

NO. 84101-2

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**SUPREME COURT OF THE STATE OF WASHINGTON**

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WASHINGTON IMAGING SERVICES, LLC,

Respondent,

v.

WASHINGTON STATE DEPARTMENT OF REVENUE,

Petitioner.

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**PETITIONER DEPARTMENT OF REVENUE'S ANSWER TO  
BRIEF OF AMICUS CURIAE, CARR KRUEGER**

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## I. INTRODUCTION

In addition to arguing about the wisdom of Washington's business and occupation tax ("B&O tax"), which is measured by the gross income of a business, Amicus Curiae, Carr Krueger ("Krueger"), raises a constitutional issue not raised by the parties in the case. Krueger argues that for this Court to hold as the trial court did, that Washington Imaging Services, LLC ("WIS") may not exclude from its taxable gross income amounts it pays to Overlake Imaging Associates, PC ("Overlake"), is a taking of property in violation of the Due Process Clause of the United States Constitution. Krueger's constitutional argument lacks merit and is not supported by adequate legal authority. If the Court considers the argument, it should be rejected. Likewise, the Court should decline to explore tax policy in deciding this case.

## II. ARGUMENT

### A. **WIS Engages In The Business Of Providing Medical Imaging Services, Not Merely Creating Medical Images, And Is Compensated For Providing Medical Imaging Services.**

Before reaching his constitutional argument, Krueger first argues that the Department misunderstands the statutory 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). Krueger argues that the definition has two parts, and that the Department focuses only on the second part, barring deductions for the cost of doing business, while “ignoring” the first part, whether the income did accrue “by reason of the transaction of the business engaged in.” Amicus Brief at 2-3 (citing one sentence from the Department’s Supplemental Brief).

The Department does not ignore the highlighted language in the statute. The Department has repeatedly highlighted the same language in its own briefing and discussed the issue from multiple perspectives. Krueger fails to recognize that whether one focuses on the money coming in from customers or the money going out to employees, contractors, or vendors, the question is the same: What is the business in which the taxpayer is engaged? Put another way, what are the services for which the taxpayer is receiving compensation? To answer that question where a taxpayer in a service business pays a third party to provide a portion of the services the taxpayer sells to customers, as in the present case, the Department promulgated a rule, WAC 458-20-111. This Court’s decisions confirm that the answer to that question in a particular case depends upon the respective business relationships and liabilities of the customers, the taxpayer, and the contractor.

Suppose, as in *Walthew*, the evidence demonstrates the taxpayer is acting solely as an agent for the customer in paying a third party because only the customer has liability to pay that third party. In that case, the

business the taxpayer engages in does not include providing the service for which the taxpayer pays the third party, and the money from the customer used to pay for that service is not “gross income” to the taxpayer.

*Walthew, Warner, Keefe, Arron, Costello & Thompson v. Dep’t of Revenue*, 103 Wn.2d 183, 186-90, 691 P.2d 559 (1984) (amounts not gross income where clients agreed they would pay third-party costs and ethics rule required them to retain ultimate liability for those costs).

Suppose, alternatively, that the evidence demonstrates the taxpayer has sole liability for paying the third party, without the customer having any obligation to pay the third party. In that case, the business the taxpayer engages in *does* include providing the service for which the taxpayer pays the third party, and the money from the customer is “gross income” to the taxpayer. *City of Tacoma v. Wm. Rogers Co.*, 148 Wn.2d 169, 179, 60 P.3d 79 (2003) (temporary staffing company that had sole liability to pay workers could not exclude from its taxable gross income the amounts it paid to the workers under Tacoma’s Rule 111).

The evidence here confirms that WIS is engaged in the business of providing medical imaging services. That fact is undisputed. “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.” Appellant’s Brief at 17; *see* CP 91-92, 135. Providing that written report is the service WIS renders and the service for which it is compensated. Its “gross income of the business” includes the entirety of the “global” payments it receives on its “global” bills.

Examined from the standpoint of liability or agency, the result is the same. Patients contracted solely with WIS and did not owe anything to Overlake. CP 141. The patient registration form, WIS's contracts with insurance companies, and the bills WIS sent to patients are all consistent with that result: patients owed WIS, not Overlake, and Overlake was not mentioned. CP 99-100, 141, 143. The only party with any liability to Overlake was WIS.<sup>1</sup> CP 50, 61. Because patients had no liability to Overlake, WIS could not have been acting "solely as agent" for patients in making payments to Overlake.

The Department agrees with Krueger that this case turns on identifying what value WIS receives for transacting business as a medical imaging service provider. Rather than repeat the Court of Appeals' error of deciding the case based solely on WIS's business relationship with Overlake, however, this Court should do as it did in *Walthew* and *Wm. Rogers*, and decide the case based on the respective business relationships between *all* interested parties: the patients, WIS, and Overlake. That is the correct analysis.

