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STATE OF WASHINGTON

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**COURT OF APPEALS FOR DIVISION II
STATE OF WASHINGTON**

UNITED STATES TOBACCO SALES AND MARKETING COMPANY
INC.,

Respondent/Cross-Appellant,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE,

Appellant/Cross-Respondent.

BRIEF OF APPELLANT

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I. ASSIGNMENTS OF ERROR

1. The Thurston County Superior Court's Finding of Fact No. 22 states:

The 1992 fair market value for Tobacco Manufacturing's sales of smokeless tobacco products to Tobacco Sales was \$.82/can.

The superior court erred in finding that the fair market value of a can of smokeless tobacco product between United States Tobacco Manufacturing Company Inc. (Tobacco Manufacturing) and United States Tobacco Sales and Marketing Company Inc. (Tobacco Sales) was \$.82/can.

2. Finding of Fact No. 23 states:

Neither Tobacco Sales' nor Tobacco Manufacturer's 1992 selling price represents the fair market value of the smokeless tobacco products sold by Tobacco Manufacturing to Tobacco Sales. Tobacco Manufacturing's selling price was a discounted price as compared to the fair market value price (\$.82) for those sales.

The superior court erred in finding that the fair market value price was \$.82 for Tobacco Manufacturing's sales of smokeless tobacco products to Tobacco Sales. The superior court did not err as to the remaining findings in paragraph 23.

3. Finding of Fact No. 24 states:

Tobacco Sales paid excessive OTP tax in the amount of \$68,488.

The superior court erred in finding that Tobacco Sales paid excessive Other Tobacco Products (OTP) tax in the amount of \$68,488.

4. Conclusion of Law No. 5 states:

Plaintiff is entitled to a refund of OTP taxes for the difference between the price on which the OTP tax was paid (\$1.43/can) and the fair market value of the OTP for sales by Tobacco Manufacturing (\$.82/can).

The superior court erred in concluding that a refund of OTP taxes was due and in concluding that the fair market value of the OTP for Tobacco Manufacturing's sales was \$.82/can.

5. Conclusion of Law No. 6 states:

Plaintiff is entitled to an award of interest and taxable costs as provided by RCW 82.32.060.

The superior court erred in concluding that Tobacco Sales was entitled to an award of interest and taxable costs per RCW 82.32.060.

II. ISSUES

A. Did Tobacco Sales fail to meet its burden under RCW 82.32.180 to prove that the "wholesale sales price" between Tobacco Sales and Tobacco Manufacturing was a "fair market value" price as defined by

this Court's decision in *United States Tobacco Sales & Marketing Co. Inc. v. Dep't of Rev.*, 96 Wn. App. 932, 940, 982 P.2d 652 (1999) for purposes of calculating the OTP tax?

B. Is the price between two affiliated entities, Tobacco Manufacturing and Tobacco Sales, a "wholesale sales price" that reflects fair market value to calculate the OTP tax, when the price between these two entities is not available to any other distributors?

III. STATEMENT OF THE CASE

A. Statutory, Appellate Background and Procedural History.

Washington State imposes an excise tax on the "sale, use, consumption, handling, or distribution of all tobacco products" in the state.¹ "Tobacco products" are all types of chewing and smoking tobacco, snuff, and cigars, but not cigarettes.² The tax is called the Other Tobacco Products tax (OTP). The tax is measured by the "wholesale sales price" of tobacco products brought into the state.³ The "wholesale sales price" means "the established price for which a manufacturer sells a tobacco product to a distributor, exclusive of any discount or other reduction."⁴

¹ RCW 82.26.020(1).

² RCW 82.26.010(1).

³ RCW 82.26.020(1).

⁴ RCW 82.26.010(7).

For purposes of the OTP tax, a manufacturer is defined as a “person who manufactures and sells tobacco products” and a distributor means “any person engaged in the business of selling tobacco products in this state who brings or, causes to be brought, into this state from without the state any tobacco products for sale.”⁵ The OTP tax is imposed at the time the tobacco product is delivered into the state:

(2) Taxes under this section shall be imposed at the time the distributor (a) brings, or causes to be brought, into this state from without the state tobacco products for sale . . .^[6]

United States Tobacco Sales and Marketing Company Inc., (Tobacco Sales) filed a complaint for a refund of OTP taxes for the year 1992 for samples it distributed in this state.⁷ Tobacco Sales and the Department filed cross motions for summary judgment. The trial court denied Tobacco Sales’ motion and granted the Department’s motion. Tobacco Sales appealed to this Court.

⁵ RCW 82.26.010(3). The full definition of distributor is:

(a) any person engaged in the business of selling tobacco products in this state who brings, or causes to be brought, into this state from without the state any tobacco products for sale, (b) any person who makes, manufactures, or fabricates tobacco products in this state for sale in this state, (c) any person engaged in the business of selling tobacco products without this state who ships or transports tobacco products to retailers in this state, to be sold by those retailers, (d) any person engaged in the business of selling tobacco products in this state who handles for sale any tobacco products that are within this state but upon which tax has not been imposed.

For purposes of this case, the distributor definition that applies is subsection a.

⁶ RCW 82.26.020(2).

⁷ CP at 120.

In *U.S. Tobacco Sales & Marketing Co. Inc. v. Dep't of Rev.*, 96 Wn. App. 932, 982 P.2d 652 (1999) (attached in appendix), this Court determined that the OTP statute was not ambiguous.⁸ In evaluating the “wholesale sales price,” defined as an “established price exclusive of any discount or other reduction,”⁹ the Court determined that an “‘established price’ from a manufacturer must be a generally available, stable, fixed price, such as a list price or invoice price.”¹⁰ According to the Court, this manufacturer’s “‘established price’ would be available to all customers and would represent the fair market value of the products.”¹¹ The Court then defined “fair market value” to mean “the amount a willing buyer would pay a seller who is willing but not obligated to sell.”¹² Since this case involved affiliated companies, the Court stated, “In the case of affiliated companies, which, in effect, are obligated to buy and sell from each other, the ‘established price’ must be based upon fair market value rather than the manufacturer’s price to its affiliate.”¹³

⁸ *U.S. Tobacco Sales & Marketing Co. Inc. v. Dep't of Rev.*, 96 Wn. App. 932, 938, 982 P.2d 652 (1999).

⁹ RCW 82.26.010(7): “‘Wholesale sales price’ means the established price for which a manufacturer sells a tobacco product to a distributor, exclusive of any discount or other reduction.”

¹⁰ *U.S. Tobacco Sales & Marketing Co. Inc. v. Dep't of Rev.*, 96 Wn. App. 932, 938, 982 P.2d 652 (1999).

¹¹ *Id.* at 940.

¹² *Id.* citations omitted.

¹³ *Id.*

The trial court was directed to make a factual determination as to whether Tobacco Manufacturing's price to Tobacco Sales was a fair market price or whether it was a discounted price.¹⁴ The Court reversed the summary judgment order in favor of the Department and affirmed the trial court's denial of summary judgment in favor of Tobacco Sales and remanded the matter back to the trial court for proceedings consistent with its opinion.¹⁵ Both parties again moved for summary judgment, but the trial court denied both motions and set the matter for hearing. Tobacco Sales filed a petition for discretionary review in this Court seeking review of the denial of its summary judgment motion. The Court denied Tobacco Sales' petition.¹⁶ The trial court conducted a three-day hearing based in part upon stipulated facts on January 21-23, 2003.¹⁷

B. Statement of Facts.

In 1992, United States Tobacco Company formed two wholly owned subsidiaries: United States Tobacco Sales and Marketing Company Inc. (Tobacco Sales) and United States Tobacco Manufacturing Company Inc. (Tobacco Manufacturing).¹⁸ Prior to 1990, United States Tobacco

¹⁴ *Id.* at 941-42.

¹⁵ *Id.* at 944.

¹⁶ CP at 4-5. Petitioner filed a motion to modify the Commissioner's ruling, but the Court denied the motion (No. 28059-1-II).

¹⁷ RP Vol. 1 at 1.

¹⁸ CP at 127-28; 131-32.

Company performed all functions relating to the manufacturing, sale and marketing of its smokeless tobacco products.¹⁹ Afterwards, Tobacco Manufacturing manufactures smokeless tobacco products, primarily the brand names Copenhagen and Skoal, which are sold only to other affiliated corporations, including Tobacco Sales.²⁰ Tobacco Sales engages in the business of marketing and selling the smokeless tobacco products that it purchases from Tobacco Manufacturing.²¹ Tobacco Manufacturing arranges for the shipping of the smokeless tobacco products on behalf of Tobacco Sales as its agent.²² Tobacco Sales advertises and distributes its smokeless tobacco products samples to adult consumers at promotional events such as rodeos, auto races, and fishing tournaments.²³

Senior management at Tobacco Sales determined the price charged for its smokeless tobacco products.²⁴ The price for the smokeless tobacco products sold by Tobacco Manufacturing to Tobacco Sales, commonly referred to as the transfer price, is based upon a formula.²⁵ Tobacco Sales sells its smokeless tobacco products at prices higher than the prices at which it purchases from Tobacco Manufacturing.²⁶ Tobacco

¹⁹ CP at 128, 133.

²⁰ CP at 128; 133; RP Vol. 1 at 100; ll. 13-16; RP Vol. 1 at 209, ll. 9-12.

²¹ CP at 129; 133.

²² *Id.*

²³ CP at 130, 134.

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.*

Manufacturing's 1992 transfer price to Tobacco Sales for smokeless tobacco products was \$.625 per can.²⁷ In 1995, the company engaged the services of an accounting firm, Ernst & Young, to conduct a transfer price study prepared under Section 482 of the Internal Revenue Code to determine the transfer prices for a wide range of inter-company transactions.²⁸ Because the transfer price study related to 1995 and not the tax year 1992, another transfer price study was conducted for the year in question and completed in July 2000 for sales between Tobacco Manufacturing and Tobacco Sales for the purposes of the litigation.²⁹ Additionally, Tobacco Sales engaged the services of appraiser, Mr. Robert Reilly of Willamette Management Associates, to provide a fair market value opinion.³⁰

The transfer price study for the tax year 1992 indicated that the transfer price was in the range between \$.68 and \$.72 per can, and the appraiser agreed with the study.³¹ Tobacco Sales' 1992 selling price to unaffiliated customers/distributors averaged \$1.43 per can.³² For the

²⁷ CP at 130, 134.

²⁸ RP Vol. 1 at 46, ll. 15-23.

²⁹ RP Vol. 1 at 25, ll. 2-7; RP Vol. 1 at 87, ll. 6-9; *See* Trial Exhibit 1 (attached as Exhibit II, Ernst & Young, LLP Transfer Pricing Report July 2000).

³⁰ RP Vol. 1 at 25, ll. 8-11.

³¹ RP Vol. 1 at 55, ll. 1-3; Ex. 1, pg. 23; The actual inter-company transfer price between the two companies for the tax year 1992 was determined to be \$.73 per can. RP Vol. 1 at 147, ll. 5-7; *See also* Trial Exhibit 1, pg. 23.

³² CP at 130, 134; *See also* Ex. 4, 5, 6.

samples of smokeless tobacco products Tobacco Sales distributed in Washington in 1992, the Other Tobacco Products tax (OTP) was calculated based on Tobacco Sales' selling price to unaffiliated customers/distributors (\$1.43 per can) and not on the original transfer price of \$.625.³³

At the hearing, the Department presented two experts, an economist from its research division and an appraiser also employed by the Department. The trial court found that the 1992 selling price of \$.68 to \$.72 from Tobacco Manufacturing to Tobacco Sales based upon the 1992 transfer price study and the original transfer price of \$.625 failed to represent the fair market value of the smokeless tobacco products sold by Tobacco Manufacturing to Tobacco Sales.³⁴ The trial court further found that Tobacco Manufacturing's selling price was a discounted price compared to the fair market value price.³⁵ The trial court concluded as a matter of law that the transfer prices did not reflect a fair market value because Tobacco Manufacturing would not willingly sell to an unaffiliated buyer at that price.³⁶ However, the trial court derived a 1992 fair market value for Tobacco Manufacturing's sales of smokeless tobacco products to

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.*

³⁶ CP at 135; RP Vol. 1 at 452-53, ll. 20-25, 1-5.

Tobacco Sales at \$.82 per can.³⁷ The court arrived at this price simply by “taking the middle price of \$.70 per can” and re-allocating the residual profit split from the transfer price study offered by Tobacco Sales and adding this additional amount to arrive at the fair market value of \$.82 per can without regard to whether Tobacco Manufacturing would sell its product to an unaffiliated company at that price.³⁸ Indeed, the trial court offered no rationale for the reallocation that it selected. The trial court then ordered a refund of OTP taxes based upon its calculation of OTP tax being due on \$.82 per can.³⁹

IV. SUMMARY OF ARGUMENT

In *U.S. Tobacco Sales*, this Court directed the trial court to determine the fair market value of the tobacco product based on the amount a willing buyer would pay a seller who is willing but not obligated to sell. The trial court correctly concluded that Tobacco Manufacturing was not a willing seller, because it would not sell at the price advocated by Tobacco Sales, \$.68 to \$.72 per can, to any other entity except to its affiliate Tobacco Sales. Tobacco Manufacturing did not contend or demonstrate that it would sell its product to any distributor other than Tobacco Sales for \$.82 per can, and the trial court did not conclude that Tobacco Manufacturing would sell its

³⁷ CP at 134.

³⁸ RP Vol. 3 at 456, ll. 12-17; 457, ll. 4-7.

³⁹ CP at 135.

product to any distributor other than Tobacco Sales at \$.82 per can. As Tobacco Sales failed to demonstrate that this price would have been available to any other distributor, the \$.82 “fair market value” created by the trial court does not represent fair market value as properly defined by this Court in *U.S. Tobacco*. Accordingly, this price is not fair market value on which to assess the OTP tax. In addition, Tobacco Sales came forward with no evidence of wholesale sales prices of similar products between unrelated manufacturers and distributors—willing sellers and willing buyers. In short, Tobacco Sales failed to carry its burden as required by this Court in *U.S. Tobacco* to show fair market value, as there defined, and thus failed to carry its burden under RCW 82.32.180 to demonstrate the correct amount of the tax. Having failed to meet its burden, its tax refund should have been denied.

Furthermore, the Department provided the trial court with evidence of the established price between the manufacturer and in-state distributors in the form of invoices. Such price reflects the fair market value, the actual wholesale price for the product.

Finally, the trial court erred in finding a fair market value of \$.82 per can, based upon an allocation of profits in a transfer price study. Such studies are used simply to ensure that related companies do not avoid their correct share of taxable income and thus liability for income tax. Such

studies are not designed to determine fair market value, as correctly defined by this Court in *U.S. Tobacco*, for purposes of collecting an excise tax measured by a wholesale selling price the actual price that would be paid between a willing buyer and a willing seller. Tobacco Manufacturing is not a willing seller. The trial court should be reversed. Tobacco Sales' request for tax refund should be denied and the Department's assessment of the OTP tax should be affirmed.

V. ARGUMENT

A. Standard of Review.

The challenged findings of fact are binding on appeal if supported by substantial evidence in the record.⁴⁰ Substantial evidence exists “where there is a sufficient quantity of evidence in the record to persuade a fair-minded, rational person of the truth of the finding.”⁴¹ The appellate court reviews the trial court's conclusions of law de novo. As the state Supreme Court has repeatedly stated, “[c]onstruction of a statute is a question of law that is reviewed de novo.”⁴²

⁴⁰ *Pilcher v. Dep't of Rev.*, 112 Wn. App. 428, 435, 49 P.3d 947 (2002) (quoting *In re Contested Election of Schoessler*, 140 Wn.2d 368, 385, 998 P.2d 818 (2000)).

⁴¹ *Pilcher*, 112 Wn. App. at 435, citing *Schoessler*, 140 Wn.2d at 385 (quoting *State v. Hill*, 123 Wn.2d 641, 644, 870 P.2d 313 (1994)).

⁴² *City of Seattle v. Burlington N.R.R.*, 145 Wn.2d 661, 665, 41 P.3d 1169 (2002) (quoting *Rettowski v. Dep't of Ecology*, 128 Wn.2d 508, 515, 910 P.2d 462 (1996)); *Seattle Filmworks, Inc., v. Dep't of Rev.*, 106 Wn. App. 448, 453, 24 P.3d 460 (2001).

B. Tobacco Sales Failed to Meet Its Burden of Proving That The Price Between The Affiliates, Tobacco Sales And Tobacco Manufacturing, Was a “Fair Market Price.”

The statutory authority for the Court’s consideration of the application of the tax statute is contained in RCW 82.32.180. That statute places the burden on the taxpayer to prove (1) that the tax as assessed by the Department is incorrect, and (2) to establish what the correct tax is.⁴³ Tobacco Sales advocated that the fair market price that should be used to measure the OTP tax between Tobacco Manufacturing and Tobacco Sales was in the range of \$.68 to \$.72 per can.⁴⁴ Tobacco Sales failed to meet its burden.

In evaluating the “wholesale sales price” defined as an “established price exclusive of any discount” this Court determined that an “‘established price’ from a manufacturer must be a generally available, stable, fixed price, such as a list price or invoice price.”⁴⁵ This manufacturer’s “established price” “would be available to all customers and would represent the fair market value of the products.”⁴⁶ There are no list prices or invoices reflecting a price between Tobacco Manufacturing and Tobacco Sales. The “established price” generally available to the

⁴³ RCW 82.32.180.

⁴⁴ RP Vol. 1 at 28, ll. 10-12.

⁴⁵ *U.S. Tobacco Sales*, 96 Wn. App. at 943.

⁴⁶ *Id.* at 940.

Tobacco Sales' customers, who are the distributors of the tobacco product in Washington, was presented to the trial court in the form of invoices for the years 1991 and 1992 as \$1.41 per can, \$1.45 per can and \$1.55 per can.⁴⁷ The parties even stipulated that the average price for a can of tobacco product in 1992 sold to a Washington distributor (Tobacco Sales customer) was \$1.43 and that such price was always higher than the sale price between Tobacco Manufacturing and Tobacco Sales.⁴⁸

Tobacco Sales' expert testified that Tobacco Manufacturing would not sell to customers at the same price it sold them to Tobacco Sales:

Q: (Mr. Hankins) Now, you correct me if I'm wrong, Mr. Reilly, but I wrote down that you said manufacturing would not sell to customers and distributors at the same price it sold to Sales & Marketing.

A: (Mr. Reilly) Yes, absolutely.^[49]

Additionally, Mr. Sharif Lofti, Tobacco Sales' expert, who conducted the transfer price study, testified that Tobacco Sales would not charge the same price it "paid" to Tobacco Manufacturing for the tobacco product to an unaffiliated buyer:

Q: (Mr. Severson): Is the price that you determined for the sale of tobacco from Tobacco Manufacturing to Tobacco Sales a price at which Tobacco Sales could be expected to,

⁴⁷ Ex. 4, 5, 6. Attached in Appendix.

⁴⁸ CP at 129-30. RP at 217, ll. 16-20.

