

Rulemaking File Index
Title 18. Public Revenue
Sales and Use Tax
Regulation 2558.1, *Wine*

OAL Approval

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**State of California
Office of Administrative Law**

In re:
Board of Equalization

**NOTICE OF APPROVAL OF REGULATORY
ACTION**

Regulatory Action:

Government Code Section 11349.3

Title 18, California Code of Regulations

OAL File No. 2011-0615-01 S

Adopt sections: 2558.1

Amend sections:

Repeal sections:

The Board of Equalization submitted this rulemaking action to clarify the statutory definition of wine under Business and Professions Code section 23007 for purposes of delineating wine-based alcoholic beverages that are subject to the excise tax for wine and wine-based alcoholic beverages that are subject to the excise tax for distilled spirits under California's Alcoholic Beverage Tax Law.

OAL approves this regulatory action pursuant to section 11349.3 of the Government Code. This regulatory action becomes effective on 8/7/2011.

Date: 7/8/2011

RECEIVED

JUL 11 2011

Board Proceedings

Richard L. Smith

Richard L. Smith
Staff Counsel

For: DEBRA M. CORNEZ
Assistant Chief Counsel/
Acting Director

Original: Kristine Cazadd
Copy: Richard Bennion

OFFICE OF ADMINISTRATIVE LAW

300 Capitol Mall, Suite 1250
Sacramento, CA 95814
(916) 323-6225 FAX (916) 323-6826



DEBRA M. CORNEZ
Assistant Chief Counsel/Acting Director

MEMORANDUM

TO: Richard Bennion
FROM: OAL Front Desk
DATE: 7/11/2011
RE: Return of Approved Rulemaking Materials
OAL File No. 2011-0615-01S

OAL hereby returns this file your agency submitted for our review (OAL File No. 2011-0615-01S regarding Wine).

If this is an approved file, it contains a copy of the regulation(s) stamped "ENDORSED APPROVED" by the Office of Administrative Law and "ENDORSED FILED" by the Secretary of State. The effective date of an approved file is specified on the Form 400 (see item B.5). (Please Note: The 30th Day after filing with the Secretary of State is calculated from the date the Form 400 was stamped "ENDORSED FILED" by the Secretary of State.)

DO NOT DISCARD OR DESTROY THIS FILE

Due to its legal significance, you are required by law to preserve this rulemaking record. Government Code section 11347.3(d) requires that this record be available to the public and to the courts for possible later review. Government Code section 11347.3(e) further provides that "...no item contained in the file shall be removed, altered, or destroyed or otherwise disposed of." See also the Records Management Act (Government Code section 14740 et seq.) and the State Administrative Manual (SAM) section 1600 et seq.) regarding retention of your records.

If you decide not to keep the rulemaking records at your agency/office or at the State Records Center, you may transmit it to the State Archives with instructions that the Secretary of State shall not remove, alter, or destroy or otherwise dispose of any item contained in the file. See Government Code section 11347.3(f).

Enclosures

REGULAR

See instructions on reverse

For use by Secretary of State only

STD. 400 (REV. 01-09)

OAL FILE NUMBERS	NOTICE FILE NUMBER Z-2011-0310-02	REGULATORY ACTION NUMBER 2011-0615-015	EMERGENCY NUMBER
For use by Office of Administrative Law (OAL) only			
NOTICE		REGULATIONS	

ENDORSED FILED
NOTICE OFFICE

2011 JUL -8 PM 3:1

Diane G. Olson
DIANE G. OLSON
SECRETARY OF STATE

AGENCY WITH RULEMAKING AUTHORITY
State Board of Equalization

AGENCY FILE NUMBER (if any)

A. PUBLICATION OF NOTICE (Complete for publication in Notice Register)

1. SUBJECT OF NOTICE		TITLE(S)	FIRST SECTION AFFECTED	2. REQUESTED PUBLICATION DATE
3. NOTICE TYPE <input type="checkbox"/> Notice re Proposed Regulatory Action <input type="checkbox"/> Other		4. AGENCY CONTACT PERSON	TELEPHONE NUMBER	FAX NUMBER (Optional)
OAL USE ONLY	ACTION ON PROPOSED NOTICE <input type="checkbox"/> Approved as Submitted <input type="checkbox"/> Approved as Modified <input type="checkbox"/> Disapproved/Withdrawn		NOTICE REGISTER NUMBER 2011#12-2	PUBLICATION DATE 3-25-2011

B. SUBMISSION OF REGULATIONS (Complete when submitting regulations)

1a. SUBJECT OF REGULATION(S) Wine	1b. ALL PREVIOUS RELATED OAL REGULATORY ACTION NUMBER(S)
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2. SPECIFY CALIFORNIA CODE OF REGULATIONS TITLE(S) AND SECTION(S) (Including title 26, if toxics related)	
SECTION(S) AFFECTED (List all section number(s) individually. Attach additional sheet if needed.)	ADOPT 2558.1
	AMEND
TITLE(S) 18	REPEAL

3. TYPE OF FILING			
<input checked="" type="checkbox"/> Regular Rulemaking (Gov. Code §11346)	<input type="checkbox"/> Certificate of Compliance: The agency officer named below certifies that this agency complied with the provisions of Gov. Code §511346.2-11347.3 either before the emergency regulation was adopted or within the time period required by statute.	<input type="checkbox"/> Emergency Readopt (Gov. Code, §11346.1(h))	<input type="checkbox"/> Changes Without Regulatory Effect (Cal. Code Regs., title 1, §100)
<input type="checkbox"/> Resubmittal of disapproved or withdrawn nonemergency filing (Gov. Code §511349.3, 11349.4)	<input type="checkbox"/> Resubmittal of disapproved or withdrawn emergency filing (Gov. Code, §11346.1)	<input type="checkbox"/> File & Print	<input type="checkbox"/> Print Only
<input type="checkbox"/> Emergency (Gov. Code, §11346.1(b))		<input type="checkbox"/> Other (Specify) _____	

4. ALL BEGINNING AND ENDING DATES OF AVAILABILITY OF MODIFIED REGULATIONS AND/OR MATERIAL ADDED TO THE RULEMAKING FILE (Cal. Code Regs. title 1, §44 and Gov. Code §11347.1)

5. EFFECTIVE DATE OF CHANGES (Gov. Code, §§ 11343.4, 11346.1(d); Cal. Code Regs., title 1, §100)			
<input checked="" type="checkbox"/> Effective 30th day after filing with Secretary of State	<input type="checkbox"/> Effective on filing with Secretary of State	<input type="checkbox"/> §100 Changes Without Regulatory Effect	<input type="checkbox"/> Effective other (Specify) _____

6. CHECK IF THESE REGULATIONS REQUIRE NOTICE TO, OR REVIEW, CONSULTATION, APPROVAL OR CONCURRENCE BY, ANOTHER AGENCY OR ENTITY			
<input type="checkbox"/> Department of Finance (Form STD. 399) (SAM §6660)	<input type="checkbox"/> Fair Political Practices Commission	<input type="checkbox"/> State Fire Marshal	
<input type="checkbox"/> Other (Specify) _____			

7. CONTACT PERSON Rick Bennion	TELEPHONE NUMBER (916) 445-2130	FAX NUMBER (Optional) (916) 324-3984	E-MAIL ADDRESS (Optional) rbennion@boe.ca.gov
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8. I certify that the attached copy of the regulation(s) is a true and correct copy of the regulation(s) identified on this form, that the information specified on this form is true and correct, and that I am the head of the agency taking this action, or a designee of the head of the agency, and am authorized to make this certification.

