

EXECUTIVE BRIEF

STATE BOARD OF EQUALIZATION

Fiscal Year 2009-10

Flavored Malt Beverages

Background

On April 8, 2008, the Board adopted regulations to clarify for the purposes of taxation when an alcoholic beverage meets the definition a "distilled spirit" under the Alcoholic Beverage Tax Law. The Alcoholic Beverage Tax Law Regulations: 2558. *Distilled Spirits*, 2559. *Presumption - Distilled Spirits*, 2559.1. *Rebuttable Presumption - Distilled Spirits*, 2559.3. *Internet List* and 2559.5. *Correct Classification* (hereafter, collectively, Regulations) were subsequently approved by the Office of Administrative Law on June 10, 2008, with the Regulations effective, in part on July 10, 2008, and fully operative on October 1, 2008. The Regulations result in a new BOE workload.

Request

This proposal requests \$768,000 (General Fund) in Fiscal Year (FY) 2008-09, \$1,171,000 (General Fund) in FY 2009-10, and \$745,000 (General Fund) in FY 2010-11 and ongoing to establish 5.5 permanent positions and related resources to address the new workload associated with the new Regulations.

In addition to the 5.5 permanent positions, the Board of Equalization's (BOE) Legal Department requests \$600,000 in consultant services to procure independent expert consultants in several areas. For FY 2008-09, \$250,000 is anticipated for specialized services of independent consultants such as chemists and alcohol beverage industry experts to assist with the implementation of the regulations. For FY 2009-10, \$350,000 is anticipated for experts to provide continuous technical support in the area of chemistry and knowledge of the beverage industry in order to assist with any issues regarding classification issues including, but not limited to, the precise sources and distillation of the alcohol actually contained in the beverages at the time of retail sale.

Current need

The regulations create a substantial new workload that cannot be met through a redirection of existing resources by establishing a rebuttable presumption that all alcoholic beverages, other than wine, are distilled spirits. For the period July 1, 2008, through December 31, 2008, the implementation workload is being met through a redirection of staff and overtime hours. Post implementation ongoing workload cannot be met through a continued reallocation of resources. The rebuttable presumption requires manufacturers (including, but not limited to, beer manufacturers, micro breweries, and brew pubs) to file, with the BOE, by October 1, 2008, a report for each of their alcoholic beverage products certifying that the products do not meet the clarified definition of distilled spirits, i.e., rebut the regulatory presumption. The BOE is required initially, and on an ongoing basis, to review the certifications and post on its website a listing of products that have successfully rebutted the distilled spirits presumption. To date, staff has identified approximately 6,500 unique beer products that would have to rebut the regulatory presumption in order to not be considered "Distilled sprits" for tax purposes. Those products that rebut the presumption must then be posted on the BOE's website, as required by the Regulations. Monthly tax returns will be mailed and processed beginning in October and staffs are already fielding many questions on this. New return filings also creates new follow up workloads of return delinquency, billings and refunds that will have to be addressed beginning in December or put off until staff is available to process. At the same time staff will continue its educational outreach efforts targeted to the alcoholic beverage industry in preparing notices.

EXECUTIVE BRIEF

Workload to be addressed

The current staffing resources for the alcoholic beverage tax program are fully utilized and this significant new workload cannot be absorbed with existing resources without jeopardizing revenues that these resources produce. The Excise Taxes Division (ETD) has determined that any redirection of program audit staff would come at a cost of \$350 per hour in lost or delayed audit revenue. In addition, given the substantiality of the taxes payable under the new Regulations, the BOE staff anticipates many appeals and numerous lawsuits. The Litigation Division will be responsible for defending the BOE in lawsuits brought by the Flavored Malt Beverage industry both in complaints seeking to overturn the new Regulations and in lawsuits brought by individual companies seeking tax refunds of amounts paid to the BOE under such new Regulations. The Appeals Division will be responsible for holding individual conferences and issuing Decisions and Recommendations on each such appeal. Therefore, the Legal Department anticipates that the new Regulations will generate a substantial volume of new legal work.

**STATE BOARD OF EQUALIZATION
FISCAL YEAR 2009-10
PROPOSAL No. XX**

TITLE OF PROPOSED CHANGE:

Flavored Malt Beverages

SUMMARY OF PROPOSED CHANGES:

This proposal requests \$768,000 (General Fund) in Fiscal Year (FY) 2008-09, \$1,171,000 (General Fund) in FY 2009-10, and \$745,000 (General Fund) in FY 2010-11 and ongoing to establish 5.5 permanent positions and related resources to address the new workload associated with the new Regulations adopted on April 8, 2008. The new Regulations were adopted to clarify for the purposes of taxation when an alcoholic beverage meets the definition a "distilled spirit" under the Alcoholic Beverage Tax Law. The Alcoholic Beverage Tax Law Regulations: 2558. *Distilled Spirits*, 2559. *Presumption - Distilled Spirits*, 2559.1. *Rebuttable Presumption - Distilled Spirits*, 2559.3. *Internet List* and 2559.5. *Correct Classification* (hereafter, collectively, Regulations) were subsequently approved by the Office of Administrative Law (OAL) on June 10, 2008, with the Regulations effective, in part on July 10, 2008, and fully operative on October 1, 2008. The Regulations result in a new BOE workload.

Revenue is estimated, in the absence of any reformulation of products by manufacturers, at \$28.7 million in FY 2008-09, and \$38.3 million in FY 2009-10 and ongoing. The estimated benefit-to-cost ratio of this proposal is 37.4 to 1 in FY 2008-09, 32.7 to 1 in FY 2009-10, and 51.4 to 1 in FY 2010-11 and ongoing. The Excise Taxes Division is currently reviewing and processing Rebuttable Presumption forms being submitted by beer manufacturers and importers that include product certifications which indicate that revenue will be less than that originally estimated. Regulations 2558 and 2559 are effective October 1, 2008. Distilled Spirits Tax returns are due on or before November 15, 2008. Based on this timeline, BOE does not anticipate having a clear picture of estimated revenue until early December 2008.

