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COURT OF APPEALS, DIVISION II
OF THE STATE OF WASHINGTON

WASHINGTON IMAGING SERVICES, LLC,

Appellant,

v.

WASHINGTON STATE DEPARTMENT OF REVENUE,

Respondent.

BRIEF OF RESPONDENT

ROBERT M. MCKENNA
Attorney General

Heidi A. Irvin, WSBA No. 17500
Peter B. Gonick, WSBA No. 25616
Assistant Attorneys General
Revenue Division
PO Box 40123
Olympia, WA 98504-0123
(360) 753-5528

ORIGINAL

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I. INTRODUCTION

Washington's business and occupation ("B&O") tax is imposed on the "gross income of the business." RCW 82.04.220. The Legislature intended to impose the B&O tax on virtually all business activities in the state, unless an exemption or deduction applies. To accomplish this, the Legislature provided a broad definition of "gross income of the business" in RCW 82.04.080. In some circumstances, however, businesses might receive and handle money for reasons other than being compensated for goods or services sold. The Department of Revenue described one of these circumstances in a rule allowing taxpayers to exclude from taxable gross income amounts taxpayers receive solely as an agent for a client, which the agent must pay on the client's behalf to third parties. WAC 458-20-111 ("Rule 111"). These are sometimes described as "pass-through" payments.

The "pass-through" concept seems simple, but in practice the Department and taxpayers often disagree about the circumstances under which Rule 111 applies. Rule 111 actually sets the bar for tax exclusion fairly high, requiring taxpayers to meet several conditions. If any one of the conditions is missing, then the taxpayer's receipts are taxable "gross income of the business" under RCW 82.04.080. Likewise, if a taxpayer's

receipts are "gross income of the business," the taxpayer will be unable to prove the requirements of Rule 111 for tax exclusion.

This case presents the issue whether certain amounts a medical imaging service business receives from patients and pays to a professional services corporation owned by radiologists should be treated as taxable "gross income of the business" or as nontaxable amounts under Rule 111. The undisputed facts of this case demonstrate that the amounts at issue are taxable "gross income of the business." As a matter of law, Washington Imaging Services, LLC ("WIS"), cannot prove it received money from patients merely as an agent to pay a debt owed by patients to the professional services corporation. Rather than the patients owing that money to the radiologists, it was WIS who had a contractual duty to pay the professional services corporation. Thus, Rule 111 cannot exclude those amounts from B&O tax. This Court should affirm the trial court's summary judgment for the Department because the receipts are taxable as "gross income of the business."

II. STATEMENT OF ISSUE

In RCW 82.04.080, the Legislature broadly defined as taxable "gross income of the business" virtually all money a taxpayer receives "by reason of the transaction of the business engaged in . . . ," without any deduction for labor or materials costs or any other expenses. The

Department adopted a rule interpreting this definition, Rule 111, which excludes from taxable "gross income of the business" certain amounts received and paid by agents on their clients' behalf to third parties. Under RCW 82.04.080 and Rule 111, did the trial court correctly conclude as a matter of law that the total amount of money WIS received for providing medical imaging services was taxable, although WIS paid some of it to an independent contractor for interpreting the medical images?[1]

III. STATEMENT OF THE CASE

WIS was in the business of providing medical imaging services to patients during the relevant tax period. According to WIS, WIS presented itself to the public as "dedicated to providing state-of-the-art outpatient medical imaging services utilizing the most sophisticated imaging equipment. WIS' product is a written interpretation of images acquired through its imaging technologies in the context of the patient's history by a qualified physician, in this case a fellowship trained radiologist, licensed to practice medicine in the State of Washington." CP 135. The CEO of WIS described WIS's business as follows:

> A: Washington Imaging Services is an outpatient, by and large, medical imaging center that exists in two locations – Bellevue and Issaquah – to provide outpatient imaging services, medical imaging services, to patients referred to Washington Imaging Services by practitioners in the community.

[1] Copies of RCW 82.04.080 and Rule 111 are appended to this brief.

> Q: And when you state that it provides medical imaging services, what does that entail?
> A: Medical imaging services generally are thought to be provision of a report that interprets the information that is presented to radiologists by the scanners that are used to examine patients. So our final product is a report.
> . . .
> A: [The report] is entirely dictated and generated by radiologists . . . .

CP 91-92. WIS describes medical imaging services as involving two components. The "technical component" involves the actual imaging of the patient, such as an x-ray. The "professional component" involves the radiologist's interpretation of the image. CP 60, 101-02. Thus, WIS's product – what it sold to the public – included the radiologist's interpretation of imaging that is done at WIS facilities.

WIS did not directly employ physicians. Instead, it hired a physician group as an independent contractor to provide the professional interpretation of the images, Overlake Imaging Associates, LLC ("Overlake"). CP 114. WIS and Overlake set forth their respective responsibilities and obligations in 1996 in a Medical Imaging Agreement. CP 37-59. Regarding billing, the Medical Imaging Agreement designated WIS as the party responsible for billing patients for medical imaging services provided, on behalf of both WIS and Overlake. CP 49-50. Overlake designated WIS its collection agent for purposes of Overlake's contractual share of the fees. *Id.* In a second contract, the Agency

Agreement, WIS and Overlake reiterated these billing and collection responsibilities. CP 60-62.[2]

WIS's interactions with its patients, along with its billing procedures and marketing, were consistent with the fact that the product WIS sold to the public included not only technical imaging services, but also a radiologist's interpretation of those images. During the tax period, WIS did not inform patients arriving at WIS to receive medical imaging services of the existence of Overlake or that patients would have any obligation to pay Overlake as a result of the patient receiving medical imaging services through WIS. CP 112-13. Patients signed a patient registration form, in which they agreed to be financially responsible to WIS. CP 141. The patient registration form assigned insurance payments to WIS, not to anyone else. *Id.* The form made no mention of Overlake or of any agreement to pay Overlake. *Id.* Similarly, insurance companies contracted with WIS, but not with Overlake, to reimburse WIS for medical imaging services provided at WIS locations. CP 99-100.

During the tax period, WIS billed patients or insurance companies for both the technical component (the actual imaging) and the professional

[2] The tax dispute in this case does not turn in any way on whether WIS acted as Overlake's agent in collecting fees WIS owed Overlake under the Medical Imaging Agreement. Rather, it turns on whether WIS acted as an agent *for patients* in making payments to Overlake. The Rule 111 exclusion WIS seeks to apply requires that an agent receive money from the agent's principal for the purpose of paying a third party; in other words, WIS must make the payments to the third party, Overlake, solely as a paymaster.

component (the radiologist's interpretation of the image) of the medical imaging services. CP 95. The bill did not set forth a separate charge for each component but billed the two components together in one "global" charge for medical imaging services. *Id.*; CP 103-04, 143. The bill was on WIS letterhead, asked that payment be remitted to WIS, and made no reference to Overlake whatsoever. CP 143. The bill did not indicate that WIS was acting as a billing agent for Overlake, that patients or insurance companies owed a fee to Overlake, or that WIS would act as an agent for patients or insurance companies to pay Overlake. *Id.* WIS generally made billing-related policy decisions regarding discounts and write-offs without Overlake's input. CP 119-20.

Consistent with the way WIS presented its bills to patients or insurance companies, when WIS received payment, the payment was not separated into a professional component and a technical component. CP 98. Patients had no say in how much of the payment on the "global bill" was transmitted to Overlake. CP 98-99. Insurance companies making payments to WIS similarly had no say in how much of the global payment was paid to Overlake. CP 99. Rather, the percentage of the payment on the "global bill" paid to Overlake depended entirely on the negotiated contract between WIS and Overlake. CP 121.

In the Medical Imaging Agreement, WIS and Overlake determined the percentage of net collections that would be paid to Overlake. CP 50, 104. According to the CEO of WIS, these percentages were based on Medicare reimbursement rates, which separated each procedure performed at WIS into a technical component and a professional component. CP 104. But rather than agree to pay Overlake the percentage that Medicare reimbursement rates indicated on any given procedure, WIS and Overlake averaged numerous procedures into several broad categories of imaging, and through negotiation determined how they would split the global fee in each of the broad categories of imaging. CP 50, 104.

