

Cite as Det. No. 07-0019, 27 WTD 83 (2008)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

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| In the Matter of the Petition For Correction of) | <u>D E T E R M I N A T I O N</u> |
| Assessment of) | |
|) | No. 07-0019 |
|) | |
| ...) | Registration No. . . . |
|) | FY . . ./Audit No. . . . |
|) | Docket No. . . . |
|) | |

- [1] Rule 186; RCW 82.24.040: CIGARETTE TAX – SALES TO WHOLESALEERS. The Washington cigarette tax is imposed on the first sale, use, consumption, handling, possession or distribution of cigarettes within this state. The tax is normally collected through the purchase of stamps. Only a licensed wholesaler is authorized to purchase and affix tax stamps to packs of cigarettes. Rule 186, Part 204(d)(i) allows a licensed wholesaler to sell or transfer unstamped cigarettes to another licensed wholesaler, but only if the sale or transfer takes place within the first 72 hours of handling or possessing the cigarettes in this state.

- [2] Rule 186; RCW 82.24.040: CIGARETTE TAX – EXEMPTION – SALES TO INDIAN OR TRIBAL SELLERS. The cigarette tax does not apply to cigarettes taxed by an Indian tribe in accordance with a cigarette contract under RCW 43.06.450 through 43.06.460. A Taxpayer must provide records to show that it purchased Tribal cigarette stamps or otherwise paid Tribal cigarette tax on any of the cigarettes sold to the Tribe or tribal seller in order to qualify for the exemption.

- [3] Rule 192; RCW 82.24.040: CIGARETTE TAX – EXEMPTION – SALES TO INDIAN OR TRIBAL SELLERS. The delivery, or attempted delivery, of unstamped cigarettes to an Indian or tribal seller without advance notice to the department will make the person attempting such delivery liable for payment of the cigarette tax and penalties. A cigarette wholesaler who made sales to an Indian or tribal seller without advance notice to the Department did not qualify for the exemption.

- [4] Rule 186; RCW 82.24.040: CIGARETTE TAX – OUT OF STATE SALES. The exemption for sales to out-of-state distributors applies only where the person making the sale furnishes a surety bond in a sum equal to twice the amount of the tax that would be affixed to the cigarettes that are set aside for the conduct of such business without affixing cigarette stamps. Where a taxpayer did not furnish the surety bond required under Rule 186, the exemption for out of state sales did not apply.

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.

Zalesky, A.L.J. – Licensed cigarette wholesaler appeals from cigarette tax assessment, claiming that the Audit Division (Audit) erroneously included in the assessment unstamped cigarettes that taxpayer (1) sold to other Washington licensed cigarette wholesalers, (2) sold to a . . . shop located on [an] Indian Reservation, and (3) sold and delivered to a cigarette distributor located [outside the state]. According to taxpayer, these sales are either expressly exempt from the Washington tax or are permitted by Department of Revenue (Department) practice. . . . We conclude that taxpayer has not established that any of its sales of unstamped cigarettes are exempt from the Washington tax or that the cigarettes should be excluded from the assessment. . . . As a result, taxpayer’s petition . . . is denied.¹

ISSUES

1. Is taxpayer authorized by law or by Department practice to sell unstamped cigarettes to other Washington licensed cigarette wholesalers?
2. Is taxpayer entitled to an exemption for cigarettes sold to a tribal smoke shop operating within the boundaries of [an] Indian Reservation?
3. Does taxpayer meet the requirements of the out-of-state delivery exemption set out in RCW 82.24.040(2)(b) and WAC 458-20-186, Part 404, for cigarettes sold and delivered to an out-of-state distributor?
4. . . .
5. . . .
6. . . .

FINDINGS OF FACT

¹ Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410. Nonprecedential portions of this determination have been deleted.

