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COURT OF APPEALS  
DIVISION III  
STATE OF WASHINGTON  
By \_\_\_\_\_

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IN THE COURT OF APPEALS OF THE STATE OF WASHINGTON  
DIVISION III

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ARMAND DeFELICE,

Appellant,

v.

STATE OF WASHINGTON,  
EMPLOYMENT SECURITY DEPARTMENT,

Respondent

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APPEAL FROM THE SUPERIOR COURT OF THE STATE  
OF WASHINGTON FOR SPOKANE COUNTY

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**APPELLANT'S REPLY BRIEF**

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## Table of Contents

|   |    |
|---|----|
| I. INTRODUCTION .....   | 1  |
| ASSOCIATION AGREEMENTS .....  | 5  |
| 1. A Partnership was formed even though the Tax Specialist<br>did not know how to interpret the financial records that she<br>compiled. The records reflect a 100% distribution of the<br>profit.....   | 7  |
| OWNERSHIP OF THE PARTNERSHIP ASSETS .....   | 9  |
| 2. Review of Agency Orders in Adjudicative Proceedings .....  | 10 |
| 3. The Department's Response Brief, Pages 23, through 28<br>Are Nothing More Than A Red Herring.....  | 15 |
| 4. IRS Rev. Proc. 84-35, 1984-1 DB was utilized by the<br>DeFelice Partnership to demonstrate that a small<br>partnership such as the DeFelices would not be subject to<br>an IRS penalty for failure to file Form 1065, a<br>partnership income tax return ..... | 15 |
| 5. Findings of Fact and Conclusions of Law made by the<br>Administrative Law Judge which were in turn<br>adopted by counsel for the Commissioner.....   | 17 |
| 6. Attorneys' Fees and Costs Appellant Hearing .....  | 21 |
| Legal Fees .....  | 21 |
| II. CONCLUSION.....   | 22 |

## Cases

|   |        |
|---|--------|
| 1B Kelly Kunsch, <i>Washington Practice: Methods of Practice</i> § 67.2,<br>at 37 (4th ed. Supp.2005) ..... | 3      |
| <i>Affordable Cabs, Inc.</i> , 124 Wn. App. at 368.....   | 11     |
| <i>Curley Elec., Inc. v. Bills</i> , 130 Wn.App. 114, 118, 121 P.3d 106<br>(2005) .....                     | 3      |
| <i>Penick</i> , 82 Wn. App. at 39 .....   | 11, 12 |
| <i>Rogerson Hiller Corp. v. Port of Port Angeles</i> , 96 Wn. App. 918,<br>927-30 (Division 2, 1999).....   | 21     |

## Statutes

|                       |       |
|-----------------------|-------|
| RCW 4.84.170 .....    | 21    |
| RCW 25.05.005 .....   | 2, 7  |
| RCW 25.05.055 .....   | 7, 15 |
| RCW 34.05.570 .....   | 10    |
| RCW 34.05.570(d)..... | 18    |
| Title 50 RCW .....    | 17    |

### Internal Revenue Service:

|                                  |        |
|----------------------------------|--------|
| Rev. Proc. 84-35, 1984-1 CB..... | 15, 16 |
| Rev. Proc. 85-34 .....           | 16     |

|  |    |
|--|----|
| H.R. Rep. No. 95-1800 (Conf. Report) 95th Cong., 2d Sess. 221<br>(1978)..... | 16 |
|--|----|

## I. INTRODUCTION

The Employment Security Department (hereinafter Department) filed its Response Brief as Respondent in this action. Its Brief is extremely elaborate and numerous charges are made, most of which are not supported by the facts or evidence. In certain instances substantial evidence to establish the fact that the DeFelice Dental Practice was indeed a partnership and not subject to the Department's Unemployment Taxes was ignored. The Dental Practice consists of Dr. Armand DeFelice ("Dr. Armand"), his daughter, Dr. Louise, and his daughter-in-law, Dr. Loretta DeFelice ("Dr. Loretta").<sup>1</sup>

Dr. Armand and his daughter, Dr. Louise and Dr. Loretta as professional, sophisticated dentists who only grossed \$1,370,027. CR 232. Ex. 14. It should be obvious that the operation with the utilization of the three dentists' technical support staff was merely a Mom and Pop operation. It becomes even more so when one considers at the time of the Administrative Hearing before the Administrative Law Judge, Dr. Armand was just slightly south of 80 years of age.

