84101-2

No. 38247-4-II

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

WASHINGTON IMAGING SERVICES, LLC,

Appellant,

v.

WASHINGTON STATE DEPARTMENT OF REVENUE,

Respondent.

APPELLANT'S BRIEF

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DIVISION II
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I. INTRODUCTION

Funds paid to a taxpayer that the taxpayer then passes through to a third party as payment for rendering services to the taxpayer's customer, services the taxpayer does not, and cannot, render, are not gross income to the taxpayer for purposes of the business and occupation tax imposed under RCW 82.04.220. The Court recognized this limitation on gross income in *Med. Consultants N.W. v. State*, 89 Wn. App. 39, 947 P.2d 48 (1997); *review denied* 136 Wn.2d 1002 (1998) and affirmed it in distinguishing *Pilcher v. Department of Revenue*, 112 Wn. App. 428, 439 n.11, 49 P.3d 997 (2002) based on the fact that the taxpayer in *Pilcher* could and did render the precise services for which all funds at issue were paid.

The taxpayer here is Washington Imaging Services, LLC ("WIS"). Local doctors send their patients to WIS to obtain, through medical imaging services, information to assist them in the diagnosis and treatment of the patient.

WIS produces the medical image ordered by the treating doctor but does not, and, by law, cannot, provide the professional medical interpretation of the image. Because the referral would not accomplish its

purpose without a professional medical interpretation of the image, WIS contracts with Overlake Imaging Associates, P.C. ("OIA"), a group of radiologists, to provide this professional medical service.

By agreement with OIA, WIS sends out one bill, initially to the patient's health insurance company, that combines the charge for its technical service with the charge for OIA's professional medical service. An agreed percentage of the amount collected on any bill is passed through to OIA as compensation for its professional medical services. By contract with OIA, WIS agrees it has no ownership interest in these funds. If WIS does not get paid on a bill, WIS has no obligation to pay OIA for its professional medical services.

The portion of funds WIS collects and passes through to OIA as compensation for its professional medical services is not gross income to WIS for purposes of Washington's business and occupation tax. The trial court's ruling to the contrary on summary judgment was error.

II. ASSIGNMENTS OF ERROR

A. ASSIGNMENTS OF ERROR

1. The Trial Court erred in denying WIS' motion for summary judgment and in entering judgment for the Department of Revenue.

B. ISSUES PERTAINING TO ASSIGNMENTS OF ERROR

1. Do funds collected by WIS for professional medical services rendered by OIA that WIS passes through to OIA as compensation for those professional medical services, meet the statutory definition of gross income to WIS. (Assignment of Error No. 1)

2. Is the money WIS collects, primarily from the insurance companies of the referred patient, and only secondarily, if at all, from the referred patient, with which WIS is to pay the professional fees of OIA, an advance under WAC 458-20-111? (Assignment of Error No. 1)

3. Can or does WIS render professional medical services to interpret the medical images it produces? (Assignment of Error No. 1)

4. Does WIS act as the agent of the referred patient in obtaining the professional medical services of OIA to interpret the medical image it produces? (Assignment of Error No. 1)

5. Is WIS primarily or secondarily liable to OIA for its professional service fees? (Assignment of Error No. 1)

III. STATEMENT OF THE CASE

A. PROCEDURAL HISTORY.

The Washington State Department of Revenue ("DOR") audited WIS for the period January 2000 through June 2005. (CP 34) The DOR concluded that WIS had underpaid business and occupation tax for the audit period because it had not included in its gross income the amounts it collected and then passed through to OIA as compensation for professional medical services provided by OIA. (CP 34) WIS

unsuccessfully contested this audit within the DOR. On August 21, 2007, WIS paid the alleged deficiency, with interest and penalties, in the total amount of $250,597.79 and filed this lawsuit for a refund. (CP 34)

WIS sought judgment in its favor under CR 56. (CP 10-25) The DOR agreed there were no material issues of fact and, in its response, requested that judgment be entered in its favor. (CP 64) On August 15, 2008, the Thurston County Superior Court denied WIS' motion for summary judgment and granted summary judgment to the DOR. WIS appeals the August 15, 2008 order granting the DOR summary judgment. (CP 173-78)

B. UNDISPUTED FACTS.

1. The Appellant-Taxpayer, WIS

WIS is a Washington limited liability company that operates medical imaging facilities in Bellevue and Issaquah, Washington. (CP 31; 91 L. 14-15) At these facilities, WIS provides all the equipment necessary to produce medical images, including MRI scans, CT scans, PET scans, X-rays and other forms or modalities of medical images. (CP 31) WIS is owned, in part, by a non-physician. (CP 30)

WIS employs a trained staff of technicians who operate the medical imaging equipment. (CP 31) WIS provides the supplies needed for the production of the various medical imaging modalities. (CP 31) WIS also employs administrative support staff at both facilities and provides for the maintenance of the equipment and the facilities. (CP 31)

WIS provides medical imaging services only for patients sent to it by their treating physicians. (CP 145) Treating physicians send their patients to WIS to obtain medical image information in the form of a written report that will assist them with diagnosis and treatment of their patients. (CP 92 L. 2-5; 145) To accomplish this purpose requires both the production of the medical image, which WIS does, and the professional medical interpretation of that image by a radiologist, which WIS does not, and cannot, do. (CP 146)

2. The Radiologist group, OIA

To provide the necessary professional medical interpretations of the medical images it produces, WIS contracts with OIA. (CP 146) OIA is a Washington professional services corporation that employs radiologists. (CP 31) By contract with WIS, OIA provides radiologists to interpret the medical images WIS produces. (CP 31, 146)