Once these percentages were agreed to, WIS was obligated by the Medical Imaging Agreement to pay the percentages even though the Medicare reimbursement rates changed over time. CP 107-08, 122-23. Thus, WIS's obligation to Overlake depended entirely on the terms negotiated in its contract with Overlake rather than any Medicare reimbursement rates or direction from patients or insurance companies.

The Department audited WIS for the period January 1, 2000, through June 30, 2005, and issued two assessments. CP 5. The Department's Appeals Division affirmed the assessments, and in August 2007, WIS paid the assessments in full. CP 6. In September 2007, WIS filed a refund claim in Thurston County Superior Court under RCW

82.32.180. CP 4-8. The Honorable Gary R. Tabor granted summary judgment to the Department on August 15, 2008. CP 175-76. WIS timely filed a notice of appeal with this Court. CP 173-74.

IV. ARGUMENT

In this appeal from a summary judgment, the standard of review is de novo, and this Court may affirm the summary judgment order on any basis supported by the record. *See Int'l Brotherhood of Elec. Workers, Local No. 46 v. Trig Elec. Constr. Co.*, 142 Wn.2d 431, 435, 13 P.3d 622 (2000); *Redding v. Virginia Mason Med. Ctr.*, 75 Wn. App. 424, 426, 878 P.2d 483 (1994).[3] This Court should affirm the trial court's summary judgment for the Department because the income WIS seeks to exclude from tax under Rule 111 is taxable "gross income of the business" under RCW 82.04.080. Similarly, the Court should affirm the trial court's order because WIS cannot, as a matter of law, establish the required elements to exclude the disputed income from taxation under Rule 111.

[3] When considering whether to affirm summary judgment for the Department, the Court should draw all reasonable inferences from the evidence in a light favorable to WIS. When considering whether to reverse and direct the trial court to enter summary judgment for WIS, the Court should draw all reasonable inferences in a light favorable to the Department. *Burris v. General Ins. Co. of America*, 16 Wn. App. 73, 75-76, 553 P.2d 125 (1976).

A. Rule 111 Cannot Exclude From Taxation Any Receipts Falling Within The Statutory Definition of "Gross Income Of The Business" In RCW 82.04.080.

The B&O tax is imposed on every person "for the act or privilege of engaging in business activities" and applies to the "gross income of the business." RCW 82.04.220. The "legislature intended 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) (quoting *Time Oil Co. v. State*, 79 Wn.2d 143, 146, 483 P.2d 628 (1971)). As a result, unless an exemption or deduction applies, a taxpayer owes B&O tax on all income received for the rendition of services, including services related to health care.

Because the B&O tax is imposed on the "gross income of the business," the analytical starting point in this case is the statutory definition of that term. Under RCW 82.04.080, "gross income of the business" means:

> [T]he value proceeding or accruing *by reason of the transaction of the business engaged in* and includes gross proceeds of sales, *compensation for the rendition of services*, gains realized from trading in stocks, bonds, or other evidences of indebtedness, interest, discount, rents, royalties, fees, commissions, dividends, and other emoluments however designated, all 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 and without any deduction on account of losses.

(Emphasis added). WIS's "business engaged in" is providing medical imaging services to the public. CP 101-02; CP 135 (Interrogatory No. 9). The income it receives for providing medical imaging services presumptively is "gross income of the business."

Here, the issue in dispute centers on the Department's Rule 111, which creates an exclusion from taxable gross receipts. Rule 111 allows a taxpayer to exclude from gross income "advances" or "reimbursements" that merely "pass through" a business when the taxpayer acts solely as an agent for a client to pay the money to a third party. An exclusion from taxable income is allowed because such income is not attributed to the business activities of the agent. *City of Tacoma v. William Rogers Co.*, 148 Wn.2d 169, 175, 60 P.3d 79 (2003).

A classic example of a Rule 111 exclusion is when an automobile dealer collects from a buyer licensing fees and taxes. *See* example provided in WAC 458-20-111. The buyer owes licensing fees and taxes to the State, not to the automobile dealer, and the dealer merely collects the money and then passes it along to the State in its entirety. The automobile dealer incurs no liability to the State except as an agent of the buyer. The income is not properly attributed to the business of selling cars, but rather to the buyer's payment to the State of required fees and taxes.

No statutory exemption exists for "pass-through" payments; the Department created this exclusion by rule.[4] Agency rules are subject to the same principles of interpretation as statutes. *See Seattle FilmWorks, Inc. v. Dep't of Revenue*, 106 Wn. App. 448, 453, 24 P.3d 460 (2001).[5] Because there is no statutory exemption for "pass-through" payments, and because the Department has no statutory authority to create tax exemptions on its own, Rule 111 should be interpreted so that it "excludes" from tax *only* those amounts that do not meet the statutory definition of "gross income of the business." In other words, Rule 111 cannot be interpreted to allow exclusion of any amounts constituting "the value proceeding or accruing *by reason of the transaction of the business engaged in* [including] . . . *compensation for the rendition of services*."

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[4] Actually, the Department's predecessor, the Washington State Tax Commission, created this exclusion, in a rule that has been in place since 1936. *See* Washington State Tax Commission, *Rules & Regulations relating to Revenue Act of 1935* at 49 (1936) (then Rule 112). The Legislature granted the Department the authority to promulgate rules "not inconsistent" with the revenue statutes. RCW 82.32.300. Courts retain the ultimate authority to determine the purpose and effect of a statute, but give considerable deference to agency interpretations by those charged with enforcing it. *Impecoven v. Dep't of Revenue*, 120 Wn.2d 357, 363, 841 P.2d 752 (1992).

[5] Generally, taxation is the rule, and exemptions and deductions are the exception. Because of the broad application of Washington's taxing statutes and the legislative intent noted above, tax deduction and exemption statutes are narrowly construed. *United Parcel Serv., Inc. v. Dep't of Revenue*, 102 Wn.2d 355, 360, 687 P.2d 186 (1984); *see also Budget Rent-A-Car, Inc. v. Dep't of Revenue*, 81 Wn.2d 171, 174-75, 500 P.2d 764 (1972). Any ambiguity in such a statute is construed strictly, but fairly, against the taxpayer. *Group Health Coop. v. Washington State Tax Comm'n*, 72 Wn.2d 422, 429, 433 P.2d 201 (1967); *Lacey Nursing Center, Inc. v. Dep't of Revenue*, 128 Wn.2d 40, 49-50, 905 P.2d 338 (1995). The taxpayer has the burden of proving qualification for a tax deduction. *Group Health*, 72 Wn.2d at 429. For practical purposes, Rule 111 acts like an exemption, and courts applying it have referred to it as such. *See City of Tacoma v. William Rogers Co.*, 148 Wn.2d 169, 172, 60 P.3d 79 (2003); *Pilcher v. Dep't of Revenue*, 112 Wn. App. 428, 442, 49 P.3d 947 (2002).

RCW 82.04.080 (emphasis added). If Rule 111 were interpreted to exclude from taxation amounts falling within the statutory definition of "gross income of the business," it would be inconsistent with the statute and invalid to that extent. *See Walthew, Warner, Keefe, Arron, Costello & Thompson v. State of Washington*, 103 Wn.2d 183, 187-88, 691 P.2d 559 (1984) (discussing relationship between Rule 111 and B&O tax statutes).

Whether one examines the undisputed facts in this case from the standpoint of the B&O tax statutes or Rule 111, the result is the same. The record demonstrates as a matter of law that (a) the portion of WIS's receivables that it pays to Overlake for radiology services is part of WIS's "gross income of the business"; and (b) the same amounts fail to qualify as excludable agent payments under Rule 111. The trial court's summary judgment for the Department should be affirmed.

