

Cite as Det No. 08-0111, 27 WTD 221, (2008)

BEFORE THE APPEALS DIVISION  
DEPARTMENT OF REVENUE  
STATE OF WASHINGTON

In the Matter of the Petition For )	<u>D E T E R M I N A T I O N</u>
Refund/Correction of Assessment of )	
)	No. 08-0111
)	
)	
)	Registration No. . . .
)	Document No. . . .
)	Audit No. . . .
)	Docket No. . . .
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RCW 82.04.050, RCW 82.04.250, RCW 82.04.290: SERVICE AND OTHER ACTIVITIES B&O TAX -- RETAILING B&O TAX. Revenues of a business operating a website where customers can obtain prescription drugs without a physician, and whereby pharmacies dispense the drugs directly to the customer on behalf of the business, are subject to Retailing B&O tax, given that the dispensing of drugs by the pharmacy is analogous to a drop shipment arrangement wherein the pharmacies sell the drugs at wholesale to the business, and the business sells the drugs at retail to its customers.

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.

Pardee, A.L.J. – Taxpayer, who runs a website where customers can obtain prescription drugs without visiting a physician, appeals the Department of Revenue’s (DOR) imposition of Service and Other Activities B&O tax on what DOR alleges is Taxpayer’s income from hosting a website, arguing that its revenues are properly reportable under the Retailing B&O classification. We grant the petition.<sup>1</sup>

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<sup>1</sup> Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

## ISSUE

Are Taxpayer's revenues from operating a website where customers can obtain prescription drugs without visiting a physician subject to the Retailing B&O classification (RCW 82.04.250(1)) or the Service & Other Activities B&O classification (RCW 82.04.290(2))?

## FINDINGS OF FACT

The Washington business activities of [Taxpayer], a Washington Limited Liability Company, include running a website where customers can obtain prescription drugs without visiting a physician.

Taxpayer never has physical possession of the prescription drugs, and it does not dispense or distribute the prescription drugs. Taxpayer handles and secures the internet transmissions, handles the customer credit card transaction, coordinates the physician review of customer questionnaires and the pharmacy dispensing of the medications, and makes payment to all contracting parties. Each transaction occurs as follows:

- A customer visits Taxpayer's or an affiliate's website, sees a drug she wants to purchase (with a listed price), and clicks to purchase that drug.<sup>2</sup>
- Once a customer clicks to purchase a drug, they are asked to complete a questionnaire. This questionnaire originates from Taxpayer. From this point on, the entire transaction occurs on Taxpayer's server.
- When the questionnaire is complete, the customer signs Taxpayer's Patient Responsibility Statement electronically and authorizes the purchase.
- The questionnaire is then transferred to the physician's queue to await physician review. The physicians have special log-in authorization to access the questionnaires.
- A physician reviews the questionnaire and either approves the request or denies it.
- The physicians are not employees, but independent contractors. They are paid a fee for each questionnaire reviewed, regardless of whether a prescription is approved or denied.
- If the physician approves the prescription request based on the questionnaire, the physician writes and signs (by digital signature) a prescription and sends it to the pharmacy queue on the same server.<sup>3</sup>

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<sup>2</sup> Taxpayer contracts with a large network of websites (affiliates), which serve as advertising portals to prospective customers. The affiliates are required to charge at least Taxpayer's list price for each drug. Taxpayer has an obligation to provide so many hits for the pharmacy to make it attractive for the pharmacy to be involved with the Taxpayer and their website. One of the ways that Taxpayer fulfills this obligation is to use a "hot key" that links other websites with Taxpayer's website, which makes it simple for a purchaser of drugs to be directed to the Taxpayer's website. The connecting websites, called "affiliates" by Taxpayer, usually are businesses engaged in health-care related activities, such as health insurance companies or drug companies. The affiliates receive income from Taxpayer for having this "hot key" on their website. Taxpayer pays these affiliates based on how many "hits" the "hot key" produces to Taxpayer's website.

- The pharmacy accesses the pharmacy queue, using a special log-in, and prints the prescription (together with shipping labels and drug label).
- The pharmacy checks each order against a “blacklist” of customers (maintained by Taxpayer) who have demonstrated abuse or fraud. The pharmacy also checks for any contraindications that the physician may have missed. In addition, both the pharmacy and Taxpayer systems check to ensure that each prescription is not sent to the customer until the customer’s existing prescription has run its course. After running the checks, the pharmacy fills the prescription and ships it to the customer . . . The pharmacy is responsible for procuring and paying for the prescription drugs.
- [When the order is shipped] Taxpayer authorizes the merchant processor to debit the customer’s credit card.

Payment to all other parties is controlled by Taxpayer and occurs as follows:

- Pharmacies are paid [on a regular schedule for the] shipped orders. Payment includes the Medicine Cost, which the pharmacy has paid out in procuring the drugs, and [a] Dispensing Fee (both defined in the . . . Agreement between Taxpayer and the pharmacy).
- Affiliate websites are paid commissions [on a regular schedule]
- Physicians are paid [on a regular schedule].

