



STATE BOARD OF EQUALIZATION

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Executive Director

May 18, 2007

Dear Interested Party:

Staff has reviewed comments received in response to our February 22, 2007 interested parties meeting regarding the classification and taxation of flavored malt beverages. After considering the comments and information provided to date, staff has identified alternatives and drafted regulatory language that if adopted by the Board, would tax flavored malt beverages as distilled spirits.

Enclosed is the *Second Discussion Paper* on this subject. This document provides the background, a discussion of the issues and explains alternatives in more detail. Also enclosed for your review is a copy of the draft regulatory language.

A second meeting of interested parties is scheduled for June 6, 2007 at 10:00 a.m. in Room 121 (Boardroom) at 450 N Street, Sacramento, California to discuss these alternatives and the draft regulations. If you are unable to attend the meeting but would like to provide input for discussion at the meeting, please feel free to write to me at the above address or send a fax to (916) 323-3204 before the June 6, 2007, meeting. You may also listen in on the meeting via streaming audio at the following link <http://www.boe.ca.gov/sptaxprog/alcoholicbeverage.htm>. If you are aware of other persons that may be interested in attending the meeting or presenting their comments, please feel free to provide them with a copy of the enclosed material and extend an invitation to the meeting. If you plan to attend the meeting on June 6th, I would appreciate it if you would let us know by contacting Mr. Mike Hale at (916) 322-2768 or by e-mail at Mike.Hale@boe.ca.gov prior to June 4, 2007. This will allow staff adequate time to prepare materials and handouts for distribution at the meeting.

Any comments you may wish to submit subsequent to the June 6, 2007 meeting must be received by **June 21, 2007**. They should be submitted in writing to the above address. After considering all comments, staff will complete a formal issue paper on the alternatives and proposed regulations for discussion at the **Business Taxes Committee meeting scheduled for August 14, 2007**. Copies of the formal issue paper will be mailed to you approximately ten days prior to this meeting. Your attendance at the August Business Taxes Committee meeting is welcomed and encouraged. The meeting is scheduled for 9:30 a.m. in Room 121 at 450 N Street, Sacramento, California.



Please be aware that a copy of the material you submit may be provided to other interested parties. Therefore, it is important that your comments not contain confidential information.

If you are interested in other topics to be considered by the Business Taxes Committee, you may refer to the "Business Taxes Committee" page on the Board's Internet Web site (<http://www.boe.ca.gov/meetings/btcommittee.htm>) for copies of Committee discussion or issue papers, minutes, a procedures manual and calendars, which are arranged according to subject matter and by month.

Thank you for your consideration. I look forward to your comments and suggestions. Should you have any questions, please contact Mike Hale at (916) 322-2768.

Sincerely,

Lynn Bartolo
Chief, Excise Taxes Division
Property and Special Taxes Department

LRB: mh

Enclosures

cc: (all with enclosures)
Honorable Betty T. Yee, Chairwoman, First District (MIC 71)
Honorable Judy Chu, Ph.D., Vice-Chair, Fourth District
Honorable Bill Leonard, Member, Second District (MIC 78)
Honorable Michelle Steel, Member, Third District
Honorable John Chiang, State Controller, C/O Ms. Marcy Jo Mandel (via e-mail)
Mr. Alan LoFaso, Board Member's Office, First District (via e-mail)
Mr. Mark Ibele, Board Member's Office, First District (via e-mail)
Mr. Steve Shea, Board Member's Office, Fourth District (via e-mail)
Mr. Tom Hudson, Board Member's Office, Second District (via e-mail)
Ms. Margaret Pennington, Board Member's Office, Second District (via e-mail)
Mr. Lee Williams, Board Member's Office, Second District (via e-mail)
Mr. Ken Maddox, Board Member's Office, Third District (via e-mail)
Mr. Neil Shah, Board Member's Office, Third District (via e-mail)
Ms. Melanie Darling, State Controller's Office (via e-mail)
Mr. Ramon J. Hirsig (MIC 73)
Ms. Kristine Cazadd (MIC 83)
PSTD Acting Deputy Director (MIC 63)
Ms. Anita Gore (MIC 86)
Mr. Robert Lambert (via e-mail)
Ms. Janice Thurston (via e-mail)
Ms. Jean Ogrod (via e-mail)
Mr. Jeff Vest (via e-mail)
Ms. Monica Brisbane (via e-mail)

