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County of San Francisco

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Superior Court of California
County of San Francisco

CLERK OF THE COURT
BY: AUDREY HUIE
Deputy Clerk

U.S. SMOKELESS TOBACCO
BRANDS INC.,

Plaintiff(s)

vs.

STATE BOARD OF
EQUALIZATION,

Defendant(s)

Case Number: CGC-07-463592

AMENDED CERTIFICATE
OF MAILING
(CCP 1013a (4))

I, **Audrey Huie**, a Deputy Clerk of the Superior Court of the County of San Francisco, certify that I am not a party to the within action.

On **April 12, 2010** I served the attached **Decision after Nonjury trial** by placing a copy thereof in a sealed envelope, addressed as follows:

AMY L. SILVERSTEIN, ESQ.
55 HAWTHORNE STREET, STE. 440
SAN FRANCISCO, CA 94105

JOYCE E. HEE
SUPERVISING DEPUTY ATTORNEY
GENERAL, OFFICE OF THE ATTORNEY GENERAL
1515 CLAY STREET, 20TH FLOOR
P.O. BOX 70550
OAKLAND, CA 94612-0550

and, I then placed the sealed envelopes in the outgoing mail at 400 McAllister Street, San Francisco, CA. 94102 on the date indicated above for collection, attachment of required prepaid postage, and mailing on that date following standard court practices.

Dated: April 12, 2010

CLERK OF THE COURT

By: Audrey Huie
Audrey Huie, Deputy Clerk

1 Prepared by the Court

FILED
Superior Court of California
County of San Francisco

MAR 23 2010

CLERK OF THE COURT
BY: *Andray Jones*
Deputy Clerk

8 **SUPERIOR COURT OF CALIFORNIA**
9 **County Of San Francisco**

10 Department No. 604

12 U.S. SMOKELESS TOBACCO BRANDS,
13 INC.,
14 Plaintiff,

Case No.: CGC 07-463592

14 vs.

DECISION AFTER NONJURY TRIAL

15 STATE BOARD OF EQUALIZATION,
16 Defendant.

19 **Introduction**

20 Plaintiff U.S. Smokeless Tobacco Brands, Inc. (UST Sales), formerly known as United
21 States Tobacco Sales and Marketing Company, Inc., brought this timely action seeking a refund
22 of excise taxes it paid pursuant to the Cigarette and Tobacco Products Tax Law, Rev. & Tax.
23 Code §30001 et seq. (the Tobacco Tax Law). Hereafter all code sections refer to the Rev. &
24 Tax. Code unless otherwise indicated. The defendant is the State Board of Equalization (SBE),
25

1 an agency of the State of California that is empowered to assess and collect taxes and to make
2 refunds of overpayments under the Tobacco Tax Law. UST Sales seeks a refund of taxes it paid
3 for the period January 1, 1994 through November 30, 1996 (the Relevant Period).

4 During the Relevant Period UST Sales provided free samples of its non-cigarette tobacco
5 products – referred to in the Tobacco Tax Law as “tobacco products” (§30121(b)) and by the
6 parties as other tobacco products (OTP) – to individuals in California at various events such as
7 rodeos and automobile races. The OTP involved in this case is principally moist snuff, which
8 was sold in cans under the brand names of Copenhagen and Skoal. The parties agree that the
9 provision of these free samples triggers an excise tax payable by UST Sales under §30123(b).

10 That subdivision provides, in relevant part: “There shall be imposed upon every distributor a tax
11 upon the distribution of tobacco products, based on the wholesale cost of these products.” The
12 parties disagree about what constitutes “wholesale cost” for determination of the amount of taxes
13 owed by UST Sales for its provision of the free samples. Moreover, if I adopt a construction of
14 the phrase “wholesale cost” favorable to UST Sales, the parties further disagree whether UST
15 Sales has met its burden of proving the wholesale cost of the free samples it distributed during
16 the Relevant Period.

17 The parties only dispute the tax “basis” of the OTP samples distributed by UST Sales
18 during the Relevant Period. Significantly, the parties do not dispute whether those samples are
19 taxable, the amount of the samples distributed by UST Sales, or the “rate” at which those
20 samples are taxed. Once the tax basis is determined, the amount of tax that UST Sales is
21 obligated to pay is calculated by the number of samples distributed by UST Sales during the
22 Relevant Period multiplied by the tax basis of those samples multiplied by the tax rate.

1 **Trial and Agreed Post-Trial Procedure**

2 This case was assigned to me for a nonjury trial. UST Sales appeared by its counsel Amy
3 Silverstein and Edwin Antolin. SBE appeared by Deputy Attorney General Julian Standen. The
4 trial was held over the course of four days in September 2008. The parties submitted two
5 stipulations regarding agreed facts entitled "Stipulation of Facts" dated April 2, 2008 and
6 "Second Joint Stipulation of Facts" filed September 8, 2008. Four witnesses – Stuart Harden,
7 Hoy Carman, William Kimsey and Rosemary Coates – testified in person at the trial. In addition,
8 pursuant to the parties' stipulations, three other witnesses – Kenneth Tamaro, Elizabeth Galvin
9 and Dov Seewald – provided testimony in the form of declarations under penalty of perjury.

10 Numerous exhibits were submitted by the parties, which are identified in documents
11 entitled "Plaintiff's Exhibit List" and "Defendant's List of Exhibits," both of which are dated
12 September 29, 2008. Per letters sent by counsel for both UST Sales and SBE also dated
13 September 29, 2008, with a few specified exceptions, the parties stipulated to the admissibility of
14 all the exhibits identified in the two exhibit lists, while preserving "the right to contest the
15 relevancy of the exhibits." By letter dated October 6, 2008 from Mr. Standen, SBE objected to
16 the admissibility of UST Sales' exhibit L (entitled "Supplemental Affidavit of Dov Seewald") on
17 the ground that it is untimely. Because SBE was subsequently given a full opportunity to contest
18 to respond to Exhibit L and UST Sales provided testimony authenticating that exhibit and
19 otherwise establishing its admissibility, SBE's objection to Exhibit L is overruled and Exhibit L
20 is admitted into evidence. For clarity of the record, the two exhibit lists and three letters
21 referenced in this paragraph were filed.

