Respondent's Reply (Cross-Appeal)

NO. 30434-1-II

COURT OF APPEALS
FOR THE STATE OF WASHINGTON
DIVISION II

U.S. SMOKELESS TOBACCO BRANDS INC., PREVIOUSLY KNOWN AS UNITED STATES TOBACCO SALES AND MARKETING COMPANY, INC.,

Respondent/Cross-Appellant,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE,

Appellant/Cross-Respondent

REPLY BRIEF OF CROSS-APPELLANT

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I. INTRODUCTION

In the first appeal in this case, the Department of Revenue argued that the Other Tobacco Products ("OTP") tax should be measured by Tobacco Sales' selling price to its unaffiliated customers, while Tobacco Sales argued that the tax is measured by the transfer price that Tobacco Sales pays to acquire the OTP from its manufacturing affiliate, Tobacco Manufacturing.[1] The Court agreed with Tobacco Sales that the manufacturer's selling price (not the price to unaffiliated customers) measures the tax. However, the Court remanded with instructions that the trial court compare Tobacco Manufacturing's transfer price with fair market value to assure that the actual transfer price is not set at a "below market rate." *United States Tobacco Sales & Mktg. Co. v. Dep't of Revenue*, 96 Wn. App. 932, 942-43, 982 P.2d 652 (1999).

On remand, Tobacco Sales obtained a thorough appraisal by a prominent appraisal expert, Mr. Robert Reilly, of the fair market value price for Tobacco Manufacturing's sales to Tobacco Sales. The Department, in contrast, again presented <u>no</u> evidence of fair market value. Instead, it repeated the same "price to unaffiliated purchaser" argument that was rejected in the first appeal.

[1] The Respondent/Cross-Appellant, now known as U.S. Smokeless Tobacco Brands Inc., is referred to as "Tobacco Sales" and its manufacturing affiliate, U.S. Smokeless Tobacco Manufacturing Limited Partnership, is referred to as "Tobacco Manufacturing."

The only issue on which the parties disagree is the measure of market value to use in comparing Tobacco Manufacturing's transfer price to fair market value. Tobacco Sales believes that the correct measure is an arm's length sale by a tobacco manufacturer to a distributor where each entity owns the same property interests and performs the same functions as are actually performed by Tobacco Manufacturing and Tobacco Sales. This measure reflects the market value equivalent to the actual transfer price between Tobacco Manufacturing and Tobacco Sales.[2]

The Department, on the other hand, contends that market value must be measured by the price at which the OTP sells to the first unaffiliated purchaser, *i.e.*, Tobacco Sales' selling price. Dept.'s Reply Br. at 10. The Department asserts that there cannot be a fair market value price that is less than the price at which the OTP sells to unaffiliated customers.

The parties' tax measure dispute boils down to a dispute over the level of trade at which fair market value should be measured. Goods passing through the stream of commerce do not have a single market value. Instead, they increase in value as they move from the point of manufacture to final consumption. At each step in the distribution chain (*i.e.*, each level of trade) they increase in value because each entity in the

[2] This is the market value measure that Mr. Reilly used in his appraisal.

chain must mark up the price of the goods to cover costs and return a profit. *See generally* RP 157-168; Resp. Br. at 12-14.

Tobacco Sales maintains that the OTP tax is measured by the market value price at the manufacturer's trade level, *i.e.,* the price at which a manufacturer would sell to an unaffiliated distributor under conditions comparable to the actual sale by Tobacco Manufacturing to Tobacco Sales. There is no dispute that the market value price for a sale between such entities is \$.68 to \$.72 per can. The Department contends, on the other hand, that the tax is measured by the price for the first sale of OTP to an unaffiliated customer. There is no dispute that this would be \$1.43 per can. The only dispute is which of these transactions measures the OTP tax.

II. STANDARD OF REVIEW

Interpreting the Tax Measure is an Issue of Law That is Reviewed *De Novo*.

RCW 82.26.010(7) defines the sale price that measures the OTP tax as "the established price for which a manufacturer sells a tobacco product to a distributor, exclusive of any discount or other reduction." The market value standard announced in the Court's prior opinion does not alter this statutory tax measure. Rather, it indicates how the statutory measure applies to transactions between affiliated corporations. Determining the measure of market value to use when applying

RCW 82.26.010(7) to transactions between affiliated corporations is a question of law. *Medcalf v. Dep't. of Licensing*, 133 Wn.2d 290, 297, 944 P.2d 1014 (1997) (statutory interpretation is a question of law and is reviewed *de novo*).

Interpreting how RCW 82.26.010(7) applies to affiliate transactions is not a topic of appraisal expertise. As Mr. Reilly explained at trial, appraisers have expertise in measuring value, but not in interpreting statutes or determining what measure of value is called for under a tax statute. RP 197-98.[3] That is the job of the courts. *See Marbury v. Madison*, 5 U.S. (1 Cranch) 137, 2 L. Ed. 60 (1803) (it is the province of the courts to say what the law is).

III. ARGUMENT

A. Mr. Reilly's Appraisal Reflects Fair Market Value at the Correct Level of Trade.

The Department argues that Mr. Reilly's appraisal measured value at the wrong trade level because his value for the sale by a manufacturer is less than the price charged to unaffiliated customers. Dept.'s Reply Br. at 20-21. But this is precisely the argument that the Court rejected in the prior appeal:

[3] The Department's appraiser, Mr. Cook, acknowledged on cross-examination that his interpretation of the statutory tax measure was not based on appraisal expertise, but was just his lay reading of the statutory language. RP 370. That interpretation should be disregarded as testimony on an issue of law under the guise of expert opinion. *King County Fire Protection Dist. No. 16 v. Housing Auth.*, 123 Wn.2d 819, 826 n.14, 872 P.2d 516 (1994).

> [T]he Department contended that a transfer price between affiliated companies cannot represent a market price. . . . The Department argued that a "common sense" construction of the statute is that the "wholesale sales price" is the wholesale price paid by a nonaffiliated Washington customer. <u>The Department's position is contrary to the statutory language, which refers to the manufacturer's price</u>.

96 Wn. App. at 942-943 (emphasis added). The Department lost its "price to unaffiliated purchaser" argument in the first appeal, and it presented nothing on remand to change that result.

RCW 82.26.010(7) measures the OTP tax by the value at which the OTP transfers from a manufacturer to the first distributor. Tobacco Sales is a distributor, not a manufacturer. *United States Tobacco Sales & Mktg. Co.,* 96 Wn. App. at 398. Washington law does not permit the Department to disregard Tobacco Sales' and Tobacco Manufacturing's separate corporate identities and treat Tobacco Sales' selling price as if it were a manufacturer's selling price. 96 Wn. App. at 943. Tobacco Sales' selling price is not a manufacturer's price because it includes the value that Tobacco Sales adds to the OTP and that value is not part of the tax base. 96 Wn. App. at 940. These issues were decided in the first appeal, and law of the case does not permit the Department to reargue them in this second appeal. *Lutheran Day Care v. Snohomish County*, 119 Wn.2d 91, 113, 829 P.2d 746 (1992).

The Department presented no evidence that Tobacco Sales is a manufacturer. It presented no evidence of fair market value or pricing comparisons showing the value of the OTP at the manufacturer's trade level. *See* 96 Wn. App. at 942. To the contrary, the un-refuted evidence was that unaffiliated customers would not buy OTP from Tobacco Manufacturing at Tobacco Sales' selling price because Tobacco Manufacturing does not provide the sales and marketing services that Tobacco Sales provides. RP 227-28. Using Tobacco Sales' selling price as an indicator of value at the manufacturer's trade level violates the fundamental principle that the price at one level of trade does not indicate value at a different level of trade. UNIFORM STANDARDS OF PROFESSIONAL APPRAISAL PRACTICE ("USPAP") Rule 7-3(b); RP 165, 196-97 (Reilly); RP 378 (Cook). Neither Tobacco Sales, nor any other distributor, could buy the OTP from the manufacturer, incur substantial sales and marketing costs, and then resell the product without a markup. *See, e.g.,* RP 56, 375. Yet that untenable assumption lies at the heart of the Department's theory. The Department's "price to unaffiliated purchaser" argument is fundamentally at odds with the Court's prior opinion, all of the evidence and basic economic principles.

After the first appeal, the Court remanded to the trial court to compare Tobacco Manufacturing's transfer price with fair market value to assure that the transfer price had not been set at a "below market rate." *United States Tobacco Sales & Mktg. Co.,* 96 Wn. App. at 943. The actual transfer price was \$.62 per can. Mr. Reilly concluded that the fair market value for that sale was between \$.68 and \$.72 per can. His appraisal measures the arm's length, market value price for the sale of OTP from Tobacco Manufacturing to Tobacco Sales. That is the transaction that measures the OTP tax. RCW 82.26.010(7). Mr. Reilly and Mr. Lotfi, Tobacco Sales' other expert, used widely accepted 26 U.S.C. § 482 methodologies in making their analysis.[4] Their value conclusion respects UST's corporate structure; promotes tax uniformity by valuing transactions between affiliates on the same basis as transactions between unaffiliated entities; protects against tax fraud by assuring that affiliated taxpayers do not set transfer prices at "below market rates"; and is consistent with the Court's prior decision.