Mr. Randy Ferris (via e-mail)
Mr. Todd Gilman (MIC 70)
Mr. Dave Hayes (MIC 67)
Mr. Tim Treichelt (MIC 82)
Mr. Mike Hale (MIC 56)
Ms. Cecilia Watkins (MIC 50)
Ms. Beth Lindley (MIC 67)

SECOND DISCUSSION PAPER

Flavored Malt Beverages

I. ISSUE

Should the Board of Equalization (BOE) authorize publication of a regulation to tax flavored malt beverages¹ (FMB) as distilled spirits?

II. BACKGROUND

In December 2006, the Board voted to initiate the rulemaking process with respect to the taxation and classification of FMB. In a letter dated October 25, 2006, California Friday Night Live Partnership, Students Making a Community Change (SMACC), and the California Youth Council (hereafter, collectively, petitioners) filed a petition pursuant to Government Code section 11340.6, requesting the Board adopt a regulation to tax FMB as distilled spirits and/or amend Regulation 2530. FMB are currently classified and taxed at the same rate as beer. In response to the petition, the Board directed staff to initiate the rulemaking process and to hold a series of public meetings with interested parties to discuss the classification and taxation of FMB and to offer alternatives and proposed regulatory language for consideration by the Board.

Interested parties have submitted approximately 70 written comments and made oral presentations at a first meeting of interested parties that was held February 22, 2007, in Sacramento. Excise Taxes Division staff (staff) continue this rulemaking process with this second issue paper which encompasses, in summary, the public comment made by interested parties and reflects staff's understanding and analysis of the various concerns and the legal issues that are relevant to the classification, identification, and taxation of FMB. Additionally, staff has provided draft regulatory language to tax certain products containing alcohol from distillation as distilled spirits for purposes of the Alcoholic Beverage Tax Law. The draft proposals, Regulation 2558, Distilled Spirits; Regulation 2559, Presumption – Distilled Spirits; and Regulation 2559.1, Rebuttable Presumption – Distilled Spirits, are attached as Exhibit 1.

Grounds for the Petition:

The grounds advanced in the original petition are as follows:

1. "Alcopops," which are also known as flavored malt beverages, contain distilled spirits and, accordingly, should be taxed as distilled spirits under Revenue and Taxation Code section 32201, not as beer under Revenue and Taxation Code section 32151.

¹ Some interested parties have taken exception to our use of the term flavored malt beverage to describe the alcoholic beverages under discussion. Interested parties use many terms to reference these products that include: FMB, flavored alcohol beverage, alcopops, malternatives, alcoholic lemonades, alcoholic colas, and flavored beer. In staff's estimation, the term flavored malt beverage seems to be the most common term used by interested parties, industry, and other governmental agencies to identify these products, and is, accordingly, the term adopted by staff for use in this discussion paper. Staff's use of the term flavored malt beverage should in no way be seen as a comment on the merits of the issue or as an attempt to limit the use by others of alternative terms to reference the products under consideration.

SECOND DISCUSSION PAPER

Flavored Malt Beverages

2. Taxpayers are not properly reporting under Regulation 2530. Regulation 2530 requires every distilled spirits taxpayer to furnish to the BOE a statement of the gallonage of finished packaged distilled spirits on hand. Since flavored malt beverages contain distilled spirits, distilled spirits taxpayers should be reporting the gallonage. Therefore, petitioner's request that the Board amend the language of Regulation 2530 to define distilled spirits to specifically include flavored malt beverages that contain distilled spirits, and place the burden on the taxpayer to provide sufficient evidence to prove a claim that its flavored malt beverage product does not contain distilled spirits.

