Cite as Det No. 07-0209, 27 WTD 145 (2008)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Tax Ruling of	)	D E T E R M I N A T I O N
	)	No. 07-0209
. . .	)	Registration No. . . .
	)	Docket No. . . .

[1] RULE 169, RCW 82.04.4297, RCW 82.04.431: B&O TAX -- DEDUCTION -- NON-PROFIT HEALTH & WELFARE ORGANIZATION -- ELIGIBILITY REQUIREMENTS -- PAID EMPLOYEE. A physician employed by an independent third-party service provider that had a contract to provide professional services to a nonprofit health or social welfare organization was not a "paid employee" of the health or social welfare organization.

[2] RULE 169, RCW 82.04.431: B&O TAX -- DEDUCTION -- NON-PROFIT HEALTH & WELFARE ORGANIZATION -- ELIGIBILITY REQUIREMENTS – INDIRECT PAYMENT OF INCOME. Where an independent third-party service provider employs a member of an organization's board of trustees, a payment of reasonable compensation to the service provider for actual services rendered does not constitute a prohibited indirect payment of the organization's income to a trustee.

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.

Okimoto, A.L.J. – A nonprofit health or social welfare organization appeals a Taxpayer Information and Education (TI&E) letter ruling that an employee of an independent third-party service provider placed on its board of trustees disqualifies it from claiming a business and occupation (B&O) tax deduction under RCW 82.04.4297. We reverse the TI&E ruling.[1]

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

ISSUES

1) Is a physician, employed by an independent third-party service provider under contract to provide professional services to a nonprofit health or social welfare organization, a "paid employee" of the health or social welfare organization for purposes of WAC 458-20-169 and RCW 82.04.431?

2) Under Rule 169 and RCW 82.04.431, does reasonable compensation paid to an independent third-party service provider who employs a member of the nonprofit organization's board of trustees constitute an indirect payment of the organization's income to a trustee?

FINDINGS OF FACT

[Taxpayer] is a nonprofit[2] acute care hospital located in . . . Washington. It is a health or social welfare organization under RCW 82.04.431. Under RCW 82.04.4297, it can deduct from its B&O taxes amounts received from instrumentalities of the United States and the state of Washington as compensation for health or social welfare services.

[Taxpayer] needed a qualified physician to oversee, train, accredit, and assist Hospital's program manager with [a specialized program]. Hospital contracted with [a PLLC] for a physician to provide . . . oversight and other related services. PLLC is an independent professional limited liability company made up of . . . physician members that work in . . . different locations. PLLC's principal business activity is to provide physician services to patients. PLLC employs the . . . physician members to provide those services. In addition, PLLC is responsible for all physician payroll taxes, including federal withholding and social security. PLLC also employs several administrative and support staff . . . to enable it to provide medical services to patients. PLLC is responsible for all administrative and support staff salaries and benefits. PLLC is also responsible for providing office space, working areas, and other overhead expenditures related to physician services to patients. PLLC is registered and files tax returns with the Internal Revenue Service and the Washington State Department of Revenue.

In addition to physician services, PLLC also provides management services for Hospital's [specialized program]. Under a professional services contract, PLLC selects the medical director, subject to Hospital's approval. Once a physician or co-physicians are selected by PLLC, the physicians continue to see patients in their private capacity. The physician serves as the [specialized program] medical director for a limited number of hours per month. Hospital pays PLLC $. . ./hour to perform the management and oversight services for its [specialized program]. The hourly fee paid to PLLC for the [specialized program] medical director services is reasonable and within the fair market value for similar services. . . . At year-end, Hospital submits an IRS Form 1099 to report PLLC's income.

[2] Under RCW 24.03.005(3) the term nonprofit and not for profit are the same and we will use them interchangeably.

Hospital was aware of the numerous restrictions limiting the B&O tax deduction under RCW 82.04.[4297]. Hospital also wanted the most informed and qualified candidates to serve on its Board of Trustees. In addition, a Joint Commission on Accreditation of Health Care Organizations' hospital accreditation standards requires that a physician serve on a hospital's board, unless it is illegal. Due to the size of the community and a desire for a physician board member who was familiar with local standards of care, Hospital began an inquiry to determine whether it could appoint a physician medical director to its Board of Trustees. . . . Hospital's attorney wrote a letter to TI&E inquiring whether it could appoint the PLLC physician serving as medical director for Hospital's [specialized program] to the Hospital's Board of Trustees without violating the RCW 82.04.431 restrictions.