Because many of the claims asserted by the Department was utilized to eliminate relevant documents and testimony in order to

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<sup>1</sup> The Dentists share a common last name, thus this Brief refers to the doctors by their first names.

preclude Dr. Armand's defense of a partnership, and therefore is not subject to the Unemployment Taxes. In addition the Department ignored the sworn testimony Dr. Armand that certain Association Agreements between Dr. Loretta, dated February 1, 1990 (CR 239-Ex. 21) and Dr. Louise, dated January 2, 2004 (CR 246-Ex. 28) were in fact cancelled prior to the Audit Period. The Senior Doctor, Dr. Armand, started the practice in 1966. The Audit Period is 2010, 2011, 2012. It should be obvious that the time devoted to the dental practice by Drs. Loretta and Louise during their tenure with Dr. Armand demonstrates they were not mere trainees but indeed were sophisticated professional dentists. Neither woman was under the control of Dr. Armand. The testimony on this particular point is clear and unambiguous. The Department disposes of this element by a personal attack upon both women. When Dr. Armand asserted that the Association Agreements (CR 239, Ex. 21 and P. 246, Ex. 28) were cancelled, the Department claimed such a statement was self-serving. In other words not a truthful statement! The record doesn't appear that they attacked Dr. Armand on this point, but they did attack on the basis that there was not a partnership.

Under the Revised Uniform Partnership Act, a Partnership is "created whenever two or more persons agree to carry on a business and *share in profits and ownership control.*" A Partnership is an entity distinct

from its partners and may be formed regardless of whether the persons entering into the agreement intend to form the partnership entity. *Curley Elec., Inc. v. Bills*, 130 Wn. App. 114-118, 121 P.3d 106 (2005) (Quoting Kelly Kunsch, *Washington Practice: Methods of Practice Section 67.2 at 37 (4th) Supp-2005*) The Department simply brushes this aside and recites: “Dr. Armand emphasizes his own self-serving testimony and merely asks the Court to reweigh the conflicting evidence, which it may not do on appeal. See Page 19 of the Department’s Response Brief.

One of the primary charges of the Department is the above-referred-to Association Agreements are not recognized even in spite of the testimony of Dr. Armand which was unchallenged. Dr. Armand asserted that the Association Agreements were terminated in 2008, prior to the Audit Period. The question originates, how did the Association Agreements become relevant? The Special Tax Auditor for the Department asked the bookkeeper if there were any agreements. Thereafter the Association Agreements were produced. The Special Tax Consultant did not ask whether or not the Agreements were still being enforced. Dr. Armand testified: “That he did not mention the fact to the Special Tax Consultant that written agreements were terminated.” His explanation was

“No, I had no idea of the relevance of it. I was never asked that

question before, and I had no idea of the relevance. This is the problem. I am a dumb dentist. I have been doing dentistry for 53 years, so I don't follow all of the (inaudible) what the accountants do, and etc., etc. etc." (CR 171)

With respect to the existence of the Partnership, the Special Tax Consultant for the Department had her own work papers reflecting the profit distributions to the partners. Also she could check it against the income statement. The production schedule is reflected on CR 231, Dep't Ex. 13 showing what the Special Consultant described as "wages" \$186,671 paid to Dr. Louise for 2010 and \$156,318 titled Wages paid to Dr. Loretta. The Special Consultant also had the income statement for the practice as reflected on CR 232. A simple process would have been to compare the gross receipts to ascertain that all the gross income was accounted for and that each Doctor received 40% of his or her production after the deduction for expenses of 60%. This computation reflected that all of the income was accounted for and the net income was distributed to the Partners.

Dr. Armand spoke of his discussion with the Tax Specialist at the conclusion of her examination.