[Taxpayer] is a cigarette and other tobacco products distributor located in . . . Washington. Taxpayer's cigarette distribution business primarily involves the wholesaling of luxury and novelty cigarette brands The majority of the cigarettes purchased by Taxpayer are from manufacturers and distributors located outside of Washington. Taxpayer resells the cigarettes to wholesalers and retailers located mostly within Washington. Taxpayer estimates that [less than half] of its sales are made to other Washington licensed cigarette distributors. The remainder of its sales are made to Washington cigarette retailers, two out-of-state distributors . . . , and [a tribal smoke shop] located on the . . . Indian Reservation.

Taxpayer is a Washington licensed cigarette wholesaler. As a licensed wholesaler, Taxpayer is authorized to purchase and affix Washington cigarette tax stamps to the packs of cigarettes it sells. *See* RCW 82.24.030(2)-(3). Taxpayer's business practice is to affix Washington cigarette tax stamps to some, but not all, of the cigarettes it sells. According to the Taxpayer, it routinely sells unstamped cigarettes to other Washington licensed cigarette wholesalers and to distributors located out-of-state or on the . . . Indian Reservation.

Taxpayer was audited for the March 2001 through March 2005 taxable periods. The audit resulted in two separate assessments. The first assessment . . . relates to additional retail sales tax, use tax, business and occupation tax, and other tobacco products tax owed for the periods under review. The second assessment . . . relates to additional cigarette tax owed for the periods under review. Taxpayer has protested both assessments. This Determination involves only the cigarette tax assessment. . . .

Taxpayer did not maintain accurate business records showing all transactions relating to the purchase, inventory, and sale of cigarettes. As a result, the cigarette tax assessment . . . was computed by estimating the number of packs of unstamped cigarettes purchased during the audit period and then subtracting the number of Washington cigarette stamps purchased by Taxpayer during that same period. As more fully explained in the Auditor's Detail of Differences:

All records provided to the auditor, including general ledgers, wire transfer detail, and purchase invoices were reviewed. Each invoice for the purchase of cigarettes was documented and converted into total packages of cigarettes for reconciliation purposes. Those purchases of cigarettes not containing tobacco products were excluded from the reconciliation measure. Moreover, purchases that were returned to the vendor, and for which a subsequent cigarette tax refund was not provided directly by the Department of Revenue, were appropriately credited from the purchase totals. Due to a lack of detail provided on invoices issued by certain vendors, estimates were occasionally utilized to arrive at a quantity of cigarettes purchased as opposed to the value. . . .

Id. at p. 2.

The auditor's estimate of the total number of packs of cigarettes purchased by Taxpayer is detailed [in two audit workpapers]. The detail of Washington cigarette stamps purchased by

Taxpayer is set out in [another audit workpaper]. Based on the records reviewed, it was assumed that all cigarettes purchased by Taxpayer were unstamped. In addition, due to lack of adequate documentation, no credit was given for cigarette stamps Taxpayer claims it purchased from the [Tribe] to affix to packs sold to the [shop] located on the . . . Indian Reservation. *Id.* Finally, the audit staff did not deduct from its reconciliation any of the cigarettes that Taxpayer sold to out-of-state distributors or to persons licensed as Washington cigarette wholesalers.

The audit resulted in an assessment of \$. . . The assessment is made up of \$. . . tax, \$. . . interest, and \$. . . assessment penalty.² Taxpayer has paid none of the assessment and has petitioned for a correction to the assessment, claiming that the audit reconciliation included a number of errors. Many of the claimed errors have been resolved between Taxpayer and Audit.. . . There are, however, a handful of issues that remain in dispute.

ANALYSIS

A. Wholesaler-to-Wholesaler Sales.

[1] The first and most significant issue raised in this Petition is whether Taxpayer is authorized under Washington law to make sales of unstamped cigarettes to other licensed wholesalers. Taxpayer asserts that Washington law and Department of Revenue practice allow a licensed cigarette wholesaler to sell cigarettes to other Washington licensed wholesalers without first purchasing and affixing Washington cigarette stamps. In light of its understanding that wholesaler-to-wholesaler sales of unstamped product is permissible, Taxpayer has made numerous sales of unstamped cigarettes to other licensed wholesalers. Taxpayer believes that the audit staff erred when it failed to delete these wholesaler-to-wholesaler sales from the audit reconciliation.

