State of California

Board of Equalization
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Memorandum

To: Honorable Judy Chu, Ph.D., Chair
Honorable Betty T. Yee, Vice Chairwoman
Honorable Bill Leonard
Honorable Michelle Steel
Honorable John Chiang

Date: February 28, 2008

From: Kristine Cazadd
Chief Counsel

Subject: **Board Meeting, March 19, 2008 – Chief Counsel Matter J____**
Regulation 2558, *Distilled Spirits;* Regulation 2559, *Presumption – Distilled Spirits;* Regulation 2559.1, *Rebuttable Presumption – Distilled Spirits;* Regulation 2559.3, *Internet List;* Regulation 2559.5, *Correct Classification*

This memorandum sets forth the staff recommendation regarding revised language in Regulation 2558, *Distilled Spirits;* Regulation 2559, *Presumption – Distilled Spirits;* Regulation 2559.1, *Rebuttable Presumption – Distilled Spirits;* Regulation 2559.3, *Internet List;* and Regulation 2559.5, *Correct Classification* (hereafter, collectively, Regulations). Staff recommends that the Board approve the revised language as provided in the attached Regulations and summarized below. Additionally, as discussed below, staff recommends that the Board approve making Formal Issue Paper No. 07-007 and its exhibits (copy attached) available to the public for 15 days.

The Board authorized publication of the Regulations on August 14, 2007. After the required public hearing, the Board adopted the Regulations on November 15, 2007. The Regulations were subsequently filed with the Office of Administrative Law (OAL) on December 10, 2007. Subsequently, in order to make changes recommended by OAL, the file was withdrawn on January 24, 2008. The resulting changes are summarized as follows:

Regulation 2558, *Distilled Spirits*:

- Added California Constitution, article XX, section 22 as an authority.

Regulation 2559, *Presumption – Distilled Spirits*:

- For clarity, deleted "unless the contrary is established" and added "unless this presumption is rebutted pursuant to Regulation 2559.1."

- Added the term "fermented." This term was inadvertently left out of the previously adopted language. It has been added in order to maintain consistency with Regulation 2558 and the definition of "distilled spirits." (Bus. & Prof. Code, § 23005.)
- Added California Constitution, article XX, section 22 as an authority.

Regulation 2559.1, *Rebuttable Presumption – Distilled Spirits*:

- Clarified that the regulation is effective 30 days after filing with the Secretary of State.
- Added the term "fermented." This term was inadvertently left out of the previously adopted language. It has been added in order to maintain consistency with Regulation 2558 and the definition of "distilled spirits." (Bus. & Prof. Code, § 23005.)
- Added new subdivisions (b) and (c) and numbered the previous language as new subdivision (a).
- Added subdivision (b) to clarify when the Board may require a "Statement of Process" or "Formula."
- Added subdivision (c) to provide a review process should the manufacturer not successfully rebut the presumption. Staff has patterned this review after the Board's current petition for redetermination of taxes process.
- Added California Constitution, article XX, section 22 as an authority.
- Added reference to section 23006 of the Business and Professions Code.

Regulation 2559.3, *Internet List*:

- Added "to add or remove from the list," in new subdivision (a) in order to clarify that the Internet list will be updated to add or remove alcoholic beverages on a quarterly basis.
- Deleted the phrase "in the Board's discretion" because revised Regulations 2559.1 and 2559.3 now explicitly specify the process by which the Board will determine whether or not a particular alcoholic beverage should be posted or should remain on the list.
- Added new subdivisions (b), (c) and (d) and numbered the previous language as new subdivision (a).
- Added subdivision (b) to clarify that after an alcoholic beverage is on the list, the Board may require a "Statement of Process" or "Formula" and under what circumstances.
- Added subdivision (c) in order to provide a process to remove an alcoholic beverage from the list and provide notification to the manufacturer.
- Added subdivision (d) to provide a review process that allows a manufacturer to petition the Board's determination to remove an alcoholic beverage from the list. Staff has pattered this review after the Board's current petition for redetermination of taxes process.
- Added the California Constitution, article XX, section 22 as an authority.

Regulation 2559.5, *Correct Classification*:

- Clarified that the regulation is effective July 1, 2008.
- Moved "for purposes of tax reporting," and added "as not being a distilled spirit, as defined by Business and Professions Code section 23005" to clarify that if the alcoholic beverage is on the list then it is not a distilled spirit, as defined by Business and Professions Code section 23005. Without this clarifying language, a taxpayer's classification could arguably be deemed correct, even if, for example, the alcoholic beverage is improperly classified as a wine.
- Changed "were incurred" with "are imposed" to harmonize with the addition of a reference to the relevant imposition statutes.
- Added a reference to the Revenue and Taxation Code, division 2, part 14, chapters 4, 5 and 5.5 to clarify the location of the statutes that impose tax under the Alcoholic Beverage Tax Law.
- Added California Constitution, article XX, section 22 as an authority.
- Added reference to section 23005 of the Business and Professions Code.

Staff has not changed the effective date of the Regulations. Regulation 2559.1 remains effective 30 days after filing with the Secretary of State. As discussed above, the additional proposed language in Regulation 2559.1 is to clarify that point. The remaining regulations continue with the July 1, 2008, effective date. With the withdrawal of the file, staff anticipates that the soonest the Regulations would be approved by OAL would be in mid-to-late May, which would result in an effective date thirty days later, after the filing with the Secretary of State. This would result in a mid-to-late June effective date for Regulation 2559.1. An effective date of July 1, 2008, for the remaining regulations would mean that industry would likely have no more than two weeks to rebut the presumption that a product is a distilled spirit. The original timeline for the July 1, 2008, effective date estimated OAL approval in January 2008 and an effective date thirty days later. This provided industry an approximate four-month window to file reports to rebut the presumption and staff adequate time to review the reports, revise returns and make the necessary technology changes. Therefore, staff suggests the Board consider revising the operative date for Regulations 2558, 2559, 2559.3 and 2559.5 to either January 1, 2009, or at the earliest, October 1, 2008, to facilitate an efficient implementation of the new regulatory scheme.

The proposed changes are considered sufficiently related to the original text of the Regulations, such that the public was adequately placed on notice that the changes discussed above could result from the originally proposed regulatory action. If approved for publication, the revised language will be made available to the public for 15 days before adoption of the revised Regulations. The approved changes will also be mailed to those interested parties who previously commented on the proposed regulatory action orally or in writing or who asked to be informed of such changes.

Additionally, staff is recommending that Formal Issue Paper No. 07-007 and its exhibits, be identified as a document relied upon and made available to the public, upon request, for 15 days. While this document has been available to the public, it was not

specifically identified in the Notice of Rulemaking. This is recommended to ensure that all required public notice has been provided during the formal rulemaking process.

At the next Board meeting, after the 15-day comment period, staff will report on any comments received and will recommend whether the Board should adopt the revised Regulations for filing with OAL.

If you have any questions regarding this case, please contact Tax Counsel III (Specialist) Monica Brisbane, at (916) 322-0438.