B. Payments WIS Receives For Medical Imaging Services Are Compensation For Services Rendered, And Therefore Are Taxable As "Gross Income Of The Business."

The Department's Audit Division, its Appeals Division, and the trial court all concluded that the payments WIS receives for providing medical imaging services to patients are taxable as gross income, even though WIS pays a portion of the money to Overlake for radiology interpretations. WIS argues otherwise, based primarily on a single sentence in one of its agreements with Overlake and a prior case interpreting Rule 111 in the

medical field context. Appellant's Brief at 14-20. This Court should reject WIS's arguments and affirm summary judgment for the Department.

1. WIS offers the public complete medical imaging services, bills for complete medical imaging services, and is paid for complete medical imaging services.

WIS is in the business of providing medical imaging services, which includes creating the image, interpreting the image, and creating a report that is provided to the referring physician. CP 33, ¶ 7; CP 91-92, 101-02; CP 135 (Interrogatory No. 9). WIS divides the process into two components, "technical services" and "professional services." The professional services consist of the services Overlake provides under contract to WIS by supplying radiologists to interpret the medical images and dictate their findings.

WIS sends what it calls a "global bill" to patient insurers that includes both the technical and professional components of the medical imaging services, without mentioning Overlake by name. CP 93-95. It receives a global payment in return. CP 98. The payments do not allocate a portion to WIS and a portion for the professional services provided through Overlake. CP 98, 110-111. WIS's CEO testified that both the technical and professional components of medical imaging services are "essential" and that the technical component (the image alone) is "incomplete" and will not

be reimbursed by insurers without a professional interpretation of the image. CP 96-97, 102.

When WIS sends out its global billings for payment and receives global payments in return, the payments to WIS constitute "compensation" to WIS for rendering medical imaging services, whether through independent contractors or otherwise. They also constitute "value proceeding or accruing *by reason of the transaction of the business engaged in*," which is WIS's advertised business of providing medical imaging services. *See* CP 101. Accordingly, the payments WIS receives for having provided medical imaging services qualify as the "gross income of the business" under RCW 82.04.080. "Compensation or consideration for the service is thus the basis for the tax." *Walthew*, 103 Wn.2d at 187.

The money WIS owes and pays to Overlake under the Medical Imaging Agreement is a cost of doing business as a medical imaging service that may not be deducted from the global payments WIS receives. Under RCW 82.04.080, "gross income of the business" is taxable "without any deduction on account of the cost of materials used, labor costs, . . . or any other expense whatsoever paid or accrued . . . ." Rule 111 recognizes this component of RCW 82.04.080: "no charge which represents . . . a cost of doing or obtaining business, even though such charge is made as a separate item, will be construed as an advance or reimbursement. Money

so received constitutes a part of gross sales or gross income of the business, . . ."

Because the money WIS pays to Overlake represents a cost of doing business as a medical imaging service, it is taxable as gross income and Rule 111 does not apply.

2. Payments WIS received from patients or insurers, from which WIS calculated the amount it owed Overlake, constituted "value proceeding or accruing" to WIS.

The definition of "gross income of the business" includes all "value proceeding or accruing" from engaging in a business, including compensation for services rendered. RCW 82.04.080. WIS argues that the amounts it pays to Overlake do not represent "value proceeding or accruing" in the first instance to WIS. Appellant's Brief at 15-16. According to WIS, it never "receives" or "accrues" these amounts from an accounting perspective because WIS agreed with Overlake that WIS has "no ownership interest" in these funds. *Id.*; *see* CP 61. The Court should reject this argument, which is legally and factually flawed.

Under the definition in RCW 82.04.090, "value proceeding or accruing" means:

> [T]he consideration, whether money, credits, rights, or other property expressed in terms of money, actually received or accrued. The term shall be applied, in each case, on a cash receipts or accrual basis according to which method of

> accounting is regularly employed in keeping the books of the taxpayer.

WIS's Agency Agreement provides that WIS acts as a collection agent for Overlake and that WIS "shall have no ownership interest in the Overlake portion of the billing . . . ." CP 61. From this, WIS concludes that the funds it collects and pays to Overlake are never "received" or "accrued" to WIS and therefore cannot constitute "gross income" to WIS.

The flaw in WIS's argument is that it assumes a taxpayer may change otherwise taxable income into amounts excludable from taxation merely by declaring in a contract with a third party that the taxpayer has "no ownership interest" in the funds. The taxability of any business's receipts is governed by applying the statute to the actual operations of the business, not by agreements between taxpayers. Under WIS's argument, any business using subcontractors could avoid taxation of income merely by agreeing with the subcontractors that the primary business had "no ownership interest" in the funds the primary business received and paid to the subcontractors. Businesses that previously hired employees would have an incentive to change all employees to independent contractors, so that they could avoid B&O taxation on their labor costs through a "no ownership interest" clause in all those contracts.

The Agency Agreement between WIS and Overlake may define the legal relationship between those two firms and determine rights between them to funds WIS collects for medical imaging services. It does not, however, determine who "owns" the funds upon receipt by WIS for purposes of parties outside the confines of the Agency Agreement, and therefore does not limit federal, state, or local taxation of funds received by WIS.

Similar to Washington tax law, the Internal Revenue Code contains a very broad definition of "gross income," which federal courts interpret broadly as extending to all economic gains not exempted. *Commissioner of Internal Revenue v. Banks*, 543 U.S. 426, 433, 125 S. Ct. 826, 160 L. Ed. 2d 859 (2005). For the better part of a century, federal courts have applied the doctrine of anticipatory assignment of income to reject arguments similar to the one WIS advances here. The anticipatory assignment doctrine precludes a taxpayer from excluding an economic gain from gross income by assigning the gain in advance to another party. *Id.*; *Lucas v. Earl*, 281 U.S. 111, 50 S. Ct. 241, 74 L. Ed. 731 (1930).

In *Banks*, the Supreme Court held that in general, when a plaintiff's recovery in a successful lawsuit constitutes taxable income, the taxable income includes the portion of the recovery paid to the attorney as a contingent fee. *Banks*, 543 U.S. at 430. With this holding, the Court

reversed a Ninth Circuit ruling that the income was excludable if state law gave the plaintiff's attorney a special property interest in the fee. *Id.* at 429-30.

In *Lucas*, the Court held a husband's entire salary was taxable, notwithstanding the husband's contract with his wife that any property acquired by either was owned by the husband and wife as joint tenants, with the right of survivorship. The Court did not question the validity of the contract under state law, but held the entire salary was taxable based "on the import and reasonable construction of the taxing act," notwithstanding any anticipatory arrangements and contracts. *Lucas*, 281 U.S. at 114-15. The Court also noted that the husband was the only party to the contracts by which the salary and fees were earned, "and it is somewhat hard to say that the last step in the performance of those contracts could be taken by anyone but himself alone." *Id.* at 114.

Here, as in *Lucas*, WIS is the only party that contracted with patients to provide medical imaging services. The last step in the process of fulfilling those contracts, producing a written report to the referring physician interpreting the medical images, is a step WIS performed. CP 91-92. WIS sent out the bills for the medical imaging services, and WIS received the payments for medical imaging services. The "import and reasonable construction" of the B&O tax statutes, including the statutory

definitions of "gross income of the business" and "value proceeding or accruing," strongly suggest this Court should reject WIS's argument that it never "received" the portion of income it paid to Overlake.

Even if the Court concludes that WIS's argument is legally viable, the argument is flawed for evidentiary reasons. The evidence in the record contradicts WIS's argument in its brief that it did not "actually" receive funds it later paid to Overlake. In response to discovery requests, WIS described its billing and collection procedures, which included using a contractor to bill and collect WIS's "receivables." CP 132. The contractor "would bill the *global receivable* (including both the professional and technical fees bundled together)," remitting to WIS the cash collected, less any refunds issued. *Id.* (emphasis added). The billing contractor also charged specified billing and coding fees. *Id.* WIS calculated the amount it owed to Overlake "net of prorated billing fees." *Id.* As WIS described the process:

> That methodology was to divide the *gross cash received* into two pools (1. MRI etc., 2 all other), then reduce each pool by the appropriate [billing contractor] variable fee (5%, 10.63%) and fixed fees, then apply the appropriate percentage (20%, 23%) to calculate the net amount payable to OVERLAKE.

