

Cross-Appellant's Brief

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COURT OF APPEALS  
DIVISION III

04 MAR 26 PM 2:53

STATE OF WASHINGTON

BY  DEPUTY

NO. 30434-1-II

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COURT OF APPEALS  
FOR THE STATE OF WASHINGTON  
DIVISION II

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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

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**BRIEF OF  
RESPONDENT/CROSS-APPELLANT**

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ORIGINAL

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## **I. CROSS-APPELLANT'S ASSIGNMENTS OF ERROR**

1. The trial court erred in denying Tobacco Sales' Second Motion for Summary Judgment.<sup>1</sup>
2. The trial court erred in arbitrarily disregarding the uncontroverted evidence that the 1992 fair market value of Tobacco Sales' smokeless tobacco product ("OTP") samples did not exceed 72¢ per can.
3. The trial court erred in finding that the 1992 fair market value for Tobacco Manufacturing's sales of OTP to Tobacco Sales was 82¢ per can (Finding of Fact No. 22).
4. The trial court erred in finding that Tobacco Sales paid excessive OTP tax of only \$68,488, rather than \$79,715 (Finding of Fact No. 24).

## **II. ISSUES**

1. Did the Trial Court abuse its discretion in denying Tobacco Sales' Second Motion for Summary Judgment where (1) there were no material factual disputes, and (2) Tobacco Sales was entitled to judgment as a matter of law?
2. Did Tobacco Sales prove that the \$160,553 OTP tax

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<sup>1</sup> The Respondent/Cross-Appellant, now known as U.S. Smokeless Tobacco Brands Inc. is referred to in this brief as "Tobacco Sales" and its manufacturing affiliate, U.S. Smokeless Tobacco Manufacturing Limited Partnership, is referred to as "Tobacco Manufacturing." This, and the other terminology in the brief, is consistent with that used in the Court's prior opinion.

assessed by the Department of Revenue (“Department”) was incorrect and that the correct amount of tax was no more than \$80,838?

3. Is Tobacco Sales entitled to a refund of excessive taxes of at least \$79,715, rather than \$68,488 as ordered by the trial court?

### **III. COUNTER STATEMENT OF CASE**

#### **A. The Prior Appellate Decision in this Case.**

This appeal involves the measure of Washington’s OTP tax on smokeless tobacco products that Tobacco Sales distributes as promotional samples in Washington. It is the second appeal in this case. The relevant facts regarding Tobacco Sales’ operations are detailed in the briefs in the prior appeal and are accurately summarized in this Court’s prior opinion. *United States Tobacco Sales & Marketing Co. v. Department of Revenue*, 96 Wn. App. 932, 982 P.2d 652 (1999). None of those facts have changed.

The legal dispute in the first appeal centered on whether the OTP tax is to be measured by Tobacco Manufacturing’s selling price or by the price at which Tobacco Sales resells the OTP to its unaffiliated customers. The Court held that the tax is to be measured by the manufacturer’s price, not Tobacco Sales’ resale price. 96 Wn. App. at 939-940. Because Tobacco Manufacturing and Tobacco Sales are affiliates, however, the Court also held that Tobacco Manufacturing’s selling price should be

compared to fair market value to assure that the transfer price between the related companies is not set at an artificially low level. *Id.* at 941-42, 943 n.19. The Court remanded to the trial court to make this fair market value inquiry. *Id.* at 942.

**B. The Parties' Second Round of Summary Judgment Motions on Remand.**

On remand, Tobacco Sales retained a nationally recognized valuation expert, Mr. Robert F. Reilly, to prepare a fair market value appraisal of the OTP.<sup>2</sup> Mr. Reilly was instructed to use the following valuation standard in his appraisal:

[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.<sup>3</sup> Applying this valuation standard, Mr. Reilly concluded that the fair market value of the OTP in 1992 was between 68¢ and 72¢ per can.<sup>4</sup>

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<sup>2</sup> Mr. Reilly has co-authored a leading text on business 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. He has been selected both by taxpayers and the Internal Revenue Service to serve as a transfer price expert in I.R.C. § 482 disputes. *See* CP 476-509; RP 135-42.

<sup>3</sup> In making his appraisal, Mr. Reilly utilized an updated transfer price study performed by the Ernst & Young accounting firm. *See infra* at p. 6.

<sup>4</sup> The \$.68 to \$.72 interval indicates the appraisers' judgment regarding the

The Department of Revenue’s theory on remand was very different from that of Tobacco Sales. The Department interpreted “fair market value” to mean the price at which Tobacco Sales resells OTP to its unaffiliated customers – the very price that the Court had rejected in the first appeal. The Department argues that this resale price must be the fair market price because any lower price is discounted, and thus not a proper measure of the OTP tax:

Fair market value . . . is what a non-affiliated distributor *would be willing* to pay for the OTP. . . .

The price contracted for, and paid by, the independent distributor is, by definition, the “fair market value” of the OTP. As this price is always higher than the “transfer price” the “transfer price” is a “discounted” price, which cannot be the “wholesale sales price” measure of the OTP tax under RCW 82.26.020 and RCW 82.26.010(7).

CP 227-28 (emphasis in original). *See also* Appellant’s Br. at 25.<sup>5</sup>

The parties argued their respective interpretations of this Court’s prior decision in a second round of cross-motions for summary judgment. Tobacco Sales presented Mr. Reilly’s appraisal as *prima facie* evidence that the fair market value of the OTP was between 68¢ and 72¢ per can. The Department argued that fair market value is \$1.43 per can (the price

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reasonable range for fair market value. RP 81-2.

<sup>5</sup> This “discounted price” theory is essentially the same “reduced price” argument that the Court rejected in the prior appeal. *See* 96 Wn. App. at 937. If the “discounted price” theory were correct, the reversal and remand in the prior appeal would be nonsensical because the tax measure under the “discounted price” theory is, by definition, Tobacco Sales’ resale price. That argument was rejected in the first appeal.

charged to Tobacco Sales' unaffiliated customers) and that Mr. Reilly's appraisal was incorrect as a matter of law because he applied the wrong valuation standard. RP 6/29/01 Summary Judgment Argument at 17, 25. However, the Department did not identify or present any admissible, competent evidence to dispute Mr. Reilly's value opinion under the valuation standard that he was instructed to apply in making his appraisal.<sup>6</sup> Once again, the issues boiled down to a legal dispute, this time over the meaning of "fair market value" in the Court's prior opinion.

Judge Tabor denied both parties' summary judgment motions but not because of any factual disputes. Instead, he indicated that he found the case "extremely difficult" and that he did not "feel comfortable" with his understanding of the issues. RP 6/29/01 Summary Judgment Ruling at 2, 4-5.<sup>7</sup> He wanted to hear testimony from the experts. *Id.* at 5.

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<sup>6</sup> The Department did submit affidavits from Dr. Stephen Smith, an economist employed by the Department, in opposition to Tobacco Sales' motion. However, the opinions in those affidavits were inadmissible for a host of reasons, including that the affidavits failed to show that Dr. Smith was competent to offer a valuation opinion or that he had any factual foundation for his opinions. *Lilly v. Lynch*, 88 Wn. App. 306, 320, 945 P.2d 727 (1997) ("An expert's affidavit submitted in opposition to a motion for summary judgment must be factually based and must affirmatively show that the affiant is competent to testify to the matters stated therein."). *See also* CP 610-23; *Rothweiler v. Clark County*, 108 Wn. App. 91, 100-101, 29 P.3d 758 (2001).

<sup>7</sup> Although Judge Tabor claimed to find the summary judgment issues very difficult, he asked very few questions during argument. Moreover, it is hard to reconcile this claimed difficulty with his statement after trial that this Court had made it "clear" that the manufacturer's price – not Tobacco Sales' selling price – is the tax measure. RP 436. If that was clear at the time of the summary judgment argument, Tobacco Sales' motion should have been granted.

**C. Tobacco Sales' Case in Chief.**

Trial did not disclose any factual disputes. 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 testified to his fair market value opinion as reflected in the appraisal submitted with Tobacco Sales' second summary judgment motion.<sup>8</sup> He explained in detail the applicable appraisal principles and standards and his valuation analysis. RP 132-278. In his appraisal, Mr. Reilly utilized an updated 1992 transfer price study prepared by Ernst & Young. Mr. Lotfi is the Ernst & Young valuation expert who was responsible for the updated study which again used the arm's length price standard established by Internal Revenue Code ("I.R.C.") § 482. The Ernst & Young study evaluates whether Tobacco Manufacturing's selling price to Tobacco Sales was an arm's length price for purposes of I.R.C. § 482. Mr. Lotfi explained the arm's length price standard and his evaluation of what an arm's length price would be for the 1992 sales of OTP by Tobacco Manufacturing to Tobacco Sales. RP 39-132.

