Cite as Det. No. 99-013, 20 WTD 471 (2001)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Refund of	)	D E T E R M I N A T I O N
	)	
	)	No. 99-013[1]
	)	
. . .	)	Registration No. . . .
	)	REQUEST FOR REFUND
	)	
	)	

[1] RULE 111: ADVANCES AND REIMBURSEMENTS – ELEMENTS. When a taxpayer receives funds from its customer to pay a third party for services the taxpayer did not or could not provide and the taxpayer is liable to the third party solely as agent for its customer, the amounts received are not considered part of the taxpayer's gross income. If any of the elements are missing, the taxpayer must include the amounts received in its measure of tax.

[2] RULE 111: ADVANCES AND REIMBURSEMENTS – RHO. The decision in Rho holds that where an employer-employee relationship exists and there is an issue as to who is the employer, the Department must consider the actual intent of the parties and not just the contract, to determine the identity of the employer. The Rho decision did not find that an agency relationship exists whenever there is a three-party relationship.

[3] RULE 111: ADVANCES AND REIMBURSEMENTS – INTENT OF PARTIES. Where the contract language is clear and there is no evidence to refute the contract language, the Department will rely on the contract language to determine if Rule 111 applies.

[4] RULE 111: ADVANCES AND REIMBURSEMENTS – LIABILITY SOLELY AS AGENT. If the first two elements of Rule 111 exist, then an agreement between the service provider and the taxpayer limiting the taxpayer's liability when the customer fails to pay for the services satisfies the third element of Rule 111.

[1] The reconsideration determination, Det. No. 99-013R, is published at 20 WTD 481 (2001).

> However, such a limitation on liability does not create a presumption that the first two elements exist.

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:

A medical clinic requests a refund of business and occupation (B&O) taxes paid on amounts received from patients and paid to third-party specialists and medical laboratories. It claims it is liable to the third-party providers solely as the agent for the patient in procuring these services.[2]

FACTS:

Coffman, A.L.J. -- The taxpayer operates a medical clinic. As part of the operation of the medical clinic, the taxpayer employs physicians, nurses, administrative staff, and laboratory personnel. The taxpayer does not employ radiologists. Rather, it contracts with a radiology firm to perform radiology services. We reviewed a copy of the taxpayer's contract for radiology services, which states in part:

> [Taxpayer] provides comprehensive medical care to patients through its physicians, its support staff, and also by contracting for specialized services; and . . . .
>
> [Taxpayer] desires to retain the services of physicians specializing in radiology.

(Emphasis added.) According to the contract, the radiology firm provides radiologists who work on the taxpayer's premises[3] during scheduled clinic hours[4] using equipment provided by the taxpayer[5] with the assistance of taxpayer's employees.[6] These employees include licensed radiology technicians and administrative staff. The taxpayer is obligated to bill the patients for radiology services and remit a percentage of the taxpayer's receipts to the radiology firm.[7] The contract provides that the radiology firm "shall have the exclusive right to provide all radiology services" for the taxpayer.[8]

The taxpayer performs some laboratory work, but it is not equipped to perform all medical tests. When it cannot perform the laboratory tests ordered by its physicians, the taxpayer refers the patient, or sends samples to, an outside laboratory. We reviewed a sample contract for

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[2] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.
[3] See the taxpayer's radiology contract § 1.1.
[4] Ibid, § 1.2.
[5] Ibid §§ 1.5 and 2.1.
[6] Ibid § 2.2.
[7] Ibid § 5.1.1. In the event that the taxpayer enters into "capitated care contracts," the compensation paid to the radiology firm is adjusted using the same percentages as used for other radiology services.
[8] See the taxpayer's radiology contract, § 10.

laboratory services which the taxpayer states is representative of its agreements with third-party laboratories. According to the contract, the laboratory is paid on a fee-for-service basis and payment is made within 30 days of the taxpayer's receipt of an invoice from the laboratory.[9] There is no requirement that the taxpayer must first receive payment from the patient before it can be held liable to the laboratory. The laboratory is the taxpayer's "primary reference laboratory."[10]

According to the taxpayer, sometimes the radiology firm and the outside laboratories bill it for their services and, other times, they bill the patients directly. The taxpayer claims when it accepts the patients' payments for the laboratory and radiology services and passes those payments onto the third-parties, it is acting solely as the patients' agent. The taxpayer claims the different billing methods are the result of the dictates of the patients' insurance carrier. Some insurance companies require single billing for comprehensive medical services relating to the specific condition. Others require individual billing per medical treatment or service.

