

Memorandum

To: Honorable Betty T. Yee, Chairwoman
Honorable Jerome E. Horton, Vice-Chair
Honorable Bill Leonard
Honorable Michelle Steel
Honorable John Chiang

Date: November 30, 2009

From: Kristine Cazadd, Chief Counsel
Legal Department, MIC:83

David Gau, Deputy Director
Property and Special Taxes Department, MIC:63

Subject: Board Meeting, December 15 – 17, 2009
Item J 1
Chief Counsel's Rulemaking Calendar
Proposed Regulation 4076. Wholesale Cost of Tobacco Products

The Legal Department and the Property and Special Taxes Department request that the Board authorize the staff to commence a new rulemaking proceeding to add proposed Regulation 4076, pertaining to the wholesale cost of tobacco products under the Cigarette and Tobacco Products Tax Law, to article 13, Particular Transactions, of chapter 9, Cigarette Tax, of division 2 of title 18 of the California Code of Regulations. Therefore, we request that the Board authorize staff to commence the new rulemaking proceeding by publishing a proposed Board regulation in the form attached hereto as an exhibit.

The purpose for proposing this rulemaking is to clarify the existing law with respect to certain issues that were raised by the trial court and opposing counsel in *U.S. Smokeless Tobacco Brands, Inc. v. State Bd. of Equalization* (Super. Ct. San Francisco County, 2009, No. CGC 07-463592) (UST case) with respect to how the distributor's wholesale cost of tobacco products, upon which the tax is based, should be determined and what costs are to be included in determining the distributor's wholesale cost. The wholesale cost of tobacco products is defined in section 30017 of the Cigarette and Tobacco Products Tax Law to mean "the cost of tobacco products to the distributor prior to any discounts or trade allowances." Staff's intent in proposing this regulation is to clarify the law and further clarify its longstanding interpretation of the definition of wholesale cost in order to assist distributors of tobacco products in determining correctly the taxable wholesale cost of their products. One issue that the regulation specifically clarifies is how such wholesale costs are to be determined with respect to free samples.

Revenue and Taxation Code section 30451 authorizes the Board to promulgate regulations under the Cigarette and Tobacco Products Tax Law. Consequently, staff recommends that

the Board authorize staff to begin the process to adopt proposed Regulation 4076 to provide clarification and guidance in the determination of the wholesale cost of tobacco products.

Attached to this memorandum is the text of proposed Regulation 4076.

If you have any questions regarding this request, please let me know or contact Mr. Robert Lambert, at (916) 708-1030, or Ms. Carolee Johnstone, at 323-7713.

Approved:

Ramon J. Hirsig
Executive Director

Attachment

KC/BMH/yg

J:/Bus/Use/Finals/Heller/tob prdt whlst Bd memo.doc

cc: (w/ attachment)

Mr. Ramon Hirsig	(MIC:73)
Mr. Robert Lambert	(MIC:82)
Mr. Randy Ferris	(MIC:82)
Mr. Gil Haas, Jr.	(MIC:42)
Ms. Carolee Johnstone	(MIC:82)
Ms. Lynn Bartolo	(MIC:56)
Mr. Bill Kimsey	(MIC:56)
Mr. Richard Parrott	(MIC:56)

PROPOSED REGULATION

Add Regulation 4076, Wholesale Cost of Tobacco Products, to article 13, Particular Transactions, of chapter 9, Cigarette Tax, of division 2 of title 18 of the California Code of Regulations to read as follows:

Regulation 4076. Wholesale Cost of Tobacco Products.

(a) Definition of terms. The following definitions shall apply for purposes of this regulation:

- (1) **Arm's-length.** An "arm's-length" transaction means a purchase or other business transaction entered into in good faith and for valuable consideration that reflects the fair market value in the open market between two informed and willing parties, neither under any compulsion to participate in the transaction.
- (2) **Discounts or trade allowances.** "Discounts or trade allowances" means and includes any discounts, price reductions, or allowances of any kind made by the supplier in setting a price, including, without limitation, any discounts applied to a supplier's price list, such as for prompt payment, payment in cash, bulk purchases, or favored customer status.
- (3) **Distribution; distribute.** "Distribution" and "distribute" mean: (A) the sale of untaxed tobacco products in the state; (B) the use or consumption of untaxed tobacco products in the state; or (C) the placing of untaxed tobacco products in retail stock in the state for the purpose of selling the tobacco products to consumers.
- (4) **Distributor.** "Distributor" means every person that: (A) distributes tobacco products; or (B) sells or accepts an order for tobacco products that are to be transported from a point outside the state to a consumer within the state.
- (5) **Finished tobacco products; finished condition.** "Finished tobacco products" and tobacco products in "finished condition" mean and include tobacco products that will not be subject to any additional processing before first distribution in the state.
- (6) **Production; produce; processing.** "Production," "produce," and "processing" mean and include a fabrication process, or a step in a fabrication process, leading to the production of a finished tobacco product.

