

77690-3

FILED
JAN 12 2006
CLERK OF SUPREME COURT
STATE OF WASHINGTON
af

NO. 77690-3

SUPREME COURT OF THE STATE OF WASHINGTON

UNITED STATES TOBACCO SALES AND MARKETING COMPANY
INC.,

Petitioner,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE,

Respondent.

BY C. J. HERRITT

CLERK

06 JAN 30 PM 4:05

RECEIVED
SUPREME COURT

**CONSOLIDATED ANSWER TO MEMORANDA OF AMICI
ASSOCIATION OF WASHINGTON BUSINESS, THE COUNCIL
ON STATE TAXATION, THE NATIONAL ASSOCIATION OF
MANUFACTURERS AND THE INSTITUTE FOR
PROFESSIONALS IN TAXATION**

ROB MCKENNA
Attorney General

David M. Hankins, WSBA #19194
Assistant Attorney General
P.O. Box 40123
Olympia, WA 98504-0123
(360) 753-5528

ORIGINAL

TABLE OF CONTENTS

I.	INTRODUCTION.....	1
II.	COUNTER STATEMENT OF THE CASE	1
III.	ARGUMENT	5
	A. The Court of Appeals Decision is Completely Consistent with Widely Accepted Valuation Principles And Does Not Warrant Discretionary Review.	5
	B. The Court of Appeals Decision Does Not Deny Tobacco Sales a Fair, Speedy and Adequate Remedy.....	11
IV.	CONCLUSION	12

TABLE OF AUTHORITIES

Cases

<i>Chicago Milwaukee & St. Paul Railway Co. v. Alexander</i> , 47 Wash. 131, 91 Pac. 626 (1907).....	10
<i>Motor Mill Co, v. Wilson</i> , 128 Wash. 592, 223 Pac. 1041 (1924).....	10
<i>North Coast Railroad Co., v. Newman</i> , 66 Wash. 374, 119 Pac. 823 (1911).....	10
<i>Port Townsend S. Railway Co. v. Barbare</i> , 46 Wash. 275, 89 Pac. 710 (1907).....	10
<i>U.S. Tobacco Sales & Mktg. Co. Inc., v. Dep't of Revenue</i> , 96 Wn. App. 932, 982 P.2d 652 (1999).....	passim
<i>U.S. Tobacco Sales & Mktg. Co. Inc., v. Dep't of Revenue</i> , 128 Wn. App. 426, 115 P. 3d 1080 (2005).....	passim

Statutes

I.R.C. § 482 (2006)	9
RCW 82.32.180	11

Rules

RAP 13.4(b)	10, 12
RAP 13.4(b)(4)	11

I. INTRODUCTION

Amici dramatically claim a fair and speedy trial has been denied in a tax refund lawsuit. In reality, the Court of Appeals gave the taxpayer (Tobacco Sales) instructions on the evidence needed to establish their burden. Despite this instruction, Tobacco Sales chose not to provide the evidence required to meet its burden. Instead, it has persistently provided only the discounted price between its affiliate Tobacco Manufacturing and itself. The remand will establish whether Tobacco Sales is capable of meeting its burden and provide evidence of the fair market value price of its product between unaffiliated entities.

II. COUNTER STATEMENT OF THE CASE

Prior to the 2005 legislative session, the other tobacco product (OTP) tax was measured by the “wholesale sales price” of tobacco products brought into the state.¹ The “wholesale sales price” was defined as “the established price for which a manufacturer sells a tobacco product to a distributor, exclusive of any discount or other reduction.”² In *U.S. Tobacco Sales & Mktg. Co. Inc., v. Dep’t of Revenue*, 96 Wn. App. 932, 982 P.2d 652 (1999) (*Tobacco Sales I*), the Court evaluated the OTP tax’s former statutory definitions and determined that they were unambiguous.³ In evaluating the term “wholesale sales price,” the Court concluded that an

¹ Former RCW 82.26.020(1) (1993). In 2005, the Legislature changed the rate and also the measurement of the OTP tax from “wholesale sales price” to “taxable sales price,” and added statutory definitions for “actual price” and “affiliated” entities such as U.S. Tobacco. See Laws of 2005, ch. 180, § 2 (codified at RCW 82.26.010(12), (13), (18)(a)(i)-(vi), (20) and (21)).