This Court's prior opinion challenged the Department to show that "the federal arm's length price standard differs from fair market value."

96 Wn. App. at 942-43. The Department failed to do so. Both Mr. Reilly

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<sup>8</sup> 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.

and Mr. Lotfi testified that the arm's length standard under I.R.C. § 482 is the same as fair market value. RP 52, 183-84. In fact, the Department's own appraisal expert, Mr. Neal Cook, agreed with this conclusion. RP 356.<sup>9</sup>

**D. The Department's Case in Chief.**

The Department presented no evidence to dispute the expert opinions, qualifications or credibility of Mr. Reilly and Mr. Lotfi. The two witnesses called by the Department were a staff economist, Dr. Stephen Smith, and Mr. Neal Cook, an appraiser with the Department's Property Tax Division. The substance of Dr. Smith's testimony was that the Department lacks the staff to perform the sort of valuation analyses which were conducted by Mr. Reilly and Mr. Lotfi. RP 315-16, 322-23.<sup>10</sup> Mr. Cook testified regarding several appraisal issues and also gave his personal views as to how the OTP tax should be administered. He did not present an opinion of the fair market value of the OTP. RP 368. Nor did he identify any appraisal errors in Mr. Reilly's or Mr. Lotfi's valuation analysis. Mr. Cook had only one point of disagreement with their testimony: he concluded that Tobacco Sales is a

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<sup>9</sup> See also 26 C.F.R. § 1.482-1(b); *Northwestern Nat'l Bank v. United States*, 556 F.2d 889 (8th Cir. 1977).

<sup>10</sup> The trial court also permitted Dr. Smith to testify to tax policy preferences that are matters for legal argument, not expert testimony. That discussion is not proper evidence and cannot be treated as such. *Queen City Farms v. Central Nat'l Ins. Co.*, 126 Wn.2d 50, 102, 882 P.2d 703 (1994).

tobacco manufacturer and, therefore, that its selling price is the manufacturer's price that measures the OTP tax. RP 378.<sup>11</sup>

Mr. Cook did not dispute that "the valuation evidence presented by Mr. Reilly reflects the fair market value of the transaction between Tobacco Manufacturing and 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 as an authoritative reference on the subject. RP 356. His dispute with Mr. Reilly's appraisal was not whether it fairly reflected fair market value for a sale by Tobacco Manufacturing to Tobacco Sales, but rather, whether that transaction is the correct OTP tax measure. RP 373-74. In other words, the only disagreement between Mr. Cook and Mr. Reilly was whether the valuation assignment given to Mr. Reilly was correct.

The Department's economist, Dr. Smith, also complimented Mr. Reilly's and Mr. Lotfi's work:

This has been an educational experience. I am not an appraiser, and I'm very much impressed with the work presented here in the past two days. It's very impressive and this is a world that I have not been involved with. It's not an unfamiliar world in terms of methodology. What we

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<sup>11</sup> Mr. Cook admitted that his interpretation of the tax measure was not based on any appraisal expertise. RP 370. Rather, it was based on his lay reading of the statute. *Id.* Mr. Reilly confirmed that appraisers have no special expertise in interpreting tax statutes. RP 197-99.

have here is . . . a very good estimate of the average annual market value from the prior year in this transaction.

. . .

In no way do I want to impugn what the appraisers have done. I'm very impressed. This is, again, an estimate, a good estimate of the average market value, average annual market value for some past year . . . .

RP 311-13.

The trial did not change the evidence or produce any material new evidence that had not been presented by the parties' second cross-motions for summary judgment. The only dispute at summary judgment and at trial was whether "fair market value" means the market value price for a sale of OTP by Tobacco Manufacturing to Tobacco Sales or the price at which Tobacco Sales resells the OTP to its unaffiliated customers. This is an issue of law.

**E. The Trial Court's Decision.**

The trial court decided the disputed legal issue in favor of Tobacco Sales, ruling that the tax measure is the fair market price for a sale by Tobacco Manufacturing to Tobacco Sales. Conclusion of Law No. 3; RP 436. However, instead of implementing that decision based on the evidence, Judge Tabor came up with his own value for the OTP. He began at \$1.00 per can, a price that was about half-way between Tobacco Manufacturing's transfer price (\$.625) and Tobacco Sales' resale price (\$1.43). RP 437. He explained his reasoning as follows:

The State did not provide through their experts any testimony as to what the fair market value was. So, on the one hand I've heard arguments, well, it's unrebutted, there's expert testimony that the fair market value is indeed then 68 to 72 cents. Well, it is a clear role of a trier of fact to determine the facts from testimony and other evidence through exhibits and so forth, and the Court is not bound by any particular expert's opinion or any study. The Court may take parts of a study and disregard parts if the Court chooses.

RP 445-46. After presenting his rationale for this result, however, Judge Tabor realized that he had miscalculated. RP 456-57. His announced rationale raised Mr. Reilly's value only to 82¢ per can rather than the intended \$1.00 per can. *See* Finding of Fact No. 22. Both parties agree that this 82¢ per can value is wholly arbitrary.

**F. Corrections to the Department's Statement of the Case.**

The Department's Statement of the Case hardly mentions Mr. Reilly's appraisal or the market value evidence presented by Tobacco Sales. Instead, the Department suggests that Tobacco Sales relied directly on the Ernst & Young transfer price study as its valuation evidence.

Appellant's Br. at 8. That is incorrect.

The Department also asserts that the issue on remand was whether "Tobacco Manufacturing would sell its product to an unaffiliated company" at the fair market value price shown by the evidence.

Appellant's Br. at 10. This, too, is incorrect. The issue on remand was:

"What is the fair market value for sales of OTP by Tobacco

Manufacturing to Tobacco Sales?”<sup>12</sup>

**IV. ARGUMENT IN OPPOSITION TO  
DEPARTMENT’S APPEAL**

**A. Tobacco Sales Presented Clear Uncontested Evidence of Fair Market Value.**

**1. The Sole Issue on Remand was the Fair Market Value for Tobacco Manufacturing’s Sales of OTP to Tobacco Sales.**

The dispute on remand and on this appeal concerns the meaning of “fair market value” in the Court’s prior opinion. This definitional issue is a question of law, not fact:

"An expert's opinion on market value . . . must be based upon those legal principles which define the factors which the expert can or cannot consider in reaching his expert opinion." *Doolittle v. Everett*, 114 Wn.2d 88, 104, 786 P.2d 253 (1990).

*Bellevue Plaza v. City of Bellevue*, 121 Wn.2d 397, 411, 851 P.2d 662 (1993). *See also Matthew G. Norton Co. v. Smyth*, 112 Wn. App. 865, 51 P.3d 159 (2002) (focus on measurement technique is meaningless absent agreement on what is to be measured). Tobacco Sales contends that fair market value is the market price at which a manufacturer would

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<sup>12</sup> The Department’s Statement of the Case contains two other minor errors. First, the Department indicates that the corporate reorganization of United States Tobacco Company occurred in 1992. Appellant’s Br. at 6. In fact, it occurred in 1990. *See* Finding of Fact Nos. 11 & 12. Second, it suggests that the actual 1992 transfer price between Tobacco Manufacturing and Tobacco Sales was \$.73 per can. Appellant’s Br. at 8, n.31. In fact, it was \$.625. Finding of Fact No. 19. The Department’s \$.73 price is based on an error in Mr. Reilly’s appraisal that he corrected at trial. *See* RP 145-50.

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 Inc. manufacturing and marketing subsidiaries. This definition respects UST Inc.'s corporate form. The uncontroverted evidence shows that this value is 68¢ to 72¢ per can. The Department argues, on the other hand, that fair market value is the price charged to unaffiliated purchasers, i.e., Tobacco Sales' selling price. Although this definition ignores the transaction between Tobacco Manufacturing and Tobacco Sales, there is no dispute that the price to unaffiliated customers is \$1.43 per can. The only dispute here is which of these measures is correct.

**2. Mr. Reilly Used the Correct Valuation Standard in His Appraisal.**

Mr. Reilly applied the correct valuation standard because it reflects the fair market value price for Tobacco Manufacturing's sales to Tobacco Sales. 96 Wn. App. at 937-38. Mr. Reilly's appraised value includes all of the value added to the OTP by Tobacco Manufacturing, but does not include value added by Tobacco Sales. RP 174-81; CP 301. The value added to the OTP by Tobacco Sales should not be added to the tax base because it is value that is "added to the products after the manufacturer sells them." 96 Wn. App. at 941. This is an example of what is

commonly referred to as the “trade level” concept.