- (7) **Profit.** "Profit" means the positive gain from an investment or business operation after subtracting all costs and expenses determined in accordance with generally accepted accounting principles.
- (8) **Similarly situated distributors.** "Similarly situated distributors" means distributors operating under reasonably similar economic and market circumstances.
- (9) **Supplier.** "Supplier" means any manufacturer, seller, or transferor that sold or transferred tobacco products to the distributor whose wholesale costs are being determined.
- (10) **Tobacco product costs.** "Tobacco product costs" means and includes the cost of tobacco products to the distributor, determined as set forth below in paragraph (d), as of either (A) the date the distributor acquires finished tobacco products or (B) the date the distributor completes production of finished tobacco products.
- (11) **Tobacco products.** "Tobacco products" includes, but is not limited to, all forms of cigars, smoking tobacco, chewing tobacco, snuff, and any other articles or products made of, or containing at least 50 percent, tobacco, but does not include cigarettes.
- (12) **Wholesale cost.** "Wholesale cost" means tobacco product costs, prior to and exclusive of any discounts or trade allowances; but excluding the cost of tobacco products that were returned by a customer during the same reporting period in which the tobacco products were distributed if the distributor refunds the entire amount the customer paid for the tobacco products either in cash or credit. For purposes of this subparagraph, refund or credit of the entire amount shall be deemed to be given when the purchase price less rehandling and restocking costs is refunded or credited to the customer. The amount withheld for rehandling and restocking costs may be a percentage of the sales price determined by the average cost of rehandling and restocking returned merchandise during the previous accounting cycle.

(b) Presumption – not-at-arm's length. Sales, purchases, and transfers of tobacco products between and among relatives (by blood or marriage, which relationships include, but are not limited to, spouses, parents, children and siblings), a partnership and its partners, a limited liability company or association and its members, a corporation and its shareholders, and persons, as defined in Revenue and Taxation Code Section 30010, and entities under their control, are rebuttably presumed to be not-at-arm's-length transactions. If the Board determines that a sale, purchase, or transfer was between or among any of the related parties set forth in this paragraph, the distributor may rebut the presumption only by showing by clear and convincing evidence that the transaction was, in fact, at arm's length or,

alternatively, that the terms and conditions of the transaction were substantially equivalent to those that would have been negotiated between unrelated parties in an arm's-length transaction.

(c) Calculation of the taxable wholesale cost of tobacco products.

For purposes of the tax set forth in Revenue and Taxation Code Section 30123, subdivision (b), and Section 30131.2, subdivision (b), the taxable wholesale cost of tobacco products shall be the "tobacco product costs," as determined pursuant to subdivision (d) below, exclusive of any discounts or trade allowances.

(d) Calculation of tobacco product costs. The Board shall determine tobacco product costs in accordance with the following:

- (1) **Standard methods for determining tobacco product costs.** Except as provided in paragraphs (2) and (3) below, tobacco product costs shall be determined as follows:
 - (A) **Tobacco product costs to a distributor that acquires finished tobacco products from a supplier.** When a distributor acquires tobacco products in finished condition from a supplier, tobacco product costs shall be equal to the cumulative costs paid or incurred by the distributor for and with respect to the acquisition of the finished tobacco products, exclusive of freight-in costs.
 - (B) **Tobacco product costs to a distributor that produces finished tobacco products.** When a distributor produces finished tobacco products, tobacco product costs shall be equal to the sum of all direct and indirect costs that the distributor paid or incurred with respect to the production of finished tobacco products. Such costs include, without limitation, all of the distributor's outlays and expenditures, such as amounts paid to suppliers for raw tobacco, the costs of overhead, labor, other materials, and their related freight-in costs, paid or incurred in the production process, and the costs of marketing the finished tobacco product to customers and prospective customers.
 - (C) **Tobacco product costs to a distributor that imports tobacco products or finished tobacco products from outside the United States.** In addition to the costs described in subparagraphs (A) and (B) above, a distributor's tobacco product costs for finished tobacco products that the distributor acquires or produces shall also include customs fees and federal excise taxes on finished tobacco products and tobacco products that the distributor imports from outside the United States.
 - (D) **Tobacco product costs to a distributor that acquires finished tobacco products free of charge, or as a free sample, from a supplier.** Where a distributor acquires finished tobacco products free of charge, or as a free sample, from a supplier, the distributor shall be considered to have acquired the finished tobacco products at a 100 percent discount. In

such event, the board, in its sole discretion, may determine the tobacco product costs of those finished tobacco products in accordance with one or more of the alternative methods for determining tobacco product costs set forth in paragraph (3) below.