Approved: _____
Ramón J. Hirsig
Executive Director

KC/MGB/ef
ChiefCounsel/Final/08-090CCMatter
Bus/Special/Final/MGB/08-090CCMatter

Attachments

cc: (w/ attachments)

Mr. Ramon Hirsig	MIC: 73
Ms. Anita Gore	MIC: 86
Mr. David Gau	MIC: 63
Ms. Lynn Bartolo	MIC: 56
Mr. Randy Ferris	MIC: 82
Ms. Monica Brisbane	MIC: 82

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Note: New language is in bold/double underlined and deletions of previous language are shown with strikeout.

Regulation 2558. DISTILLED SPIRITS.

Effective July 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.

Authority: ***California Constitution, article XX, section 22;*** *Section 32451, Revenue and Taxation Code.*
Reference: Section 32002, Revenue and Taxation Code; Sections 23004, 23005, 23006, 23007, Business and Professions Code.

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Note: New language is bold/double underlined and deletions of previous language are shown with strikeout.

Regulation 2559. PRESUMPTION - DISTILLED SPIRITS.

Effective July 1, 2008, ~~unless the contrary is established,~~ 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**.

Authority: ***California Constitution, article XX, section 22;*** *Section 32451, Revenue and Taxation Code.*
Reference: Section 32002, Revenue and Taxation Code; Sections 23004, 23005, 23006, 23007, Business and Professions Code.

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Note: New language is bold/double underlined and deletions of previous language are shown with strikeout.

Regulation 2559.1. REBUTTABLE PRESUMPTION - DISTILLED SPIRITS.

(a) On or after _____,* ~~t~~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. ~~Additionally, the Board may require a copy of the manufacturer's "Statement of Process" or "Formula" filed with the Alcohol and Tobacco Tax Trade Bureau, its predecessor agency or successor agency.~~

(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 Regulation, 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.).

Authority: ***California Constitution, article XX, section 22;*** *Section 32451, Revenue and Taxation Code.*
Reference: Sections 32002, 32452, 32453, Revenue and Taxation Code; Sections 23004, 23005, ***23006,*** *23007, Business and Professions Code.*

*** OAL to enter effective date of regulation**

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Note: New language is bold/double underlined and deletions of previous language are shown with strikeout.

Regulation 2559.3. INTERNET LIST.

(a) Not later than July 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~~, in the Board's discretion,~~ 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 Regulation, 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.).

Authority: ***California Constitution, article XX, section 22;*** *Section 32451, Revenue and Taxation Code.*
Reference: Section 32002, Revenue and Taxation Code; Sections 23004, 23005, 23006, 23007, Business and Professions Code.

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Regulation 2559.5. CORRECT CLASSIFICATION.

Effective July 1, 2008, for purposes of tax reporting, a~~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,** ~~for purposes of tax reporting~~ if at the time taxes **are imposed** ~~were incurred~~**, 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.

Authority: ***California Constitution, article XX, section 22;*** *Section 32451, Revenue and Taxation Code.*
Reference: Section 32002, Revenue and Taxation Code; Sections 23004, ***23005,*** *23006, 23007, Business and Professions Code.*

Issue Paper Number **07-007**

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

BOARD OF EQUALIZATION
KEY AGENCY ISSUE

Flavored Malt Beverages

I. Issue

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

II. Alternative 1 – Tax FMB as Distilled Spirits

Language was prepared by staff to meet the Board's directive to prepare draft regulations that, if adopted, would result in FMB being taxed as distilled spirits. In response to concerns expressed by interested parties (IP) and staff at the second IP meeting, two additional draft regulations have been prepared that supplement the three draft regulations previously discussed in the second discussion paper. These two additional draft regulations pertain to an Internet listing of alcoholic products that a taxpayer could refer to and rely on for purposes of tax reporting. These draft regulations, if adopted, would create a mechanism for classifying alcoholic beverages such that FMB would be taxed as distilled spirits and traditional beer products would be taxed as beer. The draft regulations can be summarized as follows:

(1) Alcoholic Beverage Tax Law, Regulation 2558. *Distilled Spirits.* Would define distilled spirits to include an alcoholic beverage, except wine, which contains 0.5 percent or more alcohol by volume from flavors or ingredients containing alcohol obtained from the distillation of fermented agricultural products.

(2) Alcoholic Beverage Tax Law, Regulation 2559. *Presumption – Distilled Spirits.* Would establish a presumption that alcoholic beverages, except wine, contain 0.5 percent or more alcohol by volume from flavors or ingredients containing alcohol obtained from the distillation of agricultural products.

(3) Alcoholic Beverage Tax Law, Regulation 2559.1. *Rebuttable Presumption – Distilled Spirits.* Would allow the manufacturer the ability to rebut the presumption set forth in Regulation 2559 as to any particular alcoholic beverage by filing a statement, under penalty of perjury, that specifies the sources and amount of the alcohol content of the beverage. Additionally, these regulations define the process whereby manufacturers could rebut the presumption by filing a copy of the "Statement of Process" or product "Formula" with the BOE that was filed with the Alcohol and Tobacco Tax Trade Bureau (TTB) for any alcoholic beverage.

Continued

(4) Alcoholic Beverage Tax Law, Regulation 2559.3. *Internet List.* Would establish and provide a time frame for staff to create and maintain an Internet listing of alcoholic beverages that have been found to have successfully rebutted the presumption set forth in Regulation 2559.

(5) Alcoholic Beverage Tax Law, Regulation 2559.5. *Correct Classification.* Would provide that a taxpayer may rely on the Internet listing set forth in Regulation 2559.3 for purposes of tax reporting with respect to alcoholic beverage products shown on the Board's list at the time the tax liability was incurred.

Again, staff prepared this alternative for the Board's consideration pursuant to the Board's direction. However, staff notes that consensus has not been reached amongst IPs who remain clearly split in their support and opposition to this alternative.

A copy of the draft regulations is attached as Exhibit 3. See Formal Issue Paper pages 7 – 12, and Agenda Action Item 1.

III. Other Alternative(s) for Consideration

Alternative 2: Tax all alcoholic beverages containing distilled alcohol as distilled spirits

Plaintiffs in *County of Santa Clara, et al. v. State Board of Equalization* (San Francisco Superior Court Case No. 06-506789) acting as a participant to this rulemaking process provided comments and suggested alternative regulatory language to identify alcoholic beverages that contain distilled spirits for purposes of taxation. Specifically, this alternative proposes revisions to current Regulation 2500, *Records.*

The proposed regulatory language, as written, appears to assume that any alcoholic beverage with any amount of alcohol derived from distillation processes would meet the definition of distilled spirits for tax purposes.

A copy of the proposed amendment to current Regulation 2500, *Records* is attached as Exhibit 4. See Formal Issue Paper pages 12 – 13, and Agenda Action Item 1.

Alternative 3: Make no regulatory changes and continue to tax FMB as beer

This alternative is the least difficult to administer because it follows the Department of Alcoholic Beverage Control's (ABC) current classification practices for licensing purposes and makes no changes to BOE staff's current administrative procedures. However, this alternative is not responsive to the concerns raised in the petition that prompted this rulemaking process.

See Formal Issue Paper page 13 – 14, and Agenda Action Item 1.