The Department offers nothing of substance to refute Tobacco Sales' valuation evidence. It criticizes Mr. Reilly's use of § 482 valuation methodologies, arguing as it did in the prior appeal that the § 482 arm's

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[4] All of the valuation experts agreed that the arm's length valuation standard of Internal Revenue Code § 482 (26 U.S.C. § 482) is equivalent to the fair market value standard. RP 52 (Lotfi); RP 183-84 (Reilly); and RP 356 (Cook). Mr. Reilly has recently published an article with Melvin Rodriguez on the use of § 482 valuation methods for establishing excise tax values. Appendix B: R. Reilly and M. Rodriguez, *Excise Tax and Inventory: IRC Section 482 Transfer Price Rules May Provide a Reasonable Valuation Approach*, JOURNAL OF MULTISTATE TAXATION AND INCENTIVES 20 (May 2004).

length standard is only relevant for income taxes, but it has again failed to show "in what respect the federal arm's-length-price standard differs from fair market value." *United States Tobacco Sales & Mktg. Co.*, 96 Wn. App. at 942. In fact, the Department's *own* appraiser contradicted its claim that the § 482 arm's length standard differs from fair market value:

> Q. [by Mr. Hankins] Okay. And what if anything else did you find significant of the Ernst & Young report.
>
> A. [Mr. Cook] Well, the Ernst & Young report made calculations of fair market value using a methodology that I was unfamiliar with, the Section 482 methodology. So what I did is I got a hold of one of the publications co-authored by Mr. Reilly and read up on Section 482 to find out if that methodology met the standard that I would think would be appropriate for measuring market value at any level, and I found that it did.
>
> Q. So it was an appropriate standard for fair market value?
>
> A. Yes.

RP 356.

The Department offers no explanation for why corporate form should be disregarded or why products that are marketed and distributed through affiliated corporations should be taxed at a higher level than products that are marketed and distributed through unaffiliated companies. All of Tobacco Manufacturing's domestic sales are made to Tobacco Sales, so the first sales to unaffiliated purchasers are always made by Tobacco Sales. This exclusive selling arrangement is not a new fact that was discovered on remand. That arrangement was disclosed in the initial discovery phase of this case, noted by the Department in its original summary judgment motion and recognized in the Court's prior opinion.[5] That relationship, however, does not mean that there cannot be a fair market value price for Tobacco Manufacturing's sales to Tobacco Sales. *See* Resp. Br. at 19-26. The Department offers no explanation for why the Court's prior resolution of this issue was clearly wrong or why its attempt to reargue this issue is not barred by the law of the case doctrine.

B. The Trial Court Abused Its Discretion by Establishing a Value Outside the Evidence.

The trial court agreed that Mr. Reilly used the correct measure of fair market value in his appraisal. Conclusion of Law No. 3; RP 436. It rejected the Department's "price to unaffiliated purchaser" theory. That should have resolved the litigation. Unfortunately, however, the trial court then went beyond the evidence to make an arbitrary and unsupported adjustment to Mr. Reilly's appraised value. Both parties agree that the trial court's adjustment went beyond the evidence. *See* Dept.'s Reply Br. at 21 ("the trial court's only error was to create a fair market value price outside of the evidence."). The Department's appraiser, Mr. Cook, agreed that if Tobacco Sales is a distributor rather than a manufacturer,

[5] *See* Appendix A: Excerpts from Ernst & Young Transfer Price Study and Department's first summary judgment brief. *See also United States Tobacco Sales & Mktg. Co.,* 96 Wn. App. at 934 and 942.

Mr. Reilly's appraisal reflects market value. RP 374-76. Tobacco Sales is a distributor, and, therefore, the trial court should have adopted Mr. Reilly's value as the tax base. *Cf. Weyerhaeuser Co. v. Easter,* 126 Wn.2d 370, 381, 894 P.2d 1290 (1995) ("Once the taxpayer meets the standard of proof, the reviewing tribunal substitutes the taxpayer's value for the assessor's."). There was no evidence for any other result.

This same situation arose in *In re Petition of Seattle to Acquire Certain Property*, 49 Wn.2d 247, 299 P.2d 843 (1956), but there the trial court adopted the correct approach to evaluating the evidence:

> One-third of the entire value seems to me to be a fairly high price for that access. However, the real estate men say it is worth that. That is, those that I think have the better viewpoint and I don't know that it makes much sense for the court, who knows nothing of these things of themselves, to arbitrarily subtract a certain sum from the opinion of men who have specialized in this business for a great many years. It is a little bit presumptuous, I think.

49 Wn.2d at 253. Here, instead of limiting his consideration to the evidence, Judge Tabor cast aside Mr. Reilly's uncontradicted opinion of value and substituted his own opinion which, at best, seems based on a misunderstanding of the evidence. That was an abuse of discretion. *See* Resp. Br. at 36-47.

The trial court's arbitrary valuation decision in this case is particularly troubling because of the importance of tax uniformity:

> One fundamental premise pervades the constitutional limitations on the exercise by the Legislature of the power of taxation. This premise is that the distribution of the burdens of taxation should be uniform.

Bond v. Burrows, 103 Wn.2d 153, 156-57, 690 P.2d 1168 (1984). Just as the Legislature is barred from establishing arbitrary discriminations in the distribution of the tax burden, so too are trial court judges. Taxes are to be distributed uniformly based on law and principle, not arbitrarily on the whim and fancy of individual judges. The trial court's arbitrary adjustment to Tobacco Sales' tax liability violates this principle.

C. An Erroneous Denial of Summary Judgment on a Legal Issue is Subject to Review After Trial.

The Department offers two reasons why the Court should not review the trial court's denial of Tobacco Sales' motion for summary judgment:

> 1. The dispute over fair market value was a question of fact and, therefore, denial of summary judgment was proper. Dept.'s Reply Br. at 22-23.
>
> 2. A denial of summary judgment is never subject to appellate review after a trial on the merits. Dept.'s Reply Br. at 23-27.

Neither of these arguments are correct.

1. The Second Summary Judgment Motions Presented an Issue of Law, Not Fact.

The Department argues that the trial court's denial of summary judgment was appropriate because fair market value is an issue of fact.

Dept.'s Reply Br. at 22-23. While disputes over fair market value may involve disputed facts, that is not always true and it was not true here. The Department did not dispute the factual basis for Mr. Reilly's appraisal or the validity of his opinion of value. Instead, the Department argued that Mr. Reilly's appraisal is wrong because it measures value at the wrong trade level. This argument disputes the validity of the measure of value that Mr. Reilly was instructed to use, <u>not</u> the validity of his opinion. The dispute over the proper measure of value for calculating the OTP tax is a dispute of law, not fact. *See supra* at 3-4; Resp. Br. at 11-12. *See also Propstra v. United States*, 680 F.2d 1248, 1251 (9^{th} Cir. 1982).

To demonstrate the existence of a factual dispute, the party opposing summary judgment must present evidence of disputed facts. *Johnson v. Schafer*, 110 Wn.2d 546, 548, 756 P.2d 134 (1988). If no facts are placed in dispute and the moving party is correct on the legal issue, the court grants summary judgment. CR 56(c); *Young v. Key Pharm.*, 112 Wn.2d 216, 225-26, 770 P.2d 182 (1989). Here, no facts were placed in dispute, Tobacco Sales was correct on the legal issue and, therefore, Tobacco Sales was entitled to judgment as a matter of law.

The Department suggests that when this Court refused discretionary review of the summary judgment denial, it must have concluded that the summary judgment involved disputed issues of fact.

Dept.'s Reply Br. at 23. That is not true. A denial of discretionary review is a refusal to accept review, not a decision on the merits of the ruling on which review is sought or the merits of the underlying arguments. RAP 2.3(c). A denial of discretionary review simply reflects the Court's decision not to accept interlocutory review.

2. An Erroneous Denial of Summary Judgment on a Legal Issue May Be Reviewed After Trial.

The Department also contends that a denial of summary judgment should never be subject to review after a trial on the merits. Dept.'s Reply Br. at 23-27. It urges the Court to reject the "flawed reasoning" of the Division I decisions which hold that a summary judgment denial may be reviewed after trial for an erroneous ruling on an issue of law. *See Kaplan v. Northwestern Mut. Life Ins. Co.*, 115 Wn. App. 791, 799-800, 65 P.3d 16 (2003); *Univ. Village Ltd. Partners v. King County*, 106 Wn. App. 321, 324, 23 P.3d 1090 (2001); *McGovern v. Smith*, 59 Wn. App. 721, 734-735, 801 P.2d 250 (1990). The Department labels these Division I decisions as "flawed," but it fails to explain why they are flawed.

CR 56(c) states that summary judgment *shall* be entered if there is no genuine issue of fact and the moving party is entitled to judgment as a matter of law. Unless otherwise indicated, *shall* is mandatory. *See Whisler v. Weiss*, 26 Wn.2d 446, 446 (1946). The Department fails to explain why *shall* is not mandatory in these circumstances or why an erroneous denial of summary judgment on a legal issue should not be subject to review after trial.

