



**STATE BOARD OF EQUALIZATION**

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March 18, 2016

Dear Interested Party:

Enclosed are the Agenda, Issue Paper, and Revenue Estimate for proposed Regulation 4001, *Retail Stock*, which will be presented at the Board's March 30, 2016, Business Taxes Committee meeting. The proposed regulation helps define, clarify and provide examples of "retail stock" and "non-retail stock."

Please feel free to publish this information on your website or otherwise distribute it to your associates, members, or other persons that may be interested in this issue.

Thank you for your input on these issues and I look forward to seeing you at the Business Taxes Committee meeting at **9:00 a.m.** on March 30, 2016, in Room 121 at the address shown above.

Sincerely,

Susanne Buehler, Chief  
Tax Policy Division  
Business Tax and Fee Department

SB:LS

Enclosures

cc: (all with enclosures, via email and/or hardcopy as requested)  
Honorable Fiona Ma, CPA, Chairwoman  
Honorable Diane L. Harkey, Vice Chair  
Honorable George Runner, First District  
Honorable Jerome E. Horton, Third District  
Honorable Betty T. Yee, State Controller, c/o Ms. Yvette Stowers (MIC 73)  
Ms. Genevieve Jopanda, Board Member's Office, Second District  
Ms. Kathryn Asprey, Board Member's Office, Second District  
Mr. John Vigna, Board Member's Office, Second District

Mr. Tim Morland, Board Member's Office, Second District  
Mr. Russell Lowery, Board Member's Office, Fourth District  
Mr. Ted Matthies, Board Member's Office, Fourth District  
Ms. Lisa Renati, Board Member's Office, Fourth District  
Mr. Clifford Oakes, Board Member's Office, Fourth District  
Mr. Sean Wallentine, Board Member's Office, First District  
Mr. Lee Williams, Board Member's Office, First District  
Mr. Brian Wiggins, Board Member's Office, First District  
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Mr. Alfred Buck, Board Member's Office, First District  
Ms. Kari Hammond, Board Member's Office, Third District  
Ms. Shellie Hughes, Board Member's Office, Third District  
Mr. Chris Armenta, Board Member's Office, Third District  
Mr. Ramon Salazar, State Controller's Office (MIC 73)  
Ms. Cynthia Bridges (MIC 73)  
Mr. Randy Ferris (MIC 83)  
Mr. David Gau (MIC 101)  
Ms. Lynn Bartolo (MIC 57)  
Mr. Todd Gilman (MIC 70)  
Mr. Wayne Mashihara (MIC 47)  
Mr. Kevin Hanks (MIC 49)  
Mr. Mark Durham (MIC 67)  
Mr. Robert Tucker (MIC 82)  
Mr. Jeff Vest (MIC 85)  
Mr. Jeff Angeja (MIC 85)  
Mr. David Levine (MIC 85)  
Ms. Dana Brown (MIC 85)  
Ms. Casey Tichy (MIC 85)  
Ms. Linda Cheng (MIC 85)  
Ms. Nikki Mozdyniewicz (MIC 85)  
Mr. Rick Zellmer (MIC 85)  
Mr. Bradley Heller (MIC 82)  
Mr. Lawrence Mendel (MIC 82)  
Mr. John Thiella (MIC 73)  
Mr. Stephen Smith (MIC 82)  
Ms. Pamela Mash (MIC 82)  
Ms. Kirsten Stark (MIC 50)  
Mr. Richard Parrott (MIC 57)  
Ms. Debra Kalfsbeek (MIC 62)  
Ms. Lynn Whitaker (MIC 50)  
Mr. Marc Alviso (MIC 101)  
Mr. Chris Lee (MIC 101)  
Ms. Laureen Simpson (MIC 70)  
Ms. Karina Magana (MIC 47)  
Mr. Bradley Miller (MIC 92)  
Mr. Bill Benson (MIC 67)  
Mr. Michael Patno (MIC 50)  
Ms. Laurel Smith (MIC 57)

Issue Paper Number **16-05**



- Board Meeting
- Business Taxes Committee
- Customer Services and Administrative Efficiency Committee
- Legislative Committee
- Property Tax Committee
- Other

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## **Proposed Regulation 4001, *Retail Stock***

### **I. Issue**

Whether the Board should approve proposed Regulation 4001, *Retail Stock*, to define and provide examples of the term “retail stock,” as it relates to the Cigarette and Tobacco Products Tax.

