

NO. 84101-2

SUPREME COURT OF THE STATE OF WASHINGTON

WASHINGTON IMAGING SERVICES, LLC,

Respondent

v.

WASHINGTON STATE DEPARTMENT OF REVENUE,

Petitioner

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SUPPLEMENTAL BRIEF OF PETITIONER

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ORIGINAL

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I. INTRODUCTION

This case concerns the application of business and occupation tax in a relatively common scenario – where a taxpayer provides services to its clients in part by means of services the taxpayer obtains through independent contractors. At issue is whether the taxpayer may exclude from its taxable gross income its payments to the independent contractor. The answer turns on the definition of “gross income of the business” in RCW 82.04.080 and the Department of Revenue’s rule interpreting that definition, WAC 458-20-111.

Despite this Court’s recent guidance on the subject,¹ the Court of Appeals here misunderstood how the B&O tax works under the facts of this case. The taxpayer, Washington Imaging Services, LLC (“WIS”), is a medical imaging business that contracts with a professional service corporation to obtain radiological interpretations necessary for WIS to provide written reports to its patients and their referring physicians.

The Court of Appeals erroneously held that the amounts WIS pays the contractor are not part of WIS’s costs of doing business, and thus are not part of WIS’s taxable “gross income of the business,” but instead are amounts WIS merely collects from its patients as the contractor’s agent and “passes through” to the contractor. *Washington Imaging Services, LLC v. Dep’t of Revenue*, 153 Wn. App. 281, 294, 222 P.3d 801 (2009).

¹ *City of Tacoma v. William Rogers Co.*, 148 Wn.2d 169, 60 P.3d 79 (2003) (involving similar city ordinance).

The disputed amounts WIS paid to its contractor are part of the “gross income” of WIS’s business. Patients and their insurers were obligated to pay WIS, not the contractor. WIS was the *sole* party with any liability to pay the contractor. Because patients owed only WIS for medical imaging services, WIS billed for the services on its *own* behalf, rather than as a collection agent for the contractor. In addition, WIS’s lack of a medical license neither precluded WIS from selling medical imaging services that included radiological interpretation nor relieved WIS of its own contractual liability to the contractor. For these reasons, this Court should reverse the Court of Appeals decision and reinstate the trial court’s summary judgment for the Department.

II. ISSUE ON REVIEW

Under the definition of “gross income of the business” in RCW 82.04.080, may WIS exclude the amounts it contracted to pay to a professional service corporation for radiological interpretation when WIS is the only party obliged to pay the contractor?

III. STATEMENT OF THE CASE

During the relevant tax period, WIS was in the business of providing medical imaging services to patients. In advertising, WIS presented itself as “dedicated to providing state-of-the-art outpatient medical imaging services utilizing the most sophisticated imaging equipment.” CP 135. WIS described medical imaging services as involving technical and professional components. The “technical component” is the generation of the medical image, such as an x-ray. The

“professional component” is the radiologist’s interpretation of the image. CP 33, 60, 101-02. The WIS product was a written interpretation of images it produced “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 (interrogatory answer); *see also* CP 91-92 (deposition testimony). Thus, the medical imaging services WIS sold to patients included a radiologist’s interpretation of the images created at WIS’s facilities.

WIS retained a professional service corporation, Overlake Imaging Associates, P.C. (“Overlake”), to provide radiological interpretations of the images. CP 114. WIS and Overlake stated their obligations to each other in two contracts. CP 37-59; CP 60-62. WIS was responsible for billing patients and insurers. CP 50; CP 61.

WIS did not inform patients receiving medical imaging services of Overlake’s existence or indicate that patients would have any obligation to pay Overlake as a result of receiving medical imaging services from WIS. CP 112-13. Patients signed a patient registration form in which they agreed to be financially responsible only to WIS. CP 141. The registration form assigned insurance payments to WIS and made no mention of Overlake or of any agreement to pay Overlake. *Id.* Similarly, insurance companies contracted with WIS, but not with Overlake, to pay WIS for medical imaging services provided at WIS locations. CP 99-100.

WIS billed patients or insurance companies for both the technical component (producing the image) and the professional component

(interpreting of the image) of the medical imaging services. CP 95. The bills did not set forth a separate charge for each component; WIS it billed one “global” charge for medical imaging services. CP 95, 103-04, 143. The bills were on WIS letterhead, asked that payment be remitted to WIS, and made no reference to Overlake. CP 143.