3. The WIS – OIA contracts

WIS and OIA have two contracts. (CP 37-59; 60-62) The first contract, dating from 1996, governs the terms and conditions under which OIA provides the professional medical services of its radiologists to interpret the medical images produced by WIS. (CP 37-59)

Under the 1996 services contract:

1. OIA is to employ the radiologists needed to provide the professional medical services. (CP 37, 40)

2. OIA is to ensure that all radiologists meet certain specified qualifications. (CP 41)

3. OIA is to evaluate the medical professionals on the performance of their professional responsibilities. (CP 43)

4. OIA is to be solely responsible for all financial arrangements with the radiologists. (CP 50)

5. OIA radiologists have no claim against WIS for any employee benefits and WIS has no obligation to withhold from amounts paid to OIA any amount for taxes or other withholdings. (CP 44-45)

6. WIS is to exercise no control or direction over the manner in which the radiologists perform their professional medical services. (CP 44)

7. OIA is to be paid a percentage of amounts collected for its professional medical services. (CP 50)

Billing and collection services for all fees were initially provided under the 1996 contract by a third party, National Medical Management ("NMM"). (CP 132) In 2001, NMM was bought out. (CP 106) Under the second WIS-OIA contract, WIS began directly billing for and collecting both its fee and OIA's fees. Under this second contract, OIA's compensation for professional medical services remained a percentage of amounts collected. WIS agreed that it would have no ownership interest in that portion of payments agreed to be for OIA's professional fees, but was merely to act as the collection agent for OIA for these fees. OIA also agreed that WIS could bill for its fees and OIA's fees in one global bill. (CP 60-62)

4. Provision of Services

The first contact WIS has regarding a potential patient is a call from the patient's treating physician. (CP 145) This initial contact provides WIS with the name of the treating physician, the name of the patient, the type of medical image ordered by the treating physician, and, perhaps, some brief explanation of the medical issue with the patient. For example, a treating physician may call WIS to order an MRI for her patient, explaining that the patient is suffering from knee pain secondary to soccer trauma. (CP 145)

Pursuant to the order of the treating physician, WIS contacts the patient and schedules the patient for the requested medical image. (CP 145) Upon arrival at the WIS facility, the patient completes a registration form that states, in part:

> I, the undersigned, hereby consent to and permit Washington Imaging Services, LLC (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. (CP 141; 145)

The registration form also contains the following terms of Financial Agreement:

> PRIVATE PAY: The undersigned agrees, whether signing as agent or as patient to be financially responsible to Washington Imaging Services, LLC for charges not paid by insurance. I understand this amount is due upon billing.
>
> INSURANCE COVERAGE: I hereby assign payment directly to Washington Imaging Services, 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; 145)

Once the patient completes the required paperwork, a WIS technician takes the medical image ordered by the treating physician at the appropriate views and angles. (CP 145) As a matter of practice, patients

are informed that the final product will be interpreted by a qualified physician and that the results of the interpretation of the image are generally available within 24 to 48 hours. (CP 33; 134)

To accomplish the professional interpretation of its medical images, WIS provides "reading stations" at its facilities where the OIA radiologists may examine and interpret the image. (CP 146) The images themselves are transmitted electronically to these reading stations for review by the OIA radiologists. (CP 146) In the medical community that WIS serves, the doctors who refer their patients to WIS are well aware of who WIS uses for the professional interpretation of the medical images it produces. (CP 146)

WIS also provides voice recognition software at the reading stations for the OIA radiologists to dictate their interpretations of the medical images. (CP 146) This dictation is then transcribed by staff employed by WIS into a draft report for review and approval by the OIA radiologist. (CP 146) Once the OIA radiologist has signed the report, WIS transmits it electronically to the treating physician. (CP 146) Thus, the ultimate product provided the treating physician in response to his or her referral is a written report containing a radiologist's interpretation of the

medical image that the treating physician can use in the diagnosis and treatment of his or her patient. (CP 102 L. 2-25; 145)

5. Billing and Payment

The charges for the production of the requested medical image by WIS are referred to as technical fees. The charges for the professional medical interpretation of the image by OIA are referred to as professional fees. (CP 146-147) For each medical imaging services transaction, WIS issues a single bill that combines both the technical fee and the professional fee into a single charge. This form of billing is referred to as global billing. Global billing is the customary practice in the outpatient medical imaging business. (CP 146-147)

Insurance companies prefer global billing. (CP 147) It is far more efficient and, therefore, less expensive, for the health insurance companies to deal with a single bill that contains all charges for a health care service than to deal with two partial bills for the health care service.[1]

[1] Insurance companies will not pay a bill for either the technical fee or the professional fee in isolation. Before insurance companies will pay either fee, they must have been billed for both the technical and professional fees and have been able to match the bills to a single procedure. (CP 97 L. 3-19)

(CP 96; 147) The contracts that WIS has with health insurance companies to be a provider are set up for global billing. (CP 95 L. 12-17)

WIS initially bills the global charges to the patient's health insurance company. (CP 147) The patient is informed of this billing through a statement sent by WIS. (CP 94) Regardless of what WIS states as a charge for services, each insurance company has a set allowance for reimbursement for medical imaging services provided to their insured. It is this allowance amount, and not WIS' billed amount, that determines what WIS will be paid. (CP 143; 147)

