

BEFORE THE ALASKA OFFICE OF ADMINISTRATIVE HEARINGS

In the Matter of)
)
Pete's Tobacco Shop, LLC. &) OAH Nos. 10-0231-TAX
Pete's Tobacco Too Shop, LLC.) 10-0357-TAX, 11-0470-TAX
) & 11-0415-TAX

DECISION

I. Introduction

The Alaska Department of Revenue (DOR) was granted partial summary adjudication in the above captioned consolidated cases. This order ruled that that the cost of packaging may not be deducted from the wholesale price of tobacco products when calculating Alaska tobacco products excise tax. Pete’s Tobacco Shop, LLC and Pete's Tobacco Too Shop, LLC (collectively, Pete’s Tobacco) had argued that these costs are deductible.

After the order on partial summary adjudication was issued, Pete’s Tobacco argued that there were still factual issues in dispute, namely that certain products had not correctly been taxed based on the wholesale price. These products were of pipe tobacco sold by People’s True Trust, Inc. some products sold by J.C. Newman and premium wholesale cigars sold by Fuente & Newman Premium Cigars Ltd., Inc. Pete’s Tobacco argued that these sellers were not the manufactures of these products of these products and that the price these sellers charged was therefore not the wholesale price of these products. Pete’s Tobacco argued that DOR should accept its estimate of the wholesale price of these products as the basis of its tax liability. Because Pete’s Tobacco failed to show that the amounts used by DOR were not the wholesale price of these products DOR’s informal conferences are upheld.

II. Background Facts

Pete’s Tobacco filed Alaska tobacco products excise tax-returns in which it deducted its estimate of the costs of packaging from the wholesale price it paid for those products. DOR assessed additional taxes after disallowing these deductions. Pete’s Tobacco requested informal conferences appealing these assessments. DOR upheld the assessments in informal conference decisions.

Administrative Law Judge Mark T. Handley of the Office of Administrative Hearings (OAH) was assigned to hear these appeals. Michael J. Barber, Assistant Attorney General,

represented DOR. Attorney Robert J. Dickson represented Pete's Tobacco. The appeals were consolidated.

Fuente & Newman Premium Cigars Ltd., Inc.

Pete's Tobacco presented evidence that the price that it paid for premium Arturo Fuente cigars from Pete's Tobacco that it purchased from Fuente & Newman Premium Cigars Ltd., was not the price that Fuente & Newman Premium Cigars Ltd. paid for the cigars when they were purchased from the business entity that imported them to the United States.

Ms. Shira Martin is the Chief Financial Officer for J.C. Newman Cigar Company. She also does the oversight for partnership Fuente & Newman Premium Cigars Ltd. As the CFO, Ms. Martin is involved in the operations of J.C. Newman Cigar Company.

Fuente & Newman Premium Cigars Ltd markets Fuente brand name products in the United States. Fuente & Newman Premium Cigars Ltd sold cigars made in the Dominican Republic to Pete's Tobacco. Those cigars were all Arturo Fuente cigars. The total price of sales of cigars to Pete's Tobacco was \$62,443.56.

Ms. Martin described the process of cigar production at Fuentes as beginning with growing the tobacco in the fields. The cigar tobacco is then dried and aged. Certain blends of this dried and aged tobacco are developed by the manufacture. There are three parts to a cigar. These are the filler, the wrapper and the binder. The Fuente employees in the Dominican Republic have different jobs in this manufacturing process. One of these jobs is to roll the filler into the right consistency were the cigar will draw the smoke properly with the right blend of flavors intermixed. The wrapper and filler are then placed in presses and molds. Another job is to lay the wrapper made of natural tobacco on top of the molded filler. Then the wrapped cigar is banded and covered with protective cellophane -tube packaging. The cigars will be boxed together then aged again. When the cigars have been aged, the cigars are shipped to Tampa, Florida.

Ms. Martin explained that Fuente & Newman Premium Cigars Ltd. does not undertake any of the manufacturing process described above. Ms. Martin characterized Fuente & Newman Premium Cigars Ltd. as a distributor. She described the company's role in the process of getting

Arturo Fuente to the retail shops such as Pete's Tobacco after receiving the cigars from an importer in the Fuente family of businesses.

Ms. Martin explained that there are actually three different entities in Fuente family of businesses that its cigars pass through before Fuente & Newman Premium Cigars Ltd. receives them; the manufacturing company in the Dominican Republic; another Fuente company in the Dominican Republic; and then the Fuente company based in Tampa that imports the cigars and sells them to Fuente & Newman Premium Cigars Ltd.