STATE BOARD OF EQUALIZATION

Fiscal Year 2009-10

Flavored Malt Beverages¹

A. Nature of Request

On April 8, 2008, the Board adopted regulations to clarify for the purposes of taxation when an alcoholic beverage meets the definition of a “distilled spirit” under the Alcoholic Beverage Tax Law. The Alcoholic Beverage Tax Law Regulations: 2558. *Distilled Spirits*, 2559. *Presumption - Distilled Spirits*, 2559.1. *Rebuttable Presumption - Distilled Spirits*, 2559.3. *Internet List* and 2559.5. *Correct Classification* (hereafter, collectively, Regulations) were subsequently approved by the Office of Administrative Law (OAL) on June 10, 2008, with the Regulations effective, in part on July 10, 2008, and fully operative on October 1, 2008. The Regulations result in a new Board of Equalization (BOE) workload.

This proposal requests \$768,000 (General Fund) in Fiscal Year (FY) 2008-09, \$1,171,000 (General Fund) in FY 2009-10, and \$745,000 (General Fund) in FY 2010-11 and ongoing to establish 5.5 permanent positions and related resources to address the new workload associated with the new Regulations.

Revenue is estimated, in the absence of any reformulation of products by manufacturers, at \$28.7 million in FY 2008-09, and \$38.3 million in FY 2009-10 and ongoing (see Exhibit II for details). The estimated benefit-to-cost ratio of this proposal is 37.4 to 1 in FY 2008-09, 32.7 to 1 in FY 2009-10, and 51.4 to 1 in FY 2010-11 and ongoing. The Excise Taxes Division is currently reviewing and processing Rebuttable Presumption forms being submitted by beer manufacturers and importers that include product certifications which indicate that revenue will be less than that originally estimated. Regulations 2558 and 2559 are effective October 1, 2008. Distilled Spirits Tax returns are due on or before November 15, 2008. Based on this timeline, BOE does not anticipate having a clear picture of estimated revenue until early December 2008.

B. Background/History

The Board was petitioned by community groups to revise the Alcoholic Beverage Tax Regulations related to distilled spirits. In a letter dated October 25, 2006, Friday Night Live, 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 (FMB) as distilled spirits and/or amend Regulation 2530. The Board is authorized to promulgate regulations relating to the administration and enforcement of the Alcoholic Beverage Tax Law pursuant to Revenue and Taxation Code section 32451 for taxation purposes.

¹ The term Flavored Malt Beverage (FMB) is limited to an alcoholic beverage that is (1) produced from an initial fermented malt (or barley, hops, or other similar product) beverage base that is (2) treated to remove the basic malt beverage characteristics (e.g., color, bitterness, taste, etc.) and which (3) certain flavorings or other ingredients containing distilled alcohol are added that (4) result in at least 0.5 percent of the beverage's alcohol by volume being attributable to alcohol obtained from the distillation of fermented agricultural products.

In response to the petition, the rulemaking process was initiated by the Board, and resulted in the adoption of the Regulations which clarify the definition of distilled spirits, creates a rebuttal presumption that non-wine alcoholic beverages, like FMB, are distilled spirits, not beer, if the alcoholic beverage 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.

Further, the Regulations provide a procedure for rebutting the presumption. As required by the Administrative Procedures Act, the Regulations were transmitted to the OAL and approved on June 10, 2008, with the Regulations effective, in part on July 10, 2008, and fully operative on October 1, 2008.

The Regulations create a substantial new workload that cannot be met through a redirection of existing resources by establishing a rebuttable presumption that all alcoholic beverages, other than wine, are distilled spirits. The rebuttable presumption requires manufacturers (including, but not limited to, beer manufacturers, micro breweries, and brew pubs) to file, with the BOE, by October 1, 2008, a report for each of their alcoholic beverage products certifying that the products do not meet the clarified definition of distilled spirits, i.e., rebut the regulatory presumption. The BOE is required initially, and on an ongoing basis, to review the certifications and post on its website a listing of products that have successfully rebutted the distilled spirits presumption. To date, staff has identified approximately 6,500 unique beer products that would have to rebut the regulatory presumption in order to not be considered “distilled spirits” for tax purposes. Those products that rebut the presumption must then be posted on the BOE’s website, as required by the Regulations.

Program resources have been fully utilized by the BOE and cannot be reallocated to these new duties. For the period July 1, 2008, through December 31, 2008, the implementation workload is being met through a redirection of staff and overtime hours. Post implementation ongoing workload cannot be met through a continued reallocation of resources. Additionally, the Excise Taxes Division (ETD) has determined that any redirection of program audit staff would come at a cost of \$350 per hour in lost or delayed audit revenue.

C. State Level Considerations

This proposal supports the BOE’s *FY 2007-2011 Strategic Plan, Strategic Focus, Purpose and Vision* by:

- Adopting regulations to clarify the laws it administers and to respond quickly and effectively to new tax and fee programs and changes in existing programs.

This BCP is supported by projected revenues that finance the costs; therefore, this proposal meets the Administration’s Budget Policy Letter instructions.

D. Justification and Analysis of All Feasible Alternatives

Each of the alternatives establishes compliance, audit, legal and related support resources necessary for the BOE to implement the Regulations. The positions and related resources requested are critical to meet this important regulatory change that clarifies for purposes of taxation when an alcoholic beverage meets the definition of a “distilled spirit.” Without the

requested resources, the BOE cannot address the necessary audit, compliance and administrative functions required to implement the Regulations.

Alternative 1 – Approve budget augmentation of \$768,000 in FY 2008-09, \$1,171,000 in FY 2009-10, \$745,000 in FY 2010-11 and ongoing for 5.5 positions and related resources on a permanent basis.

