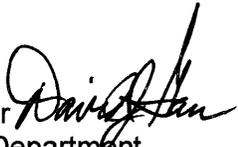


M e m o r a n d u m

To: Mr. Ramon J. Hirsig
Executive Director

Date: February 26, 2009

From: David J. Gau, Deputy Director 
Property and Special Taxes Department

Subject: **Flavored Malt Beverage Product Testing Plan**
(March 17, 2009 Deputy Director's Report)

At the February 4, 2009 Board meeting, I provided the Board Members with an update regarding the Flavored Malt Beverage Regulations. I also informed the Members that staff would be mailing a letter to 12 alcoholic beverage manufacturers that have filed Form BOE-505, *Alcoholic Beverage Tax Report for Rebutting Regulation 2559 Presumption*, by the end of this month. The letters were mailed yesterday, February 25, and requested copies of the manufacturer's "Statement of Process" or "Formula" (hereinafter referred to as documents) pursuant to the Board of Equalization's (BOE) authority under Alcoholic Beverage Tax Regulation 2559.1. The manufacturers will have 30 days to submit the requested documents to us.

The Board requested that I provide them with the attached, proposed Product Testing Implementation Plan at its March 2009 meeting. Excise Taxes staff is in the process of locating a lab that can perform the elements required for verification and testing. Once the manufacturers provide copies of their documents, we will work with the lab to verify whether each product has successfully rebutted the Regulation 2559 presumption. I hope to have a final report to the Board regarding the results of the testing effort before the end of the calendar year.

I have also attached, for the Board's consideration, *Finance Letter No. 3* requesting resources needed to administer the aspects of the program pertaining to verification of an initial sampling of the products.

With your approval, this item will be placed on the March 17, 2009 Board meeting calendar under Deputy Director, Property and Special Taxes Department

DJG:kn
Attachments

cc: Ms. Liz Houser
Ms. Diane Olson
Ms. Lynn Bartolo
Ms. Caroline Cabias

Approved: 

Ramon J. Hirsig
Executive Director

BOARD APPROVED
at the _____ Board Meeting

Diane Olson, Chief
Board Proceedings Division

**Excise Taxes Division
Flavored Malt Beverage Regulations
Product Testing Implementation Plan**

Item	Tasks	Section	Start Date	Due Date	Status
1	Develop Letter to Manufacturer Requesting "Statement of Process" or "Formula"	ETD, LD	Jan-09	Feb-09	Completed
2	Send Draft Letter through Clearance Process/3-day Review	ETD, LD	Feb-09	Feb-09	Completed
3	Identify Cross-section of Products from 505 Forms for Verification	ETD	Feb-09	Feb-09	Completed
4	Identify Product Testing Laboratory	ETD	Jan-09	Mar-09	In Progress
5	Send Letter Requesting "Statement of Process" or "Formulas" from Manufacturers	ETD	Feb-09	Feb-09	Completed
6	Prepare Inter-agency Contract Between Laboratory and BOE	ETD, LD	Feb-09	May-09	In Progress
7	Receive and/or Follow up on "Statement of Process" or "Formula" Request with Manufacturer	ETD	Apr-09	May-09	Not Started
8	Meet with Legal Appeals Section to Formalize Appeals Process	ETD	May-09	May-09	Not Started
9	Conduct Verification of the "Statement of Process" and Ingredients	LAB	May-09	Oct-09	Not Started
10	Prepare Findings of Product Testing and Document Files	ETD	Oct-09	Nov-09	Not Started
11	Formal Notification of Findings to Manufacturer	ETD	Nov-09	Nov-09	Not Started
12	Report to Board on Results of the Verification Effort	ETD	Nov-09	Dec-09	Not Started

**ETD - Excise Taxes Division
LAB - Independent Laboratory**

LD - Legal Department

STATE OF CALIFORNIA
 BUDGET CHANGE PROPOSAL - COVER SHEET
 FOR FISCAL YEAR 2009-10

Department of Finance
 915 L Street
 Sacramento, CA 95814
 IMS Mail Code: A-15

DF-46 (WORD Version)(REV 07/06)

Please report dollars in thousands.