This case demonstrates the merit of the Division I approach. If the outcome of a case depends solely on a disputed issue of law, a fact trial is not only a useless burden on the courts and the parties, it introduces the potential for further prejudicial errors during the course of trial that may confuse and complicate a final resolution of the litigation. Permitting post-trial appellate review of an erroneous denial of summary judgment reduces this problem because reversal of that erroneous ruling will eliminate the need to review other trial rulings for possible error.

The Department argues that both Division II and the federal courts have rejected the Division I approach to post-trial review of summary judgment denials. The Department substantially overstates its case. Neither Division II nor Division III have addressed post-trial review of a summary judgment denial where the issue is a dispositive legal issue. The federal courts have split on the issue. Several decisions from the Seventh, Tenth and Federal Circuits have followed the approach taken by Division I, allowing post-trial review where the denial involved only issues of law. *United Techs. Corp. v. Chromalloy Gas Turbine Corp.,* 189 F.3d 1338, 1344 (Fed. Cir. 1999); *Wolgang v. Mid-America Motorsports,* 111 F.3d 1515, 1521 (10th Cir. 1997); *Rekhi v. Wildwood Industries,* 61 F.3d 1313, 1318 (7th Cir. 1995). Most of the federal cases cited by the Department involve summary judgments that were denied because of fact disputes, not cases where the denial resulted from an erroneous legal ruling. While there are a few federal cases that support the Department's argument, they do not provide persuasive reasons for rejecting the Division I approach.

Permitting appellate review after trial where the summary judgment denial involves only issues of law will promote careful and thorough consideration of summary judgment motions and thus expedite judicial proceedings. There is no prejudice in such review because legal issues are always reviewed *de novo* by the appellate court. Therefore, this Court should adopt the approach taken by Division I and reverse the trial court's improper denial of Tobacco Sales' Second Motion for Summary Judgment.

IV. CONCLUSION

The Department's arguments on remand are nothing but a reprise of its arguments in the first appeal where the Department argued that the tax measure is the price charged by Tobacco Sales to its unaffiliated customers. That argument was rejected in the first appeal. On remand, the Department simply repackaged its "price to unaffiliated purchaser" argument and advanced it again, both at summary judgment and at trial.

Tobacco Sales, in contrast, commissioned a prominent valuation expert to appraise the fair market value price for the sales by Tobacco Manufacturing to Tobacco Sales. Mr. Reilly's appraisal was presented both at the second motion for summary judgment and at trial. The Department neither contradicted nor impeached that evidence. Tobacco Sales met its burden of establishing the fair market value for the OTP.

Tobacco Sales has now litigated the same legal issue three times, and it is long past time to bring this litigation to an end. The Department's valuation theory is invalid. The trial court's denial of Tobacco Sales' second motion for summary judgment was erroneous as a matter of law. Its adjustment to Mr. Reilly's value was an abuse of discretion. The Court should reverse the trial court and rule that the fair market value of the OTP was $.72 per can.

DATED this 30th day of July, 2004.

GARVEY SCHUBERT BARER

By William C. Severson

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In 1995, USTMC increased it purchases of dark fired, burley and dark air cured tobaccos primarily from domestic sources. In 1995, purchases from foreign suppliers declined, and continued to decline as a percentage of total tobacco purchased. Such foreign suppliers were located in Canada, Italy and Mexico.

e. Customers/Markets

USTMC sells only to related parties, who constitute its direct customer base: USTSM and USTobI which operate as wholesale distributors and undertake marketing. USTMC's end customers and markets are the same as those described under USTSM and USTobI.

f. Assets

i. Physical Assets

USTMC owns three offices and manufacturing plants in the United States at the following locations:

- Franklin Park, Illinois
- Hopkinsville, Kentucky
- Nashville, Tennessee

USTMC is presently building a new facility in Cadiz, Kentucky.

Significant capital equipment owned by USTMC includes casing cylinders, large bulking bins, high speed cutting machinery, drying equipment process, packaging, can and lid manufacturing equipment, and control systems. USTMC's control systems are custom designed by in-house engineers, and are essential to monitoring the manufacturing process.

USTMC believes it has more up to date manufacturing technology than most of its competitors. (For example, one competitor is believed to be using technology which is 20-40 years older).

Were there any doubt that the reorganization did not change the substance of the business, as far as wholesale purchasers and taxing authorities were concerned, this was resolved by a letter (See Document P100124) dated February 8, 1990 from Gary Meno, USTC Manager of Tax Planning, to state taxing authorities regarding the effect of the corporate reorganization and stating in part here pertinent:

> **"Please note that the nature and location of our business has remained unchanged."**

Although the nature and location of the USTC business was unchanged, there were some changes in the *form* of the business operation after the reorganization. The reorganized United States Tobacco Company began to effectively "buy the product from itself" at a price (the "transfer price") far below the price charged for the same tobacco product to Washington wholesale purchasers. This was accomplished by one wholly owned subsidiary of USTC (*"Sales"*) taking "title" to tobacco products from another wholly owned subsidiary of USTC (*"Manufacturing"*) at the "transfer price" set by their common parent company: USTC.

This transfer transaction is a change of form without a change of substance as it occurs wholly on paper, *after* a Washington wholesale purchaser has already purchased the goods at a market price, and with *"Sales"* never taking possession of, storing, insuring or shipping the goods from its own facility.

[It is this transfer price, available only to *"Sales"* and not available to Washington wholesalers, that Plaintiff now contends should be the "wholesale sales price" for purposes of the statutory measure of OTP tax.]

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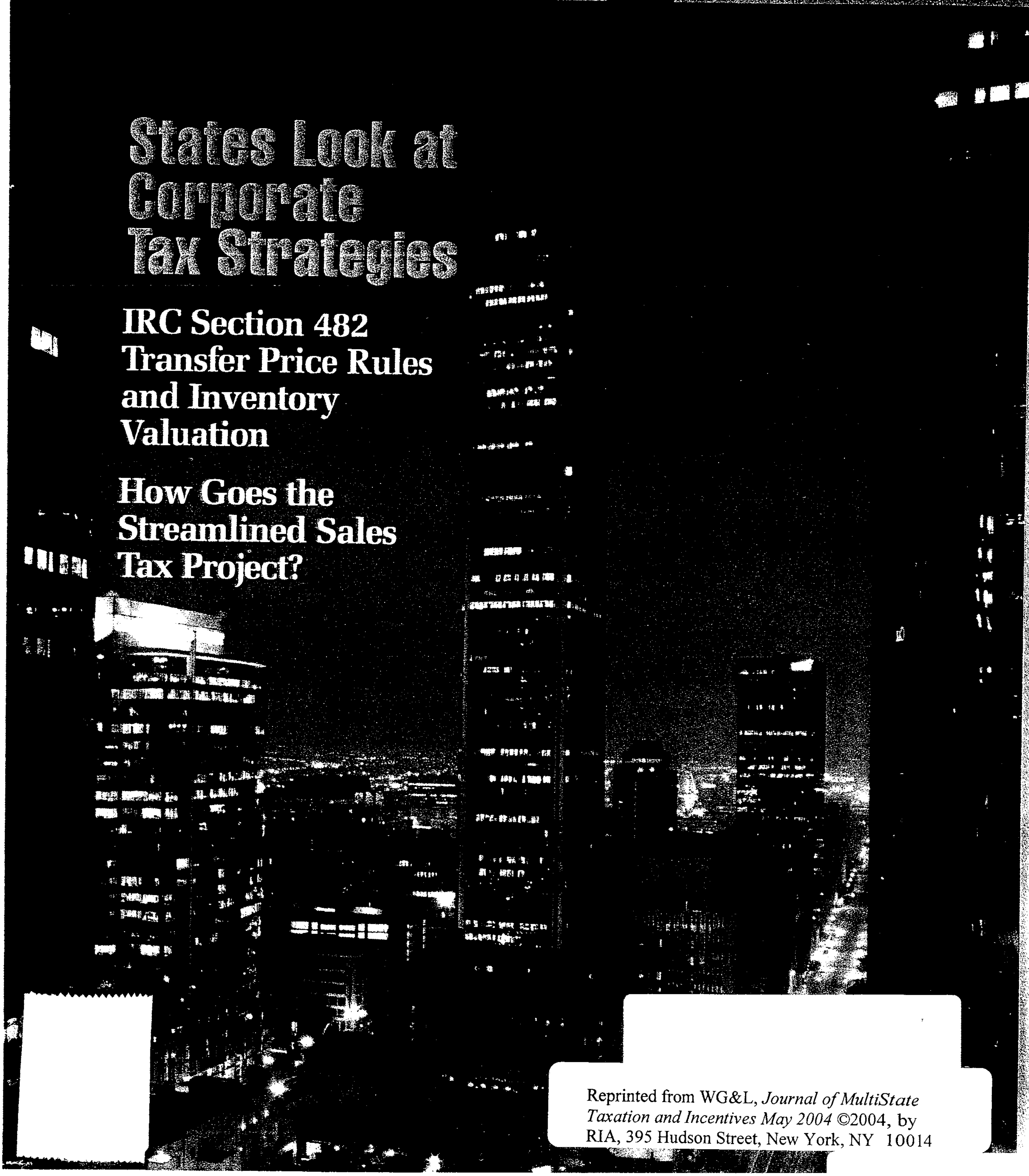

States Look at Corporate Tax Strategies

IRC Section 482 Transfer Price Rules and Inventory Valuation

How Goes the Streamlined Sales Tax Project?