TI&E ruled that appointing the Medical Director to Hospital's Board of Trustees would make Hospital ineligible for the B&O tax deduction allowed by RCW 82.04.4297 for two separate reasons. First, TI&E ruled that, because the Medical Director was controlled by Hospital and its board, the Medical Director was considered a paid employee of Hospital for purposes of RCW 82.04.431. Second, TI&E ruled that RCW 82.04.431(1)(a), prohibited Hospital from paying any part of its gross income directly or indirectly to its members, officers, directors, or trustees. TI&E ruled that since Hospital was paying PLLC for medical director services performed by a physician employed by PLLC, Hospital would be indirectly paying a portion of Hospital's gross income to a Board of Trustees member. TI&E relied on Det. No. 91-187, 11 WTD 379 (1992) in support of its position.

ANALYSIS

RCW 82.04.4297 allows a B&O tax deduction to a health or social welfare organization for amounts received from instrumentalities of the United States and the state of Washington as compensation for health or social welfare services. RCW 82.04.431(1) defines "health or social welfare organization" as:

> [A]n organization, including any community action council, which renders health or social welfare services as defined in subsection (2) of this section, which is a not-for-profit corporation under chapter 24.03 RCW and which is managed by a governing board of not less than eight individuals <u>none of whom is a paid employee of the organization</u> or which is a corporation sole under chapter 24.12 RCW. Health or social welfare organization does not include a corporation providing professional services as authorized in chapter 18.100 RCW.

(Underlining added.)

[1] TI&E first ruled that the medical director and potential trustee was controlled by Hospital and therefore a paid employee of Hospital under RCW 82.04.431(1). On that basis, TI&E ruled that the medical director was prohibited from being on the Hospital's Board of Trustees. We disagree.

The Department weighs and evaluates a number of different factors when determining if a person is an employee or independent contractor. WAC 458-20-105 (Rule 105) lists the conditions which indicate that a person is an employee of a company. It provides:

> (4) **Employees.** The following conditions indicate that a person is an employee.
> If the person:
> (a) Receives compensation, which is fixed at a certain rate per day, week, month or year, or at a certain percentage of business obtained, payable in all events;
> (b) Is employed to perform services in the affairs of another, subject to the other's control or right to control;
> (c) Has no liability for the expenses of maintaining an office or other place of business, or any other overhead expenses or for compensation of employees;
> (d) Has no liability for losses or indebtedness incurred in the conduct of the business;
> (e) Is generally entitled to fringe benefits normally associated with an employer-employee relationship, e.g., paid vacation, sick leave, insurance, and pension benefits;
> (f) Is treated as an employee for federal tax purposes;
> (g) Is paid a net amount after deductions for employment taxes, such as those identified in subsection (3)(h) of this section.

We will evaluate the significant conditions listed above as they apply to the Medical Director. In this case, Medical Director receives compensation that is fixed at a certain amount per hour. The compensation is paid first to PLLC who then pays it to Medical Director. Although Medical Director performs professional services for Hospital, he is not subject to Hospital's control in the manner those services are performed. The services contract specifically states that the Medical Director is to exercise his discretion and judgment as to the manner and means of providing services under the agreement, [without direction or control of the hospital]. While, Hospital does have authority to approve or disapprove of the appointment of a medical director assigned by the PLCC, Hospital has no control of the medical director's day-to-day exercise of professional judgment. In respect to the [specialized program], Hospital provides office space, equipment, and overhead expenses. Medical Director is not entitled to any fringe benefits from Hospital normally associated with an employer-employee relationship; e.g., paid vacation, sick leave, insurance, and pension benefits. The Medical Director is not treated as an employee of Hospital for federal tax purposes. The PLLC receives a gross amount of compensation from Hospital without any deductions. PLLC also determines the Medical Director's compensation, the deductions for employment taxes and fringe benefits, if any.

