

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :
of :
SMITHKLINE BEECHAM CORPORATION : DETERMINATION
for Revision of a Determination or for Refund of Sales and : DTA NO. 816739
Use Taxes under Articles 28 and 29 of the Tax Law for the :
Period December 1, 1990 through August 31, 1995. :

Petitioner, SmithKline Beecham Corporation, One Franklin Plaza, P.O. Box 7929/FP 2335, Philadelphia, Pennsylvania 19101, filed a petition for revision of a determination or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period December 1, 1990 through August 31, 1995.

Petitioner appeared by McDermott, Will and Emery (Arthur R. Rosen and Alysse Grossman, Esqs., of counsel). The Division of Taxation appeared by Barbara G. Billet, Esq. (James Della Porta, Esq., of counsel).

Petitioner and the Division of Taxation executed a consent waiving a hearing in this matter and agreeing to have the controversy determined on submission. Petitioner's reply was deemed received on January 24, 2000, which date began the six-month period for the issuance of this determination.

After a review of the evidence and arguments presented, Roberta Moseley Nero, Administrative Law Judge, renders the following determination.

ISSUE

Whether the use of packaging materials by petitioner in New York State in providing sample drugs and medicines to physicians to give to their patients is exempt from use tax.

FINDINGS OF FACT

1. A stipulation pursuant to 20 NYCRR 3000.11 was submitted in this matter. The facts as set forth in the stipulation have been substantially adopted in this determination with only slight changes in wording and organization.
2. Petitioner was incorporated under the laws of the State of Pennsylvania on June 29, 1929.
3. Petitioner is commercially domiciled in Pennsylvania and is primarily engaged in the business of developing, manufacturing and marketing pharmaceutical products.
4. Petitioner is subject to New York State sales and use tax under Articles 28 and 29 of the New York State Tax Law.
5. In a Notice of Determination dated May 22, 1997, the Division of Taxation (“Division”) asserted that additional sales and use taxes and interest are due from petitioner due to the imposition of use tax on the cost of the packaging material that accompanied drug and medicine samples distributed without charge by petitioner in New York State from December 1, 1990 through August 31, 1995 (“audit period”). The amount of the additional asserted sales and use tax is \$381,354.14.
6. During the audit period, petitioner distributed samples of drugs and medicines to physicians and other health care providers in New York free of charge (“sample drugs and medicines”) as part of its marketing efforts for pharmaceutical products.

7. Along with the sample drugs and medicines distributed during the audit period, petitioner distributed packaging material which was composed of the following: items containing and protecting the sample drugs and medicines, such as bottles, boxes, blister packs, and plastic tubes (“containers”); other packaging materials used in or on the containers, such as cotton and exterior wrapping; labels that are affixed to the containers and that describe the contents of the containers; and printed information that describes proper usage, dosage, possible adverse reactions and other required information concerning the sample drug or medicine. With the stipulation the parties submitted Exhibits 1 through 7, which are representative examples of the sample drugs and medicines, including the packaging material. Exhibit 1 is a patient starter package of Augmentin, which consists of two tablets of Augmentin, a cardboard box, and a blister pack. Exhibit 2 is a patient starter package of Relafen, which consists of six tablets of Relafen, a cardboard box, and a blister pack. Exhibit 3 is a patient starter package of Paxil, which consists of seven tablets of Paxil, a cardboard box, and a blister pack. Exhibit 4 is a sample package of Bactroban Cream, which consists of Bactroban Cream, several plastic tubes, cardboard backing, and labels; the plastic tubes and the labels are affixed to the cardboard backing with plastic and all of the tubes are enclosed in one plastic bag (a health care provider is furnished with the entire plastic bag and its full contents). Exhibit 5 is a sample package of Paxil tablets, which consists of 30 Paxil tablets, a plastic bottle, a child-resistant closure, a label that is attached to the bottle, an insert that is attached to the bottle by the label, a seal over the bottle opening, and cotton or similar material. Exhibit 6 is a sample of Compazine, which consists of Compazine liquid, a dark brown glass bottle, a label that is attached to the bottle, a child-resistant closure, a safety seal, and an insert that is attached to the bottle by the label. Exhibit 7 is a

collection of informational inserts that accompany sample drugs and medicines when the required insert is not physically attached to a sample drug or medicine.

8. The sample drugs and medicines are distributed in a variety of forms, including powders, tablets, creams, gels and liquids. Containers and other packaging materials used in distributing the drugs (such as the cotton packing inserted into bottles, the safety closure covers, and the safety-seals) keep the drug and medicine samples free from contamination, ensure that each sample package has a uniform quantity of the drug, and provide a means of delivering the drugs and medicines to the health care providers and for the health care providers to distribute the drugs and medicines to their patients. The Food and Drug Administration (“FDA”) mandates that the drugs be delivered in an unadulterated state. One reason petitioner uses the containers and other packaging material is to comply with the FDA requirements regulating the distribution of drugs.

