical presence” nexus requirement in RCW 82.04.220. The court’s decision was guided by a 2010 amendment to RCW 82.04.220 that specifically addressed nexus. CP 310 (FOF 39); *see also* Laws of 2010, 1st Spec. Sess., ch. 23, § 102 (amending RCW 82.04.220) and § 101 (legislative findings explaining the rationale for the amendment). As amended in 2010, RCW 82.04.220(1) provides that “[t]here is levied and collected from every person that *has a substantial nexus with this state* a tax for the

act or privilege of engaging in business activities.” CP 308 (FOF 32) (emphasis added) (quoting RCW 82.04.220(1) (2010)).<sup>1</sup>

The court reasoned that although the pre-2010 version of the statute did not contain any language addressing nexus, the statute impliedly required nexus between the taxpayer and the state. The court drew this inference from legislative findings that accompanied the 2010 amendment to RCW 82.04.220, in which the Legislature explained that it intended for the B&O tax to apply to out-of-state businesses that lack a physical presence in the state but derived substantial *economic value* from business activities directed toward the Washington market. The court reasoned that the Legislature’s adoption of an express “economic nexus” standard in 2010 implied that RCW 82.04.220 previously required “physical presence” nexus. CP 310 (FOF 38).

After interpreting the meaning of the pre-2010 version of RCW 82.04.220 as including an implied physical presence nexus standard, the trial court found that the Department exceeded its statutory authority when it “failed to include a ‘physical presence’ requirement in the 2006 amendment to Rule 194 consistent with the requirement the Court has found to be part of the statute.” CP 313 (FOF 54). The pertinent rule

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<sup>1</sup> The term “substantial nexus” as used in RCW 82.04.220(1) (2010) is defined in RCW 82.04.067, which was added to the B&O tax code in the same 2010 legislation that amended RCW 82.04.220. *See* Laws of 2010, 1st Spec. Sess., ch. 23, § 104.

language stated: “Nexus is created when a taxpayer is engaged in activities in the state, either directly or through a representative, for the purposes of performing a business activity.” WAC 458-20-194(2)(a) (2006).<sup>2</sup> The court invalidated that section of the 2006 rule because it “permitted B&O tax to be imposed on a business that lacked physical presence.” CP 316 (COL 6 and 7). The court did not invalidate any other parts of the rule, including those parts describing *how* to apportion, citing the fact that Express Scripts had not challenged those aspects of the rule in the APA proceeding. CP 313-14 (FOF 58); *see generally* WAC 458-20-194(5) (2006) (describing how to apportion under the “cost” method).

The court’s conclusion that the pre-2010 version of RCW 82.04.220 included a physical presence requirement did not impact the ultimate resolution of Express Scripts’ tax refund claim because the undisputed evidence established that Express Scripts had a substantial physical presence in Washington during the tax period. *See* CP 722 (letter ruling regarding physical presence). The trial court also granted summary judgment to the Department on all of the issues raised in the tax refund phase of the litigation. *See* CP 948 (order granting summary judgment on all but the “pass-through” issue); CP 981 (letter ruling granting summary

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<sup>2</sup> A copy of WAC 458-20-194 (2006) is attached as Appendix A.

judgment on the pass-through issue); CP 983 (final order). This appeal followed. CP 986.

#### IV. ARGUMENT

##### A. Standard of Review.

Review of an agency rule is governed by the Administrative Procedure Act (APA). *Washington Rest. Ass'n v. Wash. State Liquor Bd.*, 200 Wn. App. 119, 126, 401 P.3d 428 (2017). Agency rules may be invalidated under the APA only if they violate a constitutional provision, exceed the agency's statutory authority, were adopted without compliance with statutory rule-making procedures, or are arbitrary and capricious. RCW 34.05.570(2)(c). The validity of an agency rule is a question of law this Court reviews de novo. *Washington Rest. Ass'n*, 200 Wn. App. at 126. In this appeal, Express Scripts argues that WAC 458-20-194 (2006) exceeded the Department's statutory authority.<sup>3</sup> The party asserting that a rule exceeds the agency's statutory authority "must show compelling reasons why the rule conflicts with the intent and purpose of the legislation." *Washington Fed'n of State Emps. v. Dep't of Gen. Admin.*, 152 Wn. App. 368, 378, 216 P.3d 1061

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<sup>3</sup> Express Scripts also seeks to "incorporate by reference" an argument that the 2006 amendment to Rule 194 was arbitrary and capricious. App. Br. at 39. However, it is well established that an appellant abandons any issue which it attempts to "incorporate" into its appellate brief by reference to a trial brief or to other sources. *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).

(2009). Rules that are reasonably consistent with the underlying statute should be upheld. *Id.*

In a tax refund action under RCW 82.32.180, the person seeking the refund has the burden of establishing that the tax as paid is incorrect and also the correct amount of tax owed. RCW 82.32.180. Express Scripts' refund claim was denied pursuant to a Department motion for summary judgment. This Court reviews a grant of summary judgment de novo, engaging in the same inquiry as the trial court. *Activate, Inc. v. Dep't of Revenue*, 150 Wn. App. 807, 812, 209 P.3d 524 (2009). Summary judgment is appropriate when there are no genuine issues of material fact and the moving party is entitled to judgment as a matter of law. CR 56(c). Here, there were no disputed issues of material fact. The case involves application of B&O tax statutes to the undisputed facts, which is a question of law. *Washington Imaging Services, LLC v. Dep't of Revenue*, 171 Wn.2d 548, 555, 252 P.3d 885 (2011).

**B. Express Scripts Is Not Entitled to Exclude From Gross Income the “Ingredient Costs” It Receives From Its Clients.**

Express Scripts argues that it should be permitted to exclude from the B&O tax the amounts it receives from its PBM clients for “ingredient costs” because, according to Express Scripts, those amounts do not qualify as “value proceeding or accruing” to the company from its PBM business activities. Appellant's Br. at 25. No authority supports the claim.

**1. The B&O tax applies broadly.**

The B&O tax was enacted in 1935, and its core features have remained unchanged for more than eighty years. *See* Laws of 1935, ch. 180, Title II, §§ 4-15. The tax is imposed “for the act or privilege of engaging in business activities” and is measured by the “value of products, gross proceeds of sales, or gross income of the business, as the case may be.” RCW 82.04.220(1). It is a gross receipts tax, not a net income tax. *Tyler Pipe Indus., Inc. v. Dep’t of Revenue*, 105 Wn.2d 318, 327, 715 P.2d 123 (1986), *overruled in part on other grounds*, 486 U.S. 232, 107 S. Ct. 2810, 97 L. Ed. 2d 199 (1987). Accordingly, taxpayers may not deduct costs of doing business unless an express exemption or deduction applies. The Legislature made this clear by defining “gross income of the business” as “the value proceeding or accruing by reason of the transaction of the business . . . *without any deduction on account of the cost of tangible property sold, the cost of materials used, labor costs, interest, discount, delivery costs, taxes, or any other expense whatsoever paid or accrued . . .*” RCW 82.04.080 (emphasis added).

The term “value proceeding or accruing” is also defined broadly as the consideration “actually received or accrued.” RCW 82.04.090. Our Supreme Court has stated that “[b]roader language could hardly be devised to convey the idea implicit in [these] definitions that the tax

applies to everything that is earned, received, paid over to or acquired by the seller.” *Engine Rebuilders, Inc. v. State*, 66 Wn.2d 147, 150, 401 P.2d 628 (1965). The amounts Express Scripts seeks to exclude from its gross income fit within the plain meaning of these statutorily-defined terms.

Additionally, it is well established that the Legislature, when it enacted the B&O tax, intended it to apply to “upon virtually all business activities carried on within the state.” *Simpson Inv. Co.*, 141 Wn.2d at 149. To achieve that intent, the tax “is to be imposed as broadly as constitutionally allowed.” *Avnet, Inc. v. Dep’t of Revenue*, 187 Wn.2d 44, 51, 384 P.3d 571 (2016). As a result, “[t]he tax applies unless a specific exemption exists.” *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).

**2. Amounts Express Scripts refers to as “ingredient costs” are properly included as gross income of the business.**

The amounts that Express Scripts refers to as “ingredient costs” represent consideration it actually received under the terms of its contracts with its PBM clients. *See* CP 1221 (example PBM contract); CP 1238 (paragraph 2-4 of contract detailing the “payment procedures”). Pursuant to its PBM contracts, Express Scripts agreed to perform a variety of services pertaining to a client’s prescription drug benefit program. For instance, Express Scripts is responsible for establishing and maintaining a

“network of Participating Pharmacies to serve [plan] Members” as well as processing claims for “Covered Drugs dispensed by a Pharmacy.” CP 1242-43 (paragraphs 5-2.A and 5-3.A).