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APPENDIX B

JOURNAL OF
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Excise Tax and Inventory

IRC Section 482 Transfer Price Rules May Provide a Reasonable Valuation Approach

...ating the appropria... ...alue often proves diffi... ...hen the production of g... related businesses that pa... different stag... of the manufac... ...process.

ROBERT F. REILLY AND
MELVIN RODRIGUEZ

The excise tax is a levy imposed on the manufacture, sale, or use of goods. Many states impose an excise tax on the production or import of various types of manufactured products.

Some products typically subject to excise tax include cigarettes and other tobacco products and alcohol. Many states impose the excise tax on the cost of the manufactured product at a specific point in the distribution process (e.g., when a locally produced product is shipped from the plant or when an imported product crosses the state border). In many jurisdictions, the procedures for determining product cost (i.e., the measure of the tax) are specified by statutory authority or administrative ruling. When a state uses "cost" as the tax base, the determination is largely an accounting function.

Controversy can arise, however, in jurisdictions that impose an excise tax on the "value" (as opposed to the cost) of manufactured or imported products. Such controversies may include: (1) the appropriate standard (or definition) of value; (2) the appropriate point of trade at which to value taxable products; and (3) the valuation approaches and methods to be used. These issues often become more complex when the subject products are imported into the state as partially completed work-in-process inventory and then completed into finished goods and sold within the state.

Estimating the value of a manufactured/imported product is further complicated when the product benefits from the use of valuable intangible assets (e.g., intellectual property such as patents, copyrights, trademarks, and trade secrets) during the manufacturing process. Also, most manufactured/imported products come with a trademark or trade name brand, trade dress packaging, or copyrighted promotional materials. Accordingly, taxpayers and the taxing authorities have to estimate (1) the value of the manufactured/imported product benefiting from the intangible assets, and (2) the value of the associated intangibles.

This problem is further exacerbated when the transaction involves related parties. For example, an in- or out-of-state manufacturer transfers a product to an affiliated distributor in the taxing state. In such instances, the intercompany transfer may not necessarily reflect an arm's-length price for the manufactured/imported product.

The following discussion describes a set of procedures that may be used to estimate the "value" of manufactured/imported products when a state's excise tax valuation methodology is not adequately described in the relevant statutory authority, judicial precedent, or administrative rulings. The valuation procedures described herein are normally used for federal income tax purposes to estimate the fair, arm's-length transfer price (a typical definition of "value") of goods and services transferred between two controlled (i.e., commonly owned) taxpayers.

These rules have been promulgated under IRC Section 482 ("Allocation of income and deductions among taxpayers") in connection with both tangible and intangible assets. Most states either have a Section 482-type provision or incorporate Section 482 in arriving at state taxable income.[1] It

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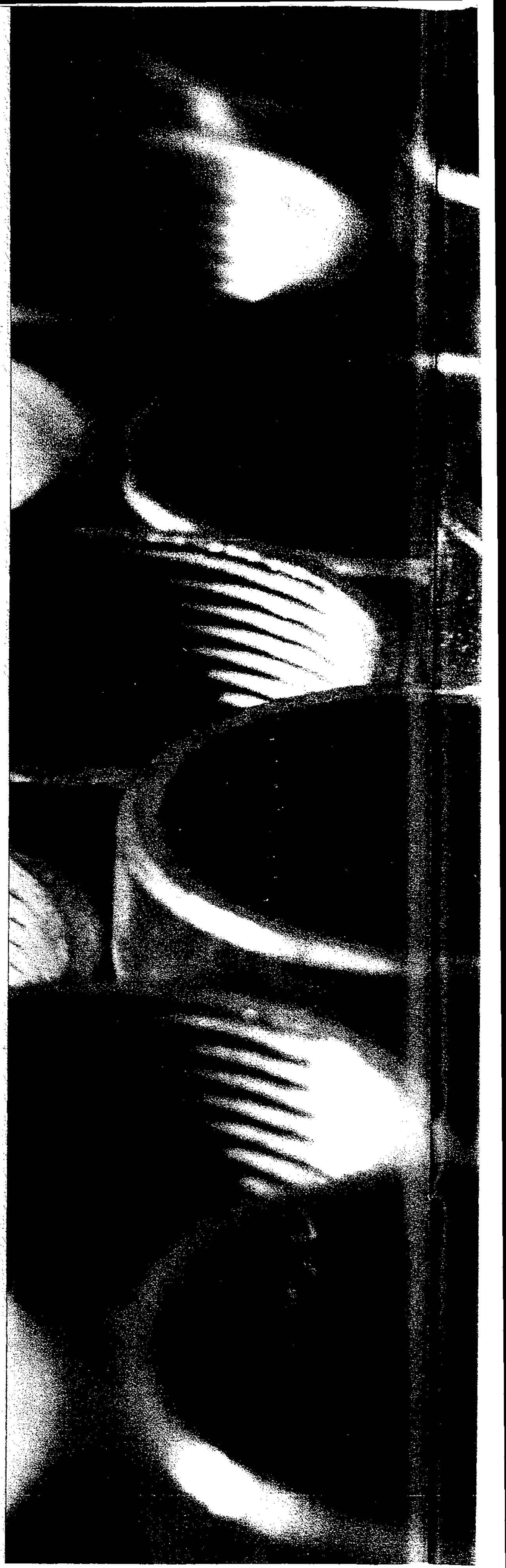
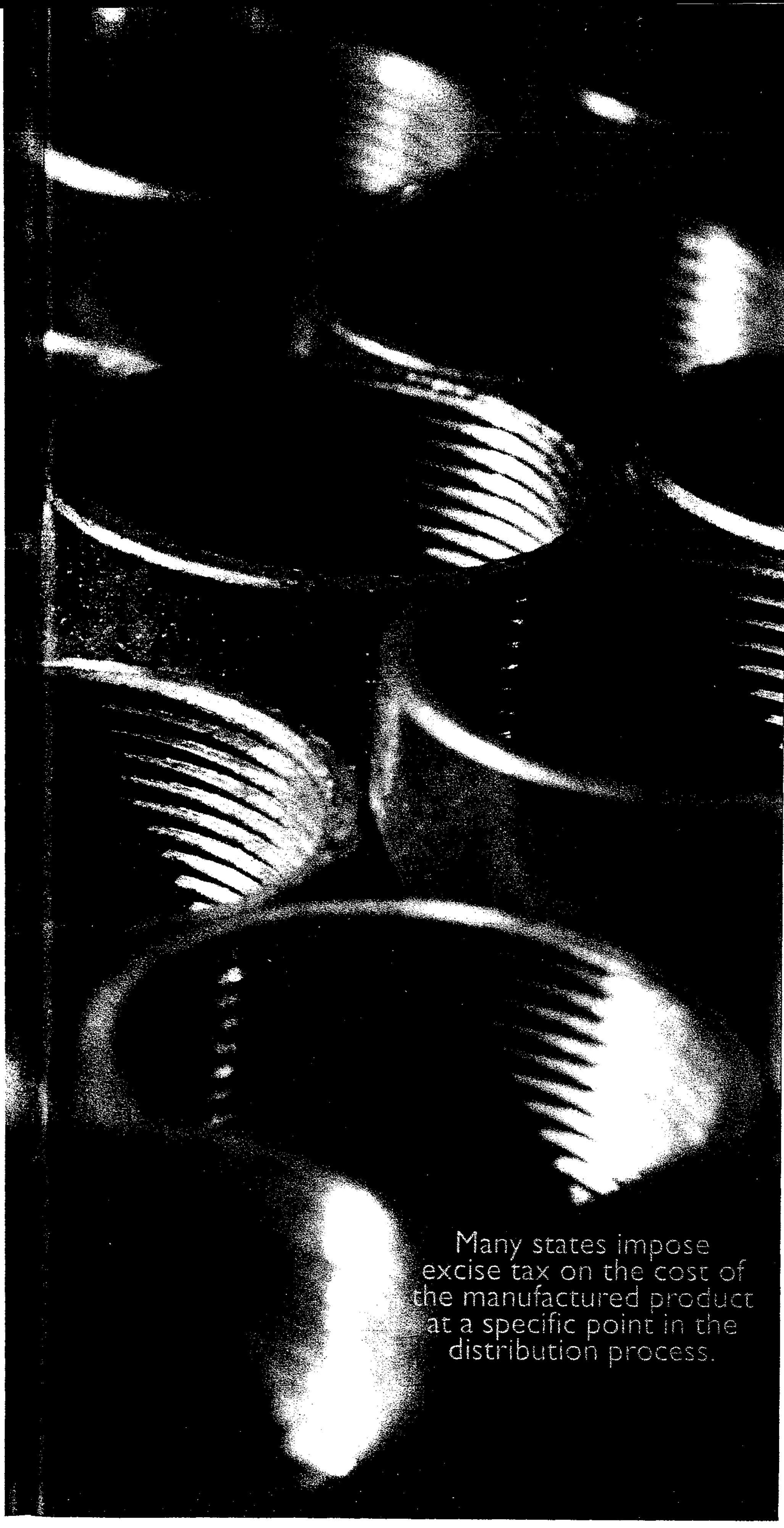




seems likely that states also would accept Section 482-type procedures in the excise tax context.