22 The parties and I agreed to a procedure to bring this case to a conclusion. That procedure
23 provided for my issuance of a tentative decision, the parties' filing further briefs, and another
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1 hearing. The agreed procedure also provided the parties an opportunity to request that they be
2 allowed to introduce further evidence.

3 In April 2009 I issued a tentative decision which largely favored the position of UST
4 Sales. Not surprisingly, then, in the parties' briefs filed after the issuance of the tentative decision
5 SBE argued that the tentative decision was wrongly decided and UST Sales took the opposite
6 view. A hearing was held on August 12, 2009 where I rejected all of the arguments made by SBE
7 regarding the tentative decision except for the argument that UST Sales had failed to prove that it
8 actually purchased OTP from UST Manufacturing at the price that it contended it paid for the
9 OTP. In accordance with the agreed post-trial procedure, I then set a hearing on that issue.

10 A short evidentiary hearing solely on the issue of the price that UST Sales purchased the
11 OTP from UST Manufacturing was held on December 15, 2009. At the outset of the hearing
12 SBE filed written objections to UST Sales' Exhibits I, J, K and L. At the hearing UST Sales
13 called two witnesses, John Miscioscia and Dov Seewald, both of whom were examined by each
14 party. UST Sales also offered three new exhibits into evidence, general ledgers and
15 accompanying schedules for the years 1994, 1995 and 1996 respectively, marked as M through
16 O, all of which I admitted over SBE's objections.

17 Because of concerns that SBE had not been provided adequate notice of the testimony of
18 Mr. Miscioscia and Mr. Seewald and it did not have adequate opportunity to review Exhibits M,
19 N and O, at the conclusion of the hearing I gave SBE the opportunity to conduct further cross-
20 examination of Mr. Miscioscia and Mr. Seewald and to call its own witnesses regarding exhibits
21 M, N and O at a mutually agreeable later date. By email dated December 18, 2009, SBE's
22 counsel stated that SBE did not wish to conduct any further cross-examination or introduce any
23 further testimony. Based on the evidence adduced at the December 15 hearing, I now overrule
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1 SBE's objections to Exhibits I, J, K and L. Accordingly, I took the case under submission as of
2 December 18, 2009.

3 Since taking the case under submission, I have done another full review of all of the
4 parties' arguments and the admissible evidence and have concluded that the tentative decision
5 was correct in all respects. Accordingly, with a few exceptions the remainder of this decision is a
6 verbatim repetition of what was in the tentative decision.

7 **Pertinent Stipulated Facts**

8 As noted previously, the parties submitted two stipulations of fact. In one area – the price
9 charged to UST Sales for OTP samples – SBE offered evidence at the trial contrary to some of
10 the facts in the stipulations. However, at no time did either party seek to withdraw from the
11 stipulations or contend that the stipulations were not entered into freely. Under long-settled
12 principles, then, those stipulations are binding on the parties as well as on me as the trier of fact.
13 (*See, e.g., CACI 5002* (the attorneys for both sides have agreed that certain facts are true ... and
14 you must accept those facts as true"); *Mercedes-Benz Corp. Credit Corp. v. Johnson* (2003) 110
15 Cal. App. 4th 53, 59; *Times Mirror Co. v. Franchise Tax Board* (1980) 102 Cal. App. 3d 872,
16 877 (tax agency "is bound by the facts stipulated to, as is the court, even in tax matters");
17 *Mooney v. Pickett* (1972) 26 Cal. App. 3d 431, 437). The pertinent facts from those stipulations
18 are recited here.

19 During the Relevant Period both UST Sales and U.S. Smokeless Tobacco Manufacturing
20 Company (UST Manufacturing), formerly known as United States Tobacco Manufacturing
21 Company Inc., were wholly-owned subsidiaries of U.S. Smokeless Tobacco Company (Parent
22 Corporation), formerly known as United States Tobacco Company.

23 During the Relevant Period UST Sales purchased OTP exclusively from its sister
24 corporation UST Manufacturing. Conversely, all OTP manufactured by UST Manufacturing was
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1 sold to UST Sales. Stated another way, UST Manufacturing was the sole source of OTP for UST
2 Sales, and UST Sales was UST Manufacturing's sole customer for OTP in the United States.

3 During the Relevant Period, except for its sales of OTP to UST Sales, UST
4 Manufacturing did not engage in any sales or marketing activities. UST Manufacturing did not
5 employ any sales representatives nor did it have any field sales offices.

6 UST Sales purchased OTP for the purpose of reselling it to its customers or distributing it
7 as samples to adult individuals. Typically UST Sales' customers were independent tobacco
8 distributors, not affiliated with UST Sales.

9 UST Manufacturing sold "marked samples" (i.e. on the samples themselves there was an
10 indication that they were samples) to UST Sales. While most of the OTP samples that UST Sales
11 distributed to individuals during the Relevant Period were marked samples, UST Sales also
12 distributed some "unmarked samples" (i.e. samples that bore no indication of being samples) to
13 individuals during the Relevant Period.

14 UST Manufacturing sold unmarked samples to UST Sales at the same price that it sold
15 OTP to UST Sales intended for resale by UST Sales to its customers. Apparently due to
16 terminology used for federal income tax purposes, the parties have referred to this price as the
17 "Transfer Price" (i.e. the price at which OTP was transferred from UST Manufacturing to UST
18 Sales). The Transfer Price was 72.9 cents per can at the beginning of the Relevant Period and
19 80.7 cents per can at the end of the Relevant Period. UST Manufacturing sold marked samples to
20 UST Sales at a significantly lower price than the Transfer Price. Although UST Sales sold
21 approximately fifteen different varieties of OTP during the Relevant Period (e.g. Skoal Long Cut
22 Classic and Skoal Long Cut Straight), the Transfer Price for all the varieties was the same
23 throughout the Relevant Period.