For example, the taxpayer cited . . . which operates a health maintenance organization. . . . requires each service provider to bill it for its respective charges. The taxpayer compared . . . to . . . . . . requires all charges relating to a patient's condition to be submitted in one claim. Thus, the third-party providers submit their bills to the taxpayer, which submits a single claim to . . . for payment. . . . then pays the taxpayer and the taxpayer pays the third-party provider.

The taxpayer requested a ruling from Taxpayer Information and Education (TI&E) Section of the Department of Revenue (Department) on November 12, 1996 regarding the taxability of amounts received from patients[11] and used to pay third-party service providers. The taxpayer, on December 30, 1996, filed a formal refund petition for the period January 1, 1992 through December 30, 1996. TI&E issued a letter on January 13, 1997 stating, in its opinion, the amounts the taxpayer received from the patients, which were used to pay third-party providers, could be excluded from gross receipts as advances and reimbursements under WAC 458-20-111 (Rule 111). On June 16, 1997, the Department's Audit supervisor denied the refund claim stating:

> Nothing provided to me convinces me that the clinic is either acting as agent or is exempt under the advance/reimbursement rule for any of its gross receipts. Other than proving agency or showing they meet the advance reimbursement requirements I do not see how the refund requested could be granted for the amounts paid to forty-one subcontractors.

On August 19, 1997, TI&E revoked its earlier opinion letter of January 13, 1997.

The taxpayer petitioned for reversal of the Audit Division's denial of its refund request and TI&E's revocation of its January 13, 1997 letter, arguing TI&E's original opinion was correct.

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[9] See the taxpayer's sample "laboratory services" contract, § 1.

[10] Ibid, we interpret the phrase "primary reference laboratory" to mean the taxpayer will refer tests it does not perform to this laboratory first.

[11] Including amounts paid on behalf of the patients by insurance companies.

The taxpayer claims it should be allowed to exclude, for B&O tax purposes, from its gross income the amounts patients pay the taxpayer and used to pay the charges for third-party radiology and laboratory costs. The taxpayer relies on Rho Co. v. Department of Rev., 113 Wn.2d 561, 782 P.2d 986 (1989) ("Rho"); Medical Consultants Northwest, Inc. v. State of Washington, 89 Wn.App. 39, 947 P.2d 784 (1997) ("MCN"); and Sequim Family Practice Center v. State of Washington, Dept. of Rev., Board of Tax Appeals Docket No. 41700, 12 WTD 263 (1992) ("Sequim") to support its claim that the Rule 111 exclusion applies to amounts it paid to third-party providers.

ISSUE:

May the taxpayer exclude from the measure of its taxable income amounts received from its patients and used to pay third-party radiologists and laboratories, as advances and reimbursements pursuant to Rule 111?

DISCUSSION:

Persons engaged in service businesses in Washington are required to pay B&O tax measured by the "gross income of the business." RCW 82.04.220 and .290. "Gross income of the business" is defined in RCW 82.04.080 as: "[T]he 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 . . . ."

The "value proceeding or accruing" is defined in RCW 82.04.090 as "the consideration, whether money, credits, rights, or other property expressed in terms of money, actually received."

Not all amounts a business receives are consideration for services it provided. Rule 111 articulates the Department's recognition that sometimes a business' receipts can include amounts a customer (the principal) advances or reimburses the business (the agent) for paying a third-party (the provider) for the service. These "advances or reimbursements" from a customer for procuring property or services which the business could not provide itself are excluded from the measure of the B&O tax, provided the business was not primarily nor secondarily liable for the payment to the third-party. In those instances, the business is said to have been acting as the client's agent and, as such, has no liability other than that of the agent of the principal on whose behalf it acted in procuring services from third-parties.

There are usually three parties in a permitted Rule 111 exclusion situation: the customer or principal, the agent, and the service provider. In this appeal, the taxpayer alleges the patients are the customers or the principals, it is the agent, and the laboratories and radiology firm are the third-party service providers.

[1] To determine whether a Rule 111 exclusion from the gross income of a business is proper, the taxpayer must prove the amounts received from the patients and paid to the third-party providers are advances or reimbursements. The Department must examine the

relationships of the parties in terms of three criteria listed in the Rule itself. If any one of the three conditions is missing, Rule 111 will not apply to the receipts. The Rho Court summarized three criteria of Rule 111 as follows:

> This court has summarized the operation of Rule 111 by stating that the rule allows an exclusion from income for a "pass through" payment when the following three conditions are met: (1) the payments are "customary reimbursements for advances made to procure a service for the client"; (2) the payments "involve services that the taxpayer did not or could not render"; and (3) the taxpayer "is not liable for paying the associate firms except as the agent of the client." Christensen, O'Connor, Garrison & Havelka v. Department of Rev., 97 Wn.2d 764, 769, 649 P.2d 839 (1982); see Walthew, Warner, Keefe, Arron, Costello & Thompson v. Department of Rev., 103 Wn.2d 183, 186, 691 P.2d 559 (1984).

