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PROPERTY AND SPECIAL TAXES DEPARTMENT
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State Controller

KRISTINE CAZADD
Interim Executive Director

February 11, 2011

Dear Interested Party:

Enclosed are the Agenda, Issue Paper, and Revenue Estimate for the February 23, 2011 Business Taxes Committee meeting. This meeting will address proposed Regulation 2558.1 *Wine*, under the Alcohol Beverage Tax Law.

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 a materials preparation and review schedule arranged according to subject matter and meeting date.

Thank you for your input on these issues and I look forward to seeing you at the Business Taxes Committee meeting at 9:30 a.m. on February 23, 2011, in Room 121 at the address shown above.

Sincerely,

David Gau, Deputy Director
Property and Special Taxes Department

DG:peb

Enclosures

cc: Honorable Jerome E. Horton, Chairman
Honorable Michelle Steel, Vice Chair
Honorable Betty T. Yee, First District
Senator George Runner (Ret.), Second District
Honorable John Chiang, State Controller, c/o Ms. Marcy Jo Mandel (via e-mail)

via e-mail:

Ms. Regina V. Evans, Board Member's Office, Fourth District
Mr. Robert Thomas, Board Member's Office, Fourth District
Ms. Cynthia Suero, Board Member's Office, Fourth District
Mr. Louis Barnett, Board Member's Office, Third District
Mr. Ken Maddox, Board Member's Office, Third District
Mr. Neil Shah, Board Member's Office, Third District
Mr. Alan LoFaso, Board Member's Office, First District
Ms. Mengjun He, Board Member's Office, First District
Mr. Sean Wallentine, Board Member's Office, Second District
Mr. Lee Williams, Board Member's Office, Second District
Ms. Elizabeth Maeng, Board Member's Office, Second District
Ms. Natasha Ralston Ratcliff, State Controller's Office
Ms. Kristine Cazadd
Mr. David Gau
Mr. Jeff McGuire
Mr. Randy Ferris
Ms. Christine Bisauta
Mr. Stephen Smith
Mr. Bradley Heller
Mr. Lou Feletto
Mr. Phillip Bishop
Ms. Leila Hellmuth
Ms. Lynn Whitaker
Mr. Robert Zivkovich

AGENDA — February 23, 2011 Business Taxes Committee Meeting
Classifying Wine-Based Products for Taxation Purposes

Action Item	Alternative 1 Staff's Proposed Language	Alternative 2 Ms. Barbara Alby's Proposed Language	Alternative 3 E&J Gallo's Proposed Language
Action 1 - Regulation 2558.1, <i>Wine</i>	(a) Effective January 1, 2012, wine as defined by Business and Professions Code section 23007, does not include any alcoholic beverage containing 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.	(a) Effective October 1, 2008, 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	(a) Effective October 1, 2008, for purposes of the Alcoholic Beverage Tax Law (Revenue and Taxation Code section 32001 et seq.) and subject to the limitation 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 and produced in accordance with the Alcohol and Tobacco Tax and Trade Bureau regulations in 27 CFR Subparts F and G (natural wine) or in 27 CFR Subpart I (agricultural wine), in either case with the treatment and materials permitted for such wine in 27 CFR Subpart L and subject to the applicable requirements of the California wine standards in 17 CCR Sections 17001 et seq. (hereinafter referred to as a "wine base"); (2) Any alcoholic beverage consisting of a wine base to which is added grape brandy, fruit brandy or spirits of wine, which is distilled from the particular

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	<p>(b) Except as provided in subdivision (a), wine-based products authorized for sale as wine by the Department of Alcoholic Beverage Control are deemed to be wine as defined by Business and Professions Code section 23007 for purposes of the Alcoholic Beverage Tax Law.</p>	<p>agricultural product or products of which the wine is made; and</p> <p>(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.</p> <p>(b) The following wine-based products are excluded from the definition of wine and shall be classified as distilled spirits for tax purposes:</p> <p>(1) Any wine-based alcoholic beverage containing more than 24 percent alcohol by volume;</p> <p>(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;</p>	<p>agricultural product or products of which the wine base is made; and</p> <p>(3) Any other alcoholic beverage made from a wine base, by whatever name, that does not contain more than 15 percent added flavoring, coloring, and blending material, and does 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 base is made.</p> <p>(b) The following alcoholic beverages are excluded from the definition of wine and shall be classified as distilled spirits for tax purposes:</p> <p>(1) Any alcoholic beverage made from a wine base and containing more than 24 percent alcohol by volume;</p> <p>(2) Any alcoholic beverage made from a wine base containing 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;</p>

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		<p>(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</p> <p>(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.</p> <p>(c) For purposes of this section, flavoring, coloring and blending material includes ingredients added during the rectification process. The addition of unadulterated water or the</p>	<p>(3) Any alcoholic beverage made from a wine base 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 also containing more than 15 percent added flavoring, coloring, and blending material; and</p> <p>(4) Any alcoholic beverage made from a wine base containing 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 also containing more than 15 percent added flavoring, coloring, and blending material.</p> <p>(c) For purposes of this section, flavoring, coloring and blending material includes water and any other ingredient added after production of the wine base other than alcohol. The</p>

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		<p>unfermented juices from the particular agricultural product or products from which the wine is made shall not be treated as flavoring, coloring or blending materials, no matter when they are added, whether concentrated or not, and whether exceeding 15 percent of the volume of the final product or not. 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.</p>	<p>volume and source of any alcohol contained in flavoring, coloring and blending material shall be included in the determination whether an alcoholic beverage made from a wine base is classified as a distilled spirit for tax purposes in accordance with subdivisions (b)(2), (b)(3), and (b)(4) of this regulation.</p>

Issue Paper Number 11-001



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

Classifying Wine-Based Products for Taxation Purposes

I. Issue

Should the Board of Equalization (BOE) authorize publication of a regulation to clarify the application of tax to wine-based products that contain distilled alcohol?

