

Cite as 4 WTD 331 (1987)

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

In the Matter of the Petition)	<u>D</u> <u>E</u> <u>T</u> <u>E</u> <u>R</u> <u>M</u> <u>I</u> <u>N</u> <u>A</u> <u>T</u> <u>I</u>
<u>O</u> <u>N</u>	
for Correction of Assessment of)	
)	No. 87-363
)	
. . .)	Registration No. . . .
)	Tax Assessment No. . .
.	
)	

[1] **RCW 82.12.0275 AND RULE 18801:** USE TAX -- EXEMPTIONS -- PRESCRIPTION DRUGS -- DRUG SAMPLES. The use tax exemption of RCW 82.12.0275 is available only for patients/users/purchasers of prescription drugs for whom such drugs are prescribed. The exemption is not available for persons who distribute free sample prescription pharmaceuticals as a marketing tool to promote subsequent sales of the product.

[2] **RCW 82.12.010(1) AND RULE 178:** USE TAX -- TAX MEASURE -- VALUE OF THE ARTICLE USED -- FREE SAMPLES. The "value of the article used" for use tax purposes is determined as nearly as possible by the retail selling price of similar products. Where no retail selling price exists for a free sample product specially packaged as such, the value is to be determined by the total costs of production, plus costs of special packaging, research and development, and distribution to arrive as nearly as possible to the retail selling price.

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: . . .

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DATE OF HEARING: November 5, 1987

NATURE OF ACTION:

Petition protesting assessment of use tax on prescription pharmaceuticals. Petition also protests assessment of use tax measured by the retail selling price when applied to samples of prescription pharmaceuticals given to physicians free of charge and when applied to samples of nonprescription medicines given to physicians, hospitals and ultimate consumers free of charge.

FACTS AND ISSUES:

Krebs, A.L.J. -- . . . (taxpayer) is a Pennsylvania corporation headquartered in Pennsylvania. The taxpayer has two divisions, [Division A] manufactures and sells a variety of prescription pharmaceuticals. [Division B] manufactures and sells nonprescription medicines.

[Division A] distributes samples of prescription pharmaceuticals to physicians. This is done by . . . employees called "detail men" who visit physicians, discuss the product, and give the samples free of charge to the physicians to dispense free of charge to their patients. Where the pharmaceutical contains a narcotic, federal law forbids the "detail man" to possess the sample. In such case, the "detail man" does not leave a sample, but gives a request card to the physician who can then request a sample by mail for delivery by mail. After a physician observes the effectiveness of [the] pharmaceutical samples, he may write prescriptions for patients to purchase [the] products from their pharmacists. This generates sales to [the taxpayer]'s actual paying customers, the wholesalers. Thus, the taxpayer asserts that samples are an important marketing tool for its . . . division.

[Division B], in order to stimulate sales of nonprescription products also distributes free samples to physicians, hospitals and the ultimate consumers.

The Department of Revenue examined the taxpayer's business records for the period from January 1, 1981 through December 31, 1985. As a result of this audit, the Department issued Tax Assessment No. . . . on June 25, 1987 asserting excise tax

liability in the amount of \$. . . and interest due in the amount of \$. . . for a total sum of \$ The taxpayer made payment of \$. . . on July 24, 1987 and the balance remains due.

The taxpayer's protest involves Schedules V, VI and X of the audit report.

Schedule V

In Schedule V, use tax was assessed on unreported values of samples distributed by the taxpayer's consumer products division [B]. The taxpayer had reported the cost of production as the value of the samples subject to use tax. The auditor based the value as subject to use tax on the retail selling price of the product itself when not packaged as a "Sample-Not to be Sold."

Schedule VI

In Schedule VI, use tax was assessed on unreported values of samples distributed by the taxpayer's pharmaceutical division [A] to physicians only. The taxpayer had not reported any of these samples as subject to use tax. The auditor based the value as subject to use tax on the retail selling price of the pharmaceutical itself when not packaged as a "Physicians Sample-Not to be Sold."