Consistent with how WIS generated its bills, WIS received payments in a lump sum, not separated into components. CP 98. Neither patients nor insurance companies had any say in how much of the payments on the “global bills” were transmitted to Overlake. CP 98-99. Rather, the percentage of the global payments WIS paid to Overlake depended entirely on the contracts between WIS and Overlake. CP 121..

In their contracts, WIS and Overlake determined the percentage of net collections that would be paid to Overlake. CP 50, 104. Using Medicare reimbursement rates as guidelines, WIS and Overlake averaged numerous procedures into several broad categories of imaging, and through negotiation determined how they would split the global fees in each category. CP 50, 104. The contracts obligated WIS to pay these negotiated percentages even though actual Medicare reimbursement rates changed over time. CP 107-08, 122-23.

The Department audited WIS for the period January 2000 through June 2005. Because WIS had excluded amounts it paid Overlake from its taxable gross income in its tax returns, the Department issued assessments, which WIS paid. CP 34. WIS filed a refund action in Thurston County

Superior Court under RCW 82.32.180. CP 4-8. On cross motions, the trial court granted summary judgment to the Department. CP 175-76.

The Court of Appeals held amounts WIS paid to Overlake were payments WIS collected “much like a collection agency for services Overlake renders and, as such, are not gross income to WIS’ business.” *Washington Imaging*, 153 Wn. App. at 284. It reversed the trial court’s order and remanded for entry of summary judgment in WIS’s favor. *Id.* at 284, 296. It denied the Department’s motion for reconsideration.

IV. ARGUMENT

The issue in this case concerns the core features of the B&O tax, which is a gross receipts tax. The tax is imposed on a taxpayer’s “gross income of the business,” without deduction for business expenses. The issue in this case turns on whether the portion of WIS’s receipts that it paid to Overlake are properly considered WIS’s business expenses or are instead funds that WIS handled solely as a payment agent for patients or as a collection agent for Overlake. If WIS acted solely as an agent with respect to its payments to Overlake, the amounts may be excluded from the measure of WIS’s taxable gross income. Reaching that conclusion, however, requires proof that patients had an obligation to pay Overlake for radiological interpretation services. In the absence of patient liability to pay Overlake, WIS could not have been acting as the patients’ agent in paying Overlake or as Overlake’s agent in billing the patients for medical imaging services.

Here, there is no patient liability to Overlake. Patients contracted

with WIS for medical imaging services and agreed to pay no one but WIS for those services. The only party with any liability to Overlake was WIS. Accordingly, WIS's payments to Overlake were part of its business expenses and were not deductible from its taxable gross income.

The Court of Appeals focused on WIS's business relationship with Overlake, without considering whether WIS's patients had obligations to Overlake. Consequently, it drew conclusions contrary to the evidence and Washington law. The court relied principally on three facts:

- WIS's contract with Overlake labeled WIS as the contractor's "collection agent." CP 50, 61; *Washington Imaging*, 153 Wn. App. at 285.
- WIS had no license to practice medicine. *Washington Imaging*, 153 Wn. App. at 284, 290, 293; see CP 30-31, 146.
- In its contract with Overlake, WIS's promise to pay was conditioned upon receiving payments from patients and their insurers. CP 50; *Washington Imaging*, 153 Wn. App. at 285.

The Court of Appeals has clouded the proper analysis of what constitutes taxable gross income. Its decision should be reversed.²

² Appellate courts review summary judgment orders de novo, engaging in the same inquiry as the trial court. *Weden v. San Juan County*, 135 Wn.2d 678, 689, 958 P.2d 273 (1998). Because rejection of one party's motion for summary judgment does require granting the opposing party's cross motion, this Court should consider each party's motion by drawing all reasonable inferences in a light favorable to the nonmoving party. *Weden*, 135 Wn.2d at 710; *Campbell v. Reed*, 134 Wn. App. 349, 361, 364, 139 P.3d 419 (2006), rev. denied, 160 Wn.2d 1023 (2007); *Burris v. General Ins. Co. of Am.*, 16 Wn. App. 73, 75-76, 553 P.2d 125 (1976). Here, the Court of Appeals erred by reversing summary judgment for the Department and granting WIS's motion without applying these standards. See *Washington Imaging*, 153 Wn. App. at 296. The absence of evidence that patients had any liability to Overlake, if not dispositive in favor of the Department, at least raises a genuine issue of material fact whether WIS received the payments as compensation for services it rendered through its contractor or received them solely in the capacity of an agent.