The BOE requests permanent funding and authority to establish 5.5 positions (3.5 ETD Audit, 1.0 ETD Compliance, and 1.0 Legal Department) and related resources beginning January 1, 2009, in order to meet the mandate of the Regulations adopted by the Board and approved by OAL. The following staff and resources are requested:

EXCISE TAXES DIVISION (ETD)

ETD Audit Section

ETD Audit Section is requesting 3.5 new positions plus associated resources to perform tax audit activities and ensure proper oversight of the Alcoholic Beverage Tax program's new Regulations (Reg. 2558 – 2559.5). As a result of the new Regulations, a new tax return is planned, with a corresponding new audit workload. In addition, the new Regulations impose significant new workloads on the ETD Audit Section. The BOE presently has 1,460 registered non distilled spirits alcoholic beverage taxpayers that may be required to file distilled spirits tax returns. Further, 650 distilled spirits taxpayers and 17 common carrier accounts, will be required to complete new tax returns and supporting schedules which will require the reporting of additional information as a result of the new Regulations. These new accounts and the increased complexity of workload on existing accounts will require additional audit oversight to insure compliance with the new Regulations. This will include field audits, desk audits, account screenings, refund processing, appeals and petitions, educational outreach, and related tasks. Further, the audit section will be required to create and maintain a detailed Internet listing of alcoholic beverage products, described below in further detail.

The 5.0 existing ETD audit staff cannot absorb the additional ongoing workload imposed by these new Regulations. As mentioned above, the Regulations create a substantial new workload that cannot be met through a redirection of existing resources by establishing a rebuttable presumption that all alcoholic beverages, except those that meet the statutory definition of wine, are distilled spirits. The rebuttable presumption allows manufacturers to file a report certifying that an alcoholic beverage does not meet the regulatory presumption. The current staffing resources for the alcoholic beverage tax program are fully utilized and this significant new workload cannot be absorbed with existing resources without jeopardizing revenues that these resources produce.

Business Taxes Specialist I (BTS I)

The establishment of 1.0 permanent BTS I position, effective January 1, 2009 is required to oversee the audit program. The BTS I will be responsible for processing the rebuttable presumption reports required by the new Regulations. Most importantly, new Regulation 2559.3 requires that no later than October 1, 2008, the Board 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. The BOE anticipates a large volume of reports will be processed on the majority of products presently classified as beer. There are presently 216 beer manufacturer accounts within California, and 318 out-of-

state beer manufacturers licensed to import their products into California. Further, each of these manufacturers may produce multiple products, with many variations in their ingredients and packaging. To date, ETD has identified 6,500 products that are impacted by the new Regulations.

The BTS I will have full responsibility for overseeing and implementing the requirements of the Regulations. It is anticipated that the first year of workload will consist primarily of taxpayer outreach, processing certifications and other tasks related to program startup. Much of this startup effort will be devoted to creating and maintaining the Internet listing required by Regulation 2559.3, a task that could include the review of thousands of alcoholic beverage products. While no field audits of the new accounts are planned for the first year, there will be additional audit workload required for existing beer and wine importer accounts and beer manufacturer accounts, to insure that the new Regulations have been properly implemented. The BTS I will act as the lead in coordinating this effort and will perform the most complex audits and will process appeals, petitions, and refunds as a result of the certification process. Exhibit I provides detail workload activity associated with the BTS I position.

Office Assistant OA (Typing)

The establishment of 1.0 permanent OA (Typing) position, effective January 1, 2009 is required to assist in the administration of the new Regulations. The OA (Typing) will prepare correspondence, create, sort and maintain files, and perform other related duties as necessary to comply with the new Regulations. This will include documentation submitted by 229 beer manufacturer accounts within California, and 336 out-of-state beer manufacturers licensed to import their products into California. This is all new workload that does not presently exist. Exhibit I provides detail workload activity associated with this position.

Associate Tax Auditor (ATA)

The establishment of 1.5 ATA positions, effective July 1, 2009, is requested to handle new workload associated with the new Regulations. The ATAs will screen returns and schedules submitted, process refunds, and conduct investigations and field audits relating to the Regulations. This will be new workload that does not presently exist. Any accounts reclassified to distilled spirits per the Regulations will involve the audit of inventories tracked through the distribution chain. Such audits will have a relatively high level of difficulty and require the experience level of ATAs. The ATAs will also devote a portion of their time to auditing distilled spirits tax returns which will also become more complex as a result of additional reporting requirements resulting from the new Regulations. The ATAs will assist the BTS I lead, as required, in maintaining the Internet listing of all alcoholic beverages that have successfully rebutted the presumption set forth in Regulation 2559. Exhibit I provides detail workload activity associated with this position.

Based on historical audit recovery data for the Alcoholic Beverage Tax program, ETD estimates an audit recovery rate of \$350 per audit hour. ETD estimates the requested audit resources will perform 2,880 hours of alcoholic beverage tax audit activity annually. The 2,880 hours are comprised of 2,280 field audit hours and 600 desk audit (BOE Headquarters) hours. 2,880 audit hours at \$350/hour extend to an estimated annual audit recovery amount of \$1,008,000 under this alternative.

ETD Compliance Section

Tax Technician (TT) III

The establishment of 1.0 permanent TT III position, effective January 1, 2009, is requested to handle workloads in tax return processing, refunds, billings, product classification question preliminary review, adjusting incorrect payments, clearing delinquencies, accounts receivable collection cases and reviewing and processing the Alcoholic Beverage Control (ABC) license suspension list. It is anticipated that the new Regulations will lead to a greater number of return reporting errors and refund workload on an ongoing basis. Exhibit I provides detail workload activity associated with this position.