II. Alternative 1 - Staff Recommendation

Staff recommends that the BOE authorize the publication of proposed Regulation 2558.1, with an effective date of January 1, 2012, to be added to the Alcoholic Beverage Tax Regulations. Regulation 2558.1 would provide clear direction to the wine industry and BOE staff regarding the proper classification for tax purposes of a wine-based product containing 0.5 percent or more distilled alcohol by volume that is not from the particular agricultural product(s) of which the wine is made (i.e., containing a substantial amount of distilled alcohol from a foreign or nonconforming source). Wine, as defined by Business and Professions Code (BPC) section 23007, is excluded from the definition of a distilled spirit in Regulation 2558 and, therefore, is not subject to the distilled spirits presumption for alcoholic beverages set forth in Regulation 2559.

A draft of proposed Regulation 2558.1, *Wine*, is attached as Exhibit 2. Staff's proposal provides needed clarification regarding when wine-based products should be classified as distilled spirits for taxation purposes.

III. Other Alternative(s) Considered

A. Alternative 2

As proposed by Mr. Tom Hudson on behalf of former Acting Board Member Barbara Alby, exclude water and juice from the same agricultural product(s) of which the wine is made from what would be considered a flavoring, coloring and blending material, regardless of when such water and juice are added to the wine-based product and whether such additions exceed 15 percent by volume of the final product or not. See Exhibit 3 for a draft of the proposed language for Alternative 2. Alternative 2 is a proposed clarification of existing statutory language with an October 1, 2008 effective date (i.e., the effective date of the existing Distilled Spirits Regulations).

B. Alternative 3

As proposed by Mr. Richard Grey, Vice President-General Counsel of E&J Gallo, consider water a blending material and subject to the 15 percent by volume limitation specified in BPC section 23007

FORMAL ISSUE PAPERIssue Paper Number **11-001**

when added to a “wine base,” as defined by reference to certain federal standards. A wine product containing 0.5 percent or more by volume of distilled alcohol from any source and exceeding the flavoring, coloring and blending material limitation specified in BPC section 23007 would be classified as a distilled spirit for taxation purposes. See Exhibit 4 for a draft of the proposed language for Alternative 3. According to E&J Gallo, the application of the Distilled Spirits Regulations to wine-based products should always have been clear to the wine industry and, thus, this regulatory proposal should be made effective October 1, 2008, which is the effective date of the existing Distilled Spirits Regulations.

Issue Paper Number 11-001

IV. 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* (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 5, 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.

Although general questions were raised during the interested parties meetings and at the Board meeting regarding wine-based products that may or may not meet the BPC section 23007 definition of wine and that may contain added distilled alcohol from a nonconforming source, no specific circumstances 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 2559.1, staff began receiving sworn statements (reports) for purposes of rebutting the distilled spirits presumption from manufacturers and brewers. Staff selected numerous products to review and requested from the manufacturers or brewers 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 manufacturers and brewers of FMBs, staff also was in communication with wine growers and importers regarding wine-based products that may not meet the BPC section 23007 definition for wine. Staff prepared two Special Notices specific to the wine industry for clarification purposes, which are attached as Exhibits 6 and 7.

The first notice, dated December 2008, titled *Special Notice to Wine Growers and Importers*, and mailed to wine grower and wine importer registrants, addressed wine that does not meet the statutory definition 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 for wine, the registrant 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, dated 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 program accounts, and advised that certain types of alcoholic beverages that may qualify as wine for federal classification 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

FORMAL ISSUE PAPERIssue Paper Number **11-001**

BPC section 23007 and, therefore, may be considered a distilled spirit and 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.

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 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 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 that 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 basic 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 distilled alcohol of the same agricultural product of which the wine is made, as opposed to a nonconforming source, 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 the distilled alcohol added.

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 foreign distilled alcohol meets or exceeds 0.5 percent by volume or whether the blending material exceeds 15 percent by volume. ABC maintains that this acquiescence to federal standards is permissible under section 32152 of the Alcoholic Beverage Tax Law (Rev. & Tax. Code, § 32001 et seq.) and 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

FORMAL ISSUE PAPERIssue Paper Number **11-001**

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

V. Discussion

The intent behind the existing Distilled Spirits Regulations and the issuance of the Special Notices was to provide guidance for the proper classification for tax purposes 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, disagreement 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 affect whether a product contains more than 15 percent by volume of added blending material. In other words, whether water is characterized as a blending material may affect whether a product is considered to be a wine as defined by BPC section 23007 or not. Confusion also exists as to the rules governing, and the tax consequences of, introducing to wine-based products distilled alcohol that may not be derived from a conforming source.

At the November 17, 2010 Board Meeting, staff requested the Board Members to authorize an informal rulemaking process by initiating an interested parties process to discuss these issues more thoroughly. The Board provided the authorization requested, and direction was given to proceed on an expedited basis. Staff prepared for discussion purposes only an initial draft of a proposed Regulation 2558.1 that would effectively raise various issues for discussion with the interested parties. On December 17, 2010, staff held an interested parties meeting at which the following initial draft of Regulation 2558.1 was discussed.

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;

FORMAL ISSUE PAPERIssue Paper Number **11-001**

(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.

At the interested parties meeting, industry representatives raised a number of concerns regarding the proper characterization of water, its use in reconstituting juice from concentrate of the same agricultural product of which the wine is made, and the various uses of water in the winemaking process. Additionally, considerable concern was expressed with regard to the expedited rulemaking process. It became apparent that there was serious disagreement within the industry about how water and the use of water in the winemaking process should be addressed. In broad strokes, the interested parties are divided into two points of view: those that consider water to be a blending material and those that do not.

