



AGENDA REPORT

Meeting Date: October 23, 2012

Item Number: D-1

To: Honorable Mayor & City Council

From: Christi Hogin, special counsel, on behalf of Administrative Services

Subject: APPEAL OF JUNE 7, 2012, HEARING OFFICER DECISION IN BUSINESS TAX ASSESSMENT HEARING ESTABLISHING BUSINESS CLASSIFICATION AND ASSESSING TAX LIABILITY, INCLUDING PENALTIES, FROM 2003 TO 2011 OF \$5,536,356.48 BY TAXPAYERS SPECIALTY SURGICAL CENTER, LLC AND SPECIALTY SURGICAL CENTER OF BEVERLY HILLS, L.P. FILED ON THEIR BEHALF BY ALLAN COOPER, ESQ., OF ERVIN, COHEN & JESSUP LLP

Attachments:

1. June 7, 2012 Decision
2. June 20, 2012 Appeal (with attachments)
3. Office Policies from SSC's website
4. Symbion's SEC 10-K filing
5. Specialty Surgical Center's website discussion of Why Choose Ambulatory Surgery Centers?
6. October 18, 2012 Memorandum and Ordinances

RECOMMENDATION

Staff recommends that the City Council conduct the public hearing on the appeal, consider all evidence, and take two actions: (1) deny the appeal and affirm the classification of appellants' business as a Classification F (in addition to Classification C) within the meaning of Beverly Hills Municipal Code (BHMC) §3-1-219; and (2) determine whether penalties are appropriate [BHMC §§3-1-213(L), 1-4-107] and whether to waive interest in light of the history of this dispute [BHMC §3-1-207(D)].

PROCEDURE

This appeal comes before the City Council in order to assure the fair implementation of the City's business tax. Persons conducting any business in the City must register and obtain a certificate. BHMC §3-1-201. Business activities are divided into ten classifications and several exempt activities. BHMC §§ 3-1-219, 3-1-201. Separate registration is required for each business tax classification conducted by a business. BHMC §3-1-208.

The director of finance administration is authorized to compute and determine the correct business tax and make an assessment "upon the basis of the facts contained in the statement or upon the basis of any information in the city's possession or that may

come into the city's possession." BHMC §3-1-213. This includes circumstances in which the director (or his designee) believes that the business classification is incorrect or the taxpayer has failed to register in all required classifications.

On January 9, 2012, the director of finance administration issued an assessment for business taxes, including penalties and interest, for calendar years 2003 through 2011, to taxpayers Specialty Surgical Center, LLC and Specialty Surgical Center of Beverly Hills, L.P. (together referred to as "SSC"), finding that the correct classification for their business was Classification F. Under the Code, a taxpayer may request a hearing before the director of finance administration to submit evidence why the assessed tax, interest and penalties should not be fixed. BHMC §3-1-213(H). On January 18, 2012, counsel for SSC requested such a hearing.

The hearing was opened on April 11, 2012 and continued open in order to allow SSC to provide additional information and evidence. On May 15, 2012, the hearing was closed. On June 7, 2012, the director (through his designee, Assistant Director Noel Marquis) issued his decision, finding that at least 75% of SSC's business in the City was attributable to Classification F and assessing a total of \$5,536,365.48 for unpaid business taxes for 2003 through 2011, including penalties and interest, through June 30, 2012, and assessing \$34,019.81 per month in interest thereafter until paid.

SSC has appealed the assessment decision, which is how this matter comes before the City Council. The hearing is de novo, which means that the City Council is being asked to make an independent examination of the assessment, including the classification determination, the allocation of the percentage and the imposition of penalties and interest.

With respect to the appropriate classification, all business conducted in the City must fall into one of the classifications or exemptions listed in the Municipal Code. Therefore, the City Council must determine the appropriate classification for all business activities of SSC. The amount of the appropriate tax going forward will be governed by that determination.

With respect to interest and penalties, the City Council has more authority and flexibility than the director. The Municipal Code assigns the director the task of making an assessment and provides limited circumstances under which he can reduce penalties [BHMC §3-1-207(B)(3)] and does not grant him the authority to waive interest [BHMC §3-1-207(D)]. The City Council may waive interest [BHMC §3-1-207(D)] and "may make such decision or determination as may appear just and reasonable in the light of the evidence presented" [BHMC §1-4-107].