9. The sample drugs and medicines cannot be legally distributed without the labels, which are affixed to the containers containing the sample drugs and medicines, and the inserts, which are either affixed to or distributed with the sample drugs and medicines. Such labels and inserts provide necessary information as to proper usage, dosage, and possible adverse reactions to the drugs and medicines being distributed, which are necessary for the safe usage of the drugs and medicines.

10. The Division calculated the asserted taxable value of the packaging material by multiplying the total cost of samples (including packaging material) by an estimated ratio of packaging material costs to total cost of the samples (including packaging material). Petitioner consented on audit to the employment of this method to determine use tax due on samples (including packaging materials) distributed by it in New York State during the audit period. The

petitioner does not contest the Division's use of the estimated ratio that was based on the Division's audit of another unrelated pharmaceutical company to compute use tax due on packaging material distributed by petitioner in New York State during the audit period.

11. The Division does not assert sales and use tax liability relating to cartons, containers or wrapping or packaging materials and supplies, or components thereof, which a vendor uses or consumes in packaging or packing tangible personal property for sale, such as petitioner's drugs and prescription medicine items for sale, when such packaging or packing items are actually transferred by the vendor to its customer or purchaser, i.e., the person to whom it sells the packaged item at retail. (*See*, Tax Law § 1101[b][2]; § 1131[2].) The Division's rationale for not asserting sales and use taxes on such packaging and packing materials depends on how the materials are used as set forth in this paragraph. The purchase of such materials by a vendor is exempt from sales and use taxes under Tax Law § 1115(a)(19) when the materials are actually transferred to the vendor's customers. (A vendor's purchase of such materials may also be exempt from sales and use taxes as a purchase for resale where the vendor includes them in its sale of tangible personal property to a customer or purchaser and the vendor actually transfers the materials to the customer or purchaser.) The purchase of packaging material used to package retail packets of goods such as individual packets of medicines or drugs that are sold at retail is thus exempt from sales and use tax under Tax Law § 1115(a)(19). (The purchase may also be exempt from sales and use taxes as a purchase for resale.)

Retail sales of individual packets of drugs and medicines are exempt from sales and use taxes under Tax Law § 1115(a)(3). The Division's position is that the packaging for such drugs and medicines is itself exempt from sales and use taxes under Tax Law § 1115(a)(19).

SUMMARY OF THE PARTIES' POSITIONS

12. Petitioner argues that since the sample drugs and medicines it distributes free of charge to doctors are not subject to use tax pursuant to Tax Law § 1115(a)(3), neither should the packaging materials be subject to use tax since such materials are a critical element of the samples. Citing *Burger King v. State Tax Commn.* (51 NY2d 614, 435 NYS2d 689) and *Celestial Foods of Massapequa Corp. v. New York State Tax Commn.* (63 NY2d 1020, 484 NYS2d 509), petitioner argues that its packaging materials are not simply items of overhead supplied for the convenience of its customers, but are an integral component of the samples since the samples could not be legally or safely transported or used without the packaging materials. Petitioner also discusses an advisory opinion issued by the Division (TSB-A97[62]S) wherein the Division held that labels attached to drugs and medicines and informational pamphlets accompanying the drugs and medicines were exempt from sales tax because such materials were a critical element of the drugs and medicines that were to be sold. Petitioner asserts that although the courts created the critical element test in answer to a sale for resale situation there is no logical reason not to apply the test to other sales tax exemptions. Finally, petitioner argues that the Division, recognizing that the packaging materials are not subject to sales tax when sold to the ultimate consumer, must apply such exemption equally to the use tax.

13. The Division argues that the packaging materials are not a critical element of the drugs and medicines given by petitioner to the doctors and that, even if the packaging materials are a critical element, that does not make them drugs and medicines and they are still subject to the use tax. The Division asserts that the critical element cases relied upon by petitioner apply only to containers and not all of the packaging materials at issue are containers. The Division also contends that the critical element test applies only to sales for resale and since neither the drugs

and medicines nor the packaging materials in this case are resold, the case law is simply inapplicable. The Division in particular discusses the Court of Appeals holding in *Burger King* and stresses that the Court specifically stated that the packaging never became part of the product sold and was exempt because the packaging was sold as packaging for resale. The Division contends that the packaging exemption exists because not all packaging is deemed resold and therefore a separate exemption is required. The Division also argues that it is not required to hold the packaging materials exempt from use tax simply because they are exempt from sales tax when resold. The Division cites a 1965 opinion of counsel that held such packaging materials are not exempt from use tax despite the legal requirements that they be used to distribute drugs and medicines. Finally the Division argues that exemptions from taxation are to be narrowly construed and petitioner has presented no statutory or case law in support of its position.¹

