Cite as Det. No. 98-151E, 18 WTD 74 (1999)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment of	)	E X E C U T I V E D E T E R M I N A T I O N
	)	No. 98-151E
. . .	)	Registration No.. . .
	)	FY. . ./Audit No. . . .
	)	FY. . ./Audit No. . . .

[1] RULE 190, RULE 233; ETB 350: B&O TAX -- FEDERAL INSTRUMENTALITY -- MEDICARE INTERMEDIARY. A fiscal intermediary for Medicare is not a federal instrumentality. Receipts from the federal government for administrative fees are subject to service B&O tax.

[2] RULE 155, RULE 257; RCW 82.04.050: RETAIL SALES TAX -- B&O TAX -- COMPUTER SERVICES -- COMBINED BILLINGS. A computer system company's receipts from billings, which include charges for updates and modifications to "canned software" are taxable under the retailing classification and subject to retail sales tax unless records adequately segregate charges for software and services taxable under the retailing classification from other services normally taxed under other classifications, ACCORD: Det. No. 93-158, 13 WTD 302 (1994); Det. No. 89-43A, 8 WTD (1989).

[3] RULE 109; RCW 82.04.4281; ETA 571: B&O TAX -- INVESTMENT INCOME -- DEFERRED PAYMENT – ACCOUNTS RECEIVABLE. Income earned from investments, rather than for deferral of payment on accounts receivable, may be excluded from the measure of tax.

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 Medicare fiscal intermediary protests the taxability of receipts from the federal government for administrative expenses.[1]

FACTS:

M. Pree, A.L.J. -- . . .The (taxpayer) is a nonprofit Washington Corporation. The taxpayer acts as a Medicare fiscal intermediary for Medicare Part A (hospitals and other institutions) in Washington and another state. The Health Care Financing Administration (HCFA) of the federal government paid the taxpayer to act as the intermediary. The taxpayer did not include receipts from HCFA in its measure of business and occupation (B&O) tax.

The Department of Revenue (Department) reviewed the taxpayer's books and records for the period July 1, 1996 through December 31, 1996. The Department's Audit Division issued the above referenced assessments on September 10, 1997. The assessments included three disputed items: (1) B&O tax on the payments from the United States to the taxpayer, (2) Use tax on computer services, and (3) B&O tax on interest from intercorporate balances.

The primary issue is the taxability of Medicare administrative fees. The taxpayer contracts with HCFA to review and pay medical claims for Medicare recipients. HCFA paid the taxpayer amounts to reimburse actual claims[2] as well as Medicare administrative fees. In two assessments, the Audit Division assessed $. . . selected business services B&O tax on the Medicare administrative fees. The taxpayer states it does not seek an exemption under a WAC 458-20-111 (Rule 111) reimbursement principle. Rather, the taxpayer seeks an exemption under WAC 458-20-190 (Rule 190) for sales to the United States and its instrumentalities.

Medicare is a federal health insurance program covering millions of beneficiaries who are 65 or over, disabled, or suffering from kidney failure. The Medicare program consists of two parts: Part A, which pays for inpatient hospital services, skilled nursing facilities, home health services, and hospice care; and Part B, which pays for physician services and certain other medical services and supplies.

Hospitals and other providers of services under Medicare Part A may nominate an organization to serve as a Part A fiscal intermediary. The fiscal intermediary calculates the amounts providers should receive for services covered under Part A. The HCFA enters contracts with the providers' nominees to serve as the fiscal intermediary. HCFA agrees to pay the intermediaries for the necessary and proper costs to perform the functions under the contract.

While the taxpayer refers to the administrative fee as being reimbursed, the Audit Division states the fee is a charge for handling and servicing Medicare payments. The Audit Division did not tax actual medical costs reimbursed by the federal government. The fee covers office overhead,

[1] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.
[2] Receipts from reimbursement of the actual medical claims were not taxed, and are not at issue.

including computer charges, telephone costs; salaries for clerks; administrators and others; and other miscellaneous costs. The taxpayer's agreement with HCFA states:

> A. It is the intent of this agreement that the [taxpayer] in performing its functions under this agreement, shall be paid its costs of administration under the principle of neither profit or loss to the [taxpayer] subject to paragraph B below.
>
> B. In determining the cost allowable under this agreement, the secretary shall take into account the amount which is reasonable and adequate to meet the costs which must be incurred by an efficiently and economically operated [taxpayer] in carrying out the terms of this agreement. . .

