Cite as Det. No. 01-011, 23 WTD 95 (2004)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Future Reporting Instructions of	)	D E T E R M I N A T I O N
	)	No. 01-011
. . .	)	Registration No. . . .
	)	Docket No. . . .
	)	FY . . . /Audit No. . . .

RULE 168; RCW 82.04.260(12): B&O TAX – SPECIAL RATE -- PUBLIC AND NONPROFIT HOSPITALS – "SERVICES TO PATIENTS" – FAMILY PRACTICE CLINIC. As demonstrated by the phrase "services to patients" in Rule 168(3)(a), the Department has determined that the legislative intent of RCW 82.04.260(12) was to extend the special rate to hospitalization services previously entitled to the RCW 82.04.4289 deduction. This includes hospitalization services rendered by nonprofit hospitals to inpatients and those services that are an "integral, interrelated, and essential part" of the hospital using the Group Health analysis. Family Practice Clinic held not to meet this criteria.

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:

Petition concerning the proper tax classification for revenues earned by a nonprofit hospital's Family Practice Clinic.[1]

FACTS:

Bauer, A.L.J. – Taxpayer's business records were reviewed by the Audit Division (Audit) of the Department of Revenue (Department) for the period January 1, 1991 through June 30, 1995. As a result of this audit, the above-referenced tax assessment was issued on November 22, 1996 in the total amount of $ . . . , which amount included interest calculated to that date. Taxpayer has

[1] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

appealed only Audit's future reporting instructions concerning the taxability of its Family Practice Clinic.

Taxpayer is a nonprofit hospital. It provides comprehensive health care services through its acute care hospitals and other medical organizations. Through June of 1993 there was only one clinic associated with the hospital, and that clinic, deemed the Family Practice Clinic, was inside the hospital adjoining the emergency room. An earlier audit by the Department assessed business and occupation (B&O) tax under the service and other activities classification on the clinic's revenue. This assessment was upheld by the Board of Tax Appeals (BTA) in . . . . The BTA holding was reversed in [Superior Court Decision].

Since the [Superior Court Decision] in 1988, Taxpayer has treated the revenue generated by its Family Practice Clinic as "public or nonprofit hospital" revenue. In 1994, however, two events occurred: First, with the assistance of an affiliate corporation for management, Taxpayer opened and/or acquired . . . more clinics, which now have become part of the Family Practice Clinic. Second, the original clinic referred to above was moved from its location next to the emergency room to a medical office building located on the hospital grounds.

The clinic is advertised separately from the hospital in the telephone book's Yellow Pages as . . . . The ad lists the head physician and . . . other physicians that are available for appointments, and states that the clinic provides "Full Service Family Care . . . ." There is a telephone number for appointments and a business office, both unrelated to those of the hospital. The clinic treats outpatients, as would any other physician's office. The clinic location nearest the hospital is now located in an office complex a few blocks from the hospital building; the other [clinics] are in other various locations around [Washington City]. The clinic has regular business hours.

The clinic is a "Family Practice Residency Program" wherein hospital resident physicians work under the instruction of practicing physicians who treat patients and train the residents. The patients are similar to the patients treated in other clinics and/or regular doctors' offices, and the treatment and fees are similar.

The Family Practice Clinic, because it is, in part, a training program, is generally staffed by younger doctors who are aggressive and highly supervised. If a patient is uninsured (and thus, "self-pay"), the clinic is less expensive than most others. The clinic receives more Medicaid patients than the average, although it tries to attract insured patients also.

A family practice residency must be affiliated with and integrated into a hospital, such as Taxpayer, to be certified. Taxpayer's Family Practice Residency Program is associated, by a long-standing agreement, with the . . . (medical school), which provides physician faculty members to serve as staff members in Taxpayer's Family Practice Clinic. These senior staff members help provide appropriate training for Taxpayer's residents who want to specialize in family medicine. The Family Practice Clinic's senior physician staff members are, therefore, not only Taxpayer's employees, but are also faculty members of the medical school pursuant to the Affiliation Agreement which links Taxpayer's Family Practice Residency Program and the

medical school's Department of Family Medicine. The Family Practice Clinic serves, in part, as a training ground for future primary care physicians.

Taxpayer explains that the family practice residency is generally a 3-year program. During the first year, residents spend four hours per week in the Family Practice Clinic, and the rest of their time in rotations in the hospital (emergency room, obstetrics, orthopedics, intensive care unit, etc.). During the second year, family practice residents spend two days every week in the clinic and the rest of the time in the hospital. During the third year, residents average over three days per week in the clinic and are also on-call in the hospital.