**B. Applying The "Gross Income" Definition In RCW 82.04.080 As The Legislature Intended Does Not Violate The Due Process Clause.**

Krueger's primary legal argument is that not allowing WIS to exclude from its taxable gross income the amounts it pays to Overlake

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<sup>1</sup> The Department has previously discussed why WIS's liability to pay Overlake based on a percentage of actual collections is not the equivalent of having no liability to Overlake and why it does not create patient liability to Overlake. Pet. for Review at 15-16; Supp. Brief of Pet. at 17-20.

would be a violation of the Due Process Clause of the Fourteenth Amendment of the United States Constitution. According to Krueger, the Department would be “taxing WIS for property that another owned.” Amicus Brief at 4; *see also Id.* at 5 (“taxing WIS on income earned and owned by Overlake”). Presumably, Krueger bases this argument on the language in WIS’s contract with Overlake stating that WIS has “no ownership interest” in the amounts it owes Overlake under the contract. *See Washington Imaging Services, LLC v. Dep’t of Revenue*, 153 Wn. App. 281, 285, 222 P.3d 801 (2009); CP 61.

Krueger’s argument should be rejected. It is based on a false premise, it is not supported by adequate legal authority, and it advances a constitutional argument not raised by any party.

**1. WIS could not and did not contract away the taxing power of the State in its contract with Overlake.**

WIS has made a similar “no ownership” argument to Krueger’s argument, but with statutory, rather than constitutional, implications. In its opening brief to the Court of Appeals, WIS argued that it never “receives” or “accrues” the amounts it pays Overlake for purposes of the definition of “gross income of the business” in RCW 82.04.080 because it agreed with Overlake that it has “no ownership interest” in the funds. Appellant’s Brief at 15-16; *see* Department’s response, Brief of Respondent at 15-21. The Court of Appeals did not base its holdings on the “no ownership” language, but WIS has raised the argument again in its supplemental brief to this Court. Resp. Supp. Brief at 11.

Both Krueger and WIS start with a false premise: they assume a taxpayer may change otherwise taxable income into amounts excludable from taxation merely by declaring in a contract with a third party that the taxpayer has “no ownership interest” in the funds. This is incorrect. The taxability of any business’s receipts is governed by applying the statute to the actual operations of the business, not by agreements between taxpayers. Under WIS’s argument, any business using subcontractors could avoid taxation of income merely by agreeing with the subcontractors that the primary business had “no ownership interest” in the funds the primary business received and paid to the subcontractors.

The contract between WIS and Overlake defines the legal relationship between those two firms and determines rights between them to funds WIS collects for medical imaging services. It does not, however, determine who “owns” the funds upon receipt by WIS for purposes of outside parties and does not limit federal, state, or local taxation of funds received by WIS. This Court has rejected such arguments for many decades:

We have held consistently that taxation is a matter involving the sovereign power of the state and subject only to the limitations which that sovereignty has imposed upon itself, either in the constitutional or positive law of the state. *To read into the operations of the tax laws the particular principles which form the accretion of judicial precedent in matters of individual relationship and of contract would be an unwarranted invasion of the legislative power.*

*City of Tacoma v. Tax Comm’n*, 177 Wash. 604, 613-14, 33 P.2d 899 (1934) (emphasis added) (quoting *Everett v. Adamson*, 106 Wash. 355,

357, 180 Pac. 144 (1919)). In *City of Tacoma*, this Court rejected the City's claim that the State's excise tax on the gross income of municipalities operating utilities was unconstitutional because the utilities had pledged gross revenues to secure payment of bonds. 177 Wash. at 609-18. The Court emphasized "that a municipality cannot contract away the taxing power of the state." *Id.* at 614. The same is true for other taxpayers. See *Rho Co., Inc. v. Dep't of Revenue*, 113 Wn.2d 561, 570, 782 P.2d 986 (1989) (terms in contracts between taxpayer and third-party provider did not necessarily 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 customer by designating customers as agent "carriers" of the retailer in bill of lading).

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

In *Banks*, the Supreme Court held that in general, when a plaintiff's recovery in a successful lawsuit constitutes taxable income, the taxable income includes the portion of the recovery paid to the attorney as a contingent fee. *Banks*, 543 U.S. at 430. With this holding, the Court reversed a Ninth Circuit ruling that the income was excludable if state law gave the plaintiff's attorney a special property interest in the fee. *Id.* at 429-30.