Rule 105 also lists the conditions that indicate a party is engaging in business as an independent contractor. It provides:

> (3) **Persons engaging in business.** The term "engaging in business" means the act of transferring, selling or otherwise dealing in real or personal property, or the rendition of services, for consideration except as an employee. The following conditions will serve to indicate that a person is engaging in business.
> If a person is:

(a) Holding oneself out to the public as engaging in business with respect to dealings in real or personal property, or in respect to the rendition of services;

(b) Entitled to receive the gross income of the business or any part thereof;

(c) Liable for business losses or the expense of conducting a business, even though such expenses may ultimately be reimbursed by a principal;

(d) Controlling and supervising others, and being personally liable for their payroll, as a part of engaging in business;

(e) Employing others to carry out duties and responsibilities related to the engaging in business and being personally liable for their pay;

(f) Filing a statement of business income and expenses (Schedule C) for federal income tax purposes;

(g) A party to a written contract, the intent of which establishes the person to be an independent contractor;

(h) Paid a gross amount for the work without deductions for employment taxes (such as Federal Insurance Contributions Act, Federal Unemployment Tax Act, and similar state taxes).

In evaluating the significant conditions listed in Rule 105(3), we note the Medical Director is entitled to receive that portion of PLLC's gross income generated by the professional services contract. PLLC is also liable for any business losses related to the professional services contract and for physician services rendered to patients. Although Medical Director may supervise others regarding some aspects of the [specialized program], final responsibility and authority for management of the [specialized program] is retained by Hospital. Medical Director is not personally liable for any of the Center's payroll. PLLC, however, controls, supervises, and employs Medical Director, physicians, and support staff . . . and is liable for all payroll expenses incurred. PLLC also maintains its own books and records and files the appropriate tax returns with the Internal Revenue Service and Washington State Department of Revenue. In addition, the management contract between PLLC and Hospital specifically provides: "[PLLC] shall be an independent contractor and not an employee of Hospital.... [and] shall not have any claim against Hospital for employee benefits of any kind from Hospital."[3] Finally, the Medical Director and PLLC are paid a gross amount for services performed without deduction for employment taxes. All applicable state and federal payroll taxes, Social Security, federal withholding, employee benefits, and other taxes, expenses, or deductions in connection with the compensation received by PLLC remain the responsibility of PLLC. After evaluating the conditions listed in Rule 105(3), we conclude Medical Director and PLLC are independent contractors hired by Hospital to perform professional services and not employees of the hospital. Therefore, the Medical Director is not a "paid employee" of Hospital for purposes of RCW 82.04.431.

TI&E's reliance on Det. No. 91-187, 11 WTD 379 (1992) in ruling that the Medical Director was a paid employee of Hospital was misplaced. Unlike the hospital now before the appeals division, the hospital discussed in the WTD had a single member "P" that was also a nonprofit

[3] *Agreement for Co-Medical Director of Wound Management Services*, §5(b).

corporation. P acted as the general administrator overseeing and coordinating all of Hospital's activities. Five of Hospital's corporate officers, including its president, executive director, secretary/treasurer, and two vice presidents, were members of Hospital's Board of Trustees in addition to being paid employees of P. It was this closely related structure of Hospital and P that resulted in little or no independence and a conclusion that the board members were paid employees of the hospital.

In addition, we note that corporate officers generally satisfy all of the requirements for being an employee under Rule 105. Corporate officers generally receive compensation, which is fixed at a certain rate per day, week, month or year payable in all events; are employed to perform services in the affairs of another, subject to the other's control or right to control; i.e., through the Board of Director's authority to remove officers;[4] have no liability for the expenses of maintaining an office or other place of business, or any other overhead expenses or for compensation of employees; generally have no liability for losses or indebtedness incurred in the conduct of the business; and are generally entitled to fringe benefits normally associated with an employer-employee relationship, e.g., paid vacation, sick leave, insurance, and pension benefits. Corporate officers are also generally treated as employees for federal income tax purposes and paid a net amount after deductions for employment taxes. In this regard, the present case differs significantly from Det. No. 91-187.

In Taxpayer's case, Medical Director is not a corporate officer of Hospital and is not subject to Hospital's direct control. PLLC is an independent third-party service provider. Consequently, any removal of Medical Director would have to be done indirectly through PLLC's independent management team or by termination of the contract.[5] Therefore, Det. No. 91-187 is not applicable. We reverse TI&E's ruling on this issue.

[2] Next, TI&E ruled that, if the Medical Director was appointed to Hospital's Board of Trustees this would violate RCW 82.04.431's restrictions, because the professional services contract between Hospital and PLLC would constitute an indirect payment of Hospital's income to a member of Hospital's Board of Trustees.