A. Taxability Under RCW 82.04.080 And WAC 458-20-111 Depends On The Respective Liabilities Of Clients, Taxpayers, And Third Parties To Each Other.

The B&O tax is imposed on every person “for the act or privilege of engaging in business activities” and is measured by the “gross income of the business.” RCW 82.04.220. *See Simpson Inv. Co. v. Dep’t of Revenue*, 141 Wn.2d 139, 149, 3 P.3d 741 (2000) (tax is “upon virtually all business activities carried on within the state”). The B&O tax is not a tax on profit or net gain, but a tax on the total amount of money or value received in the course of doing business. *Budget Rent-A-Car of Wash.-Ore., Inc. v. Dep’t of Revenue*, 81 Wn.2d 171, 173, 500 P.2d 764 (1972).³ It is a gross receipts tax, not a net income tax. *See Tyler Pipe Indus., Inc. v. Dep’t of Revenue*, 105 Wn.2d 318, 327, 715 P.2d 123 (1986).

Unlike a net income tax, the B&O tax has a pyramiding effect because multiple businesses may contribute to a single ultimate sale of products or services. Nonetheless, “each activity is separate and each may be taxed.” *Impecoven v. Dep’t of Revenue*, 120 Wn.2d 357, 364, 841 P.2d 752 (1992) (entire commission paid by insurance company to insurance agent is gross income despite percentage paid to sub-agent) (citing *Supply Laundry Co. v. Jenner*, 178 Wash. 72, 79, 34 P.2d 363 (1934)).⁴

³ *See Western Adjustment & Inspection Co. v. Gross Income Taxation Div.*, 236 Ind. 639, 645, 142 N.E.2d 630 (1957) (“The gross income tax is applicable regardless of any profit being involved.”).

⁴ The pyramiding nature of gross receipts taxes, including Washington’s B&O tax, makes them a target of criticism by tax policy commentators and the business community. *See, e.g.*, Tax Foundation, *Special Report – Tax Pyramiding: The Economic Consequences of Gross Receipts Taxes* (No. 147, Dec. 2006). On the other hand, because they tax all business activities in the economy, gross receipts taxes have lower rates than net income taxes. *See* RCW 82.04.190(2) (imposing rate of 1.5% on gross income of

In the absence of a statutory deduction, taxpayers may not deduct any of their costs of doing business. The Legislature made this clear in the definition of “gross income of the business”:

[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, rent, 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.*

RCW 82.04.080 (emphasis added).

WAC 458-20-111 represents the Department’s longstanding interpretation of RCW 82.04.080 in the factual setting represented here. Rule 111 describes how to distinguish business expenses, which may not be deducted from taxable gross income, from amounts that are excluded from gross income because they are received by a taxpayer acting solely in its capacity as an agent. An exclusion from taxable income is allowed because such receipts do not belong to the agent. *See City of Tacoma v. William Rogers Co.*, 148 Wn.2d 169, 175, 60 P.3d 79 (2003).⁵

To determine whether funds paid by a taxpayer to a third party should be considered nondeductible business expenses or may be excluded.

taxpayers engaged in business activities not specifically addressed in other sections of B&O tax statutes).

⁵ *See Western Adjustment*, 236 Ind. at 647-48 (reimbursements to insurance claims adjustment company for its costs in adjusting and paying insurance claims was properly included in taxable gross income where company was not a “mere temporary conduit through which the funds passed intact”).

from taxable gross income, it is necessary to consider who is liable to whom, and for what. This requires examining obligations running (a) between the taxpayer and its clients, (b) the taxpayer and third parties to whom it makes payments, and (c) the clients and third parties, if any. The Rule 111 exclusion from taxation is very limited, applying only in circumstances where the taxpayer has no personal liability to pay the third party, and the client alone has liability to that third party:

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.*

Rule 111 (emphasis added). Rule 111 expressly states that money received that represents payment on a taxpayer’s cost of doing business “constitutes a part of . . . gross income of the business.” Rule 111 must be read consistently with RCW 82.04.080, since the statute does not contain any express exceptions based on agency. *Walthew, Warner, Keefe, Arron, Costello & Thompson v. Dep’t of Revenue*, 103 Wn.2d 183, 188, 691 P.2d 559 (1984).