IV. Background

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

Interested parties meetings were held on February 22, 2007, and June 6, 2007, to identify and discuss issues relating to the classification and taxation of FMB. Approximately 100 written submissions have been received and routed to staff for review that expand upon the oral presentations at the IP meetings. Staff and an IP (namely, plaintiffs in *County of Santa Clara, et al. v. State Board of Equalization,* (San Francisco Superior Court Case No. 06-506789)) have provided draft regulatory language that, if adopted, would tax FMB as distilled spirits. However, such regulatory schemes raise significant issues regarding the confidentiality of proprietary information. Accordingly, Alternative 1 contains additional draft regulatory language to address those issues.

A consensus of opinion has not been reached between IPs regarding product classification of FMB and how FMB should be treated for purposes of taxation. These ongoing arguments predate this rulemaking process and have been previously made at both the federal and state level, and also in court actions brought against the ABC and currently pending against the BOE.

It should be noted that legislation is potentially pending related to FMB issues:

- AB 345 (Saldana). This bill, which has not yet been heard in committee, would require the Board to calculate the total amount of all surtaxes, interest, and penalties collected as a result of the reclassification of any alcoholic beverage from a beer to a distilled spirit and provide the Legislature with an annual revenue analysis of those amounts collected as a result of such a reclassification. The Board did not take a position on this bill.

- AB 346 (Beall). This bill would require the ABC to develop regulations, on or before July 1, 2008, to require that any alcoholic beverage represented by the manufacturer to be a malt beverage bear a label or sticker that includes the alcoholic content of the beverage and identify the product as an alcoholic beverage. This bill is currently before the Senate Governmental Organization Committee. The Board has not taken a position on this bill.

Previous action from the 2005 legislative session is also relevant:

- AB 417 (Aghazarian). This bill was vetoed by the Governor on October 7, 2005, and would have revised the definition of beer to include any alcoholic beverage that qualifies as a malt beverage under specified federal law. The Board did not take a position on this bill.

The Governor in his veto message to the Assembly stated:

> "I am returning AB 417 without my signature. This bill would codify current law and practice to treat flavored malt beverages as a malt beverage product consistent with federal standards of identity, which 49 of the 50 states follow.
>
> "I am taking this action to allow a full discussion of the issues surrounding flavored malt beverages, not to suggest that the States regulatory administration of flavored malt beverages is flawed. It was amended late in the session and only had one full hearing with short notice. I encourage all interested parties, particularly health professionals, law enforcement and the producers of flavored malt beverages, to use this opportunity for public debate and serious consideration of the policy issues surrounding this beverage."

The California Legislature, Senate Committee on Governmental Organization on February 14, 2006, held a public hearing titled *Flavored Malt Beverages: Are They Beer or Distilled Spirits?* The hearing took public comment and continued the discussion of issues as encouraged by the Governor in his veto message. The Board's rulemaking process continues this public discussion of the issues relating to the proper classification of FMB.

California's former Attorney General (AG) previously wrote to BOE staff indicating that a task force of state deputy attorneys general had begun to address a number of issues relating to alcohol use by youth. The letter opines that FMB, under California law, should be classified as "distilled spirits" if they contain any amount of distilled spirits or dilutions or mixtures thereof.[1] AG staff, in recent informal discussions with BOE staff has again reiterated this position. BOE staff is of the opinion that the concerns expressed by AG staff relate primarily to product classification for purposes of licensing and labeling (rather than taxation) and that reclassifying FMB as distilled spirits for purposes of taxation would not resolve most of the AG staff's concerns related to the proper classification of these products.

IV. Discussion

Classification of FMB

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

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

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

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

As a result of this change in law, ABC is assigned the responsibility for the licensing of all locations that sell alcoholic beverages in California. The ABC has advised the BOE of its present intention to continue classifying FMB as beer.[2] As ABC licensing is controlling over sales of alcoholic beverages in this state, the BOE may not impose additional licensing limitations that fall within the purview of the ABC. The BOE does not have jurisdiction to impose limits on where FMB may be sold because the ABC clearly has the exclusive power to license the manufacture, importation, and sale of alcoholic beverages in California.

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

Contrary to the assertions of IPs on both sides of the issue, it is staff's opinion that FMB do not neatly fit into either the statutory definition of "distilled spirits" or the statutory definition of "beer."[3] For example, petitioners contend that the final six words of the statutory definition of "distilled spirits" (i.e., "including all dilutions and mixtures thereof") definitively establish that FMB are "distilled spirits." (See Bus. & Prof. Code, § 23005.) Under petitioners' apparent interpretation, whenever alcohol obtained from the distillation of fermented agricultural products is mixed, for beverage use, into an alcoholic beverage, the resulting beverage is, by definition, a "distilled spirit" under California law. However, "beer" is defined by statute as "<u>any</u> alcoholic beverage obtained by fermentation of any infusion or decoction of barley, malt, hops, or any other similar product, or any combination thereof in water" (emphasis added). (See Bus. & Prof. Code, § 23006.) Accordingly, assuming that FMB retain enough alcohol from the initial fermentation process to cause them, on that basis alone, to qualify as alcoholic beverages (see Bus. & Prof. Code, § 23004), then it could also be reasonably argued that FMB fit California's statutory definition of "beer" because they are alcoholic beverages obtained by the requisite fermentation. In short, given that FMB could potentially meet the statutory definition of either "beer" or "distilled spirits," interpretive action by the Board is appropriate to resolve this apparent ambiguity. Thus, staff believes it is within the Board's authority to promulgate regulation(s) to clarify what products meet the definition of "distilled spirits" and which products meet the definition of "beer" in order to administer and enforce the Alcoholic Beverage Tax Law. (Rev. & Tax. Code, § 32451.)

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[2] A Writ of Mandate was filed against ABC to compel ABC to classify FMB as distilled spirits (Case No. A112671). ABC opposed the Writ of Mandate on two grounds: (1) a Writ of Mandate could not issue because the ABC has acted properly in treating FMB as beer; and (2) the public policy issues related to concerns about underage consumption of FMB were properly before, and should be dealt with by, the Legislature and were not issues for the court to resolve. The court summarily denied the Writ of Mandate.

[3] In a May 31, 2007, hearing on the above-referenced litigation related to this rulemaking process (*County of Santa Clara, et al. v. State Board of Equalization* (San Francisco Superior Court Case No. 06-506789)), the judge presiding indicated support for staff's opinion when he stated that "[i]t seems to me that the statutory issue is not as clear cut as petitioners would have it be . . . ." (Reporter's Transcript of Proceedings, Thursday May 31, 2007, at p. 3.)

What are FMB?

According to the federal TTB:

> "Flavored malt beverages are brewery products that differ from traditional malt beverages such as beer, ale, lager, porter, stout, or malt liquor in several respects. Flavored malt beverages exhibit little or no traditional beer or malt beverage character. Their flavor is derived primarily from added flavors rather than from malt and other materials used in fermentation. At the same time, flavored malt beverages are marketed in traditional beer-type bottles and cans and distributed to the alcohol beverage market through beer and malt beverage wholesalers, and their alcohol content is similar to other malt beverages in the 4-6% alcohol by volume range.
>
> "Although flavored malt beverages are produced at breweries, their method of production differs significantly from the production of other malt beverages and beer. In producing flavored malt beverages, brewers brew a fermented base of beer from malt and other brewing materials. Brewers then treat this base using a variety of processes in order to remove malt beverage character from the base.
>
> "For example, they remove the color, bitterness, and taste generally associated with beer, ale, porter, stout, and other malt beverages. This leaves a base product to which brewers add various flavors, which typically contain distilled spirits, to achieve the desired taste profile and alcohol level.
>
> "While the alcohol content of flavored malt beverages is similar to that of most traditional malt beverages, the alcohol in many of them is derived primarily from the distilled spirits component of the added flavors rather than from fermentation." (70 Fed. Reg. 194 et seq. (January 3, 2005).)