III. DISCUSSION

A. Classification of FMB

Prior to 1955, the BOE was responsible for all aspects of the regulation, licensing and taxation of the manufacture and sale of alcoholic beverages in California. Commencing on January 1, 1955, and pursuant to a Constitutional amendment (Cal. Const., art. XX, § 22), the Department of Alcoholic Beverage Control (ABC) was given "the exclusive power, except as herein provided and in accordance with laws enacted by the Legislature, to license the manufacture, importation and sale of alcoholic beverages in this State, and to collect license fees or occupation taxes on account thereof." (*Ibid.*) In addition, Business and Professions Code section 23051 states in relevant part:

On and after January 1, 1955, the department [ABC] shall succeed to all of the powers, duties, purposes, responsibilities, and jurisdiction now conferred on the State Board of Equalization under Section 22 of Article XX of the Constitution and this division, except the power to assess and collect such excise taxes as are or may be imposed by law on account of the manufacture, importation, and sale of alcoholic beverages in this State, which shall remain the exclusive power of the State Board of Equalization.

All other laws heretofore or hereafter applicable to the State Board of Equalization with respect to alcoholic beverages, except as to excise taxes, shall hereafter be construed to apply to the department.

As a result of this change in law, ABC is assigned the responsibility for the licensing of all locations that sell alcoholic beverages in California. The ABC has advised the BOE of its present intention, with respect to which it prevailed in court (Case No. A112671), to continue classifying FMB as beer. As ABC licensing is controlling over sales of alcoholic beverages in this state, the BOE may not impose additional licensing limitations that fall within the purview of the ABC. Accordingly, staff suggests that interested parties' arguments that relate to the business locations that may, or may not, be able to sell FMB and the potential impact upon retailers arising from such licensing issues, are not a proper subject for this regulatory process. The BOE does not have jurisdiction to impose limits on where FMB may be sold because the ABC clearly has the exclusive power to license the manufacture, importation, and sale of alcoholic beverages in California.

SECOND DISCUSSION PAPER

Flavored Malt Beverages

However, the ABC is of the opinion that, while the definitions of beer, wine, and distilled spirits are found in the Alcoholic Beverage Control Act (Bus. & Prof. Code, § 23000 et seq.) and are incorporated by reference into the Revenue and Taxation Code (Rev. & Tax Code, § 32002), no statutes empower or authorize the ABC to direct the BOE how to classify any alcoholic beverage for taxation purposes. Staff agrees with the ABC's opinion. Therefore, this rulemaking process will pertain only to the classification of FMB for tax purposes.

B. What are FMB?

According to the federal Alcohol and Tobacco Tax and Trade Bureau (TTB):

“Flavored malt beverages are brewery products that differ from traditional malt beverages such as beer, ale, lager, porter, stout, or malt liquor in several respects. Flavored malt beverages exhibit little or no traditional beer or malt beverage character. Their flavor is derived primarily from added flavors rather than from malt and other materials used in fermentation. At the same time, flavored malt beverages are marketed in traditional beer-type bottles and cans and distributed to the alcohol beverage market through beer and malt beverage wholesalers, and their alcohol content is similar to other malt beverages in the 4-6% alcohol by volume range.

Although flavored malt beverages are produced at breweries, their method of production differs significantly from the production of other malt beverages and beer. In producing flavored malt beverages, brewers brew a fermented base of beer from malt and other brewing materials. Brewers then treat this base using a variety of processes in order to remove malt beverage character from the base.

For example, they remove the color, bitterness, and taste generally associated with beer, ale, porter, stout, and other malt beverages. This leaves a base product to which brewers add various flavors, which typically contain distilled spirits, to achieve the desired taste profile and alcohol level.

While the alcohol content of flavored malt beverages is similar to that of most traditional malt beverages, the alcohol in many of them is derived primarily from the distilled spirits component of the added flavors rather than from fermentation.” (70 Fed. Reg. 194 et seq. (January 3, 2005).)

Recent regulations adopted by TTB recognize that many FMB contain alcohol derived from distilled spirits. The revised federal rulings, which went into effect January 3, 2006, provide that malt beverages that contain less than 6 percent alcohol by volume may derive no more than 49 percent of their alcoholic content from flavors and other nonbeverage materials² (see 27 C.F.R. §§ 7 & 25 (2005)). Staff and interested parties appear to agree that the federal regulations are not controlling with respect to California's statutory definitions of “beer” and “distilled spirits.”

² Additionally, malt beverages that contain more than 6 percent alcohol by volume may derive no more than 1.5 percent of the volume of its finished product from flavors and other nonbeverage ingredients containing alcohol.