This Court has summarized the elements of Rule 111 as follows: (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). The third element has two components. The taxpayer must prove both that the payment in dispute was made pursuant to an agency relationship and that the taxpayer's liability to pay the funds to a third party constituted solely agent liability. *Wm. Rogers*, 148 Wn.2d at 177-78; *Rho Co. v. Dep't of Revenue*, 113 Wn.2d 561, 568-73, 782 P.2d 986 (1989). If the taxpayer independently assumes any liability to the third party, the payments it receives from the client and pays to the third party are not excluded from taxation, "even if the taxpayer uses the payments to pay costs related to the services it provided to its client." *Wm. Rogers*, 148 Wn.2d at 178 (citing *Walthew*, 103 Wn.2d at 189).

Here, under the undisputed facts, none of the required elements is present. See Br. of Resp. at 27-46. In particular, evidence of the third element is entirely missing. WIS's patients had no liability to pay Overlake. Only WIS had any liability to pay Overlake. Thus, WIS did not act as an agent for the patients or for Overlake when it billed patients for medical imaging services and paid a portion of its receipts to Overlake. As a matter of law, those payments were nondeductible business expenses and were properly included in WIS's taxable gross income.

B. WIS Acted Neither As A Collection Agency For Overlake Nor As A Procurement Agent For Patients.

The Court of Appeals focused solely on the obligations running between WIS and Overlake, without examining what liability the patients had to either WIS or Overlake. As a result, it gave controlling weight to facts that do not establish a basis for excluding the amount of WIS's

payments to Overlake from WIS's taxable gross income. The first was a provision in WIS's contract with Overlake labeling WIS as Overlake's collection agent for purposes of the services Overlake performed at WIS's facilities. CP 50, 61. The Court of Appeals held WIS collected funds from patients "much like a collection agency for services that Overlake renders[.]" *Washington Imaging*, 153 Wn. App. at 284, 294 & n.3.

The Court of Appeals understood correctly that the entire amount of money a collection agency collects on behalf of a creditor is not gross income of the agency because the debtor is not paying for the agency's services – the debtor is paying the collection agency to satisfy the debtor's existing obligation to a third party. A collection agency does not bill for services it has provided or for money that is owed to itself. For example, a person paying a collection agent for a dentist would not think the collection agency had provided dental services. A collection agency collects money owed to a third party and would never accurately describe its own business as providing the service for which it bills.

However, under the undisputed facts in this case, WIS did not act as a collection agency for Overlake because patients contracted solely with WIS and did not owe anything to Overlake. CP 141. All the money WIS collected from patients and their insurers belonged to WIS. The patient registration form, WIS's contracts with insurance companies, and the bills WIS sent to patients are all consistent: Overlake was not mentioned, and patients owed WIS, not Overlake. CP 99-100, 141, 143. WIS admits it is engaged in the business of providing medical imaging services, including

the professional interpretation of those images. CP 91-92, 135. WIS's business is therefore not like a collection agency,⁶ as the Court of Appeals concluded. This money was thus "value proceeding or accruing by reason of the transaction of the business engaged in" and constituted taxable gross income to WIS. RCW 82.04.080.

Though the Court of Appeals decision gives a different impression, WIS primarily argued in the courts below that its payments to Overlake should be excluded from tax on a theory that WIS acted as a *procurement agent for patients* to obtain Overlake's radiological interpretations, rather than as a collection agent for Overlake. *See, e.g.*, Br. of App. at 34-40. As this Court discussed in *Wm. Rogers*, when the evidence proves a taxpayer acted solely as an agent for a client to secure the services of a third party, payments by the taxpayer to the third party are not considered part of the agent's gross income. *Wm. Rogers*, 148 Wn.2d at 177-81 (temporary staffing service failed to establish it paid its temporary workers as an agent for its clients). Here, however, that evidence is lacking. There is no evidence that patients and WIS consented to have WIS act under the patients' control for purposes of making payments to Overlake. *See* Br. of Resp. at 34-39. The trial court properly determined as a matter of law that