So, again, the purpose of this appeal hearing is to assure the fair implementation of the City's business tax and just treatment of appellant SSC.¹

¹While on the topic of a fair hearing, a quick note on my role is in order. My firm, Jenkins & Hogin, LLP, was hired by the City under separate contract to represent the staff position in this appeal. I did not advise the director at the original hearing and I have had no contact with David Snow of Richards, Watson & Gershon, who advises the Council in this appeal. I have also had no contact before the hearing, other than by virtue of this staff report, with any member of the City Council.

BACKGROUND

Like most disputes, this one has a back-story. Under the business tax ordinance, all commercial transactions – business and professional – require registration and payment of a tax.² As a result, all business activity must fall within one of the existing classifications or exemptions. The business tax ordinance is concerned with the business enterprise generally, not the medical profession or any other particular industry. So it is no surprise that when an industry innovates its business model it may escape the notice of the City's finance office. Similarly, a business may look one way from the outside – especially when viewed through the filters of preconceived notions of how a business likely operates – but actually function in a different manner that can be seen when viewed up close.

Three premises inform this dispute: (1) every business activity must fall into one of the ordinance's classifications; (2) a single business enterprise may be comprised of more than one classification; and (3) when business models change, the new model may require the taxpayer to register in a new classification.

In this matter, we examine a relatively new innovation in the business of delivering medical services that in some ways resembles a more familiar model. Viewed together from the patient's perspective, SSC and the medical professionals (surgeon and anesthesiologist) deliver medical services in a setting that approximates a doctor's office, outpatient experience. The kind of experience those who had wisdom teeth removed probably had – a doctor's office with surgical suite. Traditionally, medical services were received at the offices of individual medical professionals and medical groups, which are Classification C. SSC's business model is decidedly different than a doctor's office – essentially bifurcating doctor and office. From the perspective of the business tax ordinance, SSC's business is primarily to create, maintain and make available surgical suites and also to provide administrative support. The physicians that perform the medical services are separate entities and conduct separate business activity.

The business tax ordinance imposes taxes in broad categories and, depending on the category, calculates the tax on either a per-employee or percentage-of-gross-receipts basis:

General Office: Employee
Professional Office: Employee
Retail: Gross Receipts
Wholesale: Gross Receipts
Manufacturing: Gross Receipts
Personal Service: Employee
Commercial Property: Gross Receipts
Residential Property: Gross Receipts

As the City became aware of the new business model exemplified by SSC, staff began to question whether the SSC-type businesses were properly classified as "professional offices." In 2004, the City's tax consultant evaluated the SSC business model in light of the business tax ordinance. The consultant found that SSC was not properly classified

²"No person shall transact, engage in, carry on or permit the operation of any business in the city without first registering and obtaining a current valid registration permit from the department of finance administration...." BHMC §3-1-201.

as professional offices, although that is the classification under which it had been reporting.

The City then entered into a years-long dialogue with SSC over the proper classification of its business activity for the purposes of the business tax ordinance. The goal of those discussions was to reach a mutual understanding of the proper application of the ordinance. Obviously, SSC had information regarding the nature of its business activities in the City and staff wanted to better understand SSC's business in order to classify appropriately the business for tax purposes. During the course of the discussions, staff did not assess the tax, favoring instead the possibility that the City and the business would reach agreement. Ultimately, no agreement was found. Staff's understanding of the facts led it to the conclusion that the business fell within both Classifications F (surgical suites) and C (nurses and other staff); and SSC steadfastly contended that its business was only within Classification C.

DISCUSSION

SSC wants to avoid the higher tax rate based on gross receipts, so it casts its business as a professional office, which is taxed on a per-employee basis. SSC's appeal raises three distinct questions:

1. Whether Specialty Surgical Center's business is properly within Classification F;
2. Whether staff properly allocated SSC's business tax between Classifications C & F; and
3. Whether penalties and interest are warranted for back taxes owed.

This staff report will address each in turn. SSC also questions the constitutionality of the reassessment based on its theory that the assessment results in a change to the method of calculating tax liability that requires a vote of the people and that the ordinance is too vague as evidenced by the fact that surgical centers have not self-reported under Classification F. These legal issues are addressed at the end of this report.