### **II. Alternative 1 - Staff Recommendation**

Staff recommends the Board approve and authorize publication of the proposed regulation as provided in Exhibit 2. Staff’s proposal defines and clarifies the term “retail stock.” In addition to defining the term, the proposed regulation:

- includes examples to help clarify the application of tax;
- explains that when a person is both a licensed retailer and a licensed distributor and makes sales only to retail customers, all inventory is held in retail stock;
- provides a presumption of distribution for products no longer in the distributor’s possession; and
- explains how distributors can overcome this presumption.

### **III. Other Alternative Considered**

#### **Alternative 2 – SEIU Recommendation**

The Service Employees International Union (SEIU) recommends an alternative definition of the term “retail stock.” SEIU’s proposed regulation also includes a provision that a person, who is both a licensed retailer and a licensed distributor and makes substantially all sales as retail sales, holds all inventory intended for sale in the retail location in retail stock. “Substantially all” is defined as 80 percent or more of gross sales during the previous 12-month reported period. In addition, with regard to the presumption of distribution for cigarette and tobacco products no longer in the distributor’s possession, SEIU’s recommendation requires that timely filed police reports and product purchase invoices be provided to overcome the presumption. SEIU’s proposed Regulation 4001 is provided in Exhibit 4.

## IV. Background

Tax is imposed on the “distribution” of cigarettes and tobacco products. Revenue and Taxation Code (RTC) section 30008 of the Cigarette and Tobacco Products Tax Law defines “distribution” as the sale or use of untaxed cigarettes and tobacco products or “the placing in this state of untaxed cigarettes or tobacco products in a vending machine or in retail stock for the purpose of selling the cigarettes or tobacco products to consumers.” However, while the statute mentions “retail stock,” the term is not defined either in the statute or by regulation. This has led to inconsistent interpretations of what constitutes retail stock. Because retail stock must be comprised of tax-paid products only, it is essential that clear guidelines are promulgated to assist sellers, in particular those businesses that are both distributors and retailers.

This topic was originally presented at the January 2016 Business Taxes Committee Meeting. At that meeting, SEIU shared its concerns with staff’s proposed language. The Board recommended staff hold an additional interested parties meeting to further discuss proposed Regulation 4001. Submissions were received with additional language from Ms. Yvette Stowers, Deputy State Controller, and Mr. Randall Cheek from SEIU (see Exhibits 3 and 4). Based on discussion at the interested parties meeting and review of the submissions, staff has changed its recommendation to incorporate the proposed regulatory language submitted by Ms. Stowers (hereinafter referenced as “staff recommendation”).

## V. Discussion

The definition of retail stock is important, as it may determine whether excise tax is owed on cigarettes and tobacco products. When an item is placed in retail stock, it is deemed to be intended for sale to consumers and to have been distributed pursuant to RTC section 30008(c). The excise tax is due when the product has been distributed; therefore, placement of tobacco products into retail stock is an event that triggers taxation.

The lack of a detailed definition and examples of retail stock has led to disputed audits and product seizures. To provide clarity, staff proposes creating a regulation to define “retail stock.” Staff believes this will provide industry with clear and specific information to simply and accurately record and report their transactions. For that reason, the proposed regulation will be valuable to both staff and tobacco distributors who also make retail sales.

### Definition and examples – subdivision (a)

In both staff’s and SEIU’s recommendations, proposed Regulation 4001(a)(2) defines and includes examples of when cigarettes and tobacco products are considered either “retail stock” or “non-retail stock.” The examples illustrate how both the location and the current condition of the original manufacturer’s packaging help determine whether a product has been placed into retail stock.

SEIU’s proposed language, adds a requirement that cigarettes and tobacco products which are untaxed and considered “non-retail stock” must be stored in a secure area segregated and separated from inventory accessible by customers. It defines secured as “behind a locked door.” It is unclear if a jewelry case with a lock on it would be sufficient or if the requirement is a full length locked door within a building.