Schedule X

In Schedule X, use tax was assessed on unreported values of samples distributed by the taxpayer's pharmaceutical division [A] to physicians only. The taxpayer had reported the cost of production as the value of the samples subject to use tax. The auditor based the value as subject to use tax on the retail selling price of the pharmaceutical itself when not packaged as a "Physicians Sample-Not to be Sold."

The taxpayer's basic position is that the samples, both prescription pharmaceuticals and nonprescription medicines are used by the taxpayer as marketing tools, and their value as marketing tools should be the measure of the use tax. If the tax were imposed solely on their value as prescription pharmaceuticals or as nonprescription medicines, then the taxpayer contends that all . . . samples [that are] prescription pharmaceuticals should be exempt as prescription drugs.

The taxpayer contends that the value of its samples should be limited to their total production cost. In support of this contention, the taxpayer's petition states the following (. . .):

WAC 458-20-178 states in relevant part:

"The tax is levied and collected on an amount equal to the value of the article used by the taxpayer. The term 'value of the article used' is defined by the law as being the total of the consideration paid or given by the purchaser to the seller for the article use In case the article used was ... manufactured by the person using same the value of the article used must be determined as nearly as possible according to the retail selling price, at the place of use, of similar products of like quality, quantity, and character."

[Taxpayer] contends that its samples are not "of like quality, quantity, and character" to the products which it sells to customers for the following reasons:

- 1) Although the products in sample packages are chemically identical to those which are sold to [taxpayer's] customers, consumers usually perceive an item labeled "Sample" to be of lesser value or quality than the same item without such a label; e.g., patients know that samples are free to physicians, and thus are unwilling to pay for them. [Taxpayer] believes that this illustrates that packaging is an integral part of the product, and its samples do differ in quality and character from similar products in trade sizes since all of its sample packages, and most individual doses are clearly marked as such.
- 2) All of [Division A]'s samples and most of [Division B]'s samples are distributed in package sizes which

differ from those which are sold to customers.

- 3) There are severe restrictions on the distribution of [Division A] samples; i.e., they can only be dispensed by a licensed physician and are marked as samples not for resale. These restrictions indicate that the value of a sample is considerably less than the value of a similar product packaged for sale. [The individual tablet, capsule, and caplet often has the word "sample" imprinted on it.]
- 4) Samples are not distributed to [taxpayer]'s customers. They are distributed to medical professionals and directly to consumers. This indicates that the similarity of "place of use" requirement of WAC 458-20-178 has not been satisfied by valuing samples on the basis of trade sales.

The use tax should be based on their value as marketing tools, not their value as pharmaceuticals or medicines. If the tax were imposed on the latter basis, all [Division A] samples should be exempt since they are prescription medicines. Used as a marketing tool, samples certainly differ in quality and character from similar products in trade sizes. (Bracketed words supplied.)

The taxpayer points to WAC 458-20-112 (Rule 112) as providing an alternative value for products manufactured for commercial use if sales of similar products are not available as a guide.

The taxpayer asserts that the alternative guide is total production cost and that this alternative is appropriate for its samples.

The issues are: (1) Are samples of prescription pharmaceuticals given free of charge to physicians by the taxpayer as a marketing tool to promote sales exempt from use tax as a prescription drug? (2) What is the proper measure of use tax as to packaged samples of prescription pharmaceuticals and nonprescription medicines?

DISCUSSION:

The first issue is whether samples of prescription pharmaceuticals given free of charge to physicians by the taxpayer as a marketing tool are exempt from use tax as "prescription drugs."

The statute, RCW 82.12.020, imposes the use tax and in pertinent part provides:

There is hereby levied and there shall be collected from every person in this state a tax or excise for the privilege of using within this state as a consumer any article of tangible personal property . . . produced or manufactured by the person so using the same . . . This tax will not apply with respect to the use of any article of tangible personal property . . . produced or manufactured outside this state until the transportation of such article has finally ended or until such article has become commingled with the general mass of property in this state. This tax shall apply to the use of every article of tangible personal property . . . irrespective of whether the article or similar articles are manufactured or are available for purchase within this state . . . The tax shall be levied and collected in an amount equal to the value of the article used by the taxpayer multiplied by the rate in effect . . . (Emphasis supplied.)