FL # 3	PRIORITY NO. 3	ORG. CODE 0860	DEPARTMENT  State Board of Equalization
PROGRAM Alcoholic Beverage Tax	ELEMENT ALL	COMPONENT	

TITLE OF PROPOSED CHANGE:

Flavored Malt Beverages

SUMMARY OF PROPOSED CHANGES

This proposal requests \$250,000 in Fiscal Year (FY) 2009-10 to establish 1.0 one-year, limited term position (effective 7/1/09) and funding for contract laboratory services to perform 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 Board of Equalization (BOE) workload.

Revenue is estimated at \$38,500 annually.

REQUIRES LEGISLATION <input type="checkbox"/> YES <input checked="" type="checkbox"/> NO	CODE SECTION(S) TO BE AMENDED/ADDED	BUDGET IMPACT—PROVIDE LIST AND MARK IF APPLICABLE <input checked="" type="checkbox"/> ONE-TIME COST <input type="checkbox"/> FUTURE SAVINGS <input type="checkbox"/> FULL-YEAR COSTS <input checked="" type="checkbox"/> REVENUE <input type="checkbox"/> FACILITIES/CAPITAL COSTS	
PREPARED BY Manager, Budget Change Unit	DATE 3/18/09	REVIEWED BY Manager, Budget Section	DATE 3/18/09
REVIEWED BY Deputy Director, Administration	DATE 3/18/09	DIRECTOR Executive Director	DATE 3/18/09

DOES THIS BCP CONTAIN INFORMATION TECHNOLOGY (IT) COMPONENTS? YES OR NO
 IF YES, DEPARTMENT CHIEF INFORMATION OFFICER SIGNATURE _____ DATE _____

FOR IT REQUESTS, SPECIFY THE DATE SPECIAL PROJECT REPORT (SPR) OR FEASIBILITY STUDY REPORT (FSR) WAS APPROVED BY THE DEPARTMENT OF FINANCE.

DATE _____ PROJECT # _____ FSR OR SPR

IF PROPOSAL AFFECTS ANOTHER DEPARTMENT, DOES OTHER DEPARTMENT CONCUR WITH PROPOSAL?

YES NO ATTACH COMMENTS OF AFFECTED DEPARTMENT, SIGNED AND DATED BY THE DEPARTMENT DIRECTOR OR DESIGNEE.

DEPARTMENT OF FINANCE ANALYST USE
 (ADDITIONAL REVIEW)

CAPITAL OUTLAY OTROS FSCU OSAE CALSTARS

DATE SUBMITTED TO THE LEGISLATURE: _____

PPBA: _____

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.

Upon reviewing and processing Rebuttable Presumption forms being submitted by beer manufacturers, importers and others, the Excise Taxes Division (ETD) is finding that many Flavored Malt Beverages (FMB) products appear to have been reformulated and revenues are significantly less than originally estimated. This proposal requests \$250,000 (General Fund) in Fiscal Year (FY) 2009-10 to establish 1.0 one-year, limited term position (effective 7/1/09) and funding for contract laboratory services to perform workload associated with the new Regulations.

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 FMBs 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.

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.

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.

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 June 30, 2009, 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, 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.

D. Justification and Analysis of All Feasible Alternatives

The position 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 \$250,000 in FY 2009-10, for 1.0 position and funding for contract laboratory services on a one-year, limited-term basis.

The BOE requests limited term authority to establish 1.0 position and funding for contract laboratory services beginning July 1, 2009, in order to oversee and administer the mandates of the Regulations adopted by the Board and approved by OAL. The following staff and resources are requested:

EXCISE TAXES DIVISION (ETD)

Business Taxes Specialist I (BTS I)

ETD is requesting 1.0 one-year, limited term BTS I position effective July 1, 2009 plus associated resources to ensure proper oversight of the Alcoholic Beverage Tax program's new Regulations (Reg. 2558 – 2559.5). Exhibit I provides workload activity associated with the BTS I position.