The payment from the insurance company is a global payment. It does not break out the amount paid for the technical or professional fees. (CP 148) If the insurance company does not pay the full amount of the compensation it sets for the service, then, depending on the provisions of the insurance policy, the patient may have either a co-pay or deductible payment responsibility. (CP 147) The patient is informed of this through an explanation of benefits form sent by his or her health insurance company. (CP 94) If this is the case, WIS will send a secondary bill to the patient for the patient's portion. The secondary bill to the patient identifies the radiologist who interpreted the image, the initial charge for

all services, the adjustment of that charge by the insurance company, the amount paid by the insurance company, and the amount owing by the patient under his or her policy. (CP 143; 148)

Any secondary bill sent to the patient will necessarily be a global bill for the remainder of the global fee not paid by the insurance company. (CP 147)

6. Professional Fee Pass Through to OIA

Under its contract with OIA, WIS passes through to OIA, as payment for its professional medical services, an agreed percentage of what WIS collects on a bill for a medical imaging transaction. (CP 148) WIS has no ownership interest in this portion of the payment. (CP 61) Beyond passing this agreed amount through to OIA, WIS has no liability to OIA for its professional fees. (CP 34) If the global bill issued by WIS is not paid, WIS has no liability to OIA for OIA's professional services. (CP 28)

IV. SUMMARY OF ARGUMENT

The portion of funds collected by WIS that it passes through to OIA as compensation for professional medical services does not constitute compensation for services rendered by WIS. They are not funds actually

received by or accrued to WIS. WIS has no ownership interest in these funds. It simply collects them and passes them through to OIA. These funds do not fit within the statutory definition of gross income found in RCW 82.04.080 and RCW 82.04.090 as applied to WIS.

Moreover, consistent with this Court's decision in *Medical Consultants*, the funds passed through to OIA for its professional medical services meet all the conditions of WAC 458-20-111 ("Rule 111") when it is applied consistently with the business and occupation tax statutes. The funds are an "advance," as that term is defined in Rule 111. The funds are received by WIS and used in payment of the fees for the professional medical services rendered by OIA for the patient, services that WIS can not, and does not, render. WIS has no obligation with respect to OIA's professional fee beyond passing through to OIA the agreed percentage of payments received from the patient's insurance company or, secondarily, from the patient. The trial court's ruling that these funds did not meet the requirements of Rule 111 was contrary to the language of this rule, contrary to the manner in which this Court and other courts have applied this rule, and inconsistent with the statutory definition of gross income for purposes of the business and occupation tax.

V. ARGUMENT

A. THE FUNDS THAT WIS COLLECTS FOR AND PASSES THROUGH TO OIA FOR ITS PROFESSIONAL MEDICAL SERVICES ARE NOT GROSS INCOME TO WIS FOR BUSINESS AND OCCUPATION TAX PURPOSES.

WIS contends that the trial court erred in granting summary judgment to the DOR. The standard of review of a trial court decision on a summary judgment motion is de novo. *Michak v. Transnation Title Ins. Co.*, 148 Wn.2d 788, 794-95, 64 P.3d 22 (2003). Correct application of the law to the undisputed material facts requires reversal of the trial court decision granting summary judgment to the DOR and entry of an order directing that judgment be entered in favor of WIS.

RCW 82.04.220 levies a tax on every person for the privilege of engaging in business in the State of Washington to be measured, as applicable here, by the application of tax rates against the gross income of the business. As relevant, RCW 82.04.080 defines "Gross income of the business" as:

> . . . the value proceeding or accruing by reason of the transaction of the business engaged in and includes . . . compensation for the rendition of services, . . . 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)

In turn, the phrase "value proceeding or accruing" is defined in RCW 82.04.090 to mean:

> . . . 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. (Emphasis Added)

1. The funds that WIS collects and passes through to OIA for its professional medical services are not actually received by or accrued to WIS and, therefore, do not constitute gross income to WIS.

For funds paid to a business to constitute the gross income of that business, the funds must constitute value proceeding or accruing to the business. RCW 82.04.080. This means that the funds must constitute consideration that is actually received by the business if it is a cash receipts basis business or that actually accrued to the business if it accounts on an accrual basis. RCW 82.04.090

The amounts collected by WIS that are passed through to OIA as compensation for its professional medical services cannot be WIS' cash receipts or accruals because WIS agrees it has no ownership interest in

these funds. (CP 61) WIS bills for and collects the OIA professional fee component of medical imaging charges under an agreement that provides:

> In addition, WIS agrees to act as collection agent for OIA. WIS agrees to timely and accurately collect OIA's professional fees utilizing its normal collection procedures. WIS shall have no ownership interest in the OIA portion of the billing and is acting exclusively as a collection agent for OIA. As received, WIS agrees to deposit OIA fees as designated by OIA. WIS shall provide OIA monthly, or more often, collection reports. (Emphasis added) (CP 61)

With respect to what WIS is to collect and pass through to OIA, the contract provides:

> The Parties have previously mutually agreed that the global fee shall be split as follows: MRI, CT and PET (20% to OIA) and all other modalities (23% to OIA). Receipts shall pass through WIS from the patients and third party payors and be paid to OIA by WIS as collected. (CP 61)

Funds received by a business, in which the business has no ownership interest, cannot constitute the actual cash receipts of the business nor can they be funds actually accruing to the business. Therefore, under the statutory definition of "gross income" the funds WIS collects and passes through to OIA cannot constitute "gross income" to WIS.

2. The funds that WIS collects and passes through to OIA for its professional medical services are not compensation for services rendered by WIS and, therefore, do not constitute gross income to WIS.

An example of what is meant by "value proceeding or accruing" to a business under RCW 82.04.080, and the only example directly applicable to WIS is ". . . compensation for the rendition of services. . . ."