RCW 82.12.010 (5) in pertinent part provides:

(5) . . . "Consumer" . . . shall also mean any person who distributes or displays, or causes to be distributed or displayed, any article of tangible personal property, except newspapers, the primary purpose of which is to promote the sale of products or services. (Emphasis supplied.)

[1] RCW 82.12.0275 provides an exemption from use tax on the use of "prescription drugs." The statute in pertinent part provides:

The provision of this chapter shall not apply in respect to the use of prescription drugs . . . The term "prescription drugs" shall include any medicine, drug . . . for use in the diagnosis, cure,

mitigation, treatment or prevention of disease or other ailment in humans ordered by (1) the written prescription to a pharmacist by a practitioner authorized by law . . . to issue prescriptions . . . (Emphasis supplied.)

In this case, the taxpayer produces or manufactures prescription pharmaceuticals out of state. The taxpayer distributes in this state samples of the prescription pharmaceuticals to physicians free of charge who in turn give them free of charge to their patients.

The physician observes the effectiveness of the samples and may write prescriptions for the patient to buy the product at a pharmacy. This generates sales by the taxpayer to its customers, the wholesalers, who supply the pharmacies. Thus, the samples serve as a marketing tool for the taxpayer in promoting the sale of its products. The taxpayer is the "consumer" of the samples. RCW 82.12.010 (5). The taxpayer uses the samples in this state as a consumer and such use is subject to the use tax. RCW 82.12.020.

WAC 458-20-18801 (Rule 18801), . . . , in pertinent part provides:

(4) RETAIL SALES TAX. The retail sales tax applies upon all retail sales of tangible personal property unless expressly exempted by law.

(5) EXEMPTIONS. The retail sales tax does not apply to sales to patients of drugs, medicines, prescription lenses, or other substances, but only when

(a) Dispensed by a licensed dispensary

(b) Pursuant to a written prescription

(c) Issued by a medical practitioner

(d) For diagnosis, cure, mitigation, treatment, or prevention of disease or other ailment in humans.

. . .

(9) USE TAX. The use tax does not apply to the use of articles and products which are exempt from sales tax as specified herein. (Emphasis supplied.)

This tax regulation has the same force and effect as the provisions of the Revenue Act itself, unless overturned by a court of record not appealed. RCW 82.32.300. The rule provision, ever since the enactment of the exemptions for

sales and use or prescription drugs, has strictly construed such exemptions so that they are available only to patient/drug purchasers/users. Moreover, the legislature has amended the statutory exemptions on several occasions with full knowledge of the rule's limiting provisions and has not altered this construction or provided any contradictory or clarifying intent. See Council of Camp Fire v. Revenue, 105 Wn.2d 55 (1985). Tax exemption provisions must be strictly construed in favor of tax application. See MacAmusement Co. v. Department of Revenue, 95 Wn.2d 963 (1981).

The Department has consistently and uniformly administered the sales and use tax exemptions for prescription drugs as being available exclusively to the patients/purchasers/users for whom the drugs are prescribed.

We conclude that samples of prescription pharmaceuticals as distributed and used by the taxpayer are not exempt from use tax because they do not meet the conditions for exemption as set forth in RCW 82.12.0275 and Rule 18801 for "prescription drugs."

[2] Concerning the second issue, the "value of the article used" as defined in RCW 82.12.010 (1) is the proper measure of use tax. The statute in pertinent part provides:

In case the article used is . . . produced, or manufactured by the person using the same . . ., the value of the article used shall be determined as nearly as possible according to the retail selling price at place of use of similar products of like quality and character under such rules and regulations as the department of revenue may prescribe. (Emphasis supplied.)