In addition to contracting with plan sponsors, Express Scripts also contracts with retail pharmacies to provide prescription drugs to plan members. CP 1026. Importantly, through its contractual agreements, Express Scripts remains “solely responsible” for managing the client’s drug benefit program and it “assume[s] the credit risk of [its] clients’ ability to pay for drugs dispensed by [the] network pharmacies.” CP 1297. In short, the business engaged in by Express Scripts includes all aspects of managing its clients’ drug benefit programs, including the obligation to pay retail pharmacies for drugs dispensed to plan members.<sup>4</sup>

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<sup>4</sup> An essential aspect of Express Scripts’ business model is to deal directly with retail pharmacies on its own behalf and not as an agent of its clients. See CP 1297 (“[U]nder most of our client contracts, we realize a positive or negative margin represented by the difference between the negotiated ingredient costs we will receive from our clients and the separately negotiated ingredient costs we will pay to our network pharmacies”). For this reason, Express Scripts’ reliance on *Walthew, Warner, Keefe, Arron, Costello & Thompson v. Dep’t of Revenue*, 103 Wn.2d 183, 691 P.2d 559 (1984), is misplaced. See Appellant’s Br. at 25. Unlike the circumstances in *Walthew*, Express Scripts is not paying for costs that *remain the obligation of the client*. See *id.* at 185 (law firm’s practice was to sign contracts with its clients confirming the client’s obligation to pay all costs involved in litigation). Instead, Express Scripts is paying costs that are its sole responsibility under its contracts with plan sponsors and retail pharmacies. Thus, the circumstances here are more akin to those in *St. Joseph General Hospital v. Department of Revenue*, 165 Wn. App. 23, 267 P.3d 1018 (2011), where a hospital unsuccessfully sought to exclude from its gross income amounts it paid over to emergency room physicians for their services. This Court noted that the hospital took on the obligation to pay emergency room physicians for their services. See *id.* at 29 (“There is no indication in the record that *patients* had an obligation to pay *the third-party service provider* . . . for the services rendered. In fact, the evidence in the record supports that *only* St. Joseph had payment obligations to [the service provider]”).

Express Scripts points out that a large part of the consideration it receives from its clients is roughly equivalent to the amount it has contracted to pay to retail pharmacies for the cost of drugs dispensed to plan members. *See* CP 756 (diagram showing \$45 “Ingredient costs” charged and received from plan sponsor and \$44 “Ingredient costs” paid to retail pharmacy). But the fact that Express Scripts has undertaken the obligation to pay retail pharmacies for dispensing prescription drugs to plan members does not provide a legal basis to exclude part of the consideration it actually receives for managing its clients’ drug benefit programs. To the contrary, because Express Scripts has taken on the responsibility to pay retail pharmacies as part of its PBM business model, those payments are a cost of its PBM business and are not deductible under the B&O tax code. RCW 82.04.080(1).

**3. The “ingredient costs” do not merely “pass-through” Express Scripts.**

The B&O tax does not apply to amounts “that merely ‘pass through’ a business in its capacity as an agent.” *Washington Imaging*, 171 Wn.2d at 560 (quoting *City of Tacoma v. Wm. Rogers Co. Inc.*, 148 Wn.2d 169, 175, 60 P.3d 79 (2002)). For instance, the collection of an automobile licensing fee by an auto dealer acting as an agent for the licensing agency

is not taxable gross income of the auto dealer. *Wm. Rogers*, 148 Wn.2d at 176.

WAC 458-20-111 (Rule 111) represents the Department's longstanding interpretation of RCW 82.04.080 with respect to payments received by an agent. That Rule describes how to distinguish business expenses, which may not be deducted from the taxpayer's gross income, from "non-income" amounts that are excluded from gross income because they are received by a taxpayer acting solely in its capacity as an agent. Specifically, Rule 111 provides that the exclusion applies only when the taxpayer acts as an agent in advancing funds to a third party. *See* WAC 458-20-111 ("[t]he words 'advance' and 'reimbursement' apply only when the customer or client alone is liable for the payment of the fees or costs and when the taxpayer making the payment has no personal liability therefor, either primarily or secondarily, other than as agent for the customer or client"). By contrast, an amount received by the taxpayer that represents reimbursement for its costs of doing business "constitutes a part of . . . gross income of the business." *Id.* This is consistent with longstanding Washington law. *See Pullman Co. v. State*, 65 Wn.2d 860, 867, 400 P.2d 91 (1965) (reimbursement payments were gross income of the business even though no profit was realized). In short, billing a client for

“reimbursement” of business expenses does not make those charges excludable from the B&O tax.

Payments received by a taxpayer can qualify for exclusion from taxation under Rule 111 only when: (1) the payments are customary reimbursements for advances made by the taxpayer to procure a service for the client; (2) the payments involve services that the taxpayer did not or could not render; and (3) the taxpayer is not liable for the advances or payments it made to third parties other than as an agent of the client.

*Washington Imaging*, 171 Wn.2d at 561-62. The third element has two components. The taxpayer must prove both that the payment received from the client was made pursuant to an agency relationship and that the taxpayer’s liability to pay the funds to a third party constituted solely agent liability. *Wm. Rogers*, 148 Wn.2d at 177-78. If the taxpayer independently assumes any liability to the third party, the payments it receives are not excluded from taxation “even if the taxpayer uses the payments to pay costs related to the services it provided to its client.” *Id.* at 178 (citing *Walthew*, 103 Wn.2d at 189).

The “ingredient costs” Express Scripts receives from its clients do not qualify for exclusion from taxation under these standards. First, the amounts pertain to Express Scripts’ management of its clients’ drug benefit programs, not reimbursement for advances made to procure

services from a third party. In addition, the amounts do not involve “a true agency relationship.” *See* CP 912 (Express Script is “acting as a principal on its own account rather than as an agent for other parties to the PBM transaction”). And its payments to third-party retail pharmacies were not based on “agency liability.” Instead, the payments were based on Express Scripts’ own contractual obligation to pay retail pharmacies for drugs dispensed to covered members. CP 1297. Express Scripts voluntarily undertook that obligation, and the costs of paying those pharmacies became part of its costs of doing business. Thus, Express Scripts meets none of the elements required under Rule 111.

Express Scripts maintains that there are other, alternative, ways to establish that the receipt of money from a client is an excludable “pass-through” payment. Appellant’s Br. at 29. But no authority supports the claim. Moreover, the definition of a pass-through payment is an amount “that merely ‘pass[es] through’ a business in its capacity *as an agent*.” *Washington Imaging*, 171 Wn.2d at 560 (quoting *Wm. Rogers*, 148 Wn.2d at 175) (emphasis added). To qualify, the taxpayer must prove that “a true agency relationship” exists. *Id.* at 562. Without the required agency relationship, there can be no excludable pass-through.

**4. The holding in *First American Title Insurance Company* does not create an alternative pass-through theory.**

As support for its alternative “pass-through” theory, Express Scripts relies heavily on *First American Title Insurance Company v. Department of Revenue*, 144 Wn.2d 300, 27 P.3d 604 (2001). See Appellant’s Br. at 25-27. However, that case did not involve pass-through payments. Instead, *First American* involved the *allocation* of taxable receipts between entities engaged in different aspects of a bundled sale of title insurance. *First American*, 144 Wn.2d at 303. The facts and analysis in *First American* are not applicable in this appeal.

*First American* involved a title insurance company that operated in Washington in association with various “underwritten title companies” (UTCs), whereby the UTCs would “sell a bundled package to consumers in a single transaction.” *Id.* at 304. The bundled package consisted of title insurance provided by First American and title abstracting services provided by the UTCs. *Id.* Under the terms of the parties’ contracts, the UTCs collected the total fee from the consumers, retained the portion pertaining to its title abstracting service, and remitted the remaining portion of the fee to First American for providing the title insurance. *Id.* at 302. From these facts, the Court held that the amounts paid by consumers for the bundled service should be allocated in the manner provided in the

contracts entered into between First American and the UTCs. *Id.* at 305.

“Because a UTC sells its own services in addition to insurance, we conclude in this situation First American is not subject to tax liability for the sale of a UTC’s service and should pay tax on [only] the portion of the premium allocated to it under its business agreement with the UTC.” *Id.*

The Court briefly discussed the pass-through concept at the end of its opinion with respect to the tax treatment of the UTCs. *Id.* at 305.

However, the UTCs were not a party in the litigation, and the amounts paid by consumers to the UTCs never “passed through” First American. Consequently, the Court’s general discussion of pass-through payments had no bearing on First American. Rather, the Court’s analysis pertaining to First American involved the allocation of receipts between entities engaged in “two components” of a single transaction. *Id.* at 305, n.3.

*First American* is not helpful to Express Scripts because the company has presented no evidence or argument suggesting that it has entered into a business arrangement with another entity to perform “components” of a bundled transaction. To the contrary, Express Scripts is “solely responsible” for the PBM services it provides to its clients. CP 1297. It is not performing those services in conjunction with another entity, and there is no agreement pertaining to the allocation of fees

between Express Scripts and another entity. Thus, none of the facts that informed the Supreme Court's decision in *First American* are present here.

Moreover, there is nothing in *First American* suggesting that our Supreme Court intended to establish an "alternative" method by which a taxpayer could claim pass-through treatment. *First American* has certainly never been cited for that proposition. And cases decided both before and after *First American* have emphasized that treating income as merely passing through a taxpayer in its capacity as an agent can apply only when specific elements are met, including proof of a true agency relationship. *See, e.g., Walthew*, 103 Wn.2d at 189 (law firm was "acting solely as agent for the client in advancing the type of litigation expense involved here"); *Washington Imaging*, 171 Wn.2d at 566 (taxpayer "fails to show that it is in an agency relationship with its patients"). Had the Supreme Court in *First American* intended to announce an alternative means of achieving the tax benefit of pass-through treatment that requires none of the elements outlined in Rule 111, it would have made that intent clear. Express Scripts simply reads into *First American* a legal proposition that has no support in the law.