This Court's decision in *Medical Consultants* establishes that, for business and occupation tax purposes, the professional medical services for which WIS collected compensation that it passed through to OIA, are rendered by OIA and not by WIS. Set forth below is a comparison of the material stipulated facts in *Medical Consultants* with the undisputed material facts of this case. They are virtually identical.

> MCN is in the business of providing objective medical opinions in the form of written reports. MCN's opinions are based on medical exams performed by independent physicians.

Medical Consultants, 89 Wn. App. at 41.

The corresponding undisputed material facts in this case are:

- WIS is in the business of providing objective medical opinions in the form of a written report based on a professional medical interpretation of the image it produces. (CP 33; 91-92; 145)

- The medical opinions in the report are based on the OIA radiologist's professional medical interpretation of the image WIS produces. (CP 92)

MCN is not licensed to practice medicine. MCN contracts with individual physicians to conduct independent medical examinations ("IMEs") on behalf of MCN's clients.

. . .

The physicians perform as independent contractors, not employees of MCN. The physicians maintain their own staffs and practices, independent of MCN, and have absolute independence in their medical opinions.

Id. at 42

The corresponding undisputed material facts in this case are:

- WIS is not licensed to practice medicine and it would be unlawful for WIS to do so. (CP 30-31; 114)

- WIS contracts with OIA to obtain the professional medical interpretation of the patient's imaging exam. (CP 27; 31; 37-58)

- OIA has exclusive and complete control over the radiologists it employs. (CP 40-41; 44)

MCN generally schedules IMEs on behalf of its clients. Most of the IMEs are conducted on MCN's premises, although some take place in the physicians' independent offices.

MCN's staff converts the results of a physician's completed examination into a final report to be sent to the client. But first MCN resubmits the report to the examining physician for signature.

Id.

The corresponding undisputed material facts in this case are:

- WIS contacts the patient to schedule the imaging exam only after first being contacted by the patient's doctor. (CP 145)

- The professional medical interpretation of the medical image occurs at the WIS facility in reading rooms set up for the OIA radiologists. (CP 146)

- WIS' staff converts the radiologist's interpretation of the image into a report and submits it to the radiologist for signature. (CP 146)

MCN bills its clients for services provided both by MCN and by the independent physicians. The client pays the total fees for services in one check. Then, MCN forwards the allocable portion to the physician for services rendered. MCN's clients are aware that a portion of the MCN bill represents the fee due the independent physicians who performed the medical examination.

Id. at 42-43

The corresponding undisputed material facts in this case are:

- WIS submits a single bill, initially to the patient's insurance company, that includes its technical fees and OIA's professional fees. (CP 95-96; 146-147)

- The patients' insurance companies are aware that a portion of the bill represents the professional fees due to the radiologists who provided the professional medical interpretation of the WIS image. (CP 95-97; 146-147)

- A secondary bill is issued directly to the patients only if the patient's insurance company does not pay the entire reimbursement amount it allows. (CP 94; 147-148)

- The bills are paid in one check and WIS then forwards the allocable portion of the payment to OIA for the professional medical services rendered. (CP 148-149)

Based on the stipulated facts in *Medical Consultants*, this Court reached the following conclusion:

> The monies MCN collects for medical exams are not for MCN's "rendition of services," but rather are passed through to the actual renderers of the medical examination services, i.e., the physicians.

Id. at p. 48

The funds that WIS collects and passes through to OIA for the professional medical services OIA renders are not for WIS' "rendition of services." They are not gross income to WIS for purposes of the business and occupation tax. The trial court erred in concluding otherwise. Its decision should be reversed.

B. THE TRIAL COURT MISAPPLIED WAC 458-20-111 IN GRANTING SUMMARY JUDGMENT TO THE DOR.

WAC 458-20-111 ("Rule 111") is an administrative rule adopted by the DOR to recognize, consistent with RCW 82.04.080 and .090, that funds paid to a taxpayer may be excluded from the taxpayer's gross income when such funds are "passed through" by the taxpayer to pay a third party for services it provided to the taxpayer's customer as part of the taxpayer's overall business. *Medical Consultants*, 89 Wn. App. at 46. Under Rule 111 such funds are referred to as an advance.

Under Rule 111 advance ". . . means money . . . received by a taxpayer from a customer or client with which the taxpayer is to pay fees for the customer or client."

Rule 111 describes several limitations on when money that is an advance may be excluded from the gross income of the taxpayer who receives the advance. Thus, under Rule 111, an advance occurs:

> 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.

Further, under Rule 111, the circumstances in which advances may be excluded from a taxpayer's gross income are:

> limited to cases wherein the taxpayer, as an incident to the business, undertakes, on behalf of the customer, guest or client, . . . 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.

1. Rule 111 must be applied consistently with the definition of gross income in RCW 82.04.080 and RCW 82.04.090

Rule 111 cannot be used to expand the scope of gross income beyond the definition of the phrase contained in RCW 82.04.080 and .090. This was the explicit holding in *Walthew, Warner, Keefe, Arron, Costello and Thompson v. State Department of Revenue,* 103 Wn.2d 183, 187-88, 691 P.2d 559 (1984)

> Nothing in the statute refers to exceptions on the basis of agency and liability. The language in Rule 111 is consistent with the statute if it is read to reflect the statute's obvious intent to tax only gross income which is "compensation for the rendition of services" (RCW 82.04.080) or "consideration . . . actually received or accrued" (RCW 82.04.090). Rule 111 excludes those reimbursements for advances which are merely pass-throughs, where the taxpayer liability, if any, to the third party provider is solely agent liability: . . . (Emphasis Added)

In *Walthew*, the DOR argued that Rule 111 excluded only incidental costs not necessary to the taxpayer's business. Therefore,

according to the DOR's interpretation of Rule 111, funds paid to a taxpayer that are passed through to a third party provider of services essential to the taxpayer's business represent the taxpayer's cost of doing business that may not be excluded from the taxpayer's gross income.