CP 132 (emphasis added). In addition, WIS's chief financial officer testified that WIS made decisions about collections write-offs and

discounts without consulting Overlake. CP 120. These independent actions are inconsistent with someone who has "no ownership interest" in the cash collected.

The foregoing description of WIS's billing process in the discovery responses is completely consistent with the billing and collections provisions in the Medical Imaging Agreement. *See* CP 49-50. The Agreement required WIS to remit to Overlake each month Overlake's calculated share of the "net amount" collected. The Agreement defined "net amount collected" as "cash collected net of credit card charges, not sufficient funds checks, any sales, use, or similar taxes measured by the amount charged for Medical Imaging Services, required refunds, and reasonable billing and collection expenses." CP 50 at ¶ 6.2; *see also* CP 49 (deposition testimony describing payments to Overlake as based on "net cash collected"); CP 148 (Declaration referring to WIS paying Overlake "an agreed percentage of net cash receipts").

This evidence demonstrates that WIS did, in fact, "receive" or "accrue" funds for providing medical imaging services, from which it deducted billing fees and other allowed amounts, before it calculated Overlake's share of the "net cash receipts." If the amounts WIS paid to Overlake were never part of WIS's receipts from an accounting standpoint, then WIS would have had no reason to calculate the "net

amount collected" before calculating what WIS owed to Overlake for professional fees.[6] Under arrangements WIS entered into with patients to provide complete medical imaging services, WIS was compensated for the services it rendered, with the assistance of its independent contractor Overlake. WIS billed patients for the complete service and was paid for the complete service. The total amount of funds it collected constituted "gross income of the business."

3. The facts related to WIS's business, rather than the facts in *Medical Consultants*, control the determination whether payments WIS receives constitute "gross income of the business."

The second argument WIS makes related to the "gross income" definition is that the funds WIS collects and pays to Overlake for the radiology services Overlake provides are not gross income to WIS because they are not funds WIS received for "rendition of services." Appellant's Brief at 20. WIS bases this argument solely on a comparison of some similar facts in this case to those in *Medical Consultants Northwest, Inc. v. State*, 89 Wn. App. 39, 947 P.2d 784 (1997). Appellant's Brief at 17-20.

[6] If the record on this topic seems hazy, one reason is because WIS did not argue to the trial court that it did not actually receive or accrue, from an accounting perspective, funds it later paid to Overlake. By raising this argument on appeal, based on the "no ownership interest" clause in the Agency Agreement, WIS has raised the factual issue about how it treated all the funds it collected. The evidence in the record discussed above reflects WIS treated the total collections as income actually received, i.e., as its own "gross income," prior to calculation of the Overlake share from "net amount collected." Had WIS made this same argument in the trial court, the Department would have put into the record additional evidence obtained during discovery, which clearly demonstrates the same.

Contrary to WIS's argument, the facts in this case are not "virtually identical" to those in *Medical Consultants*, nor is the procedural posture of this case the same. Nothing in *Medical Consultants* dictates treating the total funds WIS collects from patients and insurers as anything other than compensation for services rendered; i.e., "gross income of the business."

One of the material differences between this case and *Medical Consultants* is the nature of the taxpayers' businesses. Medical Consultants Northwest (MCN) was a medical consulting firm in the business of facilitating independent medical examinations. MCN retained physicians in various specialties as independent contractors to perform the medical examinations. 89 Wn. App. at 42. A noteworthy feature of those independent contractor agreements was that MCN agreed to act on each physician's behalf "to facilitate [p]hysician serving as a [c]onsultant in medical matters." *Id.* (quoting MCN physician agreement). Other contract provisions quoted in *Medical Consultants* also referred to the physicians as the "Consultant" and as providing "consulting services." *Id.* at 43. The court noted that if a client later needed the physician to testify, the client arranged and paid for that service directly with the physicians.

What seems clear from the facts in *Medical Consultants* is that the key relationship from a business perspective was between the patient/client and the consulting physician MCN retained to perform the

examination. The facts in the appellate decision contain little information about the arrangements between the clients and MCN (as opposed to those between MCN and the independent physicians), but the trial court made a finding of fact that only the client had liability for paying the physician. 89 Wn. App. at 44, 45. On appeal, this Court held the trial court's finding was supported by the stipulated facts between the parties. *Id.* at 45.

In *Medical Consultants*, the record before the Court apparently demonstrated that the money MCN collected for medical examinations was not for MCN's rendition of services, but for the physicians' services. *See id.* at 48.[7] This supported the Court's conclusion that money MCN paid the physicians was not part of MCN's taxable gross income. *Id.*[8] The facts here are materially different.

WIS is not a consulting business that facilitates for patients the reading of medical images by radiologists. WIS offers complete medical imaging services to patients and provides a key component of that service, the medical image, without which the service is "incomplete." CP 97.

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[7] In *Medical Consultants* the Department disputed the trial court's interpretation of the stipulated facts submitted by the parties. 89 Wn. App. at 44. The Court held the trial court properly relied on the stipulated facts and the reasonable inferences that could be drawn from them. *Id.* at 44. Here, because this appeal arises in the summary judgment context, the Court should rely on the evidence in the record, and any reasonable inferences that can be drawn from it. There are no stipulated facts. The parties agree that the material facts are undisputed, but disagree on how the law applies to those facts.

[8] The Department believes a portion of the Court's analysis in *Medical Consultants* regarding Rule 111 is incorrect and has been refined by later published cases. Additional discussion of the case appears below in Part IV.C.

Unlike MCN, WIS is not simply arranging scheduling, providing a facility, and handling collections, for a medical imaging services business. WIS is itself in the business of providing medical imaging services. It offers customers both the "technical" and "professional" components of medical imaging services. CP 91-92, 101-02, 135. WIS bills a "global" fee for the complete services and is paid a "global" fee. CP 93-95, 98.

Because WIS's business and relationship with its client patients is materially different than MCN's business as described in *Medical Consultants*, it is not surprising that the evidence in this case is different too. Unlike the finding in *Medical Consultants* that only the client had liability to pay the physicians performing independent medical examinations, there is no evidence in this record that the patients had any obligation whatsoever to pay either Overlake or the particular Overlake radiologists who performed the medical image interpretations. The only payment obligation the patients had was to pay WIS. CP 141. Only WIS had any obligation to pay Overlake, and that obligation arose from WIS's contract with Overlake.

In summary, the holding in *Medical Consultants* cannot dictate the outcome of this case because the two cases are materially different, despite the similarity of the medical context and use of independent contractors by the taxpayers. The determination whether an income stream constitutes

the "gross income of the business" or "value proceeding or accruing" for a business is one that depends on the facts and circumstances of each business. Published cases guide the analysis, but the primary focus should be on the evidence and the Legislature's intent expressed in the statutes. Here, the evidence demonstrates the "global" fee WIS receives for providing medical imaging services is taxable gross income to WIS.

C. The Trial Court Correctly Held That As A Matter Of Law, WIS Cannot Establish The Required Elements For Excluding Income From Tax Under Rule 111.

The Rule 111 exclusion from taxation is very limited. The Rule imposes very specific conditions for taxpayers to qualify:

> The 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.*
>
> . . . .
>
> The foregoing [exclusion] *is limited to* cases wherein the taxpayer, as an incident to the business, undertakes, on behalf of the customer, guest or client, the payment of money, either upon an obligation owing by the customer, guest or client to a third person, or in procuring a service for the customer, guest or client *which the taxpayer does not or cannot render and for which no liability attaches to the taxpayer. It does not apply* to cases where the customer, guest or client makes advances to the taxpayer *upon services to be rendered by the taxpayer* or upon goods to be purchased by the taxpayer *in carrying on the business in which the taxpayer engages.*
>
> . . . .