*First American* is easily distinguishable from the facts of this case, and it did not modify Washington law pertaining to pass-through payments. Consequently, *First American* is not "controlling authority" as

Express Scripts argues. Appellant’s Br. at 25. Rather, it has no bearing on any issue raised by Express Scripts in this appeal. The controlling authorities with respect to pass-through payments are *Washington Imaging*, 171 Wn.2d 548, and *William Rogers*, 148 Wn.2d 169.

**5. Express Scripts’ analogy to credit card processors and merchant banks is inapt.**

Express Scripts also argues that it should be allowed to exclude the amount of “ingredient costs” it receives from its clients from its gross income because (in its view) “credit card processors and merchant banks” are allowed to exclude their “payments to the merchants.” Appellant’s Br. at 27. Express Scripts provides virtually no analysis of the business activities of credit card processors or merchant banks, and cites no authority supporting its novel theory that it stands in the same position as these financial service providers for B&O tax purposes. As a result, its argument fails. *See Cook v. Brateng*, 158 Wn. App. 777, 794, 262 P.3d 1228 (2010) (“Appellate courts need not consider arguments that are unsupported by pertinent authority, references to the record, or meaningful analysis”).

Moreover, Express Scripts completely misunderstands the point of the Department’s interpretive statement on credit card processors, Excise Tax Advisory (ETA) 3204 (attached as Appendix A to Express Scripts’

brief). That ETA addresses how the B&O tax applies to credit card processors in light of the complex structure of the national interbank payment system for settling credit card transactions. *See* ETA 3204, p. 2 (describing the credit card processing system). The activity of processing credit card transactions is a highly regulated function within the banking industry that is entirely and fundamentally distinct from the PBM services performed by Express Scripts.

In the national interbank payment system, credit card processors contract with merchants to provide processing services in exchange for a “merchant discount,” which usually is a percentage of the gross proceeds the merchant is entitled to receive from the buyer. The largest component of the merchant discount is the “interchange fee,” which is the amount the merchant’s bank owes to the “issuing bank” as compensation for issuing credit and advancing funds. *See generally*, ETA 3204 at p. 1 (defining key terms used in the national interbank payment system, including “merchant discount,” “interchange fee,” and “issuing bank”). The issue addressed by the Department’s ETA is whether a credit card processor must report the entire merchant discount as “gross income of the business” inclusive of the interchange fee. The resolution of this issue turns on whether the credit card processor is acting “solely as an agent” of the merchant bank in negotiating the merchant discount fee with the merchant. The ETA

explains that a credit card processor must pay B&O tax on the entire merchant discount unless it can establish it was acting “solely as an agent” of the merchant bank. *See id.* at p. 3 (Example 2).

Express Scripts contends that its business activity is analogous to that of a credit card processor. Appellant’s Br. at 27. But the analogy is entirely inapt. In addition, Express Scripts’ limited discussion of the credit card industry is inaccurate. According to Express Scripts, “credit card processors and merchant banks are allowed to exclude from the measure of B&O tax payments to merchants.” *Id.* What Express Scripts fails to explain is that the “payments” it is alluding to are the funds the *issuing bank* forwards to the merchant in settlement of the cardholder’s debt obligation to the merchant. That payment has nothing to do with any activity engaged in by a credit card processor or merchant bank. Simply put, credit card processors and merchant banks are strangers to the contractual arrangement between a cardholder, the issuing bank, and the merchant. They have no substantive involvement in the underlying sales transaction. As more fully explained in ETA 3204, the credit card processor’s activity is limited to processing the credit card payment, for which it receives gross income in the form of a merchant discount fee.

In contrast, the “ingredient costs” received by Express Scripts are amounts it bills and collects for its own account for services it has agreed

to perform. Under its PBM contracts, Express Scripts has assumed the obligation to pay for prescription drugs dispensed to plan members (and the right to realize a profit on the difference between its costs and the amount it charges its clients for the drugs). CP 1297. Consistent with that obligation, it independently negotiates the price it charges its clients and the price it will pay to network pharmacies for drugs dispensed to plan members. *Id.* And it records the full amount it receives from its PBM clients as gross income on its financial statements and federal income tax returns, which is further evidence that its analogy to “credit card processors and merchant banks” is inapt. *See* CP 1275 (full amount Express Scripts received from clients is recorded in one of three “Claims Revenue” accounts); CP 1301 (2007 proforma federal income tax return showing gross receipts of \$9,409,364,181, which includes full amount received from clients); CP 911 (Express Scripts’ counsel does not dispute that full amount received from clients are included as gross income in the company’s financial accounting records and federal tax returns).<sup>5</sup>

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<sup>5</sup> Express Scripts makes a misstatement of fact at page 20 of its brief when it asserts that a bank receiving payment on a credit card debt will “record[] the entire amount received from the [borrower] as revenue.” That is not true. The portion of the payment that represents the return of capital is not “revenue” to the bank. *See* Det. No. 90-63, 9 WTD 107 at \*22 (1990) (explaining that “since the enactment of the [B&O tax] statute in 1935, B&O tax has not been assessed against the recovery of principal indebtedness . . .”). Although Washington’s B&O tax system “is extremely broad,” *Steven Klein, Inc. v. Department of Revenue*, 183 Wn.2d 889, 896, 357 P.3d 59 (2015), it is not so broad as to impose tax on the return of loaned property.

Express Scripts' claim that its business activity was equivalent to that of a credit card processor or merchant bank is factually incorrect and supported by no pertinent legal analysis. Consequently, the claim should be rejected.

**6. Express Scripts' concerns over the measure of the B&O tax should be directed to the Legislature.**

Express Scripts and its subsidiaries have created a profitable niche within the prescription drug industry, generating roughly \$100 billion in gross revenue annually. CP 1328. The gross income at issue here is an apportioned share of the revenue the company received from its clients under the terms of PBM service contracts. Under the terms of those contracts, Express Scripts charges its clients an "ingredient cost" plus additional fees for every prescription it processes through its claim adjudication system. Express Scripts reports the entire amount it receives from its clients as gross income on its federal income tax returns. Those amounts are also gross income under the B&O tax code.

If Express Scripts believes that Washington's tax laws should be changed, its remedy lies with the Legislature. "The legislature has broad plenary powers in its capacity to levy taxes," including the authority to enact tax deductions. *Japan Line, Ltd. v. McCaffree*, 88 Wn.2d 93, 96, 558 P.2d 211 (1977). Moreover, the Legislature is capable of crafting statutory

exemptions or deductions that make fiscal and tax policy sense. For these reasons, courts are reluctant to enlarge existing tax preferences through statutory construction, and will not usurp the Legislature's role by creating new tax preferences.

**C. The Department Correctly Imposed B&O Tax Under the "Service and Other" Tax Classification.**

Express Scripts is a service provider. CP 6. It admits in its complaint that "it does not sell pharmaceutical products or other tangible personal property." *Id.*<sup>6</sup> Additionally, its business activities do not fit within any other express tax classification. Consequently, the Department correctly imposed B&O tax on Express Scripts' service income under the "service and other" tax classification in RCW 82.04.290(2). *See Steven Klein*, 183 Wn.2d at 897.

There should be no controversy about the proper B&O tax classification applicable to Express Scripts' PBM business activities. Nonetheless, Express Scripts argues that the Department "fails to grasp" that including all of the company's gross income as part of the measure of the tax "*treats* ESI as if it were selling prescription drugs." Appellant's Br. at 30. The argument is nonsense.

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<sup>6</sup> Express Scripts does have subsidiaries that sell prescription drugs to consumers through the mail, including ESI Mail Pharmacy. But the income of those subsidiaries is not at issue in this appeal.

The Department is not “treating” Express Scripts as if it were selling prescription drugs. Rather, the Department recognizes that Express Scripts is a service provider that has contracted to manage all aspects of its clients’ drug benefit programs, *including the obligation of paying retail pharmacies for prescription drugs dispensed to plan members*. Assuming the obligation to pay for prescription drugs dispensed to plan members is an integral part of Express Scripts’ business model and does not make it a “wholesaler” of those drugs, Express Scripts’ rhetorical argument to the contrary has no legal or factual support and should be summarily rejected.

**D. The Trial Court Correctly Rejected Express Scripts’ Claim That Former RCW 82.04.460(1) “Imposed” B&O Tax on Service Providers.**

Throughout this litigation Express Scripts has conflated the language and purpose of RCW 82.04.220—which imposes the B&O tax—with the language and purpose of RCW 82.04.460(1)—which permits certain businesses to apportion their gross income. Express Scripts made this argument in the rule challenge phase of the litigation and again in the tax refund phase. *See* CP 45 (arguing in support of rule challenge that “the key to taxation of service providers in Washington was the maintenance of a place of business in the state”); CP 512 (arguing in support of refund claim that RCW 82.04.460(1) imposed B&O tax on service providers with a “place of business” in the state). It continues to make the argument here.

Appellant's Br. at 32, 43, & 44. The argument was correctly rejected by the trial court and should be rejected in this appeal.

**1. Express Scripts' claim that former 82.04.460(1) imposed B&O tax on service providers is inconsistent with the language of the statute and supported by no authority.**

RCW 82.04.220 imposes the B&O tax on persons engaging in business activity within the state. By contrast, RCW 82.04.460(1) *permits* apportionment of the tax base in certain circumstances. Express Scripts cites no case supporting its claim that the pre-2010 version of RCW 82.04.460(1) somehow "imposed" the B&O on only those persons with a place of business in the state. The established authority is to the contrary. *See Smith v. State*, 64 Wn.2d 323, 391 P.2d 718 (1964) (out-of-state tugboat company with no place of business in the state was nonetheless subject to B&O tax on a portion of its service income).

