

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

In the Matter of the Petition)	<u>D</u> <u>E</u> <u>T</u> <u>E</u> <u>R</u> <u>M</u> <u>I</u> <u>N</u> <u>A</u> <u>T</u> <u>I</u>
<u>O</u> <u>N</u>	
For Correction of Assessments of)	
)	No. 87-376
)	
)	Registration No. . . .
. . .)	Tax Assessment No. . .
.	
)	
dba [A])	Registration No. . . .
)	Tax Assessment No. . .
.	
)	
dba [B])	Registration No. . . .
)	Tax Assessment No. . .
.	
)	
dba [C])	Registration No. . . .
)	Tax Assessment No. . .
.	

[1] **RULES 111 AND 168:** BUSINESS AND OCCUPATION TAX -- GROSS INCOME -- ADVANCES AND REIMBURSEMENTS -- PSRO REIMBURSEMENTS. PSRO reimbursements are payments for services rendered by the recipients of the payments. Therefore, they are not excludable from gross income as a reimbursement under Rule 111.

[2] **RULE 168:** BUSINESS AND OCCUPATION TAX -- DEDUCTION -- HOSPITAL SERVICES -- CLINICS AND DEPARTMENTS. Under Group Health Co-op. v. Tax Commission, 72 Wn.2d 422, 433 P.2d 201 (1967), compensation for services to patients is not deductible from the measure of business and occupation tax even when those services are provided by hospital departments and clinics if: the same services are offered by outlying clinics; services are primarily provided to outpatients; services are provided only during

regular business hours; the services are provided in a separate location from the main hospital building.

- [3] **RULE 169:** BUSINESS AND OCCUPATION TAX -- DEDUCTION -- HEALTH OR SOCIAL WELFARE SERVICES -- HEALTH OR SOCIAL WELFARE ORGANIZATION -- HOSPITAL CLINICS AND DEPARTMENTS. Compensation for health care services provided by a hospital department or clinic are entitled to the deduction of RCW 82.04.4297 if the hospital is a health or social welfare organization and the compensation is from the state or federal government.
- [4] **RULE 168:** BUSINESS AND OCCUPATION TAX -- DEDUCTION -- HOSPITAL SERVICES -- PAYMENT NOT RECEIVED FROM PATIENTS. Income received by a hospital from the director of one of its clinics found to qualify for the hospital service deduction where the director desired his patients to receive one consolidated billing rather than a separate billing from the hospital. He contracted to pay the hospital a percentage of his gross income "to cover hospital operating expenses". This found to be compensation for services to patients and therefore deductible.

TAXPAYER REPRESENTED BY: . . .
. . .
. . .
. . .

DATE OF HEARING: December 12, 1985

NATURE OF ACTION:

The taxpayer has petitioned for correction of four assessments issued against it as a result of a routine excise tax audit.

FACTS AND ISSUES:

Potegal, A.L.J. -- The taxpayer is a non-profit corporation which operates three hospitals It is registered with the Department of Revenue under three separate accounts. Registration No. . . . is used for the administrative office and for [A]. Registration No. . . . is used for [B]. Registration No. . . . is used for [C]. For audit purposes the four organizational units of the taxpayer's operations (three hospitals and the administrative office) were treated as individual entities. Separate audit reports and assessments were issued to each of them.

The taxpayer filed a single petition objecting to all four assessments. Some of the issues raised are common to more than one of the four units. The taxpayer's brief and presentation at the hearing was organized by issue. This Determination will also be so organized. The issues are:

A. Taxation of PSRO Reimbursements.

The taxpayer objects to the taxation of amounts paid to compensate it for Professional Standards Review Organization (PSRO) activities. The PSRO is a federally mandated program to review the professional activities of health care providers for reasonableness, medical necessity, professionalism and economy. The program relates to medicare and is a requirement for participation. PSRO activities may be delegated to health care providers. The providers are then reimbursed for their efforts on a unit cost basis. The PSRO activities were so delegated to the taxpayer.

The taxpayer contends that these amounts are nontaxable reimbursements under WAC 458-20-111.

B. Taxation of Management and Employee's Services Revenue.

The taxpayer objects to the assessment of tax on amounts received by the administrative office, [A], and [B] from certain related entities for salary and benefits paid to employees of the taxpayer who performed services for the related entities. The taxpayer claims that these are nontaxable reimbursements.

Similarly, the taxpayer objects to the assessment of amounts received by [A] out of dues paid by hospitals in [X] County and the [X] County Medical Society in support of the [X] County Medical Library. [A] houses the library. Merely as a matter of convenience it is the nominal employer of library employees. The amounts in question are to reimburse the taxpayer for the employees' salaries. Once again, the taxpayer considers these to be nontaxable reimbursements.