1 The price at which marked samples were sold will be referred to as the “Marked Samples
2 Price.” The Marked Samples Price was calculated as the cost of manufacturing the OTP,
3 including tobacco, packaging materials and overhead. The lower price for marked samples than
4 for other OTP “reflected ... [the] compromised marketability [of the marked samples], i.e. they
5 could not be sold, and were not sold, to third-party customers.” (Stip. of Facts ¶2). Unlike the
6 Transfer Price, there were some differences in the Marked Samples Price among varieties. The
7 Marked Samples Price ranged from 17.3 cents to 29 cents per can at the beginning of the
8 Relevant Period and from 16.6 cents to 29.5 cents per can at the end of the Relevant Period.

9 UST Sales sold OTP to its customers at a set price which the parties have referred to as
10 the “Extended List Price” (List Price). The List Price was \$1.70 per can at the start of the
11 Relevant Period and \$1.96 per can at the end of the Relevant Period. The List Price, like the
12 Transfer Price, was the same for all varieties of OTP.

13 **Pertinent Facts Not in Dispute**

14 Although not within the parties’ stipulations, other pertinent facts are not in dispute and
15 are briefly recited here.

16 Prior to 1990 the operations of UST Sales and UST Manufacturing had been combined in
17 a single corporate entity. In or about 1990 UST Sales and UST Manufacturing “split off” from
18 each other and were separately incorporated. As separate corporations, UST Sales and UST
19 Manufacturing had separate boards of directors and each maintained its own places of business
20 and had its own employees. However, during the Relevant Period the Parent Corporation
21 exercised control over both UST Sales and UST Manufacturing, at least to the extent that it was
22 able to determine the Transfer Price that applied to transactions between UST Sales and UST
23 Manufacturing.

1 The principal function of UST Manufacturing is the manufacture of OTP from raw
2 tobacco materials. During the Relevant Period UST Manufacturing employed approximately 700
3 employees, all of whom performed manufacturing-related tasks.

4 The principal functions of UST Sales are the sales and marketing of OTP that it
5 purchased from UST Manufacturing. During the Relevant Period UST Sales employed
6 approximately 800 employees and had numerous sales offices and sales field locations
7 throughout the United States. UST Sales sold OTP only to distributors. It did not make any retail
8 sales. UST Sales did not perform any manufacturing functions.

9 Because all of the sales of OTP that UST Sales made to its customers during the Relevant
10 Period occurred outside California, UST Sales did not owe or pay any tax under the Tobacco Tax
11 law on those sales during the Relevant Period. If UST Sales' customers distributed the OTP they
12 purchased from UST Sales in California, those customers paid tax per §31023(b) on those sales
13 based on the List Price, the price they paid to UST Sales for that OTP, excluding any discounts
14 off the List Price.

15 During the Relevant Period unmarked samples of the same variety sold by UST
16 Manufacturing to UST Sales were indistinguishable from the OTP of the same variety sold by
17 UST Manufacturing to UST Sales for the purpose of resale to UST Sales' customers. Marked
18 samples differed in appearance from unmarked samples and OTP of the same variety intended
19 for resale to UST Sales' customers only to the extent of the markings, but in all other respects –
20 including the quantity, quality and packaging of the OTP – the marked samples were
21 indistinguishable from the other OTP of the same variety.

22 During the Relevant Period the Transfer Price and Marked Samples Price at which US
23 Manufacturing sold OTP to UST Sales were not reduced or discounted for any reason. These
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1 prices were established among the two companies and the Parent Corporation for a set period of
2 time (typically but not always one year) and did not vary during the set period.

3 The Transfer Price was determined based on an annual "financial model" that, from the
4 perspective of the Parent Corporation, was intended to be a proxy for a market-based (or arm's-
5 length) price that the OTP would have been sold at had there been no corporate relationship
6 between UST Manufacturing and UST Sales. As pertinent here, the financial model was
7 essentially a budget of the total revenues of OTP expected to be sold by UST Sales and an
8 allocation of that revenue between UST Manufacturing and UST Sales based on the costs
9 incurred by and profits attributable to each company. Thus, the Transfer Price was intended to
10 reflect the cost (including overhead) of manufacturing the OTP incurred by UST Manufacturing
11 plus a profit attributable to the work of UST Manufacturing.

12 UST Manufacturing, UST Sales, the Parent Corporation and their corporate affiliates
13 used the Transfer Price in their financial books and records including, where relevant, documents
14 required to be filed with tax authorities. The Transfer Price was not developed or used solely or
15 primarily for determination of tax due under the Tobacco Tax Law.

16 As noted previously, the List Price was more than 100% greater than the Transfer Price
17 during the Relevant Period. From the perspective of the Parent Corporation, the List Price was
18 intended to recover the costs incurred by both UST Manufacturing and UST Sales as well as
19 achieve a profit attributable to the work of both companies. Because the OTP sold by UST Sales
20 to its customers was sold under arm's length circumstances between unrelated parties, the List
21 Price represents the fair market value of the OTP at the level of trade between the UST Sales and
22 its customers.

23 Considered together, UST Manufacturing and UST Sales performed all the functions –
24 manufacturing, sales and marketing – typically performed by a manufacturer of tobacco
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1 products. In the tobacco industry it is typically the manufacturer, not someone later in chain of
2 distribution, who distributes free samples. Had the two companies been combined as they were
3 prior to 1990 and all other things remained unchanged, there would have been no need for either
4 a Transfer Price or Marked Samples Price and the hypothetical combined company (hereafter
5 UST Manufacturing/Sales) would have sold OTP to its customers at the List Price and would
6 have distributed free samples.