The apportionment statute, RCW 82.04.460, is important for purposes of correctly *measuring* the amount of service income subject to B&O tax. But it is not, and never has been, the statute that imposes the tax. This is evident from the plain language of the statute and the way it has been interpreted and applied by the Department and the courts.

When the Legislature first enacted the B&O tax code in 1935, it did not include a provision specifically addressing apportionment. *See* Laws of 1935, ch. 180. Instead, the Legislature included a general tax

deduction designed to address constitutional issues such as the right to apportion income derived from interstate commerce: “In computing the tax there may be deducted from the measure of the tax amounts derived from business which the state is prohibited from taxing under the Constitution of this state or the Constitution or laws of the United States.” *Id.* at § 12(f). The provision has remained unchanged since 1935 and is codified in RCW 82.04.4286. It ties the State’s imposition of B&O tax to what is permissible under the federal and state constitutions.

One important aspect of federal constitutional law pertaining to state taxation is apportionment of the tax base. Fair apportionment is required under the dormant Commerce Clause to “ensure[] that each State taxes only its fair share of an interstate transaction.” *Ford Motor Co. v. City of Seattle*, 160 Wn.2d 32, 49, 156 P.3d 185 (2007) (citing *Oklahoma Tax Comm’n v. Jefferson Lines, Inc.*, 514 U.S. 175, 184-85, 115 S. Ct. 1331, 131 L. Ed. 2d 261 (1995)). An unapportioned tax will impermissibly burden interstate commerce if its practical effect creates a risk of multiple state taxation. *Gwin, White & Prince v. Henneford*, 305 U.S. 434, 439-40, 59 S. Ct. 325, 83 L. Ed. 272 (1939). Conversely, “by applying the principles of apportionment, states may tax that part of an interstate transaction which takes place within the state.” *Smith*, 64 Wn.2d at 334.

In *Gwin*, the United States Supreme Court invalidated on dormant Commerce Clause grounds the assessment of B&O tax on unapportioned gross receipts received by a Washington business from its interstate business activities. 305 U.S. at 439-40. In response, the Legislature enacted a provision specifically addressing apportionment. *See* Laws of 1939, ch. 225 § 4. As originally enacted, the statutory apportionment provision applied to “[a]ny person engaged in the business of rendering services both within and without the state.” *Id.* That statute, now codified as RCW 82.04.460, has been amended several times throughout its almost eighty-year history. The amendment giving rise to Express Scripts’ contention that it owed no B&O tax during the 2007 through 2010 audit period was enacted in 1941 when the phrase “rendering services both within and without the state” was replaced with “rendering services and maintaining places of business both within and without this state.” *See* Laws of 1941, ch. 178, § 5. That language, while modified by subsequent amendments, was not fully abandoned until 2010 when the statute was extensively modified. *See* Laws of 2010, 1st Spec. Sess., ch. 23, § 108.

During the periods at issue here, RCW 82.04.460(1) permitted apportionment with respect to “[a]ny person rendering services taxable under RCW 82.04.290 or 82.04.2908 and maintaining places of business both within and without this state which contribute to the rendition of such

service.” RCW 82.04.460(1) (2006). Under the statute’s plain language, the place of business requirement triggers the right to apportion, not whether B&O tax is owed. A taxpayer that failed to meet the statutory prerequisites for apportionment under former RCW 82.04.460(1) did not escape the tax. *Crown Zellerbach Corp. v. State*, 45 Wn.2d 749, 762, 278 P.2d 305 (1954). Rather, under a strict reading of the statute, the taxpayer’s income would be taxed on an unapportioned basis. If this were the result here, Express Scripts would owe considerably more tax for the periods at issue.

However, as discussed above, the right to apportion is not merely a question of state statute. Taxpayers have a right to apportionment under established dormant Commerce Clause jurisprudence if their business activities face a risk of multiple state taxation. The Department has for many years interpreted and applied former RCW 82.04.460 in a manner that comports with this constitutional requirement.

In 1987, the Department first announced in a published tax determination that “irrespective of whether the taxpayer meets the precise terms of RCW 82.04.460, the United States Constitution, and thus RCW 82.04.4286, requires apportionment of gross receipts derived from business activities which are substantially performed within and outside the state.” Det. No. 87-183, 3 WTD 195 at \*4 (1987) (copy at CP 170-

174). Many other Department tax determinations have echoed this interpretation of former RCW 82.04.460(1). *See, e.g.*, Det. No. 92-262E, 12 WTD 431 at \*9 (1992) (“apportionment is required when a tax paying business conducts revenue producing activities both within and without the state”); Det. No. 93-132, 13 WTD 271 (1994) (ruling that a taxpayer who does not maintain a place of business outside Washington is entitled to apportion service income when the out-of-state services are more than incidental). And the Court of Appeals, in a case involving apportionment of a local B&O tax imposed by the City of Seattle, cited with approval the Department’s interpretation of the state’s apportionment statute. *See KMS Financial Servs., Inc. v. City of Seattle*, 135 Wn. App. 489, 509, 146 P.3d 1195 (2006) (relying on Det. No. 87-183 and another determination as support for its holding that apportionment of the city’s tax was constitutionally required).

Express Scripts was entitled to apportion its PBM service income under former RCW 82.04.460(1). It was not, however, exempt from tax liability under that statute. *Cf. Ford Motor Co.*, 160 Wn.2d at 46-47 (City of Seattle’s apportionment statute was “merely designed to contain the measure of the tax within permissible bounds” and did not create an exemption from the City’s B&O tax). Its claim to the contrary flies in the face of the language of the statute and is supported by no authority.

**2. The 2006 revision to Rule 194 correctly interpreted the right of service businesses to apportion their income.**

Since 1987 the Department has consistently taken the position that apportionment cannot be denied based on a strict reading of RCW 82.04.460. That did not change in 2006 when Rule 194 was amended.

The 2006 amendment repealed the prior version of Rule 194 and replaced it with an updated explanation of the right to apportion and the mechanics of apportionment. *See* AR 0145 (WSR 05-24-054, amending WAC 458-20-194). Express Scripts complains primarily about section (2)(a) of the revised Rule, which interpreted the statute’s “place of business” requirement to include any activities “sufficient to create nexus.” Rule 194(2)(a) (2006). As explained in that section, “[i]t is not necessary that a taxpayer have a permanent place of business within a state to create nexus.” *Id.* Rather, “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.” *Id.* This amended language was consistent with published Department tax determinations, including Det. No. 87-183 discussed above. Additionally, the revised Rule was consistent with the language of former RCW 82.04.460(1) and RCW 82.04.4286 when those statutes are read in light of dormant Commerce Clause principles requiring apportionment.

The statutory phrase “place of business” in the pre-2010 version of RCW 82.04.460(1) did not require a restrictive construction that would cut off a taxpayer’s right to apportion even when its interstate business activities create a genuine risk of multiple state taxation. And even if the statute did require such a restrictive interpretation, RCW 82.04.4286 acts as a savings clause, permitting the Department and the courts to construe RCW 82.04.460(1) in a manner that comports with federal constitutional requirements. Denying the right to apportionment based on a strict reading of the phrase “place of business” would be repugnant to the federal constitution and, therefore, would trigger application of RCW 82.04.4286, which permits taxpayers to deduct from the measure of the B&O tax amounts that the state is constitutionally prohibited from taxing.

When Rule 194(2)(a) (2006) is read in light of both former RCW 82.04.460(1) and RCW 82.04.4286, it fairly and reasonably interprets the statutory right of service providers to apportion their income to avoid the risk of multiple state taxation. Express Scripts arguments to the contrary are inconsistent with the purpose and language of RCW 82.04.460(1) and completely ignore RCW 82.04.4286.

**3. The trial court's ruling invalidating Rule 194's interpretation of "place of business" does not result in a tax refund.**

Express Scripts argued below and continues to argue in this appeal that former Rule 194 was inconsistent with former RCW 82.04.460(1). CP 42; Appellant's Br. at 32. The trial court rejected the argument. *See* CP 317 ("Express Scripts' challenge to the 2006 amendment to WAC 458-20-194 is 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"). However, the court, on its own initiative and without the benefit of briefing from the parties, held that former Rule 194(2)(a) was inconsistent with former RCW 82.04.220 because the Rule did not discuss the "physical presence" nexus standard that the court believed was implicitly part of the statute. *Id.* The trial court's reasoning was based primarily on legislative findings contained in the 2010 amendment to RCW 82.04.220. CP 309. Although the court recognized that invalidating a 2006 rule amendment based on legislative findings made in 2010 was unusual, it nonetheless concluded that the Department in 2006 should have addressed the statute's implied physical presence requirement. CP 313 (FOF 54).

The trial court's decision proved to be harmless. Invalidating the Department's regulatory interpretation of "place of business" did not make

Express Scripts immune from B&O tax. Rather, the company was still required to establish that it was immune from the tax under the B&O tax statutes—a burden it was unable to meet because of its many contacts with Washington. *See* CP 722 (trial court found that “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”).

