

Cite as 3 WTD 393 (1987)

BEFORE THE DIRECTOR  
DEPARTMENT OF REVENUE  
STATE OF WASHINGTON

In the Matter of the Petition )		<u>F</u> <u>I</u> <u>N</u> <u>A</u> <u>L</u>
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[1] **RCW 82.12.0275 and RULE 18801:** USE TAX -- EXEMPTIONS -- PRESCRIPTION DRUGS -- DRUG SAMPLES. The use tax exemption of Revised Code of Washington (RCW) 82.12.0275 is available only for patient/users and consumers of prescription drugs for whom such drugs are prescribed, the exemption is not available for persons who distribute free "sample drugs" to promote further sales.

[2] **RCW 82.12.010 and RULE 178:** USE TAX -- TAX MEASURE -- VALUE OF ARTICLE USED -- GIFTS. The value of articles given away is to be determined as nearly as possible by the retail selling price of similar articles. Where no such similar retail value exists, the value of articles gifted in this state shall be determined by the total costs of production, (Rule 178 to be so amended).

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: . . .  
                                  . . .  
                                  . . .

HEARING CONDUCTED BY DIRECTOR'S DESIGNEES:

Sandi Swarthout, Assistant Director  
Garry G. Fujita, Chief of  
Interpretation and Appeals  
Edward L. Faker, Sr. Administrative  
Law Judge

DATE AND PLACE OF HEARING: Teleconference; March 4, 1987

NATURE OF ACTION:

Appeal from the findings and conclusion of Determination No. 86-176, issued on May 28, 1986. Appellant was denied a refund of use tax measured by the wholesale value of sample pharmaceuticals (drugs) provided to physicians free of charge for distribution, by prescription, free of charge to patients.

FACTS AND ISSUES:

Faker, Sr. A.L.J -- The facts of this case are not in dispute. They, together with the details of the audit, tax assessment, and payment of the use tax in question are fully and properly reported in Determination 86-176. The facts are not restated herein except as necessary hereafter to explain the taxpayer's testimony and arguments.

These are two interdependent issues:

1. Does use tax apply to the value of sample drugs provided free of charge to physicians for their distribution to patients, free of charge, under prescription?

2. If the use tax applies, what is the proper tax measure, i.e., what is the value of such articles used?

TAXPAYER'S EXCEPTIONS:

The taxpayer asserts that the drugs in question have been given an improper value for tax purposes, comparable to the wholesale selling price of such drugs when actually sold to pharmacies (retail sellers). Also, the taxpayer argues that no use tax should apply at all because of the exemption of RCW 82.12.0275 for the use of "prescription drugs."

For purposes of clarity the issues and arguments will be treated herein in the reverse order from that presented above and in the taxpayer's petition and legal memoranda.

The taxpayer claims total exemption of tax because its products constitute "prescription drugs," exempt of use tax under RCW 82.12.0275. This exemption, the taxpayer argues, is available all the way up the distribution chain, including the manufacturing and wholesale level. In other words, the products are tax exempt, generically, by virtue of being "prescription drugs" by definition, regardless of how or to whom they are distributed. The taxpayer's petition to the Director on this point includes the following pertinent remarks:

The taxpayer has argued that the taxation of prescription pharmaceutical samples has, in effect, subjected prescription pharmaceuticals to taxation in direct violation of the intent of the state legislature to exempt prescription pharmaceuticals from the sales and use tax. The intent of the legislature was to exempt certain necessities from the additional cost of the sales and use tax. By taxing the prescription pharmaceutical samples, the Department of Revenue has increased the cost of prescription pharmaceuticals. This tax burden or cost is passed onto the consumer in terms of a higher price for the exempt drug. On page 7 of the Determination 86-176 the administrative law judge has conceded that the ultimate use by the patients to whom such drugs would be prescribed would be exempt from the sales and use tax. The question to be answered is whether or not these articles which are ultimately prescription drugs under Washington state law should be taxed at any stage of their interstate commerce.