Intercompany Transfer Prices/Values

For decades, the IRS has been concerned that domestic taxpayers could shelter income or otherwise avoid taxes by transferring tangible assets (e.g., manufactured goods) or intangible assets (e.g., patents, trademarks) to a foreign affiliate. The taxpayer would avoid U.S. taxes by effectively allocating income to the affiliate in a lower-tax-rate foreign country by means of a "transfer price" (typically, a royalty) paid to the foreign, controlled entity for the taxpayer's use of the transferred assets. Similarly, the IRS is concerned that a foreign taxpayer could avoid U.S. taxes by not allocating sufficient income to the U.S. for the use of tangible and intangible assets that are owned/used by a domestic, controlled affiliate of the foreign taxpayer.

In order to appropriately reflect the income attributable to the use of transferred assets, as noted above, the IRS promulgated rigorous and comprehensive regulations under IRC Section 482 that describe in detail (with numerous illustrative examples) the allowable methods for determining the appropriate intercompany transfer price between controlled or related parties for the use of tangible and intangible assets. These transfer price regulations have been interpreted by the IRS and by tax practitioners over the course of decades. In addition, the regulations—and the specified transfer-price/valuation methods—have been tested and interpreted by the federal courts. From time to time, these regulations are updated (the most recent proposed regulations were issued in September 2003). Furthermore, the IRS's intercompany transfer pricing regulations are generally consistent with transfer-price/valuation rules adopted by the taxing authorities in other major industrial countries.

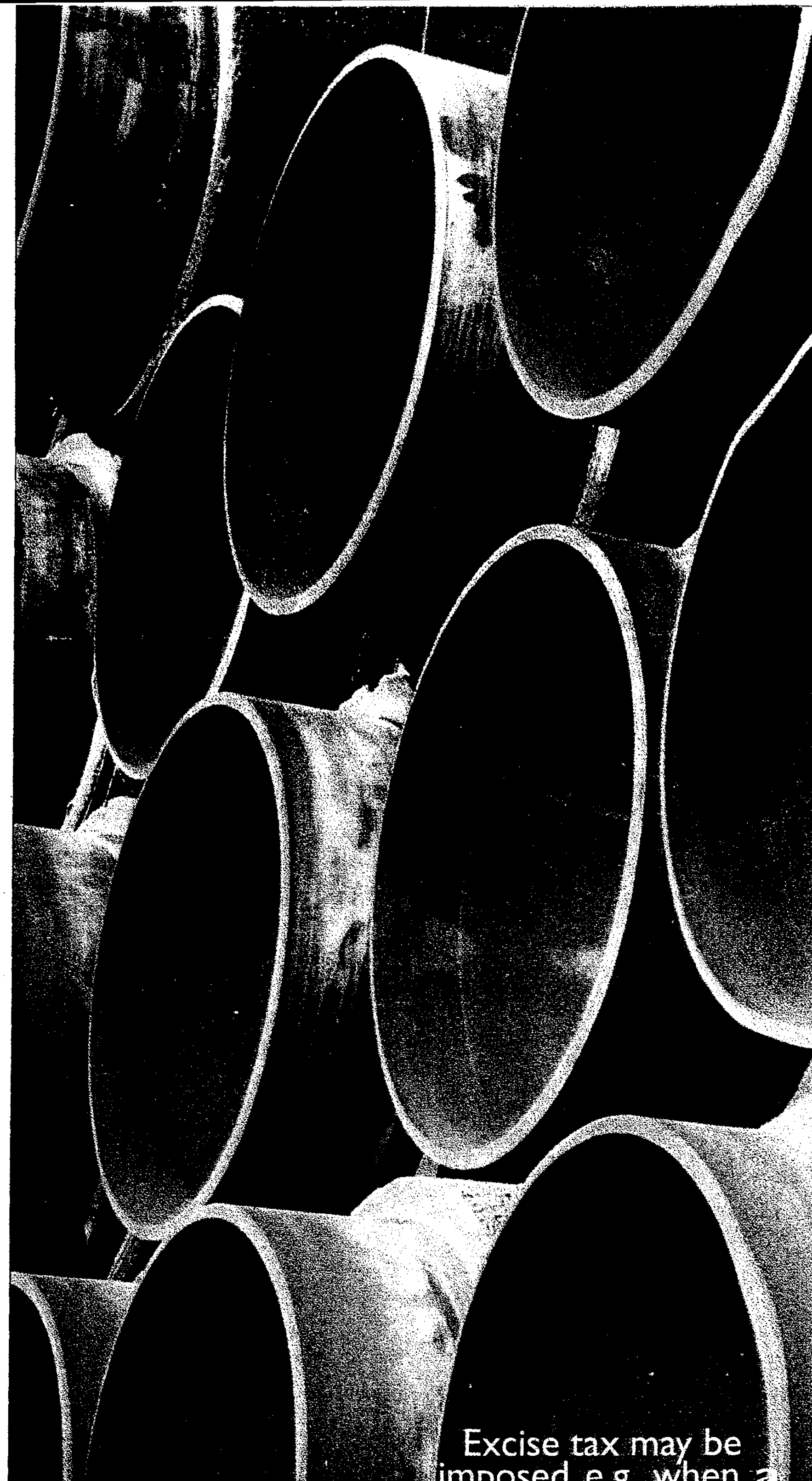
In broad concept, the IRC Section 482 transfer price rules treat the related-party's tangible and intangible assets as if they were owned by a truly independent third party operating at arm's length. Arm's-length prices are determined by the application of a specified set of approved economic analysis methods. The resulting transfer prices/values are designed to appropriately allocate the income of the overall taxpayer between the transfers of (1) the subject tangible assets and (2) the subject intangible assets. This objective is the same as the determination of the value of manufactured/imported products for excise tax purposes.

Exhibit 1 illustrates the typical intercompany transaction with which the IRS is concerned. In that scenario, the U.S. taxpayer will seek to pay an excessive transfer price to its foreign affiliate located in a low- or no-tax country. The intercompany payment would be a deductible expense in the U.S., thereby reducing the taxpayer's domestic taxable income. The IRC Section 482 methods are designed to ensure that the transfer price paid for the use of tangible and intangible assets is a fair, arm's-length price (no more and no less), and the transfer price/valuation is intended to clearly reflect the U.S. taxable income of the domestic taxpayer.

The following discussion presents the framework for the intercompany transfer pricing of tangible and intangible assets for federal income tax purposes. The methods described are used to allocate income between two commonly controlled, often multinational, organizations or businesses in connection with the intercompany use of tangible and intangible assets as if the assets were owned by two unrelated taxpayers. These same methods could be used for state excise tax purposes to value manufactured/imported products as if those products were produced by two unrelated taxpayers.

U.S. Regulatory Framework for Intercompany Transfer Pricing

As noted above, the U.S. tax rules concerning the intercompany transfer pricing/valuation of tangible and intangible assets and services are provided by IRC Section 482 and the related regulations. Final regulations were published by the U.S. Treasury Department in July 1994. It is useful to consider the key features of the framework of the transfer pricing regulations, including a review of the arm's-length standard. The following discussion summarizes each transfer pricing method presented in the federal regulations related to the allocation of

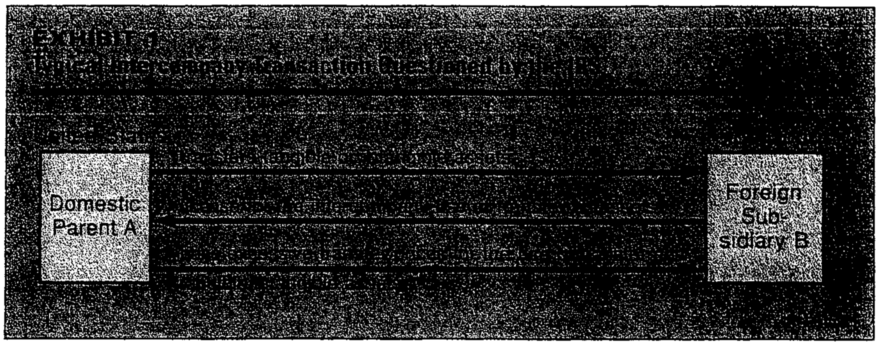


consolidated-entity income between (1) tangible assets and (2) intangible assets.

