



STATE BOARD OF EQUALIZATION

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Interim Executive Director

November 24, 2010

Dear Interested Party:

Enclosed is a Discussion Paper on *Classifying Wine-based Products for Taxation Purposes* and staff's preliminary draft Regulation 2558.1, *Wine*. Discussion is scheduled for the Board's February 11, 2011, Business Taxes Committee meeting.

However, before the issue is presented at the Business Taxes Committee meeting, staff would like to provide interested parties an opportunity to discuss the issue and present any suggested changes or comments. Accordingly, a meeting is scheduled in **Room 122 at 10:00 a.m. on December 17, 2010**, at the Board of Equalization; 450 N Street; Sacramento, California.

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) 324-2554 before the December 17, 2010, meeting. 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 December 17, 2010, or would like to participate via teleconference, I would appreciate it if you would let us know by contacting Mr. Phillip Bishop at (916) 327-6440 or by e-mail at Phil.Bishop@boe.ca.gov prior to December 14, 2010. This will allow us to make alternative arrangements should the expected attendance exceed the maximum capacity of Room 122 and to arrange for teleconferencing. In addition, please let Mr. Bishop know if you wish to have future correspondence, sent to your e-mail address rather than to your mailing address.

Whether or not you are able to attend the above interested parties' meeting, please keep in mind that the due date for interested parties to provide written responses for consideration on this topic is January 3, 2011. Please be aware that copies of your submission may be provided to other interested parties. Therefore, please ensure your comments do not contain confidential information.

Thank you for your consideration. I look forward to your comments and suggestions. Should you have any questions, please feel free to contact Mr. Phillip Bishop, at (916) 327-6440.

Sincerely,

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

LB: pb

Enclosures

cc: (all with enclosures)

Honorable Betty T. Yee, Chairwoman, First District (MIC 71)

Honorable Jerome E. Horton, Vice Chair, Fourth District

Honorable Michelle Steel, Member, Third District

Honorable John Chiang, State Controller, c/o Ms. Marcy Jo Mandel

Ms. Barbara Alby, Acting Member, Second District (MIC 78)
(via e-mail)

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Ms. Suzanne Buehler

Mr. Phillip Bishop

DISCUSSION PAPER

Proposed Regulation 2558.1., *Wine*

Classifying Wine-Based Products for Taxation Purposes

Issue

Should the Board of Equalization (Board) authorize publication of a regulation clarifying the application of tax to wine-based products that do not meet the definition of wine pursuant to Business and Professions Code (BPC) section 23007?

Background

In a letter dated October 25, 2006, California Friday Night Live Partnership, Students Making a Community Change, and the California Youth Council filed a petition pursuant to Government Code Section 11340.6 requesting the Board adopt a regulation to tax flavored malt beverages (FMBs) as distilled spirits and/or amend Alcoholic Beverage Tax Regulation 2530. At the time of the petition, all FMBs were classified and taxed as beer in California. In December 2006, the Board granted this petition, directing staff to initiate the rulemaking process and to hold a series of public meetings with interested parties to discuss the classification of FMBs for taxation purposes and to return with regulatory alternatives for the Board's consideration. After considering the alternatives generated by the interested parties process, at the August 14, 2007 Board meeting, the Board approved publication of Regulation 2558, *Distilled Spirits*; Regulation 2559, *Presumption-Distilled Spirits*; Regulation 2559.1, *Rebuttable Presumption-Distilled Spirits*; Regulation 2559.3, *Internet List*; and Regulation 2559.5, *Correct Classification* (hereafter, collectively, Distilled Spirits Regulations). Due to the focus of the petition, the Distilled Spirits Regulations were promulgated primarily to address the proper classification of FMBs for taxation purposes.

The Distilled Spirits Regulations, attached as exhibit 1, were approved by the Office of Administrative Law (OAL) with an effective date of July 10, 2008, and became fully operational on October 1, 2008. For further information on the Board's prior rulemaking action, please see the Formal Issue Paper that was considered by the Board on August 14, 2007, and the Business Taxes Committee Minutes for that day, which are available on the Board's website at the following weblinks:

Formal Issue Paper: http://www.boe.ca.gov/meetings/pdf/august14_sacramento.pdf

Minutes: <http://www.boe.ca.gov/meetings/pubmins/081407M.pdf>

Although general questions were raised during the interested parties meetings and at the subsequent public hearing regarding wine-based products that may or may not meet the BPC Section 23007 definition of wine and that may contain added distilled alcohol, no specific instances or products were identified or discussed.