The BTS I will have full responsibility for overseeing and implementing the requirements of the Regulations. The workload will primarily consist of developing and executing an inter-agency agreement/contract for laboratory services, contacting and following up with manufacturers to obtain required documentation for each beverage product to be tested which includes statements of process and formulas as filed with the Alcohol and Tobacco Tax and Trade Bureau (TTB), coordinating testing of a random sample of alcoholic beverage products to verify that their formulas comply with the level of limited ingredients prescribed by Alcoholic Beverage Tax Regulations 2558 and 2559, perform taxpayer and industry outreach, prepare status reports, handle petitions and appeals, and perform on-site verification of manufacturers' batch records and production controls.

Additionally, the BTS I will be responsible for processing new rebuttable presumption reports required by the new Regulations. Regulation 2559.3 requires that the Board develop, publish and maintain on its website a listing (effective October 1, 2008) of all alcoholic beverages that have been found to have successfully rebutted the presumption set forth in Regulation 2559. The BOE anticipates a steady volume of reports will continue to be submitted for review and processing. There are presently 216 beer manufacturer accounts within California, and 318 out-of-state beer manufacturers licensed to import alcoholic beverage 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.

Consultant/Laboratory Services for Alcoholic Beverage Product Verification/Testing

ETD will also need funding for contract laboratory services to verify and test a sample of alcoholic beverage products. The cost is estimated to be \$120,000 in FY 2009-10. ETD will be requesting alcoholic beverage manufacturers to provide a copy of the manufacturer's Formula and Process for Domestic and Imported Alcohol Beverages, as filed with the TTB. Each formula must include a detailed and specific quantitative list of each and every ingredient in the product, and a detailed description of the entire production process.

ETD will provide a copy of the formula to the lab and, using the information from ETD, the lab will scientifically review that the information contained in the manufacturer's Formula and Process for Domestic and Imported Alcohol Beverages supports the manufacturer's statement filed with BOE that certifies the alcoholic beverage product 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. A component of the testing will be an analysis of product purchased by ETD staff off-the-shelf for verification against the formulas and statement of process to fully ensure compliance with the Regulations. The lab will also provide a detailed report which includes a complete description of any analyses performed, quality assurances, and specific findings from these verifications; and a written opinion, based on the findings, whether or not the specific alcoholic beverage product is in

compliance with the new Regulations. The lab would also be used as an expert to testify regarding any findings or opinions rendered from the lab, if necessary.

Pros:

- Provides 1.0 position and related resources on a one-year, limited term basis to ensure oversight and administration of the Alcoholic Beverage Tax program's new Regulations
- Increases General Fund revenue by an estimated \$38,500 based on products that have not submitted rebuttable presumption forms or reformulated their FMB products.
- Provides funding for laboratory services to verify and/or test a sample of alcoholic beverage products to ensure compliance with the new regulations.
- Supports the Alcoholic Beverage Tax Regulations related to distilled spirits.
- Allows the BOE to evaluate the effectiveness and cost-benefit of the new position on a limited-term basis.
- Allows the BOE to determine the extent and impact of industry reformulations of alcoholic beverage products in response to the new Regulations.

Cons:

- Requires a General Fund budget augmentation to provide resources effective July 1, 2009.
- This proposal provides budget year resources beginning July 1, 2009, to implement these Regulations, for the period July 1, 2008, through June 30, 2009, 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 resources as other program work is backlogging including audit activity that represents a cost of \$350 per audit hour reallocated.

Alternative 2 – Approve permanent budget augmentation for 1.0 position and related resources.

This alternative requests permanent funding and authority to establish 1.0 BTS I position and funding for contract laboratory services beginning July 1, 2009, in order to oversee and administer the regulatory mandates of the Regulations adopted by the Board. This alternative would provide staffing resources on a permanent basis to address the on-going workload associated with the new Regulations.

Pros:

- Provides, a permanent position and related resources for the BOE to ensure permanent oversight of the Alcoholic Beverage Tax program's new Regulations.
- Provides permanent funding for laboratory services to annually verify and/or test a sample of alcoholic beverage products to ensure compliance with the new regulations.
- Supports the Alcoholic Beverage Tax Regulations related to distilled spirits.
- 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 \$38,500 in FY 2009-10 and ongoing.

