Cite as Det. No. 91-264, 11 WTD 453 (1992).

BEFORE THE INTERPRETATION AND APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment of	)	D E T E R M I N A T I O N
	)	No. 91-264
. . .	)	Registration No. . . .
	)	. . ./Audit No. . . .

[1] RULE 18801 -- PRESCRIPTION DRUGS. All levels of sales of legend drugs are exempt from sales and use taxes if the drugs are prescribed in the diagnosis, cure, mitigation, treatment or prevention of disease in patients. RPM 91-1.

[2] RULE 112 -- USE TAX -- VALUE OF SAMPLES -- COST METHOD -- PROFIT. No amount should be added for profit when determining value under the cost basis.

[3] AUDIT SAMPLE PERIODS -- REASONABLENESS. When estimates are used to project tax for nonsample periods, the estimates should be reasonable, based on all the information available.

[4] RULE 143 -- ADVERTISING CIRCULARS -- NEWSPAPER INSERTS. Advertising circulars inserted in newspapers are part of the newspaper, exempt from tax.

[5] MATC -- B&O TAX -- TYLER PIPE -- CONSTITUTIONALITY. Taxpayers may not get a refund or a reduction of an assessment resulting from the Tyler Pipe decision.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

TAXPAYER REPRESENTED BY: . . .

DATE OF HEARING: September 10, 1991

NATURE OF ACTION:

The taxpayer petitions for the correction of the assessment of retail sales tax on prescription drugs and items acquired for resale, use tax on samples and advertising inserts, and all business and occupation taxes. The taxpayer was audited for the period from October 1, 1983 through September 30, 1987. Document No. . . . was issued [in October 1990] with a total deficiency due and assessed of $ . . . . The taxpayer paid $ . . . and the balance remains contested.

FACTS AND ISSUES:

Pree, A.L.J. -- The taxpayer manufactures drugs and other products which it sells in Washington. Some of the drugs were legend drugs which could only be dispensed with a prescription. The auditor assessed retail sales tax on sales where the prescription drugs were not sold directly to a patient. The taxpayer contends that the legend drugs were exempt regardless of whether or not they were sold to the patient with the prescription.

In addition, the auditor assessed sales tax on other sales where no resale certificate was provided. Since the audit, the taxpayer has provided resale certificates from its customers regarding those sales.

The taxpayer did not pay use tax on samples distributed during the audit period. The taxpayer agrees that some use tax is due. Records were available to determine the costs of the samples for 1985 through 1987. However, no records were available for 1983 and 1984. The auditor based his computation on 1985 costs with a 50% markup to arrive at the samples' value. The taxpayer contends that sample costs were abnormally high in 1985 because a major new product was introduced then. The costs for 1986 and 1987 were much lower. The taxpayer contends that the auditor should have used the average costs for the three years to estimate the 1983 and 1984 costs. The taxpayer also contends that the auditor added an excessive markup percentage to the manufactured costs of these materials.

The auditor also assessed use tax on what he believed was unreported advertising and sales promotional material, stationery, and forms sent to the taxpayer's employees in Washington. The taxpayer contends that this account was actually for advertising supplements inserted in newspapers. The taxpayer states that these materials were not mailed to customers and not available in the stores. The taxpayer contends that the newspaper inserts were exempt under RCW 82.08.0253.

Finally, the taxpayer takes issue with the wholesaling and retailing business and occupation taxes which it contends were unconstitutional. The taxpayer argues that since the tax was declared unconstitutional, the Department cannot collect it.

To summarize, the following issues need to be resolved:

1. Are prescription drugs subject to retail sales tax when sold to nonpatients who did not provide the taxpayer resale certificates?

2. What is the proper use tax measure for samples?

3. Was it reasonable to use the 1985 period alone to project 1983 and 1984 sample totals?

4. Are advertising inserts for newspapers subject to use tax?

5. Was the business and occupation tax constitutional and was it properly applied to the taxpayer?

DISCUSSION:

[1] Following the assessment, the Department issued RPM 91-1 and amended WAC 458-20-18801. Neither retail sales tax nor use tax is applicable to legend drug sales (or samples) for a patient's use.
The taxpayer has provided a schedule of six legend drugs upon which retail sales tax was assessed. The Audit Division may review the taxpayer's computation and verify that the drugs were in fact legend drugs.

The taxpayer has also provided additional resale certificates which were not available at the time of the audit. The Audit Division will review them and allow credit where appropriate.

[2] The taxpayer gave out samples of new products to potential customers. Articles given to customers as samples are subject to use tax.[1] The measure of the tax is the value of the article used.[2] WAC 458-20-112 (Rule 112) is the department's regulation which defines the term "value of products." It provides that value be determined by actual sales or sales of similar products. In the absence of actual sales or sales of similar products, the value may be determined upon a cost basis. In such cases, every

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[1] See ETB 332.12.178 (. . .).

[2] RCW 82.12.020.

item of cost attributable to the particular article including direct and indirect overhead costs should be included in the value, but not profit.