Staff was advised to draft the necessary forms, develop the website, prepare the notices to affected parties, and to work with industry on implementing the Distilled Spirits Regulations. Beginning with the effective date of the Distilled Spirits Regulations, pursuant to Regulation

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2559.1, staff began receiving sworn statements (reports) for purposes of rebutting the distilled spirits presumption from affected manufacturers and growers. Staff selected numerous products to review and requested from the manufacturer or grower copies of their “Statement of Process” or “Formula” filed with the federal Alcohol and Tobacco Tax and Trade Bureau (TTB) to determine if they had successfully rebutted the distilled spirits presumption. Along with working with the beer manufacturers on FMBs, staff also was in communication with wine growers and importers regarding wine-based products that may not meet the BPC Section 23007 definition of wine. Staff ultimately prepared two Special Notices specific to the wine industry for clarification purposes, which are attached as exhibits 2 and 3.

The first notice, in December 2008, titled *Special Notice to Wine Growers and Importers*, and mailed to wine grower and wine importer registrants, addressed wine-based products that may not meet the statutory definition of wine in BPC Section 23007. This notice advised that if a registrant produces and/or imports an alcoholic beverage that does not meet the statutory definition of wine, they should consider filing form BOE 505, *Alcoholic Beverage Tax Report for Rebutting Regulation 2559 Presumption*. Summaries of the Distilled Spirits Regulations were included with this notice. The second notice, in December 2009, titled *Alcoholic Beverages Taxed as Wine for Federal Purposes, May Not Meet California’s Definition of Wine and Therefore May be Subject to Tax as Distilled Spirits for California Tax Purposes*, was mailed to all Alcoholic Beverage Tax program registrants, and advised that certain types of alcoholic beverages that may qualify as wine for federal purposes, namely wine specialties, flavored table wine, wine cocktails, wine coolers or other wine-based products or blends of wine from different fruits, may not meet California’s definition of wine under BPC Section 23007 and, therefore, may be considered a distilled spirit and should be taxed accordingly. The notice advised each manufacturer, grower or importer to review California’s wine definition, and if their product(s) did not meet California’s definition of wine, to file form BOE-505, if appropriate, to rebut the distilled spirits presumption.

In relevant part, BPC Section 23007 defines wine to mean:

[T]he product obtained from normal alcoholic fermentation of the juice of sound ripe grapes or other agricultural products containing natural or added sugar or any such alcoholic beverage to which is added grape brandy, fruit brandy, or spirits of wine, which is distilled from the particular agricultural product or products of which the wine is made [hereafter, for ease of discussion, “conforming distilled alcohol”] and other rectified wine products and by whatever name and which does not contain more than 15 percent added flavoring, coloring, and blending material and which contains not more than 24 percent of alcohol by volume, and includes vermouth and sake, known as Japanese rice wine.

Title 27 Code of Federal Regulations (C.F.R.) Part 24.10 provides the following general definition of wine for federal purposes: “*Wine*. When used without qualification, the term includes every kind (class and type) of product produced on bonded wine premises from grapes, other fruit (including berries), or other suitable agricultural products and containing not more than 24 percent alcohol by volume. The term includes all imitation, other than standard, or

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artificial wine and compounds sold as wine. A wine product containing less than one-half of one percent alcohol by volume is not taxable as wine when removed from the bonded wine premises.”

Title 26 United States Code section 5041, *Imposition and rate of tax*, provides:

[T]hat there is imposed on “all wines (including imitation, substandard, or artificial wine, and compounds sold as wine) having not in excess of 24 percent of alcohol by volume, in bond in, produced in, or imported into, the United States, taxes at the rates shown in subsection (b), such taxes to be determined as of the time of removal for consumption or sale. All wines containing more than 24 percent of alcohol by volume shall be classed as distilled spirits and taxed accordingly.”

The federal rates under subdivision (b) are based on alcohol content and whether the wine is still, naturally sparkling, artificially carbonated, or hard cider. California’s rates are based on the same criteria along with the distilled spirits designation for wine-based products that contain in excess of 24 percent of alcohol by volume. However, California’s wine definition differs from the federal definitions in a couple of ways, namely in the requirement that added distilled alcohol that fortifies the alcoholic strength of the beverage must come from conforming distilled alcohol of the same agricultural product, as opposed to being from a “foreign” (i.e., nonconforming) source that is not of the same agricultural product, and in the requirement that the added flavoring, coloring and blending material for all rectified wine can be no more than 15 percent by volume.

By way of contrasting example, for federal purposes, certain classes of wine known as citrus wines, fruit wine and aperitif wine have no similar restriction relating to the origin of distilled alcohol added. Moreover, approved wines are based on the approved formula submitted in the “Statement of Process” or “Formula” to TTB, which permits blending material in excess of 15 percent by volume. Again, to meet the California definition of wine pursuant to BPC Section 23007, such additives are limited to conforming distilled alcohol, and blending material cannot exceed 15 percent by volume. Further, pursuant to federal regulations, the TTB generally does not consider water to be a blending material. BPC Section 23007, however, does not expressly exclude water as a blending material, and California case law indicates that additions of water are relevant in determining whether an alcoholic beverage is properly classified as wine for taxation purposes. (See *Tux Ginger Ale Co., LTD. v. Davis* (1936) 12 Cal.App.2d 73, 74-75.)