Ms. Martin explained that Fuente & Newman Premium Cigars Ltd. then distributes these cigars to the retail shops such as Pete's Tobacco. Fuente & Newman Premium Cigars Ltd. has regular customers, who call and order their products. The Fuente family company in Tampa that Fuente & Newman Premium Cigars Ltd. buys the cigars from holds of the importer license. Fuente & Newman Premium Cigars Ltd does not have an importer license to bring tobacco products into the United States. There are some also limited sales to other companies in the U.S. from the Fuente importer.

Ms. Martin explained that Fuente & Newman Premium Cigars Ltd. is a partnership between J.C. Newman family and Arturo Fuente family. The partnership was formed in the 1990's. Members of the two families serve on the Board of Directors of Fuente & Newman Premium Cigars Ltd.

Ms. Martin believes that J.C. Newman does not have any control over the price that Fuente & Newman Premium Cigars Ltd pays for the cigars it purchases from the importer. The importer charges more for the cigars it sells than the price it pays for them.¹

J.C. Newman

Ms. Martin testified that Pete's Tobacco purchased \$40,958.60 from J.C. Newman during the tax period. Ms. Martin explained that J.C. Newman both manufactures and distributes cigars. Ms. Martin testified about the brand names that J.C Newman sold Pete's Tobacco and stated that during the tax period 31.2 percent of those were tobacco products that it had manufactured. J.C. Newman also sold accessories and cigars that it did not manufacture. Other products purchased

¹ Recording of Hearing-Testimony of Ms. Martin.

by Pete's Tobacco carried the J.C. Newman brand but were made to order by other companies. When Pete's Tobacco purchased products from J.C Newman that company held the permit that the federal government requires for manufactures of tobacco products.²

People's True Trust, Inc.

Pete's Tobacco also provided evidence regarding the pipe tobacco it purchased from Peoples True Taste. Ms. Donna Colyer testified that Peoples True Taste purchased the pipe tobacco in bulk from other companies and repackaged it for sale to retail companies like Pete's Tobacco.

When Pete's Tobacco purchased this pipe tobacco from Peoples True Taste that company also held the permit that the federal government requires for manufactures of tobacco products.³

III. Discussion

The Alaska tobacco products excise tax sets a tax paid by those importing tobacco products that are not cigarettes into Alaska. This tax is set at 75 percent of the wholesale price of the imported tobacco product.⁴

Cost of Wrapping and Packaging

Pete's Tobacco argued in motion practice that because the definition of tobacco products includes a list of items covered by the tax, but does not explicitly mention the packaging that those items are sold in, the taxpayer should estimate and deduct the cost of packaging from the wholesale price of the tobacco products imported in calculating the tax due.

Alaska Statute 43.50.390(4) lists specific types of tobacco products subject to tax:

- (A) a cigar;
- (B) a cheroot;
- (C) a stogie;
- (D) a perique;
- (E) snuff and snuff flour;
- (F) smoking tobacco, including granulated, plug-cut, crimp-cut, ready-rubbed, and any form of tobacco suitable for smoking in a pipe or cigarette;

² Recording of Hearing-Testimony of Ms. Martin.

³ Recording of Hearing-Testimony of Ms. Colyer & Exhibit D.

⁴ AS 43.50.300.

(G) chewing tobacco, including Cavendish, twist, plug, scrap, and tobacco suitable for chewing; or

(H) an article or product made of tobacco or a tobacco substitute, but not including a cigarette as defined in AS 43.50.170[.]

Pete's Tobacco's argument ignored the fact that the tobacco products subject to the tax are packaged and are sold wholesale with packaging, marketing, and other components of value, such as the quality of storage and handling of these items. The non-exclusive list of items found in the first part of the definition of tobacco products is descriptive of the types of products that are subject to the tax. Taken as a whole, this definition is very broad and includes any product or article made of tobacco or a tobacco substitute other than cigarettes.⁵ The description of how the tax is calculated is part of the statute that sets the tax at 75 percent of the wholesale price.⁶ The wholesale price is defined as either the price charged by the manufacturer, with deductions for cash or quantity discounts, or, for sales that are not arm's length transactions, the price estimated as comparable to the wholesale price as determined by DOR.⁷ Thus, the tax is based on the actual price of the products that were sold to the importer, or an estimated comparable price, not on the price of some other tobacco products that were not packaged.