(Emphasis added.) Rho, supra, at 567-8. In Rho, the factual issue before the court was "Who employed the contract personnel, Rho or Rho's corporate clients?" Id, 569. Rho was a temporary employment placement agency that contracted with businesses (principally Boeing) to provide temporary technical personnel. The Department assessed tax on Rho's gross receipts from its clients to whom it provided the temporary personnel. The Department issued the assessment and Rho appealed. The assessment was sustained by the Department and the Board of Tax Appeals, based on the language contained in Rho's contracts with its clients. Rho paid the assessment and filed a refund request with the courts, claiming the clients' payments included wages for the temporary personnel. Rho claimed its clients were the true employers of the temporary personnel and claimed it hired the employees on behalf of its clients as their agent. Rho argued the wages were excludable from its gross income as advances and reimbursements under Rule 111.

The Rho Court did not decide who was the employer.[12] As the Court of Appeals, in a recent decision, noted

> The [Rho] court ruled that determination of an agency relationship should not be restricted to an analysis of the contract between the parties, but should also take into consideration the parties' actions. The court remanded the case to the Board of Tax Appeals to determine whether Rho acted as the clients' agent in paying the temporary workers, and if so, whether Rho's liability to the temporary workers was solely that of an agent.

MCN, supra, at 47-8. Rho was settled before the BTA reached a final decision.

[12] See Rho footnote 4, id. at 571 which states: "The dissenting opinion is based on the premise that we hold that Rho is not liable on its contracts with its engineers. To the contrary, we are remanding for a determination of the nature of Rho's liability on these contracts."

[2] The taxpayer argues that the Rho decision requires an analysis of whether an agency relationship exists by determining who controlled the third-party provider. The taxpayer's petition explains its argument as follows:

> The August 19, 1997 letter from [TI&E] indicates that the real issue is whether [taxpayer] acts solely as the agent of its patients in procuring the services of labs and radiologists. The letter states that "[taxpayer] must prove it is not simply fulfilling its own contract responsibilities to the patient by having lab tests performed and x-rays read by a radiologist." Yet, in Rho the Washington Supreme Court held that the determination of whether an agency relationship existed depended on who exercised control over the third party service provider. The labs and radiological service provider procured by [taxpayer] are independent contractors, and [taxpayer] does not control, direct or supervise the providers of these services, or the provider's employees in the performance of their services. [Taxpayer] acts solely as agent in procuring the services of these independent contractors on behalf of [taxpayer's] patients and acts solely as paymaster of the service providers in collecting payment from patients.

(Emphasis added.) We agree the existence of a principal-agent relationship necessarily includes a degree of control by the principal over the agent. However, the taxpayer's position presumes that Rho stands for the proposition that there is a principal-agent relationship whenever there are three-party arrangements. While we agree that in some three-party arrangements the parties may have created an agency, we cannot agree that this is the case in every three-party arrangement.

The taxpayer reasons that because it does not control the laboratories or the radiologists, no agency can exist between them per Rho. The taxpayer then deduces that because there is no principal-agent relationship between the taxpayer and the service provider, there must an agency between the taxpayer and the patient. Therefore, the taxpayer contends, it was acting as the patients' agent when it procured the services of the laboratories and the radiology firm and the charges for these services were the responsibility of the patients only and the taxpayer bore no liability to the third-party providers. The taxpayer emphasizes this point when comparing the nature of the billing and the consequential tax liability that arises simply because one billing method includes the taxpayer as a payor and the other does not.

The taxpayer's reliance on Rho is misplaced. First, the issue in Rho was not whether an agency relationship existed because there was one: that of employer and employee. This is not the case here. There is no employer/employee relationship at issue here. Second, Rho did not state nor raise a presumption that a principal-agent relationship always exists when there is three-party relationship. Rather, that court recognized three-party relationships take different forms and it is error to rely solely on the relationship created by the "four corners" of the contract. The Rho court requires inquiry of the intent of the parties as manifested by their actions, regardless of the specific form of the relationship created by contract.

[3] The Department issued ETA 90-001[13] in response to the Rho court's conclusions. ETA 90-001 deals with the question of who is the employer and Rho, supra, specifically. By analogy it also applies to the determination of whether a person is an agent and, in pertinent part, states:

> When these elements of control[14] exist only in behalf of the business to whom the workers are provided, that business will be treated as the employer and the business providing the workers will be treated only as a payrolling agent, notwithstanding terms in any contract between the businesses.
>
> When one or more of these elements exist in behalf of the business providing the workers, and any contract between the parties designates this business as the "employer," then it will be treated as the employer for state tax purposes as well.