SECOND DISCUSSION PAPER

Flavored Malt Beverages

Neither California law, nor federal law, has a specific definition of FMB. (70 Fed. Reg. 197 (January 3, 2005) [stating that there is no provision in the TTB regulations that uniquely identifies flavored malt beverages].)

C. Taxation of FMB

In addition to submissions from petitioners, about 60 additional interested parties submissions have been received that speak in favor of the Board adopting regulation(s) to treat FMB as distilled spirits. These individuals, organizations and governmental agencies include: County of Mendocino Health and Human Services Agency; Students for a Safer Southside; San Dieguito Alliance for Drug Free Youth; Progress House, Inc.; Spring Valley Cities Association; United Coalition East Prevention Project; California Council on Alcohol Policy; San Diego County Office of Education; South County Collaborative; San Diego County Council on Alcohol Policy; SPIRITT Family Services; County Alcohol and Drug Program Administrators Association of California; Alcohol Policy Network of Alameda; the legislative advocate for the California State PTA; several local PTA councils; Director, Lutheran Office of Public Policy California; Advocacy Manager and Executive Director of the Marin Institute; California Council on Alcohol Problems; El Cajon Collaborative; Communities Against Substance Abuse; Center for the Study of Law and Enforcement Policy; California Prevention Collaborative; San Diego County Policy Panel on Youth Access to Alcohol; Latino Youth Council; Environmental Prevention in Communities; Alameda County Sacramento Legislative Office; Government Relations Director, Girl Scout Councils of California; Marin County Board of Supervisors; Alpine County Board of Supervisors; and, K. Scott Dickey of Renne, Sloan, Holtzman, Sakai LLP, Public Law Group, representing petitioners in *County of Santa Clara, et al. v. State Board of Equalization*.

The following individuals and organizations have submitted public comment that presents arguments in opposition to the Board adopting regulation(s) to tax FMB as distilled spirits: the California Licensed Beverage Association (CALBA), California Latino Association of Business Owners (CLABO), California Grocers Association (CGA), Tavern Owners United For Fairness (TOUFF), Neighborhood Market Association, California Retailers Association (CRA), Mesa Beverage, Association for Los Angeles Deputy Sheriffs, Inc. (ALADS), Asian Business Coalition, and finally, by Marc E. Sorini representing the Flavored Malt Beverage Coalition.

Expanding on above-stated grounds from the petition at issue, the following summarizes the two related arguments advanced by interested parties in favor of taxing FMB as distilled spirits:

1. As alcohol is the number one drug of choice for underage youth, it is important that we do everything possible to stop this epidemic. By limiting the availability of FMB and increasing the price on these beverages, the BOE can induce a giant step forward in reducing the incidences resulting from underage drinking, as well as saving the lives of many youth all over the State of California.

SECOND DISCUSSION PAPER

Flavored Malt Beverages

2. FMB are currently taxed as beer, even though they have no beer in them. They start out their manufactured life as beer, but all or most of the alcohol from the beer is removed, and then distilled spirits are added. Because the alcohol from beer is removed, and distilled spirits added, proper application of the existing statutes involved would mandate that FMB be taxed as distilled spirits rather than beer. Were FMB taxed as distilled spirits they would be less affordable to teens.

Additionally, California's former Attorney General has previously written to BOE staff indicating that a task force of state deputy attorneys general has begun to address a number of issues relating to alcohol use by youth. The letter opines that FMB, under California law, should be classified as "distilled spirits" if they contain any amount of distilled spirits or dilutions or mixtures thereof.³

In general, the opposition letters advanced arguments against higher tax rates for FMB and against restrictions on business locations where the products may be sold. The opposition letters also advanced arguments that FMB do not contain "distilled spirits" but rather contain flavors that may include distilled alcohol, and therefore are not distilled spirits.

Staff and all of the interested parties agree that consumption of alcohol by underage youth is a serious problem. Staff is of the opinion, however, that the only matter properly before the Board is the matter of the correct classification of FMB for the purpose of taxation. As discussed above, the sale of alcoholic beverages is specifically not within the jurisdiction of the BOE, but instead with ABC.