SIGNATURE OF AGENCY HEAD OR DESIGNEE <i>Diane G. Olson</i>	DATE June 13, 2011
TYPED NAME AND TITLE OF SIGNATORY Diane G. Olson, Chief, Board Proceedings Division	

For use by Office of Administrative Law (OAL) only

ENDORSED APPROVED

JUN 03 2011

Office of Administrative Law

Final Text of
California Code of Regulations, Title 18,

Section 2558.1. Wine.

(a) Effective January 1, 2012, wine as defined by Business and Professions Code section 23007 does not include any alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made.

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

Note: Authority cited: California Constitution, Article XX, Section 22; and Section 32451, Revenue and Taxation Code. Reference: Section 23007, Business and Professions Code; and Sections 32002, 32152, Revenue and Taxation Code.

Memorandum

To : Rick Smith
Office of Administrative Law
300 Capitol Mall, Suite 1250
Sacramento, CA 95814

Date: July 7, 2011

From : Richard Bennion
Regulations Coordinator
Board Proceedings Division, MIC: 80

Subject : *OAL File No. 2011-0615-01S*
Regulation 2558.1, *Wine*

2011 JUL -7 P 2:52
OFFICE OF
ADMINISTRATIVE LAW

The Office of Administrative Law (OAL) is authorized to make the following substitutions and corrections in connection with the above-referenced rulemaking file:

1. OAL is authorized to Insert tab 14 at the end of the rule making file, and move the items from tab 3 to 13 back one tab. Move items from tab 13 to tab 14, items from tab 12 to tab 13 and so forth.
2. OAL is authorized to insert the attached documents Informal Issue Paper, November 2, 2010, and Reporter's Transcript, November 16, 2010 to tab 3.
3. OAL is authorized to substitute the enclosed revised Rulemaking File Index and Verification at the beginning of the rulemaking file.

If you have any questions or comments, please notify me at (916) 445-2130 or email at Richard.Bennion@boe.ca.gov.

REB

Manual. As a courtesy, copies of Gold Book Revisions will be provided to you.

DECISION REGARDING PETITION FOR
SECOND REQUEST TO PROMULGATE A
REGULATION DEFINING "NAVIGABLE RIVER"
AS USED IN CAL. STS. & HYS. § 84.5

This letter is also to inform you of Caltrans' formal response to your second request under section 11340.7 of the California Government Code.

Pursuant to section 11340.7 of the California Government Code, Caltrans declines to "adopt a regulation interpreting the term "navigable river" as it appears in section 84.5 of the Streets and Highways Code, as follows:

"Navigable river," as used in Streets and Highways Code section 84.5, means:

- a. A waters or stream of sufficient capacity to transport the products of the country; and,
- b. Waters and streams declared navigable in sections 101, 102, 103, 104, 105, 106 of the Streets and Highways Code; and,
- c. A waterway of sufficient capacity for pleasure boating."

The substantive reasons for denying your petition are:

As you note on page 6 of your letter dated June 4, 2011, "[t]he plain meaning of section 84.5 is clear." As such, it requires no clarification. This fact is further underscored by the fact that Caltrans received an opinion from the California Attorney General's office on June 13, 2011 which provides an unambiguous definition of a "navigable river" drawn from *People ex rel. Baker v. Mack* (1971) 19 Cal.App.3d. 1040, 1050. Caltrans cannot displace a definition provided by the Attorney General, particularly given that it is taken verbatim from an appellate court decision. Caltrans will instead ensure that that definition is included in the guidance provided to its districts, its personnel, and any interested member of the public.

Caltrans is additionally concerned that the regulatory language you proposed (twice) refers to sections 101-106 of the California Streets and Highways Code in contrast to the body of your June 4, 2011 letter which refers to sections 101-106 of the California Harbors and Navigation Code. Since sections 101 and 106 of the former code refer specifically to bridges, Caltrans is reluctant to proceed absent clarification from you.

A copy of this correspondence will be transmitted to the Office of Administrative Law for publication in the California Regulatory Notice Register at the earliest practicable date. It will identify you as the requesting party (your personal identifying information will be re-

dacted) and Caltrans as the responding agency. Copies of the petition and ensuing documentation will be made available upon request.

If you have any additional questions, comments, or concerns, please contact Matthew B. George at (916) 654-2630.

Sincerely,

/s/

RICHARD D. LAND
Acting Chief Deputy Director

Enclosure

c: Office of Administrative Law

**AVAILABILITY OF INDEX OF
PRECEDENTIAL DECISIONS**

EDUCATION AUDIT APPEALS PANEL

Notice of Availability of Precedential Decision Index
(Government Code Section 11425.60)

Notice is hereby given that the Education Audit Appeals Panel (EAAP) maintains an index of the determinations made in the decisions EAAP has designated as precedential. The index is available on the Internet at <http://www.eaap.ca.gov>, following the text of the "Appeals" section.

**SUMMARY OF REGULATORY
ACTIONS**

**REGULATIONS FILED WITH
SECRETARY OF STATE**

This Summary of Regulatory Actions lists regulations filed with the Secretary of State on the dates indicated. Copies of the regulations may be obtained by contacting the agency or from the Secretary of State, Archives, 1020 O Street, Sacramento, CA 95814, (916) 653-7715. Please have the agency name and the date filed (see below) when making a request.

File# 2011-0615-01
BOARD OF EQUALIZATION
Wine

The Board of Equalization submitted this rulemaking action to clarify the statutory definition of wine under

CALIFORNIA REGULATORY NOTICE REGISTER 2011, VOLUME NO. 29-Z

Business and Professions Code section 23007 for purposes of delineating wine-based alcoholic beverages that are subject to the excise tax for wine and wine-based alcoholic beverages that are subject to the excise tax for distilled spirits under California's Alcoholic Beverage Tax Law.

Title 18
California Code of Regulations
ADOPT: 2558.1
Filed 07/08/2011
Effective 08/07/2011
Agency Contact:
Richard E. Bennion (916) 445-2130

File# 2011-0613-01
BOARD OF PILOT COMMISSIONERS
Incident Review Process

This regulatory action amends the incident review process to transfer authority from the Incident Review Committee to the Board for final decisions and any corrective action for navigational incidents involving a pilot or inland pilot. These amendments are made to conform the existing regulations to statutory changes made by SB 1627 (Wiggins) which became effective on January 1, 2009.

Title 10
California Code of Regulations
AMEND: 210, 221
Filed 07/13/2011
Effective 08/12/2011
Agency Contact: Terri Toohey (916) 768-5638

File# 2011-0613-03
CALIFORNIA HIGHWAY PATROL
Pupil Activity Buses

This regulatory action revises several sections in Title 13 of the California Code of Regulations and adopts one new section. The purpose of this rulemaking is to establish periodic safety inspections as well as the fees required for the inspections of Pupil Activity Buses. Pupil Activity Buses are a new classification established by Assembly Bill 830, Chapter 649, Statutes of 2008. This statute exempts motor vehicles designed to carry not more than 25 persons including the driver, from the definition of school bus when operated by a charter-party carrier of passengers; transporting school pupils to or from school related activities. These amendments/adoptions also adopt by reference the definition of "Motor Vehicle Chassis" as defined in the 1972 edition of SAE Standard J687c.