The Washington cigarette tax is imposed on “the sale, use, consumption, handling, possession or distribution of all cigarettes” within this state. RCW 82.24.020(1). It is the intent of the law to impose the tax “at the time and place of the first taxable event and upon the first taxable person within this state.” RCW 82.24.080(2). To achieve this aim, the tax is collected “from the person who first sells, uses, consumes, handles, possesses (either physically or constructively . . .) or distributes” cigarettes within Washington. RCW 82.24.080(1). *See also* Det. No. 98-040, 17 WTD 260, 262 (1998) (“[I]t is the legislative intent to levy a tax on cigarettes handled or possessed within this state and to collect the tax from the person who first handles or possesses (either physically or constructively) the articles taxed.”).

The tax is normally collected through the purchase of stamps. RCW 82.24.030. Only a licensed wholesaler is authorized to purchase and affix tax stamps to packs of cigarettes. RCW 82.24.030(2)-(3). Except where specifically authorized, possession of unstamped cigarettes is subject to both civil and criminal sanctions. RCW 82.24.120(1); 82.24.110(1)(a); 82.24.110(2). Additionally, unstamped cigarettes found within this state are subject to forfeiture. RCW 82.24.130(a). *Matheson v. Washington State Liquor Control Bd.*, 132 Wn.App. 280, 290, 130

² The failure to affix cigarette stamp penalty, RCW 82.24.120, was not assessed.

P.3d 897, 902 (2006). As discussed in greater detail below, the circumstances where unstamped cigarettes may lawfully be possessed are very limited.

The first circumstance where unstamped cigarettes may lawfully be possessed is when the cigarettes are specifically exempt from the Washington tax. The specific exemptions to the Washington cigarette tax are listed in WAC 458-20-186, Part IV. As set out in that Rule, the Washington cigarette tax does not apply to the following:

- The sale of cigarettes to the United States army, navy, air force, marine corps, or coast guard exchanges and commissaries and navy or coast guard ships' stores, or any authorized purchaser from one of these sources who purchases cigarettes for personal consumption;
- The sale of cigarettes to the United States veterans' administration, or any authorized purchaser from this source who purchases cigarettes for personal consumption;
- Cigarettes taxed by an Indian tribe in accordance with a cigarette contract entered into between the tribe and the State under authority of RCW 43.06.450 through 43.06.460;
- Cigarettes sold to an Indian in Indian country for personal consumption;
- Wholesale sales of cigarettes to Indians and Indian tribes under the specific conditions set out in WAC 458-20-192(9)(a); and
- Cigarettes sold to persons licensed as cigarette distributors in other states when the seller either delivers the cigarettes to the buyer at a point outside this state, or delivers the cigarettes to a common carrier with the shipment consigned by the seller to the buyer at a location outside this state.

WAC 458-20-186, Part IV. *See also* RCW 82.24.290; RCW 82.24.295. There is no specific exemption that allows wholesaler-to-wholesaler sales of unstamped cigarettes.

The second circumstance where unstamped cigarettes may be lawfully possessed is set out in RCW 82.24.040(2). That code section provides as follows:

(2) No wholesaler in this state may possess within this state unstamped cigarettes except that:

(a) Every wholesaler in the state who is licensed under Washington state law may possess within this state unstamped cigarettes for such period of time after receipt as is reasonably necessary to affix the stamps³ as required; and

(b) Any wholesaler in the state who is licensed under Washington state law and who furnishes a surety bond in a sum satisfactory to the department, shall be permitted to set aside, without affixing the stamps required by this chapter, such part of the wholesaler's stock as may be necessary for the conduct of the

³ Under WAC 458-20-186, Part 204(d)(i), the Department has established that a licensed wholesaler may possess unstamped cigarettes for up to 72 hours before affixing the stamp. A wholesaler must get written permission from the Department if it needs more than 72 hours to affix the Washington tax stamp. *Id.*

wholesaler's business in making sales to persons in another state or foreign country or to instrumentalities of the federal government. Such unstamped stock shall be kept separate and apart from stamped stock.