⁴⁹ RP Vol. 2 at 226-27, ll. 24-25, 1-3; RP Vol. 2, at 233, ll. 4-18; RP Vol. 1 at 189-190, ll. 12-25, 1-4.

in turn, sell the tobacco products to an unaffiliated purchaser?

A: (Mr. Lofti): No, because if they were to do so, they wouldn't make any money. They have to have a return, they have to earn a fair return on the activities that they do and on the – any addition, sort of all value-added activities that they generated.

Q: Are you telling me that a company can't stay in business if it buys the product that it's selling at the same price that it sells it at?

A: It would not be in business.^[50]

Therefore, the price between Tobacco Manufacturing and Tobacco Sales is not an "established price", because it was not generally available to an unaffiliated buyer such as its customers or distributors.

Tobacco Sales failed to carry its burden that the "established price" would be available to all customers and would represent the fair market value of the products."⁵¹ The only evidence presented to the trial court to prove the "established price" to an unaffiliated buyer/customer was in the form of invoices demonstrating that the "established price" for the years 1991 and 1992 was \$1.41 per can, \$1.45 per can and \$1.55 per can.⁵² Further, the price between Tobacco Manufacturing and Tobacco Sales is not "fair market value" price because it was not a price readily

⁵⁰ RP Vol. 1 at 56, ll. 6-19.

⁵¹ *U.S. Tobacco Sales & Marketing Co. Inc. v. Dep't of Rev.*, 96 Wn. App. 932, 940, 982 P.2d 652 (1999).

⁵² Ex. 4, 5, 6. Attached in Appendix.

available to all unaffiliated buyers/customers and would not be a price resulting from a willing buyer and willing seller. In addition, the trial court's creation of a "fair market price" of \$.82 per can is not based on any principal justification or analysis with respect to whether Tobacco Sales would sell its product to an unaffiliated business at that price.

C. The Established Price Between Tobacco Manufacturing And Tobacco Sales Was Not A "Fair Market Value" Price Because The Entities Were Not A Willing Buyer And Willing Seller As Required By This Court's Decision.

This Court defined "fair market value" to mean "the amount a willing buyer would pay a seller who is willing but not obligated to sell."⁵³ Since this case involved affiliated companies, the Court stated, "In the case of affiliated companies, which, in effect, are obligated to buy and sell from each other, the 'established price' must be based upon fair market value rather than the manufacturer's price to its affiliate."⁵⁴ The price established between Tobacco Manufacturing and Tobacco Sales was not a fair market value price because they were not a willing buyer and a seller willing, but not obligated, to sell.

At trial, Tobacco Sales presented two experts to testify regarding the fair market value price. During cross-examination, it became clear

⁵³ *U.S. Tobacco Sales & Marketing Co. Inc. v. Dep't of Rev.*, 96 Wn. App. 932, 940, 982 P.2d 652 (1999).

⁵⁴ *Id.*

that Tobacco Manufacturing was not a “willing seller” because it did not sell its product to anyone else, but to its affiliate, Tobacco Sales. Mr. Lofti conceded during cross examination that Tobacco Manufacturing did not sell to any other entity except to Tobacco Sales:

Q: (Mr. Hankins) Isn't it true that the manufacturing unit does not sell to any other entities except to its affiliated entities, Sales and Marketing?

A: (Mr. Lofti) Domestically, that's true.^[55]

Mr. Reilly testified that Tobacco Manufacturing would **never** sell to any other entity except to or through Tobacco Sales:

Q: (Mr. Hankins) Under my hypothetical that I gave you, isn't it true that manufacturing, if it sold directly to a distributor, it would not sell at a lower price than what it sells to Sales & Marketing?

A: (Mr. Reilly) Well, it's not a question of higher prices or lower price. **Manufacturing would never sell to a distributor whether it's a wholesaler or regional director or even a retailer other than through Sales & Marketing**, because what the product is that leaves the UST is the product that includes the manufactured product plus the marketing and sales and brand support that comes from Sales & Marketing, so manufacturing would not sell a product without Sales & Marketing, just like Sales & Marketing would not go to a manufacturer in Mexico and sell some other type of smokeless tobacco that doesn't come from manufacturing.^[56]

⁵⁵ RP Vol. 1 at 100, ll. 13-16.

⁵⁶ RP Vol. 2 at 231, ll. 5-21 (emphasis added); *See also* RP Vol. 2 at 384, ll. 13-19.

The trial court appropriately concluded from this cross-examination that the price between Tobacco Manufacturing and Tobacco Sales was not a fair market value price because there was not a willing seller:

Q: (Court) I think finally, Mr. Reilly did testify on cross-examination that United States Manufacturing would not sell to some other distributor. The question I think that was before him on cross-examination was whether or not if United States Manufacturing sold to a distributor other than United States Sales & Marketing, would the price be higher, and he indicated that there would be no sale. . . [I]n any event, **if we look at fair market value and its traditional definition that it's what a willing buyer would pay a willing seller, aren't we being told, then, that there is no willing seller in such a transaction?**^[57]

The Court concluded in its oral decision and in its written conclusions that there was not a willing buyer and willing seller:

Court: Based upon that I find that there was not a fair market value price even though that's been determined as supposedly arm's length and here's the reason. **There's not a willing buyer and willing seller. I should say more specifically, there's not a willing seller.** U.S. Tobacco Manufacturing would not willingly sell to some other affiliate because they get a better deal when they sell to U.S. Tobacco Manufacturing and Sales, so it's not arm's-length from that standpoint.^[58]

Once the Court determined that there was not a willing buyer and willing seller, it should have concluded that Tobacco Sales failed to meet

⁵⁷ RP Vol. 3 at 431-32, ll. 20-25, 1-3, 7-12 (emphasis added).

⁵⁸ RP Vol. 3 at 452-53, ll. 20-25, 1-4; CP at 135 (emphasis added).

its statutory burden to prove that the OTP tax was not appropriately levied, and to demonstrate the correct amount of the tax. Tobacco Sales failed to meet its burden and its tax refund should have been denied. Therefore, although the court came to the correct conclusion, it erred in thereafter creating a “fair market value” without any proof that Tobacco Manufacturing would sell its product at that price to an unaffiliated distributor, and granting Tobacco Sales a refund. There was no evidence before the trial court that \$.82 per can constituted the fair market value of the product as required by this Court in *U.S. Tobacco*.

D. Tobacco Sales Failed To Establish The Correct Amount Of Tax Owed Pursuant To RCW 82.32.180.

Tobacco Sales bore the burden of proving the correct amount of OTP tax it owed to the State of Washington. It attempted to prove “fair market value” price through a transfer price study for the year 1992, completed in 2000, solely for litigation purposes to evaluate fair market value, and testimony through an appraiser. Such evidence failed to prove the ultimate issue this Court directed to the parties, “What is the fair market value of Tobacco Manufacturing’s product?”⁵⁹

⁵⁹ *U.S. Tobacco Sales*, 96 Wn. App. at 943.

Tobacco Sales presented a transfer price study to prove fair market value.⁶⁰ A transfer price study measures inter-company pricing to comply with income tax requirements under the Internal Revenue Code section 482 (2003) and as a tool for management.⁶¹ Section 482 of the Internal Revenue Code seeks to “ensure that taxpayers clearly reflect income attributable to controlled transactions, and to prevent the avoidance of taxes with respect to such transactions.”⁶² A transfer price study examines a company’s allocation of income to determine true taxable income for purposes of **income tax**. It is not designed to arrive at fair market value for purposes of an excise tax based on wholesale selling price. Indeed, both of Tobacco Sales’ experts agreed that they have not seen a transfer price study used to establish a fair market value to measure an excise tax.⁶³

The transfer price study evaluated the profit structure of the company and then allocated the profits among the companies in order to arrive at a price per can of \$.68 to \$.72 a can:

(Mr. Lofti): So we say the cost of operations plus their profits would be their implicit sales so that’s what they should sell, their total sales to the Sales & Marketing

⁶⁰ See Trial Exhibit 1 (attached as Exhibit II, Ernst & Young, LLP Transfer Pricing Report July 2000).

⁶¹ RP Vol. 1 at 48-9, ll. 8-25, ll. 1-10. See also, 26 U.S.C. § 482.

⁶² 26 CFR § 1.482-1 (1999); See also, *E.I. Du Pont de Nemours & Co. v. United States*, 608 F.2d 445, 449 (Ct. Cl. 1979) (“Section 482 gives the Secretary of the Treasury (or his delegate) discretion to allocate income between related corporations when necessary to ‘prevent evasion of taxes or clearly to reflect the income’ of any such corporations”).

⁶³ RP Vol. 1 at 89-90. l. 25, ll. 1-3; RP Vol. 2 at 214, ll. 10-19.

Company should be A plus C plus E plus their cost of goods sold plus operating expenses, and that gives this sales between the Manufacturing Sales to the Sales & Marketing Company. And that total number we then divide by total cans to get an average price per can.^[64]

Allocating profits among the company for purposes of income tax does not demonstrate the fair market value price for purposes of the OTP tax because it does not demonstrate the actual price a willing buyer and willing seller would pay for the product. As indicated by this Court, “The pertinent inquiry is what *is* the fair market value, not how it is determined, for what purpose, or by whom.”⁶⁵ The Department imposes the OTP tax “upon the sale, use, consumption, handling, or distribution of all tobacco products in this state.”⁶⁶ As explained by the Department’s expert appraiser witness, a transfer price study is a “methodology adopted for markets or trade levels where there weren’t typically sales that you could calculate a value that would mirror or be reasonably reflective of fair market value.”⁶⁷ But an excise tax is based upon the actual sale or actual price.⁶⁸

⁶⁴ RP Vol. 1 at 125, ll. 9-18; See also Ex. 1, (attached as Exhibit number II, Exhibit 8, Pg. 14, and 16).

⁶⁵ *U.S. Tobacco Sales*, 96 Wn. App. at 943.

⁶⁶ RCW 82.26.020

⁶⁷ RP Vol. 2 at 366-67, ll. 22-25, 1.

⁶⁸ RP Vol. 2 at 338, ll. 7-11; *See also* RP Vol. 2 at 316, ll. 16-20; RP Vol. 2 at 367, ll. 6-13.

For example, the federal government through the Internal Revenue Service uses a market price in assessing a manufacturer's federal excise tax even when the companies are affiliated.⁶⁹ In *Crème Mfg. Co., Inc. v. United States*, 492 F.2d 515 (5th Cir. 1974), Crème Manufacturing Company sought a tax refund for claimed overpayment of federal excise taxes.⁷⁰ A husband and wife, Nicholas and Cosma Crème, organized Crème Lure Company to manufacture and sell artificial fishing lures known as plastic "worms".⁷¹ Eventually, they formed another company called Crème Manufacturing to manufacture the "worms" and Crème Lure Company primarily handled the sales and marketing of the product.⁷² Crème Lure sold to wholesalers at approximately 40 percent of the suggested retail price and Crème Manufacturing sold to Crème Lure at a price of 25 percent of the list price.⁷³ Crème Manufacturing based its federal excise taxes on this lower price.⁷⁴ The Internal Revenue Service assessed additional taxes based upon the price Crème Lure sold to

⁶⁹ See *Campana Corp. v. Harrison*, 114 F.2d 400, 409 (7th Cir. 1940) *overruled on other grounds*, *F.W. Fitch Co. v. United States*, 323 U.S. 582, 65 S.Ct. 409, 89 L.Ed. 472 (1945) (Court held that the price between two affiliated companies was not a fair market price as the federal excise tax "is measured by the manufacturer's actual sales price at the factory or place of production."); see also 26 U.S.C.S. § 4216(b)(2) (2003).

⁷⁰ *Crème Mfg. Co., Inc. v. United States*, 492 F.2d 515, 517 (5th Cir. 1974).

⁷¹ *Id.* at 518.

⁷² *Id.*

⁷³ *Id.*

⁷⁴ *Id.*

independent wholesalers and not the price it paid to Crème Manufacturing.⁷⁵

The Seventh Circuit Court affirmed the Internal Revenue Service’s assessment of additional excise tax, because it found the lower price was not an arms-length-price, nor a fair market value price.⁷⁶ In examining the elements of a “fair market price” the Court opined that such price must be a “market” price that is available to buyers and represent the true worth of the product:

The arm’s length and fair market criteria are interrelated. Both are directed to ensuring that the price on which the excise tax is based represents a bona fide expression of what the article is in fact worth. . . The price must be more than “fair”; it is not enough that the price compensate the manufacturing company for costs—and even provide a profit. The price must be a “market” price; it must be the price which independent buyers in arm’s length transactions would be willing to pay.^[77]

Just like the *Crème Manufacturing Company* case, Tobacco Manufacturing and Tobacco Sales have organized into one entity solely manufacturing and the other entity solely sales and marketing. However, unlike the *Crème Manufacturing Company* case, Tobacco Manufacturing does not “sell” its product to any other entity except to Tobacco Sales.⁷⁸

⁷⁵ *Id.*

⁷⁶ *Id.* at 520-21.

⁷⁷ *Id.* at 520.

⁷⁸ RP Vol. 1 at 100, ll. 13-16; RP Vol. 3 at 431-32, ll. 20-25, 1-3, 7-12.

There are no sales to evaluate a fair market price. The trial court properly concluded that in order to determine whether Tobacco Manufacturing's price to Tobacco Sales was a "fair market price" it would have to compare such price to a market price:

To determine whether Tobacco Manufacturing's selling price was a fair market value price, that price must be compared to the market price at which a tobacco products manufacturer would sell OTP to an unaffiliated distributor, where the parties otherwise hold the same property interest, bear the same risks and performed the same functions as do Tobacco Manufacturing and Tobacco Sales.^[79]

In addition, under Washington's statute, the fair market value of the product is measured at the time the tobacco product is brought for sale into the state. This Court in *McLane Co., Inc., v. Dep't of Rev.*, 105 Wn. App. 409, 19 P.3d 119 (2001), *review denied*, 145 Wn.2d 1005 (2001), upheld the Department's imposition of the OTP tax at the time the product was brought into the state. The Court concluded that the entity liable for the tax is the in-state distributor bringing in the products for sale in this state.⁸⁰ Even if the transfer price study otherwise arrived at fair market value for the product sold by Tobacco Sales (and it does not) it also fails to evaluate the prices of the tobacco product at the time it is brought into the state and transferred by Tobacco sale to an in-state distributor.⁸¹ Yet,

⁷⁹ CP at 135.

⁸⁰ *Id.* at 417.

⁸¹ RP Vol. 1 at 92-93, ll. 25, 1-10.

all the experts agreed that the price between an independent distributor or in-state distributor and Tobacco Sales would be fair market price at that level of trade.⁸² The Department's expert appraiser testified that the transfer price study failed to examine the correct "trade level" for the fair market price.⁸³ According to the Department's expert, the correct trade level for the fair market price of the tobacco product must be determined at the time the product is brought into the state.⁸⁴ For the additional reason that the OTP tax is calculated at the time the product is brought into the state and based upon an invoice price that an in-state distributor would pay, the price between Tobacco Sales and Tobacco Manufacturing is a discounted price and not the actual fair market value price.

In sum, for each of these reasons, Tobacco Sales failed to prove the correct amount of the tax. The Department's assessment should have been affirmed and Tobacco Sales' request for a tax refund should have been denied.

E. The Trial Court Erred In Creating A Fair Market Value Price Of \$.82 Per Can.

The trial court properly found that there was not a willing buyer/willing seller relationship between Tobacco Sales and Tobacco

⁸² RP Vol. 1 at 92, ll. 18-24; RP Vol. 2 at 217, ll. 16-23; RP Vol. 2 at 362, ll. 6-12; 369, ll. 20-24.

⁸³ RP Vol. 2 at 360, ll. 1-20.

⁸⁴ RP Vol. 2 at 362, ll. 4-12. ll. 17-21; 365-66, ll. 19-25, ll. 1-13.

Manufacturing, because Tobacco Manufacturing would not willingly sell at the same price to any other entity.⁸⁵ Once the trial court determined that there was not a willing buyer/willing seller, it should have concluded that Tobacco Sales failed to prove a fair market value price and affirmed the Department's assessment. Instead, the trial court relied on an inapposite transfer price study and a further inexplicable reallocation of a percentage of profits to somehow reflect a fair market value:

Court: [I] heard testimony from experts that overall the [profit] split was 40/60, and so what I've done is instead of a 76/24 split on the profits for 1992, I have calculated that based upon a 40/60 split. I have then added that profit to the 68 to 72 cents.... Quite frankly, I took the middle of the 68 to 72 cents which is 70 cents, and then I'm going to add the additional profit that I believe should have been figured in the manufacturer's selling price for that to be fair market value.^[86]

The trial court first announced the fair market price would be \$1.00,⁸⁷ but it eventually arrived at the price of \$.82 per can based upon reallocating the residual profit split between Tobacco Manufacturing and Tobacco Sales. Although the trial court could reject the expert testimony in whole or in part,⁸⁸ the trial court abused its discretion by ignoring the substantial evidence in the record that the price between Tobacco

⁸⁵ CP at 135; RP Vol. 3 at 452-53, ll. 20-24, ll. 1-5.

⁸⁶ RP Vol. 3 at 456, ll. 12-17; 457, ll. 4-7.

⁸⁷ RP Vol. 3 at 437, ll. 1-4.

⁸⁸ *Group Health v. Dep't of Revenue*, 106 Wn.2d 391, 399, 722 P.2d 787 (1986) (citing *Brewer v. Copeland*, 86 Wn.2d 58, 74, 542 P.2d 445 (1975)).

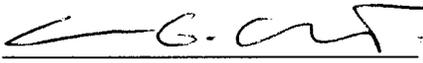
Manufacturing and Tobacco Sales was not a fair market value price, because they were not a willing buyer/willing seller, by creating a fair market value without regard to whether it reflected the price at which the product would be sold between unaffiliated companies, and by ignoring trial exhibits 4-6 demonstrating an invoice price, a readily available price or market price. In sum, the trial court simply created from whole cloth a “fair market value” without support in the record that it in fact reflects a price at which Tobacco Manufacturing would sell its product to a nonaffiliated distributor on the open market.

VI. CONCLUSION

The trial court erred in creating a “fair market price” for tobacco products distributed in Washington. Tobacco Sales failed to carry its burden to demonstrate a “fair market value”. Therefore, the trial court’s judgment and order awarding Tobacco Sales a tax refund claim should be reversed and its tax refund claim should be denied.

RESPECTFULLY SUBMITTED this 12th day of January, 2004.