1. Specialty Surgical Center rents commercial property for use as a surgical suite and is properly taxed within Classification F

The Municipal Code charges the director of finance administration and his designees with the duty to determine "the classification of the business a registrant is engaged in..." BHMC §3-1-212. Although taxpayers generally self-report, the director is authorized to implement and enforce the ordinance, which includes determining the correct classifications of businesses and conducting audits.

The Municipal Code provides that "[i]f the director of finance administration is not satisfied...that the business classification has been correctly determined...", he may make an assessment using all available information. BHMC §3-1-213(A). Once that assessment is made, the taxpayer is provided notice and an opportunity to challenge the determination and provide evidence to support the challenge, as described above and set out in the Municipal Code. This is the process that led to this appeal hearing before the City Council.

The June 7, 2012 Decision that is the subject of the appeal concludes that SSC "are providers of space for the performance of outpatient surgical procedures and providers of professional services related to the care of patients during such procedures."

Decision Finding 10. SSC contends that it is only in the business of providing professional services and not in the business of “leasing or renting any commercial property” within the meaning of Classification F of BHMC §3-1-219(F).

The business tax ordinance defines commercial real property as follows:

COMMERCIAL REAL PROPERTY: All real property, including improvements thereto, of any kind or nature which is owned, held, used, or operated for commercial or industrial purposes but shall not include the leasing or rental of real property for residential purposes.

BHMC §3-1-205. Under this definition, if SSC’s business -- its primary contribution to the marketplace -- is to make available fully furnished surgical suites, including nursing and administrative staff, for use by surgeons and patients, who are free to choose other accommodations in which to conduct the surgeries, then the business is Classification F (Commercial Property Renting and Leasing).³

The director concluded that SSC was engaging in a commercial transaction in which it was receiving compensation for renting real property, improved as a surgical suite. The evidence that supports this conclusion includes SSC’s description of its business set out on page two of its April 12, 2012 letter and referred to in its June 20, 2012 appeal letter. SSC describes in some detail how it bills for use of its facilities and the services of its staff. It is undisputed that SSC does not employ the licensed physicians that actually perform the surgeries that take place at SSC facilities. “Ultimately, the patient/insurer receives a bill from the physician for performing the medical procedure and a separate bill from SSC.” SSC’s April 12, 2012 Letter Brief at 2. In other words, SSC does not perform the medical procedure itself.

The director’s conclusion is consistent with and supported by the description of SSC’s services and sources of revenue prepared by one of its parent corporations Symbion, Inc. (which own 32% of the Beverly Hills facilities) in its 2011 filing with the Securities Exchange Commission:

Sources of Revenue

Approximately 98% of our [Symbion, Inc.] revenues in 2011 were obtained from facility fees related to healthcare services performed in our surgical facilities. The fee charged varies depending on the type of service provided, but usually includes all charges for usage of an operating room, a recovery room, special equipment, supplies, nursing staff and medications. Also, in a very limited number of surgical facilities,

³In its April 12, 2012, appeal letter, SSC spends considerable effort distinguishing “leasing and renting” from “licensing” as a legal definition of the interest (or noninterest) in property conveyed. See SSC’s April Letter at 13-18. SSC reiterates these points in its June 20, 2012 appeal letter. June Letter at 6-8. In this regard, SSC takes too technical an approach to business tax classifications. The business tax does not define property rights; it categorizes like business activities in the same classification and taxes them similarly. For the purposes of classification under the ordinance, the relationship between a salon owner and the stylists who rent “chairs,” which includes the right to host clients in the salon, use the shampoo sinks, the waiting area, the coffee machine, the receptionists and other furnishings of the salon, is analogous to SSC’s business model. Both derive income from making commercial property available, which is renting within the broad meaning of Classification F. Indeed, a number of salon owners in the City pay taxes in classification F because they engage in this commercial leasing activity. The classifications are read broadly, not narrowly.

we charge for anesthesia services. Our fees do not include professional fees charged by the patient's surgeon, anesthesiologist or other attending physician, which are billed directly by such physicians to the patient or third-party payor. We recognize our facility fee on the date of service, net of estimated contractual adjustments and discounts for third-party payors, including Medicare and Medicaid. Any changes in estimated contractual adjustments and discounts are recorded in the period of change.