Appendix B of the agreement includes taxes as a type of allowable cost. HCFA determines allowable costs in accordance with provision referenced in the Code of Federal Regulations (CFR).[3]

The Audit Division and the taxpayer differ on how they characterize the extent of government involvement. The taxpayer considers HCFA involvement extensive, with pervasive day to day supervision by HCFA employees. The Audit Division questions whether the extent of involvement exceeds that of other regulated, but taxable industries. The taxpayer, also, states its employees enjoy the status of government officials. The taxpayer explains this means its employees have similar immunity from lawsuits as federal employees.

The taxpayer's employees answer questions for several insurance companies as well as Medicare. The taxpayer states government officials are at the taxpayer's facility several days a month to evaluate the taxpayer's performance throughout the year. The taxpayer provided examples of HCFA directives regarding daily routine tasks. The taxpayer must meet detailed performance requirements in order for HCFA to approve expenditures.

The taxpayer hires and fires its employees. It trains them using government issued Medicare manuals. The taxpayer follows extensive detailed Medicare regulations. Its employees frequently call federal employees with questions on Medicare policies and procedures.

The taxpayer contends that when it acts as a Medicare intermediary, it is an instrumentality of the United States. As an instrumentality of the federal government, the taxpayer argues it is not subject to B&O tax. The taxpayer cites Rule 190 and federal constitutional cases.

The Audit Division concluded the taxpayer was not a federal instrumentality. Rather, the Audit Division found the taxpayer merely followed the guidelines, rules, and regulations set forth by HCFA regarding Medicare. The taxpayer performed the same work for self-insured companies as it performed for Medicare.

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[3] Appendix B references 48 CFR 31.205-41. The Appendix also includes as unallowable costs several other taxes, which are not at issue.

The second issue pertains to use tax on consulting agreements. The taxpayer contracted to have a canned program installed with extensive modifications to the programming. The vendor only charged sales tax on the program. The Audit Division assessed $. . . use tax on the modification charges. Other activities, such as training, were not included in the assessment if they were billed separately. The taxpayer cites Det. No. 89-43A, 8 WTD 5 (1989) where a taxpayer proved different charges for different activities.

Finally, the Audit Division assessed $. . . B&O tax on what the auditor understood was interest on accounts receivable. The taxpayer contends the interest was from loans and investments. Because the amount was less than 5% of its gross income, the taxpayer argues it should be exempt. The Audit Division requests the taxpayer clarify whether the income is from accounts receivable or investments.

ISSUES:

1. Is a Medicare fiscal intermediary an instrumentality of the United States Government exempt from B&O tax?

2. Are charges for extensive modifications to canned computer programs and other computer-related services subject to retail sales tax?

3. May the taxpayer exclude interest income?

DISCUSSION:

All medical service bureaus, medical service corporations, hospital service associations, and similar health care organizations engaging in business within this state are subject to the provisions of the B&O tax and are taxable under the service and other business activities classification upon their gross income. WAC 458-20-233 (Rule 233). Insofar as tax liability is concerned it is immaterial that such organizations may be incorporated as charitable or nonprofit corporations. Id. In Excise Tax Bulletin 350.04.190 (ETB 350)[4] the Department stated its position that Medical Service Associations are liable for B&O tax on amounts received as reimbursements for their costs in administering the Medicare program. It reasoned that Rule 190 imposes B&O tax on private companies contracting with the federal government

B&O tax is imposed upon persons engaged in business. RCW 82.04.220. RCW 82.04.030 includes federal instrumentalities in the definition of "Person":

> "Person" or "company", herein used interchangeably, means any individual, receiver, administrator, executor, assignee, trustee in bankruptcy, trust, estate, firm, copartnership, joint venture, club, company, joint stock company, business trust, municipal corporation,

[4] Effective July 1, 1998 Excise Tax Advisories (ETA) replaced Excise Tax Bulletins (ETBs). ETA 350 is persuasive only.