Audit provided future reporting instructions to report Family Practice Clinic revenue under the Service and Other Activities classification. Audit's position, referring Taxpayer to WAC 458-20-168 (Rule 168), was that the clinic was not part of the hospital and that only revenues from the care of hospital inpatients qualified for the Public or Nonprofit Hospital rate. Taxpayer has timely appealed this instruction.

ISSUE:

Should revenues from a hospital's Family Practice Clinic, which operates much like a physician's office, be reported for B&O tax purposes under the Public or Nonprofit Hospital classification of the B&O tax provided by RCW 82.04.026(12)[2], or under the Service and Other Activities rate?

DISCUSSION:

Effective July 1, 1993, the legislature removed the nonprofit hospital deduction contained in RCW 82.04.4289[3] and replaced it with a special "Public or Nonprofit Hospital" rate under RCW 82.04.260(12):

> (12) Upon every person engaging within this state in business as a hospital, as defined in chapter 70.41 RCW, that is operated as a nonprofit corporation or by the state or any of its political subdivisions, as to such persons, the amount of tax with respect to such activities shall be equal to the gross income of the business multiplied by the rate of 0.75 percent through June 30, 1995, and 1.5 percent thereafter. The moneys collected under this subsection shall be deposited in the health services account created under RCW 43.72.900.

Taxpayer argues that Washington hospitals agreed to support the July 1, 1993 change in the law, whereby they became subject to the B&O tax under RCW 82.04.260(12), only because the taxes were to be deposited in the health services account. Taxpayer argues the wording of RCW 82.04.260 would have exactly reflected the language of the prior nonprofit hospital exemption if the legislature intended to merely tax in-patient service revenue. Instead, according to Taxpayer, the

[2] The Public and Nonprofit Hospital tax rate, originally codified as RCW 82.04.260(15), has recently been re-codified as RCW 82.04.260(12). For purposes of this decision, therefore, it will be referred to as RCW 82.04.260(12).

[3] Before that, the deduction was contained in RCW 82.04.430(9).

language adopted was very broad and was intended to extend the special Public and Nonprofit Hospital rate to all business activities conducted by hospitals, and not just services to their inpatients.

WAC 458-20-168 [Rule 168],[4] however, implements RCW 82.04.260(12) as follows:

> (3) There are two B&O tax classifications which can apply to persons providing medical services through the operation of a hospital, with the tax classification dependent on the organizational structure of the hospital. The B&O tax classifications are:
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> (a) Public or nonprofit hospitals. This B&O tax classification applies to gross income derived from personal and professional services to patients by hospitals that are operated as nonprofit corporations, operated by political subdivisions of the state, or operated but not owned by the state. These hospitals became taxable for hospital services under this B&O tax classification on July 1, 1993. These hospitals were required to report under the service B&O tax classification prior to July 1, 1993, but were entitled to a deduction for services rendered to patients.
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> (b) Service. The gross income derived from personal and professional services of hospitals (other than hospitals operated as nonprofit corporations or by political subdivisions of the state), nursing homes, convalescent homes, clinics, rest homes, health resorts, and similar health care institutions is subject to business and occupation tax under the service and other activities classification. This classification also applies to nonprofit hospitals for personal or professional services which are performed for persons other than patients and not otherwise tax classified.

(Emphasis added.) As demonstrated by the phrase "services to patients" in Rule 168(3)(a), the Department has determined that the legislative intent of RCW 82.04.260(12), as discussed below, was to extend the special rate only to services rendered by nonprofit hospitals to its inpatients.

Taxpayer argues it may rely on the [Superior Court Decision] because the operation of its Family Practice Clinic -- except for its relocation --is identical to its operation at the time the decision was issued. Taxpayer argues [Superior Court Decision] relied heavily upon the Washington Supreme Court case, Group Health Cooperative v. Washington State Tax Commission, 72 Wn.2d 422, 433 P.2d 201 (1967) (Group Health), and that Taxpayer's medical residents are even more intimately involved in the operations of the hospital than were the physicians in the "central clinic" in Group Health.

Taxpayer argues the family residency was found to be integrated into the hospital in [Superior Court Decision] because the residency program/clinic at that time was next to the emergency room. Although four years ago Taxpayer moved the clinic to another building on the campus, it was still connected to the hospital by a walkway and, despite another move since the audit, the main clinic is still on Taxpayer's main campus.