Express Scripts contends, however, that it would be immune from B&O tax if this Court were to reverse the trial court’s ruling invalidating those portions of former Rule 194 that it found to be inconsistent with an implied “physical presence” requirement in former RCW 82.04.220 and, instead, invalidate the entire Rule based on Express Scripts’ claim that it was inconsistent with RCW 82.04.460(1). Appellant’s Br. at 32. There are two flaws with Express Scripts’ theory.

First, as discussed above in section IV.D.1, there is no merit to Express Scripts’ contention that former RCW 82.04.460(1) “imposed” B&O tax on only those service providers with a permanent place of business in the state. Thus, its underlying premise for attacking the 2006 version of Rule 194 is incorrect as a matter of law.

Second, regardless of what Rule 194 stated, Express Scripts was subject to the Washington B&O tax on an apportioned share of its PBM service income *under controlling statutes*, namely RCW 82.04.220

(imposing the tax), RCW 82.04.290(2) (establishing the tax rate under the service and other tax classification), and RCW 82.04.460(1) (permitting apportionment of service income). The Rule cannot create or expand tax immunity to businesses operating within the state. *See Coast Pac. Trading, Inc. v. Dep't of Revenue*, 105 Wn.2d 912, 917, 719 P.2d 541 (1986); *Avnet, Inc. v. Dep't of Revenue*, 187 Wn. App. 427, 439-40, 348 P.3d 427 (2015), *aff'd* 187 Wn.2d 44, 384 P.3d 571 (2016). It stands to reason that invalidating the Rule also cannot create or expand tax immunity.

During the 2007 through 2010 audit period, Express Scripts conducted significant business activity within Washington, and no legal authority supports its claim that it is wholly immune from Washington tax on gross income derived from that business activity. Consequently, it is not entitled to the tax refund it is seeking irrespective of the outcome of its APA rule challenge.

**4. The trial court did not err in retaining those parts of former Rule 194 that were not challenged.**

The trial court's decision in the rule challenge phase of the litigation only impacted former Rule 194(2)(a), which broadly described when apportionment was available. It did not impact those portions of the

Rule setting out the mechanics of apportionment. This was by design, and with the agreement of the parties.

The trial court's decision invalidating only part of former Rule 194 was informed by the fact that Express Scripts did not challenge those aspects of the Rule involving the mechanics of apportionment. *See* CP 17-23 (portion of complaint pertaining to rule challenge). In addition, Express Scripts expressly agreed that it would be inappropriate for the trial court to make a ruling with respect to those portions of the Rule that had not been challenged. *See* CP 275-76 ("Any issues related to the non-challenged portion of Rule 194 (2006) were not before the Court, and it would be inappropriate for the Court to address or 'validate' those parts in this Order"). And even if Express Scripts had not agreed with the trial court on this matter, the court's decision was consistent with the APA, which provides that a court can grant relief only when the party challenging agency action can show substantial prejudice. RCW 34.05.570(1)(d). Express Scripts cannot show that it was substantially prejudiced by aspects of former Rule 194 it did not challenge. Consequently, the trial court did not err in retaining the unchallenged parts of the Rule.

**E. This Court Should Reject Express Scripts' New Claim That the Department Miscalculated the Apportionment Formula.**

Express Scripts spends just over one page of its brief arguing that the Department miscalculated the company's apportionment formula. Appellant's Br. at 45-46. However, the issue was not raised in Express Scripts complaint or in any motion it filed with the trial court. For this reason, it is not surprising that none of the 22 assignments of error Express Scripts lists in its opening brief or any of its various "issues on appeal" pertain to the Department's computation of the company's apportionment formula. As a result, this Court should refuse to address whether the apportionment computation was correct. RAP 2.5(a); RAP 10.3(g).

Even if the Court were to address the merits of Express Scripts' newly offered claim of improper apportionment, the simple answer is that the apportionment method applied in the Express Scripts audit was the same method that applied to all other businesses performing services both inside and outside the state during the periods at issue. Under that method, costs that cannot be assigned by location are assigned based on the ratio of "sales in Washington over sales everywhere." Former Rule 194(4)(h)(i). That approach for assigning costs among the various states in which a taxpayer generates its gross income was consistent with the intent and

purpose of the statute and should be upheld.<sup>7</sup> Express Scripts presents no reasoned argument or cogent evidence to the contrary. As a result, its claim fails. *See Smith*, 64 Wn.2d at 339 (person challenging apportionment computation must show it was “unreasonable, excessive, or . . . arbitrarily and capriciously achieved”).

**F. The Trial Court Correctly Rejected Express Scripts’ Claim That Tax, Interest, and Penalty Should Be Waived.**

Express Scripts asserts that the tax, interest, and penalty assessed in the audit should be waived under RCW 82.32A.020(2), or that the assessment should be barred under the doctrine of equitable estoppel. Appellant’s Br. at 46-49. Both arguments fail.<sup>8</sup>

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<sup>7</sup> The Department’s application of former Rule 194 resulted in the apportionment of roughly two percent of Express Scripts’ gross income to Washington. *See, e.g.*, CP 1308 (2007 apportionment worksheet showing 2.0350% apportionment factor). The apportioned share of Express Scripts’ total income upon which the Department assessed B&O taxes fairly reflects the amount of gross income “derived from services rendered within this state.” Former RCW 82.04.460(1). Express Scripts’ contention that virtually none of its income should be apportioned to Washington is absurd on its face.

<sup>8</sup> Express Scripts, relying on *Potter v. Washington State Patrol*, 165 Wn.2d 67, 196 P.3d 691 (2008), argues that RCW 82.32A.020(2) sets out a separate remedy from the doctrine of equitable estoppel, and is not a statutory limitation to that doctrine. Appellant’s Br. at 47. The issue in *Potter* was whether “the process for redeeming an impounded vehicle as set forth in RCW 46.55.120” completely abrogated the common law remedy for conversion. *Id.* at 72. By contrast, RCW 82.32A.020(2) did not completely abrogate the common law doctrine of equitable estoppel. Rather, the Legislature merely provided that estoppel with respect to the imposition of taxes must be based on “official written advice and written tax reporting instructions from the department to the taxpayer.” RCW 82.32A.020(2). As a result, *Potter* is distinguishable. However, because Express Scripts cannot meet the requirements of either the statute or the equitable doctrine, the issue does not need to be resolved in this appeal. For this reason, the Department will separately address the statutory and common law claims.

**1. Express Scripts does not meet the requirements of RCW 82.32A.020(2).**

In 1991 the Legislature enacted the Taxpayer Rights and Responsibility Act, which details the rights and obligations that apply to the taxpaying public. Laws of 1991, ch. 142 (codified in RCW 82.32A).

As relevant here, RCW 82.32A.020 provides that taxpayers have:

(2) The 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; [and]

. . . .

(5) The right to receive, upon request, clear and current tax instructions, rules, procedures, forms, and other tax information; . . . .

RCW 82.32A.020. Express Scripts did not seek “clear and current tax instructions” from the Department pertaining to its 2007 through 2010 tax reporting obligation. Instead, the company claims that it relied on its interpretation of instructions provided by the Department in a prior audit that covered the 2001 through 2006 tax periods. Appellant’s Br. at 46. However, Express Scripts offers no evidence to support its purported “reliance.” More importantly, the evidence that is in the record undercuts Express Scripts’ bald assertion of reliance. For instance:

- The prior audit involved business activities of a subsidiary corporation that made retail sales of prescription drugs. CP 588

(Barrett Decl., ¶ 26). The prior audit did not involve Express Scripts' PBM business activities. *Id.*<sup>9</sup>

- The prior audit instructions were specifically limited to the 2001 through 2006 tax periods. *See* CP 618 (“This is a partial audit and is limited in scope to the period audited . . . .”)
- The prior audit instructions explained that service B&O tax was not being assessed for the periods under audit because the taxpayer had no physical presence in Washington and its service activity occurred entirely outside the state. CP 619-20. The instructions did not “imply” that the company’s PBM services were “not subject to B&O tax pursuant to Rule 194.” Appellant’s Br. at 46.
- The prior audit instructions were issued in December 2007, CP 622, yet Express Scripts did not file Washington B&O tax returns for any of the January 2007 through November 2007 reporting periods as required under RCW 82.32.045. (Returns due on a monthly basis absent agreement by the Department).
- The company’s Tax Director testified that he did not review the prior audit instructions until “somewhere around 2011, ‘12 time frame,” and could not explain whether or how the company had relied on that prior audit report. CP 943-45.

Reliance under RCW 82.32A.020(2) must be proven through actual evidence. Express Scripts provides only argument on this point,

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<sup>9</sup> The audit instructions that Express Scripts contends it relied on were provided with respect to the Department’s audit of a mail order pharmacy business that the auditor initially understood was conducted by Express Scripts. CP 583-84 (Barrett Decl., ¶¶ 9, 12-13). After the audit was concluded, the Express Scripts tax manager informed the Department that the mail order business was actually conducted by ESI Mail Pharmacy, a wholly owned subsidiary of Express Scripts. CP 586-87 (¶¶ 20-23). By agreement, the Department transferred the tax assessments that initially were issued to Express Scripts to ESI Mail Pharmacy. CP 587 (¶ 24). However, the Department neglected to issue a revised audit report specifying that the audited taxpayer was ESI Mail Pharmacy. *Id.* (¶ 25). That oversight has given Express Scripts the opportunity to claim in this appeal that the prior audit report was “specific, official written advice” to Express Scripts and pertained to Express Scripts PBM service activity. Appellant’s Br. at 46. But the undisputed facts in the record disprove the claim.

citing no evidence. Appellant's Br. at 46. Consequently, the company fails to establish that it is entitled to any relief.