Title 13
California Code of Regulations
ADOPT: 1231.2 AMEND: 1200, 1201, 1217, 1221, 1222, 1232
Filed 07/06/2011
Effective 08/05/2011
Agency Contact: Lee Bretney (916) 843-3400

File# 2011-0531-03
CALIFORNIA HORSE RACING BOARD
Coupling of Horses

This rulemaking action eliminates the requirement of coupling of horses in a horse race when the horses are owned in whole or part by the same person or entity. In place of the horse coupling requirement, the rulemaking adds a requirement of disclosure of multiple horse ownership or common trainer in racing materials and over the public address system. The rulemaking also specifies procedures to be followed when a horse is removed from the wagering pool for parimutuel wagering purposes after wagering has begun.

Title 4
California Code of Regulations
AMEND: 1606, 1954.1, 1957, 1959, 1974, 1976, 1976.8, 1976.9, 1977, 1978, 1979, 1979.1
Filed 07/12/2011
Effective 08/11/2011
Agency Contact: Harold Coburn (916) 263-6397

File# 2011-0628-01
DEPARTMENT OF CORPORATIONS
Private Fund Adviser Exemption

This emergency rulemaking action extends for 180 days the effectiveness of the expiring federal-law Securities and Exchange Commission registration exemption for investment advisers who rely upon and meet the criteria of that expiring federal exemption.

Title 10
California Code of Regulations
AMEND: 260.204.9
Filed 07/07/2011
Effective 07/21/2011
Agency Contact: Karen Fong (916) 322-3553

File# 2011-0617-01
DEPARTMENT OF CORRECTIONS AND
REHABILITATION
Recall of Commitment

This emergency regulatory action concerns the recall of commitment and was submitted to OAL by the California Department of Corrections and Rehabilitation (CDCR) pursuant to Penal Code section 5058.3 as operationally necessary. This action adopts and amends provisions governing the recall of commitment for eli-

Rulemaking File Index
Title 18. Public Revenue
Special Tax
Regulation 2558.1, *Wine*

1. *Final Statement of Reasons*
2. *Updated Informative Digest*
3. *Business Tax Committee , November 16, 2010*
 - Informal Issue Paper, November 2, 2010
 - Reporter's Transcript, November 16, 2010
4. *Business Tax Committee Minutes, February 23, 2011*
 - Minutes
 - BTC Agenda
 - Formal Issue Paper Number 11-001
 - Regulation History
5. *Reporter's Transcript Business Taxes Committee, February 23, 2011*
6. *Estimate of Cost or Savings, March 22, 2011*
7. *Economic and Fiscal Impact Statements, March 9, 2011*
8. *Notice of Publications*
 - Form 400 and notice, Publication Date March 25, 2011
 - Proposed Text of Regulation 2558.1
 - Email sent to Interested Parties, March 25, 2011
 - CA Regulatory Notice Register 2011, Volume No. 12-Z
9. *Notice to Interested Parties, March 25, 2011*

The following items are exhibited:

 - Notice of Hearing
 - Initial Statement of Reasons
 - Proposed Text of Regulation 2558.1
 - Regulation History
10. *Statement of Compliance*
11. *Letter of Support, May 23, 2011, Richard S. Grey, Vice President, E & J Gallo Winery*
12. *Letter of Opposition, May 25, 2011, Paul Kronenberg, President, Family Winemakers of California*
13. *Reporter's Transcript, Item F3, May 25, 2011*

14. *Minutes, May 25, 2011, and Exhibits*

The following items are exhibited:

- Notice of Proposed Regulatory Action
- Initial Statement of Reasons
- Proposed Text of Regulations 2558.1
- Regulation History

VERIFICATION

I, Richard E. Bennion, Regulations Coordinator of the State Board of Equalization, state that the rulemaking file of which the contents as listed in the index is complete, and that the record was initially closed on June 13, 2011. The file was reopened on July 7, 2011 for changes without regulatory effect and document revision requested by OAL and the file was closed on July 7, 2011. The attached copy is complete.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

July 7, 2011

A handwritten signature in black ink, appearing to read "Richard E. Bennion", written over a horizontal line.

Richard E. Bennion
Regulations Coordinator
State Board of Equalization

**Final Statement of Reasons for
Adoption of California Code of Regulations,
Title 18, Section 2558.1, Wine**

Update of Information in the Initial Statement of Reasons

On May 25, 2011, the State Board of Equalization (Board) held a public hearing regarding the proposed adoption of California Code of Regulations, title 18, section (Regulation) 2558.1, *Wine*. The Board received written comments from Richard S. Grey, Vice President – General Counsel for E. & J. Gallo Winery, and Mr. Paul Kronenberg, President of the Family Winemakers of California (FWC), prior to the close of the written comment period, and Mr. Kronenberg also made oral comments during the public hearing. At the conclusion of the public hearing, the Board voted to adopt the proposed regulation pursuant to the authority vested in it by article XX, section 22 of the California Constitution and Revenue and Taxation Code (RTC) section 32451, without making any changes. The proposed regulation clarifies that for purposes of the Alcoholic Beverage Tax Law (RTC § 32001 et seq.) the term “wine,” as defined by Business and Professions Code (BPC) section 23007, does not include any alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made and establishes January 1, 2012, as the prospective date for compliance with the clarified definition of wine. The Board considered Mr. Grey’s and Mr. Kronenberg’s comments prior to the adoption of proposed Regulation 2558.1 and their comments are summarized and responded to below.

The factual basis, specific purposes, and necessity for the adoption of proposed Regulation 2558.1 are the same as provided in the Initial Statement of Reasons.

The Board did not rely on any data or any technical, theoretical, or empirical study, report, or similar document in proposing or adopting proposed Regulation 2558.1 that was not identified in the Initial Statement of Reasons, or which was otherwise not identified or made available for public review prior to the close of the public comment period.

The Board did consider two alternatives to the text of proposed Regulation 2558.1 during its February 23, 2011, meeting. By its motion on February 23, 2011, proposing the adoption of Regulation 2558.1 and its motion on May 25, 2011, adopting the proposed regulation, the Board determined that no alternative to the text of proposed Regulation 2558.1 would be more effective in carrying out the purposes for which the regulation is proposed or would be as effective and less burdensome to affected private persons than the adopted regulation or would lessen the adverse economic impact on small businesses. The two alternatives and the Board’s reasons for rejecting the alternatives are summarized below and in the Initial Statement of Reasons.

Furthermore, the Board has determined that the adoption of proposed Regulation 2558.1 will not have a significant adverse economic impact on business.

No Mandate on Local Agencies or School Districts

The Board has determined that the adoption of proposed Regulation 2558.1 does not impose a mandate on local agencies or school districts.