These same concerns and alternative regulatory language were further articulated in the seven submissions received from interested parties by staff. The concerns raised are summarized below.

One view: Water is not a blending material

The language submitted by former Acting Board Member Barbara Alby would seek to amend the initial draft language of Regulation 2558.1 (c) to read:

For purposes of this section, flavoring, coloring and blending material includes ~~any~~ ingredients added during the rectification process, ~~including water~~. The addition of unadulterated water or the unfermented juices from the particular agricultural product or products from which the wine is made shall not be treated as flavoring, coloring or blending materials, no matter when they are added, whether concentrated or not, and whether exceeding 15 percent of the volume of the final product or not. 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.

The language proposed by Ms. Alby specifies that water and juice from a conforming source are not blending materials, and, therefore, water and juice from a conforming source may be added in any volume and at any time during the pre-fermentation, fermentation or post-fermentation stages of the winemaking process.

The Wine Group (TWG), a privately-held, management-owned, producer of wine, in their submission was also opposed to treating water as a blending material. TWG's products include flavored wine products (commonly referred to as "formula wines" by the TTB and "sangria" wines by consumers)

FORMAL ISSUE PAPERIssue Paper Number **11-001**

that are produced in accordance with an approved formula. TWG asserts that characterizing water as a blending material would impose a new restriction on wineries that diverges from longstanding California, federal and industry viewpoints on the use of water in the production of wine in California. Federal law limits the use of water in formula wines to the amount or range specified under a formula approved by TTB. According to TWG, wine producers in California have followed the federal regulations for fifty-seven years in the absence of express contrary language in BPC section 23007 and, thus, have never considered water to be a “blending material.”

A similar concern was raised in a submittal from Mr. Marc Sorini, who represents Green Mountain Beverage, a hard cider manufacturer, with regard to characterizing water and juice from a conforming source as a blending material. Water and juice are added to cider after fermentation to reduce the alcohol level to between 5 and 7 percent. This is a standard method for production of cider, which is classified under federal law as a natural fruit wine. Mr. Sorini expressed concern that the way water or juice from a conforming source is characterized could jeopardize the classification of hard cider as a wine for taxation purposes.

Although the Napa Valley Vintners (NVV), a non-profit trade association representing over 400 Napa Valley wineries, did not specifically weigh in on whether water is a blending material, their members did express concern with staff’s statement in the Informal Issue Paper that “[c]onfusion exists as to whether water is regarded a blending material” for purposes of BPC section 23007. NVV further noted that, for the good of our domestic wine industry and the consumers of wine, the definition of “wine” must have integrity and products sold as “wine” must be made according to proper standards.

The NVV is concerned with the use of water and its inclusion in any clarification of the definition of wine as it may affect consumer perception regarding wine in general. Most, if not all, aspects relating to consumer product safety or protection regarding product quality is outside the purview of the BOE and are matters for ABC and the TTB in their advertising and labeling regulations, along with the State Department of Public Health (which was once a part of the former Department of Health Services) in their administration of California Code of Regulations, title 17, section 17001 et seq. (*Wine Standards and Prohibited Practices*).

Another view: Water is a blending material

The initial draft regulation prepared by staff for discussion purposes characterized water as a blending material subject to the 15 percent by volume threshold when added during the rectification process. The initial draft further contemplated that, regardless of added blending material, any wine-based product that does not contain added distilled alcohol of 0.5 percent or more by volume from either a foreign source or conforming source, could successfully rebut the distilled spirits presumption in Regulation 2559 and be classified as a wine for taxation purposes. Under this scenario, such a product containing non-alcoholic blending material, but which does not contain distilled alcohol at or exceeding 0.5 percent by volume, would logically and appropriately default to a wine classification and be taxed accordingly. (See Rev. & Tax. Code, § 32152.)

E&J Gallo in their submission proposes that water, and presumably juice from a conforming source, added to the wine base be included as a blending material in calculating the 15 percent by volume threshold in BPC section 23007. E&J Gallo proposes to amend the initial draft of Regulation 2558.1 (a) (1) as follows: “Any alcoholic beverage obtained from normal alcoholic fermentation of the juice of sound ripe grapes or other agricultural products containing natural or added sugar and produced in accordance with the Alcohol and Tobacco Tax and Trade Bureau regulations in 27 CFR Subparts F and G (natural wine) or in 27 CFR Subpart I (agricultural wine), in either case with the treatment and

FORMAL ISSUE PAPERIssue Paper Number **11-001**

materials permitted for such wine in 27 CFR Subpart L and subject to the applicable requirements of the California wine standards in 17 CCR Sections 17001 et seq. (hereinafter referred to as a “wine base”).” E&J Gallo further proposes to revise the initial draft of Regulation 2558.1 (c) to read: “For purposes of this section, flavoring, coloring and blending material includes any water and any other ingredient added during the rectification process, including water after production of the wine base other than alcohol. ~~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. The volume and source of any alcohol contained in flavoring, coloring, and blending material shall be included in the determination whether an alcoholic beverage made from a wine base is classified as a distilled spirit for tax purposes in accordance with subdivision (b)(2), (b)(3), and (b)(4) of this regulation.~~”

In addition to defining the wine base by reference to federal regulations and specifying that water is a blending material, E&J Gallo’s proposed regulation substitutes “wine base” in place of “rectified wine” products throughout the regulation and makes other nonsubstantive changes to the language. For a complete draft of E&J Gallo’s proposed language see Exhibit 4.