It should be noted that the Department of Alcoholic Beverage Control (ABC) treats all wine-based products classified as wine for federal purposes as wine for labeling and licensing purposes in California, regardless of whether added nonconforming distilled alcohol meets or exceeds 0.5 percent by volume or whether the blending material exceeds 15 percent by volume. This acquiescence to federal standards is consistent with ABC’s position with regard to all FMBs, which ABC continues to classify as beer for labeling and licensing purposes, even when the particular FMB is considered a distilled spirit for California tax purposes pursuant to the Distilled Spirits Regulations. By approving the Distilled Spirits Regulations, OAL confirmed

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that the Board has the authority, for tax classification purposes, to diverge from ABC's approach of federal acquiescence.

Discussion of Issues Relating to Non-standard Wine-based Products

The intent behind promulgating the existing Distilled Spirits Regulations and issuing the Special Notices discussed above was to provide guidance for the proper classification and taxation of all alcoholic beverages, including wine-based products. However, based on field visits to major producers of wine-based products, staff is aware that significant differences of opinion exist as to the proper application of the Distilled Spirits Regulations to nonstandard, wine-based products. Specifically, confusion exists as to whether water is regarded as a blending material for purposes of BPC Section 23007. The inclusion or exclusion of water as a blending material may often determine whether a product exceeds 15 percent by volume of added blending material. Confusion also exists as to the rules governing, and the tax consequences of, introducing distilled alcohol to wine-based products through added flavoring.

If an alcoholic beverage does not fall within the safe harbor of being a wine pursuant to BPC Section 23007, the distilled spirits presumption may be successfully rebutted if less than 0.5 percent of distilled alcohol by volume is added to an alcoholic beverage. Problems arise when distilled alcohol that meets or exceeds 0.5 percent alcohol by volume is added and/or when the flavorings, coloring or other blending material exceed 15 percent by volume. A wine product with added flavorings, colorings, and blending material in excess of 15 percent by volume, which, therefore, does not meet the statutory definition for wine, is presumed to be a distilled spirit. When the 15-percent threshold is exceeded, if distilled alcohol (conforming and/or nonconforming) is added that meets or exceeds 0.5 percent alcohol by volume, the distilled spirits presumption remains unrebutted and the product is classified as a distilled spirit under the provisions of the Distilled Spirits Regulations. Please note, however, that an alcoholic beverage is a wine for purposes of BPC section 23007 regardless of the amount of added conforming distilled spirits, so long as the added blending material does not exceed 15 percent by volume and the total alcohol by volume does not exceed 24 percent. For further illustration of the above classification discussion, please refer to the flow chart attached as exhibit 4.

The types of products that may not meet California's statutory definition for wine because they may contain nonconforming distilled spirits and/or may contain blending materials in excess of 15 percent by volume include wine specialties, flavored table wine, wine cocktails, wine coolers, or other wine-based products or blends of wine from different fruits, generally categorized by TTB as nonstandard wines or specialty wines. Because these products may continue to be classified by the TTB as wine and their manufacturers may continue to be licensed by ABC as wine manufacturers, staff believes further clarification is needed for purposes of providing guidance on the proper reporting of alcoholic beverage taxes for wine-based products under the provisions of the Distilled Spirits Regulations.

Attached, as exhibit 5, is a draft, for discussion purposes only, of proposed Regulation 2558.1, which would clarify, for tax classification purposes, what is and what is not wine as defined by

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BPC Section 23007. Although exhibit 5 reflects staff's current understanding of how the rules already established by the Distilled Spirits Regulations should be applied to wine-based products, staff views exhibit 5 as simply the starting point for discussion with interested parties.

Summary

Board staff is aware that the forgoing information may not identify all of the potential issues and concerns related to the classification and taxation of wine-based products. Taxpayers and other interested parties are welcome to submit comments or suggestions on all relevant issues related to this topic and are invited to participate in the interested parties' meeting that is scheduled for 10:00 a.m. on December 17, 2010, in Sacramento.

Prepared by the Special Taxes and Fees Division, Property and Special Taxes Department

Current as of 11/23/2010

Discussion Paper

Classifying Wine-Based Products for Taxation Purposes

Exhibits

Exhibit 1. Distilled Spirits Regulations

Exhibit 2. *Special Notice to Wine Growers and Importers*

Exhibit 3. *Alcoholic Beverages Taxed as Wine for Federal Purposes, May Not Meet California's Definition of Wine and Therefore May be Subject to Tax as Distilled Spirits for California Tax Purposes*

Exhibit 4. Flowchart - Classifying Non-standard Wine-based Products for Tax Purposes

Exhibit 5. Draft Regulation 2558.1. WINE

Exhibit 1

Distilled Spirits Regulations

State of California
BOARD OF EQUALIZATION

ALCOHOLIC BEVERAGE TAX REGULATIONS

Regulation 2558. DISTILLED SPIRITS.