In the ordinary course of commerce, goods increase in value as they move through different levels of trade, from the manufacturer to the consumer. Each entity in the product distribution chain marks up the price to cover its costs and return a profit, and as the products pass from one level of trade to the next, these mark ups add to product value. This value increase does not depend on physical changes to the products. Rather, the increase is often attributable to services, such as transportation, distribution, warehousing, promotional support, etc. CP 299-301.

Professional appraisal standards require appraisers to identify the proper level of trade when valuing personal property:

Personal property has several measurable marketplaces, therefore the appraiser must define, and analyze the appropriate market consistent with the purpose of the appraisal.

Official Comment: 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 varying auction conditions. Therefore, the appraiser must analyze the subject property within the correct market context.

UNIFORM STANDARDS OF PROFESSIONAL APPRAISAL PRACTICE (“USPAP”)

Rule 7-3(b) (emphasis added).<sup>13</sup> See also RP 161-65; 375; WAC 458-12-

310. Because goods have different values at different levels of trade, an

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<sup>13</sup> USPAP was developed by The Appraisal Foundation under a Congressional mandate to promote and maintain ethical and responsible appraisal practices. Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (“FIRREA,” 12 U.S.C. §§ 3331-51).

appraiser cannot use a price at one level of trade to indicate the of value for goods at a different trade level. Both sides' appraisers agree with this basic principle. RP 165, 196-97 (Reilly); RP 378 (Cook).

Mr. Reilly appraised the market value of the OTP at the trade level reflecting a sale by a manufacturer, owning the same property interests and performing the same functions as are actually performed by Tobacco Manufacturer. CP 298. His appraisal reflects the full market value of the OTP at the time it is sold by Tobacco Manufacturing to Tobacco Sales. RP 173-81; CP 301. The Department does not contest this valuation. *Its appraiser conceded that, if Mr. Reilly measured value at the correct level of trade, his appraisal is correct.* RP 374. Instead, the Department argues that the appraisal instruction given to Mr. Reilly was incorrect and, as a result, he measured value at the wrong level of trade. Appellant's Br. at 24-25; RP 360-61.

### **3. Tobacco Sales is Not a Tobacco Manufacturer.**

The Department's argument that Mr. Reilly valued the OTP at the wrong trade level is premised on the assertion that Tobacco Sales is a manufacturer. The only evidence offered to support this assertion is Mr. Cook's testimony that Tobacco Sales should be viewed as a tobacco manufacturer for purposes of RCW 82.26.010(7). RP 352-53. *See* Appellant's Br. at 25. However, Mr. Cook's view that Tobacco Sales is a

manufacturer is invalid for at least four reasons.

First and foremost, this Court already rejected the Department's efforts to characterize Tobacco Sales as a manufacturer. The Court's prior opinion concluded that "Tobacco Manufacturing is the manufacturer and Tobacco Sales is the taxable distributor . . . Tobacco Sales is not a manufacturer." 96 Wn. App. at 938, 943. These conclusions were not open for reconsideration on remand, and they are not open for reconsideration in this appeal. The Court's prior determination that "Tobacco Sales is not a manufacturer" is the law of the case. *Booten v. Peterson*, 47 Wn.2d 565, 568, 288 P.2d 1084 (1955).

Second, the Department waived its right to argue that Tobacco Sales is a manufacturer by failing to assign error to the applicable Findings of Fact. The trial court found that (1) Tobacco Manufacturing manufactures the smokeless tobacco products and sells them to Tobacco Sales and (2) Tobacco Sales markets and resells the products to independent customers. (Findings of Fact Nos. 6, 9 & 13). These findings reject the Department's attempt to characterize Tobacco Sales as a manufacturer. The Department did not assign error to these Findings. Therefore, it cannot now argue that Tobacco Sales is a manufacturer or that its resale price is a manufacturer's price. *Robel v. Roundup Corp.*, 148 Wn.2d 35, 42, 59 P.3d 611 (2002) ("Unchallenged findings are

verities on appeal.”).

Third, Mr. Cook’s conclusion that Tobacco Sales is a manufacturer was not based on appraisal judgment or expertise on which he was qualified to offer an expert opinion, but instead, it was based on nothing more than his reading of the Ernst & Young study and his personal opinion of how the statute should be interpreted. RP 370. His opinion on what the tax measure should be cannot be considered because it is an opinion on an issue of law under the guise of expert testimony.

*Washington State Physicians Ins. Exchange & Assoc. v. Fisons Corp.*, 122 Wn.2d 299, 344, 858 P.2d 1054 (1993).

Finally, even if Tobacco Sales’ status as a manufacturer were an open question, *all* of the evidence confirms the Court’s prior conclusion that Tobacco Sales is *not* a manufacturer. There is no evidence to support Mr. Cook’s contrary assertion. Mr. Cook based his view that Tobacco Sales is a manufacturer on a sorely strained reading of the Ernst & Young transfer price study. He relied on just two bits of information in that study for his conclusion:

1. A sentence on page 24 of the study stating that “Trade shows of particular importance to USTSM [Tobacco Sales] include those run by chain stores and distributors for their customers, where manufacturers such as USTSM are invited to show products directly to retail customers.” (CP 376); and

2. The fact that on several occasions, the study refers to Tobacco Sales' customers as "distributors."

RP 352-56. Mr. Cook claimed that these two items prove that Ernst & Young viewed Tobacco Sales as a manufacturer. RP 372-73. This claim wildly misrepresents the Ernst & Young study.

First, Mr. Lotfi, the study's author, disavowed Mr. Cook's interpretation. He testified that nothing in the study was intended to suggest that Tobacco Sales is a manufacturer. RP 46. He was emphatic that (1) Tobacco Sales is not a manufacturer, and (2) it conducts no manufacturing operations. *Id.* Nowhere does the study directly characterize Tobacco Sales as a manufacturer. To the contrary, it specifies that "*USTMC [Tobacco Manufacturing] is responsible for all manufacturing of US Tobacco's tobacco products . . . .*" CP 361. The study ascribes all manufacturing functions to Tobacco Manufacturing and not a single manufacturing activity to Tobacco Sales. CP 361-73; 374-85.

The study describes Tobacco Sales' activities as "*the sale and marketing of moist smokeless tobacco products.*" CP 374. It identifies Tobacco Sales as a "*wholesale distributor*" which markets the tobacco products manufactured by Tobacco Manufacturing. CP 372. Mr. Cook's notion that Ernst & Young meant to paint Tobacco Sales as a manufacturer is wholly inconsistent with any fair and impartial reading of

the study.

Regarding the two specific items cited by Mr. Cook to support his interpretation of the study, Mr. Lotfi explained that the reference to “manufacturers” on page 24 was an oversight, and that the text should have read “companies” not “manufacturers.” RP 45. This correction is entirely consistent with the overall substance of the report. Mr. Cook’s second stated reason for viewing Tobacco Sales as a manufacturer, *i.e.*, the study’s references to Tobacco Sales’ customers as “distributors,” proves nothing. That Tobacco Sales sells to other distributors does not prove that Tobacco Sales is a manufacturer.<sup>14</sup> This Court’s prior opinion recognized that Tobacco Sales’ customers are distributors, yet concluded that this did not preclude Tobacco Sales from also being a distributor. 96 Wn. App. at 934 (“most of Tobacco Sales’ customers are wholesale distributors”). Even Mr. Cook acknowledged that there may be any number of distributors in the distribution chain. RP 362-63. *See also* RP 194-96 (Reilly).

Mr. Reilly independently confirmed that Tobacco Sales is not a manufacturer and that it conducts no manufacturing operations. RP 156-57, 191-97, 271-72. He described his personal investigation of the

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<sup>14</sup> The definitions for terminology in the Ernst & Young study (such as “distributor”) were based on their general usage in economics, not on Washington’s statutory definitions. RP 82-83.

operations of Tobacco Manufacturing and Tobacco Sales which show clearly that Tobacco Sales is not a manufacturer.

