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STATE OF WASHINGTON

NO.

SUPREME COURT OF THE STATE OF WASHINGTON

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

Petitioner

v.

STATE OF WASHINGTON, DEPARTMENT
OF REVENUE,

Respondent

PETITION FOR DISCRETIONARY REVIEW
BY SUPREME COURT

William C. Severson, WSBA #5816
Norman J. Bruns, WSBA #16234
GARVEY SCHUBERT BARER
Attorneys for Petitioner

Eighteenth Floor
1191 Second Avenue
Seattle, Washington 98101-2939
(206) 464-3939

STATE OF WASHINGTON
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I. IDENTITY OF PETITIONER

Petitioner U.S. Smokeless Tobacco Brands Inc. ("Tobacco Sales") is the Respondent/Cross-Appellant and was previously known as United States Tobacco Sales and Marketing Co. Inc.

II. COURT OF APPEALS' DECISION

This Petition seeks review of the Court of Appeals' decision filed on July 19, 2005, reported as *U.S. Tobacco Sales & Mktg. Co. v. Dep't of Revenue*, 128 Wn. App. 426, 115 P.3d 1080 (2005), *See* Appendix 1, and the Order Denying Reconsideration of that decision which was filed on September 1, 2005. *See* Appendix 2.

III. ISSUES PRESENTED FOR REVIEW

1. Did Tobacco Sales carry its burden of proving that it is entitled to a tax refund and the amount of the refund?
2. Was it error for the Court of Appeals to remand this case to take more evidence where: (a) the evidence to be taken on remand does not exist, (b) the evidence would be inadmissible if it did exist, (c) the trial court did not erroneously exclude any evidence, and (d) the requirements of CR 59(4) for introducing new evidence have not been met?
3. Is Tobacco Sales entitled to entry of judgment based on the evidence presented at trial?

IV. STATEMENT OF THE CASE

This dispute involves the measure of Washington's Other Tobacco Products ("OTP") tax on smokeless tobacco products which Tobacco Sales distributed as promotional samples in Washington in 1992. RCW Chap. 82.26 (amended by Laws of 2005 ch. 180). The relevant facts are accurately stated in the two Court of Appeals' decisions which have been issued in this case, *U.S. Tobacco Sales & Marketing Co. v. Dep't of Revenue*, 96 Wn. App. 932, 982 P.2d 652 (1999) ("*U.S. Tobacco I*"), and *U.S. Tobacco Sales & Marketing Co. v. Dep't of Revenue*, 128 Wn. App. 426; 115 P.3d 1080 (2005) ("*U.S. Tobacco II*"). Through two sets of cross-motions for summary judgment, a trial and two appeals, none of these facts have changed.

Tobacco Sales markets, distributes and promotes smokeless tobacco products ("OTP") that it purchases from its manufacturing affiliate, United States Tobacco Manufacturing Company Inc. ("Tobacco Manufacturing"). During 1992, Tobacco Sales distributed product samples at special events and as part of promotional campaigns. The tax imposed by the Department of Revenue on these samples (\$160,553) was calculated based on the price at which Tobacco Sales sells the OTP to its customers (\$1.43 per can).

In 1997, after a tax audit by the Department of Revenue, Tobacco Sales filed this refund lawsuit. Tobacco Sales claimed that the OTP tax should be based on the price that it paid to acquire the OTP from Tobacco Manufacturing (62.5¢ per can), not its \$1.43 resale price. The statutory measure of the OTP tax is the "wholesale sales price" which in 1992 was defined as the "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) (emphasis added). *See* Appendix 3. In *U.S. Tobacco I*, the Court of Appeals agreed that the Department of Revenue erred in using Tobacco Sales' resale price as the measure of the tax. The Court held that a remand was necessary, however, to take evidence regarding whether the actual price charged by Tobacco Manufacturing reflected fair market value. The Court of Appeals believed this inquiry was necessary to assure that Tobacco Manufacturing and Tobacco Sales – affiliated corporations – did not set an artificially low transfer price to evade taxes. *U.S. Tobacco I*, 96 Wn. App. at 943 n.19. *Cf. U.S. West v. Utilities & Transport. Comm'n*, 134 Wn.2d 74, 94, 949 P.2d 1337 (1997) (actual transaction prices reviewed to prevent collusion). Neither party sought further appellate review of *U.S. Tobacco I*.

On remand, Tobacco Sales retained a nationally recognized

valuation expert, Mr. Robert F. Reilly, to appraise the market value of the OTP.¹ Mr. Reilly valued the OTP using the following standard:

[T]he appropriate valuation standard is the market price at which a manufacturer would sell OTP to an unaffiliated distributor under the circumstances in which the parties otherwise held the same property interests and performed the same functions as are actually performed by the UST manufacturing and marketing subsidiaries.

Pl. Ex. 1 at p. 3; CP 298.² Mr. Reilly concluded that the fair market value price for Tobacco Sales' purchases in 1992 was 68¢ to 72¢ per can.³

The Department of Revenue, however, maintained the same position on remand that it had argued in *U.S. Tobacco I*, interpreting “fair market value” to mean the \$1.43 price at which Tobacco Sales resells OTP to its unaffiliated customers. *See U.S. Tobacco II*, 128 Wn. App. at 431.

The parties argued their differing views of fair market value in a second round of cross-motions for summary judgment. Tobacco Sales

¹ Mr. Reilly has co-authored leading texts on valuation theory and practice, as well as numerous journal articles on a wide range of valuation topics. He has extensive teaching experience and frequently provides expert valuation testimony, including testimony involving inventory valuation and transfer pricing between affiliated entities. He has been selected both by taxpayers and the Internal Revenue Service to serve as a valuation expert in transfer price disputes under Internal Revenue Code § 482. *See* CP 476-509; RP 135-42. Mr. Reilly's appraisal was an exhibit to Tobacco Sales' Second Motion for Summary Judgment (CP 296-525) and was Pl. Ex. 1 at trial.

² In making his appraisal, Mr. Reilly utilized a transfer price study performed by the Ernst & Young accounting firm. *See* Pl. Ex. 1 at 10-11.

³ The 68¢ to 72¢ interval indicates the appraiser's judgment regarding the reasonable range for fair market value. RP 81-2.

presented Mr. Reilly's appraisal to show that the fair market value for Tobacco Manufacturing's sales to Tobacco Sales was between 68¢ and 72¢ per can. The Department argued that fair market value is Tobacco Sales' selling price to its customers, *i.e.*, \$1.43 per can.

The trial court judge denied both summary judgment motions, but not because of any factual disputes. Instead, he stated that he found the case "extremely difficult" and he did not "feel comfortable" with his understanding of the issues.⁴ RP 6/29/01, Summary Judgment Ruling at 2, 4-5. The case was then set for trial.