RCW 82.24.040(2)(a) and (b) recognize that a licensed wholesaler, as the first person to possess and handle cigarettes shipped into this state, has a justifiable need to possess unstamped cigarettes in order to make authorized tax exempt sales and to carry out the duty of stamping cigarettes for sale in this state.

Taxpayer asserts that the authority granted to licensed wholesalers under RCW 82.24.040(2)(a) and (b) necessarily includes the authority to sell unstamped cigarettes to other licensed wholesalers.⁴ According to the Taxpayer, "absent . . . the ability to transfer unstamped cigarettes between licensed wholesalers, intended interstate sales, exempt sales or sales requiring other types of stamps, e.g. Indian, would not be possible." . . . Taxpayer also insists that wholesaler-to-wholesaler sales of unstamped cigarettes is authorized by the Department's administrative rules and by forms and instructions created by the Department. Taxpayer points specifically to Rule 186, Part 204(d)(i) . . . and to Schedule C of the Washington cigarette tax form. Rule 186, Part 204(d)(i) provides that a "[l]icensed wholesalers may possess unstamped cigarettes for up to 72 hours after receipt; however, the cigarettes must be stamped on or before sale or transfer to any other party other than another licensed wholesaler." *Id.* (Emphasis added). Schedule C is the form that the Department has created for cigarette manufacturers, distributors, and wholesalers to report interstate shipments of cigarettes into Washington, interstate sales exported from Washington, and exempt sales taking place within Washington. With respect to this form, Taxpayer maintains that:

1. Schedule C is regularly used to report taxpayer sales of unstamped cigarettes from one licensed wholesaler to another licensed wholesaler;
2. The form specifically provides for these types of sales;
3. The Department's Miscellaneous Tax Section (cigarette tax) regularly advises taxpayers to report dealer-to-dealer sales on this form; and
4. This is the form that the Liquor Control Board ("LCB") recognizes as the report of wholesale dealer-to-dealer sales.

. . . Taxpayer goes on to assert "that the enforcement of the 72 hour stamping provision is liberally construed through the use of Schedule C" and that "[t]he Department and LCB are aware that there are [wholesaler-to-wholesaler] sales of cigarettes and do not insist on a strict adherence to the 72 hour stamping requirement." . . .

⁴ Taxpayer has not furnished the Department with the surety bond that is required under RCW 82.24.040(2)(b) in order to set aside unstamped inventory for the purpose of making exempt sales. Thus, Taxpayer's reliance on RCW 82.24.040(2)(b) is misplaced. To be clear, the specific question we are faced with in this appeal is whether Taxpayer is allowed to make wholesaler-to-wholesaler sales of unstamped cigarettes under the authority of RCW 82.24.040(2)(a) and related administrative rules and practices of the Department. However, even if Taxpayer had furnished a surety bond as required under RCW 82.24.040(2)(b), that would not change our analysis since RCW 82.24.040(2)(b) does not create an exemption allowing the sale of unstamped cigarettes; it simply provides a mechanism for wholesalers to hold unstamped inventory for the purpose of making exempt sales.

We find that Taxpayer is only partially correct. Rule 186, Part 204, deals with the duties and responsibilities of licensed wholesalers. One of the primary duties is to affix Washington cigarette tax stamps to packs of cigarettes shipped into this state for resale. ... Rule 186, Part 204(d)(i) allows the sale or transfer of unstamped cigarettes between licensed wholesalers, but only if the sale or transfer takes place within the first 72 hours of handling or possessing the cigarettes in this state. The Rule clearly does not establish what would amount to an exemption of all wholesaler-to-wholesaler sales. Rather, it simply permits the passing of the duty to stamp cigarettes from one licensed wholesaler to another so long as the cigarettes are stamped within the first 72 hours of in-state handling or possession. The licensed wholesaler who acquires the unstamped cigarettes takes on the stamping responsibility from the wholesaler who first possessed the cigarettes in this state. Thus, the Rule establishes a limited exception to the duty of the first licensed wholesaler to stamp cigarettes it possesses in this state. But to fit within this limited exception, the sale must occur within the 72-hour window for affixing the stamps.