The arm's-length standard. The transfer pricing regulations give the IRS broad authority to allocate income and expenses between related entities if it determines that such an allocation is necessary (1) to prevent the evasion of taxes or (2) to clearly reflect the income of the related entities. The regulations state that "[t]he purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions, and to prevent the avoidance of taxes with respect to such transactions."[2] According to the regulations, the standard applied to any related-party transaction is to compare it to the same or a similar transaction as carried out by a taxpayer dealing at arm's length with another, independent taxpayer. "A controlled transaction meets the arm's-length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances...."[3]

The key concept underlying the IRC Section 482 regulations' arm's-length standard is the reliance on transactions that are independent or uncontrolled. In order to apply the arm's-length standard, taxpayers should identify (1) some transaction or transactions between independent, uncontrolled parties (2) where the price (or profitability) can be ascertained. Then, the "best method" rule relies on the standard of comparability to determine which transactions provide the most reliable transfer price conclusion. In this regard, taxpayers should compare (1) the results of the subject related-party transaction to (2) the results of comparable transactions between uncontrolled parties under comparable circumstances.

The best method rule. The IRC Section 482 regulations provide several methods for determining tangible and intangible asset intercompany transfer prices. Further, the regulations require that the best method be used to determine the arm's-length pricing for each tangible/intangible asset intercompany transaction. The "best method" is the one that, considering all relevant facts and circumstances, produces the most reliable measure of an arm's-length price for the related-party transaction.[4] Two primary considerations must be taken into account in determining which of the allowed transfer pricing methods is best.



Degree of comparability. The first consideration is the degree of comparability between (1) the subject controlled transaction and (2) the selected uncontrolled transaction. According to the regulations, comparability of transactions and circumstances must be evaluated considering all factors that could affect prices or profits in arm's-length dealings. These factors include:

1. Functions performed.
2. Contractual terms.
3. Risks borne.
4. Economic conditions experienced.
5. The nature of the property or services.[5]

The functional analysis procedures of a transfer price valuation are critical to assessing these five factors as they relate to the subject entity. A functional analysis involves finding and organizing facts about a business in terms of its functions, risks, and intangibles in order to identify how these characteristics are divided between the subject taxpayer business entities. In the functional analysis, the analyst describes the value-added activities undertaken by the taxpayer in order to identify independent comparable transactions that establish an arm's-length range of prices. Therefore, the functional analysis provides the factual foundation on which to apply the selected transfer pricing method—consistent with the regulations' arm's-length standard. ("Functional analysis" is discussed in greater detail below.)

Quality of data and assumptions. The second consideration in determining the best transfer pricing method is the quality of the data and assumptions used in the analysis. Factors to be considered in assessing the quality of the data and assumptions include:

1. Completeness and accuracy of data.
2. Reliability of assumptions.
3. Sensitivity of the results to deficiencies in data and assumptions.[6]

The regulations describe several methods for determining arm's-length tangible and intangible asset intercompany transfer prices. The best-method rule does not suggest a priority in the application of the allowable methods, and generally no one method is considered more reliable than another. Indeed, a taxpayer may find several possible methods appropriate in establishing an arm's-length benchmark for intercompany transfer prices. The best-method rule takes into account all facts and circumstances, including the considerations noted above, to determine which method provides the most reliable measure of an arm's-length result.

Allowable transfer pricing methods for tangible assets. The regulations describe the following five specific methods (plus a framework for using unspecified methods) for determining an arm's-length price for the related-party transfer of tangible property:

1. Comparable uncontrolled price method.
2. Resale price method.
3. Cost plus method.
4. Comparable profits method.
5. Profit split method.[7]

The best method rule is applied to select the most appropriate method; each allowable method should be applied in accordance with the general comparability rules outlined in Treas. Reg. § 1.482-1.

Comparable uncontrolled price. The comparable uncontrolled price method uses actual tangible asset transactions between unrelated parties to determine the arm's-length price for the transfer of tangible assets between related parties. This method analyzes whether the price charged in the subject related-party (controlled) transaction is at arm's-length by referring to the prices charged in comparable uncontrolled transactions.

Under this method, the selected comparable transactions should involve substantially the same products as the controlled transaction. According to the regulations, "similarity of products generally will have the greatest effect on comparability under this method." Moreover, "if there are material product differences for which reliable adjustments cannot be made, this method ordinarily will not provide a reliable measure of an arm's-length result."[8]

Resale price. The resale price method can be used to determine the arm's-length price to be paid by the purchaser entity in the subject intercompany transaction when that purchaser, in turn, resells the subject tangible asset to unrelated parties. According to the regulations, this method "evaluates whether the amount charged in a controlled transaction is arm's length by reference to the gross profit margin realized in comparable uncontrolled transactions. The resale price method measures the value of functions performed, and is ordinarily used in cases involving the purchase and resale of tangible property in which the reseller has not added substantial value to the tangible goods by physically altering the goods before resale."[9]

Cost plus. The cost plus method determines the arm's-length price that the seller entity should receive in an intercompany transaction based on the markup on gross profit earned by sellers in comparable uncontrolled transactions. Specifically, the regulations state that this method "evaluates whether the amount charged in a controlled transaction is arm's length by reference to the gross profit markup realized in comparable uncontrolled transactions. The cost plus method is ordinarily used in cases involving the manufacture, assembly or other production of goods that are sold to related parties."[10]

The cost plus method focuses on the circumstances of the subject transaction and the comparable transactions. This method does not require essential identity between the tangible assets sold in the uncontrolled and subject controlled transactions. Rather, the regulations state that "comparability under this method is particularly dependent on similarity of functions performed, risks borne, and contractual terms, or adjustments to account for the effects of any such differences. If possible, the appropriate gross profit markup should be derived from comparable uncontrolled transactions of the taxpayer involved in the controlled sale, because similar characteristics are more likely to be found among sales of property by the same producer than among sales by other producers."[11]

Comparable profits. The comparable profits method determines an arm's-length price for the related-party transfer of tangible assets by reference to a measure of profitability of an unrelated company that engages in similar activities under similar circumstances. This method compares the profitability of either the related-party buyer or the related-party seller to the profitability of the selected comparable uncontrolled company, based on objective measures (i.e., "profit level indicators" or PLIs). According to the regulations, comparability under this method depends primarily on the related party's (1) functions performed, (2) resources employed, and (3) risks assumed. Nevertheless, the degree of functional comparability required to obtain a reliable result using the comparable profits method generally is less than that required under either the resale price or the cost plus method.[12]

The first step in the comparable profits method is to select either the related-party buyer or the related-party seller to be the "tested party." The "tested party" is the entity for which (1) profitability can be ascertained and (2) reliable data on comparables can be found. In general, the tested party also should be the one that (1) has the least complex business operations and (2) employs the fewest intangible assets. Otherwise, difficulties usually arise in trying to identify sufficiently similar uncontrolled companies. The selected tested party also should be the related party with data that involve the fewest, the smallest, and the most reliable adjustments.

The second step in the comparable profits method is to select the appropriate PLI. This selection depends on the reliability of the available data and the specific facts and circumstances of the taxpayer's business. The regulations describe the following profit-level indicators as generally providing a reliable basis for comparing operating profits of the tested party and uncontrolled comparables:

1. Rate of return on capital employed (i.e., the ratio of operating profit to operating assets).
2. Ratio of operating profit to sales (net margin).
3. Ratio of gross profit to operating expenses.[13]

According to the regulations, the latter two indicators (which are financial ratios, measuring relationships between profit and costs or sales revenue) are more sensitive to functional differences than is the rate of return on capital employed, and thus a greater standard of comparability applies to their use. The regulations state that "closer functional comparability normally is required under a financial ratio than under the rate of return on capital employed to achieve a similarly reliable measure of an arm's-length result."[14] When differences exist between the tested party and the uncontrolled comparable company, the regu-

1 See generally McBurney, "Conformity Statute Does Not Encompass IRC Section 482-Type Powers, Maryland High Court Says," 10 JMT 6 (Mar/Apr 2000).
2 Treas. Reg. § 1.482-1(a)(1).
3 Treas. Reg. § 1.482-1(b)(1).
4 Treas. Reg. § 1.482-1(c)(1).
5 Treas. Reg. § 1.482-1(d)(1).
6 Treas. Reg. § 1.482-1(c)(2)(ii).
7 Treas. Reg. § 1.482-3(a).
8 Treas. Reg. § 1.482-3(b)(2)(ii)(A).
9 Treas. Reg. § 1.482-3(c)(1).
10 Treas. Reg. § 1.482-3(d)(1).
11 Treas. Reg. § 1.482-3(d)(3)(ii)(A).
12 Treas. Reg. § 1.482-5(c)(2)(ii).
13 Treas. Reg. § § 1.482-5(b)(4)(i) and (ii).
14 Treas. Reg. § 1.482-5(b)(4)(ii).
15 Treas. Reg. § 1.482-5(c)(2)(iv).
16 Treas. Reg. § 1.482-6(b).
17 Treas. Reg. § 1.482-6(c)(2)(i).
18 Treas. Reg. § 1.482-6(c)(3)(i).
19 Treas. Reg. § 1.482-3(e)(1).
20 Treas. Reg. § 1.482-4(b).
21 Treas. Reg. § 1.482-4(b)(6).
22 Treas. Reg. § 1.482-4(a).
23 Treas. Reg. § 1.482-4(c)(1).
24 Treas. Reg. § 1.482-4(c)(2)(ii).
25 Treas. Reg. § 1.482-4(c)(2)(iii)(A).
26 Treas. Reg. § 1.482-4(c)(2)(iii)(B).
27 Treas. Reg. § § 1.482-4(a)(2) and (3), referring to § § 1.482-5 and -6, respectively.
28 Compare Treas. Reg. § 1.482-4(d) (unspecified methods for transfers of intangibles) with § 1.482-(3)(e) (unspecified methods for transfers of tangibles).
29 See generally Treas. Reg. § 1.482-1(d)(3)(i).