Trial did not disclose any disputed facts. Indeed, many of the underlying facts were stipulated. CP 127-30. Tobacco Sales called Mr. Reilly and Mr. Sherif Lotfi as expert valuation witnesses. Mr. Reilly explained his appraisal and his fair market value opinion in detail. Mr. Lotfi is the Ernst & Young valuation expert who was responsible for the 1992 transfer price study which estimated the arm's length price for Tobacco Manufacturing's sales to Tobacco Sales under Internal Revenue Code ("I.R.C.") § 482. Both Mr. Reilly and Mr. Lotfi testified that the

⁴ Tobacco Sales asked the Court of Appeals for discretionary review of this decision, pointing out that the cross-motions did not disclose any disputed fact issues and that the case should be decided on the legal issue. The Court of Appeals denied that request. CP 4-5.

arm's length standard under I.R.C. § 482 is the same as the fair market value standard. RP 52, 183-84. The Department's appraisal expert, Mr. Neal Cook, agreed with this conclusion. RP 356.⁵

The Department presented no evidence of fair market value and no evidence to dispute the opinions, qualifications or credibility of Mr. Reilly and Mr. Lotfi. Mr. Cook, the Department's expert, agreed that Mr. Reilly's appraisal reflects the fair market value for sales to Tobacco Sales.

RP 361. He characterized Mr. Reilly's and Mr. Lotfi's reports as "quite credible." RP 359. He admitted that he is not an expert in I.R.C. § 482 analysis and, in fact, he looked to Mr. Reilly's valuation text, *Valuing a Business*, as an authoritative reference on the subject. RP 356. The Department's economist, Dr. Smith, also complimented Mr. Reilly's and Mr. Lotfi's work. RP 311-13.

The trial did not alter the evidence or produce any material new evidence. The trial court resolved the legal issue in favor of Tobacco Sales, ruling that the tax measure is the fair market price for Tobacco Manufacturing's sales to Tobacco Sales. CP 135 (Conclusion of Law No. 3; RP 436). However, instead of implementing that decision based on

⁵ See also 26 C.F.R. § 1.482-1(b); *Northwestern Nat'l Bank v. United States*, 556 F.2d 889 (8th Cir. 1977).

the evidence, the court made its own valuation of the OTP at 82¢ per can.

The Department of Revenue appealed the trial court's decision, and Tobacco Sales cross-appealed. The Department argued that Tobacco Sales failed to prove that the fair market value of the OTP was less than Tobacco Sales' \$1.43 resale price. Tobacco Sales argued that the *undisputed* valuation evidence showed that the fair market value price for the OTP purchased by Tobacco Sales was between 68¢ and 72¢ per can.

In *U.S. Tobacco II*, the Court of Appeals again rejected the Department's argument that the OTP tax is based on Tobacco Sales' resale price. The Court of Appeals also ruled that there was no evidence to support the trial court's 82¢ per can valuation. Inexplicably, however, the Court of Appeals also rejected the Reilly and Lotfi valuations. Instead, the court remanded the case again to take more evidence regarding "the price a completely unaffiliated entity would have had to pay to purchase OTP from Tobacco Manufacturing in 1992." *U.S. Tobacco II*, 128 Wn. App. at 437-38. On September 1, 2005, the Court of Appeals denied Tobacco Sales' request for reconsideration.

V. **ARGUMENT WHY SUPREME COURT REVIEW SHOULD BE ACCEPTED**

A. **Tobacco Sales Satisfied Its Burden of Proving Both that the Department's Calculation of the OTP Tax Was Incorrect and the Correct Amount of the Tax.**

RCW 82.32.180 places the burden on the taxpayer to show (1) that the amount of tax imposed is incorrect, and (2) the correct amount of tax owed. *See* Appendix 3. Tobacco Sales has met this burden. It proved that the tax measure used by the Department, *i.e.*, Tobacco Sales' \$1.43 selling price was incorrect. *U.S. Tobacco II*, 128 Wn. App. at 433. Tobacco Sales also proved the correct amount of its tax liability.

The OTP tax measure is the “manufacturer’s established price.” RCW 82.26.010(7). Here, it is undisputed that Tobacco Manufacturing's actual selling price was 62.5¢ per can. The Department of Revenue did not present any evidence to dispute this price.⁶

Under *U.S. Tobacco I*, the measure of the OTP tax is the manufacturer’s regular selling price, with one caveat: where the manufacturer sells to an affiliated distributor, the actual selling price should be tested against fair market value to assure that the manufacturer's

⁶ Instead, the Department simply repeated its erroneous legal argument that the tax should be measured by Tobacco Sales' resale price, rather than the price that Tobacco Sales paid to buy the OTP from Tobacco Manufacturing. *See U.S. Tobacco II*, 128 Wn. App. at 433.

price is not set at an artificially low level. Somewhat ironically, the only evidence questioning whether Tobacco Manufacturing's actual selling price is less than fair market value was presented by Tobacco Sales, itself. That evidence, *i.e.*, the valuation reports of Mr. Lotfi and Mr. Reilly, shows that the fair market value price for Tobacco Manufacturing's sales to Tobacco Sales was between 68¢ and 72¢ per can. If this valuation evidence is convincing, then it is appropriate under *Tobacco Sales I* to calculate the OTP tax based upon the 68¢ to 72¢ value rather than Tobacco Manufacturing's actual selling price. However, if the market value evidence is not convincing, then the tax must be based on the actual 62.5¢ per can selling price, and judgment entered accordingly.

Instead of doing either of these things, the Court of Appeals ordered yet another remand to take more evidence. This remand order is directly at odds with the decisions of this Court and should be reversed.

B. A Remand for Taking Additional Evidence is Unwarranted and Futile Because the Additional Evidence Contemplated by the Court of Appeals Does Not Exist and Would Be Inadmissible if It Did Exist.

The Court of Appeals' remand instruction directs the parties to "provide evidence of the price a completely unaffiliated entity would have had to pay to purchase OTP from Tobacco Manufacturing in 1992." *U.S. Tobacco II*, 128 Wn. App. 932. If by this the court meant evidence of the

arm's length, fair market value price for the OTP that Tobacco Sales purchased, that is exactly the valuation evidence which was submitted at trial. However, if the court meant that the parties should provide evidence of the price at which Tobacco Manufacturing *itself* would have sold OTP to other distributors, that inquiry is both futile and improper.⁷

The inquiry would be futile because factual evidence of the price at which Tobacco Manufacturing would have sold OTP to other purchasers in 1992 simply does not exist. Tobacco Manufacturing did not sell OTP to unaffiliated entities in 1992 because it maintained an exclusive marketing arrangement with Tobacco Sales. There is no evidence of the price which would have been charged in transactions that did not occur. Nor would fact witnesses be permitted to speculate regarding hypothetical prices that might have been charged in hypothetical transactions in the distant past. Such speculation would plainly be inadmissible under ER 701. *See Pybus Steel Co. v. Department of Labor & Industries*, 12 Wn. App. 436, 440, 530 P.2d 350 (1975); *Griswold v. Kilpatrick*, 107 Wn. App. 757, 762, 27 P.3d 246 (2001).