Mr. Cook had no personal knowledge of any fact to support his conclusion that Tobacco Sales is a manufacturer. He had no knowledge of any manufacturing functions performed by Tobacco Sales. RP 371. He had no knowledge of any facts to dispute Mr. Lotfi's testimony that Tobacco Sales doesn't perform any manufacturing functions. He had no knowledge to dispute Mr. Reilly's description of the operations of Tobacco Sales and Tobacco Manufacturing. RP 371-72. Mr. Cook's attempt to characterize Tobacco Sales as a manufacturer flies in the face of all of the evidence and is even inconsistent with the parties' stipulation that Tobacco Manufacturing manufactures smokeless tobacco products and Tobacco Sales markets and sells the products. CP 128-29. The trial court rejected the Department's claim that Tobacco Sales is a manufacturer, and the Department cannot point to any evidence, let alone substantial evidence, to dispute that conclusion.

**B. Tobacco Sales' Burden Was to Prove Fair Market Value, Not Whether Tobacco Manufacturing Would Sell OTP to an Unaffiliated Distributor.**

The Department argues that Tobacco Sales' valuation evidence should be disregarded because it failed to prove that Tobacco

Manufacturing would sell OTP to unaffiliated purchasers at the same price at which it sells to Tobacco Sales:

[T]he price between Tobacco Manufacturing and Tobacco Sales is not a ‘fair market value’ price because it was not a price readily available to all unaffiliated buyers/customers and would not be a price resulting from a willing buyer and willing seller.”

Appellant’s Br. at 15. This argument lies at the heart of the Department’s appeal. According to the Department, fair market value is the price at which Tobacco Manufacturing would sell OTP to any unaffiliated customer, and Tobacco Sales’ burden on remand was to prove that Tobacco Manufacturing would sell to unaffiliated purchasers at a price other than Tobacco Sales’ resale price (\$1.43 per can). This argument misconceives the issue on remand and is legally incorrect.

**1. The Department’s “Price to Unaffiliated Purchaser” Argument is Barred by Law of the Case.**

The Department’s “price to unaffiliated purchaser” argument is just a reprise of the argument it made in the first appeal. The Department previously 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.” 96 Wn. App. 932, 942-943. Now the Department again argues that the tax measure must be “a price readily available to all unaffiliated buyers/customers.” Appellant’s Br. at 16. This is just old wine in a new bottle.

In the first appeal, it was no secret that Tobacco Manufacturing and Tobacco Sales maintain an exclusive selling arrangement under which Tobacco Manufacturing does not sell to unaffiliated entities. 96 Wn. App. at 934. With that fact in mind, the Court rejected the Department's argument that the OTP tax is measured by the selling price to unaffiliated purchasers. *Id.* at 943. Law of the case bars the Department from once again arguing that same theory in this appeal. *Booten, supra.*

**2. Whether Tobacco Manufacturing Would Sell to Unaffiliated Entities is Irrelevant.**

Even if the Department's "price to unaffiliated purchaser" argument were properly before the Court, it should be rejected because it is incorrect under both generally accepted valuation principles and Washington law. The Department's idea that "fair market value" means a price that is available to *any* potential purchaser directly conflicts with the trade level concept because purchasers at lower trade levels are never able to buy at the price charged at earlier levels. For example, Tobacco Sales' customers generally resell to other distributors at a marked up price. If "fair market value" is the price available to *any* potential willing buyer, Tobacco Sales selling price could not be fair market value because that price is not available to those who purchase from Tobacco Sales' customers. Carrying the Department's argument to its logical conclusion,

the manufacturer's price would be much higher even than Tobacco Sales' \$1.43 selling price. It would be the highest price charged to the final reseller because that is the only price that is available to any and all distributors. This is an absurd result because that price is never charged by the manufacturer.

The Department's argument that a price can only be fair market value if the seller would sell to anyone at that price necessarily implies that there cannot be a fair market price for a sale where the parties have an exclusive selling agreement. That, however, is not true, and the Department presented no evidence and cites nothing in economic or valuation theory to support its argument. Exclusive sales contracts are not uncommon, whether between affiliated or unaffiliated entities. They are entered into when mutually beneficial, which may occur for any number of reasons. Mr. Reilly testified at some length regarding the mutual benefits of the exclusive selling arrangement between Tobacco Manufacturing and Tobacco Sales. RP 168-69, 226-33, 244-45, 259-60. Exclusivity enhances Tobacco Sales' incentive to market Tobacco Manufacturing's products in a manner that maximizes brand value. This enhances profitability for both Tobacco Sales and Tobacco Manufacturing. The fact that Tobacco Manufacturing and Tobacco Sales choose to maintain a mutually beneficial exclusive sales arrangement does

not mean that there cannot be a fair market value price for the sale by Tobacco Manufacturing to Tobacco Sales. Nor does it mean that Mr. Reilly's appraisal of that market value price is erroneous. Tobacco Manufacturing and Tobacco Sales' exclusive sales arrangement simply does not bear on fair market value.

The Department implies that fair market value can only be determined by actual transaction prices between unrelated, arm's length participants. Nothing in Washington law or valuation theory supports this idea. *Cf. Gilmartin v. Stevens Inv. Co.*, 43 Wn.2d 289, 294, 261 P.2d 73 (1953) (market value proved by competent opinion testimony). Mr. Reilly explained that market value does not depend on actual transactions. RP 168-69; 186-87. This evidence is undisputed.

Moreover, both sides' appraisers agreed that the sales by Tobacco Manufacturing to Tobacco Sales occur at a different trade level than the sales by Tobacco Sales to its unaffiliated customers. RP 171-72 (Reilly); RP 360-61 (Cook). The appraisers also agreed that the price at one level of trade does not indicate market value at a different trade level. RP 165-66 (Reilly); RP 378 (Cook). The Department's notion that Tobacco Sales' selling price can be used to indicate market value for the sales by Tobacco Manufacturing to Tobacco Sales that occur at a different level of trade is

directly contrary to this evidence and contrary to basic principles of valuation theory.

*Fair market value* is a valuation concept that is not necessarily the same as an actual transaction price. *See, e.g.*, International Association of Assessing Officers, PROPERTY APPRAISAL AND ASSESSMENT ADMINISTRATION, at 52-53 (1990); RP 272. It is an objective standard that is premised on a *hypothetical* transaction between typically motivated, well-informed, arm's length market participants in an open competitive market. *Id.*<sup>15</sup> Market value is not determined by the actual behavior and preferences of individual property owners under other conditions. *Id.* While market value can be directly determined in large, well-organized markets (such as a stock exchange) where actual market conditions closely approximate the conditions assumed for the *hypothetical* market value transaction, in many circumstances market value must be appraised indirectly, using sound appraisal practices and appraisal judgment. That is true here. There are no OTP transactions between arms' length entities at the level of trade at which Tobacco Manufacturing sells to Tobacco Sales. Therefore, the market value price for such transactions had to be appraised, and Mr. Reilly made such an appraisal. His valuation fully

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<sup>15</sup> *See also* Appraisal Institute, THE DICTIONARY OF REAL ESTATE APPRAISAL, (3<sup>rd</sup> ed., 1993); IAAO, GLOSSARY OF PROPERTY APPRAISAL AND ASSESSMENT (1997).

complies with the UNIFORM STANDARDS OF PROFESSIONAL APPRAISAL PRACTICE and the Court's prior opinion. There is no evidence to dispute Mr. Reilly's opinion of value at the level of trade he examined.

The Court remanded this case for a determination of the fair market value price for sales by Tobacco Manufacturing to Tobacco Sales, not for a determination of whether Tobacco Manufacturing would sell its products to others at that price. 96 Wn. App. at 943. Whether Tobacco Manufacturing would sell to others at that price is irrelevant to the fair market value inquiry. This was decided in *Port Townsend S. Railway Co. v. Barbare*, 46 Wash. 275, 89 P. 710 (1907), a railroad right-of-way condemnation in which the owner did not want to sell at any price. The trial judge had instructed the jury that it could consider the owner's unwillingness to sell in determining the property's market value. The Supreme Court reversed:

The condemning party is required to pay the just or full compensation for the property taken. Such compensation is the market value of the property, and the desire or unwillingness of the owner to sell does not in the least affect the market value and the jury should not consider such elements.

*Id.* at 277 (emphasis added). This same principle applies equally in this case. There is no basis in law or valuation theory for the Department's effort to convert the remand proceeding from a fair market value inquiry

into an inquiry regarding whether Tobacco Manufacturing would sell OTP to unaffiliated customers.