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

Effective October 1, 2008, any alcoholic beverage, except wine as defined by Business and Professions Code section 23007, which contains 0.5 percent or more alcohol by volume derived from flavors or other ingredients containing alcohol obtained from the distillation of fermented agricultural products, is a distilled spirit.

History: Adopted April 8, 2008, effective July 10, 2008.

State of California
BOARD OF EQUALIZATION

ALCOHOLIC BEVERAGE TAX REGULATIONS

Regulation 2559. PRESUMPTION - DISTILLED SPIRITS.

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

Effective October 1, 2008, any alcoholic beverage, except wine as defined by Business and Professions Code section 23007, is presumed to contain 0.5 percent or more alcohol by volume derived from flavors or other ingredients containing alcohol obtained from the distillation of fermented agricultural products, unless this presumption is rebutted pursuant to Regulation 2559.1.

History: Adopted April 8, 2008, effective July 10, 2008.

State of California
BOARD OF EQUALIZATION

ALCOHOLIC BEVERAGE TAX REGULATIONS

Regulation 2559.1. REBUTTABLE PRESUMPTION - DISTILLED SPIRITS.

Reference: Sections 32002, 32452, 32453, Revenue and Taxation Code; Sections 23004, 23005, 23006, 23007, Business and Professions Code.

(a) On or after July 10, 2008, 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 the distillation of fermented agricultural products 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.

(b) The Board shall require a manufacturer's "Statement of Process" or "Formula" filed with the Alcohol and Tobacco Tax Trade Bureau, its predecessor agency or successor, under the following circumstances: (1) if the Board obtains information that casts doubt on the accuracy or truthfulness of a report filed under subdivision (a); or (2) for purposes of verifying any report filed under subdivision (a).

(c) (1) If the Board determines that a manufacturer has not successfully rebutted the presumption in Regulation 2559, the Board shall notify the manufacturer of such determination, and the manufacturer may petition for a redetermination.

(2) Upon receiving notice from the Board, the manufacturer may petition the Board's determination within 30 days. If a petition for redetermination is not filed within the 30-day period, the determination becomes final at the expiration of the 30-day period.

(3) Every petition for redetermination shall be in writing and shall state the specific grounds upon which the petition is founded.

(4) The Board shall reconsider the determination pursuant to its administrative appeals process set forth in California Code of Regulations, title 18, sections 5260-5271 and shall grant the applicant an oral hearing if timely requested within 30 days of the date the Decision and Recommendation issued by the Appeals Division is mailed to the manufacturer. Any Board hearing will be governed by the rules set forth in California Code of Regulations, title 18, sections 5510-5576.

(5) The order or decision of the Board upon a petition for redetermination becomes final 30 days after the date notice thereof is mailed to the manufacturer, except as provided in California Code of Regulations, title 18, section 5560.

(6) Any notice required by this section shall be placed in a sealed envelope, with postage paid, addressed to the manufacturer at the manufacturer's last known address as it appears in the records of the Board. The giving of notice shall be deemed complete at the time of deposit of the notice at a United States Post Office, mailbox, sub-post office, substation, mail chute, or other facility regularly maintained or provided by the United States Postal Service, without extension of time for any reason. In lieu of mailing, notice may be served personally by delivery to the person to be served and service shall be deemed complete at the time of such delivery. Personal delivery to a corporation may be made by delivery of a notice to any person designated to be served for the corporation with summons and complaint in a civil action, pursuant to the Code of Civil Procedure, title 5, chapter 4 (§416.10 et seq.).

History: Adopted April 8, 2008, effective July 10, 2008.

State of California
BOARD OF EQUALIZATION

ALCOHOLIC BEVERAGE TAX REGULATIONS

Regulation 2559.3. INTERNET LIST.

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

(a) Not later than October 1, 2008, and updated on a quarterly basis thereafter to add or remove from the list, the Board shall develop, publish and maintain on its Internet site a listing of all alcoholic beverages that have been found to have successfully rebutted the presumption set forth in Regulation 2559.

(b) Notwithstanding the addition of an alcoholic beverage to the list, the Board shall require a manufacturer's "Statement of Process" or "Formula" filed with the Alcohol and Tobacco Tax Trade Bureau, its predecessor agency or successor, under the following circumstances: (1) if the Board obtains information that casts doubt on the accuracy or truthfulness of a report filed under Regulation 2559.1, subdivision (a); or (2) for purposes of verifying any report filed under Regulation 2559.1, subdivision (a).

(c) The Board shall remove from the list an alcoholic beverage that is finally determined under subdivision (d) to contain 0.5 percent or more alcohol by volume derived from flavors or other ingredients containing alcohol obtained from the distillation of fermented agricultural products, as set forth in Regulation 2558. Before the removal may take effect, the Board shall notify the manufacturer of this determination.

(d) (1) Upon receiving notice from the Board, the manufacturer may petition the Board's determination within 30 days. If a petition for redetermination is not filed within the 30-day period, the determination becomes final at the expiration of the 30-day period.