Taxpayer charges the customer’s credit card when the pharmacy ships the drugs. Taxpayer’s name appears in the descriptor on the customer’s credit card statement. The descriptor does not identify any other party other than Taxpayer as the beneficiary of the charge. From the amount charged the customer, Taxpayer pays the pharmacy, the physician, and the shipping charges.

While the pharmacy prepares the package, the package is identified as having come from Taxpayer, not the pharmacy. [Shipper] bills Taxpayer directly. In the package is a card from Taxpayer thanking the customer for their business, which identifies the customer service number of Taxpayer.

The only place where the customers sees the dispensing pharmacy’s name is on the medication bottle label, because rules and regulations prohibit Taxpayer from putting its name directly on the bottle. However, the phone number listed for the pharmacy on the medication bottle label is actually the phone number for Taxpayer’s customer service line. . . . The pharmacy’s contract with Taxpayer states that prior to dispensing any medication, the pharmacy will have direct access to the customer, and may contact the customer by e-mail or telephone with any questions about a prescription. This section also states that the pharmacy agrees to make itself available to

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<sup>3</sup> [An agreement] by and between the pharmacies and Taxpayer, states that the pharmacy is solely responsible to procure medications to be dispensed. [The agreement also] states that both the pharmacy and taxpayer agree that the pharmacy and Taxpayer are not the same business and the pharmacy is an independent contractor. Furthermore, the [agreement] states that the pharmacy represents that it complies with all rules governing the shipment of drugs, including but limited to, laws and regulations governing delivery, packaging, and shipment of prescription drugs.

Taxpayer and/or any governmental or regulatory authorities to the extent there are any questions or concerns about a particular prescription.

The . . . Agreement . . . by and between the pharmacies and Taxpayer, provides [that Taxpayer operates as an internet pharmacy].

The Audit Division (Audit) of the DOR examined the taxpayer's books and records for the period January 1, 2003, through December 31, 2005. Audit issued the assessment, Document No. . . ., on . . ., 2006, in the amount of \$. . ., which included Service & Other Activities B&O tax in the amount of \$. . ., retail sales tax in the amount of \$. . ., offsets for a small business credit in the amount \$. . ., and B&O tax previously paid under the Prescription Drug Warehousing classification in the amount of \$. . ., interest in the amount of \$. . ., and a five percent assessment penalty in the amount of \$. . .

### ANALYSIS

In its Appeal Petition (Petition) dated . . ., 2006, Taxpayer argues that its revenues are properly reportable under the Retailing B&O classification, and that an interstate sales deduction may be claimed for the sales of products shipped to customers outside Washington.

There is levied and shall be collected from every person a tax (B&O) for the act or privilege of engaging in business activities. RCW 82.04.220. Such tax shall be measured by the application of rates against value of products, gross proceeds of sales, or gross income of the business, as the case may be. *Id.*

RCW 82.04.250(1) mandates that every person engaging within the State of Washington in the business of making sales at retail shall be subject to Retailing B&O tax on the gross proceeds of sales of the business at the rate specified therein.

“Sale at retail” or “retail sale” means every sale of tangible personal property to all persons other than a sale to a person who presents a resale certificate under RCW 82.04.470 and who:

(a) Purchases for the purpose of resale as tangible personal property in the regular course of business without intervening use by such person . . .

RCW 82.04.050(1). “Sale” is defined in RCW 82.04.040 as:

[A]ny transfer of the ownership of, title to, or possession of property for a valuable consideration and includes any activity classified as a “sale at retail” or “retail sale” under RCW 82.04.050.

RCW 82.04.290(2) requires that every person engaging within this state in any business activity other than or in addition to an activity taxed explicitly under RCW 82.04.290(1) or another section of RCW Ch. 82.04 shall be subject to Service and Other Activities B&O tax on account of such activities at the rate specified therein multiplied by the gross income of the business.

Taxpayer argues that its sales of prescription medications are sales at retail within the meaning of RCW 82.04.040 and RCW 82.04.050(1).

In the Auditor's Detail of Differences (DOD), dated . . . , 2006, Audit claims that because Taxpayer does not maintain a stock of goods from which it can sell, due to the fact it cannot purchase the prescription drugs, and because Taxpayer cannot take physical possession of the drugs which would allow it to pass title to the drugs, Taxpayer cannot sell the drugs it does not own. In addition, Audit claims in the DOD that just because taxpayer pays a third party to ship the drugs does not mean that title has passed to Taxpayer (i.e., Audit does not view Taxpayer as taking "constructive possession" of the drugs as a result). Audit takes the position that the pharmacies with whom Taxpayer contracts are the retail sellers of prescription drugs to the customer.

Audit confuses the "dispensing" of drugs with the "sale" of drugs. While the Pharmacies "dispense" drugs directly to the customer, they are "selling" drugs at wholesale to Taxpayer. It is the Taxpayer that is selling the drugs at retail to the customer. . . .