> political subdivision of the state of Washington, corporation, limited liability company, association, society, or any group of individuals acting as a unit, whether mutual, cooperative, fraternal, nonprofit, or otherwise and the United States or any instrumentality thereof.

Under the statutory scheme of the Excise Tax Code, Title 82 RCW it would appear federal instrumentalies are subject to tax. However, the United States Supreme Court has limited state taxation of federal instrumentalities under the United States Constitution. See McCulloch v. Maryland, 17 US (4 Wheat) 316 (1819). RCW 82.04.4286[5] accommodates this restraint by excluding amounts derived from business which the State is prohibited from taxing under the United States Constitution. See Carrington Co. V. Dep't Of Revenue, 84 Wn.2d 444, 527 P.2d 74 (1974).

The Department recognizes instrumentalities of the Federal Government are not subject to B&O tax. Rule 190. However, other entities that transact business with the United States are liable for tax:

> The United States, its departments, institutions and instrumentalities, including corporate instrumentalities, are not subject to tax under chapter 82.04 RCW.
>
> In computing business tax liability of others, no deduction from value of products, gross sales or gross income is allowed in respect to business transacted with the United States, its departments, institutions or instrumentalities.

Rule 190.

In U.S. v. New Mexico, 455 U.S. 720 (1982), the Supreme Court set the current constitutional parameters, which guide us in the analysis of tax immunity for federal instrumentalities. In that case, the State of New Mexico imposed its use tax and gross receipts tax on receipts from management contracts paid by the Department of Energy (DOE). Similar to HCFA's regulatory control over Medicare using fiscal intermediaries, the Atomic Energy Commission of the federal government developed management contracts to secure government control over the production of fissionable materials, while making use of private industry's expertise and resources. Id. Fn. 2, citing Carson v. Roane-Anderson Co., 342 U.S. 232, 234-236 (1952).

The facts regarding the contractors' relationship with DOE in U.S. v. New Mexico, *supra* at 742-5 provided:

1. Title to all tangible personal property passed directly from the vendor to the federal government;
2. The government bore the risk of loss for property procured;
3. The contractors submitted annual vouchers for government approval;
4. The agreements gave the government control over the disposition of all property purchased under the contracts as well as over each contractor's property management procedures;

[5] Formerly RCW 82.04.430(6).

5. The contractors placed orders with third-party suppliers in their own names, and identified themselves as the buyers;
6. The contractors used an “advanced funding” procedure, writing checks to creditors and employees from a special bank account in which government funds were deposited, to meet contractor costs;
7. The contractors had a “long-standing agency status and authority” to pledge the credit of the government in accordance with the contractual provisions.

While not identical, there are many similarities to the taxpayer’s relationship with HCFA. The gross receipts tax analyzed in U.S. v. New Mexico was imposed upon “the privilege of engaging in business,” but not on "receipts of the United States or any agency or instrumentality thereof."

In U.S. v. New Mexico, the Court summarized its decisions regarding the Supremacy Clause (U.S. Const., Art. VI, cl.2) and tax immunity doctrine beginning with Chief Justice Marshall’s famous declaration that "the power to tax involves the power to destroy." McCulloch v. Maryland, 4 Wheat. 316, 431 (1819). The Court recognized this "much litigated and often confused field,"[6] has “been marked from the beginning by inconsistent decisions and excessively delicate distinctions.” U.S. v. New Mexico, at 730. The Court then stated and applied the underlying principle:

> What the Court's cases leave room for, then, is the conclusion that tax immunity is appropriate in only one circumstance: when the levy falls on the United States itself, or on an agency or instrumentality so closely connected to the Government that the two cannot realistically be viewed as separate entities, at least insofar as the activity being taxed is concerned.

Id., at 735.