If the intent of the state legislature was to exempt these items from the tax, then the Department of Revenue has violated that specific legislative intent by taxing an article which would be specifically exempt when dispensed by a licensed physician.

The taxpayer refers us to administrative rulings in other jurisdictions, notably the states of Texas and New York, holding that prescription drugs are generically exempt of tax in those states at all stages of distribution without regard to the time in the distribution chain that they are actually prescribed for and used by a patient. In other words, the exemptions from sales tax and use tax (similar in their statutory language to the Washington laws) are not triggered

only "when" the drugs are prescribed. The fact that the drugs will be ultimately prescribed for patients makes them tax exempt by nature. This is true of prescription "samples" as well, even though the statutory language makes no reference to prescription drug "samples."

The taxpayer asserts that no other state which provides tax exemptions for prescription drugs limits the exemption to the retail or patient use level. Rather, the exemptions are afforded to any user at any level, whether or not it is the person for whom the drugs have been prescribed. The taxpayer argues that limiting the exemption to patients defeats the legislative purpose of reducing the cost of prescription pharmaceuticals. This is because the tax must be, and will be recovered by increasing the cost (price) of drugs when actually sold at wholesale.

During the March 4, 1987 teleconference, the taxpayer presented the testimony of economists who have technical experience in analyzing pharmaceutical transactions. The Department stipulated to the qualifications as expert witnesses of both Gunther Schindler and David Henderson who offered support testimony and a written report concerning the value of pharmaceutical samples (re: Issue No. 2).

Mr. Henderson reaffirmed that the assessment of use tax upon free drug samples results in increased cost of pharmaceuticals actually sold. The tax cost is passed on to purchasing customers (retailers) and ultimately this increases the cost to the patient/user. This all impacts the "rate of return" in the pharmaceutical marketplace, according to this testimony.

The taxpayer submitted the written report of Mr. Schindler and Mr. Henderson which addresses the exemption issue as follows:

Imposing a sales tax on the cost to manufacture samples increases the manufactures' costs of marketing, without however increasing the cost borne by them. The incidence of this tax, as well as other marketing expenses, is readily shifted to other costs of doing business. The real incidence of a sales tax on free samples would be shifted to the sales of other products and would be a burden to the ultimate consumer (the patient).

Imposing a sales tax on free prescription pharmaceutical samples raises complex questions about the market value of something that by

definition has no value. The incidence of the tax could readily be shifted and would have a negative effect on the prices of other products sold by the manufacturer, and paid by the consumer. In light of the absence of a real market value for prescription pharmaceutical samples, and because of the pass-through to the ultimate consumer, we recommend against the imposition of a state sales tax on free prescription pharmaceutical samples.

As to the second and more aggressively argued issue, the taxpayer asserts that the value upon which it regularly reported use tax is the legally proper and appropriate value. Tax was reported upon the costs of producing the sample drugs. Again, these drugs are distributed to physicians free of charge and, in turn, the samples are given to patients free of charge. Sample drugs are never sold. They are specially packaged in units of six to ten doses and the packaging is always clearly marked, "Professional Sample."

The taxpayer's petition to the Director includes the following:

Taxpayer has stated that prescription pharmaceutical samples differ in value from samples of other products since they are distributed under additional restrictions which do not apply to the general market place. Prescription pharmaceutical samples can only be given to a licensed physician. The physician does not pay for the sample. Ultimately, the prescription pharmaceutical sample is dispensed by a licensed physician. Prescription pharmaceutical samples are marked with indications that they are not for resale and that they are samples.

Other consumer products generally do not differ in shape, size or form in the sample state as it would in the retail state. In some cases, samples for other consumer products do not even carry an indication that it is a sample. The prescription pharmaceutical sample packages do not equate to any quantity size which the taxpayer sells to wholesalers for distribution. They are specifically packaged and indicated to be samples. The samples can only be distributed pursuant to a physician's prescription.