> [the DOR] argues that services of third party providers are an essential part of the taxpayer's business and contribute to the ultimate value of those services. Business is defined as including "all activities engaged in with the object of gain, benefit, or advantage to the taxpayer . . . " RCW 82.04.140. Because the taxpayer law firm benefits from services of these third party providers, and because they are necessary to its business, not merely incidental costs, the Department considers them a cost of doing business. Under its reasoning, any reimbursements for these costs should be included in gross income. (Emphasis Added)

Walthew, at 187

Walthew rejected the DOR's argument based on the language of RCW 82.04.080 and RCW 82.04.090. The funds at issue in *Walthew*, funds paid by the clients to the law firm, were not compensation for the rendition of services by the law firm, but rather were to pay for services essential to the business of the law firm but rendered by third party providers.

Here, the DOR presented the trial court with the same argument rejected in *Walthew*. The DOR argued that all amounts paid to WIS constitute compensation for the business of medical imaging services,

regardless of whether WIS itself renders all services essential to this business or essential services are rendered ". . . through independent contractors or otherwise." (CP 72) Thus, as the DOR argued in *Walthew*, the DOR argued here that funds owed and paid to OIA were a cost of doing business as a medical imaging service.

> The money WIS owes and pays to OIA under its contract with OIA is a cost of doing business as a medical imaging service that may not be deducted from the global payments WIS receives. (CP 72)

The trial court found this argument to be the most telling decision point.

> The most telling legal – I wanted to say legal fact, but the most telling decision point for this Court is that factually we're talking about the business of providing imaging services, and the CEO of the plaintiff in his interrogatory response indicated that the service that was provided by Washington Imaging Services was a report, that their final product was a report.[2] He then went on to discuss the difference between professional and technical aspects of that imaging service.

(RP p. 34-35)

The reasons this "cost of doing business" argument was rejected in *Walthew* are equally applicable here. Funds that flowed to the law firm in

[2] This is, of course, precisely the same final product provided by the taxpayer in *Medical Consultants*, 89 Wn. App. at 41.

Walthew to pay the costs of third parties who provided services necessary for the operation of the law firm's business were not part of the law firm's gross income because: (1) the law firm could not provide these services as a cost of its business; and, (2) the law firm was not liable either primarily or secondarily for these third party services. *Walthew,* at 188-189

Just as the law firm in *Walthew* was prohibited by court rule from paying litigation expenses for a client's lawsuit, so too is WIS legally barred from engaging in the practice of medicine because it has non-physician ownership. (CP 30) In *Morelli v. Ehsan,* 110 Wn.2d 555, 756 P.2d 129 (1988), a physician and nonphysician entered into a partnership to operate an emergency and family-care clinic. *Id.* at 556. The nonphysician argued that the partnership was legal because his responsibilities and duties were strictly limited to business aspects, while the physician's authority was limited to medical affairs. The court rejected this distinction, holding that the clinic partnership agreement provided the nonphysician with "a means and an instrumentality by which he shared equally in the profits and management of a medical practice." *Morelli*, 110 Wn.2d at 561. The court further held that both the physician and the nonphysician had violated the prohibition against the corporate

practice of medicine by operating a clinic without both being licensed as physicians. *Id.*

By law, WIS cannot share in the management or profits of a medical practice and it does not. OIA is solely responsible for management of the medical practice and the hiring, evaluating, and paying of the employed physicians. (CP 31-32; 40-45) WIS has no ownership interest in the portion of the funds collected for, and passed through to, OIA for the professional services of the radiologists it employs. (CP 61)

Furthermore, even more so than in *Walthew*, there is no factual or legal issue whatsoever about the extent of WIS' liability for OIA's professional medical services. WIS has neither primary nor secondary liability for OIA's professional fees. By contract with OIA, as acknowledged by OIA, WIS has no liability for OIA's professional fees except to the extent of the agreed percentage of collected funds. (CP 27-28; 33-34; 49-50)

Under *Walthew* and *Medical Consultants*, the amounts WIS passes through to OIA for its professional medical services are not a cost to WIS of the services that WIS renders. Therefore, these amounts do not constitute non-deductible costs of doing business under RCW 82.04.090.

Consistent with *Walthew* and *Medical Consultants*, this court should reject any argument that the amounts WIS passes through to OIA must be included in WIS' gross income as a cost of doing business.

2. That portion of a payment for a medical imaging service transaction that WIS bills for, collects for, and passes through to OIA as compensation for OIA's professional medical services is an advance.

Treating physicians refer their patients to WIS for medical imaging services to obtain medical information that will assist them in the diagnosis and treatment of their patients. (CP 91-92; 145) To accomplish the purpose of the referral for the benefit of the patient, WIS first produces a high quality medical image of the type ordered by the treating physician. The medical image ordered by the treating physician is then read by a licensed radiologist employed by OIA. Finally, with the assistance of WIS staff, the radiologist's interpretation of the medical image is reduced to a written report that WIS transmits to the treating physician. (CP 102 L. 2-25; 145-146)

The treating physician, who initiates and directs the medical image service provided to his or her patient, knows that the medical imaging service will involve the professional medical services of a radiologist. The

treating physician is aware of the identity of the radiologists who provide this professional service. (CP 92-93; 145-146)

The patient who presents himself or herself to WIS for the medical imaging service ordered by his or her treating physician gives WIS written permission to obtain all necessary and advisable medical services and treatment. (CP 141) The professional interpretation of the medical image produced by WIS is a necessary part of the medical imaging service ordered and expected by the treating physician. (CP 91-92; 102; 145-146)