(2) Every petition for redetermination shall be in writing and shall state the specific grounds upon which the petition is founded.

(3) The Board shall reconsider the determination pursuant to its administrative appeals process set forth in California Code of Regulations, title 18, sections 5260-5271 and shall grant the applicant an oral hearing if timely requested within 30 days of the date the Decision and Recommendation issued by the Appeals Division is mailed to the manufacturer. Any Board hearing will be governed by the rules set forth in California Code of Regulations, title 18, sections 5510-5576.

(4) The order or decision of the Board upon a petition for redetermination becomes final 30 days after the date notice thereof is mailed to the manufacturer, except as provided in California Code of Regulations, title 18, section 5560.

(5) Any notice required by this section shall be placed in a sealed envelope, with postage paid, addressed to the manufacturer at the manufacturer's last known address as it appears in the records of the Board. The giving of notice shall be deemed complete at the time of deposit of the notice at a United States Post Office, mailbox, sub-post office, substation, mail chute, or other facility regularly maintained or provided by the United States Postal Service, without extension of time for any reason. In lieu of mailing, notice may be served personally by delivery to the person to be served and service shall be deemed complete at the time of such delivery. Personal delivery to a corporation may be made by delivery of a notice to any person designated to be served for the corporation with summons and complaint in a civil action, pursuant to the Code of Civil Procedure, title 5, chapter 4 (§ 416.10 et seq.).

History: Adopted April 8, 2008, effective July 10, 2008.

State of California
BOARD OF EQUALIZATION

ALCOHOLIC BEVERAGE TAX REGULATIONS

Regulation 2559.5. CORRECT CLASSIFICATION.

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

Effective October 1, 2008, for purposes of tax reporting, a taxpayer will be deemed to have correctly classified an alcoholic beverage as not being a distilled spirit, as defined by Business and Professions Code section 23005, if at the time taxes are imposed, as set forth in the Revenue and Taxation Code, division 2, part 14, chapters 4, 5, and 5.5, the alcoholic beverage was included on the Board's list pursuant to Regulation 2559.3.

History: Adopted April 8, 2008, effective July 10, 2008.

Exhibit 2

Special Notice to Wine Growers and Importers



Special Notice

CALIFORNIA STATE
BOARD OF EQUALIZATION

450 N STREET
SACRAMENTO, CA 95814

Special Notice to Wine Growers and Importers

BOARD MEMBERS

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800-735-2929



The Board of Equalization (BOE) approved regulations necessary to clarify the definition of "distilled spirits" under the Alcoholic Beverage Tax Law. The regulations were approved by the Office of Administrative Law (OAL) and became fully operative on October 1, 2008.

The regulations create a rebuttable presumption that all alcoholic beverages, except wine, as defined by Business and Professions Code section 23007, contain 0.5 percent or more alcohol by volume derived from flavors or other ingredients containing alcohol obtained from the distillation of fermented agricultural products and are "distilled spirits." The regulations also prescribe a procedure for rebutting this presumption.

Accordingly, unless a manufacturer files the attached BOE-505, *Alcoholic Beverage Tax Report for Rebutting Regulation 2559 Presumption*, to rebut the presumption, any product (including any wine-based products) that does not meet the definition of wine under Business and Professions Code section 23007, is presumed to be a distilled spirit for purposes of the Alcoholic Beverage Tax Law.

Please carefully review the statutory definition of wine and the new Alcoholic Beverage Tax Regulations. In the event you determine that the alcoholic beverages you produce and/or import may not meet the definition of wine, you should consider whether a report to rebut the presumption (BOE-505) should be filed.

For your convenience, the definition of wine is provided below, along with a summary of the new Alcoholic Beverage Tax Regulations 2558, 2559, 2559.1, 2559.3, and 2559.5. For the full text of the regulations, visit www.boe.ca.gov/sptaxprog/sptaxregs.htm.

Business and Professions Code section 23007. "Wine"

"Wine" means the product obtained from normal alcoholic fermentation of the juice of sound ripe grapes or other agricultural products containing natural or added sugar or any such alcoholic beverage to which is added grape brandy, fruit brandy, or spirits of wine, which is distilled from the particular agricultural product or products of which the wine is made and other rectified wine products and by whatever name and which does not contain more than 15 percent added flavoring, coloring, and blending material and which contains not more than 24 percent of alcohol by volume, and includes vermouth and sake, known as Japanese rice wine.

Nothing contained in this section affects or limits the power, authority, or duty of the State Department of Health Services in the enforcement of the laws directed toward preventing the manufacture, production, sale, or transportation of adulterated, misbranded, or mislabeled alcoholic beverages, and the definition of "wine" contained in this section is limited strictly to the purposes of this division and does not extend to, or repeal by implication, any adulterated, misbranded, or mislabeled alcoholic beverages.