The taxpayer's contention is that equating the value of the prescription sample to that which is distributed at wholesale is neither practical nor reasonable. Even though the pills themselves are identical to the pills which are sold to wholesalers, there is a general preception (SIC) among the public that an article labeled "sample" is of a different or lesser quality than an item which is not so labeled. In this particular case, the packaging becomes integral to the product and inherently, the value of the prescription sample is less in value than its counterpart. Thus, the prescription pharmaceutical samples do differ in quality or character from those drugs which the taxpayer sells in its normal course of business.

Customers do not expect to nor do they pay the same price for a sample as they would pay for the unmarked product. This is true even though the contents of the packages are identical in nature and character. In regard to the prescription samples, the public knows that the physician has received the item free of charge. As such, no one would pay the retail price for this item. Samples have a market value of their own. Since the public knows that prescription samples are free to the physician, it is unlikely that the market value is higher than the cost to produce. In fact, physician's do not sell the samples. Taxpayer is not aware of any Washington State law which prohibits physicians from selling the samples. Therefore, the marketplace has determined that items labeled as "SAMPLE" have no value. Accordingly, the assessment overvalued the prescription samples.

During the teleconference the taxpayer's economic experts provided testimony in support of the cost-of-production valuation. They testified that sample drugs have no wholesale or retail value whatever, for the very practical reason that no one would or does purchase them at wholesale or retail. Pharmaceuticals are produced and distributed at wholesale or retail in units of 100 to 1000 capsules, pills, or doses. Pharmacies or retail distributors do not carry "samples." Their purpose is exclusively for distribution to physicians, to promote the drug products themselves, to determine their efficacy, and to stimulate physicians to continue prescribing their use in the retail pharmaceutical marketplace. The testimony was that this is a "proving-up" process or a "trial"

use. Sample drugs are provided as a "marketing tool." They have no actual "market" value at all and their only value for any purpose is represented by their cost of production. Also, it was testified that the packaging of professional samples was, itself, an inherent part of the sample product.

The taxpayer submitted physical evidence consisting of sample drug packages for some 25 different sample drug products. All such packages conform with the special markings and prohibitions on sale testified to by the taxpayer's economists.

The report submitted by the economists addresses this second issue as follows:

Individually packaged and labeled as "professional prescription pharmaceutical sample," a patient does not expect to be charged when he is given a sample by his physician. Prescription pharmaceutical samples are by definition distributed free of charge, and, in our opinion, have no commercial value. To arrive at this opinion we are drawing on our insights into the role of "free samples" in marketing prescription pharmaceuticals. Additional support is drawn from considerations concerning the ultimate incidence of the indirect tax and the administrative burdens involved.

Marketing prescription pharmaceuticals differs greatly from marketing consumer products. The target for prescription pharmaceutical marketing is not the end user (the patient) but the prescribing physicians. Rather than relying on media advertising, manufacturers of pharmaceutical products customarily engage "detail men" to personally call on physicians, pharmacists, and hospital and other health care administrators. New product introduction and discussions about product efficacies, inherent qualities, side effects and other relevant details are practically unthinkable without the involvement of these sales representatives.

Free samples have become an integral part of pharmaceutical marketing. Determining the value of a free sample in the absence of a real market would prove to be difficult if not arbitrary. The absence of a ready market for prescription pharmaceutical

samples is assured by the involvement of a physician (the need for a prescription) who is prevented from charging for the "free sample." The sample is provided to encourage the physician to prescribe the drug by permitting him to first test the effectiveness of the product.

The only known value of the free sample is the manufacturer's cost. The costs of marketing pharmaceuticals, including the cost of free samples, are expensed by pharmaceutical manufacturers as a necessary cost of doing business. The prospect of adding an additional cost element in the form of a sales tax whenever free samples are distributed to physicians involves an administrative burden of unusual dimension.

Finally, the taxpayer challenges the conclusory finding of Determination 86-176 that, "(t)hose drugs given physicians as samples, although packaged differently and carrying restrictions as to their subsequent sale, are identical to those drugs of the same variety which are sold to the taxpayer's customers in normal packaging" (Det. 86-176, p. 8).