⁶ In addition to stating that WIS was a "collection agent" for Overlake, WIS's contract with Overlake stated that WIS had "no ownership interest" in the funds it owed to Overlake under the contract. CP 61. WIS cannot change the taxability of its revenue by terms in its agreement with Overlake. *Cf. Rho Co., Inc. v. Dep't of Revenue*, 113 Wn.2d 561, 782 P.2d 986 (1989) (terms in contracts between taxpayer and actual provider of services did not control whether money was gross income of taxpayer); *Wasem's Inc. v. State*, 63 Wn.2d 67, 68-70, 385 P.2d 530 (1963) (retailer could not avoid B&O taxes on Washington sales to Idaho customers by designating customers as agent "carriers" of the retailer in bill of lading); *see also* Br. of Resp. at 15-17.

no such agency relationship existed. RP 37; see *Blodgett v. Olympic Savings & Loan Ass'n*, 32 Wn. App. 116, 128, 646 P.2d 139 (1982).

Rather than acting as a collection agent for Overlake or a procurement agent for patients, WIS acted as a principal in its contracts with Overlake and its patients. The undisputed evidence provides no basis for considering WIS's payments to Overlake as anything other than nondeductible costs of doing business as a medical imaging service.

C. The Court of Appeals Confused The Practice Of Medicine With The Business Of Providing Medical Imaging Services.

Three times in its decision, the Court of Appeals noted that WIS does not have a license to practice medicine. *Washington Imaging*, 153 Wn. App. at 284, 290, 293. The court concluded that WIS's inability to render the professional medical services that Overlake provided meant the funds WIS ultimately paid to Overlake were not WIS's business expenses, but merely funds WIS collected and "passed through" to Overlake. *Id.* at 293-94 (citing *Walthev and Medical Consultants Northwest, Inc. v. State*, 89 Wn. App. 39, 947 P.2d 784 (1997), *rev. denied*, 136 Wn.2d 1002 (1998)). The Court of Appeals was mistaken.

As a corporation owned in part by an individual who is not a physician, CP 30, WIS is unable to employ licensed physicians to interpret the medical images WIS creates. Washington applies the common law prohibition on the corporate practice of medicine. Under this doctrine, unless legislatively authorized, a business may not engage in the practice of medicine by employing licensed physicians. *Columbia Physical*

Therapy, Inc. v. Benton Franklin Orthopedic Associates, PLLC, 168 Wn.2d 421, 228 P.3d 1260, 1263-64 (2010).⁷

In this case, the Court of Appeals confused professional standards governing the practice of medicine with B&O tax liability, which applies broadly to “all activities engaged in with the object of gain, benefit, or advantage to the taxpayer or to any other person . . . directly or indirectly.” RCW 82.04.140. The Court of Appeals incorrectly concluded that because WIS was not licensed to practice medicine, WIS was legally incapable of engaging in a business that required the services of licensed physicians. The common-law corporate practice of medicine doctrine does not preclude unlicensed individuals or entities from providing medical services through independent contractor physicians.

As this case demonstrates, entities providing health care services routinely do business in this manner.⁸ WIS’s CEO testified: “[B]ecause we can’t employ [physicians], we have to contract with them as an independent contractor provider of services.” CP 114.

The Court of Appeals relied on this Court’s decision in *Walthew* to reject the Department’s argument that WIS provided to patients the

⁷ The Professional Service Corporation Act, RCW 18.100, is a statutory exception to the doctrine. It allows professional limited liability companies, such as Overlake, to render the professional services for which its members are licensed. RCW 18.100.050(1); see *Columbia Physical*, 228 P.3d at 1266; CP 26-27.

⁸ The “practical effect” of the doctrine is that a medical service business “must procure physicians on an independent contractor basis, instead of hiring them as salaried employees.” Sarah K. Engelbrecht, Comment, *The Importance of Clarifying North Carolina’s Corporate Practice of Medicine Doctrine*, 33 Wake Forest L. Rev. 1093, 1099 (1998); see *Conrad v. Medical Bd. of California*, 55 Cal. Rptr. 2d 901, 907 (Cal. Ct. App. 1996) (referring to “historic practice” of treating doctors as independent contractors, not employees, where corporate practice of medicine prohibition applied).

complete package of medical imaging services, including image, interpretation, and written report, and that therefore amounts WIS paid to Overlake represented part of WIS's business expenses. *Washington Imaging*, 153 Wn. App. at 292-94. But the court failed to recognize a critical distinction between this case and *Walthew*.