The reliance required under RCW 82.32A.020(2) should also be reasonable. Here, Express Scripts' bald assertion of reliance is premised on its own interpretation of the prior audit report. According to Express Scripts, it construed the audit report "by implication" to explain that "other fees" it received from its PBM business operations were "not subject to B&O tax pursuant to Rule 194." Appellant's Br. at 46. But the audit report said no such thing, and Express Scripts made no effort to seek advice or clarification from the Department. Express Scripts' decision to read into the prior audit report "implied" audit findings pertaining to its PBM service activity, without doing any further research or investigation, was not reasonable. *Cf. Port of Seattle v. Dep't of Revenue*, 101 Wn. App. 106, 118, 1 P.3d 607 (2000) (taxpayer could not rely on its mistaken inferences from written advice regarding a specific business activity to avoid taxes on a related but different business activity).

RCW 82.32A.020(2) does not permit tax, interest, or penalties to be waived based on a taxpayer's misinterpretation of written instructions. Rather, as explained in a related statute, a taxpayer has the responsibility to seek clarification from the Department if it is uncertain about its "tax reporting obligations." RCW 82.32A.030(2). Express Scripts' purported

decision to interpret the prior audit report as implicitly carving out its PBM service activities from the reach of the B&O tax was not reasonable, and does not entitle the company to relief under RCW 82.32A.020(2).

**2. Express Scripts does not meet the requirements of equitable estoppel.**

The requirements pertaining to equitable estoppel are well established. *See generally Dep't of Ecology v. Theodoratus*, 135 Wn.2d 582, 599, 957 P.2d 1241 (1998) (listing elements); *In re Estate of Hambleton*, 181 Wn.2d 802, 833-34, 335 P.3d 398 (2014) (same). Express Scripts meets none of the elements necessary to invoke the doctrine.

Express Scripts' estoppel claim is not supported by clear and cogent proof. Instead, Express Script simply argues that (1) it did not file B&O tax returns based on its purported reliance on audit instructions that it interpreted as excluding its PBM income from tax, (2) its purported reliance prevented it from changing its business practices to lawfully avoid paying B&O tax, (3) it would be "manifestly unjust to permit DOR to retain this overpayment," and (4) the amount in dispute is only a "drop in the state budget bucket." Appellant's Br. at 49. In short, the "proof" offered by Express Scripts is its own interpretation of the prior audit report, speculation regarding what it would have done had the prior audit report been re-issued to ESI Mail Pharmacy, and its plea that its tax

liability ought to be forgiven because plenty of other taxpayers will carry the load. None of these arguments is sufficient to establish equitable estoppel. *See, e.g., Filmore LLLP v. Unit Owners Ass'n*, 183 Wn. App. 328, 352, 333 P.3d 498 (2014) (estoppel cannot be established by virtue of speculation or conjecture) (citation omitted)).

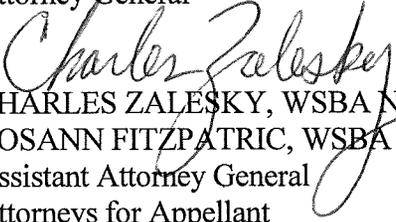
The trial court did not err when it rejected Express Scripts' unsubstantiated equitable estoppel claim. This Court should affirm.

#### V. CONCLUSION

The trial court correctly rejected each of Express Scripts' wide-ranging arguments that were properly presented below. Consequently, this Court should affirm the trial court with respect to issues 1, 2, 3, and 5. Issue 4—whether the Department's apportionment computation was accurate—was not raised below and is supported by no evidence. As a result, this Court should summarily deny the claim.

RESPECTFULLY SUBMITTED this 12th day of February, 2018.

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

DATED this 12th day of February, 2018, at Tumwater, WA.

  
Carrie A. Parker, Legal Assistant

# **APPENDIX A**

transfer of cargo; imported automobile handling prior to delivery to consignee; terminal stevedoring and incidental vessel services, including but not limited to plugging and unplugging refrigerator service to containers, trailers, and other refrigerated cargo receptacles, and securing ship hatch covers.

Persons engaging in business as an international steamship agent, international customs house broker, international freight forwarder, vessel and/or cargo charter broker in foreign commerce, or international air cargo agent are subject to business tax at the rate .0033 upon gross income with respect to such international activities.

In computing public utility tax, there may be deducted from gross income so much thereof as is derived from actually transporting persons or property or transmitting communications or electrical energy, from this state to another state or territory or to a foreign country and vice versa.

Persons, including dock companies or wharfage companies, are permitted no deduction from gross income of amounts received for services performed in this state consisting of the handling of cargo or freight even though such cargo or freight has moved or will move across the state's boundaries.

No deduction is permitted with respect to gross income derived from activities which are ancillary to transportation across the state's boundaries, such as income received by a wharf company or warehouse company for the storage of goods. The mere ownership or operation of facilities by means of which others engage in foreign or interstate commerce is an activity ancillary to such commerce and any income received therefrom is taxable.

Insofar as the transportation of goods is concerned, the interstate movement of cargo or freight ceases when the goods have arrived at the destination to which it was billed by the out-of-state shipper, and no deduction is permitted of the gross income derived from transporting the same from such point of destination in this state to another point within this state. Thus, freight is billed from San Francisco, or a foreign point, to Seattle. After arrival in Seattle it is transported to Spokane. No deduction is permitted of the gross income received for the transportation from Seattle to Spokane. Again, freight is billed from San Francisco, or a foreign point, to a line carrier's terminal, or a public warehouse in Seattle. After arrival in Seattle it is transported from the line carrier's terminal or public warehouse to the buyer's place of business in Seattle. No deduction is permitted of the gross income received as transportation charges from the line carrier's terminal or public warehouse to the buyer's place of business in Seattle.

The interstate movement of cargo or freight begins when the goods are committed to a carrier for transportation out of the state, which carrier will start the transportation to a point outside the state.

[Statutory Authority: RCW 82.32.300, 83-07-033 (Order ET 83-16), § 458-20-193D, filed 3/15/83; Order ET 74-1, § 458-20-193D, filed 5/7/74; Emergency Order ET 74-6, filed 9/30/74 and Emergency Order ET 74-7, filed 10/3/74, effective 1/1/75; Order ET 70-3, § 458-20-193D (Rule 193 Part D), filed 5/29/70, effective 7/1/70.]

## WAC 458-20-194 Doing business inside and outside the state. (1) Introduction.

(2007 Ed.)

(a) This section applies to persons entitled to apportion income under RCW 82.04.460(1). Specifically this section applies to taxpayers who maintain places of business both within and without the state that contribute to the rendition of services and who are taxable under RCW 82.04.290, 82.04.-2908, or any other statute that provides for apportionment under RCW 82.04.460(1). Persons subject to the service and other activities, international investment income, licensed boarding home, and low-level radioactive waste disposal business and occupation (B&O) tax classifications, and who are not required to apportion their income under another statute or rule, should use this section. In addition, this section describes Washington nexus standards for business activities subject to apportionment under RCW 82.04.460(1). Nexus is described in subsection (2) of this section; separate accounting in subsection (3) of this section; and cost apportionment in subsection (4) of this section.

(b) Readers may also find helpful information in the following rules:

(i) WAC 458-20-14601 (Financial institutions—Income apportionment).

(ii) WAC 458-20-170 (Constructing and repairing of new or existing buildings or other structures upon real property).

(iii) WAC 458-20-179 (Public utility tax).

(iv) WAC 458-20-193 (Inbound and outbound interstate sales of tangible personal property).

(v) WAC 458-20-236 (Baseball clubs and other sport organizations).

(c) The examples included in this section identify a number of facts and then state a conclusion. These examples should be used only as a general guide. The tax results of all situations must be determined after a review of all the facts and circumstances.

### (2) Nexus.

(a) **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 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.

(b) **Examples.** The following examples demonstrate Washington's nexus principles.

(i) Assume an attorney licensed to practice only in Washington performs services for clients located in both Washington and Florida. All of the services are performed within Washington. The attorney does not have nexus with any state other than Washington.

(ii) Assume the same facts as the example in (b)(i) of this subsection, plus the attorney attends continuing education classes in Florida related to the subject matter for which his Florida clients hired him. The attorney's presence in Florida for the continuing education classes does not create nexus because he is not engaging in business in Florida.

[Title 458 WAC—p. 301]

(iii) Assume the same facts as the example in (b)(ii) of this subsection, plus the attorney is licensed to practice law in Florida and frequently travels to Florida for the purpose of conducting discovery and trial work. Even though the attorney does not maintain an office in Florida, the attorney has nexus with both Washington and Florida.

(iv) Assume an architectural firm maintains physical offices in both Washington and Idaho. The architectural firm has nexus with both Washington and Idaho.

(v) Assume an architectural firm maintains its only physical office in Washington, and when the firm needs a presence in Idaho, it contracts with nonemployee architects in Idaho instead of maintaining a physical office in Idaho. Employees of the Washington firm do not travel to Idaho. Instead, the contract architects interact directly with the clients in Idaho, and perform the services the firm contracted to perform in Idaho. The architectural firm has nexus with both Washington and Idaho.