Though the Department has promulgated a general use tax regulation, WAC 458-20-178 (Rule 178), it simply recites the above statutory definition of "value of the article used" with one minor addition. Rule 178 in pertinent part provides:

In case the article used was . . . produced or manufactured by the person using the same . . ., the value of the article used must be determined as nearly as possible according to the retail selling price, at the place of use, of similar products of like quality, quantity and character. (Emphasis supplied.)

The word, "quantity," emphasized above is an additive in the rule which is not included in the statute. Clearly, by the addition of that word, it is the Department's position that the quantity or number of units sold has a direct bearing upon the retail selling price of any quantified goods, that is, the number of like units in a container. In this case, the not-for-sale sample package has six to eight caplets, but the packages containing the same product when packaged for sale at retail contain at least 24 caplets. Similarly, sample containers of liquid medicine will contain one ounce liquid, but the for sale containers will have two ounces liquid or more.

Rule 178 does not deal with situations where the reason that there is no retail selling price of "similar products of like quality, quantity and character" is because such products are never sold at retail. However, in the many instances when items are manufactured for a person's own commercial or industrial use, the manufacturing business tax is measured by the "value of products" manufactured and used. See WAC 458-20-134 (Rule 134), However, for use tax purposes, the manufacturer is subject to use tax on the "value of the article" used. See Rule 134 and Rule 178. Rule 134 references WAC 458-20-112 (Rule 112), . . . , for definition and explanation of "value of products."

Rule 112 in pertinent part provides:

The term "value of products" . . . shall be determined by "gross proceeds of sales" whether such sales are at wholesale or at retail ...

In the absence of sales of similar products as a guide to value, such value may be determined upon a cost basis. In such cases, there shall be included every item of cost attributable to the particular article or article . . . manufactured including direct and indirect overhead costs.

We agree with the taxpayer's position that the samples, both prescription pharmaceuticals and nonprescription medicines, are used as marketing tools, and their value as marketing tools should be the measure of the use tax. Unfortunately, neither the statutes nor rules have made provision for such valuation. However, we take administrative notice that the Department is at the present time considering amendment of Rule 178 to provide for a valuation method applicable to the

use of samples of drugs and medicines as distributed by the taxpayer.

At the conference and in the taxpayer's post-conference letter dated November 11, 1987, the taxpayer urged that the taxation of samples should be based upon the "total cost of production" methods. The taxpayer cited Final Determination No. 86-176A as supporting the "total cost of production" method. The facts in that case are substantially the same as in the subject case relative to the issue of the proper measure of use tax on sample pharmaceuticals. In pertinent part, Final Determination No. 86-176A states:

This rule [Rule 112] does provide a third alternative valuation method when there is simply no way to establish the retail value of the manufactured article. That method is the total cost of production.

We are convinced . . . that the proper measure of use tax upon sample drugs should be the total costs of production . . . By quantifying and packaging sample drugs as it does the taxpayer has developed a new and distinct product which has no retail sales value as such. Thus, it is not possible to determine a "retail selling price." The nearest possible way to determine the value of the article used is to consider the total costs of production. It is important to note here that Rule 178 is presently being considered for amendment to expressly provide for this valuation method for gifted items.

. . . We hereby . . . order adjustment of the use tax assessment to be measured by the total costs of production, including the costs of special "sample" packaging.

Final Determination No. 86-176A does not discuss research and development costs nor costs of distribution of the samples which items we presented for discussion at the conference. The taxpayer did not include these costs when reporting amounts subject to use tax. The taxpayer asserted that the costs reported included materials, labor, direct and indirect overhead, and special "sample" packaging. Where the taxpayer used an outside agency to distribute nonprescription samples, that distribution cost was included for use tax purposes. Where the taxpayer itself distributed samples of prescription

pharmaceuticals and nonprescription products, the distribution cost was not included in amounts reported as subject to use tax.

It may well be, as the taxpayer alleged, that the research and development costs are infinitesimal per sample distributed. But, then again, they may not be when totaled for all of the samples distributed.