[4] Filed May 17, 1994 and effective 31 days later.

The Supreme Court's 1967 decision in Group Health, upon which decision [the Superior Court Decision] purportedly relied, concerned that entity's entitlement to a B&O tax deduction under RCW 82.04.430(9)[5] for the revenue from Group Health's "central clinic." RCW 82.04.430(9) at that time provided as follows:

> In computing tax there may be deducted from the measure of tax the following items:
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> . . .
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> (9) 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 . . . .

RCW 70.41.020(3) provided the following definition of "hospital":

> "Hospital" means any institution, place building, or agency which provides accommodations, facilities and services over a continuous period of twenty-four hours or more, for observation, diagnosis, or care, of two or more individuals not related to the operator who are suffering from illness, injury, deformity, or abnormality, or from any other condition for which obstetrical, medical, or surgical services would be appropriate for care or diagnosis. "Hospital" as used in this chapter does not include . . . clinics, or physician's offices where patients are not regularly kept as bed patients for twenty-four hours or more.

The Supreme Court in Group Health, combining the pertinent portions of both these statutes, concluded that the legislature basically had in mind that the deduction applied to amounts received for services furnished to patients by a hospital, as such facilities and services are ordinarily comprehended." Group Health first reasoned that the RCW 82.04.430(9) deduction did not contemplate ordinary medical consultation and treatment, such as one seeks and obtains in a doctor's office or clinic.[6] The Court then went on to conclude that, even though Group Health was organizationally integrated and its various activities interrelated, that its "services to patients" could still be broken down into two different categories:

> *medical* consultation, diagnosis, treatment, and care by way of home or office calls,
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> and
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> *hospitalization* together with the usual services accompanying such a confinement.

(Group Health, 72 Wn.2d at 432, italicized emphasis in original text.) The Court noted that the bulk of the first type of service -- "medical" -- was essentially furnished and performed in respondent's outlying clinics. The second type of service -- "hospitalization" -- was supplied through respondent's central or hospital facility, including in some measure, at least, "the central clinic which served the central complex on a basis akin to the ordinary intake or emergency room in the average hospital":

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[5] This deduction was later re-codified as RCW 82.04.4289.

[6] Group Health, 72 Wn.2d at 431.

> [T]he 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. . . .[T]he 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. . . .
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> 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 over-all 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.

(Group Health, 72. Wn.2d at 432, 33, emphasis added.) The Group Health decision therefore found the "central clinic" to be, functionally, an integral part of the "hospital" portion of that entity's hospital activities.[7] It was thus rendering a deductible "hospitalization" service, as opposed to a nondeductible "medical" service."

In arriving at its conclusion that the "central clinic" was part of Group Health's "hospital," the Supreme Court considered both (1) the clinic's location in the central facility and, (2) its "round-the-clock intake and emergency services" function for patients who needed immediate hospitalization.[8] Since Group Health was decided, Taxpayer has moved its original Family Practice Clinic away from the hospital, so that it provides neither the emergency room care nor intake function that Group Health's clinic provided, (if [Taxpayer's] ever provided those functions), expanded its operations into various locations throughout the city, and reduced its business hours to resemble those of a regular doctor's office. Clearly, the rationale of Group Health cannot serve as authority for the proposition that Taxpayer's Family Practice Clinic is providing "hospitalization" services.

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[7] As opposed to the outlying clinics. Group Health, 72 Wn.2d at 430.

[8] We also note the Court did not address the clinic staff's employment or training relationship to the hospital.

The Thurston County Superior Court in [the Superior Court Decision] identified three criteria – regular business hours, proximity to central hospital, and exemption from property tax[9] -- to have been "significant" in the Group Health analysis.[10] Unlike the Supreme Court in Group Health, the Superior Court did not look to these criteria in order to determine whether the nature of the clinic's patient services was "medical" or "hospitalization." Instead, it simply gave them equal weight and determined that, because the clinic shared two out of the remaining three criteria with Group Health's "central clinic" (proximity to central hospital and exemption from property tax) – the deduction should apply.