LEGAL DEPARTMENT

Appeals Division

The Appeals Division (AD) serves as legal counsel to the elected Board with respect to administrative appeals coming to the Board. The AD provides the Board Members a written summary of the appeal if a hearing is requested or a written decision for review and approval by the Board Members if no hearing is requested.

Litigation Division

The Litigation Division (LD) furnishes legal services to the elected Board, the Executive Director, and the staff of the BOE with respect to the BOE's actions. Through its Tax Litigation Section, the LD advises and represents the BOE in tax and fee litigation. The LD also represents the BOE in administrative proceedings involving employment, labor, and civil rights laws. The LD additionally represents the BOE in tax-related bankruptcy, collection, and special collection procedure matters. Finally, the LD also represents the Board on government tort actions

In tax refund and related litigation, while Department of Justice (DOJ) litigators typically act as lead counsel, LD tax litigators are charged with defining, interpreting, applying, and advancing the Board's substantive tax positions and ensuring that such positions are fully, effectively, and persuasively communicated in court. LD tax litigators also locate, marshal, and organize the factual evidence and documentation relevant to the Board's defense that may be presented in court. These same LD litigators handle all discovery requests in these lawsuits and plan and organize the BOE's discovery plan vis-a-vis the plaintiffs. LD tax litigators additionally locate and prepare expert witnesses, which include economists, inside and outside accountants, appraisers and various regulatory experts, for trial.

Tax Counsel IV (TC IV)

The establishment of 1.0 Tax Counsel IV (TC IV) position and associated resources effective January 1, 2009 is requested to perform work in the Appeals and Litigation Divisions of the Legal Department. The TC IV is required due to the need for an experienced attorney with substantial litigation expertise to handle the most difficult cases; and act as lead in advising and supervising other attorneys with respect to such litigation. Such litigation will require a high level of legal and litigation expertise, due to one, the high tax rate differential resulting from this regulation and, two, the aggressively litigious nature of the liquor industry. Due to these factors, the Legal Department expects that numerous lawsuits will be filed by major law firms challenging both the validity of the Regulations and

their appropriate interpretation and application. This has been evidenced by the initial lawsuit filed challenging the Regulations, which was aggressively litigated by a very large national law firm. In these types of lawsuits, the state's interest is best protected by having an experienced TC IV directly involved in the defense effort. In AD, the attorney will handle the understated tax petitions (including fraud) resulting from additional audits conducted by the ETD's Audit Section, which will require the time of an attorney conference holder. In LD, the legal work can be allocated into two distinct components:

First, immediately after approval of the Regulations, the tax litigators in LD, in conjunction with deputy attorney generals will represent the Board in the lawsuits filed to challenge the constitutionality and validity of such Regulations. One such lawsuit has already been filed and is now pending in superior court, but it is likely that other lawsuits also will be filed. This initial legal work will involve legal research; the preparation of briefs and related legal analyses; meeting with DOJ attorneys; making presentations to the Board relative to the litigation; attending court hearings, depositions, and trials; handling discovery matters, including compiling the necessary documents and records; and obtaining and preparing documentary evidence and, if necessary, witnesses and expert witnesses in the defense of the Board with respect to the FMB Regulations. This initial workload can be expected to last at least from one year to three years.

Second, after the effective dates of the Regulations, the BOE will commence enforcing the new regulatory terms and requirements. This will necessarily entail increased BOE audits and deficiency assessments with respect to alcoholic beverage taxpayers. Based upon the BOE's historical experience, higher tax rates correspond with higher malfeasance rates and an overall increase in deficiency assessments. Eventually, these increased deficiency assessments will result in additional appeals and, ultimately, increases in both the number and financial significance of the tax refund lawsuits filed against the Board. Consequently, due to such increase in tax refund lawsuits, the LD tax litigators expect to experience a material increase in all aspects of their litigation duties and workload commensurate with the increase in the tax rate resulting from the clarification of which alcoholic beverages meet the definition of distilled spirits. As mentioned above, this legal work also will involve legal research; the preparation of briefs and related legal analyses; meeting with DOJ attorneys; making presentations to the Board relative to the litigation; attending court hearings, depositions, and trials; handling discovery matters, including compiling the necessary documents and records; and obtaining and preparing documentary evidence and, if necessary, witnesses and expert witnesses in the defense of the Board with respect to the Regulations. This second type of LD legal workload, however, can be expected to last indefinitely, as long as the FMB Regulations remain in full force and effect. Exhibit I provides detail workload activity associated with this position.

Legal Department – Consultant Services Subject Matter Expert (SME) Costs:

Given that the liquor industry has unified to attack the Regulations and given the BOE's lack of expertise in the area of the brewing of beer and the distillation of liquor -- it is likely that the Legal Department eventually will need to obtain the services of and consult with expert brewing, distilling, and similarly knowledgeable consultants and expert witnesses, throughout the course of this litigation. Certainly, the industry plaintiffs will have access to both in-house and external expert information and expert witnesses. The Legal Department requests \$600,000 in consultant services to procure independent expert consultants in several areas. For FY 2008-09, \$250,000 is anticipated for specialized services of independent consultants such as chemists and alcohol beverage industry experts to assist with the implementation of the Regulations. For FY 2009-10, \$350,000 is anticipated for experts to provide continuous technical support in the area of chemistry and knowledge of

the beverage industry in order to assist with any issues regarding classification issues including, but not limited, to the precise sources and distillation of the alcohol actually contained in the beverages at the time of retail sale.

ADMINISTRATION

Cashiers & Mail Services Units

The Cashiers and Mail Services Units are responsible for handling incoming return forms, return payments, processing mailings of outgoing returns, billings, and notices. Overtime and Temporary Help hours are requested to address this workload. In addition, mailing costs for postage on returns and informational notices are estimated at \$12,474 in FY 2008-09 and \$13,608 ongoing. Exhibit I provides detail workload activity associated with the Cashiers and Mail Services Units.