7 **Neither the Tobacco Tax Law Nor Application of Sham or Alter Ego Principles Require**
8 **that the Separate Corporations of UST Manufacturing and UST Sales Be Disregarded.**

9 There is nothing in the Tobacco Tax Law that requires that transactions between
10 corporate affiliates be disregarded for purposes of that statute. For instance, nothing in the
11 Tobacco Tax Law imposes any obligation on related companies to file a “unitary” or
12 “consolidated” return regarding the distribution of OTP or otherwise to ignore the separate
13 corporate status of related corporations. In this regard, the Tobacco Tax Law and the State of
14 Washington excise tax on tobacco products are identical, and under both statutes the separate
15 existence of UST Manufacturing and UST Sales is recognized. (*United States Tobacco Sales and*
16 *Marketing Company Inc. v. State of Washington, Department of Revenue* (Wash. App. 1999) 982
17 P.2d 652, 657) (“*U.S. Tobacco P*”) (“The statute makes no distinction between affiliated and
18 nonaffiliated entities” and thus, for purposes of the excise tax on OTP samples distributed by
19 UST Sales, UST Manufacturing is the manufacturer/seller of the OTP and UST Sales is the
20 distributor/buyer of the OTP)).

21 The general rule in California on tax matters is that, absent statutory language requiring
22 or permitting it, the separate corporate status of corporate affiliates is disregarded only when the
23 transaction at issue is shown to be a sham and/or common law alter ego (aka piercing corporate
24 veil) principles warrant disregard of the separate entities. (See, e.g., *H.A.S. Loan Service, Inc. v.*
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1 *McColgan* (1943) 21 Cal. 2d 518, 521; *Northwestern Pacific Railway Co. v. State Board of*
2 *Equalization* (1943) 21 Cal. 2d 524, 530-31; *Roscoe Terrace v. City of Los Angeles* (1985) 170
3 Cal. App. 3d 559, 568-69; *Mapo, Inc. v. State Board of Equalization* (1975) 53 Cal. App. 3d 245,
4 248; *Rexall Drug Co. v. Peterson* (1952) 113 Cal. App. 2d 528, 530). SBE did not contend, nor
5 is there any evidence, that the sales of OTP by UST Manufacturing to UST Sales were sham
6 transaction or that the separate corporate status of UST Manufacturing and UST Sales during the
7 Relevant Period should be disregarded due to alter ego principles. Review of the principles
8 discussed in the case law cited in this paragraph discloses no basis under California law to
9 disregard the separate corporations of UST Manufacturing and UST Sales for purposes of
10 determining the tax basis of the OTP samples distributed by UST Sales during the Relevant
11 Period.

12 **The Provisions of the Tobacco Tax Law Applicable to the “Distribution” of Free Samples**
13 **of OTP.**

14 It is useful to walk through the Tobacco Tax Law to understand how that statute, as it
15 existed during the Relevant Period, applied to the distribution of free samples of OTP.

16 As initially enacted in 1959, the Tobacco Tax Law applied only to cigarettes. (*California*
17 *Association of Retail Tobacconists v. State of California* (2003) 109 Cal. App. 4th 792, 836). In
18 November 1988 the voters passed Proposition 99, which, among other things, made distribution
19 of OTP taxable under the Tobacco Tax Law. (*Id.* at 837; *see generally Kennedy Wholesale, Inc.*
20 *v. State Board of Equalization* (1991) 53 Cal. 3d 245 (rejecting a constitutional challenge to
21 Proposition 99)). As a result of the passage of Proposition 99, the following provisions of the
22 Tobacco Tax became effective in 1989 and remained in effect throughout the Relevant Period:

23 -- §30123(b) imposed a tax on every “distributor” of OTP.
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1 -- §30111(b) defined “distributor” to include anyone who engages in the
2 “distribution” of OTP after January 1, 1989.

3 -- §30008 defined “distribution” to include not only the sale of OTP, but also the
4 “use or consumption” of OTP in California.

5 --§30009 defined “use or consumption” to include the “exercise of any right or
6 power over ... [OTP] incident to the ownership thereof.”

7 The parties have stipulated, and it seems to me correctly so, that the provision of free
8 samples of OTP by UST Sales to individuals in California during the Relevant Period constituted
9 “use or consumption” within the meaning of §30009. Therefore, as a result of §30008 and
10 §30111(b), UST Sales was a “distributor” within the meaning of §30123(b) and subject to the tax
11 imposed by that section when it provided free samples to individuals in California. (*Accord* 18
12 Cal. Admin. Code §4081 (SBE regulation promulgated under the authority of the Tobacco Tax
13 Law stating that “The giving away in this state of untaxed ... tobacco products is a taxable
14 distribution”)).

15 Although there is no dispute that the provision of free OTP samples in California is
16 taxable under the Tobacco Tax Law, it is noteworthy that the statute contains only a single
17 mention of samples and it does so in a section (§30108) that has not application to this case. (*See*
18 *California State Board of Equalization v. Chemehuevi Indian Tribe* (1985) 474 US 9 (pre-
19 Proposition 99 case construing §30108 in the context of distribution of cigarettes by an Indian
20 Tribe immune from California taxation)). Nor, despite fairly extensive analyses of Proposition 99
21 that are available on-line or in legal and health science journals, could I find any materials
22 suggesting that anyone – the drafters of Proposition 99, its proponents or opponents – gave any
23 consideration to the fact that Proposition 99 made distribution of OTP samples taxable. Nor have
24 the parties cited to any such materials.

1 However, one thing is clear about the treatment of samples under the Tobacco Tax Law,
2 which existed before the passage of Proposition 99 and was unaffected by that initiative: the tax
3 basis of samples is the same as the tax basis of all taxable distributions of tobacco. This is the
4 result of the excise tax being imposed on “distribution” (§31023(a) and (b)) and “distribution”
5 defined to include both sales of tobacco and the non-sales activities of “use or consumption”
6 (§30008(a) and (b)), the latter being defined broadly enough to include provision of samples.
7 (§30009). (See generally *United States v. 4,432 Mastercases of Cigarettes, More or Less* (9th Cir.
8 2006) 448 F. 3d 1168, 1186-87 (rejecting the argument that “distribution” as defined in §30008
9 should be limited only to sales)). In the case of cigarettes, whether sold or given away as
10 samples, the tax is based on the same per-cigarette amount. (§30123(a)). In the case of OTP,
11 whether sold or given away as samples, the tax basis is the “wholesale cost” of the OTP.
12 (§30123(b)).