As staff understands it, the primary argument in favor of taxing FMB as distilled spirits is that FMB should be classified as distilled spirits for purposes of taxation because they contain spirits derived from distillation. The primary opposing argument is that FMB do not contain distilled spirits but rather contain flavorings that include distilled alcohol and, therefore, do not meet the definition of distilled spirits.⁴

Contrary to the assertions of interested parties on both sides of the issue, it is staff's opinion that FMB do not neatly fit into either the statutory definition of "distilled spirits" or the statutory definition of "beer." Accordingly, staff believes it is within the Board's authority to promulgate regulation(s) to clarify what products meet the definition of "distilled spirits" and which products meet the definition of "beer" in order to administer and enforce the Alcoholic Beverage Tax Law. (Rev. & Tax. Code, § 32451.)

³ This "opinion" is not a formal Attorney General Opinion, but is rather a statement of the "Attorney General's position," made in letters to the Department of Alcoholic Beverage Control and the State Board of Equalization.

⁴ It should be noted that most, if not all of the arguments discussed in this paper, both for and against, are the same arguments that have been previously presented to the federal government during its recent rulemaking process regarding FMB and in the recent lawsuit against the ABC, in which ABC prevailed, in response to ABC's present decision to classify FMB as beer.

SECOND DISCUSSION PAPER

Flavored Malt Beverages

IV. Alternatives

Alternative 1

Staff has attached draft regulatory language as an initial step to meet the Board's directive to, in part, propose regulatory language to tax FMB as distilled spirits. The three proposed regulations would: (1) define distilled spirits to include an alcoholic beverage, except wine, which contains 0.5 percent or more alcohol from flavors or ingredients containing alcohol from distillation; (2) establish a presumption that alcoholic beverages, except wine, contain 0.5 percent or more alcohol from flavors or ingredients containing alcohol from distillation; and (3) allow the manufacturer the ability to rebut the presumption as to any particular alcoholic beverage by filing a statement, under penalty of perjury, that specifies the sources and amount of the alcohol content of the beverage. Additionally, these regulations authorize the BOE to require manufacturers to file a copy of the "Statement of Process" or product "Formula" with the BOE that was filed with the Alcohol and Tobacco Tax Trade Bureau for any alcoholic beverage.

The complete text of staff's draft Regulation 2558, Distilled Spirits; Regulation 2559, Presumption – Distilled Spirits; and Regulation 2559.1, Rebuttable Presumption – Distilled Spirits, is attached as Exhibit 1.

The adoption of these regulations would create a substantial, new administrative workload, both short-term and on-going. The areas of increased administrative workload include: educational outreach; revision of forms, publications and tax returns; the development of processes and procedures for enforcement affecting both audit and compliance staff; appeals processes to resolve disputed product classifications and tax assessments; and documenting, on an individual product basis, the classification of alcoholic beverages as "beer" or "distilled spirits."

The intent of these draft regulations is to tax FMB as "distilled spirits" and traditional beer products as a "beer." The 0.5 percent threshold was appropriated from TTB's regulatory process for purposes of establishing the necessary dividing line. During the federal rulemaking process traditional beer companies indicated that their products were generally under this threshold. The bright-line threshold also provides FMB manufacturers a clear standard in the event they desire to reformulate their products.

Staff is disseminating this draft regulatory language along with this second discussion paper with the understanding that the interested parties will have a full opportunity to propose suggested revisions or alternatives before the final issue paper for this topic is submitted to our Business Taxes Committee for the Board's consideration and action. Staff welcomes comment and critique of this draft regulatory language by the interested parties.

SECOND DISCUSSION PAPER

Flavored Malt Beverages

Alternative 2

Mr. K. Scott Dickey of the firm Renne, Sloan, Holtzman, and Sakai, representing members of the California Coalition on Alcopops and Youth provided comments and suggested regulatory language to identify alcoholic beverages that contain distilled spirits. Specifically, Mr. Dickey proposes revisions to Regulation 2530, *Inventories*, as follows:

A taxpayer shall maintain and make available for examination on request by the board or its authorized representatives, records in the manner set forth at California Code of Regulations, Title 18, Section 4901. In addition to the records described therein, commencing July 1, 2004, a taxpayer that manufactures any alcoholic beverage shall annually submit a statement for each of the taxpayer's alcoholic beverage products indicating whether that beverage product contains alcohol produced through the distillation, and if so, stating the percentage of such product's total alcohol content derived from distilled spirits. The taxpayer shall make this statement under penalty of perjury.