> On the other hand, *no charge which represents* an advance payment on *the . . . cost of doing or obtaining business*, even though such charge is made as a separate item, *will be construed as an advance or reimbursement.* Money so received constitutes a part of . . . gross income of the business, . . .

Rule 111 (emphasis added).

Washington courts have summarized the requirements of Rule 111 in a three-part test: (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 paying, except as the agent of the client. *Christensen, O'Connor, Garrison & Havelka v. Dep't of Revenue*, 97 Wn.2d 764, 768-69, 649 P.2d 839 (1982). Under the third requirement there are two components. The taxpayer first has the burden of proving the alleged advance was made pursuant to an agency relationship. If the taxpayer establishes the existence of an agency, then the taxpayer must also establish that the taxpayer's liability to pay the advance to a third party constituted solely agent liability. *City of Tacoma v. William Rogers Co.*, 60 P.3d 79, 83-84, 148 Wn.2d 169 (2003); *Rho Company v. Dep't of Revenue*, 113 Wn.2d 561, 568-73, 782 P.2d 986 (1989).

WIS has the burden to prove all three requirements. Here, under the undisputed facts, *none* of the required elements is present.

1. The payments were not advances or reimbursements for clients.

Under the first requirement of Rule 111, WIS must establish that the payments it received from patients (or third-party payors) were advances or reimbursements the patients made for money WIS paid to Overlake for radiological interpretations.[9] WIS provided no such evidence to the trial court and cites none on appeal. Instead of showing that patients made an "advance" or "reimbursement" to WIS of money patients owed to Overlake, the evidence shows patients made payments exclusively to WIS for medical imaging services.

In an analogous case, this Court considered the requirements of this first element. *Pilcher v. Dep't of Revenue*, 112 Wn. App. 428, 49 P.3d 947 (2002), *review denied*, 149 Wn.2d 1004 (2003). In *Pilcher*, a hospital contracted with a single physician, Dr. Pilcher, to serve as the medical director and to provide physician services for the hospital's emergency room. Because the parties realized it would be physically impossible for Dr. Pilcher to be on duty in the emergency room 24 hours a day, seven days a week, the hospital agreed in its contract that Dr. Pilcher could hire or contract with additional physicians to staff the emergency room, in a number

[9] Rule 111 defines "advance" as "money or credits received by a taxpayer from a customer or client with which the taxpayer is to pay costs or fees for the customer or client." The Rule defines "reimbursement" as "money or credits received from a customer or client to repay the taxpayer for money or credits expended by the taxpayer in payment of costs or fees for the client."

left to Dr. Pilcher's discretion. 112 Wn. App. at 430-31. Dr. Pilcher was an independent contractor to the hospital, and the additional physicians he retained were independent contractors to him. *Id.* at 431. On a monthly basis, Dr. Pilcher submitted emergency room professional service fees to the hospital for his services and those of the physicians he retained. The parties considered the charges of all the ER physicians combined to be the gross charges by Dr. Pilcher. *Id.* at 432. The hospital paid Dr. Pilcher the total amount he had submitted, minus a percentage for collection, billing, and overhead. *Id.*

The compensation paid to the other retained physicians was a matter strictly between Dr. Pilcher and each physician. *Id.* at 433. Dr. Pilcher had the exclusive responsibility of paying these other ER physicians. *Id.* He paid them what they billed in their allowed charges each month, minus a somewhat larger percentage than what the hospital had deducted. *Id.*

This Court held that the payments Dr. Pilcher made to the ER physicians he retained did not qualify as "pass-through" payments under Rule 111. *Id.* at 436-442. First, the Court noted that Dr. Pilcher was in the business of providing services to the hospital: his management services and the services of the physicians he retained as independent contractors to help staff the emergency room. *Id.* at 436. The Court also concluded as both a legal and factual matter that the payments failed to meet the first requirement

of Rule 111 of being an advance or reimbursement. *Id.* at 439-40. As the Court stated:

> The Hospital's only legal obligation was to Dr. Pilcher. The Hospital had no separate contract with the physicians Dr. Pilcher retained. Dr. Pilcher had no authority to enter into contracts on the Hospital's behalf. Dr. Pilcher was solely liable for paying the physicians. In effect, the Hospital was purchasing physician services and management from Dr. Pilcher.

Id. at 439. The Court also noted that Dr. Pilcher did not pay his physicians until after they performed their services, after he submitted the charges to the hospital, and after he received the monthly payment from the hospital. "Thus, such payments from the Hospital to Dr. Pilcher were neither advancements to him nor reimbursements for money he had paid his emergency room physicians." *Id.* at 440.

The facts in this case are similar to those in *Pilcher* in all these respects. There is no evidence in the record that (a) the patients served by WIS had a legal obligation to pay anyone but WIS for the medical imaging services they received; (b) WIS had any authority to enter into contracts on the patients' behalf; (c) the patients had a contractual relationship with Overlake; or (d) anyone other than WIS had an obligation to pay Overlake. In the patient registration form, patients consented to "Financial Responsibility" to WIS, assigning to WIS any insurance benefits otherwise

payable to the customer and agreeing they were "financially responsible to [WIS] for charges not paid by insurance." CP 141.

Likewise, the payments from patients to WIS were neither advancements nor reimbursements to WIS for money it paid Overlake. Rather, the payments from patients to WIS were payments for medical imaging services as a whole, which included production of the medical image, interpretation of the image, and a report. *See* CP 33, at ¶ 7.

In its argument on the first element of Rule 111, WIS cites evidence in the record establishing, among other things:

- Referring physicians know medical imaging services involve services of a radiologist. Appellant's Brief at 27; CP 92-92, 145-46.
- Patients sign the Patient Registration form, consenting to the test. Appellant's Brief at 28; CP 141.
- Patients are responsible for charges not covered by insurance, and WIS bills insurance first. *Id.* at 28; CP 141, 147.
- Insurers understand that charges for medical imaging services include both the technical and professional components and pay a global payment that insurers expect will be applied to both components. *Id.* at 28-29; CP 94, 141, 147-49.
- WIS pays an agreed percentage of what it receives to Overlake for the professional services, in which WIS agreed it has "no ownership interest." *Id.* at 29; CP 61, 148-49.

From this evidence, WIS concludes that the portion of funds collected that it paid to Overlake met "the literal definition of an advance." Appellant's Brief at 29. WIS provides no example of what it believes the "literal" definition of "advance" is, nor does it discuss the Rule 111 definition of "advance." That definition states the word means "money or

credits received by a taxpayer from a customer or client with which the taxpayer is to pay costs or fees *for the customer or client.*" (Emphasis added). None of the evidence WIS cites establishes any obligation on the part of WIS's *clients*, the patients, to pay Overlake. Neither the patients, nor the referring physicians or insurers, have any legal obligation to pay Overlake. The only person with an obligation to pay Overlake is WIS. When WIS makes payments of the "agreed percentages" to Overlake, WIS is not making those payments "for the customer or client" as Rule 111 requires. WIS makes those payments for itself, to satisfy its own contract obligations to Overlake.

WIS also relies on two cases to establish the first element of Rule 111, one of which is in the medical context. Appellant's Brief at 30-31; *see Rho*, 113 Wn.2d at 568; *Medical Consultants*, 89 Wn. App. at 48. As WIS concedes, however, the issue of the first element was not in dispute in either of those cases. Thus, neither of the cases provides a basis for making a determination that the "advance or reimbursement" element exists in this case. *Pilcher* is much more persuasive because it discussed the issue in a context analogous to the facts here.

Because the required element of an "advance" or "reimbursement" under Rule 111 is missing, this Court should affirm summary judgment for the Department.