13 Because the Tobacco Tax Law establishes the same tax basis for OTP that is sold by a
14 distributor as it does for OTP that is given away for free by that same distributor, it is important
15 to realize that, as to many issues regarding tax basis under the Tobacco Tax Law, the method of
16 distribution is irrelevant. Thus, only after I spent a great deal of time thinking about the
17 economic and other consequences of imposing a tax on a transaction that resulted in no direct
18 revenue, did I realize that most of the issues raised by this case are unaffected by the fact that the
19 taxable transactions were the provision of free samples. Indeed, except for the difference in price
20 charged by UST Manufacturing for marked and unmarked samples, the exact same issues would
21 still need to be resolved – and would be resolved in the same way – had the OTP at issue in this
22 case been sold, instead of given away, by UST Sales in California.

1 **Even Though it is Not What is Commonly Understood by the Phrase “Wholesale Cost,” the**
2 **Transfer Price and the Marked Samples Price are the “Cost ... to the Distributor” of the**
3 **OTP Samples Distributed by UST Sales, as that Latter Phrase is Used in Section 30017.**

4 It is, of course, a basic tenet of statutory construction that when a term is defined in a
5 statute, the definition given in the statute, and not the ordinary meaning of the term, must be
6 given effect. (*Dixon v. Superior Court* (2009) 170 Cal. App. 4th 1271, 1276). Because the phrase
7 “wholesale cost” used in §31023(b) is defined in §30017, the definition in §30017, not the
8 ordinary meaning of the phrase “wholesale cost,” is what determines the meaning of that phrase
9 for purposes of §31023(b). This simple but critical point requires the rejection of SBE’s
10 argument that, in keeping with the commonly understood meaning of “wholesale cost,” the List
11 Price (i.e. the price paid by wholesalers) is the “wholesale cost” of the OTP samples distributed
12 by UST Sales.

13 §30017 defines “wholesale cost” as the “cost of tobacco products [OTP] to the distributor
14 prior to any discounts or trade allowances.” (Emphasis added.) In this section I will focus only
15 on the first portion of this definition (i.e. “cost ... to the distributor”), deferring until the next two
16 sections the remainder of the definition (i.e. “prior to any discounts or trade allowances”).

17 By using the words “cost ... to the distributor,” the definition of wholesale cost in §30017
18 necessarily focuses on the level of trade of the distributor and the “wholesale cost” will vary
19 depending on where that distributor is in the point in the chain of distribution. Thus, for instance,
20 under §30017 there would likely be a different and smaller “wholesale cost” for a large national
21 distributor who re-sells only to regional distributors than for a local distributor who receives OTP
22 after it has passed through the hands (or at least legal title of) several larger distributors. Truly,
23 then, the first part of §30017 establishes the tax basis as “distributor cost,” which may or may
24 not, depending on where the distributor is in the point of distribution, be the same as what is
25 commonly understood by the phrase “wholesale cost.” (*Accord* §30016(b) (“wholesaler” defined

1 as anyone who makes “sales for resale” of OTP and thus potentially includes manufacturers and
2 others who are not normally considered “wholesalers”). *see also R.J. Reynolds Tobacco Co. v.*
3 *Shrewry* (9th Cir. 2004) 423 F.3d 906, 913 (while a “distributor” of cigarettes for purposes of the
4 Tobacco tax Law will usually be a someone who is traditionally considered a wholesaler, it also
5 includes a manufacturer)).

6 Despite the generally understood distinct concepts of manufacturer and wholesaler, in
7 some circumstances the wholesale cost for purposes of §30017 is the manufacturer’s cost.
8 Indeed, typically it is a manufacturer, not a wholesaler (or, as here, a separately incorporated
9 sales and marketing company) who distributes OTP samples, as SBE’s own regulation suggests.

10 (18 Cal. Admin. Code §4081 (“the manufacturer giving away such sample ... tobacco products
11 must report the distribution...”).

12 The key word in §30017 is “to.” In context, the word “to” establishes that the relevant
13 cost is the price charged **to** the distributor for the purchase of the OTP, which excludes any costs
14 **incurred by** the distributor after it purchased the OTP. This point was emphasized in both of the
15 Washington Court of Appeals decisions in the context of the sale of OTP by a manufacturer, and
16 the discussion on this point is fully applicable here, notwithstanding the differences in the
17 California and Washington statutes in other material respects. (*See especially U.S. Tobacco I,*
18 *982 P. 2d at 658* (“The statute imposes the tax ... measured at the time the manufacturer sells the
19 products. This price will reflect the quality, quantity, packaging, and trademark value of the
20 products as provided by the manufacturer ... But it need not include value that is added to the
21 products after the manufacturer sells them”)). This point was also the primary rationale for a
22 legal opinion from an SBE tax counsel concerning whether packaging costs of OTP are included
23 in the definition of “wholesale cost” for purposes of §30017. (Plaintiff’s Exhibit F
24 (memorandum dated April 20, 1999 from Susan Y. Bennett) (“packing charges invoiced to
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1 distributors ... are included in the wholesale cost [but] ... the distributors' repackaging charges
2 ... need not be included in the wholesale cost [because] repackaging charges are not part of
3 the cost ... 'to the distributor' since the distributor incurs the charges after receipt of the" OTP)).

4 Had the samples at issue in this case been distributed prior to 1990, when the functions of
5 UST Manufacturing and UST Sales were combined in one company, the "cost ... to the
6 distributor" of the samples would have been the cost of those samples to the combined company
7 prior to any costs incurred in the operations of the combined company, which is presumably little
8 more than the cost of the raw tobacco. Viewed in this light, the separate incorporation of UST
9 Manufacturing and UST Sales results in a higher "cost ... to the distributor" than when the
10 functions were combined into one company because with separate corporations, the sale from
11 one corporation to the other focuses on the cost to the second corporation, which of necessity is a
12 greater amount than the cost to the first corporation alone. This is because with separate
13 corporations the cost to the second corporation (UST Sales) includes the cost for the functions
14 performed by the first (UST Manufacturing), even though if the functions of the two
15 corporations were combined the "cost ... to the distributor" would exclude any costs for the
16 functions of the combined company.

