

Cite as 4 WTD 205 (1987)

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. 87-332
)	
. . .)	Registration No. . . .
)	Tax Assessment No. . . .
)	

[1] **RULE 233:** B & O TAX -- DEDUCTION FROM GROSS INCOME -- QUALIFIED MEDICAL SERVICE ORGANIZATIONS -- ACTING SOLELY AS AGENT OF PHYSICIAN. Qualified medical service organizations are entitled to deduct from their gross income amounts paid to physician/clinic who render medical services to subscribers of the organization where the organization contractually acts solely as the agent of the physician/clinic in offering to its subscribers medical services of the physician. This deduction is not available to a physician/clinic for amounts paid to a referral specialist, even if it can be construed that the physician/clinic acts as agent of the referral specialist, because the physician/clinic is not a qualified medical service organization.

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.

TAXPAYER REPRESENTED BY: . . .

DATE OF HEARING: February 19, 1987

NATURE OF ACTION

Petition for refund of Service business and occupation (B & O) tax assessed and paid on disallowed deductions for payments by taxpayer-clinic to outside physicians.

FACTS AND ISSUES

Krebs, A.L.J. -- [The taxpayer] is a partnership of physicians. The taxpayer operates as a clinic and is a Participating Medical Group (PMG) in the . . . insurance program. Under the terms of the . . . medical insurance program, employees of participating employers and self-employed persons enroll in [the insurance program] and select a physician in a PMG such as the taxpayer. Each month, the taxpayer as a PMG receives a "capitation payment" from [the insurance program] for each enrolled employee-patient (. . .) who has chosen the taxpayer to provide medical services. The taxpayer has a roster of primary care physicians. The member selects one from the roster as his/her primary care physician (clinic doctor). The clinic doctor is then responsible to personally, or through referral to an outside specialist, provide all medical care required by a member-patient. The taxpayer has written contracts with selected outside referral specialists who agree to treat referred patients and look only to the taxpayer for payment. It is these payments by the taxpayer to the outside referral specialists which are in issue, that is, whether the payments are deductible from the taxpayer's gross receipts for excise tax purposes.

The Department of Revenue examined the taxpayer's business records for the period from January 1, 1982 through December 31, 1985. As a result of this audit, the Department issued Tax Assessment No. . . . on . . . asserting excise tax liability in the amount of \$. . . and interest due in the amount of \$. . . for a total sum of \$. . . which has been paid in full.

The taxpayer's protest involves Schedule II of the audit report where the taxpayer's deductions from reported gross income of amounts paid to outside referral specialists were disallowed by the auditor and subjected to Service B & O tax.

The auditor explained the disallowance of the deduction as follows: WAC 458-20-233 (Rule 233), . . . , allows the deduction only when the medical organization is acting as "agent for the physician." The contract between [the] health maintenance organization, and the taxpayer mandates that the taxpayer provide a full range of health services to the patient. When outside physicians are needed to treat the taxpayer's patients under this program, the taxpayer is liable for payment to the outside physicians, despite the fact that these payments may exceed income received from [the organization] for the treatment of a particular patient. This, according to the auditor, results in a loss of agency status for the taxpayer.

The taxpayer's position is as follows:

1. The auditor's interpretation is not what was intended by Rule 233.
2. The taxpayer interprets Rule 233 as qualifying it to be an agent for the outside physician because the

physician looks solely to the taxpayer for payment. The taxpayer perceives itself as being "in the middle" in making the payments.

3. The taxpayer points to ETB 519.04.233 (ETB 519), . . . , as addressing the matter of agency relationship.
4. The auditor implied that an agency relationship existed, but was forfeited because the taxpayer might need to make referral payments which are in excess of capitation receipts. The taxpayer responds that in any insurance program there is "the risk that in any given year premiums might not be adequate to cover expenses," and that "based on a year's experience the next year's premiums are then adjusted accordingly."
5. The taxpayer believes that it is a "similar health care organization" which Rule 233 and ETB 519 address.

The issue is whether the taxpayer's payments to outside referral specialists are validly deductible from its gross income.

DISCUSSION

The taxpayer, as a provider of medical care and services, is subject to Service B & O tax. The rate of tax is applied to its "gross income of the business." RCW 82.04.290.

The term "gross income of the business" is defined in RCW 82.04.080 to mean in pertinent part:

. . . the value proceeding or accruing by reason of the transaction of the business engaged in and includes . . . compensation for the rendition of services . . . and other emoluments however designated, all without any deduction on account of . . . labor costs . . . or any other expense whatsoever paid or accrued and without any deduction on account of losses. (Emphasis supplied.)

[The organization] is a medical insurance program. It receives premiums/payments from employers of employees and from the self-employed. [The organization] contracts with the taxpayer and other Participating Medical Groups to provide the medical care and services to the employees and self-employed persons who have selected the provider. [The organization] pays a "capitation payment" monthly to the taxpayer as a provider of the medical care and services. These payments constitute the taxpayer's "gross income of the business" as "compensation for the rendition of services."