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APPENDIX

1. Chapter 82.26 RCW
TAX ON TOBACCO PRODUCTS
2. *United States Tobacco Sales and Marketing Company Inc. v. State of Washington, Department of Revenue*, 96 Wash. App. 932, 982 P.2d 652 (1999)
3. Corrected Stipulation of Facts
4. Findings of Fact and Conclusions of Law
5. Exhibits 4, 5 and 6. Tobacco Sales Invoices
6. RP - Verbatim Report Excerpts of Proceedings

Appendix 1

Chapter 82.26 RCW
TAX ON TOBACCO PRODUCTS

RCW SECTIONS

82.26.010 Definitions.

82.26.020 Tax imposed -- Additional taxes for general fund, health services account.

82.26.025 Additional tax imposed -- Rate -- Where

82.26.028 Surtax imposed -- Rate -- Health services

82.26.030 Legislative intent -- Purpose.

82.26.040 When tax not applicable under laws of United

82.26.050 Certificate of registration required.

82.26.060 Books and records to be preserved -- Entry and inspection by department.

82.26.070 Preservation of invoices of sales to other than ultimate

82.26.080 Invoices of purchases to be procured by retailer, subjobber -- Preservation -- Inspection.

82.26.090 Records of shipments, deliveries from public warehouse of first destination -- Preservation --

82.26.100 Reports and returns.

82.26.110 When credit may be obtained for tax paid.

82.26.120 Administration.

82.26.121 Enforcement -- Appointment of officers of liquor control board.

82.26.130 Invoices -- Nonpayment -- Penalties and interest.

NOTES:

Minors: Chapter 70.155 RCW.

RCW 82.26.010**Definitions.**

As used in this chapter:

(1) "Tobacco products" means cigars, cheroots, stogies, periques, granulated, plug cut, crimp cut, ready rubbed, and other smoking tobacco, snuff, snuff flour, cavendish, plug and twist tobacco, fine-cut and other chewing tobaccos, shorts, refuse scraps, clippings, cuttings and sweepings of tobacco, and other kinds and forms of tobacco, prepared in such manner as to be suitable for chewing or smoking in a pipe or otherwise, or both for chewing and smoking, but shall not include cigarettes as defined in RCW 82.24.010;

(2) "Manufacturer" means a person who manufactures and sells tobacco products;

(3) "Distributor" means (a) any person engaged in the business of selling tobacco products in this state who brings, or causes to be brought, into this state from without the state any tobacco products for sale, (b) any person who makes, manufactures, or fabricates tobacco products in this state for sale in this

state, (c) any person engaged in the business of selling tobacco products without this state who ships or transports tobacco products to retailers in this state, to be sold by those retailers, (d) any person engaged in the business of selling tobacco products in this state who handles for sale any tobacco products that are within this state but upon which tax has not been imposed;

(4) "Subjobber" means any person, other than a manufacturer or distributor, who buys tobacco products from a distributor and sells them to persons other than the ultimate consumers;

(5) "Retailer" means any person engaged in the business of selling tobacco products to ultimate consumers;

(6) "Sale" means any transfer, exchange, or barter, in any manner or by any means whatsoever, for a consideration, and includes and means all sales made by any person. It includes a gift by a person engaged in the business of selling tobacco products, for advertising, as a means of evading the provisions of this chapter, or for any other purposes whatsoever;

(7) "Wholesale sales price" means the established price for which a manufacturer sells a tobacco product to a distributor, exclusive of any discount or other reduction;

(8) "Business" means any trade, occupation, activity, or enterprise engaged in for the purpose of selling or distributing tobacco products in this state;

(9) "Place of business" means any place where tobacco products are sold or where tobacco products are manufactured, stored, or kept for the purpose of sale or consumption, including any vessel, vehicle, airplane, train, or vending machine;

(10) "Retail outlet" means each place of business from which tobacco products are sold to consumers;

(11) "Department" means the state department of revenue;

(12) "Person" 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, the state and its departments and institutions, 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. The term excludes any person immune from state taxation, including the United States or its instrumentalities, and federally recognized Indian tribes and enrolled tribal members, conducting business within Indian country;

(13) "Indian country" means the same as defined in chapter 82.24 RCW.

[2002 c 325 § 1; 1995 c 278 § 16; 1975 1st ex.s. c 278 § 70; 1961 c 15 § 82.26.010. Prior: 1959 ex.s. c 5 § 11.]

NOTES:

Effective date -- 2002 c 325: "This act takes effect July 1, 2002." [2002 c 325 § 6.]

Effective date -- 1995 c 278: See note following RCW 82.24.010.

Construction -- Severability -- 1975 1st ex.s. c 278: See notes following RCW 11.08.160.

RCW 82.26.020

Tax imposed -- Additional taxes for general fund, health services account.

(1) There is levied and there shall be collected a tax upon the sale, use, consumption, handling, or distribution of all tobacco products in this state at the rate of forty-five percent of the wholesale sales price of such tobacco products.

(2) Taxes under this section shall be imposed at the time the distributor (a) brings, or causes to be brought, into this state from without the state tobacco products for sale, (b) makes, manufactures, or fabricates tobacco products in this state for sale in this state, (c) ships or transports tobacco products to retailers in this state, to be sold by those retailers, or (d) handles for sale any tobacco products that are within this state but upon which tax has not been imposed.

(3) An additional tax is imposed equal to seven percent multiplied by the tax payable under subsection (1) of this section.

(4) An additional tax is imposed equal to ten percent of the wholesale sales price of tobacco products. The moneys collected under this subsection shall be deposited in the health services account created under RCW 43.72.900.

[2002 c 325 § 2; 1993 c 492 § 309; 1983 2nd ex.s. c 3 § 16; 1982 1st ex.s. c 35 § 9; 1975 1st ex.s. c 278 § 71; 1971 ex.s. c 299 § 77; 1965 ex.s. c 173 § 25; 1961 c 15 § 82.26.020. Prior: 1959 ex.s. c 5 § 12.]

NOTES:

Effective date -- 2002 c 325: See note following RCW 82.26.010.

Finding -- Intent -- 1993 c 492: See notes following RCW 43.20.050.

Short title -- Severability -- Savings -- Captions not law -- Reservation of legislative power -- Effective dates -- 1993 c 492: See RCW 43.72.910 through 43.72.915.

Construction -- Severability -- Effective dates -- 1983 2nd ex.s. c 3: See notes following RCW 82.04.255.

Severability -- Effective dates -- 1982 1st ex.s. c 35: See notes following RCW 82.08.020.

Construction -- Severability -- 1975 1st ex.s. c 278: See notes following RCW 11.08.160.

Effective dates -- Severability -- 1971 ex.s. c 299: See notes following RCW 82.04.050.

RCW 82.26.025

Additional tax imposed -- Rate -- Where deposited.

(1) In addition to the taxes imposed under RCW 82.26.020, there is levied and there shall be collected a tax upon the sale, use, consumption, handling, or distribution of all tobacco products in this state at the

rate of sixteen and three-fourths percent of the wholesale sales price of such tobacco products. Such tax shall be imposed at the time the distributor (a) brings, or causes to be brought, into this state from without the state tobacco products for sale, (b) makes, manufactures, or fabricates tobacco products in this state for sale in this state, (c) ships or transports tobacco products to retailers in this state, to be sold by those retailers, or (d) handles for sale any tobacco products that are within this state but upon which tax has not been imposed.

(2) The moneys collected under this section shall be deposited as follows:

(a) For the period ending July 1, 1999, in the water quality account under RCW 70.146.030;

(b) For the period beginning July 1, 1999, through June 30, 2001, fifty percent into the violence reduction and drug enforcement account under RCW 69.50.520 and fifty percent into the salmon recovery account;

(c) For the period beginning July 1, 2001, through June 30, 2021, into the water quality account under RCW 70.146.030; and

(d) For the period beginning July 1, 2021, in the general fund.

[2002 c 325 § 3; 1999 c 309 § 926; 1986 c 3 § 14.]

NOTES:

Effective date -- 2002 c 325: See note following RCW 82.26.010.

Severability -- Effective date -- 1999 c 309: See notes following RCW 41.06.152.

Severability -- 1986 c 3: See RCW 70.146.900.

Effective dates -- 1986 c 3: See note following RCW 82.24.027.

RCW 82.26.028

Surtax imposed -- Rate -- Health services account.

In addition to the taxes imposed upon the wholesale sales price of tobacco products set forth in RCW 82.26.020 and 82.26.025, a surtax is imposed equal to ninety-three and three-quarters percent of taxes levied under RCW 82.26.020, effective January 1, 2002. The surtax payable under this subsection shall be deposited in the health services account created under RCW 43.72.900 for the purposes set forth in that section.

[2002 c 2 § 4 (Initiative Measure No. 773, approved November 6, 2001).]

NOTES:

Intent -- 2002 c 2 (Initiative Measure No. 773): See RCW 70.47.002.

RCW 82.26.030

Legislative intent -- Purpose.

It is the intent and purpose of this chapter to levy a tax on all tobacco products sold, used, consumed, handled, or distributed within this state and to collect the tax from the distributor as defined in RCW 82.26.010. It is the further intent and purpose of this chapter to impose the tax once, and only once, on all tobacco products for sale in this state, but nothing in this chapter shall be construed to exempt any person taxable under any other law or under any other tax imposed under Title 82 RCW.

[2002 c 325 § 4; 1961 c 15 § 82.26.030. Prior: 1959 ex.s. c 5 § 13.]

NOTES:

Effective date -- 2002 c 325: See note following RCW 82.26.010.

RCW 82.26.040**When tax not applicable under laws of United States.**

The tax imposed by RCW 82.26.020 shall not apply with respect to any tobacco products which under the Constitution and laws of the United States may not be made the subject of taxation by this state.

[1961 c 15 § 82.26.040. Prior: 1959 ex.s. c 5 § 14.]

RCW 82.26.050**Certificate of registration required.**

From and after July 1, 1959 no person shall engage in the business of a distributor or subjobber of tobacco products at any place of business without first having received from the department of revenue a certificate of registration as provided in RCW 82.32.030.

[1975 1st ex.s. c 278 § 72; 1961 c 15 § 82.26.050. Prior: 1959 ex.s. c 5 § 15.]

NOTES:

Construction -- Severability -- 1975 1st ex.s. c 278: See notes following RCW 11.08.160.

RCW 82.26.060**Books and records to be preserved -- Entry and inspection by department.**

Every distributor shall keep at each registered place of business complete and accurate records for that place of business, including itemized invoices, of tobacco products held, purchased, manufactured, brought in or caused to be brought in from without the state, or shipped or transported to retailers in this state, and of all sales of tobacco products made, except sales to the ultimate consumer.

These records shall show the names and addresses of purchasers, the inventory of all tobacco products on hand on July 1, 1959, and other pertinent papers and documents relating to the purchase, sale, or disposition of tobacco products.

When a registered distributor sells tobacco products exclusively to the ultimate consumer at the address given in the certificate, no invoice of those sales shall be required, but itemized invoices shall be made of all tobacco products transferred to other retail outlets owned or controlled by that registered distributor. All books, records, and other papers and documents required by this section to be kept shall be preserved for a period of at least five years after the date of the documents, as aforesaid, or the date of the entries thereof appearing in the records, unless the department of revenue, in writing, authorizes their destruction or disposal at an earlier date. At any time during usual business hours the department, or its duly authorized agents or employees, may enter any place of business of a distributor, without a search warrant, and inspect the premises, the records required to be kept under this chapter, and the tobacco products contained therein, to determine whether or not all the provisions of this chapter are being fully complied with. If the department, or any of its agents or employees, are denied free access or are hindered or interfered with in making such examination, the registration certificate of the distributor at such premises shall be subject to revocation by the department.

[1975 1st ex.s. c 278 § 73; 1961 c 15 § 82.26.060. Prior: 1959 ex.s. c 5 § 16.]

NOTES:

Construction -- Severability -- 1975 1st ex.s. c 278: See notes following RCW 11.08.160.

RCW 82.26.070

Preservation of invoices of sales to other than ultimate consumer.

Every person who sells tobacco products to persons other than the ultimate consumer shall render with each sale itemized invoices showing the seller's name and address, the purchaser's name and address, the date of sale, and all prices and discounts. He shall preserve legible copies of all such invoices for five years from the date of sale.

[1961 c 15 § 82.26.070. Prior: 1959 ex.s. c 5 § 17.]

RCW 82.26.080

Invoices of purchases to be procured by retailer, subjobber -- Preservation -- Inspection.

Every retailer and subjobber shall procure itemized invoices of all tobacco products purchased. The invoices shall show the name and address of the seller and the date of purchase. The retailer and subjobber shall preserve a legible copy of each such invoice for five years from the date of purchase. Invoices shall be available for inspection by the department of revenue or its authorized agents or employees at the retailer's or subjobber's place of business.

[1975 1st ex.s. c 278 § 74; 1961 c 15 § 82.26.080. Prior: 1959 ex.s. c 5 § 18.]

NOTES:

Construction -- Severability -- 1975 1st ex.s. c 278: See notes following RCW 11.08.160.

RCW 82.26.090

Records of shipments, deliveries from public warehouse of first destination -- Preservation -- Inspection.

Records of all deliveries or shipments of tobacco products from any public warehouse of first destination in this state shall be kept by the warehouse and be available to the department of revenue for inspection. They shall show the name and address of the consignee, the date, the quantity of tobacco products delivered, and such other information as the department may require. These records shall be preserved for five years from the date of delivery of the tobacco products.

[1975 1st ex.s. c 278 § 75; 1961 c 15 § 82.26.090. Prior: 1959 ex.s. c 5 § 19.]

NOTES:

Construction -- Severability -- 1975 1st ex.s. c 278: See notes following RCW 11.08.160.

RCW 82.26.100
Reports and returns.

Every distributor shall report and make returns as provided in RCW 82.32.045. Every registered distributor outside of this state shall in like manner report and make returns.

[1983 c 3 § 218; 1961 c 15 § 82.26.100. Prior: 1959 ex.s. c 5 § 20.]

RCW 82.26.110
When credit may be obtained for tax paid.

Where tobacco products upon which the tax imposed by this chapter has been reported and paid, are shipped or transported by the distributor to retailers without the state, to be sold by those retailers, or are returned to the manufacturer by the distributor or destroyed by the distributor, credit of such tax may be made to the distributor in accordance with regulations prescribed by the department of revenue.

[1975 1st ex.s. c 278 § 76; 1961 c 15 § 82.26.110. Prior: 1959 ex.s. c 5 § 21.]

NOTES:

Construction -- Severability -- 1975 1st ex.s. c 278: See notes following RCW 11.08.160.

RCW 82.26.120
Administration.

All of the provisions contained in chapter 82.32 RCW shall have full force and application with respect to taxes imposed under the provisions of this chapter.

[1963 ex.s. c 28 § 5.]

NOTES:

Effective date -- 1963 ex.s. c 28: See note following RCW 82.04.030.

RCW 82.26.121**Enforcement -- Appointment of officers of liquor control board.**

The department shall appoint, as duly authorized agents, enforcement officers of the liquor control board to enforce provisions of this chapter. These officers shall not be considered employees of the department.

[1997 c 420 § 11.]

RCW 82.26.130**Invoices -- Nonpayment -- Penalties and interest.**

(1) The department shall by rule establish the invoice detail required under RCW 82.26.060 for a distributor under RCW 82.26.010(3)(d) and for those invoices required to be provided to retailers under RCW 82.26.070.

(2) If a retailer fails to keep invoices as required under chapter 82.32 RCW, the retailer is liable for the tax owed on any uninvoiced tobacco products but not penalties and interest, except as provided in subsection (3) of this section.

(3) If the department finds that the nonpayment of tax by the retailer was willful or if in the case of a second or plural nonpayment of tax by the retailer, penalties and interest shall be assessed in accordance with chapter 82.32 RCW.

[2002 c 325 § 5.]

NOTES:

Effective date -- 2002 c 325: See note following RCW 82.26.010.

Appendix 2



Court of Appeals of Washington,
Division 2.

UNITED STATES TOBACCO SALES AND
MARKETING COMPANY INC. Appellant,

v.

STATE of Washington, DEPARTMENT OF
REVENUE, Respondent.

No. 22676-6-II.

Aug. 20, 1999.

Distributor of tobacco products sued Department of Revenue, requesting judgment in the amount of allegedly overpaid other tobacco products (OTP) tax. The Superior Court, Thurston County, Gary Tabor, J., granted summary judgment for the Department of Revenue. Distributor appealed. The Court of Appeals, Houghton, J., held that genuine issues of material fact as to the fair market value of tobacco manufacturer's products sold to the distributor precluded summary judgment.

Reversed and remanded.

West Headnotes

[1] Appeal and Error ☞893(1)
30k893(1)

Statutory interpretation is a question of law that the appellate court reviews de novo.

[2] Statutes ☞181(1)
361k181(1)

Court's fundamental duty in construing statutes is to ascertain and to carry out the Legislature's intent.

[3] Statutes ☞188
361k188

Legislative intent is derived primarily from the language of the statute.

[4] Statutes ☞190
361k190

If a statute is plain and unambiguous, its meaning must be derived solely from the statutory language.

[5] Statutes ☞190

361k190

Statute is "ambiguous" if it is susceptible of two or more reasonable interpretations.

[6] Statutes ☞219(2)
361k219(2)

Courts defer to agency interpretations **only** when statutory language is ambiguous.

[7] Statutes ☞219(4)
361k219(4)

Administrative interpretation that conflicts with the statutory language is not entitled to deference.

[8] Statutes ☞188
361k188

In determining what a statute means, words **should** be ascribed their plain and ordinary meanings.

[9] Statutes ☞188
361k188

When a statute does not define a nontechnical word, the court may look to the dictionary for guidance.

[10] Evidence ☞113(16)
157k113(16)

"Fair market value" is the amount a **willing** buyer would pay a seller who is willing but not **obligated** to sell.

[11] Taxation ☞1292
371k1292

Statute imposing an other tobacco products (OTP) tax imposes the tax upon the value of a **manufacturer's** products, measured at the time the manufacturer sells the products, a price which, at a **minimum**, must include the costs and profits associated with manufacturing and sales, because those **functions** are mandated by the statutory definition of "**manufacturer**"; however, it need not include value that is **added** to the products after the manufacturer sells them. West's RCWA 82.26.010(2, 7).

[12] Taxation ☞1292
371k1292

(Cite as: 96 Wash.App. 932, 982 P.2d 652)

Whether a tobacco manufacturer's price is "discounted," for purposes of the other tobacco products (OTP) tax, is a factual determination evaluated without regard to the purchaser's corporate affiliation with the manufacturer. West's RCWA 82.04.030, 82.26.010(2), (3)(a), (7), 82.26.020; Wash. Admin. Code § 458-20-203.

[13] Taxation ☞ 1292
371k1292

To determine whether tobacco manufacturer's price was discounted, for purposes of the other tobacco products (OTP) tax, the trier of fact had to compare the manufacturer's price with the fair market value of its products where the manufacturer sold exclusively to an affiliate, such that its selling price did not necessarily reflect fair market value. West's RCWA 82.04.030, 82.26.010(2), (3)(a), (7), 82.26.020; Wash. Admin. Code § 458-20-203.

[14] Taxation ☞ 1292
371k1292

Law did not permit Department of Revenue to disregard tobacco distributor and tobacco manufacturer's separate corporate identities and treat them as one entity for purposes of the other tobacco products (OTP) tax, despite their corporate affiliation. West's RCWA 82.04.030, 82.26.010(2), (3)(a), (7), 82.26.020; Wash. Admin. Code § 458-20-203.

[15] Corporations ☞ 1.4(3)
101k1.4(3)

Corporate forms may be set aside only in cases of fraud.