The provision in RCW 82.04.431upon which TI&E relies states:

> (1) For the purposes of RCW 82.04.4297, the term "health or social welfare organization" means an organization, including any community action council, which renders health or social welfare services as defined in subsection (2) of this section, which is <u>a not-for-profit corporation under chapter 24.03 RCW</u> and which is managed by a governing board of not less than eight individuals none of whom is a paid employee of the organization . . . . <u>In addition</u> a corporation in order to be exempt under RCW 82.04.4297 shall satisfy the following conditions:

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[4] *See* RCW 24.03.130.

[5] The agreement allows either party to terminate the agreement at any time without penalty or cause upon sixty days (60) written notice. . . .

> (a) No part of its income may be paid directly or indirectly to its members, stockholders, officers, directors, or trustees except in the form of services rendered by the corporation in accordance with its purposes and bylaws;
> (b) Salary or compensation paid to its officers and executives must be only for actual services rendered, and at levels comparable to the salary or compensation of like positions within the public service of the state; . . .

(Underlining added.)

Over the years, Washington courts have developed several rules for interpreting statutes. The goal of any statutory construction is to ascertain and carry out the Legislature's intent, and if the statute's meaning is plain on its face, then its plain meaning must be given effect as an expression of legislative intent. *State v. J.M.*, 144 Wn. 2d 472, 28 P.3d 720 (2001). Under a plain meaning analysis:

> Additionally, while traditional plain language analysis of statutes focused exclusively on the language of the statute, this court recently has also recognized that "all that the Legislature has said in the statute and related statutes" should be part of plain language analysis. Dep't of Ecology v. Campbell & Gwinn, L.L.C. 146 Wash. 2d 1, 11, 43 P.3d 4 (2002).

Cerrillo v. Esparza, 158 Wn. 2d 194, 142 P.3d 155, 159 (2006).

The definition of a "health or social welfare organization" in RCW 82.04.431 requires that the organization be a not-for-profit corporation under "chapter 24.03 RCW." This specific reference to chapter 24.03 RCW, (The Washington Nonprofit Corporation Act) allows any legislative statements made in this related statute to be considered in a "plain-meaning" analysis. See *Dep't of Ecology v. Campbell, L.L.C.*, 146 Wn. 2d 1, 43 P. 3d 4 (2002).

In Washington's Nonprofit Corporation Act the Legislature placed certain limitations on a nonprofit corporation's powers to conduct its business. In particular, RCW 24.03.030 provides that a nonprofit corporation:

> (2) Shall not make any disbursement of income to its members, directors or officers;
> (4) May pay compensation in a reasonable amount to its members, directors or officers for services rendered;
> (5) May confer benefits upon its members in conformity with its purposes;

As structured, a nonprofit corporation may not take certain actions, in contrast to for-profit corporations (*see* RCW 23B.03.020), and may take certain actions, e.g., pay compensation to directors and officers, subject to certain limitations.

The definition of "health or social welfare organization" contained in RCW 82.04.431 uses similar criteria and a similar structure. It provides that, "in addition" to the requirements of RCW 24.03, such organizations are further limited in taking certain actions (making direct or

indirect payment of income) and allows certain actions, e.g., paying compensations, subject to certain further limitations. It provides:

> In addition a corporation in order to be exempt under RCW 82.04.4297 shall satisfy the following conditions:
> (a) No part of its income may be paid directly or indirectly to its members, stockholders, officers, directors, or trustees except in the form of services rendered by the corporation in accordance with its purposes and bylaws;
> (b) Salary or compensation paid to its officers and executives must be only for actual services rendered, and at levels comparable to the salary or compensation of like positions within the public service of the state; . . .

Under a plain reading of the limitation contained in RCW 82.04.431(1)(a), the statute does not prohibit a nonprofit health or social welfare corporation from paying compensation in limited amounts to its members, directors, or officers for services rendered. On the contrary in RCW 24.03.030(4), the Legislature specifically conferred authority for a nonprofit corporation to make a reasonable payment for services rendered. We also conclude that RCW 82.04.431(1)(b) is not an exception to RCW 82.04.431(1)(a) but instead a further limitation on the salary or compensation that can be paid to officers and executives of a health or social welfare corporation in addition to the limitations contained in RCW 24.03.030(4). Since RCW 82.04.431(b) is silent on salaries or compensation paid to members and directors, no further limitation above those contained in RCW 24.03.030(4) applies to their compensation. Therefore, we conclude that the plain meaning of RCW 82.04.431, after considering related statutes, including RCW 24.03.030, permits a nonprofit health or social welfare corporation to pay directors and trustees "a reasonable amount of compensation for services rendered."