- (2) **Addition of discount and trade allowance amounts to tobacco product costs to calculate wholesale cost.** If the board determines that, instead of reporting wholesale costs, the distributor reported tobacco product costs that included express, implicit, or unstated discounts or trade allowances, and complete and reliable information is available to the board allowing it to reasonably estimate the amounts of such discounts or trade allowances, then the board may rely upon such information to reasonably estimate the distributor's wholesale costs, prior to and exclusive of discounts and trade allowances, by adding such estimated discount and trade allowance amounts to the tobacco product costs reported by the distributor or otherwise determined under paragraph (1).
- (3) **Alternative methods of estimating or calculating tobacco product costs.**
- (A) If the board determines that (i) the distributor reported tobacco product costs that included express, implicit, or unstated discounts or trade allowances and complete and reliable information sufficient to reasonably estimate the amounts of such discounts or trade allowances is not available to the board or (ii) the distributor purchased or acquired tobacco products in one or more not-at-arm's-length transactions, then the board may, in its sole discretion, determine tobacco product costs by relying upon one or more of the methods set forth in subparagraphs (B) and (C) below.
- (B) The board may rely upon a publicly or commercially available price list that the distributor used to determine the prices of tobacco products sold to customers in arm's-length transactions during the time period at issue, less a reasonable estimate of the distributor's profit.
- (C) If a publicly or commercially available price list is not available to the board, the board may reasonably estimate tobacco product costs by relying upon industry data from the time period at issue that provide reasonable evidence of typical or normal tobacco product costs during the time period at issue, including, without limitation: (i) evidence reasonably indicative of the typical costs of the same or similar tobacco products for similarly situated distributors, with appropriate adjustments to such costs as indicated by all the facts and circumstances; or (ii) all the direct and indirect costs that the supplier paid or incurred

with respect to acquisition, production, marketing, and sale of the tobacco products sold by the supplier to the distributor, with appropriate adjustments to such costs as indicated by all the facts and circumstances, plus a reasonable estimate of the supplier's profit; or (iii) the price of the same or similar tobacco products as reflected in a supplier's price list, with appropriate adjustments to such price as indicated by all the facts and circumstances; or (iv) the retail price of the same or similar tobacco products as reflected in a retailer's price list, with appropriate adjustments to such price as indicated by all the facts and circumstances, less reasonable estimates of the retailer's and distributor's profits.

(e) Examples:

- (1) **Example 1:** Distributor A purchases a finished tobacco product from a domestic supplier in an arm's-length transaction. A's wholesale cost of the tobacco product is the amount A paid to the supplier for the tobacco product, exclusive of any freight costs, discounts, and trade allowances.
- (2) **Example 2:** Distributor B produces handmade cigars. B's tobacco product costs include all of the direct and indirect costs that B paid or incurred with respect to the production, packaging, and marketing of the cigars.
- (3) **Example 3:** Distributor C purchases tobacco products from a subsidiary corporation in which it owns or controls more than 50 percent of the voting stock. Due to this corporate relationship between seller and buyer, the board presumes that the sale and purchase were not at arm's length, and the presumption is not rebutted by C. If a publicly or commercially available price list that C used during the time period to determine its prices to unrelated customers is available, then the board may use that price list, less a reasonable estimate of C's profit, to estimate C's tobacco product costs. If, however, no such publicly or commercially available price list is available, then the board may determine tobacco product costs by relying upon other industry data, such as (A) supplier costs plus a reasonable estimate of supplier profit, (B) the price lists of other similarly situated distributors less a reasonable estimate of distributor profits, (C) supplier price lists, or (D) retailer price lists less a reasonable estimate of retailer and distributor profits, as described in paragraph (d)(3).
- (4) **Example 4:** Distributor D acquires tobacco product free of charge and reports no wholesale cost for the product on its Tobacco Products Distributor Tax Return. The board determines that D acquired such tobacco product at a 100 percent discount or trade allowance. If a publicly or commercially available

price list that D used during the time period to determine its sales prices to unrelated customers is available, then the board may use that price list, less a reasonable estimate of D's profit, to estimate D's tobacco product costs. If, however, no such publicly or commercially available price list is available, then the board may determine tobacco product costs by relying upon other industry data, such as (A) supplier costs plus a reasonable estimate of supplier profit, (B) the price lists of other similarly situated distributors less a reasonable estimate of distributor profits, (C) supplier price lists, or (D) retailer price lists less a reasonable estimate of retailer and distributor profits, as described in paragraph (d)(3).

- (5) **Example 5:** Distributor E acquires tobacco products or finished tobacco products from a supplier outside the United States. E's tobacco product costs include, in addition to all other production or acquisition costs, the costs of all customs fees and federal excise taxes paid or incurred by E with respect to such tobacco products.

Note: *Authority:* Section 30451, Revenue and Taxation Code. *Reference:* Sections 30008, 30010, 30011, 30017, 30121, 30123, and 30131.2, Revenue and Taxation Code.