[16] Taxation ☞ 1292
371k1292

Fact that a pricing study was undertaken in the context of federal income tax did not preclude its relevance in determining fair market value of tobacco sold by manufacturer, for purposes of the State other tobacco products (OTP) tax. West's RCWA 82.04.030, 82.26.010(2), (3)(a), (7), 82.26.020; Wash. Admin. Code § 458-20-203.

[17] Taxation ☞ 1292
371k1292

That a profit-sharing formula is used or that a transaction occurs between affiliated entities is not

determinative of whether a transfer price is a market price, for purpose of the other tobacco products (OTP) tax; the pertinent inquiry is what is the fair market value, not how it is determined, for what purpose, or by whom. West's RCWA 82.04.030, 82.26.010(2), (3)(a), (7), 82.26.020; Wash. Admin. Code § 458-20-203.

[18] Judgment ☞ 181(32)
228k181(32)

Genuine issues of material fact as to the fair market value of tobacco manufacturer's products precluded summary judgment as to whether the sale price charged by the manufacturer to an affiliated distributor was "discounted," for purposes of the other tobacco products (OTP) tax. West's RCWA 82.04.030, 82.26.010(2), (3)(a), (7), 82.26.020; Wash. Admin. Code § 458-20-203.

****654 *933** John Gerhart Hennen, Olympia, for Respondent.

Norman J. Bruns, William C. Severson, Garvey, Schubert & Barer, Seattle, for Appellant.

HOUGHTON, J.

A distributor of tobacco products appeals a trial court order denying its motion for summary judgment and granting summary judgment in favor of the Department of Revenue. The trial court ruled that the statutory measure of the tobacco products tax is the price at which the distributor, an affiliate of the manufacturer, sells tobacco products rather than the price at which it ***934** buys them from the manufacturer. We reverse and remand for further proceedings.

I. FACTS

Appellant, the United States Tobacco Sales and Marketing Company Inc. (Tobacco Sales), is a Delaware corporation that buys, markets, and resells smokeless tobacco products in the State of Washington and elsewhere. [FN1] Most of Tobacco Sales' customers are wholesale distributors who resell the products to retailers. Tobacco Sales exclusively purchases the tobacco products it distributes from the United States Tobacco Manufacturing Company Inc. (Tobacco Manufacturing). Tobacco Sales is Tobacco Manufacturing's only domestic customer. Both Tobacco Sales and Tobacco Manufacturing are wholly-owned subsidiaries of the United States Tobacco Company (USTC). [FN2]

FN1. Tobacco Sales' main product lines are

(Cite as: 96 Wash.App. 932, *934, 982 P.2d 652, **654)

Copenhagen and Skoal.

FN2. USTC is in turn owned by UST Inc. Prior to 1990, USTC performed both the manufacturing and marketing functions. The company reorganized in 1990, creating Tobacco Manufacturing and Tobacco Sales as wholly-owned subsidiaries of USTC. Tobacco Sales employs approximately 600 full-time workers; Tobacco Manufacturing employs about 700.

Washington State imposes an excise tax on the "sale, use, consumption, handling, or distribution of all tobacco products" in the state. RCW 82.26.020(1). "Tobacco products" are all types of chewing and smoking tobacco, snuff, and cigars, but not cigarettes. RCW 82.26.010(1). The tax is known as the Other Tobacco Products tax (OTP tax). It is measured by the "wholesale sales price" of tobacco products brought into the state. [FN3] RCW 82.26.020. The wholesale sales price is "the established price for which a manufacturer sells a tobacco product to a distributor, exclusive of any discount or other reduction." RCW 82.26.010(7).

FN3. The tax rate is currently 74.9%. RCW 82.26.020-.025.

In addition to selling tobacco products to wholesalers, Tobacco Sales gives away sample products at promotional events, such as rodeos, auto races, and fishing tournaments. [FN4] *935 Until 1996, Tobacco Sales paid the OTP tax on the free samples it distributed in Washington. Tobacco Sales' Washington customers paid the OTP tax on products for resale.

FN4. Some of these promotional products are marked "SAMPLE," while others are unmarked. Although Tobacco Sales buys the marked samples from Tobacco Manufacturing at a discounted price, it acknowledges that it is liable for OTP tax on both marked and unmarked samples based upon its regular purchase price. See RCW 82.26.010(6) ("Sale" means any transfer, exchange, or barter, ... [and] includes a gift by a person engaged in the business of selling tobacco products, for advertising....").

In 1996, the Washington Department of Revenue (Department) audited Tobacco Sales. The auditor determined that Tobacco Sales was the taxable "distributor" under the statute and should have been paying the OTP tax on its sales as well as its samples.

In the course of the audit, Tobacco Sales inquired **655 whether its purchase price, rather than its selling price, was the correct measure of the tax under the statute. In September 1996, the auditor informed Tobacco Sales that its purchase price was, in fact, the correct measure; thus Tobacco Sales had been overpaying the tax. Tobacco Sales revised its pricing scheme based upon this information.

In December 1996, Tobacco Sales requested a refund of the OTP tax it had overpaid on its samples in 1992. [FN5] The Department denied the refund claim because the audit had not been finalized. In February 1997, in a summary of its final audit instructions, the Department advised Tobacco Sales that its original measure of the tax, its selling price, was the correct measure after all. The Department stated that although the correct tax measure was the manufacturer's selling price, "a sale by a manufacturer to a distributor who is an affiliate ... is not used in establishing the manufacturer's selling price." [FN6] Therefore, the correct measure of the tax was Tobacco Sales' "selling price to distributors *936 who are not affiliated with you." According to the Department, this is what the Legislature meant by the phrase "established price."

FN5. Prior tax years had closed under the statute of limitations. See RCW 82.32.060(1)-(3).

FN6. In February 1997, at the Department's request, the Legislature considered a bill amending the OTP tax provisions. See HR 2202, 55th Leg. (Wash.1997). The proposed bill stated that: "Sales between affiliates are not sales for the purpose of establishing distribution sales price." The Legislature, however, failed to enact the proposed changes.

In April 1997, Tobacco Sales filed a lawsuit against the Department requesting judgment in the amount of allegedly overpaid OTP tax for 1992. Tobacco Sales and the Department filed cross motions for summary judgment. On October 27, 1997, the trial court denied Tobacco Sales' motion and granted the Department's motion, finding that the price Tobacco Sales paid to Tobacco Manufacturing was a discounted price within the meaning of RCW 82.26.010(7). Tobacco Sales appeals.

II. ANALYSIS

A. Standard of Review

Tobacco Sales appeals both the summary judgment in

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favor of the Department and the denial of its motion for summary judgment. Summary judgment is appropriate if there are no genuine issues of material fact, and the moving party is entitled to judgment as a matter of law. CR 56(c). The appellate court reviews the trial court's decision de novo. *Reid v. Pierce County*, 136 Wash.2d 195, 201, 961 P.2d 333 (1998); *Young v. Estate of Snell*, 134 Wash.2d 267, 271, 948 P.2d 1291 (1997) (citing *Safeco Ins. Co. of Am. v. Butler*, 118 Wash.2d 383, 394-95, 823 P.2d 499 (1992)). The court must construe the facts most favorably toward the nonmoving party. *Babcock v. State*, 116 Wash.2d 596, 599, 809 P.2d 143 (1991) (citing *Wendle v. Farrow*, 102 Wash.2d 380, 383, 686 P.2d 480 (1984)). Tobacco Sales has the burden of proving that the tax it paid was incorrect and establishing the correct amount. RCW 82.32.180.

B. Wholesale Sales Price

At issue is the statutory definition of "wholesale sales price." Tobacco Sales argues that the price it pays *937 Tobacco Manufacturing is the correct measure of the OTP tax. The Department contends that the tax should be based upon the wholesale value of tobacco products to a Washington wholesale purchaser (Tobacco Sales' selling price), because Tobacco Sales' purchase price is a "reduced price."

1. Statutory Definitions

The OTP tax is measured by the "wholesale sales price" of tobacco products. RCW 82.26.020. The "wholesale sales price" is "the established price for which a manufacturer sells a tobacco product to a distributor, exclusive of any discount or other reduction." RCW 82.26.010(7). A "manufacturer" is "a person who manufactures and sells tobacco products." RCW 86.26.010(2). A "distributor" includes: "any person engaged in the business of selling tobacco products in [Washington] who brings, or causes to be brought, into this state from without the **656 state any tobacco products for sale." [FN7] RCW 82.26.010(3)(a). The statute makes no distinction between affiliated and nonaffiliated entities. It defines "person" as "any individual ... firm, copartnership, joint venture, club, company, joint stock company ... limited liability company, association, society, or any group of individuals acting as a unit." [FN8] RCW 82.04.030; *see also* WAC 458-20-203. [FN9] Under these definitions, *938 Tobacco Manufacturing is the manufacturer [FN10] and Tobacco Sales is the taxable distributor. [FN11]

FN7. The full definition includes:

(a) any person engaged in the business of selling tobacco products in [Washington] who brings, or causes to be brought, into this state from without the state any tobacco products for sale, (b) any person who makes, manufactures, or fabricates tobacco products in this state for sale in this state, (c) any person engaged in the business of selling tobacco products without this state who ships or transports tobacco products to retailers in this state, to be sold by those retailers.

RCW 82.26.010(3).

FN8. Although "person" is not defined in the OTP tax chapter, the term is used throughout the tax code and is defined in RCW 82.04.030

FN9. For Washington tax purposes, "Each separately organized corporation is a 'person' within the meaning of the law, notwithstanding its affiliation with or relation to any other corporation through stock ownership by a parent corporation by the same group of individuals." WAC 458-20-203

FN10. The Department argues that Tobacco Manufacturing does not meet the statutory definition of "manufacturer" because Tobacco Manufacturing relies upon USTC for telemarketing services and UST Inc. for certain administrative functions. But Tobacco Manufacturing pays an arm's length price for these services. The Department presents no authority or argument to support its conclusion that manufacturers who contract with other entities for services are thereby excluded from the statutory definition of "manufacturer."

FN11. After instructing Tobacco Sales to pay OTP tax on its sales as well as its samples in the course of the 1996 audit, the Department reversed its position. The Department now claims that Tobacco Sales is not the taxpayer with regard to products it sells to Washington wholesalers. But the Department agrees that Tobacco Sales is the "distributor" of the free samples it distributes in Washington, and only the tax paid on the samples is at issue in this case.

2. Statutory Interpretation

[1][2][3][4][5] Statutory interpretation is a question of law that the appellate court reviews de novo. *Monroe*

(Cite as: 96 Wash.App. 932, *938, 982 P.2d 652, **656)

v. Soliz, 132 Wash.2d 414, 418, 939 P.2d 205 (1997); *American Legion Post No. 32 v. City of Walla Walla*, 116 Wash.2d 1, 5, 802 P.2d 784 (1991). The court's fundamental duty is to ascertain and to carry out the Legislature's intent. *State v. Chester*, 133 Wash.2d 15, 21, 940 P.2d 1374 (1997). Legislative intent is derived primarily from the language of the statute. *State v. Michielli*, 132 Wash.2d 229, 237, 937 P.2d 587 (1997). If a statute is plain and unambiguous, its meaning must be derived solely from the statutory language. *Harmon v. Department of Soc. and Health Servs.*, 134 Wash.2d 523, 530, 951 P.2d 770 (1998) (citing *State v. Mollichi*, 132 Wash.2d 80, 87, 936 P.2d 408 (1997); *Marquis v. City of Spokane*, 130 Wash.2d 97, 107, 922 P.2d 43 (1996)). A statute is ambiguous if it is susceptible of two or more reasonable interpretations. *State v. Van Woerden*, 93 Wash.App. 110, 116, 967 P.2d 14 (1998) (citing *State v. Sunich*, 76 Wash.App. 202, 206, 884 P.2d 1 (1994)), *review denied*, 137 Wash.2d 1039, 980 P.2d 1286 (1999).

[6][7] The OTP tax statute is not ambiguous; it uses plain language and defines key terms. Therefore, this court must determine the Legislature's intent from the words alone. [FN12] *939 *See Waste Management of Seattle, **657 Inc. v. Utilities and Transp. Comm'n*, 123 Wash.2d 621, 629, 869 P.2d 1034 (1994).

FN12. The Department argues that its "longstanding interpretation" of the OTP tax measure is entitled to deference by the court. But courts defer to agency interpretations only when statutory language is ambiguous. *Western Telepage, Inc. v. City of Tacoma*, 95 Wash.App. 140, 974 P.2d 1270, 1274 (1999) (citing *Simpson Inv. Co. v. Department of Revenue*, 92 Wash.App. 905, 913, 965 P.2d 654 (1998), *review granted*, 137 Wash.2d 1032, 980 P.2d 1284 (1999); *Waste Management of Seattle, Inc. v. Utilities and Transp. Comm'n*, 123 Wash.2d 621, 627-28, 869 P.2d 1034 (1994)). Also, the Department submits no evidence that its current position amounts to a "longstanding interpretation." From the record, it appears that, until 1996, Tobacco Sales voluntarily paid the OTP tax based upon its selling price, without having been instructed by the Department to do so. *See Western Telepage*, 974 P.2d at 1273-74. Moreover, an administrative interpretation that conflicts with the statutory language is not entitled to deference. *Senate Republican Campaign Comm. v. Public Disclosure Comm'n*, 133 Wash.2d 229, 241, 943 P.2d 1358 (1997).

a. Discount or Other Reduction

[8][9] In determining what a statute means, words should be ascribed their plain and ordinary meanings. *North Coast Air Servs., Ltd. v. Grumman Corp.*, 111 Wash.2d 315, 321, 759 P.2d 405 (1988). When a statute does not define a nontechnical word, the court may look to the dictionary for guidance. *State v. Myers*, 133 Wash.2d 26, 33, 941 P.2d 1102 (1997) (citing *State v. Pacheco*, 125 Wash.2d 150, 154, 882 P.2d 183 (1994)). According to Webster's dictionary, "discount" means "an abatement or reduction made from the gross amount or value of anything"; and "a reduction from a price made to a specific customer or class of customers." WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 646 (1969). "Reduction" means "a decrease in size, amount, extent, or number." *Id.* at 1905. The meaning of these words relies upon comparison with an objective, fixed value, in this case, the manufacturer's "established price."

b. Established Price

[10] Webster's dictionary defines "to establish" as "to make firm or stable: fix to prevent or check unsteadiness"; and "to place, install, or set up in a permanent or relatively enduring position." *Id.* at 778. A "fixed price" is "a uniform price for all customers." *Id.* at 861. Thus, a manufacturer's established price is a generally available, stable, fixed price, *940 such as a list price or invoice price. [FN13] Because an "established price" is available to all customers, it reflects the fair market value of the products. [FN14] "Fair market value" is the amount a willing buyer would pay a seller who is willing but not obligated to sell. *Crystal Chalets Ass'n v. Pierce County*, 93 Wash.App. 70, 77, 966 P.2d 424 (1998) (citing *Duwanish Warehouse Co. v. Hoppe*, 102 Wash.2d 249, 254, 684 P.2d 703, 57 A.L.R.4th 939 (1984)). In the case of affiliated companies, which, in effect, are obligated to buy and sell from each other, the "established price" must be based upon fair market value rather than the manufacturer's price to its affiliate.

FN13. Other state statutes similar to Washington's are in accordance with our interpretation. *See Ark.Code Ann. § 26-57-208(2)* ("manufacturer's selling price" is "actual manufacturer invoice price before discounts"); *Colo.Rev.Stat. § 39-28.5-101* ("[m]anufacturer's list price" means "the invoice price ... exclusive of any discount or other reduction"); *35 Ill. Comp. Stat. § 143/10-5* (" 'Wholesale price' means the established list price for which a manufacturer

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sells tobacco products ... [or] the manufacturer's invoice price ... to unaffiliated distributors...."); Ohio Rev.Code Ann. § 5743.01(K) (" 'Wholesale price' means the invoice price ... to unaffiliated distributors").

FN14. Cf. Conn. Gen.Stat. § 12-330a (" '[W]holesale sales price' [of tobacco products is] the price set for such products or, if no price has been set, the wholesale value of such products...."); *MAPCO Alaska Petroleum, Inc. v. United States*, 27 Fed. Cl. 405, 410 (1992) ("established price," as used in Federal Acquisition Regulation § 52.216-2, means "a price that ... is an established catalog or market price for a commercial item sold in substantial quantities to the general public."), *dismissed by* No. 94-5068, 1994 WL 745571 (Fed.Cir. Apr.8, 1994).

c. Components of the Manufacturer's Price

The Department argues that because Tobacco Manufacturing and Tobacco Sales are affiliated, the "established price" should include both entities' costs and profits, i.e., manufacturing and marketing costs. [FN15] But neither the statute nor case law provides a basis for ignoring the entities' corporate structure. See RCW 82.04.030; WAC 458-20-203; *Rena-Ware Distributors, Inc. v. State*, 77 Wash.2d 514, 517-18, 463 P.2d 622 (1970) (wholly-owned subsidiaries are separate entities for purposes of taxing statutes); *Washington *941 Sav-Mor Oil Co. v. Tax Comm'n*, 58 Wash.2d 518, 364 P.2d 440 (1961) (transactions between oil company and affiliated distributor are treated as sales between separate corporations for tax purposes).

FN15. Prior to the 1990 reorganization, USTC both manufactured and marketing its tobacco products. The tax base at that time was therefore substantially larger than after the reorganization.

****658** [11] The statute imposes the tax upon the value of a manufacturer's products, measured at the time the manufacturer sells the products. This price will reflect the quality, quantity, packaging, and trademark value of the products as provided by the manufacturer. At a minimum, this price must include the costs and profits associated with manufacturing and sales, because those functions are mandated by the statutory definition of "manufacturer." RCW 82.26.010(2). But it need not include value that is added to the products after the manufacturer sells them. Under this definition, the OTP tax will be higher on products that are extensively

marketed by their manufacturer than on products that a manufacturer sells generically. But the statute permits this disparity, and the court may not alter the statutory language. [FN16] See *King County v. City of Seattle*, 70 Wash.2d 988, 991, 425 P.2d 887 (1967) (courts are not to read into statutes matters that are not there, nor modify statutes by construction).

FN16. Other states have avoided this problem by taxing tobacco products by weight or item. See, e.g., Ala.Code § 40-25-2; Ariz.Rev.Stat. § 42-3052(6); see also Fla. Stat. ch. 210.30 (tobacco products tax imposed upon consumers); N.J.Rev.Stat. § 54:40B-3 (tax imposed upon retailers or consumers).

C. Summary Judgment

1. Order Granting Summary Judgment

[12] Before the court below, both parties argued that disposition of their summary judgment motions entailed resolution of a legal issue, the statutory measure of the OTP tax. The trial court agreed, basing its ruling that Tobacco Manufacturing's price is "discounted" upon its interpretation of the statutory definition as excluding prices between affiliates. The trial court's analysis was in error. Whether a price is discounted is a factual determination and is evaluated without regard to the purchaser's corporate affiliation.

[13] As discussed above, the statutory measure of the OTP *942 tax is the manufacturer's list or invoice price; i.e., the fair market value of the products. Here, because Tobacco Manufacturing sells exclusively to an affiliate, its selling price does not necessarily reflect fair market value. Therefore to determine whether Tobacco Manufacturing's price is discounted, the trier of fact must compare Tobacco Manufacturing's price with the fair market value of its products.