Recent regulations adopted by TTB recognize that many FMB contain flavors including alcohol derived from distillation. The revised federal rulings, which went into effect January 3, 2006, provide that malt beverages that contain less than 6 percent alcohol by volume may derive no more than 49 percent of their alcoholic content from flavors and other nonbeverage materials.[4] (See 27 C.F.R. §§ 7 & 25 (2005).) Staff and IPs appear to agree that the federal regulations are not controlling with respect to California's statutory definitions of "beer" and "distilled spirits."

Additionally, staff does acknowledge that Revenue and Taxation Code section 32152 provides that "the board [Board of Equalization] shall adopt such rules and regulations as may be necessary to coordinate so far as permitted by the provisions of this part [the California Alcoholic Beverage Tax Law] the system of beer and wine taxation imposed by this part with the system of beer and wine taxation imposed by the internal revenue laws of the United States." Relevant to this issue, this section relates to products that have been classified as either beer or wine. However, Alternatives 1 and 2, discussed below, would create a regulatory scheme whereby FMB would be classified as distilled spirits and taxed as such. In other words, Revenue and Taxation Code section 32152 would not apply to the taxation of FMB if the Board were to conclude, as a matter of law, that FMB are not properly classified as beer or wine for tax purposes.

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

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

VI. Alternative 1 - Tax FMB as Distilled Spirits

The Alternative 1 draft regulations would tax FMB as "distilled spirits" and traditional beer products as "beer." The 0.5 percent threshold was appropriated from two sources. First, TTB's regulatory process for purposes of establishing the necessary dividing line. During the federal rulemaking process traditional beer companies indicated that their products were generally under this threshold. The bright-line threshold also provides FMB manufacturers a clear standard in the event they desire to reformulate their products. Second, California law uses a 0.5 percent threshold to establish what beverage products contain a sufficient percentage of alcohol by volume to qualify as alcoholic beverages. (See Bus. & Prof. Code, § 23004.) Thus, Alternative 1 provides that, when a non-wine product fit for beverage purposes contains enough alcohol derived from distillation processes such that the product would qualify as an alcoholic beverage on this basis alone, it is reasonable to classify the product as a distilled spirit for taxation purposes.

A. Description of Alternative 1

The proposed regulations would: (1) define distilled spirits to include an alcoholic beverage, except wine, which contains 0.5 percent or more alcohol by volume from flavors or ingredients containing alcohol obtained from the distillation of fermented agricultural products; (2) establish a presumption that alcoholic beverages, except wine, contain 0.5 percent or more alcohol by volume from flavors or ingredients containing alcohol obtained from the distillation of fermented agricultural products; (3) allow the manufacturer the ability to rebut the presumption as to any particular alcoholic beverage by filing a statement, under penalty of perjury, that specifies the sources and amount of the alcohol content of the beverage; (4) require the BOE to establish and maintain on its Internet site a listing of alcoholic products that have been found, in the BOE's discretion, to have successfully rebutted the presumption; and (5) provide that taxpayers who rely on the information provided on this Internet list for reporting purposes will be afforded a safe harbor from potential tax liabilities.

Additionally, these regulations define the process whereby manufacturers could rebut the presumption by filing a copy of the "Statement of Process" or product "Formula" with the BOE that was filed with the TTB for any alcoholic beverage.

The complete text of staff's draft Regulation 2558, *Distilled Spirits*; Regulation 2559, *Presumption – Distilled Spirits*; Regulation 2559.1, *Rebuttable Presumption – Distilled Spirits*; Regulation 2559.3, *Internet List*; and 2559.5, *Correct Classification* is attached as Exhibit 3.

During the second interested parties meeting, the issue of why wine is not included in the draft regulations for Alternative 1 was raised. As staff stated at the meeting, the reason for this exclusion is that the definition of wine (Bus. & Prof. Code, § 23007) specifically allows for the inclusion of certain distilled products, if the added products are "distilled from the particular agricultural product or products of which the wine is made . . . ." Therefore, unlike the definition of "beer," the definition of "wine" specifically provides for certain mixtures or additions of alcohol obtained from distillation. Alternative 1's draft Regulations 2558 and 2559 have been revised to specify that only alcoholic beverages that meet the statutory definition of wine are subject to exclusion from the regulatory scheme under consideration. Additionally, Regulations 2558, 2559 and 2559.1 have been revised to clarify that the flavors or other ingredients containing alcohol must be obtained from the distillation of fermented agricultural products. (See Bus. & Prof. Code, § 23005.)

The Flavored Malt Beverage Coalition's June 20, 2007, submission argues that exempting wine with flavors from the draft regulations would violate the Commerce Clause of the federal constitution and the Equal Protection guarantees of the federal and state constitutions. With

respect to the former argument, the law currently taxes beer, wine and distilled spirits differently and there is no burden on interstate commerce which in any way gives rise to a Commerce Clause violation. Therefore, the addition of regulations to clarify existing statutory classifications of "beer" and "distilled spirits" for tax purposes under the current definitions would not now cause a violation of the Commerce Clause. (See *Complete Auto Transit, Inc. v. Brady* (1977) 430 U.S. 274). Interstate and intrastate transactions involving beer, wine and distilled spirits would all be treated the same under the draft regulations, within the parameters of each product's statutory definition. If an alcoholic beverage does not meet the definition of "wine" because, for example, the added alcohol from distillation is not from the relevant agricultural product(s), then the alcoholic beverage would be subject to the same presumption as FMB.

With respect to the Equal Protection argument, it is clear to staff that the classification distinctions would survive the required rational relationship test. (See, e.g., *Fitzgerald v. Racing Association of Iowa* (2003) 539 U.S. 103). The Legislature has differentiated between beer, wine and distilled spirits in statutory definitions and provided different tax rates for each. There are certainly rational reasons for the differing definitions and tax rates. Further clarification of the definitions for "beer" and "distilled spirits" for effective classification under existing statutes for purposes of addressing a product that arguably does not fit neatly into either category would not fail a rational relationship test. In short, staff does not believe that these arguments regarding asserted constitutional problems would create any substantive legal impediment if the BOE were to adopt the draft regulations under consideration.

Confidentiality Concerns

Serious issues have been raised that relate to the confidentiality of any proprietary information the BOE may receive as authorized by the regulation. The following details staff analysis of the issues relating to confidentiality.

Public Records Act Requests

The Public Records Act (PRA) (Gov. Code, § 6250 et seq.) requires the BOE to provide public access to any records the BOE maintains, unless the records are legally exempt from disclosure. Any person can file a PRA request. If the draft regulations for either Alternatives 1 or 2 were adopted, various administrative procedures would be required to implement the change. Staff recognizes that these procedures would raise various issues as to the confidentiality of proprietary taxpayer information that may be provided to the BOE. Staff fully appreciates the seriousness of the concerns of the interested parties with regard to these confidentiality issues.