#### DISCUSSION:

[1] The question presented as Issue No. 1 is not a matter of first impression before the Department. WAC 458-20-18801 (Rule 18801) expressly provides in pertinent parts as follows:

The retail sales tax does not apply to sales to patients of drugs, medicines, prescription lenses, or other substance, 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.

. . .

The use tax does not apply to the use of articles and products which are exempt of sales tax as specified herein.

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 of 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 patient/purchasers/users for whom the drugs are prescribed. In a prior final determination, No. 86-199, issued June 30, 1986, and involving the joint appeal of 38 hospitals, we said:

Concerning the use tax exemption of RCW 82.12.0275, the Department is committed to the position, consistently applied, that it is available for persons who use prescription drugs and for whom the retail sales tax exemption of RCW 82.08.0281 could have been available. That is, both of these exemptions are for the benefit of the ultimate consumer/patient/user of the drugs to whom they are actually administered. The exemptions are complimentary and in para materia in the truest sense. In response to the taxpayer's arguments, the very reason that RCW 82.12.0275 is included in the law is to prevent use tax from being assessed upon the use of prescription drugs which were exempt of sales tax when purchased. Absent the express exemption, the actual use of the drug could be taxed under the use tax even though its purchase was exempt of sales tax. The taxes are complimentary as are the expressed exemptions from them. There is absolutely no evidence or support whatever that the intent of the legislature was to grant a plenary consumer tax exemption to remove all tax burdens from healing aids, prescription drugs, or medical applications. Conversely, when the legislature has seen fit to do so it has provided special, express exemptions in this area; viz: RCW 82.08.0283 and 82.12.0277 relating to insulin and prosthetic/orthotic devices. The Department of Revenue is without authority to grant tax exemptions or deductions or to expand them beyond the express

statement of statutory law. See Budget Rent A Car v. State, 81 Wn.2d 171 (1972).

We are not persuaded by the opinions or rulings of other states' administrative agencies. They construe and implement the specific statutory exemptions of those states' acts which are not before us here and which may or may not include statements of those states' legislative purpose or intent.

RCW 82.12.010 defines the term "use" to have its common and ordinary meaning. This statute also extends the definition of the term "consumer" to include any person who distributes or causes to be distributed any article of tangible personal property for the purpose of promoting the sale of products. By the taxpayer's own testimony, this is exactly how it uses sample drugs in this state.

We must conclude that use tax is properly due upon the taxpayer's use of sample drugs in this state. Determination 86-176 is sustained as to this issue.

[2] Concerning Issue No. 2, the "value of the article used" as defined at RCW 82.12.010(1) is the proper measure of use tax. The statute provides, in pertinent part, as follows:

In case the article used is acquired by . . . gift . . . , 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 rule (WAC 458--20-178) it simply recites the statutory provision above with one minor addition, Rule 178 provides:

In case the article use was . . . acquired by gift or was sold under conditions where the purchase price did not represent the true value thereof, the value of the article use 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 the word, it is the Department's position that the quantity or number of units sold has a direct bearing upon the value of any quantified goods (i.e., the number of fungibles in a container).

This rule does not deal with a situation 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, both the manufacturing business tax measure and the use tax measure are controlled by WAC 458-20-112 (value of products). This rule 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 by the taxpayer's testimony and the record of this case that the proper measure of use tax upon sample drugs should be the total costs of production. We agree with the taxpayer's position that the unique packaging used for sample drugs is an "inherent part of this product." By quantifying and packaging sample drugs as it does the taxpayer has developed a new and distinct product which has no retail sale 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.

Accordingly, we disagree with the conclusory finding of Determination 86-176 with respect to the value of sample drug items provided to physicians free of charge, for free distribution. We hereby overturn that finding and order adjustment of the use tax assessment to be measured by the total costs of production, including the costs of special "sample" packaging.

#### DECISION AND DISPOSITION:

The Audit Section will review Audit Schedule III and will make adjustments as appropriate under the guidelines contained herein. A tax refund or credit, with interest, will be processed and the taxpayer will be notified thereof in writing.

DATED this 17th day of July 1987.

