

Cite as Det. No. 92-192, 12 WTD 377 (1992).

BEFORE THE INTERPRETATION AND APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition)	<u>D E T E R M I N A T I O N</u>
For Refund of)	
)	No. 92-192
)	
. . .)	Registration No. . . .
)	Audit No. . . .
)	

- [1] RCW 82.04.260 -- RESEARCH & DEVELOPMENT INCOME -- HOSPITALS. RCW 82.04.260 requires taxation of the "research and development" activities of every nonprofit corporation and association. The legislature did not provide a deduction or exemption. However, RCW 82.04.4289 provides a deduction for compensation received for services to patients and attendant sales of prescriptions by nonprofit hospitals. Additionally, RCW 82.04.4297 provides a deduction for revenue received from public entities for "health and social welfare services."
- [2] RCW 82.04.4289 -- EXEMPTION FOR MEDICAL SERVICE REVENUE EARNED BY CLINICS. Hospitals that also operate outpatient clinics, physically and operationally separate from the hospital facility are not entitled to the business and occupation tax exemption of RCW 82.04.4289 for revenue derived from the clinic operation. Accord: Group Health Co-op v. Tax Commission, 72 Wn.2d 422 (1967); Det. No. 87-376, 4 WTD 399 (1987). **[NOTE: EFFECTIVE JULY 1, 1993, RCW 82.04.4289 WAS AMENDED TO REMOVE ALL REFERENCES TO HOSPITALS. SEC. 305, CHAPTER 492, LAWS OF WASHINGTON 1993.]**
- [3] RCW 82.04.4297 -- EXEMPTION FOR HEALTH & SOCIAL WELFARE SERVICE REVENUE RECEIVED BY CLINICS FROM PUBLIC ENTITIES. Hospitals that also operate outpatient clinics, physically and operationally separate from the hospital facility are entitled to the business and occupation tax exemption of RCW 82.04.4297 for revenue received from public entities for "health and social

welfare services." Group Health Co-op v. Tax Commission, 72 Wn.2d 422 (1967); Det. No. 87-376, 4 WTD 399 (1987).

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

NATURE OF ACTION:

Taxpayer is a nonprofit hospital and medical center that petitions for a refund of B&O taxes assessed on: 1) research income from private and federal sources and 2) clinic income received from private and public entities.

FACTS AND ISSUES:

Lewis, A.L.J. -- [Taxpayer] was audited by the Department of Revenue for the period January 1, 1981 through September 30, 1987. The taxpayer protests two of the audit's adjustments. The taxpayer requests a refund of B&O taxes assessed in Schedules II (Taxable Research Income) and Schedule III (Clinic Income Subject To Tax) of the audit report.

Business and occupation tax was assessed on research income from all sources from January 1, 1984 through September 30, 1987. The tax assessment was based on RCW 82.04.260(6) that provides for a tax on all "research and development" income received by nonprofit organizations. The first issue is whether the provisions of RCW 82.04.260(6) are absolute or whether a nonprofit hospital may avail itself of the "hospital" deduction provided by RCW 82.04.4289.

The service business and occupation tax was assessed on income from the operation of [two clinics]. The second issue is whether the clinic income qualifies for a deduction: either the "hospital" deduction provided by RCW 82.04.4289 and/or the deduction provided by RCW 82.04.4297 ("compensation from public entities for health or welfare services").

[The taxpayer] is a nonprofit medical facility located in . . . , Washington. Its primary facility is a hospital and medical center that specializes in the treatment of children. [The taxpayer] also operates [two clinics], both of which are physically separate from the hospital and medical center complex. Both clinics keep typical business hours, operating Monday through Friday from 8:00 a.m. to 5:30 p.m.

[The first clinic] is a general medical and dental clinic that provides check-ups and immunizations for children who are well and offers diagnosis, treatment and follow-up care for children

who are sick or have a specific medical problem. The clinic has a primary care orientation.

[The second clinic] provides medical treatment by physicians specializing in a variety of pediatric sub-specialties including pediatric cardiology and gastroenterology.

DISCUSSION:

The discussion and conclusions regarding these matters will correspond to the order in which they were earlier presented.

[1] RESEARCH AND DEVELOPMENT INCOME: The audit assessed tax on research and development income received by the taxpayer. RCW 82.04.260 provides for a plenary tax on every nonprofit corporation and nonprofit association engaging in this state in research and development. Thus, such revenue will be subject to tax unless a specific exemption exists.

The taxpayer asserts that RCW 82.04.4289 and RCW 82.04.4297 provide such exemptions. Neither statute provides a deduction specifically for "research and development" income. However, the referenced statutes provide deductions for income received for providing patient services (RCW 82.04.4289) or health or social welfare services (RCW 82.04.4297). RCW 82.04.4289 provides a deduction from tax for:

amounts derived as compensation for services rendered to patients or from sales of prescription drugs as defined in RCW 82.08.0281 furnished as an integral part of services rendered by a hospital, as defined in chapter 70.41 RCW, which is operated as a nonprofit corporation, nursing homes and homes for unwed mothers operated as religious or charitable organizations, but only if no part of the net earnings received by such an institution inures directly or indirectly, to any person other than the institution entitled to a deduction hereunder. In no event shall any such deduction be allowed, unless the hospital building is entitled to exemption from taxation under the property tax laws of this state.

The deduction has three requirements: 1) The income be from services rendered to patients or from sales of prescription drugs.

2) The services or sales of prescription drugs must be as an integral part of services rendered by a qualifying nonprofit hospital or other institution. 3) The hospital building must be exempt from property tax. Element three is satisfied, as [the taxpayer's] Hospital building is exempt from real property tax.