Regulation 2558. Distilled Spirits

This regulation clarifies that, effective October 1, 2008, distilled spirits include any alcoholic beverage, except wine as defined by Business and Professions Code section 23007, which contains 0.5 percent or more alcohol by volume from flavors or ingredients containing alcohol obtained from the distillation of fermented agricultural products. The purpose of this regulation is to establish a bright line to determine when an alcoholic beverage is a "distilled spirit" under the Alcoholic Beverage Tax Law.

Regulation 2559. Presumption - Distilled Spirits

Effective October 1, 2008, this regulation established a rebuttable presumption that alcoholic beverages, except wine as defined by Business and Professions Code section 23007, contain 0.5 percent or more alcohol by volume from flavors or ingredients containing alcohol obtained from the distillation of fermented agricultural products. If a manufacturer does not rebut the presumption as provided in Regulation 2559.1, the alcoholic beverage will be presumed to meet the definition of "distilled spirits."

Regulation 2559.1. Rebuttable Presumption - Distilled Spirits

This regulation, effective July 10, 2008, allows the manufacturer to rebut the presumption set forth in Regulation 2559 with respect to any alcoholic beverage by filing a report, under penalty of perjury, that specifies the sources and amount of the alcohol content of the beverage. The regulation additionally provides that the BOE may require a copy of the manufacturer's Statement of Process or Formula filed with the Federal Alcohol and Tobacco Tax and Trade Bureau, or its predecessor agency or successor agency, only if the BOE obtains information that casts a doubt on the accuracy or truthfulness of a report filed or for purposes of verifying any report filed.

Regulation 2559.3. Internet List

Effective October 1, 2008, this regulation requires the BOE to establish and maintain a listing of alcoholic beverages that have successfully rebutted the presumption on its website. The current list can be accessed on the BOE's website at www.boe.ca.gov/sptaxprog/pdf/product_list.pdf.

Regulation 2559.5. Correct Classification

This regulation provides that effective October 1, 2008, taxpayers who rely for reporting purposes on the BOE Internet list required by Regulation 2559.3 will be afforded a "safe harbor" from potential tax liabilities.

If you have any questions regarding this notice, please call our Taxpayer Information Section at 800-400-7115 (TDD/TTY: 800-735-2929). Or you may contact the Excise Taxes Division directly at 916-327-4208. Staff are available weekdays from 8:00 a.m. to 5:00 p.m., Pacific time, except state holidays.

Exhibit 3

Alcoholic Beverages Taxed as Wine for Federal Purposes, May Not Meet California's Definition of Wine and Therefore May be Subject to Tax as Distilled Spirits for California Tax Purposes



Special Notice

STATE BOARD
OF EQUALIZATION

450 N STREET
SACRAMENTO, CA 95814

BOARD MEMBERS

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DECEMBER 2009

L-241

Alcoholic Beverages Taxed as Wine for Federal Purposes, May Not Meet California's Definition of Wine and Therefore May be Subject to Tax as Distilled Spirits for California Tax Purposes

Alcoholic beverages taxed as wine for federal tax purposes may not meet California's wine definition under Business and Professions Code section 23007, if the wine has **more than 15 percent added flavoring, coloring, and blending material.**

The types of alcoholic beverages that may not meet California's definition of wine may fall under the following federal tax classifications such as wine specialties, flavored table wine, wine cocktails, wine coolers or other wine-based products or blends of wine from different fruits. Such products may be taxed as a distilled spirit in California.

The Board of Equalization's (BOE) Alcoholic Beverage Regulation 2559 creates a rebuttable presumption that all alcoholic beverages, except wine as defined by Business and Professions Code section 23007, contain 0.5 percent or more alcohol by volume derived from flavors or other ingredients containing alcohol obtained from the distillation of fermented agricultural products and are "distilled spirits." Regulation 2559.1 prescribes procedures for rebutting this presumption.

According to Business and Professions Code section 23007:

Wine means the product obtained from normal alcoholic fermentation of the juice of sound ripe grapes or other agricultural products containing natural or added sugar or any such alcoholic beverage to which is added grape brandy, fruit brandy, or spirits of wine, which is distilled from the particular agricultural product or products of which the wine is made and other rectified wine products and by whatever name and which does not contain more than 15 percent added flavoring, coloring, and blending material and which contains not more than 24 percent of alcohol by volume, and includes vermouth and sake, known as Japanese rice wine.

Accordingly, unless a manufacturer files the attached BOE-505, *Alcoholic Beverage Tax Report for Rebutting Regulation 2559 Presumption*, to rebut the presumption, any alcoholic beverage (including any wine-based products) that does not meet the definition of wine under Business and Professions Code section 23007 is presumed to be a distilled spirit for purposes of the Alcoholic Beverage Tax Law.

If the alcoholic beverage meets the definition of wine under Business and Profession Code section 23007, no action is required.

Alcoholic beverages that have rebutted the presumption are listed on BOE's website at www.boe.ca.gov/sptaxprog/alcoholicbeverage.htm.