Aside from its inadmissibility as improper speculation, testimony

⁷ Tobacco Sales' Motion for Reconsideration asked the Court of Appeals to clarify its remand instruction and explain what further evidence it contemplates on remand. The Court of Appeals refused to provide any clarification.

regarding the price that would have induced Tobacco Manufacturing *itself* to sell directly to a distributor other than Tobacco Sales would be inadmissible because it is irrelevant to the issue of fair market value. Fair market value is an objective standard, reflecting the price "a well-informed buyer would pay to a well-informed seller, *where neither is obliged to enter into the transaction.*" *State v. Kleist*, 126 Wn.2d 432, 435, 895 P.2d 398 (1995) (emphasis added). This market value standard contemplates a hypothetical sale between willing and well-informed parties dealing at arm's length under competitive market conditions. It is the price that would be established by the forces of supply and demand operating in an open and competitive market.⁸

Tobacco Manufacturing was not willing to sell to distributors other than Tobacco Sales because it maximized the value of its brands by maintaining an exclusive marketing arrangement. *See* RP 231-33; 226-28. Selling to multiple distributors would undermine those brand values. *Id.* That is why Mr. Reilly was so confident that Tobacco Manufacturing

⁸ IAAO, PROPERTY APPRAISAL AND ASSESSMENT ADMINISTRATION at 53 (1990) (excerpts provided in Appendix 4); *Mason County Overtaxed, Inc. v. Mason County*, 62 Wn.2d 677, 384 P.2d 352 (1963); 26 Am. Jur.2d EMINENT DOMAIN §297 (2004). ("[M]arket value . . . is an objective assessment of the price agreed on by hypothetical buyers and sellers, not a subjective assessment of the value of the property to its owner."). S. Pratt, R. Reilly, R. Schweih, VALUING A BUSINESS, (4th ed. 2000) at 29 (excerpts provided in Appendix 5).

would not be willing to sell its products on a non-exclusive basis to others.⁹ *Id.* Because Tobacco Manufacturing would not be a willing seller to multiple purchasers, any speculation about its selling price to such purchasers would not meet the definition of a fair market value price.

The subjective price preference of an actual property owner, especially one who does not have the characteristics of a willing arm's length seller, is not admissible evidence to show market value. "[P]roof of value cannot be shown by proving what the owner would take for his property." *Motor Mill Co. v. Wilson*, 128 Wash. 592, 594-595, 223 P. 1041 (1924). *See also Port Townsend S. Railway Co. v. Barbare*, 46 Wash. 275, 277, 89 P. 710 (1907). Thus, the evidence that the Court of Appeals would have admitted on remand is not admissible and not relevant to prove fair market value.

This Court has made clear that a remand for taking new evidence is improper where the proposed evidence would be inadmissible. *McUne v. Fuqua*, 42 Wn.2d 65, 74, 253 P.2d 632 (1953). The Court of Appeals' remand order violates this rule.

⁹ The critical factor in Mr. Reilly's analysis is not the affiliation between Tobacco Manufacturing and Tobacco Sales, but their exclusive marketing relationship. His appraisal estimates what the OTP price would be in a transaction in which the exclusive marketing arrangement is maintained, but the parties are unaffiliated and operating at arm's length. Pl. Ex. 1 at 3; RP 187-88.

C. There is No Justification for Inventing a New Valuation Standard for the OTP Tax.

The arm's length, fair market value standard provides an objective and widely-used standard for judging the fairness and arm's length nature of prices for transactions between affiliated entities. That is the standard applied to affiliate transactions under I.R.C. § 482, and there is no reason to invent some different standard for judging the fairness of affiliate transactions for purposes of the OTP tax. Here, there is no dispute that Tobacco Sales' valuation experts correctly applied the arm's length fair market value standard in making their valuation analysis. Unfortunately, it appears that the Court of Appeals either did not understand this standard or would reject it in favor of some new, and as yet undefined, standard of value. Plaintiff presented undisputed evidence of both Tobacco Manufacturing's actual selling price and the fair market value price. The Department did not present any evidence of value. Tobacco Sales is entitled to entry of judgment based on this evidence. *Cf. Scott v. Trans-System*, 148 Wn.2d 701, 714, 64 P.3d 1 (2003) (presentation of uncontroverted evidence of value satisfies burden of proof). It is patently unfair to make Tobacco Sales litigate this matter over and over again.

D. There Are No Discrepancies in the Evidence That Require Clarification on Remand.

The Court of Appeals also indicated that a remand is necessary to clear up two points of confusion in the evidence. *U.S. Tobacco II*, 128 Wn. App. at 437. The first of these is a supposedly unexplained disparity between the arm's length price in the Ernst & Young study that was introduced in *U.S. Tobacco I* and the arm's length price shown in the Ernst & Young study presented at trial. *U.S. Tobacco II*, 128 Wn. App. at 437. In fact, there is no unexplained disparity between these studies. The two studies show different arm's length prices because the studies are for two different years. The study introduced in *U.S. Tobacco I*, estimated the arm's length price for 1995.¹⁰ The study presented at trial by Mr. Lotfi reflects the arm's length price for 1992. *See* Pl. Ex. 1. These studies simply reflect the not surprising fact that the arm's length price in 1992 was different than the arm's length price in 1995.

The second point of confusion for the Court of Appeals was whether the actual 1992 transfer price was 62.5¢ per can or 73¢ per can. *U.S. Tobacco II*, 128 Wn. App. at 437 n.9. This confusion arises from the court's misunderstanding of a reference to a 73¢ price in Mr. Reilly's

¹⁰ The *U.S. Tobacco I* study was a preexisting 1995 study that the Department had obtained through discovery. It was placed in evidence by the Department,

appraisal. Mr. Reilly fully explained his reference to a 73¢ per can price at the start of his trial testimony. RP 145-150. He understood that 73¢ was not the actual price used in 1992.¹¹ Instead, the 73¢ price is his calculation of what the 1992 transfer price *would have been* had it been calculated using the company's pricing formula with the *actual* year-end financial results for 1992 rather than the beginning-of-the-year financial *projections* that were used to calculate the 1992 price. Here again, there is no discrepancy in this evidence and thus no point in remanding the case for more clarification.

E. Tobacco Sales Is Entitled to Entry of Judgment Based on the Evidence.

Tobacco Sales met its burden of proof. It proved that the Department used the wrong price to measure the OTP tax, and it proved both the actual selling price and the fair market price for Tobacco Manufacturing's sales to Tobacco Sales. When the taxpayer meets its burden of proof, the appropriate remedy is to substitute the taxpayer's value for that of the tax authority:

Once the taxpayer meets the standard of proof, the reviewing tribunal substitutes the taxpayer's value for the assessor's.

not by Tobacco Sales. See Appendix 6.

¹¹ It is a stipulated fact that the actual 1992 price was 62.5¢ per can. CP 130.

Weyerhaeuser Co. v. Easter, 126 Wn.2d 370, 381, 894 P.2d 1290 (1995).

Tobacco Sales is entitled to a judgment based on the evidence, not a remand for more evidence.

The Court of Appeals suggests that Mr. Reilly's and Mr. Lotfi's valuation analysis is flawed because "certain language from those studies and the testimony from which they were presented suggest that the qualifier 'level of trade' included the affiliation between Tobacco Manufacturing and Tobacco Sales." *U.S. Tobacco II*, 128 Wn. App. at 437. This is not the case. Neither Mr. Reilly nor Mr. Lotfi gave any consideration to the affiliation between Tobacco Manufacturing and Tobacco Sales in their valuation analysis. Both Mr. Reilly's appraisal and Mr. Lotfi's arm's length price study estimated value based on an arm's length transaction between *unaffiliated* entities. See RP 50-52; 168-69; 184-188; Pl. Ex. 1 at 3. The Department's own appraiser agreed that Mr. Reilly and Mr. Lotfi adhered to this requirement. RP 377-78.