In support of its position that its purchase price from Tobacco Manufacturing is fair market value, Tobacco Sales submitted a transfer pricing study performed by an accounting firm, Ernst & Young, in 1995. The study was commissioned to determine, for federal tax purposes, arm's length prices for products and services transferred between various UST Inc. subsidiaries. [FN17] The study concluded that Tobacco Manufacturing's price is an arm's length price under federal law.

FN17. The study adhered to the regulations promulgated by the IRS pursuant to IRC § 482, which governs intercompany transfers.

(Cite as: 96 Wash.App. 932, *942, 982 P.2d 652, **658)

See 26 C.F.R. § 1.482-1. The regulations require that arm's length prices be charged for such transactions. 26 C.F.R. § 1.482-1(b). A price is arm's length if "the results of the transaction are consistent with the results that would have been realized if [unaffiliated] taxpayers had engaged in the same transaction under the same circumstances." 26 C.F.R. § 1.482-1(b).

The Department failed to submit any evidence of fair market value or pricing comparisons. Rather, the Department contended that a transfer price between affiliated companies cannot represent a market price. It attacked the Ernst & Young study as irrelevant because it was performed for federal income tax purposes and because the arm's length price was derived from a formula rather than set by market forces. [FN18] But the Department failed to identify in what respect the federal arm's-length-price standard differs from fair market value. The Department argued that a "common sense" construction of the statute is that the **659 *943 "wholesale sales price" is the wholesale price paid by a nonaffiliated Washington customer.

FN18. The transfer pricing regulations set forth specific methods for calculating the most accurate arm's-length-price for various transactions. *See* 26 C.F.R. § 1.482-1 to -7. Because Ernst & Young concluded that there are no tobacco products manufacturers similar to Tobacco Manufacturing, it relied on the alternate methods provided in the regulations. *See* 26 C.F.R. § 1.482-3 to -7.

[14][15][16][17] The Department's position is contrary to the statutory language, which refers to the manufacturer's price. Tobacco Sales is not a manufacturer. And the law does not permit the Department to disregard Tobacco Sales' and Tobacco Manufacturing's separate corporate identities and treat them as one entity for tax purposes. [FN19] That a pricing study is undertaken in the context of federal income tax does not preclude its relevance in determining fair market value for Washington tax purposes. Likewise, that a profit-sharing formula is used or that a transaction occurs between affiliated entities is not determinative of whether a transfer price is a market price. The pertinent inquiry is what *is* the fair market value, not how it is determined, for what

purpose, or by whom.

FN19. Corporate forms may be set aside only in cases of fraud. *Rena-Ware Distributors, Inc.*, 77 Wash.2d at 518, 463 P.2d 622 (citing *Associated Oil Co. v. Seiberling Rubber Co.*, 172 Wash. 204, 19 P.2d 940 (1933)). This safeguard will prevent the "[t]ax anarchy" the Department suggests would result from "allow[ing Tobacco Sales] to set its own tax bill." Furthermore, if Tobacco Manufacturing were to sell to Tobacco Sales at below-market rates, the Department could contest the sale price as not meeting the definition of "established price" under the statute.

[18] The trial court determined that Tobacco Sales' purchase price is a reduced price because: Tobacco Manufacturing's price is set using a calculation that takes each entity's profit margins into account, and the price is set after the transaction between Tobacco Manufacturing and Tobacco Sales; [FN20] the Ernst & Young study is not relevant because it deals with federal income tax; and, the Department's interpretation is entitled to deference. These factors do not resolve the question of what is the fair market value of Tobacco Manufacturing's products. Therefore, summary judgment in favor of the Department was not appropriate.

FN20. The price is actually set at the beginning of each year.

2. Order Denying Summary Judgment

Tobacco Sales also challenges the denial of its motion for summary judgment. Because disposition of this case entails *944 a disputed factual issue, the trial court was correct in denying the motion.

The order granting summary judgment in favor of the Department is reversed, the order denying summary judgment in favor of Tobacco Sales is affirmed, and the case is remanded for further proceedings consistent with this opinion.

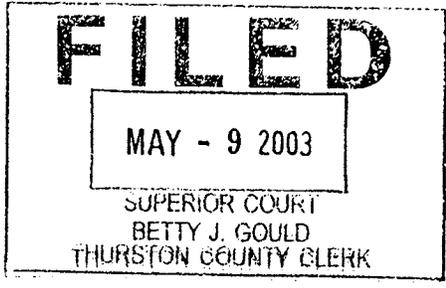
ARMSTRONG, A.C.J., and HUNT, J., concur.

END OF DOCUMENT

Appendix 3

1 EXPEDITE
2 Hearing is set:
3 Date: May 9, 2003
4 Time: 9:00 a.m.
5 Judge/Calendar: Tabor / Civil

HONORABLE GARY R. TABOR



7 **IN THE SUPERIOR COURT OF THE STATE OF WASHINGTON**
8 **IN AND FOR THE COUNTY OF THURSTON**

9 UNITED STATES TOBACCO SALES
10 AND MARKETING COMPANY INC.,

No. 97-2-00883-0

11 Plaintiff,

**CORRECTED STIPULATION
OF FACTS**

12 v.

13 WASHINGTON STATE
14 DEPARTMENT OF REVENUE,

15 Defendant.

16 This Corrected Stipulation of Facts corrects an error in paragraph 20 of the original
17 stipulation that was signed and entered on January 21, 2003. The corrected fact is that the
18 amount of OTP tax paid by Tobacco Sales for OTP distributed in 1992 was \$160,553 not
19 \$247,385.

20 **I. STIPULATED FACTS**

21
22 1. This Stipulation of Facts applies to the 1992 tax year at issue in this case. Except as
23 otherwise indicated, the stipulated facts are those that existed at that time.

24 2. Plaintiff, U.S. Smokeless Tobacco Brands Inc., known in 1992 as United States
25 Tobacco Sales and Marketing Company Inc. (Tobacco Sales), is a wholly owned subsidiary of

1 U.S. Smokeless Tobacco Company, known in 1992 as United States Tobacco Company
2 (USTC). USTC was a wholly owned subsidiary of UST Inc.¹

3 3. United States Tobacco Manufacturing Company Inc. (Tobacco Manufacturing) is a
4 wholly owned subsidiary of USTC.² Tobacco Manufacturing produces smokeless tobacco
5 products that are sold under a variety of brand names, primarily Copenhagen and Skoal. Prior
6 to 1990, USTC performed all functions relating to the manufacturing, sale and marketing of its
7 smokeless tobacco products which it sold directly to customers. USTC reorganized in 1990
8 (hereinafter the 1990 Restructuring), creating Tobacco Manufacturing and Tobacco Sales as
9 wholly owned subsidiaries to perform the manufacturing and sales and marketing functions
10 previously performed by USTC.

11 4. Since the 1990 Restructuring, USTC has been a holding company for Tobacco Sales
12 and Tobacco Manufacturing which conduct the domestic tobacco business of the UST group of
13 corporations. It provides general administration and management services for its own
14 subsidiaries, including corporate purchasing, telemarketing activities and administration for
15 research and development activities. USTC receives a service fee from its subsidiaries for
16 services provided on their behalf.

17 5. Tobacco Manufacturing manufactures smokeless tobacco products, which are sold only
18 to other affiliated corporations, including Tobacco Sales.

19 6. Tobacco Manufacturing owns and operates manufacturing facilities at Hopkinsville,
20 Kentucky, Franklin Park, Illinois, and Nashville, Tennessee.

21 7. Tobacco Manufacturing employs approximately 700 people in various departments
22 including tobacco leaf purchasing, manufacturing (both tobacco products and packaging),
23 engineering, quality control/quality assurance, and research and development.

24 ¹ Plaintiff changed its name to U.S. Smokeless Tobacco Brands Inc. effective January 2001.

25 ² During 1999, Tobacco Manufacturing changed its structure to operate in limited partnership form and is currently known as U.S. Smokeless Tobacco Manufacturing Limited Partnership.

1 8. Tobacco Sales engages in the business of marketing and selling the smokeless tobacco
2 products that it purchases from Tobacco Manufacturing. Tobacco Sales sells its smokeless
3 tobacco products primarily to licensed distributors who sell the product to retailers.

4 9. Tobacco Sales has its principal place of business in Greenwich, Connecticut, with five
5 regional sales offices and several field office locations. Tobacco Sales employs approximately
6 600 people, mostly in activities related to sales of smokeless tobacco products and the balance
7 in marketing such products.

8 10. Prior to the 1990 Restructuring the President of USTC, along with his senior
9 management responsible for areas such as sales, marketing and financial functions, determined
10 the price charged for its smokeless tobacco products.

11 11. After the 1990 Restructuring, senior management at Tobacco Sales responsible for
12 sales and marketing, along with senior management responsible for financial functions, have
13 determined the price charged for its smokeless tobacco products.

14 12. The price for the smokeless tobacco product sold by Tobacco Manufacturing to
15 Tobacco Sales, commonly referred to as the transfer price, is based upon a formula.

16 13. Tobacco Sales sells its smokeless tobacco products at prices higher than the prices at
17 which it purchases them from Tobacco Manufacturing.

18 14. Tobacco Manufacturing serves as Tobacco Sales' agent for the purpose of arranging
19 shipment of the smokeless tobacco products to Tobacco Sales' unaffiliated customers/
20 distributors. The bills of lading indicate this agency relationship between the two companies
21 with respect to the shipments.

22 15. The price and terms for each order of smokeless tobacco products by an unaffiliated
23 customer/ distributor are agreed to by the unaffiliated customer/distributor prior to shipment of
24 the product.

25

1 16. Tobacco Sales bears the cost of shipping and risk of loss for its sales to unaffiliated
2 customers/distributors. As to each individual order shipped to an unaffiliated
3 customer/distributor, title transfers from Tobacco Manufacturing to Tobacco Sales when the
4 products are placed in the delivery vehicle at Tobacco Manufacturing's factory. Title is
5 transferred from Tobacco Sales to the unaffiliated customer/distributor when the products are
6 delivered to the customer's warehouse or distribution facilities in Washington.

7 17. Tobacco Sales advertises and promotes its smokeless tobacco products through
8 advertising and distribution of samples to adult consumers at promotional events such as
9 rodeos, auto races, and fishing tournaments. Tobacco Sales also organizes and coordinates
10 promotional activities for new product roll out and special promotions.

11 18. Tobacco Manufacturing's 1992 transfer price to Tobacco Sales for the smokeless
12 tobacco products at issue in this case was \$.625 per can.

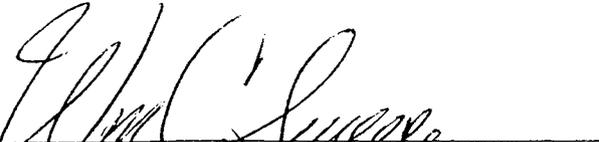
13 19. Tobacco Sales' 1992 selling price to unaffiliated customers/distributors for the
14 smokeless tobacco products at issue in this case, exclusive of discounts and other reductions,
15 averaged \$1.43 per can.

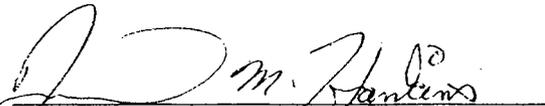
16 20. The total amount of OTP tax paid by Tobacco Sales for smokeless tobacco products
17 distributed as samples in 1992 was \$160,553. This tax amount was calculated based on
18 Tobacco Sales' selling price to unaffiliated customers/distributors.

19 DATED this 9th day of May, 2003.

20 GARVEY SCHUBERT BARER

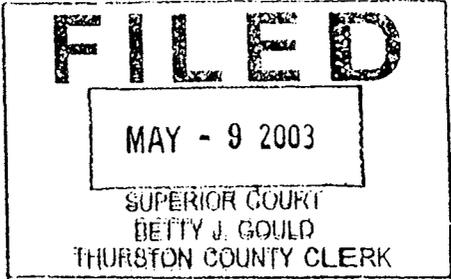
CHRISTINE O. GREGOIRE
ATTORNEY GENERAL

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24 WILLIAM C. SEVERSON, WSBA #5816
Attorneys for Plaintiff

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24 DAVID M. HANKINS, WSBA # 19194
Assistant Attorney General
Attorneys for Defendant

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EXPEDITE (if filing within 5 court days of hearing)
 Hearing is set:
Date: May 9, 2003
Time: 9:00 a.m.
Judge/Calendar Tabor / Civil



SUPERIOR COURT OF WASHINGTON FOR THURSTON COUNTY

UNITED STATES TOBACCO SALES AND
MARKETING COMPANY INC.,

Plaintiff,

v.

STATE OF WASHINGTON, DEPARTMENT OF
REVENUE,

Defendant.

No. 97-2-00883-0

JUDGMENT

CLERK'S ACTION REQUIRED

JUDGMENT SUMMARY

1. Judgment Creditor	<u>U.S. Smokeless Tobacco Brands Inc.</u> (formerly United States Tobacco Sales and Marketing Company Inc.)
2. Attorney for Judgment Creditor	<u>William C. Severson</u>
3. Judgment Debtor.....	<u>State of Washington Department of Revenue</u>
4. Judgment Amount (principal only).....	\$ <u>68,488.00</u>
5. Interest to Date of Judgment.....	\$ <u>46,412.00</u>
6. Taxable Costs & Attorney Fees	
Service of Process.....	\$ <u>162.50</u>
Filing Fee.....	\$ <u>110.00</u>
Statutory Attorney Fee	\$ <u>125.00</u>
Total Taxable Costs and Fees.....	\$ <u>397.50</u>
Total.....	\$ <u>115,297.50</u>

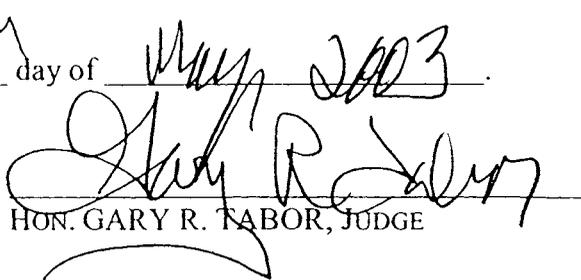
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JUDGMENT

THIS MATTER having come on for trial on January 21 through January 23, 2003 before the Honorable Gary R. Tabor, sitting without jury, and the Court having previously entered Findings of Fact and Conclusions of Law; **NOW, THEREFORE,**

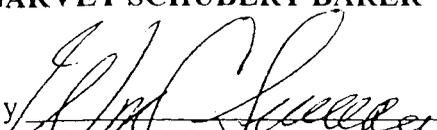
IT IS HEREBY ORDERED that judgment be entered for plaintiff, U. S. Smokeless Tobacco Brands Inc. (previously known as United States Tobacco Sales and Marketing Company Inc.) and against defendant, State of Washington Department of Revenue, in the principal amount of \$68,488, plus interest to the date of judgment in the additional amount of \$46,412, plus taxable costs in the amount of \$397.50.

DONE IN OPEN COURT this 9th day of May 2003.


HON. GARY R. TABOR, JUDGE

PRESENTED BY:

GARVEY SCHUBERT BARER

By 
William C. Severson, WSN 5846
Norman J. Bruns, WSN 16234
Attorneys for Plaintiff

APPROVED AS TO FORM; NOTICE OF PRESENTATION WAIVED:

CHRISTINE O. GREGIORE
ATTORNEY GENERAL

By 
David M. Hankins, WSN 19194
Assistant Attorney General
Attorneys for Defendant

RECEIVED

MAY 12 2003

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FILED
SUPERIOR COURT ATTORNEY GENERAL GARY R. TABOR
THURSTON COUNTY WASH REVENUE DIVISION

EXPEDITE (if filing within 5 court days of hearing)
 Hearing is set:
Date: May 9, 2003 **08 MAY -9 A9:16**
Time: 9:00 a.m.
Judge/Calendar Tabor / Civil
BETTY J. GOULD CLERK
BY _____
DEPUTY

~~FILED~~
MAY 9 2003
SUPERIOR COURT
BETTY J. GOULD
THURSTON COUNTY CLERK

SUPERIOR COURT OF WASHINGTON FOR THURSTON COUNTY

UNITED STATES TOBACCO SALES AND
MARKETING COMPANY INC.,

Plaintiff,

v.

STATE OF WASHINGTON, DEPARTMENT OF
REVENUE,

Defendant.

No. 97-2-00883-0

JUDGMENT

CLERK'S ACTION REQUIRED

JUDGMENT SUMMARY

1. Judgment Creditor	<u>U.S. Smokeless Tobacco Brands Inc.</u> (formerly United States Tobacco Sales and Marketing Company Inc.)
2. Attorney for Judgment Creditor	<u>William C. Severson</u>
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Statutory Attorney Fee	\$ <u>125.00</u>
Total Taxable Costs and Fees	\$ <u>397.50</u>
Total.....	\$ <u>115,297.50</u>

JUDGMENT - 1

GARVEY SCHUBERT BARER
1191 SECOND AVENUE, 18TH FLOOR
SEATTLE, WA 98101-2939
(206) 464-3939

03-9-00434-3

Copy to
A.G. office

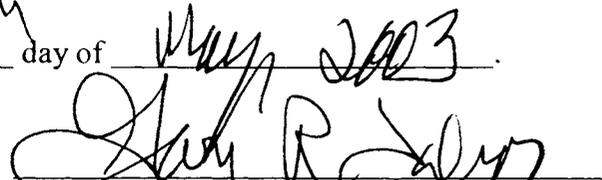
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JUDGMENT

THIS MATTER having come on for trial on January 21 through January 23, 2003 before the Honorable Gary R. Tabor, sitting without jury, and the Court having previously entered Findings of Fact and Conclusions of Law; **NOW, THEREFORE,**

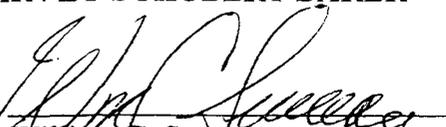
IT IS HEREBY ORDERED that judgment be entered for plaintiff, U. S. Smokeless Tobacco Brands Inc. (previously known as United States Tobacco Sales and Marketing Company Inc.) and against defendant, State of Washington Department of Revenue, in the principal amount of \$68,488, plus interest to the date of judgment in the additional amount of \$46,412, plus taxable costs in the amount of \$397.50.

DONE IN OPEN COURT this 9th day of May 2003.


HON. GARY R. TABOR, JUDGE

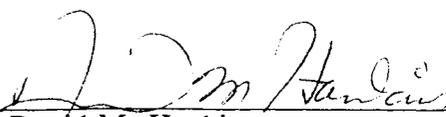
PRESENTED BY:

GARVEY SCHUBERT BARER

By 
William C. Severson, WSNB 5816
Norman J. Bruns, WSNB 16234
Attorneys for Plaintiff

APPROVED AS TO FORM; NOTICE OF PRESENTATION WAIVED:

CHRISTINE O. GREGIORE
ATTORNEY GENERAL

By 
David M. Hankins, WSNB 19194
Assistant Attorney General
Attorneys for Defendant

Appendix 4

HONORABLE GARY R. TABOR

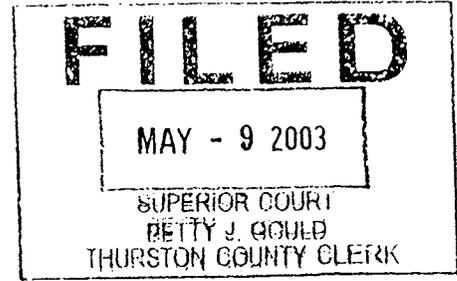
EXPEDITE (if filing within 5 court days of hearing)

Hearing is set:

Date: May 9, 2003

Time: 9:00 a.m.