We have considered TI&E's argument that the term "income" in RCW 82.04.431(1)(a) should be interpreted to mean "gross income" and thereby prohibit any payment to members, officers, directors, or trustees even if those payments are reasonable and for services actually rendered. We conclude that such an interpretation is overly broad and leads to the unreasonable result that no member, director or trustee could receive any payment for services rendered, whatsoever, no matter how reasonable, e.g., a reimbursement for actual expenses incurred.

Furthermore, because RCW 82.04.431(1) includes officers under both subsection (a) and (b), TI&E's interpretation would require that we add the word "gross" before "income" in RCW 82.04.431(1)(a) and the words "except that" before "Salary" in RCW 82.04.431(1)(b). This we can not do. "Courts may not read into a statute matters that are not in it and may not create legislation under the guise of interpreting a statute." *Kilian v. Atkinson*, 147 Wn. 2d at 16, 21, 50 P.3d 638 (footnote omitted) (citing *Associated Gen. Contractors v. King County*, 124 Wn. 2d 855, 865, 881 P.2d 996 (1994). We further note that had the Legislature intended the term "income" to mean "gross income" in RCW 82.04.431(1)(a) and for the provision in RCW 82.431(1)(b) to be an exception, it could easily have added the necessary additional words to the statute, as it had done in a similar tax exemption for fund-raising activities by nonprofit

organizations. *See* RCW 82.04.3651(2)(c).[6]

Finally, TI&E contends that the following published determinations, Det. No. 91-187, 11 WTD 379 (1992), Det. No. 91-186, 11 WTD 375 (1991) and Det. No. 95-124, 15 WTD 145 (1995) require a different result. However, each of the above published determinations involved a paid officer or paid employee of the nonprofit organization that also served on the nonprofit organization's Board of Directors.[7] This is clearly prohibited by RCW 82.04.431(1) and justified disallowing the deduction in each case.

Determination No. 91-187 also states that the management contract with P disqualifies the organization from the deduction contained in RCW 82.04.4297, because the contract would constitute an indirect payment of the organization's gross income to a Board member. We conclude that statement to be dicta and inconsistent with the Legislature's intent. Therefore, to the extent that Det. No. 91-187, Det. No. 91-18, and Det. No. 95-124 hold or imply that a board member of a health or social welfare organization may not be employed by an independent third-party service provider of the health or social welfare organization, even though the payments to the service provider are reasonable for the services rendered and the board member is not a paid employee of the organization or a closely related organization, we overrule those determinations.

DECISION AND DISPOSITION

Taxpayer's petition to correct TI&E's letter ruling is granted.

Dated this 31st day of July 2007.

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[6] RCW 82.04.3651(2)(c) provides: "A nonprofit organization that meets all of the following criteria: (i) The members, stockholders, officers, directors, or trustees of the organization do not receive any part of the organization's **gross income, except** as payment for services rendered." (Bolding added.) An earlier version of this exemption was contained in the same bill that enacted the original exemption now contained in RCW 82.04.427 and RCW 82.04.431. *See Laws of Washington 1979, 1st ex. Sess.*, chapter 196, §§ 6 & 7.

[7] Det. No. 91-186, 11 WTD 375 (1991) involved a nonprofit hospital under Chapter 24.03 RCW and §501(c)(3) of the Internal Revenue Code and sought a B&O tax deduction under RCW 82.04.4297. The hospital's board of trustees consisted of eight members, one of whom was also a paid employee of the nonprofit hospital. The Department correctly ruled that the hospital was not qualified for the B&O tax deduction under RCW 82.04.4297. Similarly, Det. No. 95-124, 15 WTD 145 (1996) involved a nonprofit hospital whose president also served on the hospital's board of directors. Det. 95-124 held that because the hospital's President was a paid employee, the hospital was also not entitled to the deduction.