Data Entry Unit

The Data Entry Unit is responsible for entering all information from return filings and the processing of accounts receivable documents which are then transferred into the Integrated Revenue Information System (IRIS). Overtime hours are requested to address this new workload associated with the new Regulations and the development of a new tax return and schedules. Exhibit I provides detail workload activity associated with the Data Entry Unit.

The Data Entry Unit has determined that costs and workload related to potential changes of adding new columns to Distilled Spirits Tax Returns and supplementary reports (501-DS, 501-DC, BOE-1056) will be absorbable. Additionally, the workload associated with the estimated accounts receivable documents received will also be absorbable.

Document Management Unit - Printing Costs

The BOE, Document Management Unit estimates costs for printing of notices, forms, updating publications and returns required under each alternative at \$621 in FY 2008-09 and \$594 in the FY 2009-10 and ongoing years.

FY 2008-09		FY 2009-10 and Ongoing Years	
Special Notice (3), 3,600 pages, (two page)	\$214	Special Notice (2), 3,600 pages (one page)	\$110
Form (rebuttable presumption)	\$164	Form (rebuttable presumption)	\$164
Returns (12,600)	\$243	Returns (16,600)	\$320
Total	\$621	Total	\$594

Technology Services Division (TSD)

To successfully implement and administer the new Regulations, the Technology Service Division (TSD) will need to modify the existing IRIS. This will entail implementing new functionality to the return processing and audit applications, as well as notification to all impacted tax and fee payers. System changes require complex programming skills and analysis existing at the Staff level. Temporary help hours will be required to address this effort. Exhibit I provides detail workload activity associated with TSD.

Pros:

- Provides, on an on going permanent basis, required positions and related resources for the BOE to fully and effectively meet the Board regulatory mandate.

- Increases General Fund revenue by an estimated \$28.7 million in FY 2008-09, and \$38.3 million ongoing (in the absence of reformulation of product by Industry).²
- Represents 37.4 to 1 benefit-to-cost ratio in FY 2008-09, 32.7 to 1 in FY 2009-10, 51.4 to 1 in FY 2010-11 and ongoing.

Cons:

- Requires a General Fund budget augmentation to provide resources effective January 1, 2009.
- This proposal provides current year resources effective January 1, 2009, to implement these Regulations, for the period July 1, 2008, through December 31, 2008, that workload is being met through a redirection of staff and overtime hours. Post implementation ongoing workload cannot be met through a continued reallocation of resources as other program work is backlogging including audit activity that represents a cost of \$350 per audit hour reallocated.
- Projected revenue estimates could be lower to the extent industry reformulates alcoholic beverage products in response to the new Regulations.

Alternative 2 – Approve budget augmentation for 5.5 positions and related resources on a three-year limited-term basis.

This alternative requests funding and authority to establish 5.5 positions and related resources beginning January 1, 2009, in order to meet the regulatory mandate of the Regulations adopted by the Board. This alternative would provide staffing resources on a three-year limited-term basis to address the new Regulations.

Pros:

- Provides, on a limited-term basis, required positions and related resources for the BOE to partially meet the Board regulatory mandate.
- Allows the BOE to evaluate the effectiveness and cost-benefit of the new positions during their three-year limited-term.
- Allows the BOE to determine the extent and impact of industry reformulations of alcoholic beverage products in response to the new Regulations.
- Increases General Fund revenue by an estimated \$28.7 million in FY 2008-09, and \$38.3 million in FY 2009-10 and ongoing (in the absence of reformulation of product by Industry).²
- Represents 37.4 to 1 benefit-to-cost ratio in FY 2008-09, 32.7 to 1 in FY 2009-10, and 51.4 to 1 in FY 2010-11.

Cons:

- After three years, in the absence of a supplemental BCP, this workload would not be addressed and puts at risk the associated annual revenue.
- Requires a General Fund budget augmentation to provide resources.
- This proposal provides current year resources beginning January 1, 2009, to implement these Regulations, for the period July 1, 2008, through December 31, 2008, the workload is being met through a redirection of staff and overtime hours. Post implementation ongoing workload cannot be met through a continued reallocation of

² The Excise Taxes Division is currently reviewing and processing Rebuttable Presumption forms being submitted by beer manufacturers and importers that include product certifications which indicate that revenue will be less than that originally estimated. Regulations 2558 and 2559 are effective October 1, 2008. Distilled Spirits Tax returns are due on or before November 15, 2008. Based on this timeline, BOE does not anticipate having a clear picture of estimated revenue until early December 2008.

resources as other program work is backlogging including audit activity that represents a cost of \$350 per audit hour reallocated

- Projected revenue estimates could be lower to the extent industry reformulates alcoholic beverage products in future years in response to the new Regulations.

E. Facility/Capital Outlay Consideration

BOE is currently completing a “restacking plan” for the BOE’s Headquarter building. This plan will allow BOE to address current optimum occupancy issues, align program functions/activities, identify additional offsite lease space, and for growth.

F. Outcomes and Accountability

This proposal will enable the BOE to carry out the new Regulations. These Regulations are effective, in limited part, on July 10, 2008, and fully operative on October 1, 2008. A formal implementation plan has been developed and is summarized below in Section H, *Timetable*. The outcomes identified in this BCP and associated revenue gain will be measured by the number of return filings, billings, new registrations, audit leads, audit recovery, and investigations of revoked or suspended BOE and ABC accounts and licenses. Statistical reports that provide detailed and summarized compliance and audit results are currently in place and are reported on a monthly, quarterly and yearly basis to management and other stakeholders. The program’s supervisory team will maintain control and oversight of program operations.