"Q. What kind of questions, as best you can recall, did she ask you with respect to the transcript?" (CR 131)

“A. I don’t recall any questions at all. She was very nice. I liked her approach (inaudible). She was a very nice person. I don’t recall any questions. Most of the answers on the accounting had to come from Rhonda who does all the bookkeeping.

The profit distributions including the computations and explanations are set forth in elaborate detail on Appellant’s Opening Brief Pages 7, 8, and 9. Through all this elaborate briefing and so forth, the Department has never referred to this schedule and refuses to recognize it. The Administrative Law Judge likewise ignored the computations that were also submitted.

With respect to control of the Partnership, Dr. Louise was questioned by the Administrative Law Judge as follows:

“Q. And does he (Dr. Armand) ever kind of tell you -- I know he is your father, as part of your dental practice, as fathers would do, does he ever tell you how to do things?

“A. No.

“Q. Okay. You are kind of on your own. You have total discretion with your patients?

“A. Yes, 100%. CR 162-163.

#### **ASSOCIATION AGREEMENTS**

Dr. Armand was questioned in reference to the Association

Agreements:

“Q. Have there been any written agreements that -- between the two of you either changing or revoking the written agreements that we have before us? CR 149.

“A. We formed an LLC, PLLC.

“Q. Okay. Before that, did you change that? Did you have any written agreements?

“A. No.

The Administrative Law Judge’s CONCLUSIONS OF LAW 6, the ALJ points out:

“The issue then is whether over time, the agreement (Association Agreement) was modified, or even terminated, so that the three related dentists practiced as partners. If so, there is no employer relationship and the work performed was not personal service.” CR 296.

Obviously, this is why it was so important for the Department to assert that the Association Agreements remained in full force and effect. The younger Doctors were thus employees -- not partners. You owe the tax!

With respect to the control issue, the Administrative Law Judge’s Conclusion 11, CR 298 recites in pertinent part, relating to the control

factor, “It’s noted:

“The undersigned does not discount the testimony offered by the Petitioner (Dr. Armand) to the effect that Dr. Armand did not train or supervise the dentistry of the two dentists. He did not necessarily control and direct how Dr. Louise and Dr. Loretta treated patients. That being said, the preponderance of the evidence shows that Dr. Louise and Dr. Loretta were likely subject to at least some direction and control.”

As a result of that, it appears that the statement caused both Dr. Armand and his daughter, Dr. Louise, to lack credibility.

1. **A Partnership was formed even though the Tax Specialist did not know how to interpret the financial records that she compiled. The records reflect a 100% distribution of the profit.**

The Uniform Partnership Act, RCW 25.05.005 Definitions. (6)

“Partnership” means an association of two or more persons to carry on as co-owners a business for profit formed under RCW 25.05.055. . . .

Moreover, (7) “Partnership Agreement” means the agreement, whether written, oral, or implied, among the partners concerning the partnership, including amendments to the partnership agreement.” (Emphasis Added.)

The formation of a partnership is controlled by RCW 25.05.055 which provides in pertinent part:

FORMATION OF PARTNERSHIP. (1) Except as otherwise

provided in subsection (2) of this section, the association of two or more persons to carry on as co-partners a business for profit forms a partnership, whether or not the persons intend to form a partnership. (Emphasis Added.)

(3) In determining whether a partnership is formed, the following rules apply:

(c) A person who receives a share of the profits of a business is presumed to be a partner in the business, unless the profits were received in payment:

(ii) for services as an independent contractor or wages or other compensation to an employee; (Emphasis Added.)

It must be remembered that the Tax Specialist for the Department even though she had prepared schedules reflecting what she called “wages paid” for 2010 to Dr. Loretta and Dr. Louise she either failed or neglected to compare her schedules with the income statement CR 231, Dep’t Ex.

13. Had she done so she would have realized that the entire profits of the Partnership were distributable to the Partners. Instead she starts before any conclusion and indicates in her schedules that the profits distributed to Dr. Loretta and Dr. Louise were “wages.” Instead of relying upon the distribution of profits, income statement, she then attacks the Association Agreements even though she failed to ask whether or not the Agreements

remained in full force and effect. Both Dr. Armand as well as Dr. Louise testified that from 2008 forward a partnership in fact had been formed. To further demonstrate the prejudice, the Tax Specialist exhibit on Page 233, Dep't Ex. 13, is titled "Armand V. DeFelice, Payroll Recon." She is only working on Dr. Louise and Dr. Loretta. There were other bona fide employees that were not included in the payroll recon. Obviously the audit was over before it started. The term, "Wages," means taxable.