The court in Group Health Co-op v. Tax Commission, 72 Wn.2d 422 (1967) gives guidance in considering elements one and two. In Group Health the court considered the above quoted deduction statute relative to a hospital facility that operated a joint "central" out-patient clinic and two outlying clinics. The essence of the court's decision was that amounts derived as compensation for services furnished to patients by a hospital, as such facilities and services are ordinarily comprehended, are deductible; whereas amounts received for ordinary medical consultation and treatment, such as may be obtained in a doctors office, are not deductible.

The term "research and development" generally denotes money expended or received to develop new products or processes, to improve present products, or to discover new knowledge that may be valuable at some future date.¹

Revenue received from the performance of activities generally considered as "research and development" would not normally fulfill the requirements for the statutory deduction allowed by RCW 82.04.4289. However, if a review of the income received for "research and development" shows that the income is received for services furnished directly to patients by a hospital, as such facilities are ordinarily comprehended, the income will be deductible.

The taxpayer also argues that "research and development" income should be deductible under RCW 82.04.4297. This statute provides that:

there may be deducted from the measure of tax amounts received from the United States or any instrumentality thereof or from the state of Washington or any municipal corporation or political subdivision thereof as compensation for, or to support, health or social welfare services rendered by a health or social organization or by a municipal corporation or political subdivision.

The deduction has three requirements: 1) The funds must be from the United States or any instrumentality thereof or from the state of Washington or any municipal corporation or political subdivision thereof. 2) The funds must be received as compensation for, or to support health or social welfare

¹Kieso, Donald E. & Weygant, Jerry J., Intermediate Accounting - Second Edition (New York, New York: John Wiley & Sons, 1977), p. 529.

services. 3) The services must be rendered by a health or social welfare organization.

[Taxpayer] meets the criteria of a "health or social welfare organization" as defined in RCW 82.04.431, thus satisfying element three. The issue is whether "research and development" income is "compensation for health and social welfare services."

The term "health or social welfare services" as defined in RCW 82.04.431 includes and is limited to nine enumerated activities' of which "health care services" is included.

A deduction for income will be allowed only if all its elements are met. Revenue received from the performance of activities generally considered as "research and development" would not normally fulfill the requirements for the statutory deduction allowed by RCW 82.04.4297. However, if a review of the income received for "research and development" shows that the income is received from public entities for "health and social welfare services," provided directly to the patient, the income will be deductible.

[2] CLINIC INCOME: The audit assessed tax on income earned by the [two clinics]. The taxpayer makes two objections to the assessment of clinic income. First, the taxpayer contends that such income is compensation received by a non-profit hospital for services rendered to patients. Under RCW 82.04.4289 such income is deductible from the measure of the business and occupation tax. Alternatively, the taxpayer believes that a portion of these amounts received from the state or federal government is deductible from the measure of tax. This belief is on grounds that these revenues are compensation for "health or social welfare services" rendered by a health or social welfare organization. Such amounts are deductible under RCW 42.04.4297.

The court discussed this deduction in Group Health Co-op v. Tax Commission, 72 Wn.2d 422, 433 P.2d 201 (1967). The court in Group Health considered the application of the deduction to amounts derived from providing services at several of Group Health's clinics. The court stated that from the language used in the statute and in the definition, that ordinary medical consultation and treatment, such as one seeks and obtains in a doctor's office, or clinic, however paid for, was not contemplated as being within the range of the pertinent deduction.

The court in Group Health found the outlying clinics' income taxable as they provided services generally found in the average physician's office or clinic and not a hospital. The court found in Group Health that the outlying clinics were open only during

regular business hours, provided no domiciliary care or overnight facilities, and were physically separate and apart from the central or hospital complex.

Thus, [the two clinics] are similar to the outlying clinics in Group Health. Like the clinics in Group Health, [the two clinics] are physically separate from the Hospital. Both clinics maintain typical business hours. Both clinics only provide outpatient care.

[The two clinics] are much more in the nature of a clinic than an "integral, interrelated and essential" part of a hospital as the term hospital is ordinarily understood. Accordingly, the petition is denied on the question of the availability of RCW 82.04.4289 to income from [the two clinics].

[3] With respect to the taxpayer's alternative argument we agree with the taxpayer. RCW 82.04.4297 permits the following deduction:

In computing tax there may be deducted from the measure of tax amounts received from the United States or any instrumentality thereof or from the state of Washington or any municipal corporation or political subdivision thereof as compensation for, or to support, health or social welfare services rendered by a health or social welfare organization or by a municipal corporation or political subdivision.

RCW 82.04.431 defines both "health or social welfare services" and "health or social welfare organization[s]." Included within the statutory definition of "health or social services" is "health care services." It is apparent that the services provided by [the two clinics] are "health care services." The taxpayer meets the definition of a "health or social welfare organization." Therefore, amounts received by the taxpayer from the United States or its instrumentalities or from the state of Washington or its municipal corporations or political subdivisions for services provided by [the two clinics] are not subject to the business and occupation tax. Accordingly, the petition will be granted on the question of the availability of RCW 82.04.4297 to income from [the two clinics].

DECISION AND DISPOSITION:

The taxpayer's petition for refund is denied in regards to allowance for taxes paid on "research and development" income. However, credit will be allowed for any revenues that may have been termed "research and development" but meet the statutory requirements of RCW 82.04.4289 and/or RCW 82.04.4297.

The taxpayer's petition is denied in regards to allowance for taxes paid on [the two clinics'] income under RCW 82.04.4289. However, credit will be allowed for any income that meets the statutory requirement of RCW 82.04.4297.

The Department's Audit Division will make the necessary assessment adjustments in accordance with the decisions reached in this determination and issue the necessary refund.

DATED this 23rd day of July 1992.