Judge/Calendar Tabor / Civil



SUPERIOR COURT OF WASHINGTON FOR THURSTON COUNTY

UNITED STATES TOBACCO SALES &
MARKETING COMPANY INC.,

Plaintiff,

v.

STATE OF WASHINGTON, DEPARTMENT OF
REVENUE,

Defendant.

No. 97-2-00883-0

**FINDINGS OF FACT AND
CONCLUSIONS OF LAW**

I. FINDINGS OF FACT

1. The tax period at issue in this case is 1992 and, except as otherwise specifically provided, all facts found by the Court are as of that time period.

2. Plaintiff, U.S. Smokeless Tobacco Brands Inc., known in 1992 as United States Tobacco Sales and Marketing Company Inc. (Tobacco Sales), is a wholly owned subsidiary of U.S. Smokeless Tobacco Company, known in 1992 as United States Tobacco Company

1 (USTC). U.S. Smokeless Tobacco Company is a wholly owned subsidiary of UST Inc., as
2 was its predecessor USTC.¹

3 3. United States Tobacco Manufacturing Company Inc. (Tobacco Manufacturing) is a
4 wholly owned subsidiary of USTC.² Tobacco Manufacturing produces smokeless tobacco
5 products that are sold under a variety of brand names, primarily Copenhagen and Skoal.

6 4. Prior to 1990, USTC performed all functions relating to the manufacturing, sale and
7 marketing of its smokeless tobacco products which it sold directly to unaffiliated customers.
8 USTC reorganized in 1990 (hereinafter the 1990 Restructuring), creating Tobacco
9 Manufacturing and Tobacco Sales as wholly owned subsidiaries to perform the
10 manufacturing and sales and marketing functions previously performed by USTC.

11 5. After the 1990 Restructuring, USTC became a holding company for Tobacco Sales
12 and Tobacco Manufacturing which conduct the domestic tobacco business of the UST group
13 of corporations. It provides general administration and management services for its own
14 subsidiaries, including corporate purchasing, telemarketing activities and administration for
15 research and development activities. USTC receives a service fee from its subsidiaries for
16 services provided on their behalf.

17 6. Tobacco Manufacturing manufactures smokeless tobacco products, which are sold
18 only to other affiliated corporations, including Tobacco Sales.

19 7. Tobacco Manufacturing owns and operates manufacturing facilities at Hopkinsville,
20 Kentucky, Franklin Park, Illinois, and Nashville, Tennessee.

21 ¹ Plaintiff changed its name to U.S. Smokeless Tobacco Brands Inc. effective January 2001.

22 ² During 1999 Tobacco Manufacturing changed its structure to operate in limited partnership form and is
currently known as U.S. Smokeless Tobacco Manufacturing Limited Partnership.

1 8. Tobacco Manufacturing employs approximately 700 people in various departments
2 including tobacco leaf purchasing, manufacturing (both tobacco products and packaging),
3 engineering, quality control/quality assurance, and research and development.

4 9. Tobacco Sales engages in the business of marketing and selling the smokeless
5 tobacco products that it purchases from Tobacco Manufacturing. Tobacco Sales sells its
6 smokeless tobacco products primarily to licensed distributors who sell the product to
7 retailers.

8 10. Tobacco Sales has its principal place of business in Greenwich, Connecticut, with
9 five regional sales offices and several field office locations. Tobacco Sales employs
10 approximately 600 people, mostly in activities related to sales of smokeless tobacco
11 products and the balance in marketing such products.

12 11. Prior to the 1990 Restructuring the President of USTC, along with his senior
13 management responsible for areas such as sales, marketing and financial functions,
14 determined the price charged for its smokeless tobacco products.

15 12. After the 1990 Restructuring, senior management at Tobacco Sales responsible for
16 sales and marketing, along with senior management responsible for financial functions, have
17 determined the price charged for its smokeless tobacco products.

18 13. The price for the smokeless tobacco product sold by Tobacco Manufacturing to
19 Tobacco Sales, commonly referred to as the transfer price, is based upon a formula.

20 14. Tobacco Sales sells its smokeless tobacco products at prices higher than the prices at
21 which it purchases them from Tobacco Manufacturing.

22 15. Tobacco Manufacturing serves as Tobacco Sales' agent for the purpose of arranging
shipment of the smokeless tobacco products to Tobacco Sales' unaffiliated customers/
distributors. The bills of lading indicate this agency relationship between the two companies
with respect to the shipments.

1 16. The price and terms for each order of smokeless tobacco products by an unaffiliated
2 customer/distributor are agreed to by the unaffiliated customer/distributor prior to shipment
3 of the product.

4 17. Tobacco Sales bears the cost of shipping and risk of loss for its sales to unaffiliated
5 customers/distributors. As to each individual order shipped to an unaffiliated
6 customer/distributor, title transfers from Tobacco Manufacturing to Tobacco Sales when the
7 products are placed in the delivery vehicle at Tobacco Manufacturing's factory. Title is
8 transferred from Tobacco Sales to the unaffiliated customer/distributor when the products
9 are delivered to the customer's warehouse or distribution facilities in Washington.

10 18. Tobacco Sales advertises and promotes its smokeless tobacco products through
11 advertising and distribution of samples to adult consumers at promotional events such as
12 rodeos, auto races, and fishing tournaments. Tobacco Sales also organizes and coordinates
13 promotional activities for new product roll out and special promotions.

14 19. Tobacco Manufacturing's 1992 transfer price to Tobacco Sales for the smokeless
15 tobacco products at issue in this case was \$.625 per can.

16 20. Tobacco Sales' 1992 selling price to unaffiliated customers/distributors for the
17 smokeless tobacco products at issue in this case, exclusive of discounts and other reductions,
18 averaged \$1.43 per can.

19 21. For the samples of smokeless tobacco products that Tobacco Sales distributed in
20 1992, the OTP tax that Tobacco Sales paid was calculated based on Tobacco Sales' selling
21 price to unaffiliated customers/distributors (\$1.43 per can). Tobacco Sales paid OTP tax of
22 \$160,553 on these samples.

23 22. The 1992 fair market value for Tobacco Manufacturing's sales of smokeless tobacco
24 products to Tobacco Sales was \$.82/can.

1 23. Neither Tobacco Sales' nor Tobacco Manufacturer's 1992 selling price represents
2 the fair market value of the smokeless tobacco products sold by Tobacco Manufacturing to
3 Tobacco Sales. Tobacco Manufacturing's selling price was a discounted price as compared
4 to the fair market value price (\$.82) for those sales.

5 24. Tobacco Sales paid excessive OTP tax in the amount of \$68,488.

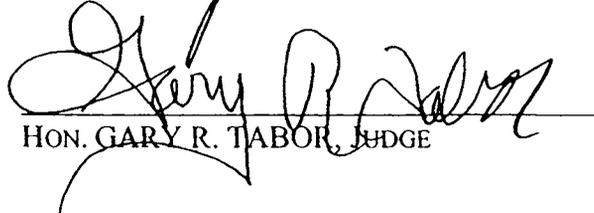
6 II. CONCLUSIONS OF LAW

- 7
- 8 1. The issue before the Court on remand from *U.S. Tobacco Sales v. Dep't of Revenue*, 96
9 Wn. App. 932, 982 P.2d 652 (1999) is whether the price for sales of smokeless tobacco
10 products by Tobacco Manufacturing to Tobacco Sales during 1992 was a fair market
11 value price.
 - 12 2. "Fair market value is the amount a willing buyer would pay a seller who is willing but
13 not obligated to sell." *U.S. Tobacco Sales*, 96 Wn. App. at 940.
 - 14 3. To determine whether Tobacco Manufacturing's selling price was a fair market value
15 price, that price must be compared to the market price at which a tobacco products
16 manufacturer would sell OTP to an unaffiliated distributor, where the parties otherwise
17 hold the same property interests, bear the same risks and performed the same functions
18 as do Tobacco Manufacturing and Tobacco Sales.
 - 19 4. The transfer price of \$.625 does not reflect a fair market value price because Tobacco
20 Manufacturing would not willingly sell to an unaffiliated buyer at that price.
 - 21 5. Plaintiff is entitled to a refund of OTP taxes for the difference between the price on
22 which the OTP tax was paid (\$1.43/can) and the fair market value of the OTP for sales
by Tobacco Manufacturing (\$.82/can).

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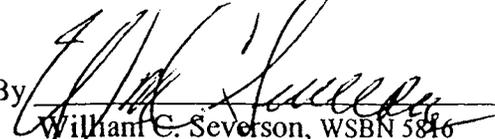
6. Plaintiff is entitled to an award of interest and taxable costs as provided by
RCW 82.32.060.

DONE IN OPEN COURT this 9th day of May 2007.


HON. GARY R. TABOR, JUDGE

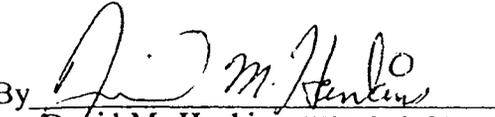
PRESENTED BY:

GARVEY SCHUBERT BARER

By 
William C. Severson, WSN 5846
Norman J. Bruns, WSN 16234
Attorneys for Plaintiff

APPROVED AS TO FORM; NOTICE OF PRESENTATION WAIVED:

CHRISTINE O. GREGIORE
ATTORNEY GENERAL

By 
David M. Hankins, WSN 19194
Assistant Attorney General
Attorneys for Defendant

Appendix 5

UNITED STATES TOBACCO
SALES and MARKETING COMPANY INC.
EFFECTIVE DECEMBER 16, 1991

MOIST BRANDS

MANUFACTURERS UPC #73100		PER CASE			
PRODUCT	CASE UPC	QUANTITY AND STYLE OF PACKING	PRICE	GROSS POUNDS	CUBIC FEET
COPENHAGEN	73100-00153	180 Pocket Cans in 18 10-Can Rolls	253.80	18.84	.76
SKOAL KEY	73100-00158	180 Pocket Cans in 18 10-Can Rolls	253.80	18.84	.76
SKOAL	73100-00137	180 Pocket Cans in 18 10-Can Rolls	253.80	18.84	.76
SKOAL LONG CUT Wintergreen Mint Straight Classic	73100-00148 73100-00088 73100-00060 73100-00541	180 Pocket Cans in 18 10-Can Rolls	253.80	16.59	.76
HAPPY DAYS Long Cut Mint	73100-00155	90 Pocket Cans in 9 10-Can Rolls	126.90	9.6	.39
RIGHT CUT	73100-00058	90 Pocket Cans in 9 10-Can Rolls	126.90	9.6	.39
WB CUT	73100-00133	72 Pocket Pouches in 12 6-Pouch Cartons	11.60	8	.34

PORTION PAK POUCHES

SKOAL BANDITS Wintergreen Mint Straight Classic	73100-11196 73100-00090 73100-00066 73100-00092	180 Pocket Cans in 18 10-Can Rolls	253.80	18.84	.76
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A CASH DISCOUNT OF 4% WILL BE ALLOWED IF PAYMENT IS RECEIVED WITHIN 14 DAYS FROM DATE OF INVOICE
FULL AMOUNT OF INVOICE DUE 15 DAYS FROM INVOICE DATE.

CONFIDENTIAL DOCUMENT
SUBJECT TO PROTECTIVE ORDER



UNITED STATES TOBACCO
SALES and MARKETING COMPANY INC.
EFFECTIVE JUNE 29, 1992

MOIST BRANDS

MANUFACTURERS UPC #73100		PER CASE			
PRODUCT	CASE UPC	QUANTITY AND STYLE OF PACKING	PRICE	GROSS POUNDS	CUBIC FEET
COPENHAGEN	73100-00153	180 Pocket Cans in 18 10-Can Rolls	261.00	21.8	.76
SKOAL KEY	73100-00158	180 Pocket Cans in 18 10-Can Rolls	261.00	18.84	.76
SKOAL	73100-00137	180 Pocket Cans in 18 10-Can Rolls	261.00	18.84	.76
SKOAL LONG CUT Wintergreen Mint Straight Classic	73100-00148 73100-00088 73100-00060 73100-00541	180 Pocket Cans in 18 10-Can Rolls	261.00	16.59	.76
HAPPY DAYS Long Cut Mint	73100-00155	90 Pocket Cans in 9 10-Can Rolls	130.50	8.295	.39
RIGHT CUT	73100-00058	90 Pocket Cans in 9 10-Can Rolls	130.50	9.6	.39
WB CUT	73100-00133	72 Pocket Pouches in 12 6-Pouch Cartons	114.48	8	.34

PORTION PAK POUCHES

SKOAL BANDITS Wintergreen Mint Straight Classic	73100-11196 73100-00090 73100-00066 73100-00092	180 Pocket Cans in 18 10-Can Rolls	261.00	9.4	.76
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A CASH DISCOUNT OF 4% WILL BE ALLOWED IF PAYMENT IS RECEIVED WITHIN 14 DAYS FROM DATE OF INVOICE
FULL AMOUNT OF INVOICE DUE 15 DAYS FROM INVOICE DATE.

CONFIDENTIAL DOCUMENT
SUBJECT TO PROTECTIVE ORDER



UNITED STATES TOBACCO
SALES and MARKETING COMPANY INC.
EFFECTIVE DECEMBER 14, 1992

MOIST BRANDS

MANUFACTURERS UPC #73100		PER CASE			
PRODUCT	CASE UPC	QUANTITY AND STYLE OF PACKING	PRICE	GROSS POUNDS	CUBIC FEET
COPENHAGEN	73100-00153	180 Pocket Cans in 18 10-Can Rolls	279.00	18.84	.76
SKOAL KEY	73100-00158	180 Pocket Cans in 18 10-Can Rolls	279.00	18.84	.76
SKOAL	73100-00137	180 Pocket Cans in 18 10-Can Rolls	279.00	18.84	.76
SKOAL LONG CUT Wintergreen Mint Straight Classic	73100-00148 73100-00088 73100-00060 73100-00541	180 Pocket Cans in 18 10-Can Rolls	279.00	16.59	.76
HAPPY DAYS Long Cut Mint	73100-00155	90 Pocket Cans in 9 10-Can Rolls	139.50	9.6	.39
RIGHT CUT	73100-00058	90 Pocket Cans in 9 10-Can Rolls	139.50	9.6	.39
WB CUT	73100-00133	72 Pocket Pouches (in 126 Pouch Cartons)	22.40	8	.34

PORTION PAK POUCHES

SKOAL BANDITS Wintergreen Mint Straight Classic	73100-11196 73100-00090 73100-00066 73100-00092	180 Pocket Cans in 18 10-Can Rolls	279.00	18.84	.76
--	--	------------------------------------	--------	-------	-----

A CASH DISCOUNT OF 4% WILL BE ALLOWED IF PAYMENT IS RECEIVED WITHIN 14 DAYS FROM DATE OF INVOICE
FULL AMOUNT OF INVOICE DUE 15 DAYS FROM INVOICE DATE.

CONFIDENTIAL DOCUMENT
SUBJECT TO PROTECTIVE ORDER

Appendix 6

IN THE SUPERIOR COURT OF THE STATE OF WASHINGTON
IN AND FOR THE COUNTY OF THURSTON

U.S. TOBACCO COMPANY,)	
)	COURT OF APPEALS NO.
Plaintiff,)	30434-1-II
)	
vs.)	SUPERIOR COURT NO.
)	97-2-00883-0
STATE OF WASHINGTON)	
DEPARTMENT OF REVENUE,)	BENCH TRIAL
)	VOLUME I
Defendant.)	

VERBATIM REPORT OF PROCEEDINGS

BE IT REMEMBERED that on January 21, 22, 23, 2003, the above-entitled and numbered cause came on for hearing before JUDGE GARY R. TABOR, Thurston County Superior Court, Olympia, Washington.

COPY

Pamela R. Jones, Official Court Reporter
Certificate No. 2154
P. O. Box 11012
Olympia, WA 98508-1012
(360) 754-3355 Ext. 6484

1 value.

2 So, in order to accomplish those goals, we
 3 asked Ernst & Young to sort of reorient their
 4 Transfer Price Study to 1992. They'd already done
 5 one for a different year so there was a lot of
 6 efficiency to having them redo it but get it
 7 adjusted for the time difference. And then we
 8 asked Mr. Robert Reilly, an appraiser, independent
 9 appraiser, to review that and to determine whether
 10 or not he could use that as basically the data
 11 foundation for a fair market value opinion. And
 12 he went through that analysis, reached the
 13 conclusion that he could do so and prepared an
 14 appraisal utilizing the work already done by the
 15 Ernst & Young firm in terms of preparing the 482
 16 study.

17 Both Mr. Reilly and Mr. Lotfi are experts
 18 with respect to 482 studies, and both of them will
 19 testify, Your Honor, that the standard under 482
 20 for deciding whether a price meets the 482
 21 arm's-length price standard for federal income tax
 22 purposes and the issue of whether or not that
 23 price is a fair market value price are, in this
 24 case, certainly identical. It's the same
 25 standard. They both ask the question, what would

1 Tobacco Sales might manipulate the transfer price
 2 in order to -- in this case it would go the
 3 opposite way of the example I gave with the
 4 Chinese manufacturing, it would set a price that
 5 was artificially low in order to get the base for
 6 the OTP tax reduced to a lower level. So in order
 7 to prevent that, the Court of Appeals said you
 8 have to judge that price against the fair market
 9 value standard.

10 We're here to present that evidence. The
 11 evidence will show, we think, that the fair market
 12 value for 1992 would be 68 to 72 cents. That's
 13 the range the experts say the price should be for
 14 a market price. Actual price was lower than that,
 15 granted the market value price should be higher.
 16 You'll hear the explanation of that, why it's
 17 lower from Mr. Reilly, I think.

18 Just a brief preview, Your Honor, of how the
 19 appraisers go about estimating value for this kind
 20 of case. It's a little bit different than the
 21 typical real estate or typical business valuation
 22 case. Section 482 establishes some specific
 23 methodologies that appraisers can use to make
 24 valuations. Mr. Lotfi will describe the method he
 25 chose here and why he chose that method. The

1 clue.

2 A. Clue taken. It's on Page 22.

3 Q. That's the major heading, so you're in the section
4 here, aren't you, talking about the functions of
5 Sales & Marketing Company, correct?

6 A. Yes, I am.

7 Q. Okay. Did you -- are you aware of whether or not
8 the Sales & Marketing Company conducts any
9 manufacturing operations?

10 A. It does not.

11 Q. Did you intend your report to give any suggestion
12 that the Sales & Marketing Company is a tobacco
13 manufacturer?