Pete's Tobacco argued the value of packaging is not taxed because the items listed in the definition of "Tobacco Product" in AS 43.50.300(4)(A) do not explicitly include the packaging that those items are sold in at wholesale, or as Pete's Tobacco characterized the packaging, "the packaging in which tobacco products are sometimes trade[d]." Pete's Tobacco's characterization is significant because it illustrates one of the ways that Pete's Tobacco misunderstands this tobacco tax. The Alaska tobacco products excise tax sets a tax based on the actual wholesale price at which tobacco products are sold rather than the price at which those products "are sometimes traded."

The only time that sales other than the actual sale charge by the wholesale manufacturer to the distributor or taxpayer are used is when that sale is not an arm's length transaction and substitute sales must be used to estimate what the arm's-length price would have been.⁸ The wholesale price is ordinarily the price that was paid for the tobacco product purchased. If that

⁵ AS 43.50.390(4)(H).

⁶ AS 43.50.300.

⁷ AS 43.50.390(5).

product was purchased at wholesale in a wrapper or container or other packaging, then the tax is 75 percent of the wholesale price of that tobacco product as it was purchased, including the packaging. If the tobacco product sold at retail did not include any packaging—if, for example, the distributor brought his own sacks to the manufacturer and filled them at the wholesale purchase out of bins of unwrapped cheroots and stogies—the tax would be 75 percent of the unwrapped and unpackage wholesale price that he paid.⁹

In setting the tax based on the wholesale price, rather than a theoretical value, the Alaska tobacco products excise tax is a system of taxation that makes the tax easy to calculate, even though a wide variety of tobacco products are covered by the tax. Using the wholesale price allows the tax to be calculated by simply using the manufacturer’s invoice in most cases. There is no indication in statutory language of the excise tax created under AS 43.50.300 that shows that a more complicated method of calculating the amount of the tax was intended.

The authority cited by Pete’s Tobacco in support of its position that the tax is based on the unwrapped and unpackage value of the tobacco products, rather than the wholesale price, is not persuasive. Pete’s Tobacco’s cites decisions from courts outside Alaska, as well as the laws of other states and the federal government where courts and laws distinguished the packaging that tobacco is sold in from the commodity or product itself for purposes other than calculating the Alaska excise tax due under AS 43.50.300-390.

This authority shows only what one would assume, or as Pete’s Tobacco puts it, what is a matter of common sense: that laws sometimes make distinctions between a tobacco commodity, such as those covered by the Alaska tobacco product excise tax, and the wrappers and packaging those commodities come in. For example, Pete’s Tobacco cites a federal case litigated in *Kentucky Commonwealth Brands, Inc. v. United States*,¹⁰ in which tobacco companies argued that the Family Smoking Prevention and Tobacco Control Act violated the U.S. Constitution. Pete’s Tobacco points out that in this case both the court and the challenged act itself made a

⁸ AS 43.50.390(5)(B).

⁹ “A cheroot” and “a stogie” are listed as types of tobacco products covered by the excise tax at AS 43.50.390(4)(B) & (C) respectively.

¹⁰ *Commonwealth Brands, Inc. v. United States*, 678 F. Supp. 2d 512 (W.D. Ky. 2010), as amended (Jan. 14, 2010), aff’d in part, rev’d in part sub nom. *Disc. Tobacco City & Lottery, Inc. v. United States*, 674 F.3d 509 (6th Cir. 2012).

distinction between the packaging that tobacco is sold in and the commodity or product itself. No such distinction can be found in the text of the Alaska law.

Pete's Tobacco filed additional briefing on other court decisions outside Alaska in a submittal of supplemental authority. These decisions provide examples of courts having determined that various types of packaging for consumer goods were not subject to various state taxes that did apply to the goods themselves. Pete's Tobacco also provided the Juneau sales tax, which specifically exempts food containers or wraps or other disposable articles from that tax. Again, the issue in this case is not whether the legislature *could* have excluded the value of packaging and wrappers from wholesale price used to calculate the tax due, but whether it did.

DOR relied on a Washington Court of Appeals case, *U.S. Tobacco Sales & Mktg. Co. v. State, Dept. of Revenue*.¹¹ In contrast to the cases cited by Pete's Tobacco, this case dealt with the scope of what should be included in the wholesale price when calculating a state tax on tobacco products, other than cigarettes, that is very similar to the Alaska tobacco product excise tax. The language that the Washington tobacco products tax uses to describe how the tax is calculated is similar to the language of the Alaska tobacco product excise tax.¹² The Washington statute uses the term "Taxable sales price" similarly to the way the Alaska law uses the term "wholesale price." The way the Washington tax is structured and calculated is essentially the same as the Alaska tax. What both these taxes do is set the tax based on the price of what was sold at the wholesale transaction, rather than what is defined as a tobacco product.