#### **OWNERSHIP OF THE PARTNERSHIP ASSETS.**

The Administrative Law Judge asked Dr. Armand,

"Q. Do you own all the equipment of the practice?"

"A. No. CR 145.

Dr. Armand went on to testify that some of the equipment is owned by the two other doctors, "Some of it is owned by the other two doctors." Again counsel for the Department is asking who owns the equipment in the dental office. Dr. Armand responded, "The practice does basically, okay?"

With respect to the Professional Limited Liability Company that was formed in 2013, it is placed in issue by the various questions of the Administrative Law Judge as well as Mr. Michael, counsel for the Department. Dr. Armand, CR 149, L 19

"A. We formed an LLC, PLLC.

“Q. Okay. Before that did you change that? Did you have any written agreements?”

“A. No. Okay.”

Thus at this point, it is clear that a PLLC was formed, and it is further clear that the assets of the former partnership consisting of equipment, patients and goodwill was transferred to the PLLC and based upon the records it is clear that the three doctors each owned in part the assets that were transferred. This indicates the Partnership was transferred.

**2. Review of Agency Orders in Adjudicative Proceedings.**

The Court shall grant relief from an agency order in an adjudicative proceeding only if it determines that:

(d) The agency has erroneously interpreted or applied the law;

(e) The order is not supported by evidence that is substantial when viewed in light of the whole record before the court, which includes the agency record for judicial review, supplemented by any additional evidence received by the court under this chapter;

(f) The agency has not decided all issues requiring resolution by the agency;

(i) The order is arbitrary or capricious. RCWA 34.05.570.

The Department as well as the Administrative Law Judge totally

ignore the computation of profits that are distributable. It is not mentioned anywhere in the ALJ Decision nor the Department's Opening Brief. This is an important element for the determination of the formation of a partnership. Therefore the Order is not supported by evidence that is substantial when viewed in light of the whole record before the Court. Not even considered.

Of equal importance, the Department as well as the Administrative Law Judge concluded that Drs. Loretta and Louise, both of whom had extensive professional experience were mere employees. To support its position the Department relies upon *Affordable Cabs, Inc.*, 124 Wn. App. at 368. The ALJ seeks to compare cab drivers to professional dentists. Moreover, in *Penick*, 82 Wn. App. at 39, the Department relies upon the decision for the proposition that truck drivers perform personal services for a sole proprietor. Now the dentists are compared to truck drivers to support the Decision. See Department's Response Brief, Page 30.

Moreover at Page 21 the Department's Response Brief continues that Drs. Loretta and Louise received "wages" because they received remuneration for the performance of personal services. In *Penick*, the Court found the drivers were paid wages, because the business collected payment from the customers, then paid the drivers on a biweekly basis. There was no evidence of separate accounts; the funds belonged to the

business until they were disbursed to the drivers.” *Id.* Similarly here, all patients’ payments were deposited into a single business account under Dr. Armand’s name, out of which Dr. Loretta and Dr. Louise were paid. This observation totally misses the point. Whatever funds that were deposited to the Partnership account were the property, as Dr. Armand pointed out, of the doctors that produced it.

Again the Association Agreements appear. The Department’s Response Brief, Page 22, “Although Dr. Armand asserted the agreements had been orally revoked over time, the weight of evidence showed that the dentists still operated their practice per the terms of the agreements, the only exception being the percent of production the two associates took home, which increased from 35 to 40 percent.” Totally disregarded is the fact of the ownership of assets which is evidenced by the transfer of the Partnership assets of DeFelice Family Dentistry to a Professional Limited Liability Company. Moreover the Department misses the point in its Footnote 10 on Page 22 of its Response Brief. First, it was not Dr. Armand that provided the agreements to the Auditor, but it was the bookkeeper. The proposed resolution as set forth in the Footnote recommends the Doctors should have established a de novo evidentiary hearing that the agreements had the agreements had been revoked, “So whether the auditor asked if they had been revoked is of no consequence.”