14 A. No, I did not.

15 Q. When you -- when Ernst & Young was asked to
16 prepare the original Transfer Price Study in --
17 with respect to 1995, did you know what the
18 precise purpose for that study was?

19 A. What we were told was they wanted to do some
20 transfer pricing planning so they wanted to
21 effectively know what ought to be the transfer
22 prices for a wide range of intercompany
23 transactions.

24 Q. Did you have any indication from the company which
25 -- that they wanted higher prices or lower prices

1 the 1995 studies we looked at not just the
2 transfer of product between the tobacco
3 manufacturing company and the tobacco sales
4 company, but we looked at also transfers of
5 product that they may have with some international
6 affiliates and as well as some intercompany
7 services as well.

8 Q. Do accounting firms, such as Ernst & Young,
9 regularly prepared arm's-length price studies
10 under Section 482 of the Internal Revenue Code?

11 A. We do, yes.

12 Q. Is there anything particular about preparing these
13 studies for clients in the tobacco industry?

14 A. No. These are -- Section 482 applies to all
15 industries, all companies, and so the -- they're
16 prepared for a very, very wide array of
17 industries, manufacturing services, financial
18 industries, the whole gamut, anybody engaging in
19 transactions that cross jurisdictions.

20 Q. And why do clients request -- request you to
21 prepare these kinds of studies?

22 A. Broadly speaking, there are two main reasons. The
23 first reason is that there's a requirement under
24 U.S. Tax Code that a company has to effectively
25 justify its transfer prices and document its

1 transfer prices every year contemporaneously with
2 the filing of the tax return. And so companies
3 often ask us, ask our assistance in helping them
4 prepare that documentation.

5 The other part of it is that they may be --
6 they want to do some sort of planning exercise or
7 just thinking about in the context of
8 reorganizations of the company, so they want to
9 establish what ought to be the transfer price, so
10 these are more for management purposes.

11 Q. So they can be used, if I understand you, not just
12 for tax purposes but for management planning
13 business purposes as well?

14 A. They can be, of course, yes.

15 Q. Does Ernst & Young have established procedures
16 that you follow when you conduct these kind of
17 studies?

18 A. Yes, we do.

19 Q. I wonder if you could just kind of outline
20 generally how you approach doing one of these
21 studies and the procedures that you go through.

22 A. Well, to take a step back, what we're trying to do
23 at this point is that we're trying to understand
24 what ought to be the relationship between -- it
25 would be the price on a transfer product between

1 A. Yes. We say that an arm's-length price for a
2 price for a can falls in the range of 68 to 72
3 cents per can.

4 Q. I guess I'd like you to begin your explanation of
5 the analysis here by explaining the nature of the
6 transaction that you were evaluating or
7 transactions, if there are more than one.

8 A. What we were -- what we were looking at is the
9 effect of the transfer of smokeless tobacco
10 products from the Tobacco Manufacturing Company to
11 the Tobacco Sales & Marketing Company, and so
12 that's a nutshell of what it is.

13 When we went about doing our functional
14 analysis and looking at sort of the -- what each
15 company does, it was clear that along with the
16 transfer of the actual smokeless tobacco that
17 there was also transfers of other types of assets,
18 and that included things like the trademark
19 because the Tobacco Manufacturing Company owns the
20 trademarks, and of a certain amount of know-how
21 involved in the things like the R & D that the
22 tobacco -- the manufacturing company does and for
23 that they ought to have a return, an appropriate
24 return, a market of return on all those
25 activities.

1 And so that's in a nutshell of what we -- of
2 the sort of the transactions we looked at. In
3 order to get to appropriate price we need to do
4 more than that, but that's sort of the actual sort
5 of transfers that we were looking at.

6 Q. Is the price that you determined for the sale of
7 tobacco from Tobacco Manufacturing to Tobacco
8 Sales a price at which Tobacco Sales could be
9 expected to, in turn, sell the tobacco products to
10 an unaffiliated purchaser?

11 A. No, because if they were to do so, they wouldn't
12 make any money. They have to have a return, they
13 have to earn a fair return on the activities that
14 they do and on the -- any addition, sort of all
15 value-added activities that they generated.

16 Q. Are you telling me that a company can't stay in
17 business if it buys the product that it's selling
18 at the same price that it sells it at?

19 A. It would not be in business.

20 Q. Okay. Is there any basis in economic or valuation
21 theory, Mr. Lotfi, for considering an arm's-length
22 price estimate to be a discounted price just
23 because the product is resold later in the
24 distribution chain at a higher price?

25 MR. HANKINS: Objection, Your Honor. I

1 U.S. Tobacco?

2 A. Yes, it is.

3 Q. So you audit them and then you also do this
4 Transfer Price Study for them, correct?

5 A. Yes.

6 Q. Okay. Isn't it true that the Transfer Price Study
7 was completed in July of 2000 for the company's
8 sales in 1992?

9 A. Yes, it is.

10 Q. And isn't it true that the -- you would need to
11 wait at the end of the year in order to calculate
12 the transfer price, if you did a Transfer Price
13 Study?

14 A. If I did a -- yes, typically because a lot of --
15 for instance, the documentation studies are filed
16 with income tax returns so those are done after
17 the close of the company's fiscal year.

18 Q. Is it done prior to the filing of the income tax
19 return?

20 A. Yes, usually it's done prior so that you can
21 file -- you're supposed to file it
22 contemporaneously or have all your documentation
23 done contemporaneously, so we need to finish our
24 work before the company does its filing of the
25 income taxes. In cases where we do, we do work

1 Q. In either case?

2 A. In either case we would try to look at
3 multiple-year data.

4 Q. So isn't it true that in a Transfer Price Study
5 you're examining the conditions after the fact?

6 A. In the ones where we're doing a study for the
7 document to help the company do its documentation
8 when they file, to prepare the documentation
9 before they file their tax return, it's looking
10 back to the fiscal year that just closed. In the
11 cases where we're doing planning for the company,
12 when they're doing 482 analyses, it could be
13 prospective because I may be using projections as
14 a part of -- as part of the analysis.

15 Q. But that's not what occurred here, correct, you
16 looked back?

17 A. That's not what occurred here, that's right.

18 Q. And you testified I think, I believe you said two
19 times regarding the Transfer Price Study; is that
20 correct?

21 A. Yes.

22 Q. In those times that you've testified, was that
23 Transfer Price Study relating to the income tax?

24 A. Yes, it was.

25 Q. So, in your experience, have you seen, besides

1 this case, a Transfer Price Study used to measure
2 an excise tax?

3 A. No, I have not.

4 Q. Now this -- isn't it true that this transfer
5 price, that's a confidential price that's not
6 known outside the holding company; is that
7 correct?

8 A. Maybe, maybe not to me. That's up to the company.
9 There's no reason why, there's no rule that says
10 it must be confidential.

11 Q. Now, when you do a 482 analysis, you're examining
12 what an arm's-length price is, is that because
13 there's no comparable data?

14 A. No, that's what we use. We use comparable data to
15 determine what an arm's-length price is. The
16 reason we're -- you need to do the analysis, that
17 is the starting point is that you've got two
18 companies that are related, so what you're trying
19 to establish is if are they behaving in the same
20 way as if they were unrelated.

21 Q. But don't you have to also go and look to see if
22 there's any other company that has, outside the
23 company you're looking at, that is similar to look
24 at that type of transaction? Do you --

25 A. You look for -- you look to, for external

1 Study can be used to determine the appropriate
2 profit split or management tool for a holding
3 company?

4 A. I think so, but again -- can you reask the
5 question to make sure I understood it correctly?

6 Q. If you don't understand just let me know.

7 A. If your question is saying that is the transfer
8 price used for -- in companies that are controlled
9 to figure out what the appropriate price would be
10 between these two related parties as if they were
11 unrelated parties, yes, and is it used by
12 management of companies for managerial purposes as
13 well. There are cases where we do that, yes.

14 Q. And it's used also to allocate the profits between
15 two companies?

16 A. Between two companies, yes, to allocate profits as
17 if they were independent parties.

18 Q. Now, based on your study, isn't it true that there
19 is a fair market value of the tobacco product
20 between Sales & Marketing and an independent
21 distributor?

22 A. There is a fair market value price between the --
23 for that level of the market for, yeah, for that
24 level of the market.

25 Q. And isn't it true you did not examine that fair

1 market value at that level between Sales &
2 Marketing and the distributor?

3 A. That was not the focus of our study, no.

4 Q. You did not look at that level, is that correct,
5 you did not examine that level between the
6 distributor and Sales & Marketing?

7 A. Between the -- we did not examine those
8 transactions. I knew what the prices were but --
9 I'm not quite sure, we did not do a study on those
10 prices, if that's the question.

11 MR. HANKINS: Your Honor, may I
12 approach the witness?

13 THE COURT: You may.

14 BY MR. HANKINS:

15 Q. I'm handing you what's been previously marked as
16 Exhibits 4, 5, 6 and 7.

17 A. Okay.

18 Q. If you'd look those over. Did you have an
19 opportunity to see those documents from the
20 company?

21 A. I can't remember if I saw these particular ones or
22 something similar, but go ahead.

23 Q. But isn't it true, Mr. Lotfi, those documents
24 represent what the price would have been between
25 Sales & Marketing and the distributor?

1 the wonderful United States Postal Service decides
2 to increase the shipping cost and that makes it
3 permanent. Isn't it true that that's not
4 accounted for in the Transfer Price Study?

5 A. All those costs should be in the Transfer Pricing
6 Study for that year. And again, a company may or
7 may not increase their prices, depends a little
8 bit on their ability to do so in certain cases.
9 They can't pass the price of an increased input to
10 their customers, and it's a decision that's going
11 to be a business decision in addition to that, and
12 how much of a price, if any, they should pass on.

13 Q. Isn't it true that the manufacturing unit does not
14 sell to any other entities except to its
15 affiliated entities, Sales & Marketing?

16 A. Domestically, that's true.

17 Q. And isn't it true that a Transfer Price Study can
18 be different than a fair market valuation?

19 A. I would think that they would be getting at the
20 exactly the same thing. It's the same concept
21 you're trying to measure, which is what would
22 be -- what would be the price that's between
23 affiliated or two independent parties undertaking
24 the transaction.

25 Q. Mr. Lotfi, isn't it true that the price for the

1 THE COURT: Okay.

2 THE WITNESS: To that number we add
3 their costs of operation, so it includes their
4 cost of goods sold, all the stuff they purchase
5 and things like that, and then their operating
6 expenses which includes their management fees and
7 other overhead allocations from the parent
8 company, and that gives that's their cost of
9 operations. So we say the cost of operations plus
10 their profits would be their implicit sales so
11 that's what they should sell, their total sales to
12 the Sales & Marketing Company should be A plus C
13 plus E plus their cost of goods sold plus
14 operating expenses, and that gives this sales
15 between the Manufacturing Sales to the Sales &
16 Marketing Company. And that total number we then
17 divide by total cans to get an average price per
18 can.

19 THE COURT: Okay. I think I
20 understand. That does lead me to another
21 question, though, and I would like you to explain
22 in more detail why you allocated the 76 percent to
23 Manufacturing as the profit ratio and 26 or 24
24 percent, excuse me, to Manufacturing.

25 THE WITNESS: Of course. That is

1 Ernst & Young did but the actual formula that UST
2 uses, to see what the formula would derive given
3 actual results, and that's the conclusion of my
4 next paragraph, which is based on the company's
5 internal transfer pricing procedures, the actual
6 intercompany transfer price of OTP between USTM
7 and USTSM during 1992 was 73 cents per unit.

8 Now, I think that may be misleading as -- and
9 I really only realized it may be misleading when
10 you and I started speaking yesterday. It's clear
11 in my mind what that means. What that means is if
12 you take the company's actual models and actual
13 methodologies and use their actual results of
14 operations for 1992, the transfer price that the
15 company would have or should have used was 73
16 cents per unit. That 73 cents per unit came very
17 close to my valuation conclusion of 68 to 72 cents
18 per unit. That assured me personally that the
19 model and the methodologies that the company uses
20 when correct data is used in those models gives
21 you a fair market value, independent, arm's-length
22 transfer price.

23 Now, clarification is 73 cents per unit is
24 not what the company actually used as its transfer
25 price in 1992. What the company actually used for

1 manufacturer and reach a price somewhere between
2 68 and 72 cents a unit.

3 Q. Would it, assuming that the distribution chain
4 is -- continues to be organized in a way where you
5 have the Sales & Marketing Company providing the
6 brand support, marketing, et cetera, and just as
7 Sales & Marketing does here, would it be
8 reasonable for a manufacturing company, an
9 independent manufacturing performing the functions
10 that Tobacco Manufacturing performs, to be able to
11 expect to sell the property -- I'm sorry.

12 Would it be reasonable for the customers of
13 that company to be able to expect to buy the
14 tobacco products directly from the manufacturer at
15 the same price that that Sales & Marketing Company
16 obtains from the manufacturer?

17 A. Sure, I understand, and the customer as being --
18 the consumers of Sales & Marketing could the
19 customers of Sales & Marketing, bypass Sales &
20 Marketing and go to the manufacturer and the
21 answer is, well, they could, but Sales & Marketing
22 wouldn't sell it to them at the same price that
23 they would sell -- rather Manufacturing would not
24 sell to them at the same price that they sell to
25 Sales & Marketing, because no other customer of

1 Sales & Marketing would or could, would or could,
2 perform the same brand marketing functions and
3 brand support functions that Sales & Marketing
4 does.

5 Now, customers could -- we heard the example
6 this morning of Wal-Mart. Wal-Mart could perform
7 some brand marketing functions within their own
8 stores, and perhaps even in the communities in
9 which they have stores, but that's not
10 particularly interesting to Manufacturing.
11 Manufacturing doesn't want national advertising
12 that says buy Skoal, and by the way, buy it only
13 at Wal-Mart. Because they sell, they
14 Manufacturing, through Sales & Marketing,
15 Manufacturing and to Sales & Marketing, Sales &
16 Marketing sells to ultimately 20,000 customers.
17 And if only one of those customers is actively
18 promoting the product not only will Sales &
19 Marketing lose revenue and share, but immediately
20 Manufacturing will lose revenue and share.

21 Unless there was another Sales & Marketing
22 Company that could do what in fact Sales &
23 Marketing does, national advertising, national
24 distribution, not limited to any one retailer, or
25 any one retailed channel or any one geographical

1 A. No, sir, it's not, correct.

2 Q. So were you aware that there's a confidential
3 protective order on this price?

4 A. No, I'm not.

5 Q. So would it surprise you to learn that there's a
6 protective order that's protecting the
7 confidential price on this?

8 A. No, not necessarily.

9 Q. Isn't it true that the manufacturing subsidiary
10 does not sell to any other entities except to its
11 affiliated entities, Sales & Marketing?

12 A. Domestically that's true, yes.

13 Q. Now, according to your testimony today it's --
14 you're looking for a price that a willing buyer
15 would pay to a willing seller, where the buyer and
16 the seller are both independent and arm's-length
17 parties; is that correct?

18 A. Yes.

19 Q. But in your report, isn't it true that that's not
20 what it states?

21 A. I don't believe, so you'll have to direct me to
22 what you're looking at.

23 Q. Sure. If you can, I believe your report the -- it
24 would be under the purpose and objective of the
25 appraisal, is that where you would place that the

1 arm's-length distributor, so if a client comes to
2 me or comes to Ernst & Young and asks for a 482
3 transfer pricing study, they get exactly that, an
4 independent, arm's-length price. If they
5 internally do their own corporate transfer pricing
6 analyses and collect transfer pricing based on
7 something other than arm's length, other than on
8 independent other relationships, then they're not
9 going to get an arm's-length price.

10 Q. Mr. Reilly, have you ever testified that the 482
11 is applicable to excise taxes?

12 A. No.

13 Q. So this would be the first time, then?

14 A. This is my first experience with excise tax in any
15 way.

16 Q. So, isn't it true in your experience over 25
17 years, you've seen the 482 analysis reflect mostly
18 the income tax for fair market value?

19 A. I don't know if it's mostly, it's maybe.

20 Q. How would you characterize it? Because you've
21 already testified that it can also be used for
22 other purposes.

23 A. Yes, it may. I can't give you percentage. It may
24 be in my practice more often than not used for
25 federal income tax purposes. We also perform 482

1 going to go to 482 standards just because it's a
2 standard body of literature.

3 Q. Fair enough. But isn't it true that it's never
4 been used for the purpose of valuing for purposes
5 of an excise tax?

6 A. I just don't know.

7 Q. But you have not used it?

8 A. I have not used it, that's correct.

9 Q. Isn't it true you only examined the fair market
10 value of the product between Manufacturing and
11 Sales & Marketing?

12 A. Yes, that's exactly true.

13 Q. Isn't it true that that is the only level of trade
14 you examined in this case?

15 A. Yes, it is.

16 Q. And isn't it true that the price for the tobacco
17 product to the independent distributor is at a
18 higher price than the price between Manufacturing
19 and Sales & Marketing?

20 A. I would certainly hope so.

21 Q. Isn't it true that the price is a fair market
22 value price at that level of trade?

23 A. Yes. As I mentioned earlier, there are several
24 fair market value prices at several levels of
25 trade. Only one, of course, would be relevant to

1 and bought the same Coke for two dollars?

2 A. If I had the foresight to bring pajamas with me I
3 think I would have done that.

4 Q. I don't want to know about that. They do, the
5 nicer hotels, give the robes out.

6 Anyway, I want to ask you, though, did you
7 consider the next section of the statute though
8 which said, "Under this definition," and this
9 definition refers back, they say, "the OTP tax
10 will be higher on product that are extensively
11 marketed by their manufacturer than on products
12 that a manufacturer sells generically." Did you
13 consider that?

14 A. Oh, yes absolutely.

15 Q. But then the next line the court says, "but the
16 statute permits this disparity and the court may
17 not alter the statutory language."

18 A. Yes, absolutely.

19 Q. You were asked if, in fact it was my hypothetical
20 about Wal-Mart, that if Wal-Mart came and found
21 out what the price was, could they go directly to
22 the manufacturer?

23 A. Yes.

24 Q. Now, you correct me if I'm wrong, Mr. Reilly, but
25 I wrote down that you said manufacturing would not

1 sell to customers and distributors at the same
2 price it sold to Sales & Marketing.

3 A. Yes, absolutely.

4 Q. Because, and I think as you answered, you said we
5 wouldn't want Wal-Mart just to say you can only
6 buy the product at Wal-Mart, and they'd want it
7 nationally?

8 A. Well, yes, exactly. Manufacturing would not want
9 a particular retailer or even a particular
10 distributor to promote the product solely to their
11 distribution channel or to their retail channel.
12 Manufacturing would want a national promotion of
13 their product that is given to them by Sales &
14 Marketing.

15 Q. Isn't it true, then, that, as you said, they
16 wouldn't sell it at that same price, isn't it true
17 they would charge a higher price?

18 A. They -- I don't think they could, and the
19 manufacturer, like any manufacturer would love to
20 charge a higher price, but they couldn't charge a
21 higher price.

22 Q. To the distributor?

23 A. To the distributor, unless the product had the
24 intangible and marketing elements that were added
25 to it by Sales & Marketing.