Staff is also concerned about how the “secured” requirement would affect tobacco products stored in a walk-in humidor. A humidor is a climate controlled environment designed to keep tobacco products from spoiling. If the products must be stored behind a locked door, it is unclear whether a business would need to have two walk-in humidors – one open to the public and one located behind a locked door. If “secured” would include a locked case within a humidor open to the public, staff has concerns that air

would not properly circulate to the product stored in the locked case, risking damage and spoilage of the product.

*Sales primarily to retail customers – subdivision (b)*

Staff's proposed Regulation 4001 (b) clarifies that if a business is both a licensed retailer and a licensed distributor and makes all of its sales to retail customers, then the entire inventory is considered retail stock.

SEIU's proposed language specifies if a business makes "substantially all" sales (defined as 80 percent of its sales) to retail customers, then its entire inventory would be considered retail stock. Staff is concerned that this would cause additional workload and sales tracking for business owners, as owners would have to track their sales and determine if they are above or below the threshold. Businesses whose sales are close to the threshold percentage are especially impacted because of the effect of meeting the threshold. That is, a business which makes 19 percent of their sales to other licensees owes tax on their entire inventory when they purchase it; however, a business which makes 21 percent of their sales to other licensees would be able to hold untaxed inventory for sale to other licensees.

*Presumption of distribution – subdivision (c)*

Subdivision (c)(1) provides a statement that all cigarettes and tobacco products placed in retail stock have been distributed. Additional language has been added to subdivision (c)(1) to emphasize that tax is due upon distribution. Subdivision (c)(2) further provides that it is presumed that all cigarettes and tobacco products no longer in a distributor's possession have been distributed. The subdivision further provides examples of evidence that may be provided to overcome this presumption.

SEIU's proposed language requires that two of the items, police reports (timely-filed) and cigarette and tobacco purchase invoices, must be provided in order to overcome the presumption. Because each case has its own facts and circumstances, having specific requirements may be limiting. Furthermore, the law already has a provision which requires retention of purchase invoices, so making this a requirement for overcoming the distribution presumption is not necessary.

## **VI. Alternative 1 - Staff Recommendation**

### **A. Description of Alternative 1**

Staff recommends the Board approve and authorize publication of proposed Regulation 4001, as provided in Exhibit 2. Staff's proposal defines and clarifies the term "retail stock." In addition to defining the term, the proposed regulation:

- includes examples to help clarify the application of tax;
- explains that when a person is both a licensed retailer and a licensed distributor and makes all sales to retail customers, all inventory is held in retail stock;
- provides a presumption of distribution for products no longer in the distributor's possession; and
- explains how distributors can overcome this presumption.

### **B. Pros of Alternative 1**

The proposed regulation will create consistent and clear definitions of terminology frequently used in the taxation of cigarette and tobacco products. The additional clarification and examples demonstrating when items are retail stock will allow business owners to more easily determine when their products have been placed into retail stock. This will allow them to more easily identify when excise tax is due on their products.

### **C. Cons of Alternative 1**

Alternative 1 does not incorporate SEIU's recommendations for "secured" storage areas and the presumption of distribution based on "substantially all" sales to consumers.

### **D. Statutory or Regulatory Change for Alternative 1**

No statutory change is required; however, Regulation 4001 will need to be adopted.

### **E. Operational Impact of Alternative 1**

Taxpayers will have an additional resource to educate themselves on the taxability of tobacco products. In addition, "retail stock" will be clearly defined, which will reduce confusion. The additional examples and clarity will likely lead to more accurate reporting, possibly resulting in fewer audit findings, billings, and appeal hearings.

### **F. Administrative Impact of Alternative 1**

#### **1. Cost Impact**

The workload associated with publishing the regulation and updating forms and publications is considered routine. Any corresponding cost will be absorbed within the BOE's existing budget.

#### **2. Revenue Impact**

None. See Revenue Estimate (Exhibit 1).

### **G. Taxpayer/Customer Impact of Alternative 1**

The proposed regulation will provide clarity for taxpayers on the application of tax to cigarettes and tobacco products. The additional clarity will allow taxpayers to file more accurately and should minimize misinterpretations of statutes.