17 SBE's argument that the List Price is the "cost ... to the distributor" is mistaken for two
18 related reasons. First, the List Price is the "cost" of the OTP to UST Sales' customers, not the
19 cost of the OTP to UST Sales. Second, the List Price includes the cost of sales and marketing
20 functions and profit on those functions that occur after the sales of OTP from UST
21 Manufacturing to UST Sales. (See *U.S. Tobacco I*, 982 P.2d at 658) (under State of Washington
22 excise tax statute, the List Price of OTP is not the manufacturer's sales price because the List
23 Price includes sales and marketing functions of UST Sales that occur after the sale of OTP from
24 UST Manufacturing to UST Sales); *United States Tobacco Sales and Marketing Company, Inc.*

1 *v. Washington State Department of Revenue* (Wash. App. 2005) 115 P. 3d 1080, 1083) (UST
2 Sales “increased the value of the OTP through an array of activities including sales, marketing,
3 promotions, product sampling, and distribution. Thus, we reiterate that it is not appropriate to
4 measure the value of OTP sold by” UST Manufacturing “by the price” UST Sales “sold to
5 independent distributors”)).

6 It follows from the foregoing that I also reject SBE’s argument that the List Price is the
7 “cost ... to the distributor” because UST Manufacturing is not and cannot be viewed as a true
8 manufacturing company due its lack of sales and marketing functions. This argument, taken to its
9 logical conclusion, seeks to disregard the separate corporate status of UST Manufacturing and
10 UST Sales, which is contrary to the general rule respecting separate incorporations that was
11 discussed earlier in this decision. Moreover, wholly apart from alter ego or sham principles,
12 SBE’s argument would, if accepted, would result in a determination of “cost ... to the
13 distributor” based on the cost to a combined UST Manufacturing/Sales (i.e. the same as the cost
14 to UST Manufacturing if the corporations are treated separately), not on the List Price, which is
15 the cost to the independent distributors who, under this scenario, would be deemed to purchase
16 OTP from UST Manufacturing/Sales.

17 SBE argues that “wholesale cost” as used in §31023(b) should be construed to mean “fair
18 market value,” just as the first Washington Court of Appeal decision construed the phrase
19 “wholesale sales price” to mean “fair market value.” Even though the parties put this case on
20 hold for years pending the conclusion of the Washington litigation because they believed that
21 litigation would be instructive to this resolution of this case, the differences between the
22 language of the Tobacco Tax Law and the language of the Washington statute require that the
23 two statutes be construed dissimilarly. Focusing on the statutory definition of “wholesale sales
24 price” as “the established price ... a manufacturer sells a tobacco product to a distributor,” the
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1 first Washington decision determined that the phrase “established price” required that the
2 Washington tobacco tax be “based upon fair market value rather than the manufacturer’s price to
3 its affiliate.” (*U.S. Tobacco I*, 982 P. 2d at 657). In contrast, §30017 does not define “wholesale
4 cost” to mean “established price,” nor is there any word or phrase in that section that connotes
5 fair market value. Had the drafters of that section intended to import a fair market value concept
6 into §30017, it would have been easy for them to do so. Instead, the phrase “cost ... to the
7 distributor” without any modifier for the word “cost” unmistakably evinces the intent to define
8 “wholesale cost” as the actual cost of the OTP sold to the distributor who is subject to the tax
9 imposed by §31023(b). Even if, contrary to my own view, that phrase could reasonably be read
10 to convey other meanings (such as fair market value) besides actual cost, I would still be
11 compelled to interpret the phrase in favor of UST Sales. (*Agnew v. California State Board of*
12 *Equalization* (1999) 21 Cal. 4th 310, 330 (“if there is ambiguity in a tax statute, the ambiguity
13 must be resolved in favor of the taxpayer”)).

14 SBE’s argument that the List Price is the “cost ... to the distributor” is, effectively an
15 argument that, due to the peculiar circumstances of the separate incorporation of UST
16 Manufacturing and UST Sales and the attendant risk of manipulation by the Parent Corporation
17 of the price at which OTP is sold by UST Manufacturing to UST Sales, it is necessary to
18 establish the List Price (i.e. a market-established price) as the “cost ... to the distributor.” Under
19 this argument, unless the List Price or some other market-established price is used, the UST
20 companies will be in a position, without constraints of the marketplace, to unilaterally set the
21 amount of tax they pay on OTP distributed by UST Sales, rather than the amount of the tax being
22 based on an objective (presumably non-manipulable) fair market value based price.

23 While initially appealing, this argument fails as well for the simple reason that nothing in
24 the Tobacco Tax Law or any other statute precludes the UST companies from organizing
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1 themselves the way they did during the Relevant Period and thus, under the first portion of
2 §30017, the tax on OTP samples distributed by UST Sales is based on the price it paid to UST
3 Manufacturing for the OTP. The drafters of Proposition 99 or the California Legislature could
4 have but chose not to address this issue by inserting language in the Tobacco Tax Law or
5 establishing a more generally applicable rule that any time an excise tax is based on a transaction
6 between related entities a constructive price rather than the price established by the related
7 entities would govern. The federal government has had such a rule in place applicable to certain
8 excise taxes long before the voters passed Proposition 99. Internal Revenue Code §4216(b)
9 provides that, where a product subject to certain excise taxes is “sold (otherwise than through an
10 arm’s length transaction) at less than the fair market price,” the excise tax is based not on the
11 sales price but on a “constructive sales price” which is a fair market value price. (*See generally*
12 *Columbia Products Co. v. United States* (D. SC 1975) (“Section 4216 provides essentially that
13 the correct definition of price varies according to the manner in which a manufacturer structures
14 his business and the nature of the customers to whom he sells”).