The Court identified the issue:

> The issue, then, is whether the contractors can realistically be considered entities independent of the United States. If so, a tax on them cannot be viewed as a tax on the United States itself.

Id., at 738.

The Court recognized an important distinction between the government and other entities:

> The tax, the taxed activity, and the contractual relationships do not differ from those involved in Boyd. [United States v. Boyd, 378 U.S. 39 (1964)] The contractors here are privately owned corporations; "Government officials do not run [their] day-to-day operations nor does the Government have any ownership interest." *First Agricultural Bank v. State Tax Comm'n, 392 U.S., at 354* (dissenting opinion). In contrast to federal

[6] United States v. City of Detroit, 355 U.S. 466, 473 (1958).

> employees, then, Sandia and its fellow contractors cannot be termed "constituent parts" of the Federal Government. It is true, of course, that employees are a special type of agent, and like the contractors here employees are paid for their services. But the differences between an employee and one of these contractors are crucial. The congruence of professional interests between the contractors and the Federal Government is not complete; their relationships with the Government have been created for limited and carefully defined purposes. Allowing the States to apply use taxes to such entities does not offend the notion of federal supremacy. [footnote omitted]
>
> For similar reasons, the New Mexico gross receipts tax must be upheld as applied to funds received by the contractors to meet salaries and internal costs. Once it is conceded that the contractors are independent taxable entities, it cannot be disputed that their gross income is taxable.

Id., at 740-741. The contractors did not even dispute the tax on their fixed fees, similar to the taxpayer's administrative charges. Indeed, the Court recognized, "the New Mexico gross receipts tax must be upheld as applied to funds received by the contractors to meet salaries and internal costs." Id., at 741. Rather, the focus of the dispute in U.S. v. New Mexico pertained to use tax and the gross receipts tax on advances for procurement.

The court considered liability arguments:

> Even accepting the Government's representation that it is directly liable to vendors for the purchase price, see Tr. of Oral Arg. 42-45, [footnote omitted] Sandia and Zia nevertheless make purchases in their own names -- Sandia, in fact, is contractually obligated to do so, App. 37 -- and presumably they are themselves liable to the vendors. Vendors are not informed that the Government is the only party with an independent interest in the purchase, as was true in Kern-Limerick, and the Government disclaims any formal intention to denominate the contractors as purchasing agents.

Id., at 742-743.

We stress that the assessment did not include tax on government reimbursements. The Audit Division allowed the exclusion of receipts in cases where the taxpayer identified itself to medical providers as the purchasing agent of the government. The assessment included administrative fees only, which the taxpayer used to pay the salaries of its employees, overhead expenses, and other indirect, internal costs such as administrative purchases in the taxpayer's name. Title for those items purchased never passed to the government, but remained with the taxpayer.

Finally, the Court recognized Congress' authority to preempt state taxation:

> But it is worth remarking that DOE is asking us to establish as a constitutional rule something that it was unable to obtain statutorily from Congress. For the reasons set out above, we conclude that the contractors here are not protected by the Constitution's

> guarantee of federal supremacy. If political or economic considerations suggest that a broader immunity rule is appropriate, "[such] complex problems are ones which Congress is best qualified to resolve." United States v. City of Detroit, 355 U.S., at 474.

Id., at 744. Congress has not addressed the taxability of Medicare intermediaries. We note, however, Appendix B of the taxpayer's HCFA contract references 48 CFR 31.205-41. Subsection (a)(1) of that section allows payment of state taxes. Because it provides for payment of state taxes, the federal government did not intend to preempt states from taxing fees for administrative services. In fact, the reference to the CFR anticipated state taxes.

There is a presumption against preempting state taxes. Our state's supreme court has ruled:

> In Washington, there is a strong presumption against finding preemption. Pioneer First Fed. Sav. & Loan Ass'n v. Pioneer Nat'l Bank, 98 Wn.2d 853, 659 P.2d 481 (1983). Preemption may be found only if federal law "clearly evinces a congressional intent to preempt state law", or there is such a "'direct and positive'" conflict "that the two acts cannot 'be reconciled or consistently stand together' . . . " Pioneer, at 856-57 (quoting State v. Williams, 94 Wn.2d 531, 538, 617 P.2d 1012, 24 A.L.R. 4th 1191 (1980)).