"Level of trade" is entirely different than affiliation. Level of trade (or "trade level") refers to the point in the manufacture/distribution chain at which the property is to be valued. The appraiser must specify the level of trade at which the appraisal is made because the value of personal property changes as it moves through the production and distribution

channels.¹² Pl. Ex. 1 at 4-6; RP 160-61. Mr. Reilly and Mr. Lotfi complied with this requirement. They identified the applicable level of trade as a sale by a manufacturer. Mr. Reilly valued the OTP at the price at which "a manufacturer would sell OTP to an **unaffiliated** distributor under the circumstances in which the parties otherwise held the same property interests and performed the same functions as are actually performed by the UST manufacturing and marketing subsidiaries."

Pl. Ex. 1 at p. 3; CP 298. This market value standard corresponds to the arm's length price standard under I.R.C. § 482 that was used by Mr. Lotfi. There is no evidence to suggest that either Mr. Reilly or Mr. Lotfi misapplied these standards, and there is no basis to claim that they considered the affiliation between Tobacco Manufacturing and Tobacco Sales. Rather, they expressly excluded the affiliation between Tobacco Manufacturing and Tobacco Sales from their valuation analysis.

Tobacco Manufacturing's actual selling price is a stipulated fact. In addition, Tobacco Sales presented clear, authoritative and undisputed evidence of the fair market value price for those sales. Even if there were a legitimate basis for rejecting the valuation testimony of Mr. Reilly and

¹² Uniform Standards of Professional Appraisal Practice ("USPAP") Rule 7-3 (b). See Appendix 7.

Mr. Lotfi, it would not call for a remand. In that event, Tobacco Sales would be entitled to judgment based on the actual selling price charged by Tobacco Manufacturing because the Department failed to present any evidence that that price is less than a fair market value price.

The function of the appellate court is to review the trial court record for errors of law. The Court of Appeals, however, did not identify any legal error made by the trial court regarding the valuation evidence that it permitted to be introduced into evidence. The Court of Appeals cannot remand the case for taking additional evidence just because it would prefer that the parties had presented more or different evidence. Ours is an adversarial system in which the parties, not the court, choose what evidence to present at trial. The court's function is to enter judgment based on that evidence, not to order the parties to present the case in a manner more to its liking.

Here, the trial court did not improperly exclude any valuation evidence or commit any other error which would make it appropriate to reopen the trial for the taking of additional valuation evidence under CR 59. There is no conflicting evidence on the issue of fair market value and no material error by the trial court in admitting or excluding valuation evidence from evidence. Therefore, Tobacco Sales is entitled to entry of

judgment based on the evidence.

VI. CONCLUSION

This case has never involved disputed issues of fact. Twice the parties have sought resolution on cross-motions for summary judgment. After the second summary judgment was denied, the parties conducted a full trial. That trial did not uncover any disputed issues of fact. There have been two appeals and a rejected motion for discretionary review after the trial court's refusal to rule on the parties' second cross-motions for summary judgment. There are still no disputed facts to be resolved by a remand.

The issue in dispute is a legal one: What is the measure of the OTP tax on the samples distributed by Tobacco Sales? *U.S. Tobacco I* answered this question by holding that the tax measure is the manufacturer's regular selling price, but where a manufacturer sells only to an affiliate, the actual price is to be tested against fair market value to assure that it is not manipulated. Neither party appealed that decision.

On remand, Tobacco Sales presented clear, competent and undisputed evidence that the fair market value price for Tobacco Manufacturing's sales to Tobacco Sales is between 68¢ to 72¢ per can. There are no grounds to question this evidence or to switch to a different

valuation standard for judging the fairness of Tobacco Manufacturer's selling price. The fair market value standard is an unbiased standard that is applied in a variety of contexts to guard against price manipulations. It is well understood by taxpayers. The Court of Appeals' remand order proposes that the parties present evidence that is nonexistent and would be inadmissible on the issue of fair market value even if it did exist. This remand serves no purpose and is contrary to the decisions of this Court.

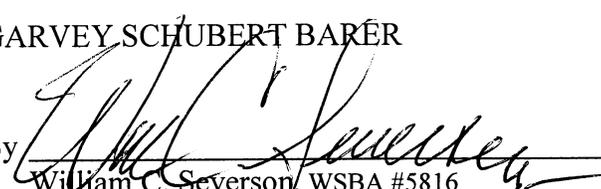
Tobacco Sales respectfully requests that the Court accept review, reverse the remand order of the Court of Appeals and set the fair market value price at 72¢ (the highest value shown by the evidence).

Alternatively, Tobacco Sales asks that the matter be remanded to the trial court with instructions that it set the tax based on Tobacco Manufacturing's actual selling price or at a fair market value price within the scope of the evidence, *i.e.*, between 68¢ to 72¢ per can.

DATED this 3rd day of October, 2005.

GARVEY SCHUBERT BARER

By


William C. Severson, WSBA #5816

Norman J. Bruns, WSBA #16234

Attorneys for Appellant

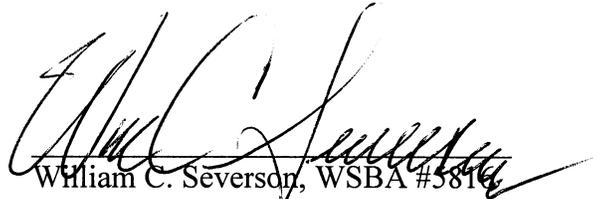
CERTIFICATE OF SERVICE

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 a true and correct copy of the Petition for Discretionary Review by Supreme Court and this Declaration of Service to be served on counsel listed below by electronic mail and U.S. First Class Mail at the address listed below:

Mr. David M. Hankins
Assistant Attorney General
Attorney General of Washington
Attorney General's Office - Revenue Division
905 Plum Street SE, Bldg. 3
P. O. Box 40123
Olympia WA 98504-0123

DATED AT SEATTLE, WASHINGTON this 3rd day of October, 2005.


William C. Severson, WSBA #5816
Garvey Schubert Barer
1191 Second Avenue, 18th Floor
Seattle, Washington 98101-2939
Tel: 206 816 1358

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APPENDIX 1

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IN THE COURT OF APPEALS OF THE STATE OF WASHINGTON

DIVISION II

UNITED STATES TOBACCO SALES AND
MARKETING COMPANY INC.,

Respondent and Cross-Appellant,

v.

WASHINGTON STATE DEPARTMENT OF
REVENUE,

Appellant and Cross-Respondent.

No. 30434-1-II

PUBLISHED OPINION

QUINN-BRINTNALL, C.J. — United States Tobacco Sales and Marketing Company Inc. (Tobacco Sales) and the Department of Revenue (DOR) each appeal a superior court ruling determining the amount of a refund owed Tobacco Sales for overpaid excise tax. Because the superior court's ruling is not supported by substantial evidence, we must reverse and remand for further proceedings.

FACTS

This is the second appeal in this matter. See *U.S. Tobacco Sales & Mktg. Co. v. Dep't of Revenue*, 96 Wn. App. 932, 982 P.2d 652 (1999) ("*U.S. Tobacco I*"). The facts of the first appeal were aptly set out in *U.S. Tobacco I*, but to the extent they are relevant here, we repeat them.