As part of the BOE audit and compliance program, manufacturers may be required to provide the BOE with a copy of their Statement of Process or Formula and Batch reports filed with the Federal Alcohol and Tobacco Tax and Trade Bureau for our review, to ensure the correct tax amounts are being reported.

For your convenience, attached is a summary of the new Alcoholic Beverage Tax Regulations 2558, 2559, 2559.1, 2559.3, and 2559.5. For the full text of the regulations, visit www.boe.ca.gov/sptaxprog/sptaxregs.htm. If you have any questions regarding this notice, please contact the Excise Tax Division at 800-400-7115.

*Special Notice
Alcoholic
Beverages Taxed
as Wine for
Federal Purposes,
May Not Meet
California's
Definition
of Wine and
Therefore May be
Subject to Tax as
Distilled Spirits
for California
Tax Purposes*

Regulation 2558. Distilled Spirits

This regulation clarifies that, effective October 1, 2008, distilled spirits include any alcoholic beverage, except wine as defined by Business and Professions Code section 23007, which contains 0.5 percent or more alcohol by volume from flavors or ingredients containing alcohol obtained from the distillation of fermented agricultural products. The purpose of this regulation is to establish a bright line to determine when an alcoholic beverage is a "distilled spirit" under the Alcoholic Beverage Tax Law.

Regulation 2559. Presumption—Distilled Spirits

Effective October 1, 2008, this regulation established a rebuttable presumption that alcoholic beverages, except wine as defined by Business and Professions Code section 23007, contain 0.5 percent or more alcohol by volume from flavors or ingredients containing alcohol obtained from the distillation of fermented agricultural products. If a manufacturer does not rebut the presumption as provided in Regulation 2559.1, the alcoholic beverage will be presumed to meet the definition of "distilled spirits."

Regulation 2559.1. Rebuttable Presumption—Distilled Spirits

This regulation, effective July 10, 2008, allows the manufacturer to rebut the presumption set forth in Regulation 2559 with respect to any alcoholic beverage by filing a report, under penalty of perjury, that specifies the sources and amount of the alcohol content of the beverage. The regulation additionally provides that the BOE may require a copy of the manufacturer's Statement of Process or Formula filed with the Federal Alcohol and Tobacco Tax and Trade Bureau, or its predecessor agency or successor agency, only if the BOE obtains information that casts a doubt on the accuracy or truthfulness of a report filed or for purposes of verifying any report filed.

Regulation 2559.3. Internet List

Effective October 1, 2008, this regulation requires the BOE to establish and maintain a listing of alcoholic beverages that have successfully rebutted the presumption on its website. The current list can be accessed on the BOE's website at www.boe.ca.gov/sptaxprog/pdf/product_list.pdf.

Regulation 2559.5. Correct Classification

This regulation provides that effective October 1, 2008, taxpayers who rely for reporting purposes on the BOE Internet list required by Regulation 2559.3 will be afforded a "safe harbor" from potential tax liabilities.