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

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

reasonable construction” of the B&O tax statutes, including the statutory definition of “gross income of the business,” requires rejection of WIS’s argument that it never “received” the portion of income it paid to Overlake and Krueger’s assumption that WIS is being taxed on income earned on property owned by another.

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

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

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

discounts without consulting Overlake. CP 120.<sup>2</sup> These independent actions are inconsistent with someone who has “no ownership interest” in the cash collected.

Despite the “no ownership interest” language in WIS’s contract with Overlake, WIS does in fact “receive,” “accrue,” and exercise control over the funds from patients or insurers that it uses to pay Overlake. These three words in WIS’s contract with Overlake do not deprive the State of its power to tax WIS’s gross income, and they do not create a due process violation. The Department properly taxed WIS’s gross income, none of which is “owned” by Overlake.

**2. Taxing WIS’s entire gross income from providing medical imaging services does not create a taking or otherwise violate the Due Process Clause.**

Krueger relies on a single case for his constitutional argument, *Hoeper v. Tax Comm’n of Wisconsin*, 284 U.S. 206, 215, 52 S. Ct. 120 (1931) (state statute measuring income tax on husband’s income by including wife’s income violated due process). In *Hoeper* the Court noted, “That which is not in fact the taxpayer’s income cannot be made such by calling it income.” *Id.* The case at bar involves a nearly opposite proposition: That which *is* a taxpayer’s gross income cannot be made otherwise by calling it another person’s property. *Hoeper* is not on point.

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<sup>2</sup> The foregoing description of WIS’s billing process in the discovery responses is completely consistent with the billing and collections provisions in the Medical Imaging Agreement. See CP 49-50.

The starting point in a constitutional challenge to a tax should be the recognition that for states, “the most basic power of government” is taxation. *State of Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444, 61 S. Ct. 246 (1940). “Every presumption is in favor of the reservation by the state of the complete exercise of this fundamental right.” *City of Tacoma*, 177 Wash. at 612. Persons raising a due process challenge to a state tax face a heavy burden. In 1933, this Court set a very high standard, affirming the constitutionality of an early gross income tax:

This being an excise tax, the Legislature, under the Fourteenth Amendment to our State Constitution, has very broad power, and we cannot interfere with that power except for arbitrary action, clear abuse, or constructive fraud appearing on the face of the act or from facts of which we may take judicial notice.

*State ex rel Stiner v. Yelle*, 174 Wash. 402, 407, 25 P.2d 91 (1933).

Federal courts are equally deferential. States have considerable latitude in imposing general revenue taxes, and the Supreme Court has consistently rejected claims that the Due Process Clause prohibits “unreasonable” or “unduly burdensome” state taxes. *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 622, 101 S. Ct. 2946 (1981) (rejecting constitutional challenges to state’s severance tax on coal); *Pittsburgh v. Alco Parking Corp.*, 417 U.S. 369, 374-75, 94 S. Ct. 2291 (1974) (rejecting due process challenge to 20 percent tax on gross receipts from nonresidential parking businesses); *Magnano Co. v. Hamilton*, 292 U.S. 40, 44, 54 S. Ct. 599 (1934) (sustaining due process attack on state excise tax of 15 cents per pound on all butter substitutes sold in state).

Courts addressing the argument Krueger makes here, that a tax violates due process because it amounts to a “taking,” frequently rely on a standard the United States Supreme Court case set in 1916. The Court explained that a tax will not run afoul of the Due Process Clause unless the act complained of was “so arbitrary” as to compel the conclusion “that it was not the exertion of taxation, but a confiscation; that is, a taking” or that the act was “so wanting in basis for classification as to produce such a gross and patent inequality as to inevitably lead to the same conclusion.” *Brushaber v. Union Pacific Railroad Co.*, 240 U.S. 1, 24-25, 36 S. Ct. 236 (1916). The *Brushaber* standard maintains its vitality. See *United States Shoe Corporation v. United States*, 296 F.3d 1378, 1384 (Fed. Cir. 2002) (applying *Brushaber* standard to reject argument that harbor maintenance tax was so arbitrary as to violate due process and constitute a taking), *cert. denied*, 538 U.S. 1056 (2003); *Butler v. United States*, 798 F. Supp. 574, 576 (E.D. Mo. 1992) (applying *Brushaber* standard and rejecting due process challenge to tax provision determining child’s tax rate by reference to that of the child’s parents); 16D C.J.S. *Constitutional Law* § 2054 (2005).