Response to Public Comments

Prior to the public hearing, Mr. Grey submitted a letter dated May 23, 2011, expressing E. & J. Gallo Winery's support for the adoption of proposed Regulation 2558.1 and stating E. & J. Gallo Winery's opinion that it is "important" for the Board to clarify the definition of "wine" for California tax purposes and that proposed Regulation 2558.1 "is straightforward and should be easy to enforce." Mr. Kronenberg appeared at the public hearing, made oral comments opposing the adoption of the regulation at this time, and submitted a letter dated May 25, 2011, containing similar comments. Mr. Kronenberg's comments expressed the FWC's opinions that:

- The Board lacks "the authority to regulate in this area";
- The Office of Administrative Law's approval of the Board's adoption of the distilled spirits regulations (discussed in the Initial Statement of Reasons) is "not, in FWC's view, determinative" of the Board's authority to adopt proposed Regulation 2558.1;
- The Board should postpone the adoption of proposed Regulation 2558.1 until there is a final decision in *Diageo-Guinness USA, Inc., v. State Board of Equalization* (Sacramento Superior Court Case No. 34-2008-00013031-CU-JR-GDS; and Court of Appeal, Third Appellate District Case No. C061227);¹ and
- The FWC "doesn't believe there is any urgency in adopting the clarification" set forth in proposed Regulation 2558.1.

The Board considered Mr. Grey's and Mr. Kronenberg's comments. The Board determined that it is necessary to adopt proposed Regulation 2558.1 to clarify the classification of wine-based alcoholic beverages containing more than a de minimis amount of alcohol obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made in order to address the wine growers' and importers' confusion regarding the definition of "wine" for California tax purposes described in the Initial Statement of Reasons.

The Board determined that it is necessary to adopt proposed Regulation 2558.1 now in order "to permit wine growers and importers who had been relying on federal law and/or the Department of Alcoholic Beverage Control's (ABC's) classification of their wine-

¹ Diageo-Guinness USA, Inc., is currently appealing the Superior Court's judgment, which concluded that the Board had the authority to adopt the distilled spirits regulations. The appeal has been briefed, but the Third Appellate District has not set a date for oral argument yet.

based alcoholic beverages for California tax purposes time, without being penalized due to any prior confusion in the industry, to determine whether their wine-based alcoholic beverages are wine or distilled spirits under the Board's regulations, reformulate any of their wine-based alcoholic beverages so that they can continue to qualify as wine for California tax purposes, if necessary and desired, and begin to report and pay the applicable wine or distilled spirits excise tax on their wine-based alcoholic beverages" by the proposed regulation's January 1, 2012, effective date, as explained in the Initial Statement of Reasons.

The Board also determined that it has authority to adopt proposed Regulation 2558.1 based upon the opinion of its Legal Department, as stated during the public hearing, that article XX, section 22 of the California Constitution grants the Board the exclusive jurisdiction to "assess and collect such excise taxes as are or may be imposed by the Legislature on account of the manufacture, importation and sale of alcoholic beverages in this State" and Revenue and Taxation Code section 32451 expressly authorizes the Board to "prescribe, adopt, and enforce rules and regulations relating to the administration and enforcement of" the Alcoholic Beverage Tax Law, including proposed Regulation 2558.1.

Alternatives Considered

The Board did consider two alternatives before it decided to propose the adoption of Regulation 2558.1 during its February 23, 2011, meeting. One alternative would have clarified that water is not a flavoring, coloring, or blending material for purposes of BPC section 23007. The other alternative would have defined the term "wine base" and clarified that water is a blending material when added to a wine base. However, the Board did not agree with either alternative because there is still general disagreement in the wine industry as to whether water should be classified as a blending material and the Board has determined that it is not necessary to determine whether water is or is not a blending material in order to determine whether a wine-based alcoholic beverage is or is not a distilled spirit for tax purposes.

No Federal Mandate

The adoption of proposed Regulation 2558.1 was not mandated by federal statutes or regulations and there is no federal regulation that is identical to proposed Regulation 2558.1.

**Updated Informative Digest for
Adoption of California Code of Regulations,
Title 18, Section 2558.1, Wine**

On May 25, 2011, the State Board of Equalization (Board) held a public hearing regarding the proposed adoption of California Code of Regulations, title 18, section (Regulation) 2558.1, *Wine*. The Board received written comments from Richard S. Grey, Vice President – General Counsel for E. & J. Gallo Winery, and Mr. Paul Kronenberg, President of the Family Winemakers of California (FWC), prior to the close of the written comment period, and Mr. Kronenberg also made oral comments during the public hearing. At the conclusion of the public hearing, the Board voted to adopt the proposed regulation pursuant to the authority vested in it by article XX, section 22 of the California Constitution and Revenue and Taxation Code (RTC) section 32451, without making any changes. The proposed regulation clarifies that for purposes of the Alcoholic Beverage Tax Law (RTC § 32001 et seq.) the term “wine,” as defined by Business and Professions Code (BPC) section 23007, does not include any alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made and establishes January 1, 2012, as the prospective date for compliance with the clarified definition of wine. The Board considered Mr. Grey’s and Mr. Kronenberg’s comments prior to the adoption of proposed Regulation 2558.1 and their comments are summarized and responded to below and in the Final Statement of Reasons.

There have not been any changes to the applicable laws or the general effect of the adoption of proposed Regulation 2558.1 described in the Informative Digest included in the Notice of Proposed Regulatory Action.

Informative Digest Included in the Notice of Proposed Regulatory Action

The Informative Digest included in the Notice of Proposed Regulatory Action provides that:

“Current Law

“Article XX, section 22 of the California Constitution authorizes and requires the Board to assess and collect all excise taxes that are or may be imposed on the manufacture, importation, and sale of alcoholic beverages. RTC section 32451 expressly authorizes the Board to administer the Alcoholic Beverage Tax Law and adopt regulations relating to its administration and enforcement. And RTC section 32152 authorizes the Board to adopt regulations to coordinate California’s and the federal government’s systems for taxing beer and wine, so far as permitted by the express provisions of the Alcoholic Beverage Tax Law.

“The Alcoholic Beverage Tax Law imposes different excise taxes on distilled spirits, beer, and wine, and the rates of the excise tax on distilled spirits are substantially higher than the rates of the excise tax imposed on beer and wine. (See RTC §§ 32151 (beer and wine) and 32201 (distilled spirits).) Still wines are taxed at a rate of one or two cents per gallon, beer is taxed at a rate of \$1.24 per 31 gallon barrel (or approximately 4.5 cents per gallon), and liquid distilled spirits are taxed at a rate of \$2 or \$4 per gallon.

“RTC section 32002 provides that the definitions contained in chapter 1 (sections 23001-23047) of division 9 of the BPC apply to the terms used in the Alcoholic Beverage Tax Law. This includes the definitions in BPC sections 23005, 23006, and 23007, which define “distilled spirits,” “beer,” and “wine,” respectively, and provide that:

23005. "Distilled spirits" means an alcoholic beverage obtained by the distillation of fermented agricultural products, and includes alcohol for beverage use, spirits of wine, whiskey, rum, brandy, and gin, including all dilutions and mixtures thereof.

23006. "Beer" means any alcoholic beverage obtained by the fermentation of any infusion or decoction of barley, malt, hops, or any other similar product, or any combination thereof in water, and includes ale, porter, brown, stout, lager beer, small beer, and strong beer but does not include sake, known as Japanese rice wine.