E&J Gallo’s proposed language, like the initial draft language prepared by staff for discussion purposes, allows a wine-based product that does not contain added distilled alcohol of 0.5 percent or more by volume from either a foreign source or conforming source, but includes water or juice in excess of the 15 percent by volume threshold, to successfully rebut the distilled spirits presumption in Regulation 2559. As discussed previously, these products would default to wine because they do not include 0.5 percent or more added distilled alcohol by volume. A wine-based product containing 0.5 percent or more by volume of distilled alcohol from any source is classified as a distilled spirit for tax purposes when blending material exceeds 15 percent by volume in both the initial draft prepared by staff for discussion purposes and the language submitted by E&J Gallo.

E&J Gallo, in their initial submission questioned why any regulatory clarification was necessary and asserted no confusion should exist as to whether water is a blending material for purposes of BPC section 23007. E&J reasoned: “If water were not considered a blending material under Section 23007 for purposes of additions to the ‘product obtained from normal alcoholic fermentation of the juice of sound ripe grapes,’ then either: (1) any additions of water to a wine base after fermentation would be prohibited; or (2) any amount of water could be added to a wine base after fermentation and the resulting product would still be considered ‘wine.’ Neither interpretation could possibly be correct.”

Additional comments and concerns from interested parties

Regulatory action is not necessary and/or is unlawful

The Family Winemakers of California (FWC), a statewide trade association of over 650 members that include wineries, vineyards and related businesses, believe rulemaking with regard to the proper tax classification of alcoholic beverages oversteps the BOE’s legislative mandate in pursuit of tax revenue. According to FWC, section 22, article 20 of the California Constitution leaves no question that, when it comes to regulating alcoholic beverages, BOE’s authority is limited to imposing and collecting taxes on alcohol according to classification made by law. Additionally, FWC opposes the regulation due to the unnecessary burden the proposed regulation would place on California’s smallest wine producers, the uncertainty and confusion the proposed regulation would insert into the regulatory scheme applicable to alcoholic beverages in general and wines in particular. FWC asserts that the initial draft regulation goes beyond taxation and delves into the actual manufacture and formulation of wine-based products. FWC recommends that the BOE not pursue rulemaking.

Issue Paper Number 11-001

TWG, in their submission contends that the initial draft regulation, if promulgated, would violate Proposition 26 by reclassifying certain wine-based products as distilled spirits with the effect of exacting a higher tax. As TWG observes, Proposition 26 provides that “any change in state statute” that results in higher taxes must be approved by a supermajority of the Legislature. TWG contends that promulgating a new regulation is tantamount to changing a statute when the regulation overturns the longstanding interpretation of the definition of wine set forth in BPC section 23007. Staff notes that Proposition 26 places certain restrictions on the Legislature’s enactment of statutes. Proposition 26 does not apply when an agency interprets existing statutes, as the agency’s interpretation of existing statutes is not a “change in state statute” enacted by the Legislature.

Further questions regarding the BOE’s authority to promulgate regulations regarding the proper classification for tax purposes of alcoholic beverages were raised during the prior FMB discussion and subsequent litigation in the matter of *Diageo-Guinness USA, Inc. v. State Board of Equalization*. In this case, the Sacramento County Superior Court affirmed that the BOE does have authority to promulgate regulations that classify alcoholic beverages for tax purposes. The case is presently pending before the Court of Appeal.

As discussed above, E&J Gallo also contends that the application of the Distilled Spirits Regulations to wine-based products should always have been clear to the wine industry and, therefore, regulatory action is unnecessary. At the interested parties meeting, several participants voiced disagreement with E&J Gallo’s contention.

Expedited Rulemaking

The general consensus from industry and industry representatives was that an expedited rulemaking process prevents the diverse winegrowing and manufacturing industry from presenting a cohesive and unified position. Most, if not all, felt there was inadequate time to work with BOE staff, making it difficult for industry to provide language to BOE staff that is acceptable for industry as a whole. Submissions from TWG, NVV and the Wine Institute (discussed more fully below) indicated a desire to continue the discussion at a second interested parties meeting.

Although the informal rulemaking has been expedited on this issue, industry was made aware of some of the possible effects the Distilled Spirits Regulations may have on wine-based products by staff in the two special notices mailed in December of 2008 and 2009. In addition, a discussion paper and agenda for the December 17, 2010, interested parties meeting was mailed on November 24, 2010, to the interested parties list, which included the seven parties making submissions. Further, at least with respect to the issue of whether water constitutes a blending material for purposes of BPC section 23007, it is apparent to staff that no amount of added time would enable industry to reach a consensus view, as industry is deeply divided.

Staff’s view: Whether water is a blending material is not determinative for tax classification purposes

Based on the discussion generated by the interested parties process, staff believes that the divergent positions taken by the interested parties with respect to whether water and juice from a conforming source should be classified as a blending material are irreconcilable and that further interested parties discussions on this topic would be unproductive. For example, the Wine Institute, a public policy trade association with a membership of over 900 operating wineries, did not take a position regarding the use of water as a blending material, as its constituent members could not agree on whether water should be regarded as a blending material. The Wine Institute indicated opposition to any regulation that would allow limitless amounts of water in the production of wine, but the Wine Institute further

Issue Paper Number **11-001**

acknowledges that both the TTB's regulations and tacit acquiescence from the state have for many years allowed these products to be made and sold without regard to the amount of water used in the production of wine-based products for California tax classification purposes.

To the best of staff's knowledge, there appears to be a general acceptance among the interested parties that, notwithstanding any objections they have, in general, to the existence of Distilled Spirits Regulations themselves, a wine-based product containing distilled alcohol from a foreign source of 0.5 percent or more by volume, although permitted by the TTB for certain classes of wine, would not be considered a wine under the Distilled Spirits Regulations for tax purposes. In addition, any wine-based product's formula must be approved by TTB and, therefore, contain less than 24 percent alcohol by volume for the producer or importer of the wine to be licensed by ABC.