**C. The Department's Arguments Fail to Address the Remand Issue or the Evidence.**

**1. The Department Fails to Address Mr. Reilly's Appraisal Evidence.**

The Department suggests that Tobacco Sales relies directly on the Ernst & Young transfer price study to prove market value. *See* Appellant's Br. at 20. This is not true. The core of Tobacco Sales' valuation evidence was Mr. Reilly's market value appraisal. While Mr. Reilly utilized an updated Ernst & Young transfer price study in his appraisal analysis, he did so only after concluding that the I.R.C. § 482 arm's length standard is consistent with the market value standard. Mr. Reilly fully explained that valuation judgment in his appraisal report and testimony. CP 305-07; RP 183-84. The Department all but ignores Mr. Reilly's valuation report and testimony because it has no response to that evidence. The Department presented no valuation evidence or price comparisons of its own and no substantive criticisms of Mr. Reilly's value opinion. Rather than contesting Tobacco Sales' valuation evidence, the Department chose to argue that the valuation standard given to Mr. Reilly was incorrect. The Department lost that legal argument in the prior

appeal, it was rejected again by the trial court on remand, and it is not open for reconsideration in this appeal.

**2. The Department's Attacks on the Ernst & Young Transfer Price Study are Baseless.**

The Department attempts to discredit the Ernst & Young transfer price analysis used by Mr. Reilly as being just an income tax analysis that cannot be used “to arrive at fair market value for purposes of an excise tax . . . .” Appellant’s Br. at 20-21. The Court already rejected this argument in the prior appeal. 96 Wn. App. at 942 (“That a pricing study is undertaken in the context of federal income tax does not preclude its relevance in determining fair market value for Washington tax purposes.”). At trial, not only did the Department fail to identify in what respect the federal arm’s length price standard differs from fair market value, its own appraiser concurred with Mr. Reilly and Mr. Lotfi that the two standards are the same. The Department’s argument that I.R.C. § 482 analysis only applies to income taxes is wrong, contrary to all of the evidence and barred by law of the case.

**3. The Fair Market Value Standard Is Not Inconsistent with the Nature of an Excise Tax.**

The Department challenges Tobacco Sales’ valuation evidence as fundamentally inconsistent with the nature of an excise tax. It asserts that the measure of an excise tax must be based on an actual sales price, rather

than market value. Appellant's Br. at 21. That assertion is baseless.

The Department cites no authority for its claim that an excise tax must be measured by an actual sale price. Valuations, as opposed to transaction prices, are used for other excise taxes. For example, the real estate excise tax is measured by the assessed value of the property if the actual selling price cannot be readily ascertained. RCW 82.45.030(4). The use tax is measured by market value in certain circumstances. *See* RCW 82.12.010(1)(a) and (b).

Moreover, the Department's argument misconceives the Court's prior opinion. That opinion did not substitute market value for actual transaction prices as the tax measure. Rather, the Court held that when the transaction which measures the tax occurs between corporate affiliates, the commonly controlled taxpayers can not evade the tax by setting a transaction price that is below fair market value. 96 Wn. App. at 943 n.19. Such a market value check on actual transaction prices between corporate affiliates is not inconsistent with the nature of an excise tax.

The Department cites *Crème Manufacturing Co., Inc. v. United States*, 492 F.2d 515 (5<sup>th</sup> Cir. 1974), in an attempt to bolster its argument that an excise tax must be measured by an actual sales price. Appellant's Br. at 22-23. *Crème*, however, does not help the Department's argument. First, the issue in *Crème* was different. There, the question was whether

the taxpayer had presented sufficient evidence to overcome the presumptive correctness of a “constructive sales price” established by the Internal Revenue Service under 26 U.S.C. § 4216. Washington law provides no comparable authority to the Department to establish “constructive sales prices” for measuring the OTP tax.

Second, the federal tax scheme in *Crème* is fundamentally different than that under Washington law. The federal constructive price statute specifically directs that transactions between corporate affiliates are disregarded if the manufacturer does not sell to unaffiliated entities. This can result in dramatically different tax treatment for transactions between affiliated entities as compared to transactions between unaffiliated entities. The United States Supreme Court reluctantly upheld such differential treatment in *F.W. Fitch Co. v. United States*, 323 U.S. 582, 587, 65 S. Ct. 409, 89 L. Ed. 472 (1945). Washington tax law, in contrast, does not authorize using a different tax measure for transactions between corporate affiliates. *Cf. Associated Grocers, Inc. v. State*, 114 Wn.2d 182, 787 P.2d 22 (1990) (differential exemption treatment for unaffiliated “wholesalers” and affiliated “distributors” is unconstitutional). The Department is not

permitted to tax affiliate transactions differently than transactions between unaffiliated entities.<sup>16</sup> 96 Wn. App. at 936 n.6.

Third, the Department's *Crème* argument is not within the scope of the Court's remand order. The issue on remand was the fair market value for Tobacco Manufacturing's sales to Tobacco Sales. The Department's *Crème* argument, in essence, is that the OTP tax should be measured by Tobacco Sales resale price to unaffiliated purchasers, rather than the market value price for sales by Tobacco Manufacturing to Tobacco Sales. This issue was decided against the Department in the prior appeal and is not open for reargument under the remand order.

Fourth, the price that the Department claims as a proper fair market value (\$1.43 per can) is a price that the trial court specifically found was not fair market value. Finding of Fact No. 23. ("Neither Tobacco Sales' nor Tobacco Manufacturer's 1992 selling price represents the fair market value of the smokeless tobacco products sold by Tobacco Manufacturing to Tobacco Sales."). The Department did not assign error to this finding and, therefore, it cannot argue that Tobacco Sales' selling price is fair market value. *Robel v. Roundup Corp., supra*.

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<sup>16</sup> As this Court noted in its prior opinion, the Department failed in its attempt to obtain legislative authority for differential tax treatment of affiliate transactions. 96 Wn. App. at 936 n.6.

Finally, the Department's argument would fail even under the analysis applied in *Crème*. There, the court ruled that the taxpayer had failed to prove that its value included the special value attributable to the fact that the products were manufactured by Crème Manufacturing. *Crème* 492 F.2d at 522. Here, in contrast, Mr. Reilly's appraisal fully accounts for all elements of value contributed by Tobacco Manufacturing and the Department presented no evidence to dispute his conclusion. The Department's appraiser, Mr. Cook, agreed that if the valuation standard applied by Mr. Reilly is correct, he has no dispute with Mr. Reilly's opinion of value. RP 360-61. Thus, even under *Crème*, Tobacco Sales carried its burden of proving fair market value.

**4. The Department's "In-State Distributor" Argument is Incorrect and Has Already Been Rejected.**

The Department argues that the tax measure must be the price at which Tobacco Sales sells to unaffiliated distributors because that is the product's value "at the time the tobacco product is brought for sale into the state." See Appellant's Br. at 24. This is yet another argument that the Court rejected in the first appeal. See Respondent's Br. in prior appeal at p. 41. The argument is barred by the law of the case.

The Department suggests that *McLane Co., Inc. v. Dept. of Revenue*, 105 Wn. App. 409, 19 P.3d 1119 (2001), *rev. denied*, 145 Wn.2d

1005 (2001), supports its argument. The Department is wrong. The issue in *McLane* was: “Who is the taxpayer?” not “What is the measure of the tax?”<sup>17</sup> Nothing in *McLane* suggests that the OTP tax is to be measured by the price charged to the first unaffiliated in-state distributor.<sup>18</sup> See 105 Wn. App. at 418. In fact, *McLane* expressly confirmed that the tax measure is the manufacturer’s price rather than the sale price to the first in-state distributor. 105 Wn. App. at 417.

**5. The Department’s “Invoice Price” Argument is Invalid and Contrary to the Evidence and Findings.**

The Department contends that the OTP tax should be measured by the invoice prices charged to Tobacco Sales’ customers because those invoices were the only evidence showing “the ‘established price’ to an unaffiliated buyer/customer . . . .” Appellant’s Br. at 15. Those invoice prices, however, reflect Tobacco Sales’ selling price, not the market value price for its purchases from Tobacco Manufacturing. It is undisputed that these are two different levels of trade and both sides’ appraisers confirmed that a sale price at one level of trade does not indicate fair market value at

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<sup>17</sup> Tobacco Sales filed an *amicus curiae* brief in *McLane* to express its concern that the Department was improperly interjecting arguments regarding the tax measure in its briefs in that case in an attempt to influence the outcome of this case, even though the tax measure was not at issue in *McLane*. See Appendix 1. The Department’s argument here confirms the validity of that concern.

<sup>18</sup> As Tobacco Sales pointed out in the prior appeal, the Department’s “in-state distributor” argument, if accepted, would render the OTP tax unconstitutional under the Commerce Clause. See Appellant’s Reply Br. in prior appeal at 12-13.

a different level of trade. *See supra* at p. 14. The Department's invoice price argument contradicts the Court's prior opinion and all of the appraisal testimony.