(vi) Assume the same facts as the example in (b)(v) of this subsection except the contracted architects never meet with the firm's clients and instead forward all work products to the firm's Washington office, which then submits that work product to the client. In this case, the architectural firm does not have nexus with Idaho. The mere purchase of services from a subcontractor located in another state that does not act as the business' representative to customers does not create nexus.

(vii) Assume that an accounting firm maintains its only office in Washington. The accounting firm enters into contracts with individual accountants to perform services for the firm in Oregon and Idaho. The contracted accountants represent the firm when they perform services for the firm's clients. The firm has nexus with Washington, Oregon, and Idaho.

(viii) Assume that an accounting firm maintains its only office in Washington and has clients located in Washington, Oregon, and Idaho. The accounting firm's employees frequently travel to Oregon to meet with clients, review client's records, and present their findings, but do not travel to Idaho. The accounting firm has nexus with Washington and Oregon, but does not have nexus with Idaho.

(ix) Assume that a sales representative earns commissions from the sale of tangible personal property. The sales representative is located in Oregon and does not enter Washington for any business purpose. The sales representative contacts Washington customers only by telephone and earns commissions on sales of tangible personal property to Washington customers. The sales representative does not have nexus with Washington and the commissions earned on sales to Washington customers are not subject to Washington's business and occupation tax.

(x) The examples in this subsection (2) apply equally to situations where the Washington activities and out-of-state activities are reversed. For example, in example (b)(ix) of this subsection, if the locations were reversed, the sales representative would have nexus with Washington, but not in Oregon.

### (3) Separate accounting.

(a) **In general.** "Separate accounting" refers to a method of accounting that segregates and identifies sources or activities which account for the generation of income within the state of Washington. Separate accounting is distinct from cost apportionment, which assigns a formulary portion of total worldwide income to Washington. A separate accounting method must be used by a business entitled to apportion its income under RCW 82.04.460(1) if this use results in an accurate description of gross income attributable to its Washington activities.

(b) **Accuracy.** Separate accounting is accurate only when the activities that significantly contribute, directly or indirectly, to the production of income can be identified and segregated geographically. Separate accounting thus links taxable income to activities occurring in a discrete jurisdiction. The result is inaccurate when services directly supporting these activities occur in different jurisdictions. For example, if a taxpayer provides investment advice to clients in Washington, but performs all of its research and due diligence activities in another state, then separate accounting would not be accurate. However, if instead of research and due diligence, only the client billing activity is performed in another state, then separate accounting would be allowed.

(c) **Approved methods of separate accounting.** The following methods of separate accounting are acceptable to the department, if accurate:

(i) **Billable hours of employees or representative third parties performing services in Washington.** If a business charges clients an hourly rate for the performance of services, and the place of performance of the employee, contractor, or other individual whose time is billed is reasonably ascertainable, then the billable hours may be used as a basis for separate accounting. The gross amount received from hours billed for services performed in Washington should be reported.

(ii) **Specific projects or contracts.** A business may assign the revenue from specific projects or contracts in or out of Washington by the primary place of performance. For example:

(A) A consulting business with no other presence in Washington that agrees to provide on-site management consulting services for a Washington business and receives five hundred thousand dollars in payment for the project must report five hundred thousand dollars in gross income to Washington.

(B) If the same business gets another Washington client for on-site management consulting, and receives another payment of five hundred thousand dollars, the business must report an additional five hundred thousand dollars in gross income to Washington.

(C) If a business contracts to distribute advertisements for another business within the state of Washington, the gross amount received for this action should be reported as Washington income.

(iii) **Other reasonable and accurate methods—Notice to the department.**

(A) A taxpayer may report with, or the department may require, the use of one of the alternative methods of separate accounting.

(B) A taxpayer reporting under this subsection must notify the department at the time of filing that it is using an

alternative method and provide a brief description of the method employed. If a taxpayer reports using an alternate method, the same method must be used for all subsequent tax reporting periods unless it is demonstrated another method is necessary under the standard in (c)(iii)(E) of this subsection.

(C) If on review of a taxpayer's return(s) the department determines another method is necessary to fairly represent the extent of a taxpayer's business activity in Washington, then the department may impose the method for all returns within the statute of limitations. Statutory interest applies to both balances due and refund or credit claims arising under this section. Further, applicable penalties will be imposed on balances due arising under this section. However, if the taxpayer reported using the separate accounting method in (c)(i) or (ii) of this subsection or cost apportionment under subsection (4)(a) through (h) of this section, the department may impose the alternate method for future periods only.

(D) A taxpayer may request that the department approve an alternative method of separate accounting by submitting a request for prior ruling pursuant to WAC 458-20-100. Such letter ruling may be subject to audit verification before issuance.

(E) The taxpayer or the department, in requesting or imposing an alternate method of separate accounting, must demonstrate by clear and convincing evidence that the separate accounting methods in (c) of this subsection do not fairly represent the extent of the taxpayer's business activity in Washington.

**(4) Cost apportionment.**

**(a) Apportionment ratio.**

(i) Each cost must be computed according to the method of accounting (cash or accrual basis) used by the taxpayer for Washington state tax purposes for the taxable period. Persons should refer to WAC 458-20-197 (When tax liability arises) and WAC 458-20-199 (Accounting methods) for further guidance on the requirements of each accounting method. Taxpayers must file returns using costs calculated based on the taxpayer's most recent fiscal year for which information is available, unless there is a significant change in business operations during the current period. A significant change in business operations includes commencement, expansion, or termination of business activities in or out of Washington, formation of a new business entity, merger, consolidation, creation of a subsidiary, or similar change. If there is a significant change in business operations, then the taxpayer must estimate its cost apportionment formula based on the best records available and then make the appropriate adjustments when the final data is available.

(ii) The apportionment ratio is the cost of doing business in Washington divided by the total cost of doing business as described in RCW 82.04.460(1). The apportionment ratio is calculated under this section as follows. The denominator of the apportionment ratio is the worldwide costs of the apportionable activity and the numerator is all costs specifically assigned to Washington plus all costs assigned to Washington by formula, as described below. Costs are calculated on a worldwide basis for the tax reporting period in question. The tax due to Washington is calculated by multiplying total income times the apportionment ratio times the tax rate. Available tax credits may be applied against the result. Statutory interest and penalties apply to underreported income. For

the purposes of this rule, "total income" means gross income under the tax classification in question, less deductions, calculated as if the B&O tax classification applied on a worldwide basis.

(b) **Place of business requirement.** A taxpayer must maintain places of business within and without Washington that contribute to the rendition of its services in order to apportion its income. This "place of business" requirement, however, does not mean that the taxpayer must maintain a physical location as a place of business in another taxing jurisdiction in order to apportion its income. If a taxpayer has activities in a jurisdiction sufficient to create nexus under Washington standards, then the taxpayer is deemed to have a "place of business" in that jurisdiction for apportionment purposes. See subsection (2) of this section.

(c) **Noncost expenditures.** The following is a list of expenditures that are not costs of doing business within the meaning of RCW 82.04.460 and are therefore excluded from both the numerator and the denominator of the apportionment ratio. Expenditures that are not costs of doing business include expenditures that exchange one business asset for another; that reflect a revaluation of an asset not consumed in the course of business; or federal, state, or local taxes measured by gross or net business income. This list is not exclusive. Costs of an activity taxable under another B&O tax classification are also excluded from the apportionment ratio. Similarly, the costs of acquiring a business by merger or otherwise, including the financing costs, are not the costs of doing the apportioned business activity and must be excluded from the cost apportionment calculation.

(i) The cost of acquiring assets that are not depreciated, amortized, or otherwise expensed on the taxpayer's books and records on the basis of generally accepted accounting principles (GAAP), or a loss incurred on the sale of such assets. For example, expenditures for land and investments are excluded from the cost apportionment formula.

(ii) Taxes (other than taxes specifically related to items of property such as retail sales or use taxes and real and personal property taxes).

(iii) Asset revaluations such as stock impairment or goodwill impairment.

(iv) Costs of doing a business activity subject to the B&O tax under a classification other than RCW 82.04.290 or 82.04.2908. For example, if a taxpayer were subject to manufacturing, wholesaling and service and other activities B&O tax, the costs associated with a warehouse and a manufacturing plant (property and employee costs) are excluded from the cost apportionment formula. But if costs support both the service activity and either manufacturing or wholesaling (for example, costs associated with headquarters or joint operating centers), then those costs must be included in the cost apportionment formula without segregating the service portion of the costs.

(d) **Specifically assigned costs.** Real or tangible personal property costs, employee costs, and certain payments to third parties are specifically assigned under (e) through (g) of this subsection.

**(e) Property costs.**

(i) **Definitions.** Real or tangible personal property costs are defined to include:

(A) Depreciation as reported on the taxpayer's books and records according to GAAP, provided that if a taxpayer does not maintain its books and records in accordance with GAAP, it may use tax reporting depreciation. A taxpayer may not change its method of calculating depreciation costs without approval of the department;

(B) Maintenance and warranty costs for specific property;

(C) Insurance costs for specific property;

(D) Utility costs for specific property;

(E) Lease or rental payments for specific property;

(F) Interest costs for specific property; and

(G) Taxes for specific property.