Staff's recommended regulatory language focuses on the source of the distilled alcohol added to wine in determining whether a wine-based product should be classified as a wine or as a distilled spirit for tax purposes. Staff's proposal follows the same regulatory approach taken in drafting the Distilled Spirits Regulations to properly classify alcoholic beverages like FMBs as distilled spirits (e.g., focusing on whether the source of the flavoring or added alcohol was from other than the fermentation of any infusion or decoction of barley, malt, hops, or any other similar product.) In light of industry's inability to reach consensus as to whether water and juice from a conforming source should be classified as a blending material, staff does not recommend that the Board make a determination as to which general wine manufacturing methods are permissible as part of its rulemaking. By clarifying the effect of adding nonconforming distilled alcohol to wine-based products, staff believes its recommended approach addresses the essential tax classification issue within the BOE's purview. In sum, staff believes its recommended approach provides the correct focus for the interpretation and implementation of BPC section 23007 as it pertains to the proper tax classification of wine-based products.

Staff recommends an effective date of January 1, 2012, so as not to penalize any wine manufacturer or importer who has been operating under the federal regulations in utilizing a foreign distilled alcohol in their flavorings or approved formula. Although two special notices were sent to wine manufacturers and importers referencing wine as defined as defined by BPC section 23007, it was never clearly stated that, if a federally approved wine contained distilled alcohol from a foreign source of 0.5 percent or more by volume, the wine would no longer qualify as a wine for California taxation purposes and would be taxed as a distilled spirit. Thus, staff believes sufficient time should be given to provide the opportunity for reformulation before the proposed regulation becomes effective.

VI. Alternative 1 - Staff Recommendation

A. Description of Alternative 1

Staff recommends adoption of the following proposed regulation:

Regulation 2558.1. WINE.

- (a) Effective January 1, 2012, wine as defined by Business and Professions Code section 23007 does not include any alcoholic beverage containing 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.

FORMAL ISSUE PAPERIssue Paper Number **11-001**

- (b) Except as provided in subdivision (a), wine-based products authorized for sale as wine by the Department of Alcoholic Beverage Control are deemed to be wine as defined by Business and Professions Code section 23007 for purposes of the Alcoholic Beverage Tax Law.

Authority: Section 32451, Revenue and Taxation Code.

Reference: Section 23007, Business and Professions Code; Sections 32002, 32152, Revenue and Taxation Code.

Staff proposes adoption of Regulation 2558.1, *Wine*, to clarify that wine as defined by BPC section 23007 does not include a wine-based product containing 0.5 percent or more of distilled alcohol by volume from a nonconforming source. A wine-based product that contains a 0.5 percent or more of distilled alcohol by volume from a nonconforming source will be classified for taxation purposes as a distilled spirit. Wine as defined must still be an approved wine by the TTB and, therefore, must be produced in accordance with the TTB's Regulations 27 C.F.R. Part 24 and may not exceed 24 percent alcohol by volume.

B. Pros of Alternative 1

1. Provides clear direction to industry and BOE staff that wine as defined for purposes of taxation does not include a wine-based product containing 0.5 percent or more by volume of distilled alcohol from a nonconforming source.
2. Follows the same regulatory approach as the Distilled Spirits Regulations in focusing on the source of the added distilled alcohol.
3. Does not cause, through the addition of water or juice from a conforming source, classification of an alcoholic beverage as a distilled spirit merely due to diluting an otherwise approved wine product.
4. Does not alter existing wine production methods, other than properly limiting the source of the distilled alcohol used in the production of formula wines.

C. Cons of Alternative 1

1. If the proposed regulation is promulgated, some wine producers will have to alter the source of distilled alcohol or flavorings used in producing their wines.
2. Certain interested parties believe the promulgation of Regulation 2558.1 would exceed the BOE's regulatory authority.

D. Statutory or Regulatory Change for Alternative 1

No other statutory or regulatory change is required at this time with respect to adoption and implementation of proposed Regulation 2558.1.

E. Operational Impact of Alternative 1

Upon approval by the OAL, staff will be required to notify appropriate taxpayers of the new regulation through special notices sent in conjunction with the mailing of returns, through articles, Special Taxes and Fees (STF) newsletters, in the Sales and Use Tax Information Bulletin (TIB), through alerts posted on the Board's website, and revision to volume 3 of the Business Taxes Law Guide to incorporate the new regulation.

Issue Paper Number **11-001**

In order to track and account for the taxes associated with a wine manufacturer's or wine importer's purchases and sales of wine-products classified for tax purposes as distilled spirits, existing Beer and Wine Importer and Winegrower returns will have to be modified to incorporate changes similar to those performed for the tracking of FMBs. Changes, again similar to those performed for the tracking of FMBs, on the BOE's integrated revenue system (IRIS) will also have to be performed.

Staffing resources should not be impacted with the adoption of Regulation 2558.1 because, unlike FMBs, a wine as defined is not subject to the presumption and rebuttal requirements of Regulations 2559 and 2559.1. Wine-based products are either a wine as defined or they are a distilled spirit. Determining whether a wine-based product qualifies as a wine would be a function of the existing audit program for the Alcoholic Beverages Taxes.

F. Administrative Impact of Alternative 1

1. Cost Impact

The workload associated with publishing the regulation and the special notice, updating the law guide, TIB articles and STF newsletter is considered routine and any corresponding cost would be absorbed within the BOE's existing budget. Many of the costs associated with enhancements to IRIS and modifications to existing returns have been incurred as a result of implementing the Distilled Spirits Regulations in 2008. Although reimbursement for these costs and others were requested, costs ended up being absorbed by the BOE due to the denial of the May 2009 Revise Finance Letter by DOF, wherein the BOE requested \$46,773 for temporary help in the Technology Services Division. Additional costs to make remaining enhancements to IRIS and modifications to returns to track the tax associated with wine-based products taxed as distilled spirits would be absorbed within the BOE's existing budget.