There are some significant differences between the statutory language of Alaska tobacco product excise tax and the Washington law addressed in *U.S. Tobacco*. The Washington law is more explicit in describing tobacco products, and it explicitly includes items made with tobacco that are not just tobacco in its definition of tobacco products covered by the tax.¹³ Despite these differences, the Washington court's reasoning in its conclusion that the value of the packaging of tobacco products is part of the wholesale price used to calculate the Washington tobacco products tax supports DOR's position. The Washington court concluded, because the Washington tax is calculated based on the wholesale price of the tobacco product, the tax is

¹¹ 96 Wash. App. 932, 941, 982 P.2d 652 (1999).

¹² See Wash. Rev. Code Ann. § 82.26.010 & 82.26.020 and AS 43.50.300 & AS 43.50.390(5).

¹³ See Wash. Rev. Code Ann. § 82.26.010(5) & (21).

based on the entirety of what was sold at wholesale, including the packaging. The Washington court observed:

The statute imposes the tax upon the value of a manufacturer's products, measured at the time the manufacturer sells the products. This price will reflect the quality, quantity, packaging, and trademark value of the products as provided by the manufacturer. At a minimum, this price must include the costs and profits associated with manufacturing and sales, because those functions are mandated by the statutory definition of “manufacturer”¹⁴.

Similarly, the mere inclusion of the list of some specific consumer products within the definition of “tobacco product” does not imply that the legislature intended to set the tax on the economic model of hypothetical bin-and-gunnysack wholesale transactions suggested by Pete’s Tobacco. The tax is based on the wholesale price paid for the actual tobacco product that was purchased, with explicit limited deductions for certain discounts that may apply to that purchase. The tax is not based on a product that was not purchased, such as an unwrapped or unpackaged version of the product, nor is it based on the wholesale price paid for the product purchased with a deduction for the estimated cost of the product’s wrapping and packaging.

Dispute over Wholesale Price of Purchases from Three Sellers

Pete’s Tobacco argued that Peoples True Taste and Fuente & Newman Premium Cigars Ltd. were distributors not manufacturers of the products that they sold Pete’s Tobacco. Pete’s Tobacco argues that the price paid for those products was therefore not the wholesale price of those products for the purpose of calculating the Alaska tax liability of Pete’s Tobacco for the importation of those products to Alaska. Pete’s Tobacco argues that the same is true for the Tabaco products it purchased from J.C. Newman that were brands not manufactured by that company. Pete’s Tobacco argued that DOR should obtain copies of confidential surveys that list average price information of cigars and other tobacco products and use the information in these surveys to estimate the wholesale price of these products for the purpose of calculating tax liability.

The issues raised by Pete’s Tobacco were only clearly raised after the motion for partial summary adjudication upholding DOR’s decision that costs of packaging and other costs were

¹⁴ *U.S. Tobacco Sales & Mktg. Co., Inc. v. State, Dept. of Revenue*, 96 Wash. App. 932, 941, 982 P.2d 652, 658 (1999).

including the wholesale price for the purpose of calculating the tax. The relief that Pete's Tobacco seeks is not supported by the law or the evidence in the record. Pete's Tobacco argues that the law imposes a requirement that DOR conduct research and estimate the wholesale price of the tobacco products imported by Pete's Tobacco. As a taxpayer appealing DOR's informal conference decisions Pete's Tobacco had the burden of showing that the tax assessed by DOR was incorrect. Pete's Tobacco did not show that the prices that DOR used to calculate that tax on these products was not the wholesale price of these products.

Peoples True Taste

The evidence in the record does not show that it is more likely than not that the prices that Peoples True Taste charged for the products it sold Pete's Tobacco was not the wholesale price of these products. The products sold to Pete's Tobacco were manufactured by Peoples True Taste, even if that process was limited to repackaging and shipping the pipe tobacco it sold to Pete's Tobacco. Having held in the order granting partial summary adjudication that packaging is part of the wholesale price, the evidence in this record shows that Peoples True Taste's packaging of the products it sold to Pete's Tobacco was part of the manufacturing process. As noted above in the language incorporating that order:

The tax is not based on a product that was not purchased, such as an unwrapped or unpackaged version of the product, nor is it based on the wholesale price paid for the product purchased with a deduction for the estimated cost of the product's wrapping and packaging.