The taxpayer also points out that the amount of time devoted by its representatives in the distribution of samples is infinitesimal in relation to the total amount of time spent performing their job functions. The majority of their time is spent discussing the advantages of using the taxpayer's products and trying to persuade the doctors to prescribe and recommend the products. But, then again, the total of all time used and of all attendant costs in effecting distribution may not be infinitesimal. We believe that use of appropriate auditing techniques for the situations involved will disclose the significance one way or the other, of the research and development costs and the distribution costs for measure of use tax purposes.

RCW 82.12.010(1), supra, states that the "value of the article used shall be determined as nearly as possible according to the retail selling price." RCW 82.08.010(1) in pertinent part defines "selling price" with respect to retail transactions to mean:

. . . the consideration . . . expressed in the terms of money paid or delivered by a buyer to a seller without any deduction on account of the cost of tangible property sold, the cost of materials used, labor costs, . . . delivery costs, . . . or any other expense whatsoever paid or accrued . . .
(Emphasis supplied.)

Thus, to arrive as nearly as possible to the retail selling price of samples which are not sold and have no marked-up selling price, we believe that, in addition to the cost of production, delivery costs or any other expense whatsoever paid or accrued are part of the nonmarked-up selling price to be included in arriving at the "value of the article used" for use tax purposes. We conclude that the taxpayer's research and development costs and distribution costs applicable to the samples are properly includible in the measure of the use tax.

We note that a retail selling price can be based on many other expenses such as advertising which are not appropriate to free samples.

Final Determination 86-176A held that it was "not possible to determine a retail selling price" for the samples, and that "the nearest possible way to determine the value of the article used is to consider the total costs of production." We do not believe that we are straying from the precedential nature of that determination when we give consideration to the research and development costs and costs of distribution. Amendment of Rule 178 to cover the measure of use tax applicable to samples has not taken place. The amendment may include research and development costs and costs of distribution as well as costs of production. If the amendment as adopted is limited to costs of production, the taxpayer will be entitled to a refund of the additional tax incurred on account of the inclusion of the additional costs beyond costs of production.

At the conference, the taxpayer requested a ruling on the following situation. The taxpayer's representative is forbidden by federal law to possess a pharmaceutical sample which contains a narcotic. When the representative visits a physician, a request card for the sample is left with the physician to mail to the out-of-state taxpayer who responds by mailing the sample.

Our ruling with respect to the above situation is that the mailed samples are subject to the use tax because the taxpayer is the consumer in this state through the activities in this state of its representatives in causing distribution of the samples in person or by mail for the purpose of promoting the sale of the taxpayer's products. RCW 82.12.010(5). RCW 82.12.020.

DECISION AND DISPOSITION:

The taxpayer's appeal is denied in part and sustained in part as indicated in this Determination.

The taxpayer's appeal with respect to the issue of exemption from use tax for prescription pharmaceuticals is denied.

The taxpayer's appeal with respect to the issue of the proper measure of use tax is substantially sustained in that the value of the samples are not to be determined solely by the selling price of the product itself as done by the auditor.

This decision requires the following adjustments to Schedules V, VI, and X of the audit report.

Schedule V: The value of the sample nonprescription medicines subject to use tax will be based on the total of the cost of production, including costs of special sample packaging, pro rata share of research and development costs, and distribution costs. It is noted that the taxpayer has allegedly already paid use tax based solely on the cost of production including costs of special sample packaging, and including cost of distribution where an outside agency was used for distribution.

Schedule VI: The value of the sample prescription pharmaceuticals subject to use tax will be based on the total of the cost of production, including cost of special sample packaging, pro rata share of research and development costs, and distribution costs. It is noted that this schedule deals with samples on which no use tax had previously been paid.

Schedule X: The value of the sample prescription pharmaceuticals subject to use tax will be based on the total of the cost of production, including special sample packaging, pro rata share of research and development costs, and distribution costs. It is noted that the taxpayer has allegedly already paid use tax based solely on the cost of production including costs of special sample packaging.

This matter is being referred to the Department's Out-of-State Audit Unit for action as directed in this Determination. It will then issue an amended assessment which will be due for payment on the date indicated thereon.

DATED this 15th day of December 1987.