Unlike other tax and fee programs administered by the BOE, the Alcoholic Beverage Tax Law has a less explicitly comprehensive statute prohibiting disclosure of taxpayer information. Specifically, Revenue and Taxation Code section 32455 prohibits the disclosure of certain information set forth or disclosed in any report from a winegrower only, but does not provide similar protection of any information for other taxpayers. Notwithstanding section 32455, the BOE is nonetheless prohibited from disclosing any information it obtains concerning the business affairs of a company under Government Code section 15619.

Government Code section 15619 provides, in pertinent part, that:

> "Any member or ex-member of the State Board of Equalization, or any agent employed by it, or the Controller, or ex-Controller, or any person employed by him or her, or any person who has at any time obtained such knowledge from any of the foregoing officers or person shall not divulge or make known in any manner not provided by law, any of the following items of information concerning the business affairs of companies reporting to the board:
>
> "[¶] . . . [¶]
>
> "(b) Any information, other than the assessment and the amount of taxes levied, obtained by the State Board of Equalization in accordance with law from any company other than one concerning which that information is required by law to be made public."

Pursuant to this section, in response to a PRA request or otherwise, BOE staff would not, absent a final court order, disclose any confidential information obtained pursuant to requirements of the draft regulations. While a court order may be sought to disclose such confidential records withheld from a PRA request, as discussed below, staff believes it would be highly unlikely that a court would issue such an order.

Trade secrets are protected by Evidence Code section 1060, which has been incorporated as an exception from disclosure of records in the PRA. (Gov. Code, § 6254, subd. (k)). However, before withholding documents from a PRA request on the basis of "trade secrets," the Board has the obligation to initially determine if the records are "trade secrets." The term "trade secrets" is defined in the Uniform Trade Secrets Act (Civ. Code, § 3426 et seq.).

Specifically, Civil Code section 3426.1, subdivision (d), provides that:

> "'Trade Secret' means information, including a formula, pattern, compilation, program, device, method, technique, or process, that:
>
> 1. Derives independent economic value, actual or potential, from not being generally known to the public or to other person who can obtain economic value from its disclosure or use; and
>
> 2. Is the subject of efforts that are reasonable under the circumstances to maintain its secrecy."

For example, staff strongly believes that information involving the formulas of the alcoholic beverages in question meets this definition. Therefore, in the event the BOE were to receive such information for purposes of establishing the proper tax classification of these beverages, staff would not disclose this information and would vigorously defend against any attempt to compel disclosure through litigation or otherwise. Additionally, staff would also give the taxpayer of record notice of any PRA request asking for disclosure of confidential information so that if, in an abundance of caution, the taxpayer desired to preemptively seek a court order enjoining disclosure, the taxpayer could do so. However, such a preemptive action would be considered unnecessary by staff since staff would not ever voluntarily disclose such information.

Although staff believes the BOE would prevail in the event that litigation ensued following the BOE's refusal to disclose the confidential information potentially at issue, staff would understand if any of the interested parties felt it were in their interests to pursue obtaining legislation that would address the lack of explicit comprehensiveness with respect to the confidentiality of taxpayer information under the Alcoholic Beverage Tax Law.

Board Appeals:

To ensure that confidential taxpayer information would not need to be disclosed during the course of the administrative appeals process, staff has drafted Regulation 2559.5, *Correct Classification* to protect taxpayers who are not the manufacturers of the products subject to the presumption set forth in draft Regulation 2559. Draft Regulation 2559.5 provides that a taxpayer will be deemed to have correctly classified an alcoholic beverage for purposes of reporting if at the time taxes were incurred, the alcoholic beverage was included in the BOE's list published on its Internet site pursuant to draft Regulation 2559.3. This "safe harbor" would be an absolute defense for the taxpayer and would mean that information about product formulas or manufacturing processes would not be required at a public Board Meeting.

If, however, it became necessary for the Board to review documentation in order to determine whether or not an alcoholic beverage successfully rebutted the presumption in draft Regulation 2559, something staff believes would be unlikely since the presumption sets forth an objective bright line (i.e., quantitative analysis should establish either that the 0.5 percent threshold has been exceeded or that it has not), the Board has the ability under current law and under its proposed new Rules for Tax Appeals to conduct hearings, or portions of hearings involving confidential information, in a closed session (See Gov. Code, § 11126, subd. (f)(7)(B) & (f)(8); see also Proposed Rule for Tax Appeals 5574).

B. Pros of Alternative 1

1. Provides, as directed by the Board, regulations that, if adopted by the Board, would tax FMB as "distilled spirits" and traditional beer products as "beer."

C. Cons of Alternative 1

1. This alternative is not consistent with the ABC and federal treatment of FMB.
2. The rebuttable presumption process places a significant new reporting burden on industry and a new administrative workload on staff.
3. The Board's authority to establish the bright-line threshold of 0.5 percent proposed in this alternative is disputed by IPs on both sides of the argument.
4. Industry IP suggests that product manufacturers' may choose to reformulate product at significant cost for sales to be made in California.[5]
5. This alternative, for the most part, exempts the wine industry from this review of flavored alcoholic products.
6. May create confusion as to the point of taxation (imposition of tax for beer differs from the imposition of tax on distilled spirits) for reporting purposes.

[5] Flavored Malt Beverage Coalition, June 20, 2007, IP submission, attachment 22, *Economic Impact of Proposed Rule Changes Concerning Flavored Malt Beverages for Sale in the State of California* prepared by Economic Consulting Services, LLC.

D. Statutory or Regulatory Change for Alternative 1

The intent of these draft regulations is to tax FMB as "distilled spirits" and traditional beer products as "beer." The 0.5 percent threshold was appropriated from TTB's regulatory process and the definition of "alcoholic beverage" under California law (Bus. & Prof. Code, § 23004) for purposes of establishing the necessary dividing line. During the federal rulemaking process traditional beer companies indicated that their products were generally under this threshold. The bright-line threshold also provides FMB manufacturers a clear standard in the event they desire to reformulate their products.

E. Operational Impact of Alternative 1

The adoption of these regulations would create a substantial, new administrative workload, both short-term and on-going. The areas of increased administrative workload include: educational outreach; revision of forms, publications and tax returns; the development of processes and procedures for enforcement affecting both audit and compliance staff; appeals processes to resolve disputed product classifications and tax assessments; and documenting, on an individual product basis, products that have rebutted the presumption set forth in draft Regulation 2559.

Because the ABC determines the type of licenses that a taxpayer receives, we anticipate cases where a taxpayer will not be licensed as a distilled spirits taxpayer (by ABC), but will buy and sell products the BOE has classified as distilled spirits (i.e., FMB). Therefore, BOE must provide an efficient way to track inventories and collect the taxes due on sales of FMB from those accounts registered with BOE as beer and wine taxpayers who will be expected to segregate their FMB product sales and inventories from their beer and wine activities. Existing Beer and Wine Importers and Beer Manufacturers returns will have to be modified to incorporate a subsidiary schedule for purposes of reporting sales of FMB due to the higher tax rate applied to this product. Likewise, existing Distilled Spirits Tax Return forms will be modified to add a separate column for reporting and tracking FMB.