In contrast, during the tax assessment process SSC describes its business as providing "registered nurses, medical equipment, anesthesia, medications, and related supplies and ancillary products for use by physicians." SSC's April 12, 2012 Letter Brief at 2. However, SSC does not sell these products or offer these services for off-site consumption. These products and services are exclusively available for use within an SSC facility. In other words, SSC is in the business of renting fully furnished surgical suites, with support staff, for use by non-employee physicians and their patients.

SSC's fee schedule for use of its facilities is based on the procedure that the physician recorded that he or she performed. SSC relies on an industry standard description system (CPT-based),⁴ which is required by most medical insurers for reimbursement. SSC's April 12, 2012 Letter Brief at 2. SSC contends that its billing method proves that it is not engaged in renting commercial property because its fees are not calculated based on time that a surgical suite was used or the amount of space used. Apparently, shoulder replacement surgery is billed as that and not as two hours for use of the surgical suite. However, SSC is not reimbursed for the surgery; the physician performs those medical services and the physician is paid for that.⁵ SSC is paid for supplying the fully furnished surgical suite in which the shoulder replacement surgery occurred. That surgery is performed within an estimable time and requires fixed supplies and routine care. Thus, SSC used billing code standards that account for the typical usage of a facility for a given procedure. This does not make SSC's contribution to, for example, the shoulder surgery the same as the surgeon's. The surgeon is paid for performing the shoulder replacement surgery and SSC is paid for providing the facility in which a shoulder replacement surgery is performed. The physician is practicing medicine; SSC is renting equipped facilities.

In sum, the evidence that supports the conclusion that SSC's business includes transactions that fall within Classification F are (1) the director's expert opinion offered after evaluation of all the facts and informed by long experience classifying businesses under the business tax ordinance, (2) SSC's description of its business as excluding performing actual surgeries or medical procedures, (3) the fact that physicians bill separately for the actual surgical services rendered at the SSC facility, (4) Symbion's 2011 SEC filing corroborating the director's description of the business as primarily the renting of surgical facilities, and (5) the fact that the surgical centers are advertised as alternative venues to perform/receive medical services.

⁴CPT stands for Common Procedural Terminology and it is an AMA maintained code set that describes medical, surgical, and diagnostic services. CPT is designed to communicate uniform information about medical services and procedures among physicians, coders, patients, accreditation organizations, and payers for administrative, financial, and analytical purposes.

⁵See "Office Policies" page on SSC's website (attached) which emphasizes that physician's bills are separate from the facility fee.

2. Staff properly allocated SSC's business tax between Classifications C & F and no additional evidence has been submitted to contradict staff's determination

The director evaluated the nature of SSC's business and the business activity for which it is paid. Taking into account the information submitted by SSC and information publicly available, including Symbion's 2011 SEC filing and SSC's own website description of its business, the evidence in the record indicates that SSC's predominate business activity is renting fully furnished surgical suites. Although the SEC filing attributed approximately 98% of Symbion's 2011 revenues to facility fees, the fees charged include all charges for usage of an operating room, a recovery room, special equipment, supplies, nursing staff and medications. Taking into account SSC's argument that its staff provided services such as billing patient insurance carriers and attending to patients in recovery, the director gave SSC the benefit of the doubt and quantified its predominate business activity at 75% and attributed the remaining 25% to professional services.

Under the Municipal Code, once the director made that assessment and provided notice to SSC, the burden was on SSC to provide evidence that would support a different conclusion.

SSC's position is that zero percent of its business is attributable to Classification F. Instead, it contends that 100% of its business is under Classification C (professional office), which position SSC claims may be justified either by attaching itself to the surgeons who perform surgeries at SSC facilities (so that SSC's business is just an extension of the professional offices of the various surgeons who might take advantage of SSC's facilities) or by claiming that the surgical center is the professional office of the nurses and other support staff in the facilities. The surgeons are not employees of SSC and they are separately registered and pay taxes under Classification C. SSC is a distinct business and legal entity from the surgeons and therefore the surgeons' professional status under the business tax does not apply to SSC's business. The director found that the support staff, including nurses, that are provided to assist the surgeons and attend to the surgeons' patients, are not the primary business of SSC. Without the surgical facility itself, SSC would not hire the staff. Further, patients have no independent reason to hire the support staff and nurses absent use of the surgical facility by an independent surgeon and SSC does not provide support staff independent of its facility. Nevertheless, SSC contends only that it has no business activity under Classification F. It therefore submitted no evidence by which the director – or to date, the City Council – could reach a different allocation.