....

Schedule C does nothing to broaden the exception to the stamping duty established under Rule 186, Part 204(d)(i). While the form is used to report sales of unstamped cigarettes, it does not purport to authorize or establish any legal right to make specific types of untaxed or exempt sales. As a result, we reject Taxpayer's argument that Schedule C allows wholesaler-to-wholesaler sales of unstamped cigarettes beyond the limited 72-hour window from first possession.

We also reject Taxpayer's claim that the Department's Miscellaneous Tax Section and the Washington Liquor Control Board have recognized and allowed wholesaler-to-wholesaler sales of unstamped cigarettes beyond the limited 72-hour window allowed under Rule 186, Part 204(d)(i). First, we have seen no proof that such advice has been provided in the past. Second, the Department is . . . not bound by mistaken oral advice given by its employees or by written or oral advice provided by third parties. *See* ETA 419. Finally, Taxpayer has not raised or established a right to abatement of the tax assessment under either RCW 82.32A.020(2)⁵ or under the equitable doctrine of estoppel. As a result, we find that any wholesaler-to-wholesaler sales of unstamped cigarettes that have been made after 72 hours from first possession in this state are not exempt and are not authorized by Rule 186 or by Department practice.

...

.... Taxpayer's petition for correction of assessment is denied as to this first issue. Taxpayer owes the tax, penalty and interest assessed on sales of unstamped cigarettes to other licensed wholesalers.

⁵ This statute establishes a taxpayer's right to rely on specific, official written advice and written tax reporting instruction given by the Department and provides a remedy "where the taxpayer has so relied to [its] proven detriment."

B. Sales to Unlicensed Tribal Smoke Shop Operating within the Boundaries of the . . . Indian Reservation.

[2] During the audit period the Taxpayer made a number of sales of unstamped cigarettes to . . . a . . . shop within the boundaries of the . . . Indian Reservation. [The shop] is not licensed with the Department as a cigarette wholesaler. As a result, sales to [the shop] do not constitute “wholesaler-to-wholesaler” sales. Rather, the issue here is whether these sales are exempt from the Washington cigarette tax as either (1) sales of Indian-taxed cigarettes pursuant to a contract with the state, or (2) wholesale sales of cigarettes to Indians and Indian tribes under the specific conditions set out in WAC 458-20-192(9)(a).

1. Taxpayer has not Established that it Paid Tribal Cigarette Tax to the Tribe on the Cigarettes Sold to [The Shop].

WAC 458-20-186(403)(b) [Rule 186(403)(b)] provides that “[t]he cigarette tax does not apply to cigarettes taxed by an Indian tribe in accordance with a cigarette contract under RCW 43.06.450 through 43.06.460.” This exemption applies only where there is a cigarette tax contract in place between the State and the Tribe which “shall provide for a tribal cigarette tax in lieu of all state cigarette taxes” RCW 43.06.455(3). The State and the [Tribe] have entered into a cigarette tax contract Pursuant to . . . that contract, the [Tribe] is to collect its cigarette tax through the use of tribal tax stamps. [The] contract provides that cigarettes bearing the tax stamp required by [the] Agreement may be delivered or transferred within or outside of Indian country by a wholesaler to the Tribe or a Tribal retailer, subject to meeting any notification requirements of [the] Agreement. [The] contract [also provides] that invoices identifying the cigarettes as .[Tribal] cigarettes must accompany such cigarettes.

The contract with the [Tribe] allows Washington licensed cigarette wholesalers to make sales of tribal-stamped cigarettes to “Tribal retailers.” . . . However, the contract also makes clear that wholesalers licensed by the State are subject to the requirements [of] Title 82 RCW and any rules adopted thereunder, and therefore must maintain adequate records detailing which cigarettes are subject to State tax and which cigarettes are subject to the Tribal cigarette tax. . . . (emphasis added).