F. Administrative Impact of Alternative 1

1. Cost Impact

Much of the workload associated with both implementation and ongoing costs of administering the proposed regulations is nonabsorbable at current staffing levels and would require the BOE to request a budget augmentation to provide funding for new positions and associated costs. Full implementation will require the modification of a number of tax returns, reports, and schedules along with related IRIS system programming costs. Although we have identified specific forms that require modification, the Technology Services Division's programming costs have not yet been developed, but could be substantial. Start-up costs associated with implementing this Alternative by July 1, 2008, including an undetermined amount for programming costs, could only be accomplished through a potentially problematic redirection of current resources, staff and funding. This alternative would (FY 2009-10) require an additional 5.5 positions and ongoing annual costs of $578,000. See Costs Estimate (Exhibit 1)

2. Revenue Impact

The total revenue gain, which includes both the excise and sales taxes, is estimated at $41.4 million annually. See Revenue Estimate (Exhibit 2)

G. Taxpayer/Customer Impact of Alternative 1

Industry is clearly in opposition to this alternative and has stated that should the new standard be adopted, FMB products as currently formulated will be subject to sharply higher state taxes, or alternatively, Industry claims FMB producers will have to spend many millions of dollars to reformulate their products for sales solely in California. Industry states that it sees two outcomes if the 0.5 percent standard is adopted; (1) either the retail price will go up by over 20 percent due to the tax and sales at retail will be reduced; or (2) FMB producers will reformulate at least some of their products to meet the new standard and continue to have their products taxed as flavored beers. According to Industry, the ultimate impact on consumers and businesses in California will be higher prices, fewer beverage choices as some products are removed from the market, and lost profits for wholesalers and retailers as retail sales are reduced.

H. Critical Time Frames of Alternative 1

This alternative, if adopted, would become effective the later of either July 1, 2008, or 30 days following approval by the Office of Administrative Law. However, prior to the effective date, staff would need to develop various administrative processes, update the BOE's Web site (including creating and maintaining the Internet list set forth in draft Regulation 2559.3), and design and provide to industry the proper forms for reporting and for rebutting the presumption set forth in draft Regulation 2559. This alternative would also increase industry's tax compliance burdens in a relatively short period of time.

VII. Alternative 2 - Tax all Alcoholic Beverages with Distilled Alcohol as Distilled Spirits

A. Description of Alternative 2

Plaintiffs in *County of Santa Clara, et al. v. State Board of Equalization* (San Francisco Superior Court Case No. 06-506789) acting as a participant to this rulemaking process provided comments and suggested regulatory language to identify alcoholic beverages that contain distilled spirits for purposes of taxation. Specifically, this alternative proposes revisions to Regulation 2500, *Records*.

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

A copy of the proposed revisions to Regulation 2500, *Records* is attached as Exhibit 4.

B. Pros of Alternative 2

1. Supports petitioners' position that FMB be taxed as distilled spirits.

C. Cons of Alternative 2

1. Includes many of the same cons to Alternative 1 regarding conformity with ABC and federal classification of alcoholic beverage products.
2. This alternative does not include a bright-line threshold level and could result in virtually all non-wine alcoholic beverages being classified for taxation as distilled spirits.
3. Could result in the BOE not receiving all the product information it needs to properly classify and tax the alcoholic beverages at issue.
4. Creates the same or greater substantial workload identified in Alternative 1.
5. May create confusion as to the point of taxation (imposition of tax for beer differs from the imposition of tax on distilled spirits) for reporting purposes.

D. Statutory or Regulatory Change for Alternative 2

No statutory change is required. However, could require the drafting of clarifying regulatory language along the lines of what is provided in Alternative 1 to properly identify the universe of products intended to be taxed as distilled spirits.

E. Operational Impact of Alternative 2

This alternative would create a substantial new workload that in staff's estimation could exceed that described in Alternative 1.

F. Administrative Impact of Alternative 2

1. Cost Impact

Equal to or greater than that described in Alternative 1 ($578,000). See Cost Estimate (Exhibit 1).

2. Revenue Impact

The total revenue gain, which includes both the excise and sales taxes, would be at least $41.4 million plus an unknown amount. See Revenue Estimate (Exhibit 2).

G. Taxpayer/Customer Impact of Alternative 2

Industry, as stated in interested parties submissions is opposed to the adoption of this alternative.

H. Critical Time Frames of Alternative 2

Same as Alternative 1 but potentially would require additional time to prepare clarifying regulatory language.

VIII. Alternative 3 – No Change and Continue to Tax FMB as Beer

A. Description of Alternative 3

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

B. Pros of Alternative 3

1. This alternative is the least difficult to administer because it follows ABC's current classification.
2. No additional burden or costs are placed upon industry in meeting reporting requirements or in potential reformulation of products.
3. Issues relating to confidentiality of proprietary information are eliminated in this alternative.

C. Cons of Alternative 3

1. Does not tax FMB as distilled spirits as requested by petitioners.

D. Statutory or Regulatory Change for Alternative 3

None.

E. Operational Impact of Alternative 3

None.

F. Administrative Impact of Alternative 3

1. Cost Impact

None.

2. Revenue Impact

There would be no reclassification of any alcoholic beverage product and consequently no resulting change in tax revenue. See Revenue Estimate (Exhibit 2).

G. Taxpayer/Customer Impact of Alternative 3

None.

H. Critical Time Frames of Alternative 3

None.

Preparer/Reviewer Information

Prepared by: Excise Taxes Division, Property and Special Taxes Department

Current as of: August 3, 2007

FY 2008-09 COSTING
Flavored Malt Beverage Issue Paper (07-007)
Property and Special Taxes Department - Excise Taxes Division

	Positions	First Yr: Cost _a/	Second Yr Cost _a/	Third Yr Cost (on-going)
Personal Services: _b/				
Permanent - Full Time:				
Associate Tax Auditor (BOE)	1.5		49,642	93,078
Business Taxes Specialist I	1.0	35,790	71,580	71,580
Office Assistant (Typing)	1.0		26,976	26,976
Tax Counsel III (Specialist)	1.0		101,628	101,628
Tax Technician III (BOE)	1.0		37,752	37,752
Subtotal	5.5	$35,790	$287,578	$331,014
Overtime:				
Sub-total		35,790	287,578	331,014
Less: Salary Savings (5%)	-0.3	-2,000	-14,000	-17,000
Plus: Staff Benefits		13,000	101,000	116,000
Total Personal Services	5.2	$47,000	$375,000	$430,000
Operating Expense & Equipment (OE & E):				
General Expense:				
Supplies			1,800	10,800
Minor Equipment/Office Furnishings		$1,800	$9,000	
Standard Desktop PC		$1,300	$3,900	
Laptop PC w/Docking Station			$3,800	
Laser Printer			$1,500	
General Services Charges			$200	
Total General Expenses		3,000	20,000	11,000
Communications		1,000	5,000	3,000
Travel			30,000	60,000
Training		1,000	4,000	4,000
Facilities Operations		1,000	33,000	17,000
Data Processing		1,000	3,000	
Total OE & E		7,000	95,000	95,000
TOTAL DIRECT COST		**$54,000**	**$470,000**	**$525,000**
Distributed Administration		5,000	47,000	53,000
GRAND TOTAL COST (Rounded to the Thousands)		**$59,000 _c/**	**$517,000 _c/**	**$578,000**

_a/ Estimate is based on standard costs used for the 2008-09 BCP cycle. **Costs are rounded to the hundreds.**
_b/ The salary is the mid-step of the salary range for the stated classifications.
_c/ Requires budget change approval of Department of Finance.