23007. "Wine" means the product obtained from normal alcoholic fermentation of the juice of sound ripe grapes or other agricultural products containing natural or added sugar or any such alcoholic beverage to which is added grape brandy, fruit brandy, or spirits of wine, which is distilled from the particular agricultural product or products of which the wine is made and other rectified wine products and by whatever name and which does not contain more than 15 percent added flavoring, coloring, and blending material and which contains not more than 24 percent of alcohol by volume, and includes vermouth and sake, known as Japanese rice wine.

“Therefore, the Board must determine whether an alcoholic beverage is a distilled spirit, beer, or wine in order to determine which excise tax and which excise tax rate applies to that beverage under the Alcoholic Beverage Tax Law.

“In late 2006, the Board received information that there were alcoholic beverages being sold as beer in California because they were made from the fermentation of malt or similar products, but which might also contain alcohol derived from the distillation of fermented agricultural products. This was because the federal government adopted alcoholic beverage regulations allowing “flavored malt beverages” to be labeled, advertised, and taxed like beer for federal purposes, and also allowing flavored malt beverages to contain specified amounts of alcohol from the distillation of fermented agricultural products. (See 27 C.F.R. §§ 7.1-7.81, 25.15.)

“The Board determined that the definition for “beer” set forth in BPC section 23006 did not allow beer to contain alcohol from the distillation of fermented agricultural products. The Board also determined that beverages containing alcohol from the distillation of fermented agricultural products had to be classified as either distilled spirits or wine because the definitions for distilled spirits and wine in BPC sections 23005 and 23007 do allow those beverages to contain alcohol from the distillation of fermented agricultural products.

“Based upon these determinations, the Board concluded that flavored malt beverages that are derived from the fermentation of malt or similar products and only contain a de minimis amount of alcohol from flavorings that are derived from the distillation of fermented agricultural products could consistently be classified as beer for federal and California purposes. However, the Board also concluded that flavored malt beverages containing more than a de minimis amount of alcohol from the distillation of fermented agricultural products had to be classified as a distilled spirits for California tax purposes because the beverages were “obtained from the distillation of fermented agricultural products” as provided in BPC section 23005 and were clearly not wine. Therefore, the Board adopted Regulations 2558 through 2559.5 to prospectively clarify that alcoholic beverages are classified as distilled spirits under BPC section 23005 if they contain “0.5 percent or more alcohol by volume derived from flavors or other ingredients containing alcohol obtained from the distillation of fermented agricultural products” (Regulation 2558), regardless of the alcoholic beverages’ classification for federal purposes, and create a rebuttable presumption that all alcoholic beverages are distilled spirits for California tax purposes, effective October 1, 2008. (Regulations 2559-2559.5.) However, the distilled spirits regulations (Regulations 2558-2559.5) did not apply to wine, as defined in BPC section 23007, which may contain alcohol that is distilled from the particular agricultural product or products of which the wine is made.

“Proposed Regulation

“Part 24.10 of title 27 of the Code of Federal Regulations provides the general definition of wine for federal purposes and provides that: “When used without qualification, the term [wine] includes every kind (class and type) of product produced on bonded wine premises from grapes, other fruit (including berries), or other suitable agricultural products and containing not more than 24 percent alcohol by volume. The term includes all imitation, other than standard, or artificial wine and compounds sold as wine. A wine product containing less than one-half of one percent alcohol by volume is not taxable as wine when removed from the bonded wine premises.”

“While Board staff was working with the manufacturers and brewers of flavored malt beverages to implement the distilled spirits regulations, staff was also in communication with wine growers and importers regarding wine-based products that are classified as wine for federal purposes, but may not meet the BPC section 23007 definition for wine. This is because BPC section 23007 expressly allows alcoholic beverages to be classified as wine if they include grape brandy, fruit brandy, or spirits of wine, which is distilled

from the particular agricultural product or products of which the wine is made, but does not expressly allow alcoholic beverages to be classified as wine if they include alcohol derived from the distillation of other fermented agricultural products; and BPC section 23007 limits the amount of flavoring, coloring, and blending materials that can be added to wine. However, federal law allows alcoholic beverages to be classified as wine regardless of the source of their alcohol and federal law does not limit the amount of flavoring, coloring, and blending materials that can be added to wine.

“As a result, Board staff issued two Special Notices to the wine industry, which both clarified that the distilled spirits regulations apply to all alcoholic beverages that do not meet the BPC section 23007 definition for wine. The first notice was dated December 2008, entitled *Special Notice to Wine Growers and Importers*, and mailed to wine grower and wine importer registrants. The notice advised producers and importers of wine-based alcoholic beverages that might not meet the statutory definition for wine, but which do not contain 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products to consider rebutting the presumption in Regulation 2559 by filing form BOE 505, *Alcoholic Beverage Tax Report for Rebutting Regulation 2559 Presumption*. Summaries of the distilled spirits regulations were included with this notice.

“The second notice was dated December 2009, entitled *Alcoholic Beverages Taxed as Wine for Federal Purposes, May Not Meet California’s Definition of Wine and Therefore May be Subject to Tax as Distilled Spirits for California Tax Purposes*, and was mailed to all of the Board’s alcoholic beverage program accounts. The second notice advised that certain types of alcoholic beverages that may qualify as wine for federal classification purposes, namely wine specialties, flavored table wine, wine cocktails, wine coolers or other wine-based products or blends of wine from different fruits, may not meet California’s definition of wine under BPC section 23007 and, therefore, may be considered distilled spirits and be taxed accordingly for California purposes. The notice also advised each manufacturer, grower, or importer to review California’s wine definition, and if their product(s) did not meet California’s definition of wine, to file form BOE-505, if appropriate, to rebut the distilled spirits presumption.

“However, based on field visits to major producers of wine-based alcoholic beverages in 2010, staff became aware that significant differences of opinion and confusion still existed as to the proper classification of nonstandard, wine-based products after the 2008 and 2009 notices were issued. Specifically, disagreement existed in the wine industry as to whether water constituted a blending material subject to BPC section 23007’s limitation on blending materials. And confusion existed in the wine industry as to the rules governing, and the tax consequences of, introducing distilled alcohol to wine-based products. Therefore, Board staff prepared an Informal Issue Paper dated November 2, 2010, and submitted it to the Board Members for consideration at the Board’s November 16, 2010, meeting.

“The Informal Issue Paper summarized the information provided above, requested the Board’s authorization for staff to initiate an interested parties process to discuss the two

issues affecting the classification of wine more thoroughly, and included the following exhibits:

1. Regulations 2558 through 2559.5;
2. Formal Issue Paper 07-007 dated August 3, 2007, regarding the classification of flavored malt beverages and recommending that the Board begin the formal rulemaking process to adopt Regulations 2558 through 2559.5, which was submitted to the Board Members for consideration at the Board's August 14, 2007, meeting;
3. The minutes from the Board's August 14, 2007, meeting showing that the Board authorized staff to begin the formal rulemaking process to adopt Regulations 2558 through 2559.5;
4. The December 2008 Special Notice (discussed above);
5. The December 2009 Special Notice (discussed above); and
6. An initial draft of Regulation 2558.1, *Wine*, that staff wanted to discuss with interested parties because it raised various issues with regard to the classification of wine-based products.