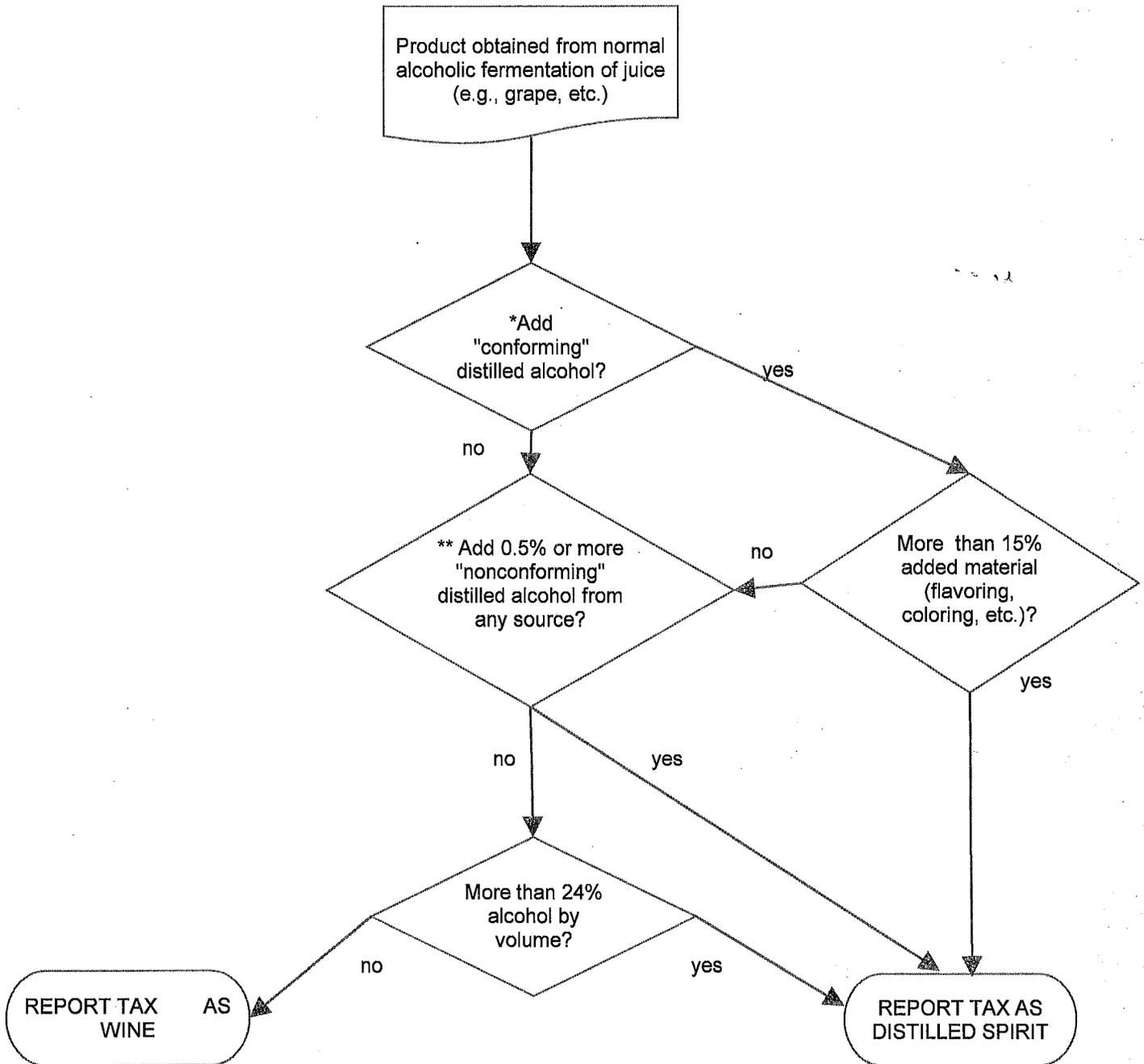
If you would like to know more about your rights as a taxpayer or if you have not been able to resolve a problem through normal channels (for example, by speaking to a supervisor), please see publication 70, *Understanding Your Rights as a California Taxpayer*, or contact the Taxpayers' Rights Advocate Office for help at 916-324-2798 (or toll-free, 888-324-2798). Their fax number is 916-323-3319. If you prefer, you can write to: Taxpayers' Rights Advocate, MIC:70; State Board of Equalization; P.O. Box 942879; Sacramento, CA 94279-0070.

Exhibit 4

**Flowchart - Classifying Non-standard Wine-based Products for Tax
Purposes**

Classifying Non-standard Wine-based Products for Tax Purposes

(For discussion purposes only)



* = "Conforming" distilled alcohol means alcohol obtained from the distillation of the fermented particular agricultural product or products of which the wine is made. For purposes of this discussion, it is assumed that any added conforming distilled alcohol meets or exceeds 0.5% by volume.

** = "Nonconforming" distilled alcohol means distilled alcohol NOT obtained from the distillation of the fermented particular agricultural product or products of which the wine is made.

Exhibit 5

Draft Regulation 2558.1. WINE

Proposed Regulation

Regulation 2558.1. WINE.

(a) [Effective xxx xx, xxxx,] for purposes of the Alcoholic Beverage Tax Law (Revenue and Taxation Code section 32001 et seq.) and subject to the limitations set forth in subdivisions (b) and (c), wine, as defined by Section 23007 of the Business and Professions Code includes:

- (1) Any alcoholic beverage obtained from normal alcoholic fermentation of the juice of sound ripe grapes or other agricultural products containing natural or added sugar;
- (2) Any such alcoholic beverage to which is added grape brandy, fruit brandy or spirits of wine, which is distilled from the particular agricultural product or products of which the wine is made; and
- (3) Any other rectified wine products, by whatever name, which do not contain more than 15 percent added flavoring, coloring, and blending material, and which do not contain 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made.

(b) The following wine-based products are excluded from the definition of wine and shall be classified as distilled spirits for tax purposes:

- (1) Any wine-based alcoholic beverage containing more than 24 percent alcohol by volume;
- (2) Any rectified wine-based alcoholic beverage that contains 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made;
- (3) Any rectified wine-based alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products from the particular agricultural product or products of which the wine is made, and that contains more than 15 percent added flavoring, coloring, and blending material; and
- (4) Any rectified wine-based alcoholic beverage that contains a combined total of 0.5 percent or more alcohol by volume obtained both from the distillation of fermented agricultural products from the particular agricultural product or products of which the wine is made and from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made, and that contains more than 15 percent added flavoring, coloring, and blending material.

(c) For purposes of this section, flavoring, coloring and blending material includes any ingredient added during the rectification process, including water. Flavoring, coloring and blending material may not contain 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made.

Authority: Section 32152, Revenue and Taxation Code;

Reference: Section 23007, Business and Professions Code; Section 32002, Revenue and Taxation Code.