Even were we to concede the correctness of the Superior Court's reasoning in applying Group Health,[11] Taxpayer has since moved its original Family Practice Clinic away from the hospital, expanded its operations into various locations throughout the city, and reduced its business hours to resemble those of a regular doctor's office. Even if the clinic enjoys an exemption from property tax,[12] its loss of proximity to the hospital and its assumption of regular business hours, even under the rationale of the Superior Court's ruling in [the Superior Court Decision], leaves the Family Clinic with only a minority, at best, of the Thurston County Superior Court's three "significant characteristics." Therefore, even under the Superior Court's rationale in [the Superior Court Decision], the [Family Practice Clinic] can no longer be treated as a nonprofit hospital.

Further, Taxpayer has been unable to provide any legislative history or other documentation in support of its argument that the legislature intended to extend the special Public and Nonprofit Hospital rate to all business activities conducted by hospitals, and not just services to their inpatients. In fact, fiscal notes and other documents in the legislative history files[13] indicate an intent, or at least a legislative understanding, that the new special Public and Nonprofit Hospital tax rate (initially at .75%) would be imposed on only that non-profit hospital revenue which had previously been deductible, i.e., revenue received from hospital services to inpatients as previously interpreted by Group Health.[14]

The Department historically took the position that the RCW 82.04.4289 nonprofit hospital deduction applied to gross receipts by otherwise qualifying institutions when they rendered traditional

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[9] We note, however, that Group Health, at 433, noted that it did not consider the exemption from property taxes to be decisive.

[10] A fourth criteria – overnight facilities -- was discounted in the analysis because neither the Group Health nor the [Taxpayer's] clinic provided them.

[11] We decline to do so. As articulated above, we believe the main thrust of Group Health's reasoning was to distinguish between "medical" and "hospital" services rendered to patients. The criteria it used in doing so were for that limited purpose, and were not applied with equal weight.

[12] We do not have this information.

[13] Archives Division, Office of the Washington Secretary of State.

[14] Representative language is as follows: "This bill . . . removes the B&O tax exemption for nonprofit hospitals. . . . Currently, . . . noprofit hospitals do not pay B&O tax at all." See, Fiscal Note, Bill Number E2SSB 5304 as Passed by the Legislature, dated 5/4/93. We also note the Washington Supreme Court's observation in In re Sehome Park Care Center, 127 Wn.2d 774, 781, 903 P.2d 443 (1995), as follows: "Turning to the 1993 amendment to RCW 82.04.4289, we see that the legislature deleted hospitals from the statute entirely . . . . These [published bill summary] documents reveal that the thrust of the bill was to increase, rather than decrease, taxes in order to pay for health care reform."

hospitalization services to patients, and did not apply to income from outpatient medical clinics, even though such clinics might be owned and operated by a nonprofit hospital. Det. No. 92-192, 12 WTD 377 (1992). Departments and services available to both inpatients and outpatients -- e.g., emergency rooms, radiology services, and laboratories -- that were an "integral, interrelated and essential part" of the hospital were evaluated using the Group Health analysis. Det. 90-245, 10 WTD 033 (1990).

As demonstrated by the phrase "services to patients" in Rule 168(3)(a), the Department has determined that the legislative intent of RCW 82.04.260(12), as discussed above, was to extend the special rate to hospitalization services previously entitled to the RCW 82.04.4289 deduction. This would include hospitalization services rendered by nonprofit hospitals to inpatients. Additionally, for departments and services available to both inpatients and outpatients -- e.g., emergency rooms, radiology services, and laboratories -- the Public and Nonprofit Hospital rate will be applicable to those that are an "integral, interrelated and essential part" of the hospital using the Group Health analysis. [15]

Because Taxpayer's Family Practice Clinic does not render services to hospital inpatients, and because it is not an "integral, interrelated, and essential part" of the hospital using the Group Health analysis, its petition to reverse its future reporting instructions directing it to report under the Service and Other Activities classification of the B&O tax, instead of the RCW 82.04.260(12) Public or Nonprofit Hospital classification, must be denied.

DECISION AND DISPOSITION:

Taxpayer’s petition for cancellation of the future reporting instructions in the above-referenced assessment concerning the taxability of the [Family Practice Clinic] is denied.

Dated this 31st day of January, 2001.

[15] We note that Thurston County Superior Court in Empire Health Services v. Department of Rev., No. 99-2-00312-5 (Superior Ct., December 17, 1999) similarly concluded that, in order to qualify for taxation at the nonprofit hospital rate, a taxpayer must provide a service that relates to treatment in the hospital and must provide services that are unique to those provided in a hospital (Conclusion of Law No. 1, emphasis the Court's).