“As relevant here, the initial draft of Regulation 2558.1 included as exhibit 6 to the Informal Issue Paper indicated that wine-based alcoholic beverages that only contain a de minimis amount of alcohol from flavorings, colorings, or blending materials that are derived from the distillation of fermented agricultural products other than the particular agricultural product or products of which the wine is made could consistently be classified as wine for federal and California purposes. However, wine-based alcoholic beverages containing more than a de minimis amount of alcohol (0.5% or more by volume) from the distillation of fermented agricultural products other than the particular agricultural product or products of which the wine is made had to be classified as distilled spirits for California tax purposes because the beverages were “obtained from the distillation of fermented agricultural products” as provided in BPC section 23005 and were clearly not wine within the meaning of BPC section 23007.

“On November 16, 2010, the Board authorized staff to conduct an interested parties meeting to discuss the draft of Regulation 2558.1 included as exhibit 6 to the Informal Issue Paper. During the interested parties process, including the interested parties meeting on December 17, 2010, Board staff learned that there was considerable disagreement in the wine industry regarding whether water should be treated as a blending material. Staff determined that the addition of any amount of water to a wine-based alcoholic beverage would not make that beverage into a distilled spirit within the meaning of BPC section 23005, assuming that the wine-based alcoholic beverage did not contain alcohol from the distillation of fermented agricultural products other than the particular agricultural product or products of which the wine is made. And staff found that there appeared to be a general acceptance among the interested parties that, notwithstanding any objections they have, in general, to the existence of the distilled spirits regulations themselves, a wine-based alcoholic beverage containing distilled alcohol from a foreign source of 0.5 percent or more by volume would not be considered

a wine under BPC section 23007 and would be classified as a distilled spirit under BPC section 23005 and Regulations 2558 through 2559.5 for tax purposes.

“Following the interested parties meeting, Board staff prepared Formal Issue Paper 11-001 dated February 4, 2011, and submitted it to the Board Members for consideration at the Board’s February 23, 2011, meeting. The Formal Issue Paper recommended that the Board authorize staff to begin the formal rulemaking process to adopt alternative 1 for Regulation 2558.1, which provided as follows:

- (a) Effective January 1, 2012, wine as defined by Business and Professions Code section 23007 does not include any alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made.
- (b) Except as provided in subdivision (a), wine-based products authorized for sale as wine by the Department of Alcoholic Beverage Control are deemed to be wine as defined by Business and Professions Code section 23007 for purposes of the Alcoholic Beverage Tax Law.

“The proposed language of alternative 1 focused solely on the addition of alcohol derived from the distillation of agricultural products to wine-based alcoholic beverages and expressly clarified that wine does not include any wine-based alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made so that these types of wine-based alcoholic beverages will clearly be classified as distilled spirits under Regulation 2558. The proposed language included a January 1, 2012, effective date to permit wine growers and importers who had been relying on federal law and/or the Department of Alcoholic Beverage Control’s (ABC’s) classification of their wine-based alcoholic beverages for California tax purposes time, without being penalized due to any prior confusion in the industry, to determine whether their wine-based alcoholic beverages are wine or distilled spirits under the Board’s regulations, reformulate any of their wine-based alcoholic beverages so that they can continue to qualify as wine for California tax purposes, if necessary and desired, and begin to report and pay the applicable wine or distilled spirits excise tax on their wine-based alcoholic beverages.

“The Formal Issue Paper also included two other alternative proposals for Regulation 2558.1, which were both based upon the draft of Regulations 2558.1 included as exhibit 6 to the Informal Issue Paper. Alternative 2, which was supported by former Acting Board Member Barbara Alby, contained proposed language that would clarify that water and juice from the same agricultural products from which the wine is made are not flavorings, colorings, or blending materials. Alternative 3, which was supported by E & J Gallo, contained proposed language that would define the term “wine base” and clarify that water is a blending material when added to a wine base. However, Board staff did not recommend that the Board choose these alternatives over Board staff’s alternative 1 because of the dispute within the industry as to whether water should be treated as a

flavoring, coloring, or blending material and because the addition of water was not crucial to the classification of an alcoholic beverage as either a wine or distilled spirit for California tax purposes. And alternatives 2 and 3 were withdrawn from the Board's consideration by their sponsors prior to the February 23, 2011, meeting. After hearing public comments, including E & J Gallo's comments supporting staff's alternative 1, and discussing staff's recommendation, the Board voted to authorize staff to begin the formal rulemaking process to adopt Board staff's alternative 1 during its February 23, 2011, meeting.

“Finally, it should be noted that ABC treats all wine-based alcoholic beverages as wine for California labeling and licensing purposes if the beverages are classified as wine for federal purposes, regardless of whether the beverages contain 0.5 percent or more by volume of alcohol obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made or whether the blending material exceeds 15 percent by volume. Also, ABC treats all flavored malt beverages classified as beer for federal purposes as beer for California labeling and licensing purposes, regardless of whether the beverages contain alcohol derived from the distillation of fermented agricultural products and would be classified as distilled spirits under BPC section 23005 and the distilled spirits regulations. However, the Board has its own independent constitutional and statutory authority to adopt regulations implementing, interpreting, and making specific the provisions of BPC sections 23005, 23006, and 23007 as they apply to the classification of alcoholic beverages under the Alcoholic Beverage Tax Law, the Office of Administrative Law has recognized that authority by approving the distilled spirits regulations, and ABC has not identified any binding or persuasive authority requiring the Board to acquiesce to the federal government's classification of alcoholic beverages where the federal classification conflicts with the express language of the BPC.”

Public Hearing

On May 25, 2011, the Board conducted a public hearing and voted to adopt proposed Regulation 2558.1 for the specific purposes of:

1. Clarifying that for purposes of the Alcoholic Beverage Tax Law “wine,” as defined by BPC section 23007, does not include any alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made; and
2. Establishing January 1, 2012, as the prospective date for compliance with the clarified definition of wine.

Interested Parties' Comments

Prior to the public hearing, Mr. Grey submitted a letter dated May 23, 2011, expressing E. & J. Gallo Winery's support for the adoption of proposed Regulation 2558.1 and stating E. & J. Gallo Winery's opinion that it is “important” for the Board to clarify the

definition of “wine” for California tax purposes and that proposed Regulation 2558.1 “is straightforward and should be easy to enforce.” Mr. Kronenberg appeared at the public hearing, made oral comments opposing the adoption of the regulation at this time, and submitted a letter dated May 25, 2011, containing similar comments. Mr. Kronenberg’s comments expressed the FWC’s opinions that:

- The Board lacks “the authority to regulate in this area”;
- The Office of Administrative Law’s approval of the Board’s adoption of the distilled spirits regulations (discussed above) is “not, in FWC’s view, determinative” of the Board’s authority to adopt proposed Regulation 2558.1;
- The Board should postpone the adoption of proposed Regulation 2558.1 until there is a final decision in *Diageo-Guinness USA, Inc., v. State Board of Equalization* (Sacramento Superior Court Case No. 34-2008-00013031-CU-JR-GDS; and Court of Appeal, Third Appellate District Case No. C061227);¹ and
- The FWC “doesn’t believe there is any urgency in adopting the clarification” set forth in proposed Regulation 2558.1.