(Emphasis added.) Specifically, factors in addition to the contract language should be evaluated in determining whether the taxpayer was the agent for its patients. However, here the contract language is clear and, when there is no evidence to refute the contract language, we will rely on the contract terms.

There are cases where a three-party arrangement results in the Rule 111 exclusion. See, e.g., Det. No. 92-73, 12 WTD 131 (1993) (Third-party costs charged by escrow companies); MCN, supra (Independent medical evaluations); Sequim, supra (Third party laboratory with specific agreement that the taxpayer was not liable unless the patient paid). However, there are numerous cases where a three-party arrangement does not result in Rule 111 exclusion of income from the B&O tax measure. See, e.g., Det. No. 89-461, 11 WTD 21 (1989) and Det. No. 90-95, 9 WTD 189 (1990) (Fees charged by banks for credit reports, appraisals, and title insurance held not to be advances or reimbursements); Det. No. 88-256, 6 WTD 133 (1988) (Construction contractor may not treat amounts paid for building permits as an advance under Rule 111); Det. No. 90-297, 10 WTD 87 (1990) (Payments made by D.S.H.S to a group home for operating costs do not qualify for Rule 111 treatment); and Det. No. 92-111, 12 WTD 147 (1992) (A security house was entitled to Rule 111 treatment on commissions paid to sales personnel when there was a contract directly with the issuer, but not entitled to Rule 111 treatment when the contract was with the security house).

The third reason the taxpayer erroneously relies on Rho is the nature of the relationship between the taxpayer and radiology firm. We note that it is similar to one of the relationships described in Rho. However, that relationship is not comparable to taxpayer's claims. Specifically, Rho hired technical personnel. The radiology firm hired radiologists. Rho provided the temporary personnel to businesses like Boeing. The radiology firm provided radiologists to the taxpayer. The taxpayer is not in Rho's position, but rather it is similar to Boeing's role. Thus, the Rho decision is factually distinguishable from the claims made by the taxpayer in this appeal.

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[13] Formerly referred to as Revenue Policy Memorandum 90-001.
[14] ETA 90-001 lists ten elements of control.

There is no evidence that the taxpayer's actions were, in any manner, different from those described in the contracts. Thus, in keeping with the Rho Court's requirements and our own rule, we must review the contracts provided by the taxpayer to determine whether there was an agency relationship created by these contracts. This seems impossible because the taxpayer has alleged an agency between itself and the patient, not itself and the third-party provider. The taxpayer provided us with the contracts between it and the laboratories and the radiology firm, but did not provide a contract between itself and the patients.

Radiology Contract:

The taxpayer expressly states in its contracts with these third-party providers that it "provides comprehensive medical care to patients." In this matter, the radiologists performed services at the taxpayer's facility and utilized the taxpayer's equipment. The sole difference between the radiologists and the taxpayer's employees appears to be the contract with the radiology firm**.**

We find the taxpayer is directly responsible for procuring the radiology services. We also find that the exclusive nature of the contract is inconsistent with the taxpayer's claim that an agency relationship exists between the taxpayer and the patient with respect to the radiology services. The taxpayer does not show how this relationship is any different from that of its own physicians and staff at the clinic. The facts support a conclusion that the taxpayer could have hired radiologists—had it so chosen. Thus, the taxpayer could have directly performed the radiology services. The taxpayer merely chose to provide those services through a subcontract with the radiology firm. Therefore, the second condition of Rule 111 is missing.

[4] As to the third condition – liability solely as agent for the patient – the taxpayer agreed to pay the radiology firm a specific percentage of the net collections for specific services provided by the radiology firm. Thus, the taxpayer states Sequim supports its claim that its acts solely as agent for the patient. We find Sequim does not apply to the taxpayer's facts. In Sequim, a medical practice referred patients to a laboratory that was owned by members of the Sequim partnership. Sequim stated it was not liable to the laboratory unless the patient paid for the laboratory services. In arguing Sequim was not entitled to a Rule 111 exclusion, the Department conceded Sequim met the first two conditions for Rule 111 exclusion: specifically, the funds paid were usual and customary and Sequim could not provide the laboratory services. However, the Department argued the third requirement had not been met. Specifically, the Department argued Sequim was liable to the third-party providers because the laboratory services were part of the entire health care package it provided its patients. The BTA rejected the Department's position stating: "The Department's concession to the second prong, 'the payments involve services that the taxpayer could not or did not render', forecloses the Department from making that argument." Thus, the BTA found the Department erred when it failed to refund taxes paid by Sequim on amounts it paid to the laboratory.