BOARD OF EQUALIZATION
REVENUE ESTIMATE
ISSUE 07-007

Flavored Malt Beverages

Issue

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

Alternative 1 – Tax FMB as Distilled Spirits

Language was prepared by staff to meet the Board's directive to prepare draft regulations that, if adopted, would result in FMB being taxed as distilled spirits. In response to concerns expressed by interested parties (IP) and staff at the second IP meeting, two additional draft regulations have been prepared that supplement the three draft regulations previously discussed in the second discussion paper. These two additional draft regulations pertain to an Internet listing of alcoholic products that a taxpayer could refer to and rely on for purposes of tax reporting. These draft regulations, if adopted, would create a mechanism for classifying alcoholic beverages such that FMB would be taxed as distilled spirits and traditional beer products would be taxed as beer. The draft regulations can be summarized as follows:

(1) Alcoholic Beverage Tax Law, Regulation 2558. *Distilled Spirits.* Would define distilled spirits to include an alcoholic beverage, except wine, which contains 0.5 percent or more alcohol by volume from flavors or ingredients containing alcohol obtained from distillation.

(2) Alcoholic Beverage Tax Law, Regulation 2559. *Presumption – Distilled Spirits.* Would establish a presumption that alcoholic beverages, except wine, contain 0.5 percent or more alcohol by volume from flavors or ingredients containing alcohol obtained from distillation.

(3) Alcoholic Beverage Tax Law, Regulation 2559.1. *Rebuttable Presumption – Distilled Spirits.* Would allow the manufacturer the ability to rebut the presumption set forth in Regulation 2559 as to any particular alcoholic beverage by filing a statement, under penalty of perjury, that specifies the sources and amount of the alcohol content of the beverage. Additionally, these regulations define the process whereby manufacturers could rebut the presumption by filing of the "Statement of Process" or product "Formula" with the BOE that was filed with the federal Alcohol and Tobacco Tax Trade Bureau for any alcoholic beverage.

(4) Alcoholic Beverage Tax Law, Regulation 2559.3. *Internet List.* Would establish and provide a time frame for staff to create and maintain an Internet listing of alcoholic beverages that have been found to have successfully rebutted the presumption set forth in Regulation 2559.

(5) Alcoholic Beverage Tax Law, Regulation 2559.5. *Correct Classification.* Would provide that a taxpayer may rely on the Internet listing set forth in Regulation 2559.3 for purposes of tax reporting with respect to alcoholic beverage products shown on the Board's list at the time the tax liability was incurred.

Again, staff prepared this alternative for the Board's consideration pursuant to the Board's direction. However, staff notes that consensus has not been reached amongst IPs who remain clearly split in their support and opposition to this alternative.

Alternative 2 – Tax all alcoholic beverages containing distilled alcohol as distilled spirits

Plaintiffs in *County of Santa Clara, et al. v. State Board of Equalization* (San Francisco Superior Court Case No. 06-506789), acting as a participant to this rulemaking process provided comments and suggested alternative regulatory language to identify alcoholic beverages that contain distilled spirits for purposes of taxation. Specifically, this alternative proposes revisions to current Regulation 2500, *Records.*

The proposed regulatory language, as written, appears to assume that any alcoholic beverage with any amount of alcohol derived from distillation processes would meet the definition of distilled spirits for tax purposes.

Alternative 3: Make no regulatory changes and continue to tax FMB as beer

This alternative is the least difficult to administer because it follows ABC's current classification practices for licensing purposes and makes no changes to BOE staff's current administrative procedures. However, this alternative is not responsive to the concerns raised in the petition that prompted this rulemaking process.

Background, Methodology, and Assumptions

Alternative #1

According to a report prepared by Economic Consulting Services (ECS) for the FMB Coalition, *Economic Impact of Proposed Rule Changes Concerning Flavored Malt Beverages for Sale in the State of California,* the FMB portion of California beer market by volume was 2.4 percent in 2004 and 2.1 percent in 2006.

In 2006, taxable gallons of beer in California were 654 million gallons. Growth in taxable beer gallons averaged 1.0 percent over five years, from 2002 to 2006. Beer consumption for 2008 is estimated to be 667 million gallons. Assuming FMB is 2.1 percent of the California beer market, we project 2008 California consumption of FMB will be 14.0 million gallons if the beverages continue to be taxed as a beer product.

The current tax rate on FMB is $0.20 per gallon. Assuming all taxes are passed on to consumers, the tax on a 12-ounce container of FMB is $0.02. If FMB were to be taxed as distilled spirits, the tax rate would increase to $3.30 per gallon, a tax of $0.31 on 12 ounces.

Thus, the reclassification of FMB from beer to distilled spirits would result in a tax increase of $0.29 per-12 ounce container.

Based on information from an article published in *Beverage Industry*, we calculated that the average retail price of FMB sold off-premise was $1.21 per 12 ounce container. Our audit staff indicated that beer prices in a bar would run between $4 and $5 per 12 ounce container. Not having data to the contrary, we will assume that average on-premise FMB prices are similar to on-premise beer prices, $4.50 per 12 ounce container. Therefore, changing the tax on FMB would result in retail prices increasing by 6.1 percent for on-premise sales and by 24.0 percent for off-premise sales.

Establishments that make sales for off-premise consumption sell the most FMB by far. Using estimated container prices for beer, beverage industry 2006 sales figures, Economic Census 2002 sales figures, and the percentage of beer sales calculated from the 2002 Economic Census data, we estimated the on-premise and off-premise percent of beer consumption in 2006. In 2006, an estimated 16.8 percent of beer was consumed on-premise and 83.2 percent was consumed off-premise.

Price elasticity (PE) describes the percent change in quantity demanded for a product per one percent change in price. Studies using survey data since the 1970's have shown that young drinkers are more sensitive to price changes than older drinkers. Also, studies that take into account the addictive quality of alcohol indicate that price sensitivity is greater in the long term and that heavy drinkers are more sensitive to price changes.

For this revenue estimate, we calculated average PE from those published in various studies. Since we could find no data specific to FMB, we assume that PE for beer and beer/alcohol demand represent PE for FMB demand. The (PE) for the various groups are shown below.

	PE	Cross PE	Diversion Ratio
Ages 21+	-0.48	0.68	65.85
Ages 19 - 20	-0.88	0.68	35.92
Ages 12 - 18	-0.58	0.68	54.50

A cross price elasticity (cross PE) describes the extent to which demand for a good is affected by price changes in another. If a good is a substitute (such as one type of potato chip for another or one type of beer for another), the cross PE is positive. Few studies have published cross PE's for beer, and none have published cross PE's for FMB. One study in the UK published cross PE's for beer, cider, spirits, and wine. We assumed that beer substitutes for cider in the UK would be similar to beer substitutes for FMB in California and used a cross PE from cider to beer to calculate diversion ratios of FMB to beer.

A diversion ratio explains how much of the displaced demand for the product on which the price was increased switched to the substitute product.