Applying the standards in *Stiner* and *Brushaber*, Washington’s B&O tax is not “arbitrary,” and it does not create any inequality. It is a tax imposed on every person “for the act or privilege of engaging in business activities.” RCW 82.04.220. It is a general revenue statute, and the Legislature intended to impose the tax on virtually all business activities in the state. *Simpson Inv. Co. v. Dep’t of Revenue*, 141 Wn.2d

139, 149, 3 P.3d 741 (2000). The statute defining “gross income of the business,” RCW 82.04.080, also applies generally to all businesses. In paying B&O tax on its gross income, WIS is not being asked to shoulder a burden any different than any other taxpayer. A reasonable relationship exists between the B&O taxes WIS pays and the benefits conferred on WIS as a business located in Washington. *City of Seattle v. Paschen Contractors, Inc.*, 111 Wn.2d 54, 61-63, 758 P.2d 975 (1988) (municipal B&O taxes requiring bridge construction business to pay tax on full contract amount did not violate due process, even though company performed a large portion of its contract outside the taxing district).

Under a more takings-focused analysis, the result is the same: there is no basis to conclude a constitutional infirmity exists. First, it is unclear whether a government’s act of taxation can ever be considered a taking of private property. *See U.S. Shoe*, 296 F.3d at 1383-84 (1.5 percent harbor maintenance tax on cargo was not a per se or regulatory taking of property because requiring money to be spent is not a taking); *Grimaud v. Pennsylvania Ins. Dep’t*, 995 A.2d 391, 409 (Pa. Commw. 2010) (statutory obligation to pay money does not constitute an actionable taking under the federal or Pennsylvania constitution).

Second, Krueger has not provided this Court with any analysis of the factors typically examined in a takings case. The sole case he cites in support of his argument is inapposite. This Court normally does not consider issues raised for the first time on appeal by amicus curiae. *In re Disciplinary Proceeding Against Whitney*, 155 Wn.2d 451, 495 n.12, 120

P.3d 550 (2005). The Court also declines to consider constitutional claims offered without sufficient analysis and adequate authority. *State v. Bradshaw*, 152 Wn.2d 528, 539, 98 P.3d 1190 (2004), *cert. denied*, 544 U.S. 922 (2005).

**C. The Question Of What Constitutes Sound Tax Policy Should Be Left To The Legislature.**

Krueger mixes in with his legal arguments a recommendation that this Court affirm the Court of Appeals decision because it constitutes “sound tax policy” by avoiding “double taxation.” Amicus Brief at 3-4.<sup>3</sup> Krueger freely acknowledges what the Court of Appeals seemed reluctant to admit: that the B&O tax is a gross income tax instead of a net income tax and therefore “pyramids” by taxing the same economic activity more than once. *Id.* at 4 n.2 (citing Washington State Tax Structure Study Committee, *Tax Alternative for Washington State: A Report to the Legislature* (2002)); *see Washington Imaging*, 153 Wn. App. at 287 & n.2; Petition for Review at 18-19 & n.6.

In raising this point, Krueger invites the Court to do what it must not – to act in a legislative policy-making role. Krueger is not the first to criticize the B&O tax on policy grounds, and he will not be the last. Tax policy decisions, however, belong to the Legislature or to the people in their legislative capacity.<sup>4</sup> “[A]rguments as to the expediency of levying

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<sup>3</sup> This Court has consistently held that there is no constitutional prohibition against “double taxation” of excise taxes. *Paschen Contractors*, 111 Wn.2d at 60 (citing *Drury the Tailor v. Jenner*, 12 Wn.2d 508, 514, 122 P.2d 493 (1942)).

<sup>4</sup> In the recent election season, for example, the people of this state defeated an initiative that would have created a net income tax for wealthy individuals and reduced B&O taxes on businesses.

such taxes, or of the economic mistake or wrong involved in their imposition, are beyond judicial cognizance.” *Brushaber*, 240 U.S. at 25. Questions of tax policy may properly be directed to the Legislature, “but are not pertinent to judicial inquiry.” *City of Tacoma*, 177 Wash. at 617.

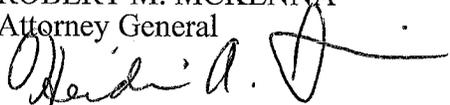
Krueger apparently would prefer a net income tax, where costs are deducted before the tax is applied, in place of the gross income tax. This Court should decline Krueger’s invitation to legislate tax policy.

### III. CONCLUSION

The trial court’s interpretation of RCW 82.04.080 and Rule 111 was correct and consistent with this Court’s prior cases on the subject of what constitutes the “gross income” of a taxpayer’s business. Nothing about that interpretation is unconstitutional, nor has any party alleged unconstitutionality. The Department requests that this Court reverse the Court of Appeals and reinstate summary judgment for the Department.

RESPECTFULLY SUBMITTED this 18<sup>th</sup> day of January, 2011.

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