2. The payments in question were for services WIS could and did render.

To meet the second requirement under Rule 111, a taxpayer must establish that the payment was for services the taxpayer did not or could not render. WIS argues that it meets this requirement because it did not perform the professional services involved in interpreting the medical images and could not do so because it does not have a medical license and may not obtain one, as a business owned in part by a nonphysician. The trial court concluded WIS met this requirement. RP 36.

This Court need not decide this element in favor of the Department to uphold the tax assessment because a taxpayer must prove all elements of a Rule 111 claim in order to avoid taxation. Nevertheless, the Department respectfully disagrees with the trial court's conclusion. As this Court established in *Pilcher*, taxpayers can and do provide services that they cannot themselves provide by hiring independent contractors to provide the services. *Pilcher*, 112 Wn. App. at 440. Here, just as in *Pilcher*, the taxpayer holds itself out as providing all of the services, some of which it provides through the use of an independent contractor. *See* CP 101 (WIS advertised itself as "a provider of medical imaging services"). This is not a situation in which patients "contract" with WIS to take the image and "contract" separately with Overlake to interpret the image. WIS

sells the complete package: image, interpretation, and written report. Accordingly, the payments WIS received were for services WIS can and did render.

3. WIS has liability for paying Overlake amounts collected from patients beyond that of an agent.

The third requirement to qualify for the Rule 111 exclusion is that the taxpayer has no responsibility to make the payment to a third party, except as an agent for the taxpayer's client. *Christensen*, 97 Wn.2d at 768-69; *Rho*, 113 Wn.2d at 568; *Pilcher*, 112 Wn. App. at 438. This requirement comes from the following limitation in Rule 111: "The 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." As noted earlier, the third test has two components. The taxpayer first has the burden of proving the alleged advance was made pursuant to an agency relationship. If the taxpayer establishes the existence of an agency, then the taxpayer must also establish that the taxpayer's liability to pay the advance to a third party constituted solely agent liability. *William Rogers Co.*, 60 P.3d at 83-84; *Rho*, 113 Wn.2d at 568-73. The evidence in this case does not establish either component of the third requirement.

a. No evidence exists that WIS acts as an agent for patients in forwarding payments to Overlake.

A taxpayer has the burden of establishing an agency relationship. *William Rogers*, 148 Wn.2d at 177-78.[10] An agency relationship "generally arises when two parties consent that one shall act under the control of the other." *Id.*; *Rho*, 113 Wn.2d at 570; *see also* Restatement (Third) of Agency § 1.01 (2006) (defining agency). Existence of an agency relationship is not controlled by contractual labels, but by a course of conduct. *Rho*, 113 Wn.2d at 570.

An agency relationship may arise without an express understanding between the principal and agent that it be created. *E.g.*, *Rho*, 113 Wn.2d at 570. Nevertheless, agency

> does not come into existence out of thin air. It does not exist unless the facts, either expressly or by inference, establish that one person is acting at the instance of and in some material degree under the direction and control of the other. It arises from manifestations that one party consents that another shall act on his behalf and subject to his control, and corresponding manifestations of consent by another party to act on behalf of and subject to the control of another.

Matsumura v. Eilertwash, 74 Wn.2d 362, 368, 444 P.2d 806 (1968) (cited with approval in *Rho*). The elements of consent and control by the

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[10] The same is true outside the tax context, where the party asserting the existence of an agency relationship has the burden of proving it. *Hewson Const., Inc. v. Reintree Corp.*, 101 Wn.2d 819, 823, 685 P.2d 1062 (1984). An agency relationship is not presumed. *Stockdale v. Horlacher*, 189 Wash. 264, 267, 64 P.2d 1015 (1937); *Blodgett v. Olympic Savings & Loan Ass'n*, 32 Wn. App. 116, 128, 646 P.2d 139 (1982).

principal of the agent are "essential" and "crucial factors" to establish agency. *Moss v. Vadman*, 77 Wn.2d 396, 403, 463 P.2d 159 (1969); *O'Brien v. Hafer*, 122 Wn. App. 279, 283, 93 P.3d 930 (2004), *review denied*, 153 Wn.2d 1022 (2005); *Heath v. Uraga*, 106 Wn. App. 506, 514 n.9, 24 P.3d 413 (2001). Without that control, the relationship is one of buyer and seller, for example, not principal and agent. *Uni-Com Northwest, Ltd. v. Argus Publishing Co.*, 47 Wn. App. 787, 797, 737 P.2d 304 (1987); *see also* Restatement (Third) of Agency § 1.01, comment c.

Agency generally is treated as a question of fact, but when the facts are undisputed and are susceptible of only one interpretation, agency can be decided as a matter of law. *Blodgett v. Olympic Savings & Loan Ass'n*, 32 Wn. App. 116, 128, 646 P.2d 139 (1982). Here, the record lacks any evidence suggesting an agency relationship between WIS's patients and WIS for purposes of the payments WIS made to Overlake. The trial court properly determined as a matter of law that no agency relationship existed. RP 37.

WIS has a relationship with its patients in which it provides medical imaging services to those patients in return for a fee. WIS also contracts with Overlake for physician services to interpret the medical images of those patients and to provide information in the form of a report to the referring physicians. In order for Rule 111 to exclude the money

WIS pays to Overlake for professional services from taxation, WIS must demonstrate that when it pays Overlake for those services, it is doing so solely as an agent for the patients.

No evidence in the record demonstrates WIS's patients consented to have WIS act on their behalf in terms of paying Overlake for professional services, either explicitly or implicitly. No evidence in the record from the tax period demonstrates that patients of WIS even knew Overlake existed or that WIS contracted separately with Overlake to provide the image interpretation component of the medical image services it provided. To the contrary, WIS admits that it represented itself to the public as providing medical imaging services, which necessarily includes a physician's professional interpretation of the image. CP 102; CP 135 (Interrogatory No. 9).

Likewise, no evidence in the record suggests WIS consented to a relationship in which the patients controlled WIS's actions with regard to paying Overlake or in any other respect. The essential elements of consent and control by the principal are entirely missing here. There is no principal/agent relationship between patients and WIS for purposes of paying Overlake or any other purpose. Because patients do not control how and whether WIS pays Overlake, the relationship between patients and WIS is merely that of buyer and seller of medical imaging services.

See Nordstrom Credit, Inc. v. Dep't of Revenue, 120 Wn.2d 935, 845 P.2d 1331 (1993) (retailer was not related credit company's agent where credit company did not control any of retailer's business activities); *Blodgett*, 32 Wn. App. at 128 (where there was no evidence building owner exercised control over contractor doing remodeling work, trial court should have found contractor was not owner's agent as a matter of law).

WIS quotes from a number of sections and comments in the Restatement (Second) of Agency, neglecting to mention the "control" requirement found in that previous Restatement or in Washington law. Appellant's Brief at 34-40. *See, e.g.,* Restatement (Second) of Agency § 14 (1958) ("A principal has the right to control the conduct of the agent with respect to matters entrusted to him.") Because there is no evidence in the record that patients in any manner controlled or had a right to control WIS with respect to paying Overlake for its services, or that WIS consented to such control, WIS focuses instead on two topics: how persons can manifest their consent to agency through their conduct; and determining the reasonable scope of agency authorization. In the absence of any evidence that WIS agreed to be controlled by patients in paying Overlake, WIS's discussion does nothing to advance its case for applying Rule 111 because no agency can exist. In any event, WIS's arguments concerning manifestation of consent to agency are also flawed.