While the staff's opinion is entitled to weight, given that staff is experienced in classifying businesses under the business tax ordinance, the City Council is not bound by the determination. If other evidence comes to light or the Council is persuaded by a different rationale for quantifying the percentage that expresses the degree to which SSC's revenues are derived from its rental of surgical suites, the City Council may modify the allocation on appeal. For example, even if SSC did not provide any further evidence, the City Council could adopt a more conservative approach to the percentage allocation by allocating 50% of SSC's revenue to Classification F and 50% to Classification C. The director's examination of the business coupled with SSC's and Symbion's description of SSC's services support the conclusion that the dominate business activity (that is, the core of how SSC generates its revenue) is charging for the opportunity to use the surgical suite. If the City Council concurs with this conclusion, then a 50% allocation to Classification F is conservative because the dominant business activity certainly accounts for at least 50% of the revenue.

3. Staff calculated the penalties and interest as provided in the business tax ordinance

BHMC §3-1-207 provides for penalties and interest in the event of delinquent taxes. The director determined that SSC had failed to properly register and pay taxes with respect to its Classification F business activities and that resulted in the penalties and interest accruing on the unpaid taxes. In this case, the director has no authority to waive penalties or interest. Accordingly, the director did not take into account the arguments raised by SSC against imposition of penalty and interest.

SSC contends that the interest and penalties are unfair under the circumstances because much of the time during which the interest and penalties accrued was time during which the City was conducting its audit and the parties were engaged in good faith discussions over the nature of SSC's business and the proper application of the business tax. SSC points out that it has been a test case for the audit of this type of use, which is relatively new to the medical industry.

SSC also complains that the penalties and interest are unfair because it was not clear to it as a taxpayer that it falls into that tax classification. This argument is the least persuasive because the ordinance provides for an administrative procedure to determine the correct classification and because an honest assessment of the business model, including how the model is portrayed to the SEC in official filings, leads readily to the conclusion that – except for purposes of the Beverly Hills business tax – SSC held itself out as a provider of a better alternative venue to receive healthcare and not itself as a healthcare provider. That comes through clearly from SSC's website discussion of Why Choose Ambulatory Surgery Centers? (attached).

Nevertheless, as discussed above, the City and SSC have been engaged in a years-long dialogue over the application of the business tax ordinance and, to a great extent, the City had control over the timing of the issuance of the assessment. While the City's delay in issuance of the assessment was certainly due to the hope that the parties would reach agreement on the percentage allocation of SSC's business activities attributable to Classification F, it is also true that the City's delay in invoking the formal mechanism available in the ordinance increased the penalties and interest for which SSC would ultimately be held liable. Further, the City had the information that it needed to issue the assessment before it was issued. That said, of course, SSC could have elected at any time to properly register and pay its Classification F tax.

SSC is requesting that the penalties and interest for the back taxes be waived. The total tax liabilities for 2002 through 2011, imposed based on the gross receipts reported by SSC, are as follows:

Specialty Surgical Center LLC		Specialty Surgical Center of Beverly Hills	
Tax:	\$1,213,436.98	LP	
50% Penalty:	\$ 606,718.49	Tax:	\$1,054,550.10
Accrued interest:	\$1,296,214.64	50% Penalty:	\$ 527,275.05
		Accrued interest:	\$ 838,170.22

Plus \$34,019.81 per month (18% interest on balance due) since July 1, 2012, until balance due paid.

If affirmed, SSC's tax liability with penalties and interest is \$5,536,365.48 plus \$136,079.24 in additional interest through October for a total of \$5,672,444.64.

The City Council could waive the interest and penalties, in which case the total tax liability would be \$2,267,987.08. If the City Council were to limit the number of past years assessed, the total liability obviously would decrease as well.