### **H. Critical Time Frames of Alternative 1**

Staff anticipates the Office of Administrative Law will complete its review and approval of the regulation revisions by September 2016.

## **VII. Alternative 2**

### **A. Description of Alternative 2**

SEIU recommends an alternative definition of the term "retail stock." In addition, SEIU's proposed regulation includes a provision that a person who is both a licensed retailer and a licensed distributor and makes substantially all sales as retail sales holds all inventory intended for sale in the retail location in retail stock. "Substantially all" is defined in subdivision (b) as 80 percent or more of gross sales during the previous 12-month reported period. In addition, with regard to the presumption of distribution for cigarette and tobacco products no longer in the distributor's possession, SEIU's recommendation requires that timely filed police reports and product purchase invoices be provided to overcome the presumption. SEIU's proposed Regulation 4001 is provided in Exhibit 4.

Alternative 2 contains additional language in subdivision (a)(2), adding the term "secured" to each possible storage area. It also defines the term "secure" as "behind a locked door," and states that untaxed tobacco and cigarettes must be segregated and secured separately from tax-paid tobacco and cigarettes away from the area where retail sales are made.

**B. Pros of Alternative 2**

The proposed regulation clarifies and provides examples of when items that are kept in secured areas of a business are “retail stock” and “non-retail stock.” In addition, it states that if a person is registered as a distributor and retailer of tobacco products and makes 80 percent or more of its sales to consumers, then all of its tobacco products have been placed into retail stock. This will allow the business to more easily identify when excise tax is due on tobacco products.

**C. Cons of Alternative 2**

The definition of “secured” can be interpreted several ways. For example, a locked door may be a small door on a shelf of a case or a full length door to a building. This may cause confusion to both taxpayers and staff. Also, the addition of the term “secured” to a walk-in humidor may change the nature of a business model, as most walk-in humidors are open to the public and intended to display product in an environment that does not cause damage to the products. The definition of “substantially all” will require additional work to determine if the 80 percent criterion has been met.

**D. Statutory or Regulatory Change for Alternative 2**

No statutory change is required; however, Regulation 4001 would need to be adopted.

**E. Operational Impact of Alternative 2**

Audit staff may incur workload in determining if a person who concurrently holds a distributor and retail license at the same location sold 80 percent or more of its cigarette and tobacco products to retail customers.

**F. Administrative Impact of Alternative 2****1. Cost Impact**

The workload associated with publishing the regulation and updating forms and publications is considered routine. Any corresponding cost will be absorbed within the BOE’s existing budget.

**2. Revenue Impact**

None. See Revenue Estimate (Exhibit 1).

**G. Taxpayer/Customer Impact of Alternative 2**

Taxpayers may have to reconfigure their operations to have a “secured” area for untaxed product. They will also have to track if they have sold 20 percent or less of their product to other licensees. This may cause an undue burden if they planned to sell more than 20 percent to other licensees, and therefore did not pay tax on inventory when received, only to have the sale fall through and to be liable for tax on their entire inventory.

**H. Critical Time Frames of Alternative 2**

Staff anticipates the Office of Administrative Law will complete its review and approval of the regulation revisions by September 2016.

**Preparer/Reviewer Information**

Prepared by: Business Tax and Fees Department

Current as of: March 14, 2016

**REVENUE ESTIMATE**

STATE OF CALIFORNIA  
BOARD OF EQUALIZATION



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**Proposed Regulation 4001, *Retail Stock***

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**II. Alternative 1 - Staff Recommendation**

Staff recommends the Board approve and authorize publication of the proposed regulation as provided in Exhibit 2. Staff’s proposal defines and clarifies the term “retail stock.” In addition to defining the term, the proposed regulation:

- includes examples to help clarify the application of tax;
- explains that when a person is both a licensed retailer and a licensed distributor and makes sales only to retail customers, all inventory is held in retail stock;
- provides a presumption of distribution for products no longer in the distributor’s possession; and
- explains how distributors can overcome this presumption.