**V. TOBACCO SALES' CROSS APPEAL**

**A. The Trial Court Erred in Denying Tobacco Sales' Second Motion for Summary Judgment.**

**1. Standard of Review**

In reviewing summary judgment, the appellate court engages in the same inquiry as the trial court. The appellate court determines whether genuine issues of fact exist and whether the moving party is entitled to judgment as a matter of law. Facts are considered in the light most favorable to the nonmoving party. *Bowles v. Dept. of Retirement Systems*, 121 Wn.2d 52, 62, 847 P.2d 440 (1993).

**2. Tobacco Sales was Entitled to Summary Judgment on Remand.**

The parties' dispute on remand boiled down to a dispute of law, not of fact. Tobacco Sales maintains that the appraisal instruction given to Mr. Reilly is correct and that his appraisal provided uncontested *prima facie* evidence of the fair market value for OTP sold by Tobacco Manufacturing to Tobacco Sales. The Department had full opportunity to conduct discovery regarding Mr. Reilly's opinions, analysis, and the factual basis for the appraisal, yet it offered no competent, admissible

evidence to dispute Mr. Reilly's qualifications, credibility, the substance of his appraisal analysis, or the validity of his opinion of value. *See Group Health Cooperative, Inc. v. Department of Revenue*, 106 Wn.2d 391, 400, 722 P.2d 787 (1986). Instead, the Department chose to defend its assessment on legal grounds, arguing that the appraisal instruction given to Mr. Reilly was incorrect, and that Tobacco Sales' resale price is, "by definition," the proper measure of the tax.<sup>19</sup> The parties submitted this legal dispute to the trial court on cross-motions for summary judgment, and Tobacco Sales was entitled to have its motion granted.

An order denying summary judgment is not appealable where the denial is based on the existence of a material factual dispute. *Kaplan v. Northwestern Mut. Life Ins. Co.*, 115 Wn. App. 791, 799, 65 P.3d 16 (2003). Where the disputed issue is legal rather than factual, however, the denial of a summary judgment may be reviewed, even after trial. *Id.* Here, the parties' cross-motions for summary judgment did not present any genuine issues of fact. The trial court acknowledged that the motions did not present factual disputes. RP 6/29/01 Summary Judgment Ruling at 3-4. The only reason that the trial court gave for denying summary judgment was that he did not "feel comfortable" with his understanding of

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<sup>19</sup> The Department's affidavits opposing Tobacco Sales' second summary judgment motion did not establish the existence of any factual issues. *See supra* at p. 5.

the issues and that he wanted to hear live testimony from the experts.

RP 6/29/01 Summary Judgment Ruling at 5. That denial was an abuse of discretion.

When resolution of a dispute turns solely on a legal issue, the court is obliged to decide the legal issue on summary judgment:

The judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law.

CR 56(c) (emphasis added). If the moving party is correct on the legal issue and the opposing party fails to present evidence of a factual dispute, the trial court grants summary judgment. CR 56(c); *Cf. Young v. Key Pharms., Inc.*, 112 Wn.2d 216, 225-26, 770 P.2d 182 (1989).

Here, the uncontradicted appraisal evidence established the fair market value of the OTP sold by Tobacco Manufacturing to Tobacco Sales. *Cf. Turner v. Kohler*, 54 Wn. App. 688, 692, 775 P.2d 474 (1989) (uncontradicted expert affidavit may establish that a party is entitled to judgment as a matter of law). If the valuation standard applied by Mr. Reilly was correct, as indeed the trial court agreed that it was, then Tobacco Sales was entitled to summary judgment. There was no dispute regarding the value of the OTP under that valuation standard. Had the

trial court properly decided this legal issue, it would have spared the parties and the courts the burden and expense of a pointless trial.

**B. The Trial Court's 82¢ Per Can Value Finding Was Arbitrary.**

The parties agree on one thing – that there was no evidence for the trial court's finding that the market value of the OTP was 82¢ per can. *See* Finding of Fact No. 23. The trial court agreed that the valuation standard applied by Mr. Reilly was correct. Conclusion of Law No. 3. However, rather than accepting the undisputed evidence of value under that standard (68¢ to 72¢), the trial court arbitrarily substituted an 82¢ value for which there was no evidence. That decision is invalid because a finding of fact that has no support in the record cannot stand. *Worthington v. Worthington*, 73 Wn.2d 759, 765, 440 P.2d 478 (1968).

**1. A Trial Court May Not Arbitrarily Disregard Reliable Uncontroverted Evidence.**

While it is clearly the fact-finder's job to evaluate the evidence, a trier of fact may not arbitrarily disregard reliable, uncontradicted evidence:

The testimony of a witness, even though uncontradicted, is for the trier of fact so long as the matter testified to remains in dispute and does not relate to some fact of which the court will take judicial notice. However, inherently probable, reasonable, credible and trustworthy testimony uncontradicted by evidence must be accepted as true in that it cannot be arbitrarily disregarded or disregarded as against the mere suspicion of untruth or falsity, and is to be regarded as conclusive.

29 Am. Jur. 2d Evidence § 1445 at 828-829. As explained by the

Wisconsin Supreme Court:

A trial court is not required to adopt uncontradicted testimony if it is inherently improbable; however, the court cannot disregard uncontradicted testimony as to the existence of some fact or the happening of some event in the absence of something in the case which discredits the testimony or renders it against reasonable probabilities.

*Ashraf v. Ashraf*, 134 Wis. 2d 336, 345, 397 N.W.2d 128 (Wis. Ct. App. 1986). A trial court abuses its discretion when it reaches a decision that goes beyond the evidence. *Cf. Krivanek v. Fibreboard Corp.*, 72 Wn. App. 632, 637, 865 P.2d 527 (1993) (reversing a jury award that was outside the range of the evidence). That is what occurred here.

The Department presented nothing to discredit the testimony of Mr. Reilly or Mr. Lotfi or to render their testimony or analysis not credible or against reasonable probabilities. To the contrary, the Department's own witnesses acknowledged that Mr. Reilly and Mr. Lotfi were both well qualified. Judge Tabor did not question the veracity of their testimony, RP 451, and he understood that their testimony was uncontradicted. RP 445. Nevertheless, he disregarded that evidence and arbitrarily set a market value price that has no support in the record. That decision must be reversed.

**2. The Trial Court Had No Factual or Legal Basis for Departing From the Valuation Evidence.**

In his oral decision, Judge Tabor offered three reasons for adjusting the valuation evidence:

1. His concern that the I.R.C. § 482 arm's length valuation standard has a downward bias because the IRS always favors a lower transfer price in order to maximize taxable income. RP 449-50.
2. His conclusion that, because Tobacco Manufacturing does not sell OTP to unaffiliated purchasers, the market value price must be higher than the price indicated in Mr. Reilly's appraisal. RP 451-52.
3. His belief that "common sense" requires a higher price as compensation for Tobacco Manufacturing's ownership of the brand names. RP 453.

None of these reasons are valid or supported by the evidence.

**a. The arm's length price standard in I.R.C. § 482 is not biased downward.**

Judge Tabor's concern that the I.R.C. § 482 arm's length standard has a downward bias is troubling because it reflects either a lack of understanding of the arm's length standard or a lack of objectivity. The arm's length standard does not have a downward bias. In fact, it is remarkably unbiased.

Judge Tabor apparently believed that the arm's length standard is biased downward because the IRS would always want to minimize the transfer price in order to maximize taxable profits. RP 450. This is not

true. The arm's length standard is most commonly used for establishing internal prices for border-crossing transactions of international corporations. In that application, whether a higher or lower transfer price will benefit (or harm) the IRS depends largely on whether the transaction involves an import or export. A lower transfer price does not always benefit the IRS. There is no one-way bias to the arm's length standard and no evidence to support Judge Tabor's speculation that such a bias exists.

**b. Tobacco Manufacturing and Tobacco Sales' exclusive sales arrangement does not impugn Mr. Reilly's valuation opinion.**

The second factor cited by Judge Tabor as support for his 82¢ value was the fact that Tobacco Manufacturing does not sell directly to unaffiliated distributors. RP 451-52. From this fact Judge Tabor inferred that, (1) Tobacco Manufacturing is not a willing seller, and therefore, (2) the fair market value must be higher than that indicated by Mr. Reilly's appraisal analysis. Neither of these inferences is correct. As discussed *supra* at 21-25, whether Tobacco Manufacturing would sell to other potential purchasers at the market value price is not relevant to the determination of market value. *Port Townsend Southern Railway Co. v. Barbare, supra* ("The . . . unwillingness of the owner to sell does not in the least affect the market value.") It was error for Judge Tabor to even

consider Tobacco Manufacturing's unwillingness to sell to other purchasers.