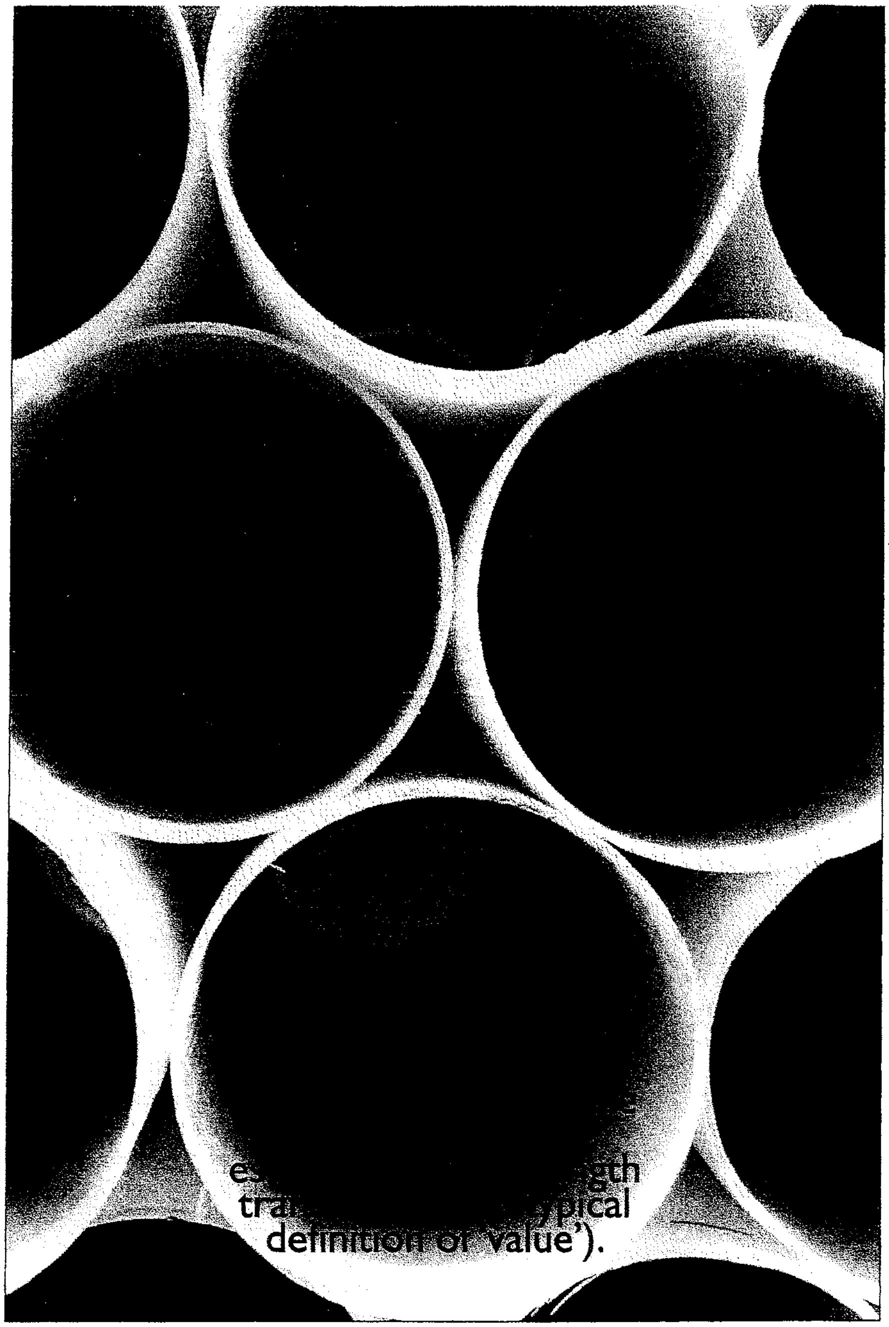
lations provide that the comparable company's (and sometimes also the tested party's) financial data should be adjusted to take the differences into account.[15]

The third and final step in the comparable profits method is to establish an arm's-length price range based on the PLIs of the selected uncontrolled companies. If the tested party's PLI falls within a reasonable range of price results, its intercompany prices for transferred tangible assets are deemed at arm's length.

Profit split. The profit split method determines a tangible asset's arm's-length transfer price based on the relative value of each related party's contribution to the combined profit or loss in a particular controlled transaction or set of controlled transactions. According to the regulations, these related-party contributions (1) are to reflect "the functions performed, risks assumed, and resources employed by each participant in the relevant business activity" and (2) should "correspond to the division of profit or loss that would result from an arrangement between uncontrolled taxpayers, each performing functions similar to those of the various controlled taxpayers engaged in the relevant business activity."[16]

Under the comparable profit split method, as described in the regulations, the proportions of combined operating profit of uncontrolled taxpayers in situations similar to the controlled transaction are used to allocate the related parties' combined operating profit.[17] Under the residual profit split method, the controlled taxpayers' combined operating profit from the relevant business activity is allocated first to routine functions, services, and tangible and intangible assets. Any remaining unallocated profit (i.e., profit attributable to the controlled group's valuable intangible property, where similar property is not owned by the uncontrolled taxpayers) is allocated based on the related parties' relative contributions of such intangibles.[18]

Unspecified methods. In addition to the five methods discussed above for determining an arm's-length price, the intercompany transfer pricing regulations allow application of another method if it provides the most reliable measure of an arm's-length return under the best method rule. The use of such unspecified transfer price methods



"should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it."[19]

Allowable transfer pricing methods for intangible assets. The regulations list five categories of intangible assets that are subject to the transfer pricing methods:

1. Patents, inventions, formulas, processes, designs, patterns, or know-how.
2. Copyrights and literary, musical, or artistic compositions.
3. Trademarks, trade names, or brand names.
4. Franchises, licenses, or contracts.
5. Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data.[20]

Under the regulations, "intangible assets" also include other items similar to those specified above. An intangible is similar if it "derives its value not from its physical attributes but from its intellectual content or other intangible properties."[21]

The arm's-length price for a controlled transfer of intangible assets must be determined using one of three specific allowable methods (or certain unspecified methods also described in the regulations):

1. Comparable uncontrolled transaction method.
2. Comparable profits method.

Practice Note
Methods for Determining Arm's-Length Price (i.e., Fair Value)

The IRS regulations under IRC Section 482 describe methods for determining an arm's-length price for related-party transfers of tangible and intangible property that also may provide a reasonable approach for valuing such property for state excise tax purposes. As described more fully in the accompanying article, the regulations prescribe the following specific methods (plus a framework for using other, unspecified methods) in connection with transfers of tangible property (TP) and intangible property (IP):

- **Comparable uncontrolled price method (TP).**
- **Resale price method (TP).**
- **Cost plus method (TP).**
- **Comparable profits method (TP and IP).**
- **Profit split method (TP and IP).**
- **Comparable uncontrolled transaction method (IP).**

3. Profit split method.[22]

As with transfers of tangible assets, the selection of a transfer price method for intangible assets also is governed by the best method rule.

Comparable uncontrolled transaction. Taxpayers may rely on comparable uncontrolled transactions to establish an arm's-length price for the transfer of intangible assets. Under this method (similar to the comparable uncontrolled price method for tangible asset transactions), the arm's-length price for a related-party transfer of intangibles is based on the price charged or incurred in a comparable uncontrolled transaction.[23] Although this method is not given formal priority under the best method rule, the regulations note that comparable uncontrolled transactions generally provide the most direct and reliable arm's-length price, provided the transaction involves the transfer of (1) the same intangible as the subject asset (2) under sufficiently similar circumstances.[24] The comparable uncontrolled transaction method may produce a single result that is the most reliable arm's-length price or a range of acceptable arm's-length prices.

While the general standards of comparability govern the selection of a comparable uncontrolled transaction, the regulations note that two comparability factors are particularly relevant here. First, the controlled and uncontrolled transactions should involve either the same or comparable intangible assets. Second, comparability also depends on similarity with respect to the contractual terms of the transfer as well as the economic conditions under which the transfer takes place.[25]

The first comparability factor is based on the nature and profitability of the transferred intangible asset. The standard is satisfied if the intangibles (1) are used in connection with similar products or processes within the same general industry or market, and (2) have similar profit potential. In evaluating the second area of comparability, regarding the contractual terms and economic conditions of the transfers, the regulations provide a list of particularly relevant factors.[26]

Comparable profits; profit split. For a related-party transfer of intangible assets, the procedures under the comparable profits method and the profit split method are generally the same as for related-party transfers of tangible assets (discussed above).[27] Particularly in transfers of intangible assets, the profit split method has long been used as a means of resolving related-party pricing disputes.