In the midst of a description of how treating physicians refer patients to WIS for medical imaging services, how appointments are scheduled, and what the insurers understand, the sole evidence WIS relies on to establish that the patient consented to have WIS act as the patient's agent in paying Overlake is the patient registration form. *See* Appellant's Brief at 38, 40. The plain terms of that document, however, fail to establish that the patients consented to anything other than having the test done and being ultimately responsible to WIS for the medical imaging service charges:

> **CONSENT TO CARE:**
> **PERMIT FOR MEDICAL AND/OR SURGICAL TREATMENT:** I, the undersigned, hereby consent to and permit Washington Imaging Services, LLS (WIS, LLC), their designees, and all other persons caring for me to perform and administer tests, examinations, including but not limited to x-rays, medical and surgical treatment and other procedures which may be deemed necessary or advisable for me. I am aware that the practice of medicine is not an exact science and acknowledge that no guarantees or promised have been made to me as to the result of the examination.
> . . . .
> **FINANCIAL AGREEMENT:**
> **PRIVATE PAY:** The undersigned agrees, whether signing as an agent or as patient to be financially responsible to Washington Imaging Services, LLC for charges not paid by insurance. . . .
> **INSURANCE COVERAGE:** I hereby assign payment directly to Washington Imaging Service, LLC for benefits otherwise payable to me, but not to exceed the charges for service. Any portion of charges not paid by the insurance company will be billed to me and is then due and payable within 30 days of invoice. . . .

CP 141.

This patient registration form does not mention Overlake, and it says nothing about creating an agency relationship between the patient and WIS. It includes consent to medical care and an acknowledgment of financial responsibility *to WIS only* for that care. The inclusion of two words, "their designees," in the consent to care portion of the form could mean either WIS employees designated to provide the medical imaging services or other WIS agents, or WIS contractors or partners. A reasonable person reading this language would not conclude patients manifested consent to have WIS act as their agents in paying Overlake or that WIS agreed to act under the control of patients in doing so. From an evidentiary standpoint, the patient registration form fails to establish (or even suggest) the existence of an agency relationship between patients and WIS.

The evidence in this case does not establish that patients who came to WIS for medical imaging services consented to have WIS act on their behalf for purposes of paying Overlake for radiology services or that WIS consented to act under the patients' control in doing so. Because there is no agency relationship between the patients and WIS with respect to Overlake, the portion of the patient payments WIS forwarded to Overlake is not excludable under Rule 111 as a matter of law.

b. WIS was not liable to Overlake solely as an agent of WIS patients.

Because WIS was not acting as an agent for patients when it paid Overlake, the conclusion necessarily follows that WIS was not liable to Overlake solely as an agent for patients, as Rule 111 requires. Even if an agency relationship somehow existed, however, WIS cannot establish solely agent liability to Overlake.

The Department does not dispute that WIS paid Overlake a percentage of net amounts actually collected from patients. CP 50, at ¶¶ 6.2, 6.4. Thus, WIS was not obligated under the Medical Imaging Agreement to pay Overlake for its professional fees unless WIS had received payment from patients. However, this fact alone does not establish that WIS's liability to Overlake was solely as an agent of patients.

That WIS had liability to Overlake beyond that of an agent for patients becomes clear when examining the possibility of a failure on WIS's part to forward to Overlake its portion of amounts collected from patients. Under the Restatement, conduct that breaches an agent's duties to the principal does not automatically result in liability to a third party, even though the conduct also harms the third party. Restatement (Third) of Agency § 7.02, comment b. "An agent is subject to liability to a third party only when the agent's conduct breaches a duty that the agent owes the third

party." *Id.* This duty to a third party can result from tort law, a contract between the agent and the third party, or from other circumstances. *Id.* Generally, an agent does not owe a duty to a third party when the agent's negligent conduct causes only economic loss. *Id.*, comment d.

Here, WIS had a contractual duty to collect money for the medical imaging services provided to patients and to pay Overlake for its services, regardless of any separate understanding WIS had regarding those payments with its patients. If WIS collected money from patients and did not forward the applicable percentage to Overlake, Overlake would have an action against WIS for breach of contract. That cause of action would not exist if WIS had liability solely as an agent of patients for purposes of paying Overlake.

Furthermore, the provisions of the contract between WIS and Overlake establish that WIS had more than agent liability to Overlake. If WIS had mere agent liability to Overlake, then it would only have an obligation to pay the amount that the principal (in this case, the patient) directed WIS to make. However, the record is clear that patients had no say whatsoever in what amount, how, or when WIS paid Overlake. CP 98-99.

Even if WIS could overcome this undisputed fact, the amount WIS was obligated by contract to pay Overlake did not represent the actual amount designated the "professional component" of the fee by Medicare

regulations. Rather, the amount WIS paid to Overlake was negotiated solely between Overlake and WIS. WIS describes the amount paid to Overlake as being "driven by suggested Medicare reimbursement allowances" CP 27, 33. But WIS and Overlake executives testified that the original, negotiated percentages to be paid to Overlake were based on an approximation, or average, of Medicare suggested reimbursement rates. CP 27, at ¶ 5; CP 33, at ¶ 8; CP 105. Thus, when an individual patient paid the bill that WIS sent to the patient, WIS did not look to Medicare suggested reimbursement rates to determine how much of the payment to transmit to Overlake, as someone with solely agent liability might do. Instead, WIS looked to its contract with Overlake to determine that amount. CP 121-23.

The simple fact that WIS's liability to Overlake was controlled by its contract rather than any agency principles is confirmed by the course of conduct of WIS and Overlake subsequent to executing the contract relating to the agreed percentages to be paid to Overlake. Although WIS witnesses testified that Medicare reimbursement rates change every year, WIS and Overlake made no attempt to confirm that the agreed-upon percentages remained an accurate approximation of the amount due to Overlake. CP 108-09; CP 122-23. Indeed, WIS witnesses confirmed that even if Medicare reimbursement rates changed so that the agreed percentages were no longer

accurate, the contract could not be changed without the consent of both contracting parties. CP 106-09.

These facts demonstrate that WIS's liability with respect to Overlake was not solely that of an agent; it was a contractual liability that was in no way affected by any direction of the alleged principal (the patient) and was in no way affected by changes to Medicare suggested reimbursement rates.

WIS argues that the facts in this case are "indistinguishable" from those in *Medical Consultants*. Appellant's Brief at 41. WIS is incorrect. In *Medical Consultants*, this Court concluded that the third prong of the Rule 111 test was satisfied "because MCN is not obligated to pay an independent physician unless MCN is first paid by its client. If MCN is paid by its client, MCN's obligation to the physician is solely as an agent of the client." *Medical Consultants*, 89 Wn. App. at 48. As the Department discussed above in Part B.3, some of the facts in *Medical Consultants* are similar to those in this case, but some of the material facts are not.

In *Medical Consultants*, MCN billed clients for services provided both by MCN and the independent physicians. MCN apparently made stronger disclaimers of liability to physicians for paying the physicians than did WIS in this case. 89 Wn. App. at 44. MCN also indicated to physicians that the "client" would pay the physician if the patient failed to show up for the appointment. *Id.* at 43. Moreover, unlike in this case, MCN's clients

were aware that a portion of the MCN bill they paid represented a fee due the independent physician. *Id.* at 42-43. The trial court found, on stipulated facts, that MCN had no liability for paying the physicians, except as an agent for the client. *Id.* at 44. No such stipulated facts exist here.

Unlike *Medical Consultants*, this case does not concern the independent medical examination context in which the client (and sometimes the patient) relies on the physician as an expert consultant, often for legal purposes. The key relationship in that context is between the client and the physician. Here, patients who obtained medical imaging services from WIS were not informed of the particulars regarding WIS's contractual and billing agency relationship with Overlake. Many of them probably never knew, or cared to know, the name of the professional services corporation that employed the radiologist who interpreted their MRI or other medical image.

The *Medical Consultants* decision discusses two earlier Rule 111 cases, but contains no discussion of agency requirements or what it means to be liable solely as an agent, as opposed to having independent liability to third parties. 89 Wn. App. at 47-48. Essentially, the *Medical Consultants* decision assumed the existence of an agency relationship between the patient/clients and MCN merely by examining MCN's contract payment terms with the *independent physicians*. Washington law does not allow an agency relationship to be presumed from a contract between the alleged

agent and a *third party*. Agency is never presumed, and it must be proved by evidence regarding the relationship between the alleged *principal* and agent. *Blodgett*, 32 Wn. App. at 128.