² Former RCW 82.26.010(7) (1995).

³ *Tobacco Sales I*, 96 Wn. App. at 938.

‘established price’ from a manufacturer must be a generally available, stable, fixed price, such as a list price or invoice price.”⁴ The Court further concluded that a manufacturer’s “‘established price’ would be available to all customers and would represent the fair market value of the products.”⁵

The Court reasoned that “because an ‘established price’ is available to all customers, it reflects the fair market value of the products.”⁶ The Court then defined “fair market value” to mean “the amount a willing buyer would pay a seller who is willing but not obligated to sell.”⁷ Since this case involved affiliated companies, the Court held, “In the case of affiliated companies, which, in effect, are obligated to buy and sell from each other, the ‘established price’ must be based upon fair market value rather than the manufacturer’s price to its affiliate.”⁸ The Court on remand directed the trial court to make a factual determination as to whether Tobacco Manufacturing’s price to Tobacco Sales was a fair market price or whether it was a discounted price.⁹

Before the trial court, the Department argued that the “established price” available to all customers, exclusive of any discount reflecting the fair market value for 1992 was the average price of \$1.43 per can.¹⁰ Tobacco Sales argued that the fair market value price was between \$.68

⁴ *Tobacco Sales I*, 96 Wn. App. at 938.

⁵ *Id.* at 940.

⁶ *Id.*

⁷ *Id.* (citations omitted).

⁸ *Id.*

⁹ *Id.* at 941-42.

¹⁰ CP at 134-35.

and \$.72 per can.¹¹ However, Tobacco Sales' price was not available to all customers as required in *Tobacco Sales I*; it was only available between Tobacco Manufacturing and Tobacco Sales. Tobacco Sales' valuation expert, Mr. Reilly, under cross-examination, refused to answer the question whether Tobacco Manufacturing would sell to unaffiliated customers at the same price that it sold its products to Tobacco Sales:

Q: (Mr. Hankins) But you would agree with me, would you not, that if Manufacturing did so [sell] to customers and distributors, it would not sell it at the same price?

A: (Mr. Reilly) I can't agree only and just because that hypothesis is so unreasonable. It's like asking me if Manufacturing set up a factory on Saturn and started shipping to Mercury and then there are customers on the moon who moved to Pluto, what would the price be. That's just such an absurd hypothesis. I just can't answer that.^[12]

The trial court rejected both parties' prices. The trial court determined that the Department's evidence examined the wrong level of trade for the price between Tobacco Sales and an unaffiliated distributor instead of the price between Tobacco Manufacturing and an unaffiliated distributor.¹³ As to Tobacco Sales' evidence, the trial court specifically found Tobacco Manufacturing's selling price to Tobacco Sales was a discounted price and did not reflect the fair market value price for those sales of OTP.¹⁴ The trial court concluded as a matter of law that the transfer prices did not reflect fair market value because Tobacco

¹¹ See Tobacco Sales' Pet. for Discretionary Review at 4.

¹² RP, Vol. II at 232-33.

¹³ RP, Vol. III at 445.

¹⁴ CP at 135.

Manufacturing would not willingly sell to an unaffiliated buyer at that price.¹⁵ The trial court determined that the fair market value for the OTP was \$.82 per can.¹⁶