CONCLUSIONS OF LAW

A. The determination in this matter was originally due on June 2, 2000. On March 31, 2000 a letter was sent by this administrative law judge to the parties requesting that they submit written comments regarding the relevance of Tax Law § 1118 to the case. While the original schedule requested simultaneous comments by May 1, 2000 the process involved extensions and comments being filed first by petitioner then by the Division with a reply from petitioner. The process took six weeks extending the due date of this determination until July 24, 2000.

¹The Division's arguments that the packaging material used in providing sample drugs and medicines may be different from the packaging material used for drugs and medicines that are sold have been disregarded as not supported by the evidence. Finding of Fact "11" from the stipulation sets forth the positions of the parties on the issues and does not imply in any manner that there is an issue of fact regarding the types of packaging used. Furthermore, in support of these arguments the Division makes no specific citation only a citation to "the audit report and log." My review of the audit report and log does not disclose any facts supporting the Division's position.

The arguments of the parties contained in their submissions have convinced me that Tax Law § 1118 is not necessarily relevant to the issue in this case. Therefore, the parties' comments concerning Tax Law § 1118 will not be discussed further in this determination with the exception of one of the Division's arguments in Conclusion of Law "E" including the parties' submissions.

B. Petitioner is in the business of selling various drugs and medicines to retailers, such as drug stores. Part of petitioner's business is sales to such retailers located within New York State. When its products are sold to retailers, the drugs and medicines are exempt from tax pursuant to Tax Law § 1115(a)(3). The Division does not assess sales tax on the packaging materials accompanying or containing the drugs sold to the retailers. To promote its business, petitioner provides doctors within New York State sample drugs and medicines that the doctors can give to their patients. The Division asserts that the use by petitioner of its products in this manner in New York State is subject to use tax pursuant to Tax Law § 1110 which provides in relevant part:

(a) Except to the extent that property or services have already been or will be subject to the sales tax under this article, there is hereby imposed on every person a use tax for the use within this state . . . except as otherwise exempted under this article, (A) of any tangible personal property purchased at retail, (B) of any tangible personal property . . . manufactured, processed or assembled by the user, (i) if items of the same kind of tangible personal property are offered for sale by him in the regular course of business. . . .

There is no doubt that the drugs and medicines and the packaging materials provided by petitioner to doctors are tangible personal property manufactured and assembled by petitioner and that these are the same kinds of items offered for sale by petitioner in its regular course of business. Therefore, unless such items are specifically excluded or exempted they would be subject to the use tax. With regard to the drugs and medicines themselves there is no question that they are exempt from tax pursuant to Tax Law § 1115(a)(3). The issue to be determined is

whether the packaging materials are also exempt from tax pursuant to Tax Law § 1115(a)(3) because of their close association with the drugs and medicines.

C. It is first necessary to review the provision of the Tax Law under which the packaging materials accompanying or containing drugs and medicines are not taxed when these materials are sold to retailers and ultimately to consumers. The stipulation in this matter provides that the packaging materials are either exempt from tax as containers (Tax Law § 1115[a][19]) or excluded from tax as a sale for resale. Contrary to the Division's assertions that the packaging materials are exempt from tax as containers under Tax Law § 1115(a)(19) are a 1965 Opinion of Counsel (November 16, 1965, NYS Tax Bulletin NO. 1965-4) and a 1997 Advisory Opinion (TSB-A-97[62]S) wherein it is evident that the Division itself has never considered such materials as exempt from tax under Tax Law § 1115(a)(19). The Opinion of Counsel proceeds under the assumption that the packaging materials are exempt as a sale for resale. However, this opinion was issued prior to the enactment of the container exemption in 1975 (L 1975, ch 581). In the Advisory Opinion (TSB-A-97[62]S) the Division, citing *Matter of Gem Stores* (Tax Appeals Tribunal, October 14, 1988), held that labels attached to drugs and medicines and the explanatory material accompanying the drugs and medicines were a critical element of the drugs and medicines. Specifically, the opinion stated:

a label is a critical element of the product sold, if it has a critical quality useful to the final customer and is not just an expense or part of the general overhead which the retailer chooses in order to profitably carry on in business. The labels and pamphlets produced by Petitioner do form a critical element of the product sold, i.e., the medication. The label and accompanying pamphlet contain critical information which is useful to the customer for the proper usage of the medication.