2. Revenue Impact

The effective date of this recommendation is January 1, 2012. There is nothing in the Staff's recommendation that could be construed as having an impact on existing tax revenues. See Revenue Estimate, Exhibit 1.

G. Taxpayer/Customer Impact of Alternative 1

Reformulations of certain formula wines by wine manufacturers may be required to continue to receive the favorable tax treatment for wine. If reformulation is not possible, the alternative would be a distilled spirits tax classification or removal of the product from the California market.

H. Critical Time Frames of Alternative 1

This alternative, if adopted, would become effective on January 1, 2012. Prior to the effective date, staff would need to prepare a special notice, update the BOE's website, modify pertinent returns and enhance the IRIS subsystems to accommodate a new taxpayer type.

VII. Alternative 2

A. Description of Alternative 2

As proposed by former Acting Board Member Barbara Alby, Alternative 2 amends the initial draft regulation prepared by staff to exclude water and juice from the same agricultural product from which

Issue Paper Number **11-001**

the wine is made from what would be considered a flavoring, coloring and blending material, regardless of when the water or juice is added to the wine-based product and whether exceeding 15 percent by volume of the final product or not. This alternative utilizes the initial draft of Regulation 2558.1 staff prepared for discussion purposes and excludes from the definition for wine: (1) any wine-based alcoholic beverage that contains more than 24 percent alcohol by volume; (2) any rectified wine-based alcoholic beverage that contains 0.5 percent or more alcohol by volume from a foreign source; (3) any rectified wine-based alcoholic beverage that contains 0.5 percent or more distilled alcohol by volume from a conforming source, and that contains more than 15 percent added flavoring, coloring and blending material; or (4) any rectified wine-based alcoholic beverage that contains a combined total of 0.5 percent or more distilled alcohol by volume from any source, and that contains more than 15 percent added flavoring, coloring and blending material.

B. Pros of Alternative 2

1. Provides clear direction to industry and BOE staff that water and juice from a conforming source is not a blending material for determining the 15 percent by volume threshold in BPC section 23007.
2. Provides clear direction to industry and BOE staff that wine as defined for purposes of taxation does not include a wine-based product containing 0.5 percent or more by volume of distilled alcohol from a nonconforming source.
3. Does not cause, through the addition of water or juice from a conforming source, classification of an alcoholic beverage as a distilled spirit merely due to diluting an otherwise approved wine product.

C. Cons of Alternative 2

1. If the proposed regulation is promulgated, some wine producers will have to alter the source of distilled alcohol or flavorings used in producing their wines.
2. Certain interested parties believe the promulgation of Regulation 2558.1 would exceed the BOE's regulatory authority.
3. Includes in the definition for "wine" a reference to water's inclusion in standard wine production, which is a matter of significant concern to standard wine producers.
4. Due to the effective date of October 1, 2008, this alternative would not allow sufficient time for reformulation and may result in unanticipated tax assessments for products containing 0.5 percent or more distilled alcohol from a foreign source.

D. Statutory or Regulatory Change for Alternative 2

No other statutory or regulatory change is required at this time with respect to adoption and implementation of proposed Regulation 2558.1.

E. Operational Impact of Alternative 2

Same as Alternative 1.

F. Administrative Impact of Alternative 2

1. Cost Impact

Same as Alternative 1.

Issue Paper Number **11-001**

2. Revenue Impact

Although, the effective date of this proposal is retroactive to October 1, 2008, there is nothing in Alternative 2 that could be construed as having an impact on existing tax revenues. See Revenue Estimate, Exhibit 1.

G. Taxpayer/Customer Impact of Alternative 2

Due to the proposed October 1, 2008 effective date, there may be immediate tax implications for wine manufacturers whose products contain 0.5 percent or more by volume of foreign distilled spirits. In addition, as with Alternative 1, reformulations of certain formula wines by wine manufacturers may be required to benefit from the favorable tax treatment for wine. If reformulation is not possible, the alternative would be the continuation of a distilled spirits tax classification or removal of the product from the California market.

H. Critical Time Frames of Alternative 2

Same as Alternative 1.

VIII Alternative 3

A. Description of Alternative 3

As proposed by E&J Gallo, Alternative 3 amends the initial draft regulation prepared by staff to define a “wine base” to be any alcoholic beverage obtained from normal alcoholic fermentation of the juice of sound ripe grapes or other agricultural products containing natural or added sugar that is produced in accordance with TTB’s regulations for natural wine and agricultural wine that may include treatment and materials permitted for such wine by the TTB (subject to applicable requirements of the California wine standards). “Wine base” is further utilized in the proposed regulation to describe such terms as “rectified wine products,” “rectified wine base” and “rectification process” as the terms were used in staff’s initial draft of Regulation 2558.1. Proposed Alternative 3 incorporates all the remaining sections and subsections included in staff’s initial draft of Regulation 2558.1.

B. Pros of Alternative 3

1. Provides a definition for wine base that is easily understood by the wine industry that currently operates within the TTB’s regulations and the California wine standards.
2. Provides clear direction to industry and BOE staff that any alcoholic beverage made from a wine base containing 0.5 percent or more by volume of distilled alcohol from a foreign source is excluded from the definition of wine and shall be classified as distilled spirits for tax purposes.
3. Provides clear direction to industry and BOE staff that any alcoholic beverage made from a wine base that contains more than 15 percent added flavoring, coloring and blending material and also contains 0.5 percent or more distilled alcohol by volume from any source is excluded from the definition of wine and classified as a distilled spirit for tax purposes.
4. Provides clear direction to industry and BOE staff that water added to the wine base is considered a blending material for determining the 15 percent by volume threshold.