**III. Other Alternative(s) Considered**

The Service Employees International Union (SEIU) recommends an alternative definition of the term “retail stock.” SEIU’s proposed regulation also includes a provision that a person who is both a licensed retailer and a licensed distributor and makes substantially all sales as retail sales to consumers holds all inventory intended for sale in the retail location in retail stock. “Substantially all” is defined as 80 percent or more of gross sales during the previous 12-month reported period. In addition, with regard to the presumption of distribution for cigarette and other tobacco products (OTP) no longer in the distributor’s possession, SEIU’s recommendation requires that timely filed police reports and product purchase invoices be provided to overcome the presumption.

## **Background, Methodology, and Assumptions**

### **Alternative 1 – Staff Recommendation**

There is nothing in the staff recommendation that would impact revenue. The proposed regulation will create consistent and clear definitions of terminology frequently used in the taxation of tobacco products. The additional clarification and examples demonstrate when items are retail stock and will allow business owners to more easily determine when their products have been placed into retail stock. This will allow them to more easily identify when excise tax is due on their products.

### **Alternative 2 - SEIU Recommendation**

There is nothing in Alternative 2 that would impact revenue. The proposed regulation clarifies and provides examples of when items that are kept in secured areas of a business are “retail stock” and “non-retail stock.” In addition, it states that if a person is registered as a distributor and retailer of tobacco products and makes 80 percent or more of its sales to consumers, then all of its tobacco products have been placed into retail stock.

## **Revenue Summary**

Alternative 1 – Staff recommendation does not have a revenue impact.

Alternative 2 – Alternative 2 does not have a revenue impact.

## **Preparation**

Mr. Joe Fitz, Research and Statistics Section, Legislative and Research Division, prepared this revenue estimate. This estimate has been reviewed by Mr. Mark Durham, Manager, Research and Statistics Section, Legislative and Research Division, and by Ms. Susanne Buehler, Chief, Tax Policy Division, Business Tax and Fee Department. For additional information, please contact Mr. Fitz at (916) 323-3802.

Current as of March 14, 2016.

**Regulation 4001. Retail Stock.**

**(a) "Retail stock" means and includes:**

(1) All cigarettes and tobacco products intended and available for sale to consumers by a person who holds a retailer license; and

(2) All cigarettes and tobacco products displayed for sale to consumers by a person who concurrently holds a distributor license and a retailer license at the same location. Cigarettes and tobacco products that are stored in the area where retail sales are made are deemed to be retail stock. Cigarettes and tobacco products that are not stored in the area where retail sales are made are not retail stock. Examples of these areas may include, but are not limited to, store rooms/closets, back offices and safes. Such cigarettes and tobacco products must be in the original manufacturer packaging, with an unbroken seal, and they must be segregated and separated from inventory accessible by consumers.

(A) Walk-in humidors. Tobacco products inside a walk-in humidor displayed for sale to consumers are retail stock. Tobacco products inside a walk-in humidor in the original manufacturer packaging with an unbroken seal, segregated and separated from retail stock, and not displayed for sale to consumers, are non-retail stock.

**(b) A person who is both a licensed retailer and a licensed distributor, but who only makes retail sales to consumers and does not make any sales for resale to other licensees, holds all inventory intended for sale in retail stock.**

**(c) Presumption of Distribution**

(1) All cigarettes and tobacco products placed in retail stock have been distributed. Tax is due upon distribution.

(2) Unless the contrary is established, it shall be presumed that all cigarettes and tobacco products no longer in a distributor's possession, including when they have been lost through an unexplainable disappearance, have been distributed. The presumption may be rebutted by a preponderance of the evidence demonstrating that an explainable disappearance, such as theft, has occurred.

Examples of evidence that may overcome the presumption include, but are not limited to, the following:

(A) Police reports

(B) Insurance claims

(C) Insurance reimbursements

(D) Video surveillance

(E) Photographs

(F) Detailed tobacco inventory reports

(G) Cigarette and tobacco purchase invoices

(H) Proof of prosecution related to charges of theft of cigarettes or tobacco products

Note: Authority: Sections 30008, 30109, Revenue and Taxation Code. Section 30451 Cigarette and Tobacco Products Law

**Regulation 4001. Retail Stock.**

(a) "Retail stock" means and includes:

(1) All cigarettes and tobacco products intended and available for sale to consumers by a person who holds a retailer license; and

(2) All cigarettes and tobacco products displayed for sale to consumers by a person who concurrently holds a distributor license and a retailer license at the same location. Cigarettes and tobacco products that are stored in the area where retail sales are made are deemed to be retail stock. Cigarettes and tobacco products that are not stored in the area where retail sales are made are not retail stock. Examples of these areas may include, but are not limited to, store rooms/closets, back offices and safes. Such cigarettes and tobacco products must be in the original manufacturer packaging, with an unbroken seal, and they must be segregated and separated from inventory accessible by consumers.