G. Timetable

Upon approval of the recommended alternative, the BOE will proceed to fill the positions and implement this request:

FY 2007-08	FY 2008-09	FY 2009-10
<ul style="list-style-type: none">• Continue Rulemaking that began in December 2006.• Office of Administrative Law approval of Regulations clarifying the definition of distilled spirits.• Program conceptual development.	<ul style="list-style-type: none">• 1.0 Business Taxes Specialist I position effective 1/01/09.• 1.0 Office Assistant (Typing) position effective 1/01/09.• 1.0 Tax Counsel IV position effective 1/01/09.• 1.0 Tax Technician III position effective 1/01/09.• Develop industry/stakeholder outreach.• Develop/load website product listing and process rebuttal forms.• Identify and develop MOU with product testing laboratory.• Develop industry outreach – notices, forms and reporting procedures.• IT development (JAD)	<ul style="list-style-type: none">• 1.5 Associate Tax Auditor positions effective 7/01/09.• Process rebuttal presumption forms.• Maintain/update website product listing.• Respond to industry concerns.• Implement audit process.• Develop Lessons Learned and Close-out report.

H. Recommendation

Alternative #1 is recommended. Approval of these positions as reflected in Exhibit I and related resources will allow the BOE to effectively meet the new regulatory requirements that clarify the definition of distilled spirits in order to appropriately tax alcoholic beverage products. This alternative allows the BOE to collect the estimated ongoing annual revenue of \$38.3 million (beginning FY 2009-10) resulting from the new Regulations. In addition to meeting the mandated workloads outlined, this alternative would facilitate outreach and education of industry groups, stakeholders, and other interested parties that would be impacted by the new Regulations.

I. Fiscal Detail

See attached "Fiscal Detail" schedules.

EXCISE TAXES DIVISION: AUDIT SECTION – WORKLOAD ACTIVITIES**Business Taxes Specialist I (BTS I):**

FY 2009-10					
Workload Detail					
		Time Measure		Ongoing Activities	
	Activity	H = Hours M = Minutes	Time Per Occurrence	Occurrences Per Year	Total Hours
Business Taxes Specialist I (Audit)					
	Field Audits (Most Difficult)	H	80	6	480
	Create Internet List Acknowledge receipt of certification Categorize certification Mail decision Add product to listing Maintain Internet List Reg. 2559.3	H	285	4	1,140
	Petitions and Appeals	H	10	10	100
	Most Difficult Refunds	H	8	10	80
	Total Hours per year				1,800
	Position based on 1,800 hours				1.0

Office Assistant OA (Typing):

FY 2009-10					
Workload Detail					
		Time Measure		Ongoing Activities	
Classification	Activity	H = Hours M = Minutes	Time Per Occurrence	Occurrences Per Year	Total Hours
Office Assistant (Typing)					
	Prepare Correspondence	M	30.0	1,200	600
	Create/Maintain Files	M	15.0	2,400	600
	Refund Action	M	10.0	200	33
	Telephone (Reception)	M	2.0	1,200	40
	Outreach (Support)	M	30.0	120	60
	Admin Support – Scanning	M	30.0	120	60
	Admin – General/attendance	M	15.0	1,200	300
	Admin Support – Personnel	M	15.0	120	30
	Audit Support – IRIS	M	45.0	100	75
	Total Hours per year				1,798
	Position based on 1,800 hours				1.0

Associate Tax Auditor (ATA):

FY 2009-10					
Workload Detail					
Classification	Activity	Time Measure		Ongoing Activities	
		H = Hours M = Minutes	Time Per Occurrence	Occurrences Per Year	Total Hours
Associate Tax Auditor					
	Field Audits	H	45	30	1,350
	Desk Audits	H	20	30	600
	Refunds	H	6	40	240
	Maintain Internet List Reg. 2559.3	H	50	4	200
	Total Hours per year				2,390
	Position based on 1,600 hours				1.5

EXCISE TAXES DIVISION: COMPLIANCE SECTION – WORKLOAD ACTIVITIES**Tax Technician (TT) III:**

FY 2009-10					
Workload Detail					
Classification	Activity	H = Hours M = Minutes	Time Per Occurrence	Occurrences Per Year	Total Hours (Rounded)
Tax Technician III					
	Verify Returns	M	2.55	16,800	714
	Revenue Adjustments	M	2.50	4,767	199
	Revenue Moves	M	1.50	78	2
	Effective Date Change	M	1.00	283	5
	Revenue Type Change	M	2.00	248	8
	Compliance Assessment	M	2.50	840	28
	Initiate Refund	M	2.50	120	5
	Initiate Notice	M	2.50	1,495	62
	Cancel Notice	M	1.00	196	3
	Payment Action	M	2.00	1,016	34
	Activate Billing	M	3.00	2,068	103
	Claim for Refund – Audit	M	15.0	1,124	281
	Industry Outreach	H	8.00	24	192
	Telephone Advisory	M	2.50	1,797	75
	Correspondence – Product Classification	M	3.00	1,260	63
	Correspondence – Other	M	2.50	674	28
	Total Hours per Year				1,802
	Position Needed Based on 1,800 Hours				1.0

LEGAL DEPARTMENT – WORKLOAD ACTIVITIES**Tax Counsel (TC) IV:**

FY 2009-10					
Workload Detail					
Classification	Activity	H = Hours	Time Per Occurrence	Occurrences Per Year	Total Hours
Tax Counsel IV					
	Hold Appeals Conferences	H	20	10	200
	Write Decisions & Board Summaries	H	10	60	600
	Prepare legal memos and court documents, points and authorities, and briefs	H	25	10	250
	Documentary evidence preparation, discovery-related work, and preparation of witnesses for testifying	H	25	10	250
	Attend hearings, trials, closed session Board meetings, prepare witnesses, and meet with DOJ attorneys	H	10	10	100
	Meet with department staff, consultants, and experts regarding FMB audits and assessments	H	10	20	200
	Act as lead to other tax counsels with respect to litigation matters, including advising and document review	H	10	20	200
	Total Tax Counsel IV Hours				1800
	Total Tax Counsel IV Positions Requested (1,800 Hours Per Position)				1.0