While not bound by this advisory opinion, I find it highly persuasive and in conformity with *Matter of Gem Stores (supra)* and *Matter of Burger King v. State Tax Commn* (51 NY2d

614, 435 NYS2d 689) which was extensively discussed in *Gem Stores*. It was in *Matter of Burger King (supra)* that the Court of Appeals determined that the packaging materials used by Burger King, such as hamburger wrappers, were a critical element of the product sold to Burger King's customers (*id.*, 435 NYS2d at 693). In reaching this determination the Court found that fast food restaurants did not sell tangible personal property, but in reality sold a hybrid product consisting of restaurant food and service (*id.*, 435 NYS2d at 691, 692). Having found that Burger King did not sell tangible personal property, the packaging materials utilized could not then be exempt as a "physical component part" of such property pursuant to Tax Law § 1101(b)(4)(ii)(A). What the Court actually determined was that, as a critical element of the goods sold, the packaging materials were simply a part of the goods and therefore also excluded from tax as a sale for resale pursuant to Tax Law § 1101(b)(4)(i)(A) (*id.*, 435 NYS2d at 693). While not explicitly stated, the implication of the Advisory Opinion is not that labels and informational materials sold with drugs and medicines are exempt as sales for resale, but rather that such materials are actually a part of the drugs and medicines. Therefore, the labels and informational materials are exempt from tax for the same reason the drugs and medicines are exempt from tax, i.e., Tax Law § 1115(a)(3). The facts in this matter are also comparable to those in *Burger King* in that what a consumer receives as a final product is not only the drugs themselves but the information necessary to safely use the drugs and medicines.

The Advisory Opinion does not address the issue of the containers of the drugs and medicines. Such containers are provided primarily for safety reasons and to ensure that the drugs and medicines delivered to the consumers are unadulterated as required by the FDA. Based upon the reasoning utilized to determine that the labels and informational materials are a critical element of the drugs and medicines, I reach the same determination with regard to the containers.

D. Having found that the packaging materials are a critical element of the drugs and medicines sold for resale, the question becomes whether the packaging materials are also a critical element of the sample drugs and medicines. The question must be answered in the affirmative as it is illogical to conclude that somehow the packaging materials become separated from the drugs and medicines because they are given away instead of sold. The 1965 Opinion of Counsel cited by the Division does state that packaging and information materials given away with drugs and medicines are not exempt despite the close relationship to the drugs and medicines and the statutory requirements that they accompany the drugs and medicines. However, this opinion was issued 15 years before the Court of Appeals enunciated the critical element test in the *Matter of Burger King v. State Tax Commn (supra)*, and some 23 years prior to *Matter of Gem Stores (supra)*. Furthermore, the 1997 Advisory Opinion holding that in a resale situation the pamphlets and information materials are a critical element of the drugs and medicines is in direct contradiction to the Opinion of Counsel. Therefore, I do not find the Opinion of Counsel persuasive argument as to the current law on the question of whether the packaging materials are a critical element of the drugs and medicines.

E. The final question is whether the finding that the packaging materials are a critical element of the sample drugs and medicines precludes the imposition of use tax. I find that it does. Again based on the reasoning set forth above, the packaging materials have become part of the drugs and medicines and there is no use which would be subject to tax. The Division's argument that Tax Law § 1118 requires that use tax be imposed because sales tax would be imposed upon the purchase of such materials by an in-state pharmaceutical company that was going to give them away is not relevant to the current analysis because no sales tax would be imposed (*see, Matter of Burger King, supra*). The packaging materials are actually a part of the

drugs and medicines making them exempt from taxation in either situation. The Division also relies on the Opinion of Counsel on this point, which I have previously determined to be unpersuasive. As further evidence that the Opinion of Counsel is no longer indicative even of the Division's position on this issue in this case, the opinion states that the inert ingredients of the drugs and medicines themselves would be subject to the use tax in the present situation, yet there is no attempt by the Division in this matter to tax those ingredients.

F. In conclusion, petitioner in this matter was seeking an exemption from tax and therefore was required to prove that its interpretation of the Tax Law was the only reasonable interpretation (*see, Matter of Grace v. State Tax Comm.*, 37 NY2d 193, 371 NYS2d 715; *Matter of Federal Insurance Co. v. State Tax Comm.*, 146 AD2d 888, 536 NYS2d 595). Petitioner has met this burden in that the packaging materials are found to be a critical element of the sample drugs and medicines and as such are exempt from the use tax pursuant to Tax Law § 1115(a)(3).

G. The petitioner of SmithKline Beecham Corporation is granted, and the Notice of Determination dated May 22, 1997, is canceled.

DATED: Troy, New York
July 13, 2000

/s/ Roberta Moseley Nero
ADMINISTRATIVE LAW JUDGE