Washington's other tobacco products (OTP) tax imposes an excise tax on the "sale, use, consumption, handling, or distribution of all tobacco products" in the state. Former RCW 82.26.020(1) (1993).¹ The tax is measured by the "wholesale sales price" of OTP brought into the state. Former 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." Former RCW 82.26.010(7) (1995).

Tobacco Sales is a corporation that buys, markets, and resells smokeless tobacco products primarily to wholesale distributors in Washington and elsewhere. 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).

In addition to selling tobacco products to wholesalers, Tobacco Sales gives away sample products at promotional events. Until 1996, Tobacco Sales paid the OTP tax on the free samples it distributed in Washington. Tobacco Sales measured the OTP tax based on the price Tobacco Sales sold other comparable OTP to wholesale distributors. Tobacco Sales's Washington customers paid the OTP tax on products for resale.

DOR audited Tobacco Sales in 1996, and determined that Tobacco Sales, not its wholesale distributor customers, should have been paying the OTP tax. Tobacco Sales inquired during the audit whether its purchase price paid to Tobacco Manufacturing, rather than its selling price, was the correct measure of the tax under the statute. After DOR informed Tobacco Sales

¹ "Tobacco products" include all types of chewing and smoking tobacco, snuff, and cigars, but does not include cigarettes. Former RCW 82.26.010(1) (1995).

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that its purchase price was the correct measure, Tobacco Sales requested a refund of the OTP tax it had overpaid on the promotional samples. DOR then took a new position 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." *U.S. Tobacco I*, 96 Wn. App. at 935 (alteration in original). Therefore, the correct measure of the tax was Tobacco Sales's selling price to wholesale distributor customers.

In April 1997, Tobacco Sales sued DOR to recover the amount of allegedly overpaid OTP tax for 1992.² In 1992, Tobacco Sales purchased OTP from Tobacco Manufacturing for \$.625 per can and sold it to wholesale distributors for \$1.43 per can. On cross-motions for summary judgment, the superior court found that the price Tobacco Sales paid Tobacco Manufacturing was a "discounted" price that did not reflect the "wholesale sales price" within the meaning of the OTP taxing statute. The superior court concluded that because the two companies were subsidiaries, the \$1.43-per-can price paid by Tobacco Sales's customers was the wholesale sales price; thus, Tobacco Sales was not entitled to a refund. Tobacco Sales appealed.

On appeal, we rejected DOR's argument that because Tobacco Manufacturing and Tobacco Sales were affiliated, they should be treated as one entity and the wholesale sales price should include both entities' costs and profits:

The [OTP tax] statute makes no distinction between affiliated and nonaffiliated entities. . . . Under the[] [statute], Tobacco Manufacturing is the manufacturer and Tobacco Sales is the taxable distributor.

. . . [N]either the statute nor case law provides a basis for ignoring the entities' corporate structure. . . .

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

² Prior tax years had closed under the statute of limitations. Former RCW 82.32.060(3) (1992). The record does not indicate why Tobacco Sales did not seek a refund for OTP tax paid in 1993 through 1996.

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.

U.S. Tobacco I, 96 Wn. App. at 937-38, 940-41 (footnotes omitted). We therefore reversed the trial court’s grant of summary judgment to DOR:

The trial court . . . bas[ed] 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.

. . . [T]he statutory measure of the OTP 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.

U.S. Tobacco I, 96 Wn. App. at 941-42.

On remand, a bench trial was held to determine the fair market value of the OTP sold by Tobacco Manufacturing in 1992. Tobacco Sales presented the findings of two studies completed in 2000: a transfer pricing study performed by an accounting firm, Ernst & Young, and an analysis performed by an appraisal firm, Willamette Management Associates. Both studies concluded that the 1992 fair market value for Tobacco Manufacturing’s OTP was between \$.68 and \$.72 per can.

DOR did not present any evidence as to the fair market value of OTP sold by Tobacco Manufacturing. Instead, it maintained its position, a position which this court rejected in the first appeal, that the correct measure of the OTP tax should be Tobacco Sales’s selling price. It

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supported this position with testimony by a DOR economist and real property appraiser. But DOR's appraiser also testified that the fair market value of the OTP at the time it was sold by Tobacco Manufacturing, as determined by Tobacco Sales's experts, was correct:

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

A. That's correct.

Q. And you're not disputing that that is a fair market value *at that level of trade*, are you?

A. No, I'm not.

2 Report of Proceedings (RP) at 360-61 (emphasis added).

The trial court concluded at the close of testimony that the appropriate fair market value for Tobacco Manufacturing's 1992 OTP was \$.82 per can. In rejecting Tobacco Sales's position, the court stated that although "no one really quarreled" with the \$.68 to \$.72 price, "common sense" suggested a higher price. 3 RP at 453. Both parties appeal.

ANALYSIS

Each party assigns error in this appeal to the trial court's determination that the 1992 fair market value of OTP sold by Tobacco Manufacturing was \$.82 per can. Because this determination is a factual finding, substantial evidence must support it. *Fisher Properties, Inc. v. Arden-Mayfair, Inc.*, 115 Wn.2d 364, 369, 798 P.2d 799 (1990). Substantial evidence does not support the trial court's finding, but in order to fully understand how the court came to enter the finding that it did, we discuss the positions of DOR and Tobacco Sales.

In *U.S. Tobacco I*, we instructed the parties and the trial court to compare Tobacco Manufacturing's 1992 invoice price of \$.625 per can with the fair market value of its OTP because the invoice price did not "necessarily" reflect the price which would be paid between unaffiliated entities. 96 Wn. App. at 942. Tobacco Sales's experts testified that there are several

ways to measure the fair market value of goods which have only been sold between affiliated entities. These measures have largely been codified by the Internal Revenue Service (IRS) for purposes of calculating the free market “arm’s-length” price of intercompany transfers. *See* 26 C.F.R. § 1.482-1. Only two of these measures were presented below: the “resale price” method and the “residual profit split” method.

DOR’s position that \$1.43 was the fair market value of OTP sold by Tobacco Manufacturing was based on the resale price method.³ This 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.” ROBERT F. REILLY & MELVIN RODRIGUEZ, *EXCISE TAX AND INVENTORY: IRC SECTION 482 TRANSFER PRICE RULES MAY PROVIDE A REASONABLE VALUATION APPROACH*, J. OF MULTISTATE TAX’N, May 2004, at 18, 24 (“*Excise Tax and Inventory*”) (citing 26 C.F.R. § 1.482-3(c)(1)). But this method is only appropriate in cases involving the purchase and resale of tangible goods in which the reseller (here Tobacco Sales) has not added *substantial* value to the goods. *Bausch & Lomb Inc. v. Comm’r*, 92 T.C. 525, 586 (1989), *aff’d*, 933 F.2d 1084 (2nd Cir. 1991); *Excise Tax and Inventory*, at 24.

³ DOR continues to maintain that the fair market value of goods can never be determined when such goods are sold only between affiliated companies. But we rejected this argument in *U.S. Tobacco I*; DOR has failed to present any evidence to support this claim; and the argument is rebutted by the IRS’s codification of formulas specifically designed to determine the “arm’s-length” price of intercompany transfers. *See* 26 C.F.R. § 1.482-1; *see also U.S. Tobacco I*, 96 Wn. App. at 942 (“[T]he Department failed to identify in what respect the federal arm’s-length-price standard differs from fair market value.”).