Unspecified methods. In addition to the three specified methods for evaluating related-party transactions involving the transfer of intangible assets, the regulations provide a framework for using other, unspecified methods. Again, the procedures under this method are similar to those for transfers of tangible assets (discussed above.)[28]

Functional Analysis

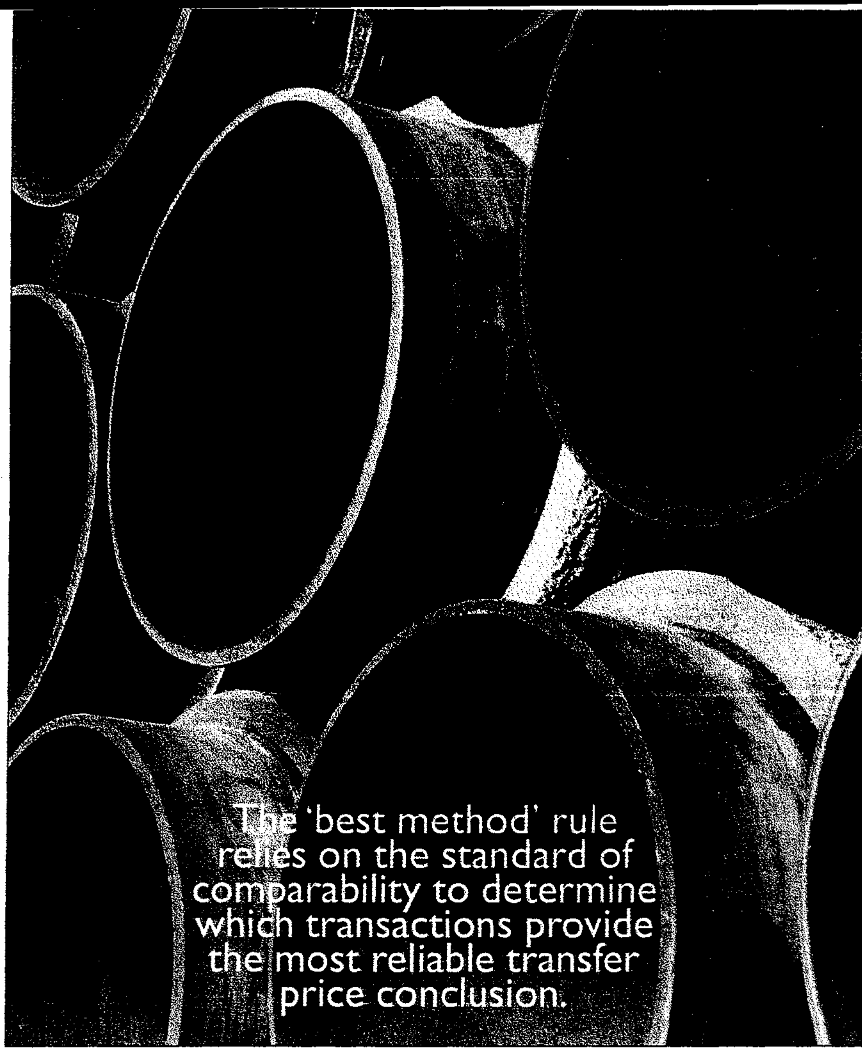
The functional analysis provides the factual foundation for establishing a transfer price method consistent with the arm's-length standard. A controlled transaction meets the arm's-length standard if the results of the transaction are consistent with the results that would have been realized had the same transaction taken place between unrelated entities.

A functional analysis is used in order to find and organize facts about a business in terms of its (1) activities, (2) risks, and (3) resources (e.g., plant and equipment, valuable intangible assets, etc.). The functional analysis identifies how these characteristics are divided between the subject related parties and the subject related-party transactions. The analysis describes the value-added activities undertaken by a taxpayer in order to identify comparable transactions that can be used to establish an arm's-length price range. This analysis is significant in developing an arm's-length transfer price because:

- The functions undertaken by each related party typically correlate to (1) the risks borne and (2) the intangible assets assumed or developed.
- The functions, risks, and assets associated with a related party's operations usually have a significant effect on its profitability.
- The functional analysis provides the information necessary to (1) characterize intercompany transactions and (2) identify uncontrolled transactions comparable to the related-party transactions.

For any given industry or line of business, the "normal" market returns in connection with certain functions or factors of production are relatively predictable and measurable. The rates of return to other, intangible assets (often including entrepreneurship) and risk-taking, however, are less easily determined. If one party to an intercompany transaction has primarily measurable functions and factors, prices can be set to reward these functions and factors with "normal" returns. This procedure leaves the residual profit to the related party responsible for (1) developing intangible assets and (2) performing entrepreneurial and risk-taking functions. By providing a description of the functions and assets (tangible and intangible) and their location within a consolidated corporate entity, a functional analysis provides the first step in evaluating the relative contributions to profit by the various related companies.

Business overview; activities assumed. The functional analysis begins with a business overview, which has two primary purposes. The first is to furnish a general understanding of the subject company by providing information on such topics as its history, products, cus-



tomers, and strategic direction. The second purpose is to describe the industry in which the company operates. This industry review should provide an understanding of the critical success factors in the industry, the company's competitors, and the major industry trends.

Following the business overview, the functional analysis investigates the functions assumed by the related parties in the particular transactions. For this purpose, the functions are simply the activities that each party to a particular transaction performs as a normal part of its operations. Functions are generally divided into the following three categories:

1. Production and manufacturing (i.e., activities that involve research, development, design, and production of products).
2. Marketing, advertising, sales, and distribution (including inventory management and warranty administration).
3. General management activities necessary to support the operations of the company (e.g., legal, accounting and finance, credit and collection, training, and personnel management services).[29]

Next, the analysis describes the significant tangible and intangible assets used in the various activities. Intangible assets include those developed or purchased by the taxpayer, including, but not limited to, trade secrets, patents, proprietary know-how, customer lists, trademarks, and distribution networks. The functional analysis should assess the contribution these assets make to the taxpayer's profit.

The analysis then summarizes the key business risks encountered by the subject related parties. Business risk involves the possibility of events occurring that are detrimental to the business. A significant portion of the return earned by any company takes into account that the business bears various kinds of risks.

The functional analysis concludes with a characterization of each of the related entities in the context of the subject transactions considered in the functional analysis. This analysis is repeated for each of the subject transactions for which an intercompany transfer pricing study is needed.

Conclusion

In jurisdictions where excise tax is imposed on manufactured and imported products, taxpayers often have difficulty estimating the appropriate taxable value of the goods. This situation is particularly true when products are manufactured in another state and then imported (as either work-in-process or finished goods inventory) into the taxing jurisdiction.

At the federal level, the IRS faces the problem of allocating taxable income/value related to the intercompany transfer of tangible and intangible assets by multinational corporations. Accordingly, over the years, the Service has promulgated detailed regulations under IRC Section 482 for determining arm's-length prices for intercompany transfers. The economic analysis methods provided by these regulations are used to allocate the related parties' total income based on the transfer of tangible and intangible assets between domestic and foreign taxing jurisdictions.

IRC Section 482 procedures also have state income tax implications. For example, when related parties engage in intercompany sales and are not qualified to, or simply do not, file a unitary combined or consolidated state income tax return, the taxing authority is justifiably interested in ensuring that the intercompany sales prices are arm's-length. Further, because these intercompany sales often include products that involve intangible assets (e.g., trademarks, packaging, advertising, etc.), the transfer price should take into consideration the value of these associated intangibles.

Developed over decades and tested and interpreted in the federal courts, these IRC Section 482 transfer price valuation methods are often used to value manufactured or imported products for excise tax purposes. Consistent with the conceptual framework of IRC Section 482, whereby the total income generated by a related-party transaction is allocated based on arm's-length prices derived from comparable sales between independent uncontrolled entities, the transfer pricing/valuation methods under the related federal regulations seem to be an effective and efficient procedure for determining the value of goods subject to excise tax. ■

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COURT OF APPEALS, DIVISION II
FOR THE STATE OF WASHINGTON

U.S. SMOKELESS TOBACCO BRANDS INC., previously known as United States Tobacco Sales and Marketing Company Inc, Respondent/Cross-Appellant. v. STATE OF WASHINGTON, DEPARTMENT OF REVENUE, Appellant/Cross-Respondent.	**No. 30434-1-II** **DECLARATION OF SERVICE**

The undersigned declares under penalty of perjury, under the laws of the State of Washington, that the following is true and correct:

That on the date below signed, I caused true and correct copies of Reply Brief of Cross-Appellant, and this Declaration of Service to be served on counsel of record for Appellant/Cross-Respondent at the below-listed address by email attachment and U.S. First Class Mail:

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Dated at Seattle, Washington, this 30th day of July, 2004.

Kristen A. Hatton
Kristen A. Hatton

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