C. Cons of Alternative 3

FORMAL ISSUE PAPER

Issue Paper Number **11-001**

1. If the proposed regulation is promulgated, some wine producers will have to alter the source of distilled alcohol or flavorings used in producing their wines.
2. If the proposed regulation is promulgated, some wine producers will have to alter their formula wines in order to meet the definition of a wine for taxation purposes.
3. Does cause certain formula wines, through the addition of water or juice from a conforming source, to be classified as a distilled spirit merely due to diluting an otherwise approved wine product.
4. Certain interested parties believe the promulgation of Regulation 2558.1 would exceed the BOE's regulatory authority.
5. Referencing federal standards in the definition of the "wine base" may cause staff difficulty in administering the proposed regulation.

D. Statutory or Regulatory Change for Alternative 3

No other statutory or regulatory change is required at this time with respect to adoption and implementation of proposed Regulation 2558.1.

E. Operational Impact of Alternative 3

Same as Alternative 1.

F. Administrative Impact of Alternative 3

1. Cost Impact

Same as Alternative 1.

2. Revenue Impact

Approximate revenue gain of \$600,000 generated for prior periods until manufactures reformulate the affected wine-based products. See Revenue Estimate, Exhibit 1.

G. Taxpayer/Customer Impact of Alternative 3

Due to the proposed October 1, 2008 effective date, as with Alternative 2, there may be unanticipated tax implications for wine manufacturers whose products contain 0.5 percent or more by volume of foreign distilled spirits or 0.5 percent or more by volume of distilled spirits from any source and water and other flavoring, coloring and blending material in excess of the 15 percent by volume threshold. In addition, as with Alternatives 1 and 2, reformulations of certain formula wines by wine manufacturers may be required to benefit from the favorable tax treatment for wine. If reformulation is not possible, the alternative would be the continuation of a distilled spirits tax classification or removal of the product from the California market.

H. Critical Time Frames of Alternative 3

Same as Alternative 2.

FORMAL ISSUE PAPER

Issue Paper Number **11-001**

Preparer/Reviewer Information

Prepared by: Special Taxes and Fees Division

Current as of: February 4, 2011

REVENUE ESTIMATE

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

Classifying Wine-Based Products for Taxation Purposes

Alternative 1 – Staff Recommendation

Staff recommends that the BOE authorize the publication of proposed Regulation 2558.1, with an effective date of January 1, 2012, to be added to the Alcoholic Beverage Tax Regulations. Regulation 2558.1 would provide clear direction to the wine industry and BOE staff regarding the proper classification for tax purposes of a wine-based product containing 0.5 percent or more distilled alcohol by volume that is not from the particular agricultural product(s) of which the wine is made. Wine as defined by BPC section 23007 is excluded from the definition of a distilled spirit in Regulation 2558 and therefore is not subject to the distilled spirits presumption for alcoholic beverages set forth in Regulation 2559. Regulation 2558.1 would make clear that a wine-based product containing 0.5 percent or more by volume of distilled alcohol from a nonconforming source is a distilled spirit for tax calculation purposes and taxed accordingly.

Other Alternative(s) Considered

Alternative 2

As proposed by Mr. Tom Hudson on behalf of former Acting Board Member Barbara Alby, exclude from what would be considered a flavoring, coloring and blending material, water and juice from the same agricultural product(s) of which the wine is made, regardless of when they are added to the wine-based product and whether exceeding 15 percent by volume of the final product or not. According to Mr. Hudson, Alternative 2 is a clarification of existing statutory language with an October 1, 2008 effective date, which is consistent with the effective date of the existing Distilled Spirits Regulations.

Alternative 3

As proposed by Mr. Richard Grey, Vice President-General Counsel of E&J Gallo (Gallo) consider water a blending material subject to the 15 percent by volume limitation specified in BPC section 23007 when added to a “wine base” defined by reference to certain federal standards. A wine product containing 0.5 percent or more by volume of

Revenue Estimate

distilled alcohol from any source and exceeding the flavoring, coloring and blending material limitation specified in BPC section 23007 would be classified as a distilled spirit for taxation purposes. According to Gallo, Alternative 3 is a clarification of existing statutory language with an October 1, 2008 effective date, which is consistent with the effective date of the existing Distilled Spirits Regulations.

Background, Methodology, and Assumptions**Alternative 1 – Staff Recommendation**

Staff's recommended regulatory language focuses on the source of the distilled alcohol added to wine in determining whether a wine-based product should be classified as a wine or as a distilled spirit for tax purposes. This approach follows the same regulatory path taken in drafting the Distilled Spirits Regulations to properly classify malt-based alcoholic beverages, known as Flavored Malt Beverages (FMB), as distilled spirits for taxation purposes. Staff recommendation clarifies the application of tax to wine-based products containing 0.5 percent or more distilled alcohol by volume that is not from the particular agricultural product(s) of which the wine is made (i.e., from a foreign or nonconforming source). The effective date of this recommendation is January 1, 2012. There is nothing in the Staff's recommendation that could be construed as having an impact on existing tax revenues.

Other Alternative(s) Considered**Alternative 2**

Proponents for Alternative 2 argue that water and juice from the same agricultural product(s) of which the wine is made, regardless of when they are added to the wine-based product and whether exceeding 15 percent by volume of the final product or not, should be excluded from what would be considered a flavoring, coloring and blending material pursuant to BPC Section 23007. According to the proponents for Alternative 2, this alternative provides clarification of existing statutory language with an October 1, 2008 effective date which is consistent with the effective date of the existing Distilled Spirits Regulations. Although, the effective date of this proposal is retroactive to October 1, 2008, there is nothing in Alternative 2 that could be construed as having an impact on existing tax revenues.