The taxpayer's primary care physician refers the patient, when necessary, to an outside specialist who looks only to the taxpayer for payment. This payment is an expense solely of the taxpayer and is not deductible from the "gross income of the business." RCW 82.04.080.

[1] Rule 233, . . . , in pertinent part provides:

All medical service bureaus, medical service corporations, hospital service associations and similar health care organizations . . . are taxable under the service and other business activities classification upon their gross income. The term "gross income" as defined in RCW 82.04.080 is construed to include the total contributions, fees, premiums or other receipts paid in by the members or subscribers . . .

Certain of these organizations operate under contracts by the terms of which the bureau or association acts solely as the agent of a physician . . . in offering to its members or subscribers medical and surgical services, hospitalization, nursing, and ambulance services. In computing tax liability, such bureaus and associations, therefore, will be entitled to deduct from their gross income the amounts paid to member physicians, hospitals and ambulance companies . . .

Under contracts wherein these organizations furnish to their members medical and surgical . . . services as a principal and not as an agent, no such deduction is allowed. (Emphasis supplied.)

The intent of Rule 233 is to allow "medical service bureaus, medical service corporations, hospital service associations and similar health care organizations" to deduct from their gross income the amounts paid to member physicians when the organization by contract acts solely as the agent of the physician. The premise for the deduction is that the organization itself does not render the medical service to the member or subscriber, but receives payments from the subscriber for its administration expenses and as agent for payment of amounts to physicians with whom the organization has contracted to act as agent in offering the services of the physician to its members/subscribers.

In order for the taxpayer's payments to outside referral specialist to be deductible from its gross income, Rule 233, in principle, requires:

1. that the taxpayer be a "similar health organization."

2. that the taxpayer as a "similar health organization" act solely as the agent of a physician, that is, the outside referral specialist.
3. that the taxpayer have members or subscribers paying contributions, fees or premiums to it.

In this case, it is clear that . . . is the "similar health organization" because it has members or subscribers who pay fees or premiums to it to receive medical and surgical services from the taxpayer-clinic with whom [the organization] has contracted. Thus, [the organization] is acting as the agent of the taxpayer-clinic in securing payments from its (. . .) members or subscribers and passing them on to the taxpayer-clinic in the form of a monthly "capitation payment." On the other hand, the taxpayer does not function as a medical service bureau or "similar health organization" because it has no members nor subscribers paying contributions, fees or premiums to it. Furthermore, the taxpayer furnishes the medical and surgical services to the patient as a principal, not as an agent of the patient. Where the taxpayer makes a referral of the patient to an outside specialist, it is the taxpayer as a principal who has engaged the outside specialist to render medical services to the patient. Even if it can be construed that the taxpayer acts as agent of the outside referral specialist in offering to its patient the medical services of the outside specialist, the deduction available in Rule 233 does not apply because the taxpayer is not a "similar health organization." Moreover, the taxpayer is not acting solely as agent of the outside referral specialist because the taxpayer itself is rendering medical services and its engagement of the outside specialist is an integral part of its rendering medical services which the taxpayer contracted to do for the capitation payments received from [the organization]. . . .

ETB 519, to which the taxpayer pointed as addressing the agency relationship, in pertinent part states:

REPORTING PROCEDURES FOR QUALIFIED MEDICAL SERVICE ASSOCIATIONS

What procedure should be followed by medical service bureaus, medical service corporations, hospital service organizations, and similar health care organizations when deductions on an excise tax return for a particular reporting period exceed gross income for that same period?

Rule 233 provides that all such organizations engaging in business within this state are subject to the provisions of the business and occupation tax under the Service and Other Business Activities classification upon gross income defined by RCW 82.04.080. Under the rule,

however, if such an organization acts under contract solely as an agent of a physician, hospital or ambulance company for services rendered to members, it is allowed to deduct amounts paid to such persons when computing tax liability.

Clearly, the agency relationship that gives rise to the deduction is that between a "qualified medical service association," as described in the ETB and Rule 233, and a physician; not between a clinic of physicians such as the taxpayer and other physicians such as the outside referral specialists.

The taxpayer has perceived itself as "being in the middle," that is, in receiving payments from [the organization] and in making payments to the outside referral specialist. However, this "being in the middle" does not fall within the special agency relationship contemplated by Rule 233 as giving rise to the deduction which only a qualified health care organization may take from its gross income when it acts solely as the agent of a physician for payments made to such physicians.

For the reasons expressed and the law stated, we conclude that the deductions in question were properly disallowed.

DECISION AND DISPOSITION

The taxpayer's petition for refund is denied.

DATED this 26th day of October 1987.