Had the Tax Specialist done a little light summary of the schedules that she prepared where she calls the distributions to the two women dentists Wages, she would have found out that the profit percentage was increased to 40% and that in and of itself should have created some idea about whether or not the Agreements were in fact still in full force and effect. Moreover, the Doctors would have gone one step beyond the de novo evidentiary hearing when they appeared before the Administrative Law Judge pre hearing and again raised the issues about revocation of the Agreements. Counsel tried to raise the issue of the revocation of the Agreements, but was turned down. In addition, the Department was fully aware of the fact that a Professional Limited Liability Company was formed on January 1, 2013.

Counsel for the Department not only is confused about the method of computing profits and agreements, but confuses the elder gentleman, Dr. Armand. Page 18 of the Department's Response Brief misquotes Dr. Armand in the statement, "After paying Dr. Loretta and Dr. Louise and paying for other overhead expenses, Dr. Armand paid himself only whatever was left each month." AR 130, 294 (FF 13). Sometimes, this was very little." AR 130. Dr. Armand testified that he bore all the costs of the dental practice. AR 142-143. A casual reading of the above-quoted sections of the record are clearly contrary to these statements. It is clear

that Dr. Armand said that he like the other two dentists pay 60% of the overhead applicable to their production and thereafter they received 40%. He did not pay all the costs and expenses.

The Department's Response Brief relies on certain citations as contained at the top of Page 18 ("It is well settled that no one fact or circumstance will be taken as the conclusive test." However, a casual reading of the Findings of Fact and Conclusions of Law clearly indicate that the ALJ relied heavily on one fact. That is, there was no partnership formed. Which is totally contrary to the facts in the case. The ultimate insult to the professional dentists, Drs. Loretta and Louise, Page 19 at the top of the page truly misstates the method for division of profits with respect to the three dentists and concludes, "This further demonstrates that they were commissioned employees, and their share of their production was payment of wages, which does not establish a partnership." Again on the same page, "the mere sharing of net proceeds of a business venture with an employee, without more, does not of itself convert the relationship between the parties concerned into a partnership." No one is talking about "the net proceeds of a business venture with an employee." First of all, the Doctors, the professional women, are not employees, and they are not sharing proceeds from a business venture. Based upon the above, it is clearly evident that it would be impossible for the Administrative Law

Judge to form a decision that a partnership is not formed when no one associated with the Department including the Administrative Law Judge did not understand the computation and division of profits even when they were laid out before them.

**3. The Department's Response Brief, Pages 23, through 28 Are Nothing More Than A Red Herring.**

It goes into great detail about the commonly referred to exception for "independent contractor exemption." Under the Partnership Law, RCW 25.05.055, Formation of Partnership, explicitly provides at "(3)(c) A person who receives a share of the profits of a business is presumed to be a partner in the business, unless the profits are received in payment (Emphasis Added)

"(i) of a debt by installment or otherwise; for services as an independent contractor or of wages or other compensation to an employee. (Emphasis Added.)

It is one or the other. It's a partner or it's an effort to establish an independent contractor relationship. That is not the intent of the DeFelice Family. As a result, Paragraph D of the Department's Brief, Page 23 is unnecessary nor is Item 2 on Page 26 of the Department's Brief.

**4. IRS Rev. Proc. 84-35, 1984-1 CB was utilized by the DeFelice Partnership to demonstrate that a small partnership such as**

**the DeFelices would not be subject to an IRS penalty for failure to file Form 1065, a partnership income tax return.**

Upon inquiry by the Internal Revenue Service involving the so-called failure to file, reasonable cause will exist and the penalty will be waived. It should be noted that the Tax Specialist did not find any communications from the Internal Revenue Service indicating any deficiency with the failure to file the so-called Form 1065. The ultimate responsible person to determine whether or not a return should be filed and whether or not a penalty should be imposed is the Internal Revenue Service. The Dental Practice has been following the same procedure for many years without any feedback or comments from the Internal Revenue Service.