The Department appealed and Tobacco Sales cross appealed. The Court of Appeals issued a published decision again reversing the trial court and remanding the matter. *U.S. Tobacco Sales & Mktg. Co. Inc., v. Dep't of Revenue*, 128 Wn. App. 426, 115 P. 3d 1080 (2005) (*Tobacco Sales II*). In *Tobacco Sales II*, the Court concluded that substantial evidence did not support the “trial court’s finding of \$.82 as the fair market value[.]”¹⁷ The Court rejected the Department’s argument that the correct measure of the OTP tax was Tobacco Sales’ selling price of an average \$1.43 per can.¹⁸ The Court also rejected Tobacco Sales’ price range of \$.68 to \$.72 per can.¹⁹ The Court stated, “But as discussed in *Tobacco Sales 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.”²⁰ As the Court indicated in *Tobacco Sales I*, the “established price” to measure the OTP tax must be a price available to all customers to reflect the fair market value of the product.²¹ Consistent with this prior ruling, the Court in *Tobacco Sales II* rejected the price championed by Tobacco Sales,

¹⁵ CP at 135; RP Vol. 1 at 452-53.

¹⁶ *Id.* at 134.

¹⁷ *Tobacco Sales II*, 128 Wn. App. at 436.

¹⁸ *Id.* at 431.

¹⁹ *Id.* at 437.

²⁰ *Id.* at 435-36.

²¹ *Tobacco Sales I*, 96 Wn. App. at 940.

because it was not a generally available price between two unaffiliated companies.²² Therefore, the Court remanded the case and directed the parties to present evidence “of the price a *completely unaffiliated entity* would have had to pay to purchase OTP from Tobacco Manufacturing in 1992.”²³

III. ARGUMENT

A. The Court of Appeals Decision is Completely Consistent with Widely Accepted Valuation Principles And Does Not Warrant Discretionary Review.

Attempting to convince this Court to accept discretionary review, amici assert that the latest Court of Appeals decision conflicts with previous appellate decisions on fair market value.²⁴ Such criticisms lack merit. Both *Tobacco Sales I* and *Tobacco Sales II* decisions correctly state and apply the law related to evaluating fair market value. Accordingly, review by this Court under RAP 13.4(b) is not warranted.

The amici contend that the Court of Appeals misapplied the fair market valuation standard, arguing that the Court should not have remanded the case back to the trial court when Tobacco Sales presented evidence of a “fair market value” price per can.²⁵ However, the amici ignore the evidence presented at trial and the trial court’s finding that the price between the affiliates, Tobacco Manufacturing and Tobacco Sales,

²² *Tobacco Sales II*, 128 Wn. App. at 437.

²³ *Id.* at 438 (emphasis in original).

²⁴ See Amicus Curiae Memorandum of Association of Washington Business at 5; Amicus Curiae Memorandum of the Institute For Professionals in Taxation at 4.

²⁵ See Amicus Curiae Memorandum of Association of Washington Business at 7; Amicus Curiae Memorandum of the Institute For Professionals in Taxation at 5.

was a discounted price and not a price that was available to all customers.²⁶ Therefore, consistent with its earlier decision, the Court of Appeals correctly reasoned that this was not an “established price” under the statute, reflecting a fair market value between two companies willing but not obligated to sell to each other.²⁷ Hence, the Court remanded the case for the parties to present evidence as to a price reflecting the fair market value price between “completely unaffiliated entities.”

Furthermore, amici’s criticism of the Court of Appeals appears to rest entirely on amici’s misperception that the Court of Appeals was requiring Tobacco Sales to establish the price at which Tobacco Manufacturing itself would sell the OTP to an unaffiliated entity.²⁸ This misperception is most likely due to the Court of Appeal’s statement that, “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.”²⁹

However, this statement must be put in the context of the Court of Appeals decisions in *Tobacco Sales I & Tobacco Sales II*. In *Tobacco Sales I*, the Court of Appeals had to determine what the manufacturer’s “established price” was exclusive of any discounts. Key to the decision in *Tobacco Sales I* was the determination that an “established price” was a

²⁶ CP at 135; RP Vol. 2 at 231; RP Vol. 2 at 384; RP Vol. 2 at 232-33.

²⁷ *Tobacco Sales II*, 128 Wn. App. at 437; *See also, Tobacco Sales I*, 96 Wn. App. at 940.

²⁸ *See Amicus Curiae Memorandum of the Institute For Professionals in Taxation* at 6; *Amicus Curiae Memorandum of Association of Washington Business* at 4.