The patient who presents himself or herself to WIS for the medical imaging service acknowledges that he or she will be responsible for charges for the service to the extent such charges are not paid by the patient's insurance company. (CP 141) WIS therefore initially bills the patient's insurance company for all medical imaging charges. (CP 147)

The patient's insurance company that, in the first instance, and perhaps exclusively, is billed for this medical imaging service for its insured understands, prefers, and, in fact, has agreed with WIS, that the bill will contains the charges for both the technical fee and the professional fee. (CP 93-97; 147) The patient's insurance company sets the amount that will be paid for both the technical and professional components of the

medical imaging service provided its insured. (CP 141; 147) The insurance company then issues a global payment that it intends and expects to be applied to both the technical and professional fees. (CP 148) The patient may or may not be billed secondarily. (CP 94; 147)

Pursuant to its contract with OIA, when WIS receives payment, an agreed percentage of what it receives is passed through to OIA as compensation for the professional medical services. (CP 148-149) WIS has no ownership interest in the funds it passes through to OIA as payment for the professional medical services OIA furnished for the patient. (CP 61)

In short, in each medical imaging transaction, that portion of the funds WIS collects and then passes through to OIA for its professional medical service is: (1) money received by a taxpayer, in this case WIS; (2) paid wholly, or primarily by an insurance company on behalf of the patient and only secondarily, if at all, by the patient; (3) with which WIS is to, and does, pay for the professional medical service provided by OIA for the referred patient. This portion of the funds collected by WIS for the medical imaging service meets the literal definition of an advance.

Judicial application of Rule 111 confirms that the portion of funds collected by WIS and passed through to OIA as payment for professional medical services is an advance. In *Rho Co. v. Department of Revenue*, 113 Wn.2d 561, 782 P.2d 986 (1989), the taxpayer provided temporary employees to its clients. The client's payment obligation was only to Rho. Rho sent a single bill to its clients that combined the charges for each worker's wages with the charges for its own profit and overhead.

> The amount that Rho collected from the client as its own profit and payment of overhead expenses was calculated either as a fixed amount per employee or as a fixed percentage of the worker's salary.

Rho Co., at 565

The DOR did not dispute that the amounts Rho received from its clients and then paid to the temporary employees based on their hours and hourly wages were advances for services the taxpayer, Rho, could not, or did not, render.

Similarly, in *Medical Consultants*, the taxpayer, MCN, contracted with individual physicians to perform the examinations. The taxpayer issued one bill to the client that combined the charges for its services and those for the professional medical services. When paid, the taxpayer

passed through to the physician his or her portion of the payment. Under these facts, the DOR did not dispute that the funds collected by the taxpayer that were paid to the physicians as compensation for their professional medical services were advances.

The undisputed material facts regarding WIS' billing for and payment of OIA's professional medical services meet the criteria for an advance, both as that term is defined in Rule 111 and as that term has been applied by the courts.

3. WIS does not and cannot provide the professional medical services it procures from OIA.

For reasons discussed above, WIS does not, and can not, render professional medical services to interpret the medical images it produces in response to treating physician orders. On identical material facts, this Court concluded that the taxpayer in *Medical Consultants* did not render medical services.

> The monies MCN collects for medical exams are not for MCN's "rendition of services," but rather are passed through to the actual renderers of the medical examination services, i.e., the physicians.

Medical Consultants, 89 Wn. App. at 48

In *Rho Co.,* the taxpayer billed its customers for its overhead and profit and the wages for the temporary employees it furnished to customers in a single bill. Rho then used a portion of the amount collected to pay the temporary employees. Rho claimed that the portion used to pay the temporary employees was not its gross income. Although the engineering services provided by the temporary employees clearly were essential to the taxpayer's business, the court resolved this issue by examining whether the taxpayer itself did, or could, perform these engineering services. The court concluded that the taxpayer did not provide engineering services, and probably could not lawfully do so, as the taxpayer was not licensed to render engineering services.

> The clients customarily paid Rho for procuring the engineering services rendered by the technical personnel, and Rho did not itself perform these services. The facts described above clearly reveal that Rho itself did not supervise or otherwise become involved in the rendering of the engineering services. Indeed, it appears from oral argument that Rho was not even licensed to render such services. (Emphasis Added)

Rho Co., 113 Wn.2d at 568

As in *Medical Consultants* and *Rho Co.,* the funds WIS collects for OIA's professional fees are not for WIS' rendition of services but are

passed through to OIA, the entity that renders the professional medical service.

By contrast, in *Pilcher v. Department of Revenue,* 112 Wn. App. 428, 49 P.3d 947 (2002), this Court disallowed exclusion from the taxpayer's gross income of amounts the taxpayer paid to third parties to render precisely the same services as the taxpayer could, and did, render. The taxpayer, Dr. Pilcher, was a licensed physician and certified specialist in Emergency Medicine. Dr. Pilcher signed a contract with Evergreen Hospital under which he agreed to provide emergency medical services on a full time basis. Dr. Pilcher then hired other physicians to assist him in fulfilling his contractual obligations to provide full time emergency medical services to the hospital emergency department.

Dr. Pilcher sought to exclude from his gross income that portion of the compensation he received under the Hospital contract that he used to pay the other physicians he hired to assist him in providing emergency medical services. The court disallowed the exclusion for a variety of reasons, among which was the fact that the funds the taxpayer wished to exclude were used to pay for the very same services that the taxpayer not only could provide, but did provide, to the Hospital.