C. Taxation of Hospital Departments and Clinics.

1. [C] Departments and Clinics.

The taxpayer objects to the taxation of amounts received in connection with [C]'s Speech and Hearing Department, Occupational and Physical Therapy Department, Maternal and Child Care Clinic, and Cardiology Clinic. 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 the 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 82.04.4297.

2. The [Y] Clinic.

The taxpayer objects to the taxation of compensation received for services provided by the [Y] Clinic. The clinic treats inpatients at the three hospitals and also treats outpatients. It is associated with the University of Washington School of Medicine in that it provides training to residents

The taxpayer believes that the clinic is an arm of the University of Washington and as such is not subject to business and occupation tax. The taxpayer also makes the same objections it did with respect to the [C] departments and clinics; i.e., the income is compensation received by non-profit hospital for services to patients and, governmental income is not taxable because it is derived from health or social welfare services rendered by a health or social welfare organization.

DISCUSSION:

The taxpayer's objections will be discussed in the same order presented above.

A. Taxation of PSRO Reimbursements.

PSRO reimbursements are payments to the taxpayer to compensate it for activities which it has itself performed. WAC 458-20-111 defines a nontaxable reimbursement as follows:

The word "reimbursement" as used herein, means money or credits received from a customer or client to repay the taxpayer for money or credits expended by the taxpayer in payment of costs or fees for the client.

[1] The PSRO payments do not fall within this definition. The taxpayer has not paid costs or fees to third parties for which the federal government is reimbursing it. Rather, the taxpayer has engaged in business activity for which it has received income subject to tax.

The taxpayer's petition will be denied on this issue.

B. Taxation of Management and Employee's Services Revenue.

With respect to salary reimbursements received from related entities the reimbursement provisions of WAC 458-20-111 do not apply. As is the case with the PSRO payments, the taxpayer has not made payments to someone else on behalf of the related parties. The taxpayer instead has been paid for services which it has itself rendered to the related entities. This conclusion is supported by the one sample contract between the taxpayer and one of the related entities which the taxpayer submitted. Under the contract the taxpayer agreed to provide management services to the related entity through a full-time executive director employed by the taxpayer. As consideration for the management services the related entity agreed to pay the taxpayer an amount equal to the cost of the executive director's salary and other expenses.

The taxpayer's petition will be denied on this issue.

With respect to amounts received out of library dues we again find that the reimbursement provisions of WAC 458-20-111 do not apply. The agreement under which the [X] County Medical Library operates requires [A] to perform certain management services. Included among these services are the "employment and dismissal of all library personnel." [A] reports library personnel as its own employees to various government agencies. Thus, [A], not the library, is liable for paying persons working in the library. When [A] pays library employees it is not making payment on behalf of the library but is paying one of its own costs.

The taxpayer made an additional argument that these amounts are exempt of tax because they are dues. RCW 82.04.4282 provides a deduction for

. . . dues If dues are in exchange for any significant amount of goods or services rendered by the recipient thereof to members without any additional charge to the member, or if the dues are graduated upon the amount of goods or services rendered, the value of such goods or services shall not be considered as a deduction hereunder.

This provision does not apply to the taxpayer. First, it is intended to provide an exemption for recipients of dues. In this case that would be the library, not the taxpayer.

Second, the dues must not be in return for a significant amount of goods or services. The dues here pay for a medical library which is of substantial service to the dues-paying members.

The taxpayer's petition will be denied on this issue.

C. Taxation of Hospital Departments and Clinics.

1. [C] Departments and Clinics.

a. Speech and Hearing Department.

This department is located in a building which neighbors the main hospital building. Like the main hospital building, the building housing the Speech and Hearing Department is exempt from property tax. The services offered by the department are the same as those offered at outlying speech and hearing clinics and by mobile van. Services are provided both to inpatients and outpatients, but primarily to outpatients. The hours of operation are generally from eight to five. On request the department will be open outside of those hours. The department provides no services on an emergency basis.

The taxpayer testified that the services offered by this department are an integral part of hospital services. Restoration of speech and hearing enhancement are often needed with head injuries. The vast majority of . . . hospitals have speech and hearing departments. Furthermore, as a tertiary care facility (a facility recognized by the medical community as providing certain services such as emergency room, intensive care, and transportation) the hospital would have a speech and hearing department.