In this case, the assessment is based on the taxpayer's cost account plus a mark-up for profit. There is no authority which provides for a profit mark-up to the measure of tax. The Audit Division may consider sales of the samples or similar products. Or, if sales of similar products are not available, the Audit Division may recheck its cost figures to be sure overhead costs were included in its value. It must drop the profit mark-up from its cost computation.

[3] The taxpayer was unable to retrieve its 1983 and 1984 records to determine the costs of samples for those years. The Audit Division computed the assessment for those years based on the 1985 sample costs which totaled [approximately $11,000,000]. The sample costs for 1986 [and 1987 were much lower]. The taxpayer argues that the 1985 costs were abnormally high because a new product was introduced that year, and requests that the costs used for computing the 1983 and 1984 costs be the average costs of the three later years rather than the abnormally high 1985 costs.

The Audit Division has provided no reason for not considering the taxpayer's sample costs over the three year period rather than only the 1985 costs. If there is a reason why the 1985 costs better reflect what the taxpayer spent in 1983 and 1984, we need to be aware of it. The taxpayer's request that the larger sample period be used to project those costs is reasonable, and lacking any explanation of why it should not be used, the Audit Division should expand the sample period to include it.

[4] The taxpayer stated the advertising circulars inserted in newspapers were only used in newspapers. They were not given out in stores or mailed out to customers. The taxpayer states it had a different account for such items. We find that since they were inserted in newspapers, that they were a part of the newspapers.

The retail sales tax[3] does not apply to the sale and distribution of newspapers. Since the inserts are part of the newspapers, they are exempt from tax.

[5] In Tyler Pipe Industries, Inc. v. Department of Rev., 483 U.S. 232, 97 L.Ed.2d 199, 107 S.Ct. 2810 (1987), the United States Supreme Court held that a portion of Washington State's multiple activities exemption was unconstitutional and

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[3] RCW 82.08.0253.

discriminatory. The Court remanded the actions to the Washington Supreme Court to decide whether the State was obligated to pay refunds to the taxpayers. The Court's unanimous opinion was that Tyler Pipe should be applied prospectively only. National Can Corp. v. Department of Rev., 109 Wn.2d 878 (1988).

In March 1988, National Can and other plaintiffs appealed the decision. The United States Supreme Court refused to accept the case, cert. den., 486 U.S. 1040, 108 S.Ct. 2030 (1988). Therefore, the state court's decision that Tyler Pipe should be applied prospectively became final.
In making its decision, the Washington Supreme Court applied the test enunciated by the United States Supreme Court in Chevron Oil Co. v. Huson, 404 U.S. 97, 30 L.Ed. 2d 296, 92 S. Ct. 349, (1971). The Court determined that Tyler Pipe did establish new principles of law--the threshold factor necessary for prospective application. 109 Wn.2d at 882.

The Department's position is that there should be no distinction between taxpayers who paid their taxes before Tyler Pipe and sought refunds, taxpayers who had outstanding but unpaid assessments before the decision, and taxpayers who had outstanding tax liabilities but had not yet been assessed. Final Det. 89-188A, 10 WTD 278 (1991). This position is supported by the Washington Supreme Court's decision in National Can. The Court noted that if it afforded retroactive application and ordered full refunds, taxpayers engaged in interstate commerce would not pay their fair share of the tax burden. "Forcing the State to collect no taxes for the entire period of the statute of limitations would be more in the nature of a punitive award for misconstruing the constitutionality of the B&O tax." 109 Wn.2d at 889.

The decision by the United States Supreme Court in American Trucking Associations, Inc. v. Smith, 496 U.S. 167, 110 S.Ct. 2323 (1990) also supports the Department's position. In that case, the Court stated:

> It is, of course, a fundamental tenet of our retroactivity doctrine that the prospective application of a new principle of law begins on the date of the decision announcing the principle.

In this part of its decision the Court explicitly stated that a state would not be precluded from collecting taxes after the date of its decision which it accrued by reason of events occurring before that date. To hold otherwise, in the Court's own words:

> . . .would also penalize States that do not immediately collect taxes, but nevertheless plan their operations

> on the assumption that they will ultimately collect taxes that have accrued.

110 L. Ed.2d at 165 (1990). Accordingly, the taxpayer's petition for correction of the B&O tax assessed for periods prior to June 23, 1987 is denied.

The Washington Legislature passed the 1987 credit law on August 11, 1987. Laws of 1987, 2d Ex. Sess., ch. 3 (hereinafter 1987 credit law). The law was designed to remedy the constitutional defects of RCW 82.04.440 by replacing the "multiple activities exemption" with a "2-way credit." 1987 credit law, § 2.

The Washington Supreme Court issued its opinion holding that the 2-way credit was constitutional and that the credits applied retroactively to the interim period. American National Can Corp. v. Department of Rev., 114 Wn.2d 236 (1990). The United States Supreme Court refused to hear the appeal, cert. den., 59 U.S.L.W. 3250 (1990). Accordingly, the tax assessed after June 23, 1987 is also sustained.

DECISION AND DISPOSITION:

The assessment is remanded to the Audit Division for revision consistent with this determination.

DATED this 20th day of September, 1991.