In Sequim, the BTA found that the taxpayer was the agent for a laboratory partnership.[15] In the instant appeal, the taxpayer expressly states that it is not the agent of the laboratory or the radiology firm but, rather, the agent for its patients. This is a different relationship. While there is some evidence that the radiology firm would not look to the taxpayer for payment if the patients did not pay, this evidence does not, of itself, create an agency relationship between the patient and the taxpayer. In Mills and Uchida, BTA Docket No. 46110 (1996), the BTA addressed a similar situation. Specifically, Mills and Uchida was a court reporting firm that contracted with individual court reporters and agreed to pay them a percentage of the gross receipts it received for the services they provided. Mills and Uchida argued it was not liable to the individual court reporters unless the client paid the bill. Therefore, Mills and Uchida argued it was liable to the court reporters only as an agent.

The BTA said:

> Mills and Uchida's version of the exemption would characterize revenue generated by subcontract work as "pass-throughs." We decline to make that leap. Mills and Uchida is not prevented from hiring reporters to provide court reporter services.

The BTA stated: "Such a conclusion would mean that any business who uses subcontractors could qualify subcontract work as a 'pass-through' if it had an agreement that it was not liable when the customer failed to pay." The BTA rejected that conclusion.

We note that the Board, in reaching its conclusion in Mills and Uchida, did not refer to Sequim. It neither affirmed nor reversed Sequim, but simply did not apply its own holding to a factually similar issue. We find conspicuous the absence of any mention of Sequim in the Mills and Uchida decision and must conclude under the BTA's decisions if the first two conditions are met and there is an agreement to limit liability when the customer fails to pay for the services then Rule 111's conditions have been met.

There is no evidence that the patients authorize the taxpayer to procure these services on their behalf. Further, there is no evidence either in the radiology contract or by taxpayer's actions that the patient has any control over how the taxpayer acquires the radiology services or whom it uses to provide these services. Thus, the taxpayer is not the agent of the patient when it procures radiology services.

Laboratory Contract:

The laboratory contract also fails to meet the second and third conditions for Rule 111 exclusion. The taxpayer operates a laboratory. Thus, it can and does perform laboratory services for its patients.

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[15] We note that in Sequim many of the partners in the clinic were also partners in the laboratory. We have no evidence that a similar situation exists in the present appeal.

Further, in Sequim, because the Department conceded the first two conditions for Rule 111 treatment, the BTA stated: "In order to qualify as an agent, SFPC must show clearly that the laboratory partnership absolved SFPC of the remaining obligation in situations where SFPC did not collect or remit the charges." But the taxpayer is liable to the laboratory regardless of whether it receives payment from the patient. The taxpayer was required to the pay the laboratory on a "fee for service" basis within 30 days of the laboratory's billing to the taxpayer. Thus, the laboratory contract is distinguishable from the contract in Sequim.

Because we find the taxpayer fails to meet both the second and third conditions for the Rule 111 exclusion, the taxpayer must pay B&O tax on its receipts used to pay its subcontracted laboratory.

The taxpayer also relies on MCN, supra. In MCN, the Court of Appeals found the party who arranged for independent medical examinations (IMEs) was entitled to treat the amounts it received from its clients and paid to the physicians for their services as advances and reimbursements. Generally, IMEs are requested by MCN clients to determine if there is a continuing need for medical treatment for an injury. That is, the client has paid, or may be liable, for medical treatment and wants to know if the injured party recovered.

The court, based on stipulated facts, found that all three Rule 111 conditions were present in MCN.[16] It found the parties agreed that the payments were usual and customary advances. Second, the court found because MCN was not licensed to perform medical services, it could not perform the services and the amounts received were not for the rendition of its services. Finally, the court found based on a stipulation of facts that MCN was not obligated to pay the physicians except as agent for its clients. Thus, the court allowed the Rule 111 exclusion. However, the court's factual findings are not relevant to this appeal. In MCN, the factual findings were based on a stipulation. There is no stipulation in this appeal. In fact, we have found that the taxpayer can and does provide laboratory services.

DECISION AND DISPOSITION:

The taxpayer's request for a refund is denied except for taxes paid on amounts paid to independent third-party laboratories and radiologists during the period between January 13, 1997 and June 16, 1997.

Dated this 28th day of January 1999.

[16 In that case, the court relied on a factual stipulation of the parties that conceded the first two prongs had been met. That is not the case here.]