DOR presented no evidence that the OTP sold by Tobacco Manufacturing did not gain value while owned by Tobacco Sales.⁴ Nor has DOR ever demonstrated that Tobacco Sales was a shell entity through which the OTP was funneled to evade taxes. As set forth in the studies conducted by Tobacco Sales's experts, Tobacco Sales increased the value of the OTP through an array of activities including sales, marketing, promotions, product sampling, and distribution. Thus, we reiterate that it is not appropriate to measure the value of OTP sold by Tobacco Manufacturing by the price Tobacco Sales sold to independent distributors.⁵ The trial court properly rejected DOR's position that the \$1.43 price was the fair market value of OTP sold by Tobacco Manufacturing.

For its part, Tobacco Sales's \$.68- to \$.72-per-can fair market value calculation was based upon the residual profit split method. This 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 or controlled transactions."

Excise Tax and Inventory, at 25 (citing 26 C.F.R. § 1.482-6(b)). Under this method:

⁴ It is in this respect that DOR's citation to *Creme Manufacturing Co. v. United States*, 492 F.2d 515 (5th Cir. 1974), fails. In that case, a manufacturing corporation sold taxable fishing lures to its related selling corporation for 25 percent of list price and the selling corporation resold the lures to unrelated wholesale distributors for 40 percent of list price. *Creme Mfg.*, 492 F.2d at 518. Because there was no evidence that the lures gained value between sale to the selling corporation and sale to the unrelated distributors, the Fifth Circuit affirmed the IRS's decision to calculate an excise tax based on the higher sales price. *Creme Mfg.*, 492 F.2d at 521-22.

⁵ See Uniform Standards of Professional Appraisal Practice (USPAP), Standard Rule 7-3(b) cmt.: The appraiser must recognize that there are distinct levels of trade and each may generate its own data. For example, a property may have a different value at a wholesale level of trade, a retail level of trade, or under various auction conditions. Therefore, the appraiser must analyze the subject property within the correct market context.

Available at <http://commerce.appraisalfoundation.org/html/USPAP2005/std7.htm>. Washington has adopted the USPAP as the standard of practice governing real estate appraisal activities. WAC 308-125-200(1).

[T]he 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.

Excise Tax and Inventory, at 25 (citing 26 C.F.R. § 1.482-6(c)(3)(i)). The residual profit split method is best explained by an example: If Manufacturer sells to Distributor a widget for \$1 (which includes Manufacturer's costs and set operating profit), and Distributor sells the widget for \$3 (which includes \$1 for Distributor's costs and set operating profit), there is \$1 of residual profit. The residual profit split method allocates that \$1 based on Manufacturer and Distributor's contribution of intangible assets to the entire transaction. Thus, for example, if Manufacturer contributes 40 percent of the intangible assets while Distributor contributes the rest, the \$1 of residual profit would be split accordingly.

In this case, Tobacco Sales's experts each testified that the appropriate allocation of the residual profit was 24 percent for Tobacco Manufacturing and 76 percent for Tobacco Sales. DOR did not dispute the allocation, which was based on Tobacco Manufacturing's "ownership of trademarks and trade names" and Tobacco Sales's performance of "brand management and brand marketing." 1 RP at 192. The allocation captured the expenditures by each company "done to promote those sort of nonroutine intangibles." 1 RP at 126. The fair market value under this residual profit split method was \$.68 to \$.72 per can.

In rejecting the \$.68- to \$.72-per-can price, the trial court noted that "no one really quarreled with the . . . 76/24 split," but then concluded that "common sense indicates that if there were a nonaffiliated distributor that [Tobacco Manufacturing] was going to sell to, they would not say, well, here, we'll take 24 percent of the profit and you can have 76 percent." 3 RP at

453. The court then assigned a residual profit rate of 40 percent for Tobacco Manufacturing and 60 percent for Tobacco Sales. This rate resulted in a fair market value of \$.81 to \$.84 per can, from which the court selected \$.82. But no evidence supports the trial court's 40/60 allocation rate in this context.

The 40/60 rate was USTC's projection, at the beginning of 1992, of how 1992 total gross profits in 1992 would be allocated between Tobacco Manufacturing and Tobacco Sales. This projection was made in order to set each company's 1992 budget, which in turn set the internal transfer prices between the two subsidiaries. These transfer prices, fixed by the 40/60 rate, included the \$.625-per-can price actually used between Tobacco Sales and Tobacco Manufacturing. But as discussed in *U.S. Tobacco I*, the internal transfer price between the two subsidiaries does not establish fair market value, i.e., what a willing buyer would pay a willing seller in an arm's-length transaction in a free market. In testimony not disputed by DOR, Tobacco Sales's expert explained that the 40/60 rate was the result of an "internal transfer pricing formula"⁶ which had no bearing on the residual profit distribution or fair market value of Tobacco Manufacturing's 1992 OTP:

[The 24/76 rate is] a very specific analysis to one specific slice of profits. Either level of profit has been allocated separately, one based on . . . a return on assets for [Tobacco] Manufacturing or return on sales for [Tobacco Sales]. A second layer is based on a return on actual expenses, which are different for [Tobacco Sales] than for [Tobacco] Manufacturing, obviously, it's only this residual level after most of the pizza pie has been consumed there's a slice left, and we have to allocate that last slice of profits and that was based on a relative expense, a relative cost of certain intangible assets creating creation expenses. But only that slice should be allocated 24/76 because that's the right way to allocate that slice. That slice shouldn't be allocated 40/60, just like all of the profits shouldn't be allocated 24/76.

⁶ 2 RP at 240.

2 RP at 257.

The trial court's basis for discarding the 24/76 split—i.e., that a “nonaffiliated distributor . . . would not say . . . we'll take 24 percent of the profit and you can have 76 percent”⁷—misconstrues the residual profit split method. The residual profit split method seeks to allocate residual profit only; it assumes that each company has already allocated for itself an operating profit. The decision to split residual profit 24/76 does not suggest the same result for overall profits. Because there was no basis for the trial court to adopt a 40/60 residual profit split, the trial court's finding of \$.82 as the fair market value is not supported by substantial evidence.

Each party advocates that, on remand, we instruct the trial court to set fair market value at its respective amount. But as already discussed, DOR's \$1.43 per can position is wholly unsupported. And we are not convinced that the \$.68 to \$.72 range championed by Tobacco Sales truly reflects the fair market value of OTP sold by Tobacco Manufacturing in 1992. The lengthy Willamette Management Associates and Ernst & Young studies both state the conclusion that the \$.68 to \$.72 range was the appropriate measure of fair market value. And DOR's appraiser did not dispute that this range was the correct “fair market value at that level of trade.” 2 RP at 360-61. But certain language from those studies and the testimony from which they were presented suggest that the qualifier “level of trade” included the affiliation between

⁷ 3 RP at 453.