²⁹ *Tobacco Sales II*, 128 Wn. App. at 437-38.(emphasis in original)

generally available price. The Court of Appeals reasoned that a price available to all customers represented the fair market value of the products.³⁰ The Court went on to state:

“Fair market value” is the amount a willing buyer will pay a seller who is willing but not obligated to sell. In the case of affiliated companies, which, in effect are obligated to buy and sell from each other, the “established price” must be based upon fair market value rather than the manufacturer’s price to its affiliate.^[31]

Thus, the evidence the Court of Appeals required under *Tobacco Sales I* was evidence of a manufacturer’s price for OTP products the manufacturer would sell to buyers, but was not obligated to sell to buyers.

In *Tobacco Sales II*, the Court of Appeals noted that the valuation evidence provided by Tobacco Sales did not reflect the price that a manufacturer would sell OTP products to buyers it was not obligated to sell to and therefore did not constitute the fair market price of OTP sold between unaffiliated entities.³² As an example, the Court of Appeals cited the testimony of Tobacco Sales’ appraiser where he stated that Tobacco Manufacturing would never sell to another distributor besides Tobacco Sales.³³

³⁰ *Tobacco Sales I*, 96 Wn. App. at 939-40.

³¹ *Id.* at 940. (emphasis added, citations omitted)

³² *Tobacco Sales II*, 128 Wn. App. at 437.

³³ *Id.* at 437, n. 8:

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]?

Tobacco Sales characterizes its relationship to Tobacco Manufacturing as an “exclusive marketing arrangement.”³⁴ Understanding this context, it should be apparent that the affiliation the Court of Appeals in *Tobacco Sales II* is concerned with is the affiliation created by having an exclusive marketing agreement where the manufacturer is obligated to sell its products to a specific marketing company. This exclusive marketing agreement contravenes the requirement from *Tobacco Sales I* that an “established price” is a generally available price reflecting the fair market value a willing buyer would pay a willing seller who is willing but not obligated to sell.³⁵

By valuing the transaction with the exclusive marketing agreement, Tobacco Sales shifted the level of trade from the fair market value price that Tobacco Manufacturing would make its OTP generally available to customers to the fair market value price it would charge a distributor with which it had an exclusive marketing agreement. The evidence Tobacco Sales presented at trial did not establish the price at which Tobacco Manufacturing would sell OTP in the absence of an exclusive marketing agreement. The Court of Appeals properly determined that Tobacco Sales’ evidence was not evidence of the fair

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.

³⁴ Tobacco Sales Petition for Discretionary Review, at 11.

³⁵ See *Tobacco Sales I*, 96 Wn. App. at 939-40.

market value price at which the OTP would have been sold if it were generally available.³⁶

Additionally, regardless of the depth of the analysis performed by Tobacco Sales' valuation experts under I.R.C. § 482 (2006) or the amici's urging of the use of this standard to determine fair market value,³⁷ the Court of Appeals noted this was not a fair market value price between unaffiliated entities as it did not represent a generally available price. Therefore, the Court of Appeals remand to determine what the generally available price would be is not a contradiction of the fair market standard or a rejection of I.R.C. § 482 (2006), but a clarification of the level of trade.

The Court of Appeals is requiring the parties, on remand to provide evidence of the price a completely unaffiliated entity would have had to pay to purchase OTP from Tobacco Manufacturing in 1992. This is not an abandonment of the fair market standard, but rather a clarification that the level of trade at which the OTP is to be valued is the sales by manufacturers to unaffiliated distributors who manufacturing is not obligated to sell to. In other words, the price manufacturers would generally make available to distributors.

The Court of Appeal's remand does not conflict with previous appellate decisions regarding fair market valuation and does not support

³⁶ See *Tobacco Sales II*, 128 Wn. App. at 437.