15 The parties have not cited, nor have I located, any California statute that is similar to IRC
16 §4216(b) or that requires or permits the use of a constructive price to determine “cost ... to the
17 distributor” for purposes of the Tobacco Tax Law. In the absence of such a statute and in the
18 absence of the application of alter ego or sham principles, the plain language of §30017 requires
19 that “cost ... to the distributor” of the OTP samples distributed by UST Sales be the actual price
20 paid by UST Sales to UST Manufacturing for those samples, which is the Transfer Price for
21 unmarked samples and the Marked Samples Price for marked samples. Any other construction of
22 §30017 would be to engage in re-writing of that section or to write into the Revenue & Taxation
23 Code a statute akin to IRC §4216(b), both of which clearly exceed the judicial function.

1 If under the facts of this and/or other cases §30017 is subject to perceived or actual abuse
2 or unfair manipulation, it is up to the voters or the Legislature to make any needed corrective, not
3 for a judge to re-write that section. In all events, as observed by a highly-regarded federal
4 appellate judge in a case involving IRC §4216(b), the situation presented by this case of separate
5 incorporation of related companies that sell products subject to an excise tax from one to another
6 is not “per se improper.” (*Crème Manufacturing Co., Inc. v. United States* (5th Cir. 1974)
7 (Wisdom, J.) (“There is nothing per se improper, therefore, with splitting manufacturing and
8 selling functions into distinct corporations. And, furthermore, we consider the motivation of the
9 taxpayer to be irrelevant. Courts have long held that a taxpayer may arrange its business affairs
10 with an eye toward the tax consequences and that it need not maintain a corporate structure so as
11 to pay the highest taxes”).

12 **The Transfer Price is not a Discounted Price as the Term “Discounts” is used in Section**
13 **30017.**

14 Having determined that the Transfer Price is the “cost ... to” UST Sales for the unmarked
15 samples it purchased from UST Manufacturing for the purposes of the first portion of §30017, I
16 now address SBE’s argument that the Transfer Price is a discounted price off the List Price as the
17 term “discounts” is used in the remaining portion of §30017.

18 Nowhere in the Tobacco Tax Law are the words “discount,” “discounts,” “discounted” or
19 anything similar defined. Absent any special definition given to the word “discounts,” a well-
20 established rule of statutory construction requires that “discounts,” as that term is used in
21 §30017, be given its “usual and ordinary meaning.” (*Schatz. v. Allen Matkins Leck Gamble &*
22 *Mallory LLP* (2009) 45 Cal. 4th 557, 571). In *U.S. Tobacco I*, 982 P.2d at 657, the court, quoting
23 a standard dictionary, defined “discount” as “an abatement or reduction made from the gross
24 amount or value of anything” and “reduction from a price made to a specific customer or class of
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1 customers.” Those definitions accord with my understanding of the usual and ordinary meaning
2 of the word “discounts” and thus that is how I will construe that word for the purposes of
3 §30017. (*Accord Koire v. Metro Car Wash* (1985) 40 Cal. 3d 24 (in a civil rights case the court
4 assumed, without explicitly stating, that a “discount” was a price charged to one customer less
5 than a price charged to another customer for the same product or service)).

6 The foregoing common understanding of “discount” necessarily assumes that a discount
7 occurs only when a seller sells the same product for a price higher than the assertedly discounted
8 price. Here, however, the parties stipulated that the Transfer Price is the same price that UST
9 Manufacturing sells all OTP other than marked samples to UST Sales and that marked samples
10 are sold for a lower price than the Transfer price. Accordingly, there is no higher price charged
11 by UST Manufacturing to UST Sales from which the Transfer Price is being reduced or
12 discounted. In sum, because the phrase “prior to any discounts” as used in §31007 clearly
13 connotes a lower price charged by a seller than another price charged by that same seller, SBE’s
14 argument that the Transfer price is a discounted price off the List Price – a price charged not by
15 UST Manufacturing but by UST Sales to its own customers – lacks merit. Even if there was
16 some ambiguity to the word “discounts” as used in §31007 and that word could be construed to
17 include a lesser price charged by someone other than the vendor at issue, which I do not believe
18 there is, such ambiguity would have to be resolved in favor of UST Sales. (*Agnew, supra*).

19 Most or all of what I wrote in the previous section about the “cost ... to the distributor”
20 being pegged to the level of trade between UST Manufacturing and UST and therefore excluding
21 the sales and marketing costs incurred by UST Sales applies to – and requires rejection of –
22 SBE’s argument that the Transfer Price is an “artificial price” and thus a discounted price
23 because it does not reflect any sales or marketing costs. While SBE in its trial brief and at times
24 during the trial couched its arguments that UST Manufacturing’s absence of sales and marketing
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1 functions renders the Transfer Price a “discount” price per the second portion of §30017,
2 analytically I have chosen to deal with those arguments in the context of addressing “cost ... to
3 the distributor” as that phrase is used in the first portion of §30017.

4 Regardless of whether SBE’s arguments are framed in terms of “cost ... to the
5 distributor” or as “discounts,” the analysis set forth in the previous section requires rejection of
6 those arguments. This is because the “discount” that is asserted by SBE is a “reduction in price”
7 due to the Transfer Price not taking into account sales and marketing costs, yet, as explained
8 above, under §30017 the Transfer Price need not cover such costs because at the point in the
9 chain of distribution that it is charged, no sales or marketing costs have been incurred. Stated
10 another way, the Transfer Price cannot be a “discount” due to the fact that it doesn’t reflect the
11 cost of sales and marketing functions when an applicable “undiscounted” price would also not
12 reflect the cost of such functions.

13 **Because the Marked Samples Price is a Discount Off the Transfer Price, the Transfer Price**
14 **is the Tax Basis for all OTP Samples, Both Marked and Unmarked, Distributed by UST**
Sales in California During the Relevant Period.