Tobacco Manufacturing's unwillingness to sell to purchasers other than Tobacco Sales has nothing to do with price or market value for its sales to Tobacco Sales. Instead, that unwillingness is based on the fact that both Tobacco Manufacturing and Tobacco Sales are better off if Tobacco Manufacturing does not sell to others. Their exclusive sales arrangement, however, provides no reason to believe that Mr. Reilly's evaluation of fair market value for the sales to Tobacco Sales was erroneous.

Mr. Reilly explained that the exclusive sales arrangement was irrelevant to his appraisal analysis. RP 168-69. His analysis was based on the hypothetical willing buyer/willing seller transaction that defines market value, not the specific preferences and sales policies of Tobacco Sales and Tobacco Manufacturing. Judge Tabor's disregard of this market value evidence and his focus on the exclusive sales arrangement between Tobacco Manufacturing and Tobacco Sales is inconsistent with the terms of the market value standard and it violates Washington law. *Port Townsend S. Railway Co. v. Barbare*, 46 Wash. 275, 89 P. 710 (1907). Whether a particular property owner is willing to sell at a fair market value price is irrelevant to market value.

c. **“Common sense” and “fairness” do not require an allocation of more profits to Tobacco Manufacturing.**

Judge Tabor’s final reason for disregarding the appraisal evidence was his belief that “common sense” and “fairness” required a higher manufacturer’s price. He explained his thinking as follows:

I understand that . . . no one really quarreled with the way accountants went through the details here and arrive at the 24/76 split, I think *common sense* indicates that if there were a nonaffiliated distributor that U.S. 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 because we just want to deal with you. They don't want to deal with them and it would have to be at a higher level if they were to deal with anybody else.

...

The arm’s length transaction here between two nonaffiliated corporations would take into greater account the trademark value . . . .

[W]hile the scenarios gave what I think Mr. Reilly said was at least in Scenario 1 a rather high percentage for royalty because royalty was important in this case, and that was 5 percent, if you look at how that's calculated, even though that 5 percent royalty is to Manufacturing, when the breakdown ultimately occurs in the percentage that's one of the factors in the residual profits for which there was a 76 to 24 percent split. So Sales & Marketing got 76 percent of residual profits in regard to trademark. *I don't think that's fair.* That's why I'm going with 40/60.

...

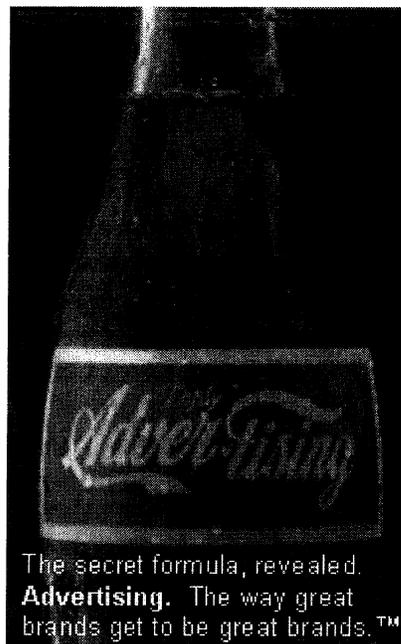
In any event, I feel comfortable in what I’ve done. I think there was evidence as to a 40/60 split and that’s what I’ve determined instead of a 24/76 split.

RP 453–62 (emphasis added). This explanation suggests that Judge Tabor did not understand either the appraisal evidence or the adjustment that he

was trying to make to that evidence.

To begin with, there is no evidence – nor any fact of which a court may properly take judicial notice – to indicate that the 5 percent of gross sales (\$53 million) royalty that Mr. Reilly and Mr. Lotfi allocated for Tobacco Manufacturing’s passive brand ownership was inadequate. Common sense does not require more. Mr. Reilly and Mr. Lotfi recognized that Tobacco Manufacturing’s brands have high value and they assigned a high royalty rate that reflects that judgment. The evidence indicated that premium brand value depends on successful marketing, especially for consumer products such as OTP. RP 190-91; 228; 250-52. Common sense suggests that brand value depends on successful marketing efforts (*see* Illustration 1) and that the party that produces marketing success will command a significant financial reward. There are no facts in the record (or subject to judicial notice) from which

**Illustration 1**



Advertisement for American Advertising Federation appearing in *National Geographic* (March 2004)

Judge Tabor could decide that the 5 percent brand royalty was inadequate or that a passive brand owner could command more.

The trial court's conclusion that a passive brand owner, in the circumstances presented here, could extract a super royalty premium from the sales and marketing company whose efforts create and maintain the brand value is pure speculation. Faced with an excessive royalty demand, a successful sales and marketing company could choose instead to develop its own brand, rather than paying too much to the owner of an existing brand. These questions and issues were not placed in dispute by the evidence because the Department chose not to contest Mr. Reilly's valuation on a factual basis. Our adversarial system relies on the parties to identify the issues in dispute and to present evidence relevant to those issues. Cross-examination and rebuttal are critically important tools for testing the credibility of the evidence in the issues in dispute. Those tools are not available, however, when a trial court makes a decision that goes beyond the issues and evidence presented by the parties.

It is unclear whether Judge Tabor understood the appraisal evidence or the value adjustment that he made. His discussion of profit allocations suggest that he did not understand the difference between the overall profit allocation reflected in appraisal analysis (approximately 40/60 at the 72¢ per can price) and the 24/76 residual profit split. The

24/76 residual profit split was a specific allocation of residual profits that were distributed between Tobacco Manufacturing and Tobacco Sales based on their costs for activities that contribute to intangible value that were not otherwise compensated. RP 70-71, 125-26, 240-43. CP 420-24. This residual split reflects the specific application of the I.R.C. § 482 residual profit split valuation methodology. That methodology is premised on the assumption that the taxpayer will attempt to allocate resources to maximize profits. Judge Tabor's rejection of this approach was based on nothing but an arbitrary gut feeling that the valuation experts were wrong.

Judge Tabor's only explanation for picking a 40/60 split was his statement that "I think there was evidence as to a 40/60 split and that's what I've determined instead of a 24/76 split." RP 459. In fact, Mr. Reilly specifically testified that residual profits should not be allocated based on the overall 40/60 profit allocation ratio. RP 257. Judge Tabor's decision flies in the face of this direct, uncontroverted evidence.

Judge Tabor's comments suggest that he may have thought that Mr. Reilly's appraisal reflected a 24/76 *overall* profit split, and that the purpose of his adjustment was to allocate *overall* profits on a 40/60 basis. *See* RP 453; 456; 463. In fact, at a 72¢ value the 24/76 residual split resulted in an overall profit allocation of 37.3/62.7, very close to the 40/60

split.<sup>20</sup> Instead of achieving a 40/60 split, Judge Tabor's adjustment results in a 50/50 allocation of overall profits. If Judge Tabor's goal was a 40/60 overall profit split, he should have stayed within the evidence and adopted the 72¢ price. CP 440; RP 242-43.

Judge Tabor seemed to think that somehow the brand royalty to Tobacco Manufacturing was subject to the 24/76 residual profit split. RP 459. This, too, is incorrect. The \$53 million royalty profit went entirely to Tobacco Manufacturing and was in addition to the profits allocated under the 24/76 residual profit split. Judge Tabor's misunderstanding of the royalty profit allocation adds to the suspicion that he did not understand the valuation evidence.

Judge Tabor's confusion regarding the evidence was evident when he announced his decision from the bench. He began by declaring that the fair market value of the OTP should be \$1.00 per can. Then, in the middle of explaining his justification for that decision, he realized that he had miscalculated and that his announced rationale did not support his \$1.00 per can value.

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<sup>20</sup> This ratio is calculated from Ex. 8 to the Ernst & Young study. CP 440. The formula (using the line numbers in parenthesis on that exhibit) is:  
Tobacco Manufacturing Profit = [(4)+(11)+(18)]/[(4)+(11)+(18)+(8)+(16)] = 37.3%;  
Tobacco Sales Profit = [(8)+(16)]/[(4)+(11)+(18)+(8)+(16)] = 62.7%.