In the present case, Taxpayer has provided no records to show that it purchased [Tribal] cigarette stamps or otherwise paid [Tribal] cigarette tax on any of the cigarettes sold to [the shop]. . . . Because Taxpayer has not maintained adequate records establishing that it has purchased . . . tribal cigarette stamps, it is not entitled to the exemption allowed under Rule 186(403)(b).

2. Taxpayer has not Met the Requirements for the Sale and Delivery of Unstamped Cigarettes to Indian Country.

WAC 458-20-192(9)(a) [Rule 192(9)(a)] relates to the administration and enforcement of the Washington cigarette tax to sales of cigarettes taking place within Indian country. Rule 192(9)(a)(ii) provides a mechanism for the sale and delivery of unstamped cigarettes by licensed

wholesalers to Indians or tribal sellers for resale to “qualified purchasers.” More specifically, the Rule provides:

(ii) Delivery or sale and delivery by any person of stamped exempt [*i.e.*, unstamped] cigarettes to Indians or tribal sellers for sale to qualified purchasers may be made only in such quantity as is approved in advance by the department. Approval for delivery will be based upon evidence of a valid purchase order of a quantity reasonably related to the probable demand of qualified purchasers in the trade territory of the seller.

Id. Rule 192(9)(a)(iii) goes on to provide that “[a]ny delivery, or attempted delivery, of unstamped cigarettes to an Indian or tribal seller without advance notice to the department” will make the person “attempting such delivery . . . liable for payment of the cigarette tax and penalties.” *Id.*

[3] None of the sales made by Taxpayer to [the shop] were approved in advance by the Department.⁶ As a result, Taxpayer does not meet one of the necessary elements of the exemption for wholesale sale and delivery of cigarettes to an Indian or tribal seller. Moreover, because of the lack of advance notice of these transactions, Taxpayer is “liable for payment” of the amount owed. Rule 192(9)(a)(iii). Taxpayer’s petition for correction is denied as to this second issue.

C. Sales to Out-of-State Distributor.

[4] Taxpayer made several sales of unstamped cigarettes to [out-of-state distributors]. . . . The cigarettes were delivered by Taxpayer to the distributor at a point outside this state. Washington law allows an exemption from the cigarette tax for sales of cigarettes “to persons licensed as cigarette distributors in other states when, as a condition of the sale, the seller either delivers the cigarettes to the buyer at a point outside this state, or delivers the same to a common carrier with the shipment consigned by the seller to the buyer at a location outside the state.” Rule 186, Part 404. However, for this exemption to apply, a wholesaler must make the sale from a stock of unstamped cigarettes that has been set aside in the manner authorized by RCW 82.24.040(2)(b).

RCW 82.24.040(2)(b) provides that “[a]ny wholesaler . . . who is licensed under Washington state law and who furnishes a surety bond in a sum satisfactory to the department, shall be permitted to set aside, without affixing the stamps required by this chapter, such part of the wholesaler’s stock as may be necessary for the conduct of the wholesaler’s business in making sales to persons in another state or foreign country or to instrumentalities of the federal government.” In addition, “[s]uch unstamped stock shall be kept separate and apart from stamped stock.” *Id.* See also Rule 186, Part 204(d)(ii).

⁶ The {Tribe} or member of the [Tribe] is not required to give advance notice. See *United States v. Smiskin*, 487 F.3d 1260 (9th Cir. 2007). This taxpayer’s transaction is not affected by that decision.]

Rule 186, Part 404 specifically provides that the exemption for sales to out-of-state distributors will only apply where the person making the sale “furnish[es] a surety bond in a sum equal to twice the amount of the tax that would be affixed to the cigarettes that are set aside for the conduct of such business without affixing cigarette stamps.” Taxpayer has not furnished the surety bond required under Rule 186, Part 204(d)(ii) and Rule 186, Part 404. As a result, the exemption does not apply.

Because Taxpayer has not met the specific requirements for the exemption for sales to out-of-state distributors, Washington cigarette tax is owed on these sales. Consequently, Taxpayer’s petition for correction is denied as to this third issue.

....

DECISION AND DISPOSITION

Taxpayer’s Petition is denied

Dated this 24th day of January, 2007.