Cons:

- Requires a General Fund budget augmentation to provide resources.
- Resource need may diminish if all manufacturer's successfully rebut the presumption and proven in test results of sampled products.

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 position and implement this request:

FY 2008-09	FY 2009-10
<ul style="list-style-type: none"> • Maintain website product listing and process rebuttal forms. • Develop industry outreach – notices, forms and reporting procedures. • IT development (JAD) • Identify laboratory to verify and/or test a sample of alcoholic beverage products. • Develop product test plan. 	<ul style="list-style-type: none"> • 1.0 Business Taxes Specialist I position effective 7/01/09. • Develop industry/stakeholder outreach. • Develop Inter-agency agreement with product testing laboratory. • Implement product testing plan • Obtain statement of process and formulas from manufacturers. • Process rebuttal presumption forms. • Maintain/update website product listing. • Respond to industry concerns. • On-site verification of Manufacturers’ batch records. • Develop Lessons Learned and Close-out report.

H. Recommendation

Alternative #1 is recommended. Approval of a limited term BTS I position and funding for a contract for laboratory services 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. 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					
	Activity	Time Measure		Ongoing Activities	
		H = Hours M = Minutes	Time Per Occurrence	Occurrences Per Year	Total Hours
Business Taxes Specialist I (Audit)					
	Prepare Laboratory Service Contract or Inter-agency agreement, Implement Product Testing Plan, Prepare Status Reports, Conduct Taxpayer and Industry Outreach, Handle Petition and Appeals, On-site Verification of Manufacturers' Records, and Oversee Administration of New Regulations	H	95	12	1,140
	Maintain Internet List Acknowledge receipt of certification Taxpayer Correspondence Categorize certification	H	55	12	660
	Total Hours per year				1,800
	Position based on 1,800 hours				1.0

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

	PERSONNEL YEARS			CY	BY	BY + 1
	CY	BY	BY + 1			
TOTAL SALARIES AND WAGES <i>_a/</i>		1.0			\$74	
Salary Savings		-.1			-4	
NET TOTAL SALARIES AND WAGES		.9			70	
Staff Benefits <i>_a/</i>					26	
Distributed Administration <i>_b/</i>						
TOTAL PERSONAL SERVICES		.9			\$96	

OPERATING EXPENSE AND EQUIPMENT

General Expense					\$11	
Distributed Administration						
Printing						
Communications					1	
Postage						
Travel--In-State						
Travel--Out-of -State						
Training					1	
Facilities Operations					20	
Consulting & Professional Services: Interdepartmental					120	
Consulting & Professional Services: External						
Department of Technology Services						
Data Processing					1	
Equipment						
Other Items of Expense: (Specify Below)						

_a/ See page 11 of 12 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		\$154	
TOTAL EXPENDITURES (State Operations)		\$250	

Source of Funds

General Fund	(0001)		\$250
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)			\$250

**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		\$5,355	
Health Insurance		8,322	
Retirement		11,898	
Workers' Compensation		29	
Industrial Disability Leave		50	
Non-Industrial Disability Leave		36	
Unemployment Insurance		11	
Other		185	
TOTAL		\$25,886	

Classification	Positions			Salary Range	<i>a/</i>	Amount		
	<u>CY</u>	<u>BY</u>	<u>BY + 1</u>			<u>CY</u>	<u>BY</u>	<u>BY + 1</u>

Property & Special Taxes:								
Excise Taxes Division:								
Business Taxes Specialist I <i>b/</i>		1.0		74,016			74,016	
Blanket Funds:								
Overtime (Various)								
Temporary Help								
TOTAL SALARIES AND WAGES		1.0					\$74,016	

a/ The salary is the mid-step of the salary range for the stated classification.
b/ One-year, limited term position effective 7/1/09 - 6/30/10.

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 and Professional Services: Interdepartmental		\$120	
Total		<u>\$120</u>	
One-Time Costs:			
General Expense		\$11	
Communication		\$1	
Training		\$1	
Facilities		\$20	
Consulting and Professional Services: Interdepartmental		\$120	
Data Processing		\$1	
Total		<u>\$154</u>	
Future Savings:			
N/A			
Total			
Full-Year Cost Adjustments:			
N/A			
Total			