After a decidedly cool reception to his request to counsel for assistance in recalculating his adjustment, Judge Tabor's final comments captured the courtroom mood and perhaps the real basis for his decision:

Counsel, I'll just tell you that when I rule sometimes people are incredulous and say how can he do that. Well, I did the best I could. If I'm wrong somebody can tell me that. It's happened before. On the other hand, I do recognize that a trier of fact is given a great deal of discretion and courts don't normally review factual determinations except in one narrow area and that's sufficiency of the evidence. One might argue that nobody suggested this particular figure, but I would indicate that I believe that this particular percentage was addressed and I've given you the reasons that I did not feel that the 24/76 percent split was appropriate under these particular facts.

RP 465. Whether Judge Tabor understood the appraisal evidence or the adjustment he made to Mr. Reilly's market value opinion is anybody's guess. What seems apparent is that he wanted a higher tax base and that he was relying on appellate deference, rather than evidence or reasoning, to support that decision.

When a trial court ignores the evidence, it undermines the adversarial system and prejudices the rights of the parties. Neither party had an opportunity (nor would it have been appropriate) to cross-examine Judge Tabor regarding his "common sense" reasoning, or whether he understood the facts and applicable appraisal principles. It would have been futile for Tobacco Sales to try to recall Mr. Reilly to explain why

Judge Tabor's reasoning regarding the exclusive sales arrangement between Tobacco Manufacturing and Tobacco Sales was misguided and contrary to appraisal principles. Nor did Tobacco Sales have an opportunity to question whether Judge Tabor understood the royalty allocation in the appraisal or his basis for believing that the 5 percent royalty was inadequate or subject to the 24/76 residual profit split. When a trial judge goes beyond the evidence, he becomes a shadow advocate for positions that are not subjected to the truth-testing safeguards of cross-examination or rebuttal. Doing so is an abuse of discretion that undermines the rights of the litigants and the fairness of the judicial process.

## **VI. CONCLUSION**

This Court's prior opinion identified the remand issue, and Tobacco Sales' tax liability should be determined based on the evidence and the legal principles set out in that prior opinion. The parties' dispute in this case is a dispute of law, not of fact. It should have been decided on the second cross-motions for summary judgment.

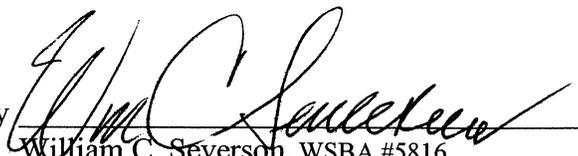
In its prior decision, this Court rejected the Department's arguments that Tobacco Sales' selling price is the measure of the OTP tax. It ruled instead that the tax measure is the manufacturer's established price, but where a manufacturer sells to an affiliate, the actual price must

reflect fair market value. On remand, Tobacco Sales presented clear, authoritative evidence of the fair market value price for its purchases from Tobacco Manufacturing. Rather than contest that evidence, the Department argued that, as a matter of law, the tax should be measured by Tobacco Sales' selling price to unaffiliated purchasers. The Court should decide this legal dispute in Tobacco Sales' favor, reverse the decision of the trial court, and set the tax measure at 72¢ per can, the highest value established by the evidence.<sup>21</sup>

Respectfully submitted this 26<sup>th</sup> day of March, 2004.

GARVEY SCHUBERT BARER

By



William C. Severson, WSBA #5816

Norman J. Bruns, WSBA #16234

Attorneys for Respondent/Cross-Appellant

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<sup>21</sup> Tobacco Sales asks the Court to set the value at the high point shown by the evidence in order to expedite a final decision and to avoid the need for a remand.

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COURT OF APPEALS  
DIVISION II  
OF THE STATE OF WASHINGTON

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McLANE COMPANY, INC. d/b/a McLANE  
NORTHWEST and CORE-MARK  
INTERNATIONAL, INC.,

Appellants,

v.

WASHINGTON STATE DEPARTMENT OF REVENUE

Respondent.

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**BRIEF OF AMICUS CURIAE UNITED STATES  
TOBACCO SALES AND MARKETING COMPANY INC.**

---

**WILLIAM C. SEVERSON, WSBA 5816**  
**NORMAN J. BRUNS, WSBA 16234**  
*Attorneys for Amicus Curiae United States  
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## I. IDENTITY AND INTEREST OF AMICUS

United States Tobacco Sales and Marketing Company Inc. ("Tobacco Sales") is a distributor of tobacco products ("OTP") in Washington and the plaintiff in *United States Tobacco Sales and Marketing Co. Inc. v. Department of Revenue*, 96 Wn. App. 932, 982 P.2d 652 (1999). That case is currently on remand in the Thurston County Superior Court where the issue is measure of the OTP tax on samples that Tobacco Sales distributes in Washington.

In its *Tobacco Sales* decision, this court ruled that the OTP tax measure (i.e., the manufacturer's established price) must be tested against the fair market value standard for transactions involving corporate affiliates. Thus, where an OTP distributor acquires product from an affiliated manufacturer, the price paid to the manufacturer must be compared to fair market value to assure that the affiliates do not set an artificially low price in an effort to evade the OTP tax. *Id.* at 942. The question of whether Tobacco Sale's purchase price from its manufacturing affiliate reflects fair market value is currently before the trial court in the remand proceedings in the *Tobacco Sales* case. Tobacco Sales' interest in appearing as an amicus in this case is to assure that the Department of Revenue does not improperly prejudice this court on that tax measure issue.

## II. ARGUMENT

### The Court Should Ignore The Department's Argument Regarding The Measure Of The OTP Tax.

At several points in its brief, the Department of Revenue acknowledges that the measure of the OTP tax is not at issue in this case. *See, e.g.*, Respondent's Br. at 3 (“[T]he amount of the OTP tax due . . . is not affected by what is at issue in this case.”), 11 (“In the case at bar . . . the *measure* . . . [of the tax is not] directly in dispute.”) and 34-35 (“[T]he instant case does not involve any issue of the OTP tax *measure* . . . ”). Thus, the Department recognizes that the issue in this case is *who* pays the tax, not the *amount* of the tax.

Had the Department confined its argument to the relevant issue in this case, there would be no need for this amicus brief. However, in footnote 4 of its brief, the Department interjects an inappropriate argument regarding the tax measure, urging that the proper measure of the OTP tax is the price at which the plaintiffs (unaffiliated distributors) in this action acquire OTP from Tobacco Sales, rather than the price at which Tobacco Sales acquires OTP from its manufacturing affiliate.<sup>1</sup> The Department asserts that the “*fair market value* [of the OTP] is fixed at the market price

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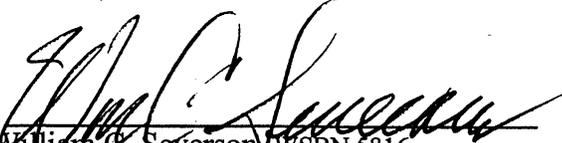
<sup>1</sup> The court should note that the tax measure that the Department argues for in footnote 4 is the very same price that the court rejected as the tax measure in the *Tobacco Sales* decision. *See* 96 Wn. App. at 933-934. The argument in footnote 4 is also the same argument that the Department has advanced in the remand proceedings in the *Tobacco Sale* case.

paid by the first non-affiliated distributor to buy it at a generally available price.” Respondent’s Br. at 4, n. 4. This assertion is not relevant to the issue in this case (i.e., who remits the tax), but it is relevant to the central issue in the remand proceedings in the *Tobacco Sales* case. The issue on remand in that case is whether the price paid by Tobacco Sales to its manufacturing affiliate reflects fair market value. Footnote 4 seems to be an attempt by the Department to prejudice the court on this issue.

The court should ignore footnote 4 of the Department of Revenue’s brief. If, as the Department concedes, the tax measure is not at issue in this case, then the Department’s tax measure argument is irrelevant. Moreover, to the extent that footnote 4 seeks to prejudice the court on an issue that may be presented in a further appeal in the *Tobacco Sales* litigation, it is improper. *See* RPC 8.4(d).

RESPECTFULLY SUBMITTED this 2<sup>nd</sup> day of January, 2001.

**GARVEY, SCHUBERT & BARER**

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STATE OF WASHINGTON  
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DEPUTY

**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**

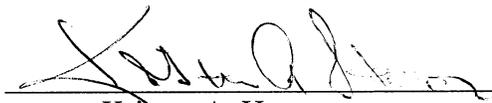
**DECLARATION OF SERVICE**

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 Brief of Respondent/Cross-Appellant, and this Declaration of Service to be served on counsel of record for Appellant at the below-listed address by email attachment and U.S. First Class Mail:

Mr. David M. Hankins  
Assistant Attorney General  
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 26<sup>th</sup> day of March, 2004.

  
\_\_\_\_\_  
Kristen A. Hatton