CASHIERS AND MAIL SERVICES UNITS – WORKLOAD ACTIVITIES**CASHIERS UNIT**

Office Assistant - OA (Typing)

<u>FY 2008-09</u>	<u>Temp Help</u>	<u>Overtime</u>
Incoming Returns: 12,600 Returns	150 hrs	33 hrs

<u>FY 2009-10 & Ongoing</u>	<u>Temp Help</u>	<u>Overtime</u>
Incoming Returns: 16,800 Returns	200 hrs	37 hrs

MAIL SERVICES UNIT**FY 2008-09: Outgoing**

<u>Mailing</u>	<u>Quantity</u>	<u>Postage Cost</u>
Informational Notices (1 oz)	10,800	\$4,536
Returns (2 oz)	<u>12,600</u>	<u>\$7,938</u>
TOTAL:	23,400	\$12,474

FY 2008-09: Overtime hours

Mailing Machine Operator I/II (MMOI/II)

	<u>MMOI</u>	<u>MMOII</u>
Informational Notices (1 oz)	4 hrs	4 hrs
Returns (2 oz)	8 hrs	8 hrs

FY 2008-09: Incoming Mailing

	<u>Quantity</u>
Returns	12,600

FY 2008-09: Overtime hours

Mailing Machine Operator I/II (MMOI/II)

	<u>MMOI</u>	<u>MMOII</u>	<u>OA (Typing)</u>
	1 hr	1 hr	7 hrs

Ongoing Outgoing Mailing:

	<u>Quantity</u>	<u>Postage Cost</u>
Informational Notices (1 oz)	7,200	\$3,024
Returns (2 oz)	<u>16,800</u>	<u>\$10,584</u>
TOTAL:	24,000	\$13,608

Ongoing Overtime:

	<u>MMOI</u>	<u>MMOII</u>
Informational Notices (1 oz)	3 hrs	3 hrs
Returns (2 oz)	10 hrs	10 hrs

Ongoing Incoming Mailing:

	<u>Quantity</u>
Returns	16,800

Ongoing Overtime:

	<u>MMOI</u>	<u>MMOII</u>	<u>OA (Typing)</u>
	1 hr	1 hr	9 hrs

DATA ENTRY UNIT – WORKLOAD ACTIVITIES:

468 hours of overtime funding for FY 2008-09 first year costs and 625 hours of ongoing overtime funding at the Key Data Operator level.

Assumptions:

16,800 new returns (annual)

Year One Workload

# of returns	12,600
Average keystrokes per return	316
Total Keystrokes	<u>3,981,600</u>
Average keystrokes per hour	8,500
Total hours (12,600 x 316/8,500)	468

Ongoing Workload

# of returns	16,800
Average keystrokes per document	316
Total Keystrokes	<u>5,308,800</u>
Average keystrokes per hour	8,500
Total hours (16,800 x 316/8,500)	625

Total Overtime Funds Needed - Key Data Operator Level

First year (partial year)	468	hours
Ongoing	625	hours

TECHNOLOGY SERVICES DIVISION – WORKLOAD ACTIVITIES:

Staff Programmer Analyst:

FY 2008-09					
Workload Detail					
Classification	Activity	Time Measure			
		H = Hours M = Minutes	Time Per Occurrence	Occurrences Per Year	Total Hours
Staff Programmer Analyst					
Design and Documentation:					
	<ul style="list-style-type: none"> Engaged in Joint Application Development (JAD) Prepare data flow and data conversion documents Mock up report formats 	H	461	1	461
Construction:					
	<ul style="list-style-type: none"> Code Prepare system design documents Unit and integration testing and planning Establish object traceability Build reports Walk through coding 	H	922	1	922
Total Hours per year					1,383

Summary Table of Boardwide Positions / Temporary & Overtime Hours Requested:

The following table details the 5.5 positions and related resources requested in this proposal:

Position / Unit	FY 2008-09		FY 2009-10		FY 2010-11	
	Positions	OT / Other Hours / Costs	Positions	OT / Other Hours / Costs	Positions	OT / Other Hours / Costs
Business Taxes Specialist I (ETD)	1.0 (1/01/09)		1.0 ongoing		1.0 ongoing	
Associate Tax Auditor (ETD)			1.5 (7/01/09)		1.5 ongoing	
Office Assistant (Typing) (ETD)	1.0 (1/01/09)		1.0 ongoing		1.0 ongoing	
Tax Technician III (ETD)	1.0 (1/1/09)		1.0 ongoing		1.0 ongoing	
Tax Counsel IV (Legal Department)	1.0 (1/01/09)		1.0 ongoing		1.0 ongoing	
Subject Matter Expert (SME)(Legal)		\$250,000		\$350,000		N/A
Data Entry & Mail Services Units		\$10,668 (OT)		\$14,084 (OT)		\$14,084 (OT)
Excise Taxes Division		\$17,790 (Temp Help)		\$16,605 (Temp Help)		\$16,605 (Temp Help)
Cashiers		\$2,012 (Temp Help) \$664 (OT)		\$2,682 (Temp Help) \$744 (OT)		\$2,682 (Temp Help) \$744 (OT)
Technology Services Division		\$46,773 (Temp Help)				
Totals	4.0 Positions	OT \$11,333 Temp Help \$66,575 SME Costs: \$250,000	5.5 Positions	OT \$14,828 Temp Help \$19,287 SME Costs: \$350,000	5.5 Positions	OT \$14,828 Temp Help \$19,287

REVENUE ESTIMATE

(REV. 4/98)

STATE OF CALIFORNIA
BOARD OF EQUALIZATION



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%)	<u>2.0 million</u>
Total State	40.3 million
Local sales and use tax (at 2.00%)	0.8 million
District tax (at 0.69%)	<u>0.3 million</u>
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