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Tobacco Manufacturing and Tobacco Sales.⁸ As such, the court's market price would not reflect the price of OTP sold between unaffiliated entities. Moreover, although the Ernst & Young study in this appeal came to the conclusion that the 1992 fair market value was between \$.68 and \$.72 per can, the Ernst & Young study in the first appeal concluded that the \$.625 price was an appropriate arm's-length price for that same year. *U.S. Tobacco I*, 96 Wn. App. at 942. Neither party has clarified this disparity.⁹

The record does not contain substantial evidence supporting the trial court's finding that the fair market value of OTP sold in 1992 by Tobacco Manufacturing was \$.82 per can. The parties are directed to provide evidence on remand of the price a *completely unaffiliated entity* would have had to pay to purchase OTP from Tobacco Manufacturing in 1992.

⁸ See, e.g., 2 RP at 228-29:

Q. Let's take my hypothetical though, Mr. Reilly. Isn't it true that -- let's say Wal-Mart came in and said we're going -- for all our stores have our own internal unit, we don't care about you nationally, [Tobacco] Manufacturing, but we're going to push your products in our stores and we're a big customer. Isn't it true that if [Tobacco] Manufacturing did sell to them that they would charge them a higher price than what they charge to [Tobacco Sales]?

A. Well, would they, I just don't think it would ever be possible because that's just not a hypothetical that I could see occurring on the planet Earth, given the economics, the principles of economics that have, you know, been around since Malthus and Ricardo and for the last several hundred years.

⁹ We also note that while throughout these proceedings it appeared undisputed that the 1992 internal invoice price was \$.625 per can, the Willamette Management Study concluded that the invoice price was actually \$.73 per can that year. While the invoice price does not necessarily reflect fair market and, therefore, this discrepancy may be irrelevant, it reflects the need for further clarification below.

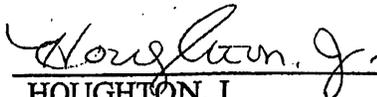
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Reversed and remanded.

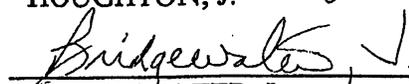


QUINN-BRINTNALL, C.J.

We concur:



HOUGHTON, J.



BRIDGEWATER, J.

APPENDIX 2

IN THE COURT OF APPEALS OF THE STATE OF WASHINGTON

DIVISION II RECEIVED

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GARVEY SCHUBERT
& BARER

No. 30434-1-II

ORDER DENYING RESPONDENT/
CROSS-APPELLANT'S MOTION
TO RECONSIDER

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.

FILED
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STATE OF WASHINGTON
BY DEPUTY

Respondent/Cross-Appellant moves for reconsideration of the court's decision

terminating review, filed August 8, 2005. Upon consideration, the Court denies the motion.

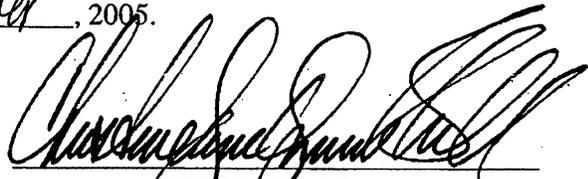
Accordingly, it is

SO ORDERED.

PANEL: Jj. Quinn-Brintnall, Houghton, Bridgewater

DATED this 1st day of September, 2005.

FOR THE COURT:


CHIEF JUDGE

William Colwell Severson
Attorney at Law
1191 2nd Ave Ste 1800
Seattle, WA, 98101-2996

David M. Hankins
Attorney General's Ofc/Revenue Division
905 Plum St Bldg 3 Fl 2
PO Box 40123
Olympia, WA, 98504-0123

Reporter of Decisions

APPENDIX 3

TAX ON TOBACCO PRODUCTS

Sections	
82.26.010	Definitions.
82.26.020	Tax imposed—Additional tax imposed.
82.26.025	Additional tax imposed—Rate—Deposit in water quality account.
82.26.030	Legislative intent.
82.26.040	When tax not applicable under laws of United States.
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 consumer.
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—Inspection.
82.26.100	Reports and returns.
82.26.110	When credit may be obtained for tax paid.
82.26.120	Administration.

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(4);

(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;

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

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

82.26.020 Tax imposed—Additional tax imposed.

(1) From and after June 1, 1971, 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. 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, or (c) ships or transports tobacco products to retailers in this state, to be sold by those retailers.

(2) An additional tax is imposed equal to the rate specified in RCW 82.02.030 multiplied by the tax payable under subsection (1) of this section. [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.]

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.

APPENDIX 4

Property Appraisal and Assessment Administration

General editor

Joseph K. Eckert, Ph.D.

Senior technical editors

Robert J. Gloudemans

Richard R. Almy

**The International Association
of Assessing Officers**

it must be *scarce*, and there must be a *desire* for it. An object that lacks utility cannot have value, because utility arouses desire for possession and has the power to give satisfaction.

Utility and scarcity do not by themselves confer value on an object; desire by the purchaser must also be present. Desire must be backed up by purchasing power (the ability to pay) in order to constitute effective demand, and potential purchasers must be able to participate in the market to satisfy their desires. If these conditions are met, the price of a good determined in a market can be considered as the net present value of the future benefit of owning the good.

Kinds of Value Adam Smith's distinction between *value in use* and *value in exchange* is important. A property may have one value in use and a significantly different value in exchange. Value in use embodies the premise that an object's value is related to its current use. For example, an obsolete, but functioning, oil refinery may still have considerable use value to its owners. Value in exchange, however, is determined by the market. Value in exchange is a relative value in that the good must be compared to other substitute goods and services in a competitive, open market.

Market Price vs. Market Value *Market price*, or value in exchange, is represented by the equilibrium price determined by supply and demand in a market. Market price is the amount actually paid in a particular transaction. The type of competition prevailing in the market is ignored in this definition. For example, no allowance is made for knowledge or prudent conduct on the part of buyer or seller, degree and type of stimulus motivating either or both, financing terms,

the use for which the property is best suited or is to be put, or length of time the property is exposed to the market. Market price can, and often does, result from caprice, carelessness, desperation, egotism, ignorance, pressure, sentiment, social ambition, whim, and many other factors.

Market value is a hypothetical, or estimated, sale price, such as would result from the careful consideration by the buyer and seller of all data, with primary reliance on those data that reflect the actions of responsible, prudent buyers and sellers under conditions of a fair sale. The definition of market value is concerned with the type of competition prevailing in the market. Although the definition does not require adherence to all the features of pure competition, it incorporates many of them. It principally leaves out the requirement that goods be exact substitutes for each other. Market value, as defined here, is what the appraiser is trying to estimate in the appraisal process.

Market price approximates market value and value in exchange under the following assumptions:

1. No coercion or undue influence over the buyer or seller in an attempt to force the purchase or sale
2. Well-informed buyers and sellers acting in their own best interests
3. A reasonable time for the transaction to take place
4. Payment in cash or its equivalent

Equilibrium and Time Periods

Equilibrium is central to economics. The concept is borrowed from Newtonian physics, where it describes a system in a state of rest. No forces exist within the system that tend to bring about further change. Supply

APPENDIX 5

Valuing a Business

The Analysis and Appraisal
of Closely Held Companies

Fourth Edition

Shannon P. Pratt, DBA, CFA, FASA, MCBA

Managing Director

Willamette Management Associates

Robert F. Reilly, CPA, CFA, ASA, CBA

Managing Director

Willamette Management Associates

Robert P. Schweihs, ASA

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In most interpretations of fair market value, the willing buyer and willing seller are hypothetical persons dealing at arm's length, rather than any particular buyer or seller. In other words, a price would not be considered representative of fair market value if influenced by special motivations not characteristic of a typical buyer or seller.