Pete's Tobacco purchased pipe tobacco from Peoples True Taste. The tobacco had been purchased in bulk lots by Peoples True Taste that was not suitable for the needs of retail sellers such as Pete's Tobacco. Peoples True Taste repackaged this tobacco into the products that Pete's Tobacco purchased. This product was not the bulk product from Peoples True Taste. This new repackaged product was manufactured by Peoples True Taste. Peoples True Taste had a permit to manufacture tobacco products. The evidence in the record shows that Peoples True Taste was the manufacturer of retailer-sized packages of pipe tobacco purchased by Pete's Tobacco. The price paid by Pete's Tobacco was therefore the wholesale price for the purpose of calculating the tax.

Fuente & Newman Premium Cigars Ltd

The evidence in the record does not show that it is more likely than not that the prices that Fuente & Newman Premium Cigars Ltd. charged for the products it sold Pete's Tobacco was not the wholesale price of these products. Pete's Tobacco argued that treating the Fuente family of businesses and Fuente & Newman Premium Cigars Ltd. as one entity for the purpose of estimating the wholesale price would be an illegal attempt to pierce the corporate veil of those companies. The Fuente family of businesses Fuente & Newman Premium Cigars Ltd. are not parties in this appeal. Nor is it necessary to ignore the separate legal status of these entities to find that the sales of cigars between these entities between these companies that have both interlocking ownership and directorates are not arms-length transactions. The Alaska law establishing this tax specifically provides that DOR should estimate the price that would be charged to a distributor in these situations.¹⁵ The evidence in the record does not show that the price Fuente & Newman Premium Cigars Ltd. charged Pete's Tobacco was more than those cigars would have been sold to distributors. There was testimony that there were some direct sales of these cigars that did not go through Fuente & Newman Premium Cigars Ltd. It is reasonable to infer that these sales did not undercut the prices charged by Fuente & Newman Premium Cigars Ltd., a company in which the owners of Fuente family of businesses that manufactured these cigars had an ownership interest.

J.C Newman

Pete's Tobacco argued 68 percent of the products that it purchased from J.C. Newman were not manufactured by J.C. Newman and therefore that the price Pete's Tobacco paid for those products was not the wholesale price.

The evidence in the record does not support Pete's Tobacco position that all the products it purchased from J.C. Newman were not manufactured by that company. While Pete's Tobacco provided evidence that J.C. Newman purchased some of the products from other companies, some of these products were made to J.C. Newman specifications and carried the J.C. Newman brand. The fact that some or most of the production of a process of a tobacco product is carried on by another company does not mean the company sells that product is not the manufacturer for the purpose of determining the wholesale price. The wholesale price of tobacco product includes

all the value of the product that was purchased. That value includes the marketing and branding and certainly includes product designs and setting the specifications for production.

IV. Conclusion

The Alaska tobacco products excise tax assessed in AS 43.50.300-390 is a tax based on the wholesale price of tobacco products. This price includes the price of the wrapping, packaging and other components of the wholesale value of the tobacco products sold in the wholesale transaction. A deduction for the estimated value of the wrapping or packaging components of tobacco products included in the wholesale purchase is not allowed under Alaska tobacco products excise tax.

Pete's Tobacco failed to show that the amounts used by DOR to calculate its tax liability were not the best estimates of the wholesale price. The retail-sized packages of pipe tobacco sold by People's True Trust, Inc., the premium wholesale cigars sold by Fuente & Newman Premium Cigars Ltd., Inc. and the products sold by J.C. Newman, were all purchased by Pete's Tobacco at the wholesale price.

V. Order

DOR's informal conference decisions are upheld.

DATED this 9th day of May 2014.

By: Signed
Mark T. Handley
Administrative Law Judge

NOTICE

1. This is the hearing decision of the Administrative Law Judge under Alaska Statute 43.05.465(a). Unless reconsideration is ordered, this decision will become the final administrative decision 60 days from the date of service of this decision.¹⁶

¹⁵ AS 43.50.390(5).

¹⁶ AS 43.05.465(f)(1).

2. A party may request reconsideration in accordance with Alaska Statute 43.05.465(b) within 30 days of the date of service of this decision.
3. When the decision becomes final, the decision and the record in this appeal become public records unless the Administrative Law Judge has issued a protective order requiring that specified parts of the record be kept confidential.¹⁷
4. A party may file a motion for a protective order, showing good cause why specific information in the record should remain confidential, within 30 days of the date of service of this decision.¹⁸
5. Judicial review of this decision may be obtained by filing an appeal in the Alaska Superior Court in accordance with Alaska Statute 43.05.480 within 30 days of the date of this decision becomes final.¹⁹

¹⁷ AS 43.05.470.

¹⁸ AS 43.05.470(b).

¹⁹ AS 43.05.465 sets out the timelines for when this decision will become final.