1 at that -- in the trade would know it. I'm sure
2 UST is a public company, doesn't want, you know,
3 every Dick, Jane and Harry to know that
4 information.

5 Q. Under my hypothetical that I gave you, isn't it
6 true that Manufacturing, if it sold directly to a
7 distributor, it would not sell at a lower price
8 than what it sells to Sales & Marketing?

9 A. Well, it's not a question of higher price or lower
10 price. Manufacturing would never sell to a
11 distributor whether it's a wholesaler a regional
12 director or even a retailer other than through
13 Sales & Marketing, because what the product is
14 that leaves the UST is the product that includes
15 the manufactured product plus the marketing and
16 sales and brand support that comes from Sales &
17 Marketing, so manufacturing would not sell a
18 product without Sales & Marketing, just like Sales
19 & Marketing would not go to a manufacturer in
20 Mexico and sell some other type of smokeless
21 tobacco that doesn't come from Manufacturing.

22 Q. I understand that, but that's based on your
23 understanding of the corporate identity, isn't
24 that correct, the functions that they have?

25 A. No, not at all. I mean, it does come in part from

1 customers on the moon who moved to Pluto, what
2 would the price be. That's just such an absurd
3 hypothesis. I just can't answer that.

4 Q. Mr. Reilly, earlier when I asked you isn't it true
5 that you said that Manufacturing would not sell to
6 customers and distributors at the same price it
7 sold to Sales & Marketing?

8 A. Yes, absolutely.

9 Q. You said yes?

10 A. Yes, because we do know that, they would not sell
11 at the same price.

12 Q. That's what I just asked you. Would you agree
13 with me that manufacturing would not sell to
14 customers and distributors at the same price that
15 it sells --

16 A. That's not the question you just asked, but I do
17 agree with that question, they would not sell at
18 the same price.

19 Q. All right.

20 A. They wouldn't sell at all.

21 Q. All right. I want to ask you finally on this
22 Internal Revenue Code, the Section 482, isn't this
23 set up as to minimize the combined company's
24 global tax liability by shifting taxable income
25 between companies according to differences in

1 boom, and at that point in time at that price,
2 6 and a half percent of that transaction belongs
3 to the State, and it's our statutory obligation to
4 collect it. Again, I'm not an appraiser, but I do
5 deal with excise taxes, and we have a statutory
6 obligation to collect excise taxes, point in time,
7 we want to see the bill, we want to see the price.

8 Q. And is the price that is paid at the time, at the
9 point in time that's it's collected, is that a
10 fair market value?

11 MR. SEVERSON: Objection, lack of
12 foundation.

13 THE COURT: Well, I'm not sure I
14 understand the question. I want to hear the
15 answer and then I'll rule.

16 A. I would say according to common sense economics,
17 definitions of market value and a buyer and seller
18 come together and make a transaction, that's the
19 value at that point in time, at that, for both
20 buyer and seller. I know we heard yesterday about
21 the value, four dollar Coke, two o'clock in the
22 morning in the pop machine, I'm sorry, in the
23 hotel refrigerator, and we heard perhaps it's only
24 a dollar or two down the hall at the pop machine,
25 and it's only 50 cents or 25 cents at Wal-Mart.

1 A. I was looking to see if the, first of all, if the
2 definition of market value that would be
3 appropriate was the one used for the Section 482
4 analysis. What I discovered was that it appeared
5 that the wrong thing was being measured for
6 collection of the excise tax. That was something
7 beyond my initial scope of the assignment.

8 Q. And how did you determine that it was measured at
9 the wrong level, I think you said?

10 A. Right. Well, it seemed to me the measure needs to
11 be at the point of a sale to a distributor, and
12 from what I could read from the Ernst & Young
13 report, they were measuring the price going to a
14 related party who was not a distributor.

15 Q. And what is that called in your trade?

16 A. Trade level.

17 Q. So it's called a trade level. So if I understand
18 you correctly, you said they were looking at the
19 level of trade between two affiliated companies?

20 A. Correct.

21 Q. And the conclusions Ernst & Young and Willamette
22 Management came up with indicated that that was a
23 fair market value; is that correct?

24 A. That's correct.

25 Q. And you're not disputing that that is a fair

1 Q. I believe it's Exhibit 8. Is that an example of
2 the copy of the invoice that you have?

3 A. Yes, this looks very familiar.

4 Q. So you looked at the invoice as the price?

5 A. Yes.

6 Q. And at the level between the, and correct me if
7 I'm wrong, the level of the distributor in state
8 and the Tobacco Sales, did you come to a
9 conclusion of whether that was fair market value
10 price?

11 A. Well, I came to the conclusion that that would be
12 the wholesale sales price.

13 Q. Are you familiar with how the retail sales tax is
14 determined?

15 A. Yes.

16 Q. And how is -- how is that determined?

17 A. Well, at the point of purchase of something that's
18 the subject of retail sales tax, you go up to the
19 cash register, and based upon the price you're
20 willing to pay, you pay a certain percentage in
21 retail sales tax.

22 Q. Now, from -- you've described that level of trade.
23 Is there another level of trade there then at the
24 retail level?

25 A. Well, that would be the retail level of trade.

1 the level of trade within the State of Washington
2 at that distributor, how does that compare to the
3 price between the affiliated companies, what --
4 how would you view that?

5 A. Well, it was a higher price. If you were to
6 contend that they were both at same trade level, I
7 suppose you'd have to consider one discounted over
8 the other.

9 Q. And which one would you have considered
10 discounted?

11 A. The one between the affiliated companies.

12 Q. And why is that?

13 A. Well, it was a lower price.

14 Q. And you mentioned earlier that you examined the
15 valuation of businesses. You went back to look at
16 that, in fact picked up one of Mr. Reilly's books,
17 is that correct, that he co-authored?

18 A. I looked at one of his books because I didn't know
19 what Section 482 was about.

20 Q. And what, if anything, did you discover about the
21 use of a 482?

22 A. It tends to be used for income tax purposes and it
23 seemed to be a methodology adopted for markets or
24 trade levels where there weren't typically sales
25 that you could calculate a value that would mirror

1 or be reasonably reflective of fair market value.

2 Q. In your experience as an appraiser, have you ever
3 been hired to value an excise tax?

4 A. No.

5 Q. Why not?

6 A. Well, excise tax is a pretty simple tax. It's
7 whatever you paid, you paid a percentage of it in
8 excise tax, so I suppose there haven't been a lot
9 of disputes over that to where anyone would have
10 hired me to talk about it.

11 Q. And is that because you use the actual sales and
12 that price to determine the value?

13 A. Yes.

14 Q. So if we were to have appraisers have to value an
15 excise tax, what would happen?

16 A. Well, any time you involve appraisers you have the
17 threat of chaos, I suspect, because things would
18 take a long time to do because appraisers have to
19 follow certain requirements like we talked about,
20 USPAP, in order to determine value, which usually
21 is retrospective but not always. It would seem
22 like it would be difficult to administer a tax on
23 that basis as compared to the area that I'm most
24 familiar with, property tax. Appraisers are
25 needed there because those properties don't sell

1 MR. SEVERSON: Objection.

2 THE COURT: I think you've withdrawn
3 your objection and we'll go on.

4 MR. SEVERSON: I've withdrawn my
5 objection.

6 MR. HANKINS: I thought he might.

7 BY MR. HANKINS:

8 Q. Based upon your review of the documents, the trade
9 level you're using is the trade level and in the
10 State of Washington; is that correct?

11 A. I didn't understand the question.

12 Q. What trade level did you use to determine the
13 value in this case?

14 A. I didn't determine the value.

15 Q. You determined -- you examined to determine which
16 price should be used?

17 A. Well, I examined to see if the report from
18 Ernst & Young seemed to fit into what was required
19 for the excise tax and concluded it was not.

20 Q. And you concluded that which -- based upon your
21 conclusion, which level do you believe that should
22 have been used?

23 A. Well, the price paid by distributors similar to
24 the invoice which is, what, Exhibit 8.

25 MR. HANKINS: Thank you.

1 exercise well using our time.

2 Let's see if I have any more questions of
3 Dr. Smith in regard to economic theories. It's my
4 understanding your testimony was that market value
5 is determined by what the price actually is
6 between two entities, is that correct?

7 THE WITNESS: I would say just a common
8 sense definition of the market value of
9 transaction is the price people struck and it's
10 certainly the definition we follow when we collect
11 excise taxes.

12 THE COURT: Are there sometimes other
13 factors based upon the association between the two
14 entities that would result in the price negotiated
15 between the two not being the appropriate market
16 value?

17 THE WITNESS: I could speculate but the
18 answer may be yes, may be no, I really don't know.

19 THE COURT: I think that's fair, okay.
20 I don't have any further questions.

21 Either side wish to follow up now?

22 MR. SEVERSON: . One brief one, Your
23 Honor.

24 THE COURT: Actually I'll let his Mr.
25 Hankins go first.

1 that if Sales & Marketing is a distributor, there
2 can be no other distributors of OTP. Well,
3 frankly, that's not the way this industry works,
4 nor is it the way the English language works.
5 Sales & Marketing can be a distributor, and, in
6 fact, there can be other distributors of OTP.

7 MR. SEVERSON: I have no further
8 questions.

9 MR. HANKINS: Briefly, thank you, Your
10 Honor.

11 CROSS-EXAMINATION

12 BY MR. HANKINS:

13 Q. Isn't it true, Mr. Reilly, that the Manufacturing
14 Company does not sell any product to any
15 unaffiliated customer or distributor?

16 A. Well, you asked me that question yesterday, and I
17 can only give you exactly the same answer.
18 Domestically, that's true; internationally, that's
19 not true.

20 Q. And that's all we're talking about in this case,
21 correct, the domestic?

22 A. That's correct.

23 Q. And since Manufacturing doesn't sell, isn't it
24 true that Tobacco Sales sells on behalf of the
25 Manufacturing?

1 yes, we do. I mean, we concede that the value
2 that is proper here is the 68 to 73 cent price
3 range, it's not the 62 and a half price range.

4 THE COURT: I realize that it's not for
5 this Court, it's not before me as to how a price
6 is set in the future. However, this case may have
7 or may not have some precedential value. I don't
8 know. Are you saying that it should be a transfer
9 price that's based upon principles now understood
10 based upon the Ernst & Young study?

11 MR. SEVERSON: I think our view would
12 be that the kind of arm's-length price standard
13 that is used for federal tax purposes is perfectly
14 appropriate for the function that's contemplated
15 by the Court of Appeals decision. So yes, on an
16 ongoing basis, the Department of Revenue could
17 utilize those same procedures to make sure that
18 companies are not establishing artificially
19 adjusted prices for intercompany transactions.

20 THE COURT: I think finally, Mr. Reilly
21 did testify on cross-examination that United
22 States Manufacturing would not sell to some other
23 distributor. The question I think that was before
24 him on cross-examination was whether or not if
25 United States Manufacturing sold to a distributor

1 other than United States Sales & Marketing, would
2 the price be higher, and he indicated that there
3 would be no sale.

4 MR. SEVERSON: I remember some talk
5 about Saturn and Pluto and Jupiter and stuff as I
6 recall.

7 THE COURT: I followed that analogy.
8 In any event, if we look at fair market value and
9 its traditional definition that it's what a
10 willing buyer would pay a willing seller, aren't
11 we being told, then, that there is no willing
12 seller in such a transaction?

13 MR. SEVERSON: There is, I think Mr.
14 Reilly, we could call him back up, he probably
15 would be better to explain this than I.

16 THE COURT: Well, this is argument now
17 and you're stuck with his testimony.

18 MR. SEVERSON: He wouldn't deny that
19 there's a sale between Tobacco Manufacturing and
20 Tobacco Sales & Marketing. He would say, of
21 course, they sell, they sell to their affiliate.
22 And then the second question is, you know, is that
23 an arm's-length market price, and he recognizes,
24 as we all do, that if companies subject to common
25 control could manipulate that price. So he would

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1 I find that the fair market value in this
2 particular case is one dollar per can, not the 68
3 to 72 cents suggested by the plaintiff through its
4 experts in the studies.

5 Now, having said that, I don't wish to
6 reiterate in great detail materials that are
7 already of record as to the posture of this case.
8 Nevertheless, I do wish to make a clear record
9 about my understanding of some of those things and
10 so I will be reiterating some things that are
11 probably already stated in the Court of Appeals
12 case, U.S. Tobacco Sales vs. Department of Revenue
13 that is found at 96 Wn.App. 932, a 1999 decision.
14 I'm also going to be referring in passing to
15 stipulated facts, and there was a four-page
16 stipulation of facts that was entered, and I want
17 to make sure that this gets filed in the court
18 file. I made a copy because I marked up my copy
19 somewhat.

20 I'll also indicate that Exhibit No. 10, which
21 was admitted in this case, is a third request for
22 admissions and answers thereto, and does contain
23 some factual material that's been admitted or
24 stipulated.

25 Prior to 1990, United States Tobacco Company

1 that said that residual profits were apportioned
2 based upon a 23.8 to 76.2 split. I think we
3 referred to that a number of times as the 76/24
4 percent split, that is, Sales & Marketing receives
5 76 percent of residual profits and Manufacturing
6 receiving 24 percent according to this formula.

7 I was also told, however, in a hypothetical
8 which turns out to be an example based on real
9 facts and Mr. Reilly's report, Willamette report,
10 that there was a 40/60 split to profits and that
11 was one of the ways that the original transfer
12 price calculation was made. Mr. Lotfi also
13 indicated that he believed that overall there was
14 a 40/60 split.

15 This Court believes that Tobacco
16 Manufacturing in selling to Tobacco Sales &
17 Marketing is selling to an affiliated company
18 based upon a discounted price. I want to say that
19 the experts in this case all, in my opinion,
20 showed integrity. I don't think that anybody
21 tried to go out a limb and say something that they
22 didn't truthfully believe based upon their
23 analysis, not who they were retained by or working
24 for. Mr. Reilly indicated candidly that he did
25 not believe that there would be a sale from

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1 Tobacco Manufacturing to a nonaffiliated company
2 because that just isn't the way things work in
3 this situation. That was in response to a
4 question by Mr. Hankins in regard to, well, if
5 there was a sale to a nonaffiliated distributor,
6 wouldn't the price be higher. And Mr. Reilly
7 never said the price would be higher, he never
8 conceded that, but he said there wouldn't be a
9 sale at all.

10 This Court has put great weight in that
11 understanding, and that is that there are some
12 inherent associations, if you will, the trademark
13 value of the products, Skoal and Copenhagen are
14 two of those, and I think there's some others that
15 were named, and the marketing that would be done,
16 and no one wanted marketing to be done by some
17 independent that would do so less than the way
18 that U.S. Tobacco wanted it done or specifically
19 the way that Manufacturing wanted it done.

20 Based upon that I find that there was not a
21 fair market value price even though that's been
22 determined as supposedly arm's length and here's
23 the reason. There's not a willing buyer and
24 willing seller. I should say more specifically,
25 there's not a willing seller. U.S. Tobacco

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1 Manufacturing would not willingly sell to some
2 other affiliate because they get a better deal
3 when they sell to U.S. Tobacco Manufacturing and
4 Sales, so it's not arm's-length from that
5 standpoint.

6 And although I understand that accountants,
7 and no one really quarreled with the way
8 accountants went through the details here and
9 arrive at the 76/24 split, I think common sense
10 indicates that if there were a nonaffiliated
11 distributor that U.S. Manufacturing was going to
12 sell to, they would not say, well, here, we'll
13 take 24 percent of the profit and you can have 76
14 percent because we just want to deal with you.
15 They don't want to deal with them and it would
16 have to be at a higher level if they were to deal
17 with anybody else.

18 If for some reason, and I don't know what the
19 contingency would be, U.S. Sales & Marketing were
20 unable to continue and an unaffiliated distributor
21 had to step in, the sales price would definitely,
22 in this Court's opinion, be higher than the 68 to
23 72 cents that was set forth.

24 I'll tell you that I was tempted to look and
25 say, well, it would be a 50/50 split, so you folks

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1 went because the profits were divided in the
2 study. I've taken the figures which represent the
3 total profit per can in each of those Scenarios 1
4 and 2, and I've multiplied them by 40 percent. I
5 told you that I was tempted to go 50/50. I
6 considered that. I did run those figures, I did
7 look at that. A 50/50 split was my first
8 inclination.

9 However, I have determined that based upon
10 the facts that were admitted in the stipulation
11 that there is a great deal of marketing work
12 that's done by Sales & Marketing, and I heard
13 testimony from experts that overall the split was
14 40/60, and so what I've done is instead of a 76/24
15 split on the profits for 1992, I have calculated
16 that based upon a 40/60 split. I have then added
17 that profit to the 68 to 72 cents. And I'm
18 pausing for just a minute because I want to make
19 sure that I haven't overlooked something.

20 Well, it appears that I probably have. When
21 I added that to the 68 to 72 cents there was
22 already some profit in that 68 to 72 cents which
23 was the 24 percent. So we're going to have to
24 recalculate and I'll do so based on my
25 understanding. So instead of the dollar that I've

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1 indicated, it's going to be a lesser amount but it
2 is going to be an amount greater than 68 to 72
3 cents. Quite frankly, I took the middle of the 68
4 to 72 cents which is 70 cents, and then I'm going
5 to add the additional profit that I believe should
6 have been figured in the manufacturer's selling
7 price for that to be fair market value. So I've
8 been told I'm wrong before and you would have told
9 me that I was wrong at some point in time based on
10 that calculation. In any event, I want to correct
11 that and I will sit down and do the math in that
12 regard and make that clear on the record.

13 Mr. Reilly testified that, in his opinion,
14 Sales & Marketing did absolutely no manufacturing,
15 and while I think the Court of Appeals has said
16 that as well, the definition of manufacturing does
17 include manufacturing and sell, whether selling,
18 and the word S-E-L-L, sell must be in some way
19 equated with sales and that is the marketing or
20 the sales work, the contact with nonaffiliated
21 distributors and so forth, I suppose is an
22 argument for another day.

23 And while I've told you that I was tempted,
24 and if the Court of Appeals had not told me
25 otherwise to factor that in and say there was some

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DIVISION II

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STATE OF WASHINGTON

NO. 30434-1-II

BY _____
DEPUTY

**COURT OF APPEALS FOR DIVISION II
STATE OF WASHINGTON**

WASHINGTON STATE
DEPARTMENT OF REVENUE,

Appellant,

v.

UNITED STATES TOBACCO
SALES AND MARKETING CO.,
INC.,

Respondent.

AFFIDAVIT OF
SERVICE

STATE OF WASHINGTON)
County of Thurston) ss.

I certify that I mailed a copy of Brief of Appellant and
Affidavit of Service postage prepaid via Consolidated Mail
Service on January 12, 2004, as follows:

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Candy Zilinskas

Candy Zilinskas, Legal Assistant
to David M. Hankins,
Assistant Attorney General
(360) 753-5528

SIGNED and SWORN to before me, this 12th day of
January, 2004.

Sharon J. Kezar

Signature of Notary
Public

Printed Name

NOTARY Public in and
for the State of
Washington,
residing at

Olympia

Commission expires:

10/4/05