15 Per the parties’ stipulation and the evidence at trial the only difference between the
16 marked samples and all other OTP, including unmarked samples, is the markings on the former.
17 Per the parties’ stipulation, this marking – and this marking alone – “compromised [the]
18 marketability” of the marked samples and thus UST Manufacturing charged a lower price for the
19 marked samples than it did for all other OTP it sold to UST Sales. Though not argued by the
20 parties, the foregoing facts establish that the “abatement or reduction” in price charged for
21 marked samples is a “discount” off the Transfer Price due to the compromised marketability of
22 marked samples. Indeed, the evidence submitted by UST Sales, and not disputed by SBE, was
23 that the only difference in the way the Transfer Price was calculated from the way the Marked
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1 Samples Price was calculated was that the former included profit and the latter did not, while
2 both prices covered the same costs.

3 That the Marked Samples Price is a discount off the Transfer Price does not necessarily
4 answer the question of whether it is a “discounts” within the meaning of §30017. At least
5 theoretically the word “discount” as used in that section could be limited to discounts based on
6 volume, prompt payment or other customary reason why sellers provide discounts to others in
7 the chain of distribution. Such theory is inapplicable here because §30017 plainly and
8 unambiguously refers to “any discounts,” thereby precluding any construction of that section
9 covering only some discounts. A discount for compromised marketability could only fall outside
10 the scope of §30017 if the word “any” is “construed” out of that section, but to do so runs afoul
11 of a familiar requirement of statutory construction. (*Agnew, supra* (“whenever possible,
12 significance must be given to every word in pursuing the legislative purpose, and the court
13 should avoid a construction that makes some words surplusage”)).

14 Treating the difference in price between the Transfer Price and Marked Samples Price as
15 a “discount” under §30017 is in keeping with the fact that, for purposes of determining tax basis
16 of both cigarettes and OTP, the Tobacco Tax Law equates the giving away of tobacco samples
17 with the sales of tobacco. Since the Marked Samples Price was less than the Transfer Price only
18 because of the “compromised marketability” of the marked samples as a result of their being
19 marked as samples, giving effect to the difference in the prices would result in the distribution of
20 samples having a lower tax basis than other taxable distributions, which is contrary to the equal
21 tax basis treatment in the Tobacco Tax Law of “distributing” samples with all other taxable
22 distributions. Nor is it relevant that, at least theoretically, unmarked samples could be more
23 readily re-sold and thus might not have the same “compromised marketability” as marked
24 samples. Putting aside that the applicable SBE regulation now requires that all samples of OTP

1 be "marked" (18 Cal. Admin. Code §4081), the marking of samples during the Relevant Period
2 merely designated that certain OTP was intended to be given away as samples and such a
3 designation by itself surely doesn't warrant departure from the Tobacco Tax Law's mandate that
4 the distribution of samples have the same tax basis as other taxable distributions.

5 Though not dispositive of the California issues presented in this case, it is worth mention
6 that, as stated in a footnote of the first Washington Court of Appeals decision, UST Sales
7 "acknowledged" that the tax basis for the marked samples it distributed in 1992 in Washington
8 was the same as for unmarked samples, and that UST Sales purchased the marked samples from
9 UST Manufacturing at a "discounted price." (*U.S. Tobacco I*, 982 P. 2d at 934, n.4).

10 **SBE is Bound by the Stipulation that all OTP Other than Marked Samples was Sold by**
11 **UST Manufacturing to UST Sales at the Transfer Price, and Therefore is Precluded from**
12 **Arguing that the Transfer Price was Not the Wholesale Cost. Even in the Absence of the**
13 **Stipulation, UST Sales Presented Sufficient Evidence to Meet its Burden on this Point.**

14 At the trial SBE presented evidence that checks from UST Sales to UST Manufacturing
15 revealed that UST Sales actually paid less for the OTP it purchased from UST Manufacturing
16 during the Relevant Period than was claimed in the invoices issued by UST Manufacturing.
17 Presumably this evidence was presented not only for the purpose of bolstering SBE's argument
18 that the Transfer Price and the Marked Sales Price were "artificial" contrived prices, but also to
19 show that UST Sales' actual cost of the OTP was different than what UST Sales claimed. At the
20 time this evidence was presented it was not clear whether the parties recalled that they had
21 previously stipulated that all OTP except marked samples was sold by UST Manufacturing to
22 UST Sales during the Relevant Period at the Transfer Price and all marked samples was sold at
23 the Marked Samples Price. As discussed earlier, this stipulation binds SBE and me, and thus any
24 evidence to the contrary must be disregarded.
25

1 Even if the parties had not entered into a stipulation that the Transfer Price was the price
2 at which UST Manufacturing sold all OTP other than marked samples to UST Sales during the
3 Relevant Period, the evidence presented at the December 15, 2009 hearing was more than
4 sufficient to establish this fact. In particular, I am satisfied that UST adequately explained the
5 reason why SBE could not reconcile the checks from UST Sales to UST Manufacturing. I now
6 find that UST Sales' books and records do in fact reconcile on this point. Accordingly, I find that
7 UST Sales met its burden of proving the "wholesale cost" of the OTP samples it distributed in
8 California during the Relevant Period, as I have construed that phrase in this decision. The
9 weight of the evidence establishes that UST Sales purchased all its OTP except marked samples
10 during the Relevant Period at the Transfer Price.

11 **Conclusion**


12 For the reasons set forth above, I conclude that during the Relevant Period the tax basis
13 for all samples of OTP, both marked and unmarked, distributed by UST Sales in California was
14 the Transfer Price. As set forth in the attachments to the Stipulation of Facts dated April 2, 2008,
15 that Transfer Price was 72.9 cents per can for all of 1994 for all varieties of OTP that were
16 distributed as samples, 78.3 cents per can for all of 1995 for all varieties of OTP that were
17 distributed as samples, and 80.7 cents per can for the portion of 1996 included within the
18 Relevant Period for all varieties of OTP that were distributed as samples.

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1 The parties are required to meet and confer regarding the language of a judgment that is
2 in accordance with this decision. If the parties cannot agree on the language of a judgment, each
3 party should submit a proposed judgment.

4 IT IS SO ORDERED.

5 Dated: March 22, 2010



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Harold E. Kahn
Judge of the Superior Court