The estimated percent decline in FMB consumption is the product of the percent increase in retail price and the PE. If FMB were taxed as distilled spirits, retail prices would increase by 6.1 percent for on-premise sales and by 24.0 percent for off-premise sales. Multiplying the percent increases in price by the PE for the various groups gives the predicted percent decline

in FMB consumption. Estimated on-premise and off-premise consumption declines are shown below. Total decline in FMB sales is estimated to be 11.2 percent or 1.6 million gallons.

Estimated decline in FMB consumption			
	Total Gallons	Percent Decline	Decline in Gallons
Ages 21+ off-premise	8,880,000	11.5	1,021,000
Ages 21+ on-premise	2,353,000	2.9	68,000
Ages 19 - 20	1,222,000	21.1	258,000
Ages 12 - 18	1,560,000	13.9	217,000
Total	14,015,000	11.2	1,564,000

For a portion of this decline in FMB consumption, consumers are likely to substitute beer. To estimate replacement by beer, we multiplied the predicted declines in FMB by the diversion ratios for each of the various groups. We estimate that 0.9 million gallons of beer would be consumed in place of the forgone FMB consumption. Thus, 0.7 million gallons of FMB would not be replaced by beer.

Estimated replacement beer			
	FMB Gallons	Percent Replaced	Gallons
Ages 21+ off-premise	1,021,000	65.8	672,000
Ages 21+ on-premise	68,000	66.2	45,000
Ages 19 - 20	258,000	36.0	93,000
Ages 12 - 18	217,000	54.4	118,000
Total	1,564,000	59.3	928,000

The excise tax revenue on the estimated 14.0 million gallons of FMB now taxed as a beer product at $0.20 per gallon amounts to $2.8 million.

If FMB were considered to be distilled spirits rather than beer products for purposes of taxation, the number of gallons of FMB that would be subject to the distilled spirits tax rate of $3.30 per gallon is estimated to be 12.4 million gallons (14 million gallons – 1.6 million gallons = 12.4 million gallons). The excise tax revenue on these gallons would be $40.9 million. The amount of beer that would be substituted for FMB is estimated to be 0.9 million gallons. The excise tax revenue on these gallons at $0.20 per gallon would be $0.2 million. The total excise tax revenues would be $41.1 million.

The increase in excise tax revenue therefore, would amount to $38.3 million ($41.1 million - $2.8 million).

Alternative #2

Alternative 2 appears to assume that any alcoholic beverage with any amount of alcohol derived from distillation processes would meet the definition of distilled spirits for tax purposes. This could result in beer products other than FMB being taxed as distilled spirits. We do not know what products might be subject to this classification. Any beer products that would be taxed as distilled spirits would result in an increase in excise tax revenues above the $38.8 million estimated above.

Alternative #3

This alternative would maintain the status quo. All alcohol products would continue to be taxed under their current classifications. Thus, FMB would continue to be taxed as beer.

Revenue Summary

Alternative #1

The estimated increase in excise tax revenues and in sales and use tax revenues that would occur from considering FMB to be distilled spirits for taxation purposes is as follows:

	Revenue Increase
Alcoholic beverage tax increase	$38.3 million
State sales and use tax (at 5.25%)	2.0 million
Total State	40.3 million
Local sales and use tax (at 2.00%)	0.8 million
District tax (at 0.69%)	0.3 million
Total Local	1.1 million
TOTAL	41.4 million

Alternative #2

The revenue increase would be at least the $41.4 million shown above.

Alternative #3

There would be no reclassification of any alcoholic beverage product and consequently no resulting change in tax revenue.

Qualifying Remarks

The estimate above assumes that the Department of Alcoholic Beverage Control (ABC) will not reclassify FMB to distilled spirits. However, should the ABC reclassify FMB, it would limit the number of establishments that could sell these beverages. We estimate that 1.6 million gallons

of FMB is sold in establishments that could no longer sell FMB if they were reclassified by ABC as distilled spirits. Assuming none of these stores will carry FMB, and applying the diversion ratios to determine replacement beer purchases, we estimate that total consumption of FMB would decline by 3.0 million gallons and beer replacement purchases would be 1.8 million gallons. The excise tax revenue increase is estimated at $33.9 million and sales and use tax revenues would increase by 2.7 million for a total revenue increase of $36.6 million.

While the Alternative #1 tax increase seems large, it should be noted that for every gallon of distilled spirits, there are many more drinks than there are for every gallon of FMB. At 1.5 ounces per serving, a gallon of distilled spirits will result in 85.3 servings. At 12 ounces per serving, a gallon of FMB contains just 10.7 servings.

If flavored malt beverages were considered to be distilled spirits rather than beer products, the manufacturers of those products might decide to reformulate their products. Or they might continue to produce the current products in a smaller quantity and develop new products that would meet the definition of beer products. There is no way for us to predict the industry's response. However, any such change will result in a decrease in excise tax revenues.

Preparation

This revenue estimate was prepared by Beth L. Lindley, Research and Statistics Section. This revenue estimate was reviewed by Mr. David E. Hayes, Manager, Research and Statistics Section, and Ms. Lynn Bartolo, Chief, Excise Taxes Division. For additional information, please contact Beth Lindley at (916) 445-0840.

Current as of July 25, 2007

Regulation 2558. DISTILLED SPIRITS.

Effective July 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.

Authority: Section 32451, Revenue and Taxation Code.
Reference: Section 32002, Revenue and Taxation Code; Sections 23004, 23005, 23006, 23007, Business and Professions Code.

Regulation 2559. PRESUMPTION - DISTILLED SPIRITS.

Effective July 1, 2008, unless the contrary is established, any alcoholic beverage, except wine 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 agricultural products.

Authority: Section 32451, Revenue and Taxation Code.
Reference: Section 32002, Revenue and Taxation Code; Sections 23004, 23005, 23006, 23007, Business and Professions Code.

Regulation 2559.1. REBUTTABLE PRESUMPTION - DISTILLED SPIRITS.

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

Authority: Section 32451, Revenue and Taxation Code.
Reference: Sections 32002, 32452, 32453 Revenue and Taxation Code; Sections 23004, 23005, 23007, Business and Professions Code.

Regulation 2559.3. INTERNET LIST.

Not later than July 1, 2008, and updated on a quarterly basis thereafter, the Board shall develop, publish and maintain on its Internet site a listing of all alcoholic beverages that have been found, in the Board's discretion, to have successfully rebutted the presumption set forth in Regulation 2559.

Authority: Section 32451, Revenue and Taxation Code.
Reference: Section 32002, Revenue and Taxation Code; Sections 23004, 23005, 23006, 23007, Business and Professions Code.

Regulation 2559.5. CORRECT CLASSIFICATION.

A taxpayer will be deemed to have correctly classified an alcoholic beverage for purposes of tax reporting if at the time taxes were incurred, the alcoholic beverage was included on the Board's list pursuant to Regulation 2559.3.

Authority: Section 32451, Revenue and Taxation Code.
Reference: Section 32002, Revenue and Taxation Code; Sections 23004, 23005, 23006, 23007, Business and Professions Code.

Regulation 2500. RECORDS.

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

Authority: Section 32451, Revenue and Taxation Code.
Reference: Sections 32452 and 32453, Revenue and Taxation Code.

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