STATE OF CALIFORNIA
 BUDGET CHANGE PROPOSAL--FISCAL DETAIL
 STATE OPERATIONS
 FISCAL YEAR 2009-10
 (Dollars in Thousands)

Title of Proposed Change: Flavored Malt Beverages

Program/Element/Component: 40: Alcoholic Beverage Tax Program/All Elements

	PERSONNEL YEARS			CY	BY	BY + 1
	CY	BY	BY + 1			
TOTAL SALARIES AND WAGES <i>_a/</i>	3.2	5.9	5.9	\$205	\$385	\$385
Salary Savings	-.2	-.3	-.3	-10	-19	-19
NET TOTAL SALARIES AND WAGES	3.0	5.6	5.6	195	366	366
Staff Benefits <i>_a/</i>				69	131	131
Distributed Administration <i>_b/</i>				56	85	54
TOTAL PERSONAL SERVICES	3.0	5.6	5.6	\$320	\$582	\$551
OPERATING EXPENSE AND EQUIPMENT						
General Expense				\$43	\$30	\$11
Distributed Administration				14	21	14
Printing				1	1	1
Communications				3	4	3
Postage				12	14	14
Travel--In-State				4	40	40
Travel--Out-of -State				6	30	30
Training				3	4	4
Facilities Operations				98	85	68
Consulting & Professional Services: Interdepartmental						
Consulting & Professional Services: External				250	350	
Department of Technology Services				12	9	9
Data Processing				2	1	
Equipment						
Other Items of Expense: (Specify Below)						

_a/ See page 26 of 27 for itemized staff benefits and classification detail.

_b/ Represents Distributed Administration costs resulting from this BCP. The Distributed Administration costs for existing BOE programs will reflect a corresponding decrease which will be addressed in the Planning Estimate process.

	<u>CY</u>	<u>BY</u>	<u>BY + 1</u>
TOTAL OPERATING EXPENSE AND EQUIPMENT	<u>\$448</u>	<u>\$589</u>	<u>\$194</u>
TOTAL EXPENDITURES (State Operations)	<u>\$768</u>	<u>\$1,171</u>	<u>\$745</u>

Source of Funds

General Fund	(0001)	\$768	\$1,171	\$745
Special Funds:				
Breast Cancer Fund	(0004)			
State Emergency Telephone	(0022)			
Motor Vehicle Fuel Account	(0061)			
Occupational Lead Prevention Fund	(0070)			
Childhood Lead Poisoning Prev. Fund	(0080)			
Cig. and Tobacco Prod. Surtax Fund	(0230)			
Oil Spill Prevention and Admin. Fund	(0320)			
Integrated Waste Management	(0387)			
Underground Storage Tank Fund	(0439)			
Energy Resources Programs Account	(0465)			
CA. Children and Families First Trust Fund	(0623)			
Federal Trust Fund	(0890)			
Timber Tax Fund	(0965)			
Gas Consumption Surcharge Fund	(3015)			
Water Rights Fund	(3058)			
Elec. Waste Recovery and Recycling Acct.	(3065)			
Cig. and Tobacco Prod. Compliance Fund	(3067)			
Federal Funds				
Other Funds				
Reimbursements	(0995)			
Net Total Augmentation (Source of Funds)		<u>\$768</u>	<u>\$1,171</u>	<u>\$745</u>

**DETAIL OF STAFF BENEFITS
AND PERSONAL SERVICES**

Staff Benefits Detail:	<u>CY</u> <u>BY</u> <u>BY + 1</u>		
	<i>(Whole Dollars)</i>		
OASDI	\$14,918	\$27,999	\$27,999
Health Insurance	21,836	41,750	41,750
Retirement	31,218	59,689	59,689
Workers' Compensation	75	143	143
Industrial Disability Leave	131	251	251
Non-Industrial Disability Leave	95	182	182
Unemployment Insurance	28	54	54
Other	484	926	926
TOTAL	\$68,785	\$130,994	\$130,994

Classification	Positions			Salary Range <small>_a/</small>	Amount		
	CY	BY	BY + 1		CY	BY	BY + 1
Property & Special Taxes Dept							
<u>Excise Tax Division:</u>							
Associate Tax Auditor - (7-1-09)		1.5	1.5	\$64,164		\$96,246	\$96,246
Business Taxes Specialist I - (1-1-09)	.5	1.0	1.0	74,016	37,008	74,016	74,016
Office Assistant - (1-1-09)	.5	1.0	1.0	27,888	13,944	27,888	27,888
Tax Technician III - (1-1-09)	.5	1.0	1.0	39,036	19,518	39,036	39,036
<u>Legal Dept</u>							
Tax Counsel IV - (1-1-09)	.5	1.0	1.0	113,784	56,892	113,784	113,784
Blanket Funds:							
Overtime (Various)	(.3)	(.4)	(.4)		11,332	14,828	14,828
Temporary Help	1.2	.4	.4		66,575	19,287	19,287
TOTAL SALARIES AND WAGES	3.2	5.9	5.9		\$205,269	\$385,085	\$385,085

_a/ The salary is the mid-step of the salary range for the stated classification.

SUPPLEMENTAL INFORMATION

Dollars in Thousands

	<u>Current Year</u>	<u>Budget Year</u>	<u>Budget Year + One</u>
Proposed Equipment:			
N/A			
Total			
Proposed Contracts:			
Consulting & Professional Services: External	250	350	
Total	<u>\$250</u>	<u>\$350</u>	
One-Time Costs:			
General Expense	\$43	\$22	
Consulting & Professional Services: External	250	350	
Department of Technology Services	12		
Data Processing	2	1	
Facilities	52	17	
Total	<u>\$359</u>	<u>\$390</u>	
Future Savings:			
N/A			
Total			
Full-Year Cost Adjustments:			
N/A			
Total			