The taxpayer believes that the deduction provided by RCW 82.04.4289 applies to amounts received in connection with the operation of the Speech and Hearing Department. RCW 82.04.4289 states in part:

In computing tax there may be deducted from the measure of tax amounts derived as compensation for services rendered to patients . . . by a hospital, as defined in chapter 70.41 RCW, which is operated as a nonprofit corporation, . . . 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 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.

There is no question that [C] is a qualifying hospital. The building which houses the Speech and Hearing Department is exempt of property tax. The issue is whether these amounts are "compensation for services rendered to patients . . . by a hospital."

The only case which discusses this deduction is Group Health Co-op. v. Tax Commission, 72 Wn.2d 422, 433 P.2d 201 (1967). The court was considering the application of the deduction to amounts derived from services rendered at several of Group Health's clinics. The court stated:

Whatever else may be said regarding the clarity, or lack of clarity, in the statutes or any combination thereof, and/or about the uniqueness of respondent's organization and operation it appears reasonably evident that the legislature basically had in mind, as deductible amounts from the measure of the tax imposed, such amounts as were derived as compensation for services furnished to patients by a hospital, as such facilities and services are ordinarily comprehended. We are satisfied, 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.

It is true, as the trial court found, that organization-wise respondent corporation is integrated and its various activities are interrelated. Yet, it is also true that respondent undertakes to furnish to its members, according to its membership agreement and fee or "medical dues" schedule, two severable types of health service and coverage, *i.e.*, medical consultation, diagnosis, treatment, and care by way of home or office calls, and *hospitalization* together with the usual services accompanying such a confinement. The first type of service is essentially furnished and performed in respondent's outlying clinics. The second type of service is, of course, supplied through respondent's central or hospital facility, including in some measure, at least, the central clinic which serves the central complex on a basis akin to the ordinary intake or emergency room in the average hospital. In short, the type of coverage offered by respondent

to its members is not too dissimilar from that afforded by various other hospital and medical insurance plans. The uniqueness of respondent's operation springs principally from the fact that it is a cooperative, owns and operates its own facilities, and employs its own professional medical staff in all of its phases.

As we have indicated, the line of demarcation between the character of the services supplied by respondent is reasonably discernible. Likewise, the division between the facilities which afford the respective services is, with the exception of the central clinic, fairly observable. In this vein, the stipulated facts, the evidence presented, and the trial court's findings clearly reveal that the outlying clinics are staffed, equipped, administered, and provide that type of medical service to the members which one would expect to find and receive in the average private physician's office or clinic. They are open only during regular business hours, provide no domiciliary care or overnight facilities, and are physically separate and apart from the central or hospital complex. And, as with the ordinary doctor's office, when the patient's needs exceed the resources at hand referral to specialists or to the hospital, as the case may be, is recommended and becomes available. The only difference, in this latter respect, from a private practitioner's procedure, is that the member patients are referred to respondent's staff specialists and/or hospital complex rather than to other resources, and the budgeting, accounting, and supply functions are handled by a central agency.

On the other hand, the central facility, including the central clinic, furnishes modern as well as all of the traditional hospital services, i.e., bed wards, surgery rooms, laboratories, X-ray equipment, pharmaceutical supplies, specialized professional staff, nursing staff, catering services, and 24 hour intake and emergency facilities. These services differ in no substantial way, except in their overall organizational scheme, from the ordinary hospital. Within the framework of this aspect of respondent's service, the central clinic truly forms an integral, interrelated and essential part of the central facility, for, although it undertakes to provide some out-patient services akin to the outlying clinical service, it nevertheless provides

the round-the-clock intake and emergency services which form a constituent part of the normal hospital operation. In this sense, then, the central clinic is no more separable from the central or hospital facility than the surgery rooms, the bed wards, the laboratory or the other components of the hospital activity, all of which might incidentally perform some out-patient service.

(Underscoring ours.)

[2] When applying the guidance provided by the Group Health case to the facts surrounding the operation of the Speech and Hearing Department, we are led to the conclusion that the deduction does not apply. Several facts are of particular significance in arriving at this conclusion:

- (1) The services offered are the same as those offered by the outlying clinics and the mobile van.
- (2) Services are primarily offered to outpatients.
- (3) The department is only open during regular business hours.
- (4) The department is physically separate from the main hospital building.

The Speech and Hearing Department is much more in the nature of an independent clinic than of an "integral, interrelated and essential" part of a hospital as the term hospital is ordinarily understood.

The petition will be denied on the question of the availability of RCW 82.04.4289 to income from the Speech and Hearing Department.

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.

[3] RCW 82.04.431 defines both "health or social welfare services" and "health or social welfare organization[s]".