The Board considered Mr. Grey’s and Mr. Kronenberg’s comments. The Board determined that it is necessary to adopt proposed Regulation 2558.1 to clarify the classification of wine-based alcoholic beverages containing more than a de minimis amount of alcohol obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made in order to address the wine growers’ and importers’ confusion regarding the definition of “wine” for California tax purposes described in the Informative Digest included in the Notice of Proposed Regulatory Action (and quoted above).

The Board determined that it is necessary to adopt proposed Regulation 2558.1 now in order “to permit wine growers and importers who had been relying on federal law and/or the Department of Alcoholic Beverage Control’s (ABC’s) classification of their wine-based alcoholic beverages for California tax purposes time, without being penalized due to any prior confusion in the industry, to determine whether their wine-based alcoholic beverages are wine or distilled spirits under the Board’s regulations, reformulate any of their wine-based alcoholic beverages so that they can continue to qualify as wine for California tax purposes, if necessary and desired, and begin to report and pay the applicable wine or distilled spirits excise tax on their wine-based alcoholic beverages” by the proposed regulation’s January 1, 2012, effective date, as explained in the Informative Digest included the Notice of Proposed Regulatory Action.

The Board also determined that it has authority to adopt proposed Regulation 2558.1 based upon the opinion of its Legal Department, as stated during the public hearing, that article XX, section 22 of the California Constitution grants the Board the exclusive jurisdiction to “assess and collect such excise taxes as are or may be imposed by the Legislature on account of the manufacture, importation and sale of alcoholic beverages in

¹ Diageo-Guinness USA, Inc., is currently appealing the Superior Court’s judgment, which concluded that the Board had the authority to adopt the distilled spirits regulations. The appeal has been briefed, but the Third Appellate District has not set a date for oral argument yet.

this State” and Revenue and Taxation Code section 32451 expressly authorizes the Board to “prescribe, adopt, and enforce rules and regulations relating to the administration and enforcement of” the Alcoholic Beverage Tax Law, including proposed Regulation 2558.1.

Comparable Federal Regulation

Part 24.10 of title 27 of the Code of Federal Regulations (Part 24.10) (quoted above and in the Notice of Proposed Regulatory Action) provides the general definition of wine for federal purposes and allows wine-based alcoholic beverages to be classified as wine regardless of the source of their alcohol. BPC section 23007 (also quoted above and in the Notice of Proposed Regulatory Action) expressly allows wine-based alcoholic beverages to be classified as wine if they include grape brandy, fruit brandy, or spirits of wine, which is distilled from the particular agricultural product or products of which the wine is made, but does not expressly allow wine-based alcoholic beverages to be classified as wine if they include alcohol derived from the distillation of other fermented agricultural products. Proposed Regulation 2558.1 differs from Part 24.10 because it clarifies that wine-based alcoholic beverages are not “wine,” as defined by BPC section 23007, for California tax purposes if they contain more than a de minimis amount of alcohol obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made.” This significant difference between Part 24.10 and proposed Regulation 2558.1 was discussed in the Informative Digest included in the Notice of Proposed Regulatory Action.

- For Information
- For Discussion
- For Decision Making

BOARD OF EQUALIZATION

INFORMAL ISSUE PAPER

Classifying Wine-Based Products for Taxation Purposes**Issue**

Whether the Board should initiate an interested parties process regarding the need for rulemaking to clarify the application of tax to wine-based products that do not meet the definition of wine pursuant to Business and Professions Code (BPC) section 23007.

Background

In a letter dated October 25, 2006, California Friday Night Live Partnership, Students Making a Community Change, and the California Youth Council filed a petition pursuant to Government Code Section 11340.6 requesting the Board adopt a regulation to tax flavored malt beverages (FMBs) as distilled spirits and/or amend Alcoholic Beverage Tax Regulation 2530. At the time of the petition, all FMBs were classified and taxed as beer in California. In December 2006, the Board granted this petition, directing staff to initiate the rulemaking process and to hold a series of public meetings with interested parties to discuss the classification of FMBs for taxation purposes and to return with regulatory alternatives for the Board's consideration. After considering the alternatives generated by the interested parties process, at the August 14, 2007 Board meeting, the Board approved publication of Regulation 2558, *Distilled Spirits*; Regulation 2559, *Presumption-Distilled Spirits*; Regulation 2559.1, *Rebuttable Presumption-Distilled Spirits*; Regulation 2559.3, *Internet List*; and Regulation 2559.5, *Correct Classification* (hereafter, collectively, Distilled Spirits Regulations). Due to the focus of the petition, the Distilled Spirits Regulations were promulgated primarily to address the proper classification of FMBs for taxation purposes.

The Distilled Spirits Regulations, attached as Exhibit 1, were approved by the OAL with an effective date of July 10, 2008, and became fully operational on October 1, 2008. For further information on the Board's prior rulemaking action, please see the Formal Issue Paper that was considered by the Board on August 14, 2007, and the Business Taxes Committee Minutes for that day, which are attached as Exhibits 2 and 3, respectively.

Although general questions were raised during the interested parties meetings and at the Board meeting regarding wine-based products that may or may not meet the BPC Section 23007 definition of wine and that may contain added distilled alcohol, no specific instances or products were identified or discussed.

Staff was advised to draft the necessary forms, develop the Web site, prepare the notices to affected parties, and to work with industry on implementing the Distilled Spirits Regulations. Beginning with the effective date of the Distilled Spirits Regulations, pursuant to Regulation 2559.1, staff began receiving sworn statements (reports) for purposes of rebutting the distilled spirits presumption from affected manufacturers and growers. Staff selected numerous products to review and requested from the manufacturer or grower copies of their "Statement of Process" or "Formula" filed with the federal Alcohol and Tobacco Tax and Trade Bureau (TTB) to determine if they had successfully rebutted the distilled spirits presumption. Along with working with the beer manufacturers on FMBs, staff also was in communication with wine growers and importers regarding wine-based products that may not meet the BPC Section 23007 definition for wine. Staff eventually prepared two Special Notices specific to the wine industry for clarification purposes, which are attached as exhibits 4 and 5.

The first notice, in December 2008, titled *Special Notice to Wine Growers and Importers*, and mailed to wine grower and wine importer registrants, addressed wine that does not meet the statutory definition in BPC Section 23007. This notice advised that if a registrant produces and/or imports an alcoholic beverage that does not meet the statutory definition for wine, they should consider filing form BOE 505, *Alcoholic Beverage Tax Report for Rebutting Regulation 2559 Presumption*. Summaries of the Distilled Spirits Regulations were included with this notice. The second notice, in December 2009, titled *Alcoholic Beverages Taxed as Wine for Federal Purposes, May Not Meet California's Definition of Wine and Therefore May be Subject to Tax as Distilled Spirits for California Tax Purposes*, was mailed to all Alcoholic Beverage Tax accounts, and advised that certain types of alcoholic beverages that may qualify as wine for federal purposes, namely wine specialties, flavored table wine, wine cocktails, wine coolers or other wine-based products or blends of wine from different fruits, may not meet California's definition of wine under BPC Section 23007 and, therefore, may be considered a distilled spirit and be taxed accordingly. The notice advised each manufacturer, grower or importer to review California's wine definition, and if their product(s) did not meet California's definition of wine, to file form BOE-505, if appropriate, to rebut the distilled spirits presumption.