There is also general agreement that the definition implies that the parties have the ability as well as the willingness to buy or to sell. The *market* in this definition can be thought of as all the potential buyers and sellers of like businesses or practices.

The concept of fair market value also assumes prevalent economic and market conditions at the date of the particular valuation. You have probably heard someone say, "I couldn't get anywhere near the value of my house if I put it on the market today," or, "The value of XYZ Company stock is really much more (or less) than the price it's selling for on the New York Stock Exchange today." The standard of value that those people have in mind is some standard *other than* fair market value, since the concept of fair market value means the price at which a transaction could be expected to take place under *conditions existing at the valuation date*.

The terms *market value* and *cash value* are frequently used interchangeably with the term *fair market value*. The use of these essentially synonymous standard of value terms is often influenced by the type of asset, property, or business interest subject to valuation.

In the United States, the most widely recognized and accepted standard of value related to real estate appraisals is *market value*. The Appraisal Foundation defines *market value* as follows:

MARKET VALUE: Market value is the major focus of most real property appraisal assignments. Both economic and legal definitions of market value have been developed and refined. A current economic definition agreed upon by agencies that regulate federal financial institutions in the United States of America is:

The most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

1. buyer and seller are typically motivated;
2. both parties are well informed or well advised, and acting in what they consider their best interests;
3. a reasonable time is allowed for exposure in the open market;
4. payment is made in terms of cash in United States dollars or in terms of financial arrangements comparable thereto; and
5. the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

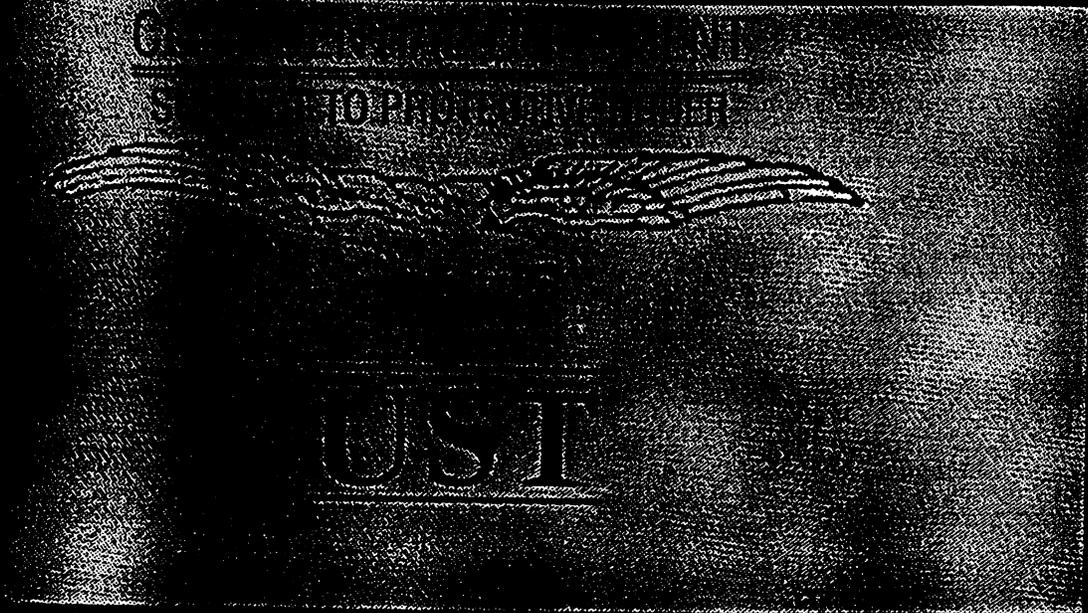
Substitution of another currency for United States dollars in the fourth condition is appropriate in other countries or in reports addressed to clients from other countries.

APPENDIX 6

CONFIDENTIAL DOCUMENT
SUBJECT TO PROTECTIVE ORDER

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for the year ended
December 31, 1995

EXHIBIT 4

P100326
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 ERNST & YOUNG LLP

APPENDIX 7

UNIFORM STANDARDS OF PROFESSIONAL APPRAISAL PRACTICE and ADVISORY OPINIONS 2005 EDITION

APPRAISAL STANDARDS BOARD



THE APPRAISAL FOUNDATION

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- 2113 ▪ it is required to properly develop credible opinions and conclusions;
 2114 ▪ the appraiser has a reasonable basis for the extraordinary assumption;
 2115 ▪ use of the extraordinary assumption results in a credible analysis; and
 2116 ▪ the appraiser complies with the disclosure requirements set forth in USPAP for
 2117 extraordinary assumptions.

2118 **(h) identify any hypothetical conditions necessary in the assignment.**

2119 Comment: A hypothetical condition may be used in an assignment only if:

- 2120 ▪ use of the hypothetical condition is clearly required for legal purposes, for purposes
 2121 of reasonable analysis, or for purposes of comparison;
 2122 ▪ use of the hypothetical condition results in a credible analysis; and
 2123 ▪ the appraiser complies with the disclosure requirements set forth in USPAP for
 2124 hypothetical conditions.

2125 **Standards Rule 7-3 (This Standards Rule contains specific requirements from which departure is
 2126 permitted. See DEPARTURE RULE.)**

2127 **In developing a personal property appraisal, an appraiser must collect, verify, analyze, and reconcile
 2128 all information pertinent to the appraisal problem, given the scope of work identified in accordance
 2129 with Standards Rule 7-2(f).**

2130 **(a) Where applicable, identify the effect of highest and best use by measuring and analyzing the
 2131 current use and alternative uses to encompass what is profitable, legal, and physically
 2132 possible, as relevant to the type and definition of value and intended use of the appraisal;**

2133 **(b) Personal property has several measurable marketplaces; therefore, the appraiser must
 2134 define and analyze the appropriate market consistent with the type and definition of value;
 2135 and**

2136 Comment: The appraiser must recognize that there are distinct levels of trade and each
 2137 may generate its own data. For example, a property may have a different value at a
 2138 wholesale level of trade, a retail level of trade, or under various auction conditions.
 2139 Therefore, the appraiser must analyze the subject property within the correct market
 2140 context.

2141 **(c) Analyze the relevant economic conditions at the time of the valuation, including market
 2142 acceptability of the property and supply, demand, scarcity, or rarity.**

2143 **Standards Rule 7-4 (This Standards Rule contains specific requirements from which departure is
 2144 permitted. See DEPARTURE RULE.)**

2145 **In developing a personal property appraisal, an appraiser must collect, verify, and analyze all
 2146 information applicable to the appraisal problem and the type of property, given the scope of work
 2147 identified in accordance with Standards Rule 7-2(f).**

2148 **(a) When a sales comparison approach is applicable, an appraiser must analyze such
 2149 comparable sales data as are available to indicate a value conclusion.**

2150 **(b) When a cost approach is applicable, an appraiser must:**

2151 **(i) analyze such comparable cost data as are available to estimate the cost new of the
 2152 property; and**