Included within "health or social welfare services" are "health care services." Clearly, the services provided by the Speech and Hearing Department are health care services. At the hearing the taxpayer presented extensive evidence supporting its claim that it met the statutory definition of a "health or social welfare organization." In addition, during the course of the audit the audit staff determined that the taxpayer was 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 Speech and Hearing Department are not subject to business and occupation tax.

The petition will be granted on the question of the availability of RCW 82.04.4297 to income from the Speech and Hearing Department.

b. Occupational and Physical Therapy Department.

This Department has two locations. One, inside the main hospital building, is used for emergencies and group therapy for inpatients. The other is in a neighboring building which is exempt from property tax. The Department has regular office hours of eight to five. The majority of patients served are outpatients.

To the extent the taxpayer can identify income for services performed at the location inside the main hospital building the deduction provided by RCW 82.04.4289 will be granted. These services are ordinarily comprehended as the type of services furnished to patients by a hospital.

In other respects the discussion of the taxability of the Speech and Hearing Department applies in exactly the same way and for the same reasons to the Occupational and Physical Therapy Department. Other than for services provided inside the main hospital the petition will be denied as to the deduction of RCW 82.04.4289. The petition will be granted as to the deduction provided by RCW 82.04.4297.

c. Maternal and Child Care Clinic.

This clinic only provides outpatient services to needy mothers and children in the community. It is located one half block from the main hospital building.

Again, the discussion concerning the Speech and Hearing Department applies to the Maternal and Child Care Clinic. The

petition will be denied as to RCW 82.04.4289 and granted as to RCW 82.04.4297.

d. Cardiology Clinic.

This clinic is located within the main hospital building. It provides many types of cardiac care including cardiac catheterizations. Cardiac catheterizations require hospitalization because they are invasive procedures and special radiological equipment must be used.

The services provided to patients of the clinic are in fact hospital services. Tax was nevertheless assessed on the taxpayer's income derived from this clinic's operation. The basis for the assessment was that the income was not compensation for services to patients. The income was not received from patients or insurance companies or governments but from the physician who directed the clinic.

The director of the clinic preferred to have clinic patients receive one consolidated bill for all services rendered through the clinic rather than one bill for his services and one bill for the hospital facility and staff. Accordingly, the director and the taxpayer entered into a written agreement which provided that the taxpayer would not charge clinic patients a room fee and that the director of the clinic would pay the taxpayer 32.5 percent of his gross receipts.

[4] Even though the income was received from the clinic director rather than the patients, we believe that it represented compensation for hospital services rendered to patients. Under the agreement the clinic director provided clinical and administrative duties with respect to the clinic. The taxpayer provided space, nursing, technical, and secretarial staff, supplies, and medical record services. The agreement specifically states that the director of the clinic will pay the taxpayer "32.5 percent of his gross cash receipts to cover hospital operating expenses." (Underscoring ours.) While the manner in which the hospital is paid is somewhat unusual, the services for which it is paid are the same as those for which it is paid by patients.

The petition will be granted on this item.

2. The [Y] Clinic.

The clinic is located in a building separate from the hospital which is not exempt from property tax. The taxpayer pays the salaries of both the faculty and the residents who staff the clinic. The University of Washington reimburses the taxpayer

for a portion of the salaries because the residency program is associated with the University's School of Medicine. While the clinic provides treatment to both outpatients and inpatients, when a patient requires hospitalization he or she is admitted to the hospital and pays the hospital for its services. Thus, the revenue of the clinic does not include compensation for those services rendered by the hospital.

The taxpayer has not demonstrated that the clinic is an arm of the University of Washington. Even if it was, the income in question was received and retained by the taxpayer and not the University. The taxpayer's petition will be denied on the issue of the clinic being an arm of the University of Washington.

Because the clinic does not receive compensation for hospital services it is not eligible for the deduction provided by RCW 82.04.4289. The petition will be denied on that issue.

However, the clinic does provide health care services. As a component of a health and social welfare organization it is entitled to the deduction provided by RCW 82.04.4297 for amounts received from governmental sources. The petition will be granted to that extent.

DECISION AND DISPOSITION:

- A. Taxation of PSRO Reimbursements.
The taxpayer's petition is denied.
- B. Taxation of Management and Employee's Services Revenue.
The taxpayer's petition is denied.
- C. Taxation of Hospital Departments and Clinics.
The petition is granted with respect to all cardiology clinic income. The petition is granted with respect to the availability of the health and social welfare service deduction for the other departments and clinics. The petition is otherwise denied.

DATED this 30th day of December 1987.