³⁷ See Amici Curiae Memorandum of the Council on State Taxation and The National Association of Manufacturers, at 4.

review under RAP 13.4(b). The amici cite three decisions involving property condemnation proceedings:³⁸ *North Coast Railroad Co., v. Newman*, 66 Wash. 374-75, 119 Pac. 823 (1911) (testimony as to offers for land in railroad condemnation proceeding held inadmissible); *Port Townsend S. Railway Co. v. Barbare*, 46 Wash. 275, 276, 89 Pac. 710 (1907) (evidence of the unwillingness of a seller to sell property in a condemnation proceeding is inadmissible); and *Chicago Milwaukee & St. Paul Railway Co. v. Alexander*, 47 Wash. 131, 134, 91 Pac. 626 (1907) (another owner's opinion of property in a condemnation proceeding for a right of way constituted error as the correct test of value). These cases are distinguishable, because the present case does not involve a property tax or valuation of property, but the application of an excise tax, which is measured by actual sales.³⁹ A condemnation proceeding by definition does not involve a willing seller. The government or in these cases a railroad takes the individual's property and pays the fair market value price for the property. In that context, it certainly would be irrelevant as to the seller's opinion as to value or willingness or unwillingness to sell its property, because the question is not "when will the sale occur", but "how much". Additionally, the amici cite *Motor Mill Co, v. Wilson*, 128 Wash. 592, 594-95, 223, Pac. 1041 (1924) for the proposition that a property

³⁸ See Amicus Curiae Memorandum of the Institute For Professionals in Taxation at 5; Amicus Curiae Memorandum of Association of Washington Business at 5.

³⁹ See RP Vol. 2, pp. 315-16; pg. 319; pg. 367.

owner's testimony of value is irrelevant to prove fair market value.⁴⁰ Again, this case does not apply. Tobacco Sales must show the price a willing buyer who the seller is not obligated to sell to would pay for the OTP. Therefore, the Court of Appeals decision does not conflict with previous appellate decisions regarding fair market valuation and does not support review under RAP 13.4(b).

B. The Court of Appeals Decision Does Not Deny Tobacco Sales a Fair, Speedy and Adequate Remedy.

Amici assert that Tobacco Sales has been denied a speedy and adequate remedy.⁴¹ In an excise tax refund action under RCW 82.32.180, Tobacco Sales bears the “burden . . . to establish the correct amount of tax.” Tobacco Sales failed to comply with the Court of Appeals decision *Tobacco Sales I*, as it did not present evidence of an “established price” available to all customers. In essence, the Court of Appeals has given Tobacco Sales another “bite of the apple” to meet its burden. The Court of Appeals rejection of Tobacco Sales’ evidence, when Tobacco Sales failed to follow the Court’s instructions, does not warrant review as a substantial public interest under RAP 13.4(b)(4).

⁴⁰ See Amicus Curiae Memorandum of the Institute For Professionals in Taxation at 5; Amicus Curiae Memorandum of Association of Washington Business at 5; The Council on State Taxation and the National Association of Manufacturers at 8.

⁴¹ See Amici Curiae Memorandum of The Council on State Taxation and The National Association of Manufacturers at 6; Amicus Curiae Memorandum of The Institute For Professionals in Taxation at 9; Amicus Curiae Memorandum of Association of Washington Business at 9-10.

IV. CONCLUSION

The amici's criticisms of the decisions of the Court of Appeals lack merit and do not justify discretionary review by this Court under RAP 13.4(b). The Court of Appeals has determined the correct amount of tax must be based on an established price generally available to all customers. Tobacco Sales presented a discounted price that was only available between Tobacco Manufacturing and Tobacco Sales. Therefore, Tobacco Sales chose not to offer evidence to meet its burden of establishing a price that was a fair market price generally available to a willing buyer from a willing seller. Thus, the Court remanded the case for the parties to present evidence as to the price reflecting the fair market value between "completely unaffiliated entities." The petition for discretionary review should be denied.

RESPECTFULLY SUBMITTED this 30th day of January, 2006.

ROB MCKENNA
Attorney General



DAVID M. HANKINS,
WSBA No. 19194
Assistant Attorney General
Attorneys for Respondent