(ii) **Assignment of costs.** Real or tangible personal property costs are assigned to the location of the property. Property in transit between locations of the taxpayer to which it belongs is assigned to the destination state. Property in transit between a buyer and seller and included by a taxpayer in the denominator of the apportionment ratio in accordance with its regular accounting practices is assigned to the destination state. Mobile or movable property located both within and without Washington during the measuring period is assigned in proportion to the total time within Washington during the measuring period. An automobile assigned to a traveling employee is assigned to the state to which the employee's compensation is assigned below or to the state in which the automobile is licensed. Where a business contracts for the maintenance, warranty services, or insurance of multiple properties, the relative rental or depreciation expense may be used to assign these costs.

**(f) Employee costs.**

(i) **Definitions.** For the purposes of this subsection:

(A) "Compensation" means wages, salaries, commissions, and any other form of remuneration paid to or accrued to employees for personal services. Employer contributions under a qualified cash plan, deferred arrangement plan, and nonqualified deferred compensation plan are considered compensation. Stock based compensation is considered compensation under this rule to the extent included in gross income for federal income tax purposes.

(B) "Employee" means any individual who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an employee, but does not include corporate officers.

(ii) **Allocation method.** Employee costs include all compensation paid to employees and all employment based taxes and other fees, for example, amounts paid related to unemployment compensation, labor and industries insurance premiums, and the employer's share of Social Security and Medicare taxes. An employee's compensation is assigned to Washington if the taxpayer reports the employee's wages to Washington for unemployment compensation purposes. Employee wages reported for federal income tax purposes may be used to assign the remaining compensation costs.

**(g) Representative third-party costs.**

(i) **Definitions.** For the purposes of this section:

"Representative third party" includes an agent, independent contractor, or other representative of the taxpayer who provides services on behalf of the taxpayer directly to customers. The term includes leased employees who meet the standards under (g) of this subsection.

(ii) **Allocation method.** Payments to a representative third party are assigned to the third party's place of performance. For example, if a business subcontracts with a representative third party who provides services on behalf of the taxpayer from a California location, the cost of compensating the representative third party is assigned to California. This is true even if the third party provides services to Washington customers. Conversely, the cost of compensating a representative third party providing services to California customers from a Washington location is assigned to Washington.

**(iii) Examples.**

(A) X, a Washington business, hires Taxpayer to design and write custom software for a document management system. Taxpayer subcontracts with Z, whose employees determine the needs of X, negotiate a statement of work, write the custom software, and install the software. Z's employees perform all of these services on-site at the X business location. Taxpayer's payments to Z are representative third-party costs and specifically assigned to Washington.

(B) Taxpayer, a service provider, subcontracts with X, who agrees to maintain a customer service center where staff will answer telephone inquiries about Taxpayer's services. X in turn subcontracts with Z, whose employees actually respond to questions from a phone center located in California. The payments by taxpayer to X are representative third-party costs with respect to Taxpayer because X is responsible for providing the staff of the service center. The payments to X are specifically assigned to California.

(C) Taxpayer sells various manufacturers' products at wholesale on a commission basis. Taxpayer subcontracts with X, who agrees to act as Taxpayer's sales representative on the West Coast. Taxpayer has various other sales representatives working on as independent contractors, who are assigned territories, but may make sales from an office or through in-person visits, or a combination of both. Taxpayer does not maintain records sufficient to show the representatives' places of performance. Taxpayer may use sales records and the standards under (h) of this subsection to assign commissions by each subcontractor.

**(h) Costs assigned by formula.**

(i) Costs not specifically assigned under (e) through (g) of this subsection and not excluded from consideration by (c) of this subsection are assigned to Washington by formula. These costs are multiplied by the ratio of sales in Washington over sales everywhere. For example, if a business has one thousand dollars in other unassigned costs and sales of ten thousand dollars in each of the four states in which it has nexus under Washington standards (including Washington), twenty-five percent (\$10,000/\$40,000), or two hundred fifty dollars of the other costs are assigned to Washington.

(ii) Sales are assigned to where the customer receives the benefit of the service. If the location where the services are received is not readily determinable, the services are attributed to the location of the office of the customer from which the services were ordered in the regular course of the customer's trade or business. If the ordering office cannot be determined, the services are attributed to the office of the customer to which the services are billed.

(iii) If under the method described above a sale is attributed to a location where the taxpayer does not have nexus under Washington standards, the sale must be excluded from

both the numerator and denominator of the sales ratio. For the purposes of this calculation only, the department will presume a taxpayer has nexus anywhere the taxpayer has employees or real property, or where the taxpayer reports business and occupation, franchise, value added, income or other business activity taxes in the state. The burden is on the taxpayer to demonstrate nexus exists in other states.

**(i) Alternative methods.**

(i) A taxpayer may report with, or the department may require, the use of one of the alternative methods of cost apportionment described below:

(A) The exclusion of one or more categories of costs from consideration;

(B) The specific allocation of one or more categories of costs which will fairly represent the taxpayer's business activity in Washington; or

(C) The employment of another method of cost apportionment that will effectuate an equitable apportionment of the taxpayer's gross income.

(ii) A taxpayer reporting under (i) of this subsection must notify the department at the time of filing that it is using an alternative method and provide a brief description of the method employed. If a taxpayer reports using an alternate method, the same method must be used for all subsequent tax reporting periods unless it is demonstrated another method is necessary under the standard in (i)(v) of this subsection.

(iii) If on review of a taxpayer's return(s) the department determines another method is necessary to fairly represent the extent of a taxpayer's business activity in Washington, the department may impose the method for all returns within the statute of limitations. Statutory interest applies to both balances due and refund or credit claims arising under this section. Further, applicable penalties will be imposed on balances due arising under this section. However, if the taxpayer reported using the cost apportionment method in (a) through (h) of this subsection and separate accounting is unavailable, the department may impose the alternate method for future periods only.

(iv) A taxpayer may request that the department approve an alternative method of cost apportionment by submitting a request for prior ruling pursuant to WAC 458-20-100. Such letter ruling may be subject to audit verification before issuance.

(v) The taxpayer or the department, in requesting or imposing an alternate method, must demonstrate by clear and convincing evidence that the cost apportionment method in (a) through (h) of this subsection does not fairly represent the extent of the taxpayer's business activity in Washington.

**(5) Effective date.** This amended rule shall be effective for tax reporting periods beginning on January 1, 2006, and thereafter.

[Statutory Authority: RCW 82.32.300 and 82.01.060(2), 05-24-054, § 458-20-194, filed 12/1/05, effective 1/1/06. Statutory Authority: RCW 82.32.300, 83-08-026 (Order ET 83-1), § 458-20-194, filed 3/30/83; Order ET 70-3, § 458-20-194 (Rule 194), filed 5/29/70, effective 7/1/70.]

**WAC 458-20-195 Taxes, deductibility. (1) Introduction.** This rule explains the circumstances under which taxes may be deducted from the gross amount reported as the measure of tax under the business and occupation tax, retail sales

(2007 Ed.)

tax, and public utility tax. It also lists deductible and nondeductible taxes.

**(2) Deductibility of taxes.** In computing tax liability, the amount of certain taxes may be excluded or deducted from the gross amount reported as the measure of tax under the business and occupation (B&O) tax, the retail sales tax, and the public utility tax. These taxes may be deducted provided they have been included in the gross amount reported under the classification with respect to which the deduction is sought, and have not been otherwise deducted through inclusion in the amount of another allowable deduction, such as credit losses.

The amount of taxes which are not allowable as deductions or exclusions must in every case be included in the gross amount reported. License and regulatory fees are not deductible. Questions regarding the deductibility or exclusion of a tax that is not specifically identified in this rule should be submitted to the department of revenue for determination.

**(3) Motor vehicle fuel taxes.** RCW 82.04.4285 provides a B&O tax deduction for certain state and federal motor vehicle fuel taxes when the taxes are included in the sales price. These taxes include:

State motor vehicle fuel tax . . . . .	chapter 82.36 RCW;
State special fuel tax . . . . .	chapter 82.38 RCW;
Federal tax on diesel and special motor fuels (including leaking underground storage tank taxes), except train and aviation fuels . . . . .	26 U.S.C.A. Sec. 4041;
Federal tax on inland waterway commercial fuel . . . . .	26 U.S.C.A. Sec. 4042;
Federal tax on gasoline and diesel fuel for use in highway vehicles and motorboats . . . . .	26 U.S.C.A. Sec. 4081.

**(4) Taxes collected as an agent of municipalities, the state, or the federal government.** The amount of taxes collected by a taxpayer, as agent for municipalities, the state of Washington or its political subdivisions, or the federal government, may be deducted from the gross amount reported. These taxes are deductible under each tax classification of the Revenue Act under which the gross amount from such sales or services must be reported.

This deduction applies only where the amount of such taxes is received by the taxpayer as collecting agent and is paid by the agent directly to a municipality, the state, its political subdivisions, or to the federal government. When the taxpayer is the person upon whom a tax is primarily imposed, no deduction or exclusion is allowed, since in such case the tax is a part of the cost of doing business. The mere fact that the amount of tax is added by the taxpayer as a separate item to the price of goods sold, or to the charge for services rendered, does not in itself, make such taxpayer a collecting agent for the purpose of this deduction. Examples of deductible taxes include:

FEDERAL—	
Tax on communications services (telephone and teletypewriter exchange services) . . . . .	26 U.S.C.A. Sec. 4251;

[Title 458 WAC—p. 305]

**ATTORNEY GENERAL'S OFFICE - REVENUE & FINANCE DIVISION**

**February 12, 2018 - 4:21 PM**

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