(A) Walk-in humidors. Tobacco products inside a walk-in humidor displayed for sale to consumers are retail stock. Tobacco products inside a walk-in humidor in the original manufacturer packaging with an unbroken seal, segregated and separated from retail stock, and not displayed for sale to consumers, are non-retail stock.

(b) A person who is both a licensed retailer and a licensed distributor, but who only makes retail sales to consumers and does not make any sales for resale to other licensees, holds all inventory intended for sale in retail stock.

(c) Presumption of Distribution

(1) All cigarettes and tobacco products placed in retail stock have been distributed. Tax is due upon distribution.

(2) Unless the contrary is established, it shall be presumed that all cigarettes and tobacco products no longer in a distributor's possession, including when they have been lost through an unexplainable disappearance, have been distributed. The presumption may be rebutted by a preponderance of the evidence demonstrating that an explainable disappearance, such as theft, has occurred.

Examples of evidence that may overcome the presumption include, but are not limited to, the following:

- (A) Police reports
- (B) Insurance claims
- (C) Insurance reimbursements
- (D) Video surveillance
- (E) Photographs
- (F) Detailed tobacco inventory reports
- (G) Cigarette and tobacco purchase invoices
- (H) Proof of prosecution related to charges of theft of cigarettes or tobacco products

Note: *Authority:* Sections 30008, 30109, Revenue and Taxation Code.

**Regulation 4001. Retail Stock.**

(a) "Retail stock" means and includes:

(1) All cigarettes and tobacco products intended and available for sale to consumers by a person who holds a retailer license; and

(2) All cigarettes and tobacco products displayed for sale to consumers by a person who concurrently holds a distributor license and a retailer license at the same location. Cigarettes and tobacco products that are stored in the area where retail sales are made are deemed to be retail stock. Cigarettes and tobacco products that are securely stored away from the area where retail sales are made, are not considered retail stock. Examples of these areas may include, but are not limited to, secured store rooms/closets, secured back offices and secured safes. Such cigarettes and tobacco products must be in the original manufacturer packaging, with an unbroken seal, and they must be secured, segregated, and separated from inventory accessible by consumers. For the purpose of this regulation, secure is defined as behind a locked door. Untaxed tobacco must be segregated and secured separately from tax-paid tobacco away from the retail area.

(A) Walk-in humidors. Tobacco products inside a walk-in humidor displayed for sale to consumers are retail stock. Tobacco products inside a walk-in humidor in the original manufacturer packaging with an unbroken seal, secured, segregated and separated from retail stock, and not displayed for sale to consumers, are non-retail stock.

(b) A person who is both a licensed retailer and a licensed distributor and makes substantially all sales as retail sales to consumers holds all inventory intended for sale in the retail location in retail stock. For the purposes of this regulation, "substantially all" means 80 percent or more of gross sales during the previous 12 month reported period.

(c) Presumption of Distribution

(1) All cigarettes and tobacco products placed in retail stock have been distributed. Tax is due upon distribution.

(2) Unless the contrary is established, it shall be presumed that all cigarettes and tobacco products no longer in a distributor's possession, including when they have been lost through an unexplainable disappearance, have been distributed. The presumption may be rebutted by a preponderance of the evidence demonstrating that an explainable disappearance, such as theft, has occurred.

Examples of evidence that may overcome the presumption include, but are not limited to, the following:

- (A) Police reports (Required and must have been filed timely)
- (B) Insurance claims
- (C) Insurance reimbursements
- (D) Video surveillance
- (E) Photographs
- (F) Detailed tobacco inventory reports
- (G) Cigarette and tobacco purchase invoices (Required)
- (H) Proof of prosecution related to charges of theft of cigarettes or tobacco products

Note: *Authority:* Sections 30008, 30109, Revenue and Taxation Code.