Five years after *Medical Consultants*, this Court decided *Pilcher*. The Court discussed each of the required Rule 111 elements in detail and held that Dr. Pilcher did not have solely agent liability where only Dr. Pilcher, and not the hospital, was responsible for paying the physicians. *Pilcher*, 112 Wn. App. at 439-41.

Shortly thereafter, the Supreme Court issued *William Rogers*, which emphasized the importance of the "solely agent liability" requirement for excluding income from tax under Rule 111. *Williams Rogers*, 148 Wn.2d at 178-81. In the Court's words,

> If a taxpayer assumes *any* liability beyond that of an agent, the payments it receives are not "pass through" payments, even if the taxpayer uses the payments to pay costs related to the services it provides to its client.

148 Wn.2d at 178 (citing *Walthew*, 103 Wn.2d at 189) (emphasis added).

Here, the contract terms under which WIS was obligated to pay Overlake receipts from patient billings were somewhat favorable to WIS, in that WIS did not guarantee payment to Overlake in the absence of payments from patients. Nonetheless, WIS did have liability beyond that of an agent. It had contract liability to Overlake. This Court in *Medical Consultants* did

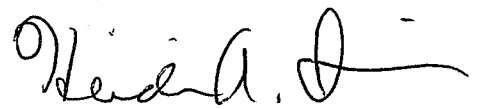
not review agency law to determine the limits of agent liability to third parties. Though the issue may not have been squarely presented in that case, it is in this case. WIS cannot, as a matter of law, satisfy the third requirement to qualify these payments under Rule 111.

V. CONCLUSION

For the foregoing reasons, this Court should affirm the trial court's order granting summary judgment to the Department.

RESPECTFULLY SUBMITTED this 20th day of November, 2008.

ROBERT M. MCKENNA
Attorney General



HEIDI A. IRVIN, WSBA No. 17500
PETER B. GONICK, WSBA No. 25616
Assistant Attorneys General
Attorneys for Defendant

458-20-110 << 458-20-111 >> 458-20-112

WAC 458-20-111 No agency filings affecting this section since 2003

Advances and reimbursements.

The word "advance" as used herein, means money or credits received by a taxpayer from a customer or client with which the taxpayer is to pay costs or fees for the customer or client.

The word "reimbursement" as used herein, means money or credits received from a customer or client to repay the taxpayer for money or credits expended by the taxpayer in payment of costs or fees for the client.

The 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.

There may be excluded from the measure of tax amounts representing money or credit received by a taxpayer as reimbursement of an advance in accordance with the regular and usual custom of his business or profession.

The foregoing is limited to cases wherein the taxpayer, as an incident to the business, undertakes, on behalf of the customer, guest or client, the payment of money, either upon an obligation owing by the customer, guest or client to a third person, or in procuring a service for the customer, guest or client which the taxpayer does not or cannot render and for which no liability attaches to the taxpayer. It does not apply to cases where the customer, guest or client makes advances to the taxpayer upon services to be rendered by the taxpayer or upon goods to be purchased by the taxpayer in carrying on the business in which the taxpayer engages.

For example, where a taxpayer engaging in the business of selling automobiles at retail collects from a customer, in addition to the purchase price, an amount sufficient to pay the fees for automobile license, tax and registration of title, the amount so collected is not properly a part of the gross sales of the taxpayer but is merely an advance and should be excluded from gross proceeds of sales. Likewise, where an attorney pays filing fees or court costs in any litigation, such fees and costs are paid as agent for the client and should be excluded from the gross income of the attorney.

On the other hand, no charge which represents an advance payment on the purchase price of an article or a cost of doing or obtaining business, even though such charge is made as a separate item, will be construed as an advance or reimbursement. Money so received constitutes a part of gross sales or gross income of the business, as the case may be. For example, no exclusion is allowed with respect to amounts received by (1) a doctor for furnishing medicine or drugs as a part of his treatment; (2) a dentist for furnishing gold, silver or other property in conjunction with his services; (3) a garage for furnishing parts in connection with repairs; (4) a manufacturer or contractor for materials purchased in his own name or in the name of his customer if the manufacturer or contractor is obligated to the vendor for the payment of the purchase price, regardless of whether the customer may also be so obligated; (5) any person engaging in a service business or in the business of installing or repairing tangible personal property for charges made separately for transportation or traveling expense.

Revised May 1, 1947.

[Order ET 70-3, § 458-20-111 (Rule 111), filed 5/29/70, effective 7/1/70.]

RCW 82.04.080
"Gross income of the business."

"Gross income of the business" means the value proceeding or accruing by reason of the transaction of the business engaged in and includes gross proceeds of sales, compensation for the rendition of services, gains realized from trading in stocks, bonds, or other evidences of indebtedness, interest, discount, rents, royalties, fees, commissions, dividends, and other emoluments however designated, all 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 and without any deduction on account of losses.

[1961 c 15 § 82.04.080. Prior: 1955 c 389 § 9; prior: 1949 c 228 § 2, part; 1945 c 249 § 1, part; 1943 c 156 § 2, part; 1941 c 178 § 2, part; 1939 c 225 § 2, part; 1937 c 227 § 2, part; 1935 c 180 § 5, part; Rem. Supp. 1949 § 8370-5, part.]

RCW 82.04.090
"Value proceeding or accruing."

"Value proceeding or accruing" means the consideration, whether money, credits, rights, or other property expressed in terms of money, actually received or accrued. The term shall be applied, in each case, on a cash receipts or accrual basis according to which method of accounting is regularly employed in keeping the books of the taxpayer. However, persons operating grain warehouses licensed under chapter 22.09 RCW may elect to report the value proceeding or accruing from grain warehouse operations on either a cash receipts or accrual basis. The department of revenue may provide by regulation that the value proceeding or accruing from sales on the installment plan under conditional contracts of sale may be reported as of the dates when the payments become due.

[2001 c 20 § 1; 1975 1st ex.s. c 278 § 40; 1961 c 15 § 82.04.090. Prior: 1955 c 389 § 10; prior: 1949 c 228 § 2, part; 1945 c 249 § 1, part; 1943 c 156 § 2, part; 1941 c 178 § 2, part; 1939 c 225 § 2, part; 1937 c 227 § 2, part; 1935 c 180 § 5, part; Rem. Supp. 1949 § 8370-5, part.]

Notes:

Effective date -- 2001 c 20: "This act is necessary for the immediate preservation of the public peace, health, or safety, or support of the state government and its existing public institutions, and takes effect July 1, 2001." [2001 c 20 § 2.]

Construction -- Severability -- 1975 1st ex.s. c 278: See notes following RCW 11.08.160.

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COURT OF APPEALS
DIVISION II
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STATE OF WASHINGTON
BY
DEPUTY

NO. 38247-4-II

COURT OF APPEALS, DIVISION II
OF THE STATE OF WASHINGTON

WASHINGTON IMAGING SERVICES, LLC,

Appellant,

v.

WASHINGTON STATE DEPARTMENT OF REVENUE,

Respondent.

DECLARATION OF MAILING

Candy Zilinskas, states and declares as follows:

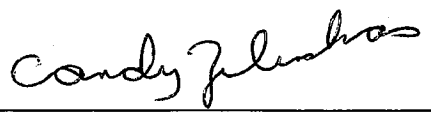
I am a citizen of the United States of America and over 18 years of age and I am competent to testify to the matters set forth herein. On November 20, 2008, I provided a true and correct copy of Brief of Respondent and this Declaration of Mailing to be sent electronically via email to greg.montgomery@millernash.com and monica.langfeldt@millernash.com and by U.S. Mail, postage prepaid via Consolidated Mail Service, to:

Greg Montgomery
Monica Langfeldt
MILLER NASH LLP
4400 Two Union Square
601 Union Street
Seattle, WA 98101-2352

ORIGINAL

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

Executed this 20th day of November, 2008, in Tumwater, Washington.



CANDY ZILINSKAS
Legal Assistant