In *Walthew*, this Court held advances made by a law firm to third parties to finance litigation were the obligation of the client, and accordingly, reimbursement of those advances by the client were not taxable as gross income. *Walthew*, 103 Wn.2d at 184-85, 190. Clients assumed the obligation when they signed contracts with the law firm confirming they would pay those third-party costs. *Id.* at 185. In addition, the lawyer ethics rules prohibited attorneys from paying litigation costs for clients, unless clients retained ultimate liability for those expenses. *Id.* at 185, 188-89; *see* RPC 1.8(d)(1). Thus, when the law firm received funds from clients as a reimbursement of those expenses, the law firm was acting "solely as agent for the client." *Walthew*, 103 Wn.2d at 188.

Unlike the facts in *Walthew*, no evidence here proves or even hints at any patient liability to Overlake. WIS's patients agreed to pay WIS and only WIS. CP 112-13, 141. Similarly, the insurers who made payments to WIS on behalf of the insured patients had contracts with WIS, and not with Overlake. CP 99-100.

In addition, unlike the lawyer ethics rule in *Walthew*, there is no analogous medical practice rule prohibiting WIS from contracting with Overlake or requiring the patient to be "ultimately liable" for paying

Overlake. Rather, “[a]ttorneys are unique in this respect. The Department’s concern that other professionals will necessarily gain an exemption by our holding is misplaced.” *Walthew*, 130 Wn.2d at 188. The corporate practice of medicine doctrine, unlike the lawyer ethics rule, does not require that WIS act “solely as agent” for its patients.

The corporate practice of medicine doctrine does not preclude WIS from being liable to Overlake for costs associated with interpretation of the medical images, and the undisputed facts in this case demonstrate patients had no responsibility to pay anyone other than WIS for the “global” medical imaging services WIS advertised and billed. Therefore, the Court of Appeals should not have relied on WIS’s lack of a license to practice medicine to reverse the trial court.⁹

A taxpayer’s lack of a professional or occupational license may lead a court to more closely examine the respective relationships of a taxpayer to its clients and contractors. However, it does not by itself transform a taxpayer’s receipts from taxable gross income to excludable advances or reimbursements, in the absence of a legal rule, such as the lawyer ethics rule in *Walthew*, precluding law firms from being liable for such costs. If taxpayers could not sell integrated services to clients where a licensed subcontractor was necessary to perform a portion of those

⁹ Likewise, to the extent *Medical Consultants* can be read as holding that a taxpayer’s mere lack of a license to practice medicine precludes the taxpayer from being taxed on gross income comprised in part on amounts paid to contract physicians or a professional service corporation, it should be overruled. See *Medical Consultants*, 89 Wn. App. at 48 (money MCN collects for medical exams not for MCN’s rendition of services because MCN does not have a medical license and cannot perform medical examinations).

services, many businesses could not operate the way they do today. In the construction industry, for instance, a general contractor who is not himself licensed as an electrician or plumber would be precluded from contracting to construct a new building, and the property owner would need to enter into separate contracts with licensed electricians and plumbers.

In reality, however, the law allows businesses a great deal of flexibility in structuring their operations and contracts with customers and other persons. Under the B&O tax scheme, sometimes those arrangements will create multiple levels of tax liability. The Department's duty is to tax the gross income of a business according to how it actually operates, rather than how it might have been structured. The amounts WIS paid to Overlake were properly included in WIS's taxable gross income as a provider of medical imaging services.

D. The Court of Appeals Incorrectly Equated WIS's Conditional Liability To Overlake With An Absence Of Liability.

Relying on its earlier case, *Medical Consultants*, the Court of Appeals held that WIS could deduct from its gross income the amounts it paid Overlake because it was not obligated to pay Overlake other than from collections it actually received. *Washington Imaging*, 153 Wn. App. at 289-91; see *Medical Consultants*, 89 Wn. App. at 48 (taxpayer liable solely as an agent and could exclude payments made to independent physicians from taxable gross income because taxpayer not obligated to pay physicians until payment received from clients). The court equated WIS's conditional liability to Overlake with an absence of liability. *Id.* at

294-95 n.4 (WIS has “no obligation” to pay Overlake).

The court erred in ruling for WIS based on WIS’s conditional liability to Overlake. It made assumptions contrary to law because it did not recognize that WIS’s conditional liability to Overlake has no bearing on the key issue here, whether *patients* had any liability to Overlake, which WIS must demonstrate in order to exclude from taxation the portion of receipts it paid to Overlake.