4. Responses to miscellaneous legal issues raised in the appeal

SSC asserts that the business tax ordinance is "void for vagueness." This legal doctrine prohibits criminal prosecution or civil penalties imposed for violation of a statute where the violator did not have fair notice of what conduct was required to comply. Beverly Hills' business tax ordinance clearly puts on notice all those who engage in any form of commerce in the City that they must register and pay a tax based on the classification of their business activities. The ordinance provides for an administrative determination of the classification of a business and for an appeal process to challenge the administrative determination. While SSC is correct to point out that new business models must be assigned a classification using existing categories, that does not render the ordinance too vague. The classifications are intentionally broad. The ordinance provides an unambiguous mechanism to determine a proper classification where there may be doubt on the part of the taxpayer.

SSC points out that Measure P would have taxed professionals on a gross receipts basis and claims that the imposition of a gross receipts tax on SSC as a lessor of commercial property is an end run around the fact that Measure P failed. This argument is meant to associate the assessment of SSC with the politically rejected idea of a gross-receipts tax on professionals. However, Measure P would not have affected Classification F and, as discussed in detail above and in the Decision, SSC is not a professional office.

SSC also argues that the assessment "revises the methodology" of assessing SSC's taxes by using a gross receipts formula imposed on lessors of commercial property rather than the per-person assessment of professionals and therefore the decision purports to raise SSC's taxes without voter approval. The argument rejects out of hand that SSC improperly registered its business as professional Classification C without accounting for the predominate part of its business that consisted of renting fully furnished surgical suites, which is Classification F. The implementation of a tax ordinance does not require voter approval.

Finally, SSC argues that the City accepted SSC's business tax under Classification C in the past so the City is effectively changing its position now by assessing SSC under Classification F. SSC ignores the fact that it had superior knowledge of its business model. It is not obvious from its operations that SSC provides only facilities and that the actual surgeries are performed by independent physicians. This is a fact that is only uncovered by research and reference to SEC filings and other business documents. The City's acceptance of self-reported taxes does not constitute certification that the taxpayer has complied. The ordinance provides for audits and assessments.

SSC predominately makes its money by providing a place where medical services are rendered; independent physicians provide the medical services. The fact that the fee schedule for use of its facilities is set by the procedure for which they are used does not change the character of what SSC contributes to the medical procedure – SSC

contributes the venue. Once the City understood the nature of SSC's business model, it properly invoked the assessment procedure of the business tax ordinance.

OPTIONS

There are three issues that need to be resolved in this appeal. The central issue is whether SSC engages in business activity properly categorized under Classification F. If so, the City Council must determine the percentage of the business that is attributable to Classification F activity. The City Council must also determine whether to impose penalties and interest. The City Council has various options with respect to how to address these three issues, which are outlined here:

A. CLASSIFICATION

1. The City Council must evaluate the evidence and the arguments and decide whether SSC's business activities fall within Classification F (Commercial Property Renting and Leasing). If no, uphold the appeal. If YES, proceed to 2.

2. With respect to the Decision's 75% attribution of Classification F to SSC business, the City Council has three options after considering all the evidence at the hearing:

a. AFFIRM and ADOPT the 75% attribution based on staff's reasonable, conservative assessment of SSC's business model.

b. MODIFY % SPLIT: If SSC produces further evidence at the hearing that tends to prove a different percentage allocation or if the City Council views the existing evidence differently, the City Council may establish a different allocation based on that evidence.

c. REMAND ON % SPLIT: Alternatively, after the Council determines that Classification F applies, if SSC is interested in producing additional evidence, the City Council could remand the matter to the director with directions to set a hearing to accept new evidence with respect to the allocation of uses and make a new determination in light of all the evidence.

B. PENALTIES AND INTEREST

1. The City Council may waive the interest charges if it finds that the interests of justice are served by the waiver. Among the considerations the City may take into account is the fact that SSC engaged in a dialogue with the City over the classification issues and the fact that other surgical centers elected to pay the tax.

2. The City Council may also waive the penalties if it finds that the interests of justice are served by the waiver.

C. MITIGATION OF ASSESSMENT

1. The City Council should also indicate whether, in the interest of fairness, it wishes to reduce the number of years that staff has assessed (2003 – 2011).

FISCAL IMPACT

The direct impact of the decision would be to increase the general fund by the amount assessed. If affirmed in full and paid by the end of October, that amount would be \$5,672,444.64. If penalties and interest were waived, the amount received would be \$2,267,987.08. Other options would lower the amount.