In ruling against the taxpayer in *Pilcher,* this Court distinguished *Medical Consultants,* explaining that the funds paid to the taxpayer in the latter case for professional medical services were not taxable to the taxpayer because these were "services that cannot be performed by the taxpayer, but rather taxpayer contracted for on behalf of client, who remains liable for payment." *Pilcher,* 112 Wn. App. at 439 n.11 The trial court correctly recognized that WIS does not, and can not, render the services that generate the advance at issue. (RP 36)

4. WIS acts as an agent in procuring and paying for the professional medical services provided by OIA.

Under Rule 111, for funds to be an advance, the taxpayer must act on behalf of the customer or client in procuring and paying for a service the taxpayer does not or cannot render for the customer. In *Rho Co.*, the court concluded that the standard definitions of agency should be used in analyzing agency under Rule 111. Applying these standard definitions, the court recognized:

> . . . agency is a legal concept that depends on the manifest conduct of the parties; it "does not depend upon the intent of the parties to create it, nor their belief that they have done so. . . . [A]n agency exists although the parties did not call it agency and did not intend the legal consequences of the relation to flow." Restatement (Second) of Agency

§ 1, comment b (1958), *quoted in Busk v. Hoard*, *supra* at 129.

Rho Co., 113 Wn.2d at 570

In discussing what is required to create an agency relation, Restatement, Second, Agency § 15 provides:

> An agency relation exists only if there has been a manifestation by the principal to the agent that the agent may act on his account, and consent by the agent so to act.

The comment to this section further provides:

> One becomes an agent only if another in some way indicates to him consent that he may act on the other's account. . . . It is only where the person acting believes reasonably, from conduct for which the other is responsible, that he is authorized so to act that there is an agency relation.

Restatement, Second, Agency § 15, comment a

Restatement, Second, Agency § 26 discusses the circumstances that can constitute manifestation by the principal of authority to the agent to do an act, in part, as follows:

> . . ., authority to do an act can be created by written or spoken words or other conduct of the principal which, reasonable interpreted, causes the agent to believe that the principal desires him so to act on the principal's account.

The comments to this section emphasize that it is the principal's manifestation that is controlling and not the principal's actual intention.

> In accordance with the rule stated in the Restatement of Contracts, Section 20, the manifestation and not the intention of the principal is important; hence, whenever the principal manifests to the agent that the agent is to act on his account, authority exists although the principal is not in fact willing that he should do so.
>
> * * *
>
> The manifestations to the agent can be made by the principal directly, or by any means intended to cause the agent to believe that he is authorized or which the principal should realize will cause such belief.

Restatement, Second, Agency § 26, comments a and b

As to the scope of the agency authorization, Restatement, Second, Agency §§ 33 and 35 provide, respectively:

> § 33. General Principal of Interpretation
>
> An agent is authorized to do, and to do only, what it is reasonable for him to infer that the principal desires him to do in the light of the principal's manifestations and the facts as he knows or should know them at the time he acts.
>
> § 35. When Incidental Authority is Inferred
>
> Unless otherwise agreed, authority to conduct a transaction includes authority to do acts which are incidental to it, usually accompany it, or are reasonably necessary to accomplish it.

Again, the comments expand on these basic concepts, in part, as follows:

> Almost all directions are ambiguous without knowledge of the background in which they are given. All include by implication authorization to do what is necessary in order to accomplish the end. The specific words which the principal uses must be interpreted so that his object can be accomplished by the agent.
>
> * * *
>
> . . . In either case, it is inferred that the principal is not doing a vain thing, but intends to give a workable and effective consent.

Restatement, Second, Agency § 35, comments b and c

WIS first learns that it may provide medical imaging services for a patient when it is contacted, not by the patient, but by the patient's treating physician. The treating physician gives WIS the patient's name and orders a specific type of medical image. WIS then contacts the patient directly to schedule an appointment for the medical imaging service ordered by the treating physician. (CP 145)

When the patient appears at WIS for his or her medical imaging appointment, the patient does not request any service. This already has been done by the patient's treating physician. Rather, upon arrival at WIS,

the patient signs a registration form in which he or she expressly permits WIS, and its designees, to procure for the patient all necessary and advisable medical treatment and in which the patient accepts responsibility for all WIS charges not paid by his or her insurance company. (CP 141; 145)

Once the patient has completed the required paperwork, consistent with the direction and expectation of the patient's treating physician, WIS does three things: (1) it obtains the medical image ordered by the treating physician; (2) it transmits that image to a reading station at its facility where it is interpreted by an OIA radiologist; and (3) it transcribes and transmits the radiologist's report to the treating physician. (CP 145-146) WIS informs the patient that the results of the medical image examination will be available within 24 to 48 hours. (CP 33)

Certainly by scheduling an appointment with WIS for medical imaging services pursuant to his or her treating physician's direction, by showing up for the appointment, and by signing the registration form expressly permitting WIS and its designees to provide all necessary and advisable medical treatment, the patient manifests authorization to WIS to provide medical imaging services on his or her behalf. This manifestation

of authority to conduct a medical imaging transaction includes agency authority reasonably necessary to accomplish the purpose of the transaction, which includes not only creating the image, but obtaining a professional medical interpretation of the image. (CP 101-102; 145)

Whether the patient specifically authorized the professional medical service provided by OIA, or even knew that these specific professional medical services would be part of the medical imaging transaction, does not defeat WIS' agency authority to obtain these services on behalf of the patient. As the comments to Restatement, Second, Agency § 35 provide:

> In most cases the principal does not think of, far less specifically direct, the series of acts necessary to accomplish his objects. . . .
>
> * * *
>
> It is not essential to the authorization of an act that the principal should have contemplated that the agent would perform it as incidental to the authorized performance.