The Department wants to make a big issue with respect to Rev. Proc. 84-35. This has been modified by the United States Congress to H.R.Rep. No. 95-1800 (Conf. Report) 95th Cong., 2d Sess. 221 (1978). Rev. Proc. 85-34 provides at Section .03 Section 6231(a)(1)(B) of the Code provides an exception to the definition of "partnership" for small partnerships. In general, the term "partnership" does not include a partnership if the partnership has ten or fewer partners, each of whom is a natural person (other than a non-resident alien) or an estate, and each partner's share of a partnership item is the same as such partner's share of

every other item....”

The issue is another red herring. It is similar to the Employment Security Department’s position to assist small taxpayers except if a piece of paper is not filed with the Department of Employment Security indicating the change in the nature of the business and owners, partners, members, et cetera, then more likely than not you will have to experience the same misfortune that all three DeFelice dentists have experienced herein. It is not as kind as the Internal Revenue Service.

**5. Findings of Fact and Conclusions of Law made by the Administrative Law Judge which were in turn adopted by counsel for the Commissioner.**

ALJ’s Conclusion of Law No. 2 poses the question: In determining whether Appellant herein, Armand was in employment as concerns Dr. Louise and Dr. Loretta:

*The first question to be answered is whether the two dentists performed personal services of whatever nature, for wages or under a contract calling for performance of such services. RCW 50.40.100.*

*An individual is not an employee if the answer is affirmed in the negative. If the answer is answered in the affirmative, the individual is in employment unless the services are excluded from coverage by another section of Title 50 RCW. CR 295.*

It is submitted had the Tax Specialist examined all the relevant facts including the financial statements clearly reflecting that all income

for 2010 was distributable to the Partners together with the fact that Dr. Armand did not exercise any power of control over Drs. Loretta and Louise, there is only one logical conclusion supported by substantial evidence that the individual dentists were not employees and therefore the Conclusion of Law is in error and subject to being reversed by the Court pursuant to RCW 34.05.570(d) as well as the Order is not supported by evidence that is substantial in light of the whole record before the Court (a) as well as (f) the agency has not decided all issues requiring resolution by the agency. The issue to be decided was simply whether or not the DeFelices formed a partnership. The evidence excluded by the ALJ was the analysis of profits, distributable portion of profits, and the fact that the dental practice assets were transferred to a PLLC on January 1, 2013.

Findings of Fact recites in pertinent part: “Effective February 1, 1990 Dr. DeFelice, as owner of the business entered into an Association Agreement with Dr. Loretta. The record is clear during the Audit Period, 2010, 2011, 2012, the so-called Association Agreements were not valid and enforceable. They no longer existed as far as the dental practice was concerned. For the most part the Findings of Fact are predicated upon the Association Agreements and are invalid. As a result, the Conclusions of Law would likewise be invalid.

Finding of Fact 14, CR 294, is incorrect insofar as it contends that

the failure to file the income tax return for the partnership on Form 1065 is fatal. There is no penalty. Thus far the Doctors have not received any complaints from the IRS -- the ultimate authority. Oftentimes the Department throws around "Form 1065," the Partnership Income Tax Return. It should be noted that the Partnership Income Tax Return, Form 1065, is a very complicated return requiring numerous matters such as a balance sheet, reconciliation of capital accounts, et cetera, et cetera. The net result by filing a Partnership Income Tax Return, the accounting fees for preparation of the return would probably exceed the Unemployment Insurance Tax asserted by the Department in this case.

Additionally, the Conclusion of Law 6, CR 296, is predicated upon facts which are based upon the Association Agreements which are invalid and revoked.

Additionally Conclusion of Law 7, CR 296, also is in error with the ALJ concluding that Dr. Louise and Dr. Loretta did not share in the profits or losses. "They were paid exclusively a percentage of their own respective gross production."