The effect of WIS’s conditional liability to Overlake was nothing more than that Overlake shared the risk of nonpayment by patients and insurers. Contrary to being dispositive of the question whether funds WIS paid Overlake were part of WIS’s costs of engaging in the business of providing medical imaging services, this feature of WIS’s contracts with Overlake is irrelevant.¹⁰ This is because the patients were obligated to pay only WIS, *regardless* of WIS’s contract terms with Overlake.¹¹

Here, the Court of Appeals did not address whether WIS’s patients or their insurers had any obligation to pay Overlake. Thus, it implied that funds paid to a taxpayer by a client may be excluded from the taxpayer’s

¹⁰ WIS’s conditional liability to Overlake also is irrelevant from a factual standpoint, because the Department’s tax assessment was based on income WIS actually received from patients and their insurers, not on WIS’s total billings. Thus, the condition precedent of being paid was satisfied, triggering WIS’s obligation to pay Overlake the agreed percentage. *See* CP 50, 61.

¹¹ *See Pilcher v. Dep’t of Revenue*, 112 Wn. App. 428, 442, 49 P.3d 947 (2002), (Dr. Pilcher’s payments to contracted physicians who staffed hospital ER not deductible from Pilcher’s gross income), *rev. denied*, 149 Wn.2d 1004 (2003). The respective roles of the patients, WIS, and Overlake are identical to those of the hospital, Dr. Pilcher, and the ER physicians: The hospital’s only legal obligation was to Dr. Pilcher, the hospital had no separate contract with the ER physicians, and Dr. Pilcher was solely liable for paying the ER physicians. *Id.* at 439.

“gross income” and treated as payments by an agent on behalf of a client to a third party, *even if the client has no legal obligation or liability to pay the third party*. The decision is contrary to existing caselaw. *See Wm. Rogers*, 148 Wn.2d at 179 (no agency relationship where staffing service solely liable for paying workers and client had no role in deciding amount staffing service paid to workers); *see also Impecoven*, 120 Wn.2d at 364 (entire commission paid by insurance company to insurance agent is gross income despite percentage paid to sub-agent, who was not paid unless agent paid, but had no right to receive money from insurance company).

Both here and in *Medical Consultants*, the court’s analysis also conflicts with agency law. The Court of Appeals assumed that a conditional liability clause between a taxpayer and a third-party contractor resulted in an agency relationship between the taxpayer and its client. *Medical Consultants*, 89 Wn. App. at 48, *quoted in Washington Imaging*, 153 Wn. App. at 294-95 n.4. In other words, the court assumed terms of a contract between party B and party C can have the effect of creating an agency relationship between party A and party B. To the contrary, an agency relationship only arises when two parties consent that one shall act under the control of the other. *Wm. Rogers*, 148 Wn.2d at 177-78; *Rho*, 113 Wn.2d at 570. The record here provides no support for assuming, as the court did, a principal-agent relationship between patients and WIS, under which WIS acted solely as an agent for patients in paying Overlake. WIS’s patients had no say in what amount, how, or when WIS paid

Overlake. CP 98-99.¹²

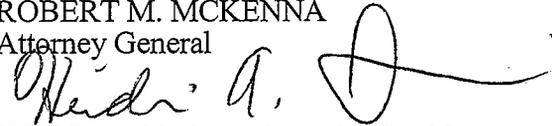
As a matter of law, the Court of Appeals erred when it held that WIS's conditional liability to pay Overlake rendered those payments excludable from WIS's taxable "gross income of the business."

V. CONCLUSION

For the foregoing reasons, the Department requests that this Court reverse the Court of Appeals decision and reinstate the trial court's summary judgment in favor of the Department.

RESPECTFULLY SUBMITTED this 28th day of May, 2010.

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¹² The absence of an agency relationship between patients and WIS is highlighted from another perspective: WIS offered no evidence that if it breached its contract with Overlake or became insolvent, Overlake would have recourse against WIS's patients or their insurers. *See City of Alexandria v. Morrison-Williams Associates, Inc.*, 288 S.E.2d 482, 484 (Va. 1982) (amounts taxpayer paid to third party not deductible from gross income; taxpayer not agent of client or third party where third party would have no recourse against client if taxpayer became insolvent or unwilling to meet its contractual obligations to third party).

WAC 458-20-111

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.]