Restatement, Second, Agency § 35, comments b and c

As illustrative of these comments, Restatement, Second, Agency § 35 provides the following:

> P employs A to obtain photographs illustrating Eskimo life. A finds it necessary, in order to obtain photographs, to employ an interpreter and to make small gifts to the Eskimos

> to induce them to permit him to make photographs. Nothing to the contrary having been manifested by P, A's authority includes authority to employ an interpreter and procure gifts.

Restatement, Second, Agency § 35, Illustration 2

Here, the patient employs WIS to provide medical information through medical imaging services for use by the patient's treating physician in the patient's diagnosis and treatment. (CP 141; 145) To accomplish this purpose, WIS must do more than simply produce the image. It must procure the services of a radiologist to interpret the image. (CP 101-102; 145-146) Under settled rules of agency, WIS' authority to provide medical imaging services for the benefit of the patient includes the authority to obtain professional interpretive services for the image it produces.

In the registration form signed by all WIS patients, the patients assign to WIS direct payment of all health insurance benefits to which they may be entitled. (CP 141) All of the health insurance companies who are billed first by WIS understand that when they pay WIS' initial global bills for imaging services provided to their insureds, they are paying both for the technical and professional services provided to their insureds. (CP 95-96; 97; 146-147)

5. WIS has neither primary nor secondary liability for OIA's professional fees.

The final Rule 111 condition that must be met for an advance to be excluded from the gross income of a taxpayer is that the taxpayer must have neither primary nor secondary liability for the service procured for the customer. Here, WIS is authorized to bill for and collect OIA's professional fees on two conditions. An agreed percentage of whatever WIS collects is paid to OIA as compensation for its professional medical services and WIS agrees it has no ownership interest in these funds. (CP 61)

Beyond these conditions, WIS has no liability to OIA for its professional fees. (CP 28) WIS is not primarily liable for OIA fees, meaning OIA cannot look to WIS for these fees in the first instance. WIS is not secondarily liable for these fees, meaning that OIA cannot look to WIS for payment of these fees in the event the patient's insurance company or the patient does not pay the fees. If WIS bills for the fees but collects nothing, it has no liability to OIA for unpaid professional fees. (CP 28) The material facts regarding billing, collection, and payment are indistinguishable from the facts in *Medical Consultants.*

MCN's agreement with the independent physicians was that if a client did not pay MCN for the examination, MCN was not obligated to pay the physician. MCN's written contract with the physicians provides:

> (8) MCN will make every reasonable effort to collect fees for any consultation services provided by [the physician]. However, if MCN is unable to collect the fee from a client for consultation services provided by Consultant, MCN is not obligated to pay [the physician] for his services.

Medical Consultants, 89 Wn. App. at 43.

WIS has the same agreement with OIA.

> [WIS] shall not be responsible for the collectability of Medical Fees, but [WIS] shall use its best efforts to collect such fees. (CP 50)
>
> [WIS] does not retain any portion of the fees it collects that are due to [OIA] for its professional services. All such funds that [WIS] is able to collect simply pass through [WIS] to [OIA]. If for any reason, [WIS] is unable to collect any fees for [OIA's] professional services, [WIS] has no liability for those fees to [OIA]. (CP 28)

With respect to this aspect of Rule 111, this Court stated:

> Finally, the third prong of the *Christensen* test is 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 its client. Accordingly, the trial court properly concluded that payments MCN receives for the

> purposes of paying independent physician bills are not subject to Washington's business and occupation tax.

Medical Consultants, 89 Wn. App. at 48.

WIS is not obligated to pay OIA unless WIS is first paid by its patient through its patient's insurance company. WIS also has solely agent liability.

VI. CONCLUSION

The funds collected by WIS and passed through to OIA are not payment for services rendered by WIS. These funds are not actually the cash receipts of WIS because WIS has no ownership interest in them. These funds simply do not meet the statutory definition of gross income for WIS.

This Court's decision in *Medical Consultants* establishes that the funds collected by WIS and passed through to OIA for professional medical services also meet all the requirements of Rule 111 when it is applied in a manner consistent with the statutory definition of gross income for business and occupation tax purposes.

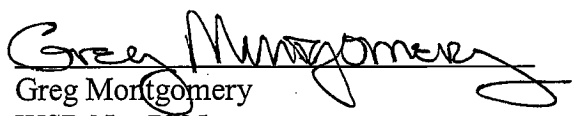
The trial court erred in concluding that funds collected by WIS and passed through to OIA for its professional medical services constitute

gross income to WIS. This Court should reverse the trial court decision and remand for entry of judgment in favor of WIS.

DATED this 20th day of October, 2008.

Respectfully submitted,

MILLER NASH LLP



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

WASHINGTON IMAGING SERVICES, LLC,

Appellant,

v.

WASHINGTON STATE DEPARTMENT OF REVENUE,

Respondent.

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FILED
COURT OF APPEALS
DIVISION II
08 OCT 21 PM 1:44
STATE OF WASHINGTON
BY
DEPUTY

STATE OF WASHINGTON)
) ss.
COUNTY OF KING)

The undersigned, being first duly sworn on oath, deposes and says:

That she is a citizen of the United States of America; that she is over the age of 18 years, not a party to the above-entitled action and competent to be a witness therein; that on the date herein listed below, affiant had hand delivered the Appellant's Brief addressed to the following parties:

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SIGNED AND SWORN to (or affirmed) before me on 10-20-08 by Kristin Martinez Clark

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My appointment expires 3-9-11

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