Conclusion of Law 8, CR 296, is in error because the ALJ ruled, "Accordingly, the undersigned concludes that the services performed by Dr. Louise and Dr. Loretta during the time period at issue clearly and directly benefited the employer, and that the services performed were

performed for wages.” The theory appears to be that there was no partnership, there was no profits, there was no distribution of profits, the practicing dentists did not have any interest in the assets of the practice, they did not have any control over their patients, et cetera. Totally ignores the distribution of profits.

Conclusion of Law 11, CR 298, involving the control reportedly exercised by Dr. Armand over the two younger Doctors results in the conclusion by the ALJ that the preponderance of the evidence shows that Dr. Louise and Dr. Loretta were *likely subject to at least some direction and control.*” This is totally contrary to the sworn testimony of Dr. Louise. She testified that she was in 100% control of the patients.

Based upon the numerous Findings of which at least 16 are in error, it is impossible to conclude that the Conclusions of Law are valid and demonstrate that Dr. Loretta and Dr. Louise were mere employees. Such conduct of the Department and the ALJ is tantamount to an arbitrary and capricious result. The latter is defined as “Willful and unreasoning action, without consideration and in disregard of facts and circumstances. Where there is room for two opinions, action is not arbitrary and capricious even though one may believe an erroneous conclusion has been reached.” Appellant’s Opening Brief, Page 20. Such definition surely does not include this situation where relevant controlling evidence is

omitted in order to assist the Department in proving its case.

**6. Attorneys' Fees and Costs Appellant Hearing.**

In the event of success in this Appeal, Appellant will apply to the Court for attorney's fees and costs in accordance with the provisions of RCW 4.84.170, which provides: "The state or county should be liable for costs in the same case and to the same extent as private parties."

**Legal Fees.** It is claimed by the Department "Attorney fees may be recovered only when authorized by a private agreement of the parties, statute, or a recognized ground of equity." The most common equitable ground for receipt of attorneys' fees is bad faith. Bad faith litigation can warrant an award of attorneys' fees for three types of conduct: (1) pre-litigation misconduct, (2) procedural bad faith, and (3) substantive bad faith. *Rogerson Hiller Corp. v. Port of Port Angeles*, 96 Wn. App. 918, 927-30 (Division 2, 1999).

This case could have been resolved before it started by simply affording counsel for the DeFelices an exit interview with the Tax Specialist and her Manager. It was denied, and counsel was directed to appeal. During the course of appeal, the Administrative Law Judge made numerous errors, the least of which is the total disregard for the computations predicated upon the Tax Specialist's workpapers and income statement which clearly demonstrate in accordance with the partnership

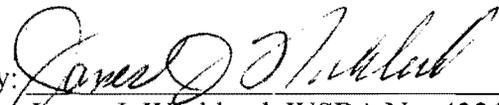
concept, all the profits of the operation were distributed to the Partners. Additionally, the Partners had an interest in the assets of the Dental Practice. In January 1, 2013 the Partners transferred those assets to a Professional Limited Liability Company. The latter could not have occurred legally, if Drs. Loretta and Louise were mere employees.

## II. CONCLUSION.

Dr. Armand's appeal was brought about by the disregard of substantial evidence by the Department. As well as the Department's refusal to allow the Doctor's counsel an exit interview upon completion of the audit. For these reasons, Dr. Armand and the Partnership respectfully request that the Court reverse the Commissioner's Decision and order the payment of attorneys' fees and costs, as well as a refund of taxes, penalties, and interest paid to the Department.

RESPECTFULLY SUBMITTED this 10th day of September,  
2014.

WORKLAND & WITHERSPOON, PLLC

By:   
James J. Workland, WSBA No. 4324  
Attorneys for Appellant

**CERTIFICATE OF SERVICE**

I hereby certify that the foregoing and/or attached was served by the method indicated below to the following this 10th day of September, 2014.

- U.S. Mail
- Hand Delivered
- Overnight Mail
- Telecopy (FAX) to:

Leah E. Harris  
Washington State Attorney  
General's Office  
800 5th Ave. Ste 2000  
Seattle, WA 98104-3188  
LeahH1@atg.wa.gov

Email Transmission to: \_\_\_\_\_

  
\_\_\_\_\_  
JAMES J. WORKLAND