Taxpayer explains in its Petition . . . that its contract with the pharmacies only requires the pharmacies to provide services, including dispensing medications to customers. The contract does not in any way indicate that the pharmacy is selling directly to the customer. [On] its Petition Taxpayer cites the definition of "dispense" or "dispensing" promulgated by the National Association of Boards of Pharmacy, which is as follows:

[T]he interpretation, evaluation, and implementation of a Prescription Drug Order, including the preparation and Delivery of a Drug or Device to a patient or Patient's agent in a suitable container appropriately labeled for subsequent Administration to or use by, a patient.

After citing this definition, Taxpayer explains . . . that this definition does not indicate that a retail transaction necessarily takes place when medications are dispensed. The analysis which follows demonstrates that Taxpayer is correct.

An exemption from sales tax concerning prescription<sup>4</sup> drugs is codified in RCW 82.08.0281(1),<sup>5</sup> which reads as follows:

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<sup>4</sup> "Prescription" is defined in RCW 82.08.0281(4)(a) as:

[A]n order, formula, or recipe issued in any form of oral, written, electronic, or other means of transmission by a duly licensed practitioner authorized by the laws of this state to prescribe.

WAC 458-20-18801(1)(b) (Rule 18801(1)(b)) defines "prescription" as follows:

[A] formula or recipe or an order written by a medical practitioner or the composition, preparation and use of a healing, curative or diagnostic substance, and also includes written directions and specifications by

The tax levied by RCW 82.08.020 shall not apply to sales of drugs for human use dispensed or to be dispensed to patients, pursuant to a prescription.

The element of sale is separate from the element of drugs being dispensed in RCW 82.08.0281(1). There are three elements that must be satisfied to claim the exemption in RCW 82.08.0281(1), which are as follows:

- (1) There must be a sale of drugs for human use;
- (2) Dispensed or to be dispensed to patients; and
- (3) Pursuant to a prescription.

The statute contemplates that the sale of the drugs can be a separate event from the dispensing of the drugs. For example, a drug company might sell prescription drugs to a clinic, which in turn dispenses the prescription drugs free of charge to its patients. In that case, the sale to the clinic would be a retail sale, even though the drug company did not “dispense” the drugs to the clinic. Therefore, Audit’s argument that a pharmacy dispensing drugs is equivalent to a retail sale of the drugs is erroneous.

Taxpayer sells the drugs in its own name. Taxpayer’s name appears in the descriptor on the customer’s credit card statement. The descriptor does not identify any other party other than Taxpayer as the beneficiary of the charge. From the amount charged the customer, Taxpayer pays the pharmacy, the physician, and the shipping charges. In addition, the pharmacy sends the product to the customer [using Taxpayer’s shipping] account. While the pharmacy prepares the package, the package is identified as having come from Taxpayer, not the pharmacy. In the package is a card from Taxpayer thanking the customer for their business, which identifies the customer service number of Taxpayer.

We conclude that the pharmacies sell the drugs at wholesale to Taxpayer; Taxpayer in turn sells drugs at retail to its customers. The pharmacies dispense those drugs directly to the customer by having them delivered to the customer on behalf of Taxpayer.<sup>6</sup> This is analogous to a drop shipment.<sup>7</sup>

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physicians or optometrists for the preparation, grinding, and fabrication of lenses intended to aid or correct visual defects or anomalies of humans.

<sup>5</sup> This statute became effective July 1, 2004. However, for purposes of this analysis we do not have to address the prior version of RCW 82.02.0281 which was in effect until July 1, 2004. Even under the previous version of RCW 82.08.0281, the sale of drugs and dispensing of drugs are considered to be entirely different events:

The tax levied by RCW 82.08.020 shall not apply to sales of prescription drugs, including sales to the state or a political subdivision or municipal corporation thereof of drugs to be dispensed to patients by prescription without charge.

<sup>7</sup> A similar drop shipment arrangement was analyzed in Det. No. 95-134E, 15 WTD 149 (1996). In Det. No. 95-134E, taxpayer protested the assessment of litter tax on baking ingredients and packaging containers which were drop shipped to taxpayer’s customers, arguing that it never had physical possession of the items. The taxpayer therein described a drop shipment as follows: First, the taxpayer received an order from its customer (a retailer) for

Taxpayer's revenues are subject to the Retailing B&O classification (RCW 82.04.250(1)), with a deduction for sales of drugs that are delivered out of state.

#### DECISION AND DISPOSITION

Taxpayer's petition for correction is granted. .

Dated this 18<sup>th</sup> day of April 2008.

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certain items (e.g., disposable pie pans); second, the taxpayer placed the order with its supplier for the items; third, the order directed the supplier to deliver the items directly to the taxpayer's customer (a retailer). The taxpayer reported these drop shipment sales as wholesale transactions for B&O tax purposes. The DOR agreed that these drop shipment sales were wholesale transactions, even though the taxpayer (wholesaler) did not take possession of the products.