Department of Labor & Indus. v. Common Carriers, Inc., 111 Wn.2d 586, 588, 762 P.2d 348 (1988). The federal government anticipated fiscal intermediaries would pay state taxes. 48 CFR 31.205-41 referenced in the taxpayer's HCFA contract reconciles state taxes on fiscal intermediaries.

The United States Supreme Court upheld the New Mexico taxes upon the contractors. Likewise, Washington's B&O tax is applicable to the taxpayer's administrative fees.

The taxpayer attempts to distinguish its situation from that in U.S. v. New Mexico. The taxpayer states AEC contractors were hired by the Government voluntarily for economic reasons. According to the taxpayer, the Medicare intermediary was hired because the Medicare intermediary was a Congressionally mandated, integral part of the Medicare program.

We fail to see a distinction. Actually, the Court in U.S. v. New Mexico noted the purpose for government-contractor relationship:

> AEC management contracts were developed in an attempt to secure Government control over the production of fissionable materials, while making use of private industry's expertise and resources. See Carson v. Roane-Anderson Co., 342 U.S. 232, 234-236 (1952); Tr. of Oral Arg. 4-6.

Id., footnote 2. In 42 U.S.C. 1395(h), Congress authorized the use of private agencies or organizations to facilitate payment to providers of services for a more effective and efficient administration of Medicare.

The relationship between the AEC and its contractors is more of a similarity with the Medicare Intermediary program rather than a distinction. Congress did authorize the use of the private contractors in the nuclear program, but also sought to keep a high level of control. Likewise, Congress authorized use of fiscal intermediaries, and like the AEC the HCFA strictly monitors the fiscal intermediaries.

One case relied upon by the taxpayer is U.S. v. Spokane, 918 F.2d 84 (9th Cir. 1990). In finding the Red Cross was an instrumentality of the of the government, not subject to Spokane's gambling tax, the 9th Circuit Court of Appeals stated:

> Private independent contractors may be agencies because they act as agents. They are not to be confused with instrumentalities like the Red Cross which are agencies because they were created to carry out functions of the government itself, and are therefore, imbedded in the structure of the government to that extent. As the Supreme Court has said, "both the President and the congress have recognized and acted in reliance upon the Red Cross' status virtually as an arm of the Government." [Department of Employment v. U.S., 385 U.S. 355, 359-360 (1966).]

The Red Cross was created by the United States to carry out public functions. See 36 U.S.C. 3. The Ninth Circuit Court of Appeals recognized that Congress created the Red Cross. U.S. v. Spokane, supra. There is a critical distinction. Congress did not create the taxpayer. The taxpayer is a private, nonprofit corporation. Its nonprofit status is immaterial. See Rule 233. Furthermore, the President appoints eight of the governors of the Red Cross, one of whom acts as its principal officer. The taxpayer's single voting member, another nonprofit corporation, controls the taxpayer.

We find the taxpayer is not so closely connected to the Government that the two cannot realistically be viewed as separate entities. The taxpayer is not a federal instrumentality. The Audit Division properly assessed B&O tax on its administrative fees.

[2] Generally, receipts for tangible personal property are taxable as retail sales, while receipts for many services do not fall within the retail classification. See RCW 82.04.050. WAC 458-20-155 (Rule 155) discusses the taxability of computer software receipts. Receipts for providing information services or custom programs developed for a specific user of an original, one-of-a-kind nature are taxable under the service and other activities classification. Rule 155. From July 1, 1993 through June 30, 1998, these receipts, including training charges, are taxable under the selected business service classification. RCW 82.04.055.