This language, as written, appears to assume that any alcoholic beverage with any amount of alcohol derived from distilled spirits would meet the definition of distilled spirits for tax purposes. Staff finds the definitions of “beer” and “distilled spirits” sufficiently unclear to definitively support such an assumption and notes that such an assumption could result in virtually all alcoholic beverages being classified as “distilled spirits.” Additionally, not all manufacturers of alcoholic beverages taxed under the Alcoholic Beverage Tax Law are taxpayers because some products are imported by importers and not the manufacturer. Accordingly, this alternative regulatory language could result in the BOE not receiving all the product information it needs to properly classify and tax the alcoholic beverages at issue. Moreover, this alternative would create the same substantial, new administrative workload that Alternative 1 would create.

Alternative 3

Make no regulatory changes and continue to tax FMB as beer.

This alternative is the least difficult to administer because it follows ABC's current classification. However, this alternative would not address any of the important social policy issues raised by petitioners and supportive interested parties.

V. Summary

The petition and the Board's direction to initiate the rulemaking process to draft regulatory language to tax FMB as distilled spirits raise complex legal issues related to statutory interpretation, significant administrative issues related to interagency roles and responsibilities with respect to the BOE's relationship with ABC, and substantial public policy issues regarding the role taxation should play in discouraging underage drinking.

SECOND DISCUSSION PAPER

Flavored Malt Beverages

As stated above, it is the opinion of staff that, under the relevant statutes, the Board could reasonably classify FMB for purposes of taxation as either beer or distilled spirits. Of course, at any time, the Legislature could intervene and provide statutory clarification regarding how FMB should be classified and taxed under the California Alcoholic Beverage Tax Law.

Taxpayers and other interested parties are welcome to submit further comments on this issue and the draft language for the proposed regulations and are invited to participate in the second interested parties' meeting that is scheduled for 10:00 a.m. on June 6, 2007, in Sacramento. Note, this is a change from the original meeting date of May 17, 2007, and the date for interested parties to respond following the meeting, has also been changed to June 21, 2007.

Prepared by the Excise Taxes Division, Property and Special Taxes Department.

Current as of 05/18/2007

Regulation 2558. DISTILLED SPIRITS.

Effective July 1, 2008, any alcoholic beverage, except wine, which contains 0.5 percent or more alcohol by volume derived from flavors or other ingredients containing alcohol obtained from distillation, is a distilled spirit.

Authority: Section 32451, Revenue and Taxation Code.

Reference: Section 32002, Revenue and Taxation Code; Sections 23004, 23005, 23006, 23007, Business and Professions Code.

Regulation 2559. PRESUMPTION - DISTILLED SPIRITS.

Effective July 1, 2008, unless the contrary is established, any alcoholic beverage, except wine, is presumed to contain 0.5 percent or more alcohol by volume derived from flavors or other ingredients containing alcohol obtained from distillation.

Authority: Section 32451, Revenue and Taxation Code.

Reference: Section 32002, Revenue and Taxation Code; Sections 23004, 23005, 23006, 23007, Business and Professions Code.

Regulation 2559.1. REBUTTABLE PRESUMPTION - DISTILLED SPIRITS.

The presumption in Regulation 2559 may be rebutted by the manufacturer of the alcoholic beverage filing a report, under penalty of perjury, with the Board stating that the alcoholic beverage contains less than 0.5 percent alcohol by volume derived from flavors or other ingredients containing alcohol obtained from distillation and specifying the sources of the alcohol content of the alcoholic beverage, including the alcohol by volume derived from flavors or other ingredients containing alcohol obtained by distillation. Additionally, the Board may require a copy of the manufacturer's "Statement of Process" or "Formula" filed with the Alcohol and Tobacco Tax Trade Bureau, its predecessor agency or successor agency.

Authority: Section 32451, Revenue and Taxation Code.

Reference: Sections 32002, 32452, 32453 Revenue and Taxation Code; Sections 23004, 23005, 23007, Business and Professions Code.