Alternative 3

Proponents for Alternative 3 argue that water is a blending material and thereby subject to the 15 percent by volume threshold, pursuant to BPC Section 23007, when added during the rectification process. However, the BPC Section 23007 does not expressly state that water is a blending material. It should also be noted that there is a likelihood of a small number of wine-based products sold in California that exceed the 15 percent by volume limitation for blending material since the Department of Alcoholic Beverage Control acquiesces to the federal rules in this matter in reliance on Alcoholic Beverage Tax Law section 32152. In addressing Alternative 3, staff recommended that the regulatory language should focus on the source of the distilled alcohol added to wine in

Revenue Estimate

determining whether a wine-based product should be classified as a wine or as a distilled spirit for tax purposes. According to staff, this approach follows the same regulatory path taken in drafting the Distilled Spirits Regulations to properly classify malt-based alcoholic beverages, namely FMBs, as distilled spirits, if the source of the flavoring or added alcohol comes from a nonconforming source.

In conclusion, by including water as a blending material, it is likely that a small number of wine-based products sold in California may exceed the 15 percent by volume limitation threshold for blending material. However, we do not know the volume (number of gallons) of wine-base products that may be affected by Alternative 3. Nonetheless, as an order of magnitude, if 1/10th of 1% of the total gallons (88,000 gallons) of table wines sold in California in FY 2009-10 exceeded the 15% limitation, the resulting revenue gain would amount to approximately \$600,000 generated for prior periods until manufacturers reformulate the affected wine-based products.

Revenue Summary

Alternative 1 – The staff recommendation does not have a revenue impact.

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

Alternative 3 – Alternative 3 could have a revenue impact of approximately \$600,000.

Preparation

Mr. Bill Benson, Jr., Research and Statistics Section, Legislative and Research Division, prepared this revenue estimate. Mr. Robert Ingenito, Chief, Research and Statistics Section, Legislative and Research Division and Ms. Lynn Bartolo, Chief, Special Taxes and Fees Division, Property and Special Taxes Department, reviewed this revenue estimate. For additional information, please contact Mr. Benson at 916-445-0840.

Current as of February 3, 2011.

Alternative 1 - Staff Recommendation

Regulation 2558.1. WINE.

- (a) Effective January 1, 2012, wine as defined by Business and Professions Code section 23007 does not include any alcoholic beverage containing 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) Except as provided in subdivision (a), wine-based products authorized for sale as wine by the Department of Alcoholic Beverage Control are deemed to be wine as defined by Business and Professions Code section 23007 for purposes of the Alcoholic Beverage Tax Law.

Authority: Section 32451, Revenue and Taxation Code.

Reference: Section 23007, Business and Professions Code; Sections 32002, 32152, Revenue and Taxation Code.

Alternative 2**Regulation 2558.1. WINE.**

(a) Effective **October 1, 2008**, 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 ingredients added during the rectification process, including water. The addition of unadulterated water or the unfermented juices from the particular agricultural product or products from which the wine is made shall not be treated as flavoring, coloring or blending materials, no matter when they are added, whether concentrated or not, and whether exceeding 15 percent of the volume of the final product or not.** 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.

Alternative 2

Authority: Section 32451, Revenue and Taxation Code.

Reference: Section 23007, Business and Professions Code; Sections 32002, 32152, Revenue and Taxation Code.

Alternative 3**Regulation 2558.1 WINE.**

(a) Effective October 1, 2008, for purposes of the Alcoholic Beverage Tax Law (Revenue and Taxation Code section 32001 et seq.) and subject to the limitation 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 and produced in accordance with the Alcohol and Tobacco Tax and Trade Bureau regulations in 27 CFR Subparts F and G (natural wine) or in 27 CFR Subpart I (agricultural wine), in either case with the treatment and materials permitted for such wine in 27 CFR Subpart L and subject to the applicable requirements of the California wine standards in 17 CCR Sections 17001 et seq. (hereinafter referred to as a “wine base”);

(2) Any ~~such~~ alcoholic beverage consisting of a wine base 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 base is made; and

(3) Any other ~~rectified-wine-products~~ alcoholic beverage made from a wine base, by whatever name, ~~which do~~ that does not contain more than 15 percent added flavoring, coloring, and blending material, and ~~which do~~ does 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 base is made.

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

(1) Any ~~wine-based~~ alcoholic beverage made from a wine base and containing more than 24 percent alcohol by volume;

(2) Any ~~rectified-wine-based~~ alcoholic beverage made from a wine base ~~that contains~~ containing 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 made from a wine base 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~~ also containing more than 15 percent added flavoring, coloring, and blending material; and

(4) Any ~~rectified-wine-based~~ alcoholic beverage made from a wine base containing 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~~ also containing more than 15 percent added flavoring, coloring, and blending material.

(c) For purposes of this section, flavoring, coloring and blending material includes ~~any water and any other~~ ingredient added ~~during the rectification process, including water~~ after production of the wine base other than alcohol. ~~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~~

Alternative 3

~~made.~~The volume and source of any alcohol contained in flavoring, coloring and blending material shall be included in the determination whether an alcoholic beverage made from a wine base is classified as a distilled spirit for tax purposes in accordance with subdivisions (b)(2), (b)(3), and (b)(4) of this regulation.

Authority: Section 32451, Revenue and Taxation Code.

Reference: Section 23007, Business and Professions Code; Sections 32002, 32152, Revenue and Taxation Code.

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.

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.

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.

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.

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.



Special Notice

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BOARD OF EQUALIZATION

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Special Notice to Wine Growers and Importers

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.

December 2008
L-214

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.



Special Notice

STATE BOARD OF EQUALIZATION

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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.

STATE BOARD
OF EQUALIZATION

***Special Notice
Alcoholic
Beverages Taxed
as Wine for
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May Not Meet
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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.