Sales of standard, prewritten programs, sometimes referred to as "canned" or "off-the-shelf" software, are taxable as tangible personal property under the retailing classification, subject to retail sales tax. Rule 155. Likewise, the retail classification applies to charges for the alteration or modification of standard, prewritten software including regular updates sent to all of its customers. Det. No. 92-340, 12 WTD 493 (1992); See also Det. No. 87-222, 3 WTD 333 (1987).

In this case, the taxpayer's payment includes both activities normally taxable under the service classification (such as training), and services (such as modifications to the taxpayer's canned program and updates) taxable under the retailing classification. Usually, when payments for the various software and computer services are not adequately segregated, the combined charge is taxable under the retailing classification. See Det. No. 93-158, 13 WTD 302 (1993); See also Subsection (6) of Rule 257. We have allowed taxpayers to separate individual retail charges if they can be traced to specific activities:

> However, the information now provided leads to the conclusion that the programmer in fact provided services of both a retail nature (modifications to the program), and services of a professional nature (i.e.., "price book set", stated to be programming developed from "scratch"). Since the programmer has been able to "group" its various activities, and the audit identifies a number of individual charges, it appears that specific charges can be traced to specific activities. It is important to note here that the work at issue was not performed pursuant to a single contract for a single, lump sum billing. Rather, the work constituted a combination of activities classifiable as either retailing or service activities. Taxpayer now claims to have documented the various activities. Accordingly, subject to confirmation of the claimed segregation of activities and charges, the taxpayer is entitled to the appropriate tax classification for each. See RCW 82.04.440.

Det. No. 89-43A, 8 WTD 5, 6 (1989).

The taxpayer's contract provides that some non-retail services such as training may be charged separately. If the taxpayer adequately segregates retail charges from other charges, the measure of retail sales tax can be reduced. Otherwise, the entire fee is taxable under the retailing classification and subject to retail sales tax. This issue is remanded to the Audit Division for verification.

[3] The taxpayer relies on Excise Tax Advisory 571.04.146/109 (ETA 571)[7] issued June 30, 1995, as authority for excluding intercompany investment income. The taxpayer states this income was less than 2% of its of its gross income. RCW 82.04.4281 gives a deduction from the measure of the business and occupation (B&O) tax for amounts received from investments or the use of money as such for taxpayers not engaged in financial businesses. ETB 571 is persuasive in that investment income of less than 2% is considered incidental, and excludable for non-financial businesses.

The Audit Division questioned whether the income was derived from accounts receivable, and not investments. ETA 571 recognizes the RCW 82.04.4281 is limited to investment income:

> However, businesses who sell merchandise on an installment basis and directly carry these accounts receivable are not considered as receiving the interest from investments or the use

[7] Effective July 1, 1998, Excise Tax Advisories (ETAs) replaced Excise Tax Bulletins (ETBs). ETA 571 is Advisory for taxpayers, but binds the Department.

> of money as such. The interest received from these transactions is directly related to the sale of the merchandise and the deduction for "investments or use of money as such" does not apply. This interest is not related to a banking, loan, security, or other financial business activity with respect to these transactions. (See WAC 458-20-109.)

For instance, the unpaid balance on a real estate contract is not an investment of the contract vendor, nor is the interest received by the vendor "amounts derived from investments or the use of money as such" within the meaning of RCW 82.04.4281. O'Leary v. Department of Rev., 105 Wn.2d 679, 717 P.2d 273 (1986). Making a loan and taking a land contract as security is not the same activity as selling a piece of land and accepting the payment in installments. In one activity, money is advanced. In the other, the seller advances no money; rather he relinquishes the right to immediate payment. Clifford v. State, 78 Wn.2d 4, 8, 469 P.2d 549 (1970).

Provided the taxpayer meets the requirements of ETA 571 and earned the income from true investments, rather than for deferral of payment on its services, it may exclude the income. The Audit Division will review the taxpayer's records to verify the nature of the income.

DECISION AND DISPOSITION:

We deny the taxpayer's petition on the first issue. The assessment properly taxed receipts from HCFA for administrative expenses. Regarding the second and third issues, the taxpayer's petition is conditionally granted, provided the taxpayer verifies the facts as discussed above.

Dated this 31st day of August 1998.