BPC Section 23007 defines wine to mean:

[T]he product obtained from normal alcoholic fermentation of the juice of sound ripe grapes or other agricultural products containing natural or added sugar or any such alcoholic beverage to which is added grape brandy, fruit brandy, or spirits of wine, which is distilled from the particular agricultural product or products of which the wine is made [hereafter, for ease of discussion, "conforming distilled alcohol"] and other rectified wine products and by whatever name and which does not contain more than 15 percent added flavoring, coloring, and blending material and which contains not more than 24 percent of alcohol by volume, and includes vermouth and sake, known as Japanese rice wine.

Title 27 Code of Federal Regulations (C.F.R.) part 24.10 provides the following general definition for wine for federal purposes: "*Wine*. When used without qualification, the term includes every kind (class and type) of product produced on bonded wine premises from grapes, other fruit (including berries), or other suitable agricultural products and containing not more than 24 percent alcohol by volume. The term

includes all imitation, other than standard, or artificial wine and compounds sold as wine. A wine product containing less than one-half of one percent alcohol by volume is not taxable as wine when removed from the bonded wine premises.”

Title 26 United States Code section 5041, *Imposition and rate of tax*, provides that there is imposed on “all wines (including imitation, substandard, or artificial wine, and compounds sold as wine) having not in excess of 24 percent of alcohol by volume, in bond in, produced in, or imported into, the United States, taxes at the rates shown in subsection (b), such taxes to be determined as of the time of removal for consumption or sale. All wines containing more than 24 percent of alcohol by volume shall be classed as distilled spirits and taxed accordingly.” The federal rates under subdivision (b) are based on alcohol content and whether the wine is still, naturally sparkling, artificially carbonated, or hard cider. California’s rates are based on the same criteria along with the distilled spirits designation for wine-based products that contain in excess of 24 percent of alcohol by volume. However, California’s wine definition differs from the federal definitions in a couple of ways, namely in the requirement that added distilled alcohol that fortifies the alcoholic strength of the beverage must come from conforming distilled alcohol of the same agricultural product, as opposed to being from a foreign source or not of the same agricultural product, and in the requirement that the added flavoring, coloring and blending material for all rectified wine can be no more than 15 percent by volume.

By way of contrasting example, for federal purposes, certain classes of wine known as citrus wines, fruit wine and aperitif wine have no similar restriction relating to the origin of distilled alcohol added. Moreover, approved wines are based on the approved formula submitted in the “Statement of Process” or “Formula” to TTB, which permits blending material in excess of 15 percent by volume. Again, to meet the California definition of wine pursuant to BPC section 23007, such additives are limited to conforming distilled alcohol, and blending material cannot exceed 15 percent by volume. Further, pursuant to federal regulations, the TTB generally does not consider water to be a blending material. BPC Section 23007, however, does not expressly exclude water as a blending material, and California case law indicates that additions of water are relevant in determining whether an alcoholic beverage is properly classified as wine for taxation purposes. (See *Tux Ginger Ale Co., LTD. v. Davis* (1936) 12 Cal.App.2d 73, 74-75.)

It should be noted that the Department of Alcoholic Beverage Control (ABC) treats all wine-based products classified as wine for federal purposes as wine for labeling and licensing purposes in California, regardless of whether added foreign distilled alcohol meets or exceeds 0.5 percent by volume or whether the blending material exceeds 15 percent by volume. This acquiescence to federal standards is consistent with ABC’s position with regard to all FMBs, which ABC continues to classify as beer for labeling and licensing purposes, even when the particular FMB is considered a distilled spirit for California tax purposes pursuant to the Distilled Spirits Regulations. By approving the Distilled Spirits Regulations, OAL confirmed that the Board has the authority to diverge from ABC’s approach of federal acquiescence for tax classification purposes.

Discussion of the Issue

The intent behind the existing Distilled Spirits Regulations and the issuance of the Special Notices was to provide guidance for the proper classification and taxation of all alcoholic beverages, including wine-based products. However, based on field visits to major producers of wine-based products, staff is aware that significant differences of opinion exist as to the proper application of the Distilled Spirits Regulations to non-standard, wine-based products. Specifically, confusion exists as to whether water is regarded as a blending material for purposes of BPC section 23007. The inclusion or exclusion of water as a blending material may often determine whether a product exceeds 15 percent by volume of added blending

material. Confusion also exists as to the rules governing, and the tax consequences of, introducing distilled alcohol to wine-based products through added flavoring.

If an alcoholic beverage does not fall within the safe harbor of being a wine pursuant to BPC section 23007, the distilled spirits presumption may be successfully rebutted if less than 0.5 percent of distilled alcohol by volume is added to an alcoholic beverage. Problems arise when distilled alcohol that meets or exceeds 0.5 percent alcohol by volume is added and/or when the flavorings, coloring or other blending material exceed 15 percent by volume. A wine product with added flavorings, colorings, and blending material in excess of 15 percent by volume, which, therefore, does not meet the statutory definition for wine, is presumed to be a distilled spirit. When the 15 percent threshold is exceeded, if distilled alcohol (conforming and/or foreign) is added that meets or exceeds 0.5 percent alcohol by volume, the distilled spirits presumption remains unrebutted and the product is classified as a distilled spirit under the provisions of Distilled Spirits Regulations. Please note, however, that an alcoholic beverage is a wine for purposes of BPC section 23007 regardless of the amount of added conforming distilled spirits, so long as the added blending material does not exceed 15 percent by volume and the total alcohol by volume does not exceed 24 percent.

The types of products that may not meet California's statutory definition for wine because they may contain foreign distilled spirits and/or may contain blending materials in excess of 15 percent by volume include wine specialties, flavored table wine, wine cocktails, wine coolers, or other wine-based products or blends of wine from different fruits, generally categorized by TTB as non-standard wines or specialty wines. Because these products may continue to be classified by the TTB as wine and their manufacturers may continue to be licensed by ABC as wine manufacturers, staff believes further clarification is needed for purposes of providing guidance on the proper reporting of tax for wine-based products under the provisions of the Distilled Spirits Regulations.

Staff recommends that the Board initiate an interested parties process to discuss these issues more thoroughly. Attached, as Exhibit 6, is a draft, for discussion purposes only, of proposed Regulation 2558.1 that would clarify, for tax classification purposes, what is and what is not wine as defined by BPC Section 23007. Although exhibit 6 reflects staff's current understanding of how the rules already established by the Distilled Spirits Regulations should be applied to wine-based products, staff views exhibit 6 as just a starting point for discussion with interested parties. Staff is not presently asking for the Board's approval of this language or of any of the concepts inherent in this language.

Other Sections

No impact.

Alternatives

Do not initiate an interested parties process.

Recommendation

It is staff's opinion that there is a need to clarify the treatment of wine-based products for tax reporting purposes and for compliance with the Distilled Spirits Regulations. Staff recommends that an interested parties process be initiated and anticipates that a proposed regulation, similar in content to the draft of Regulation 2558.1 will ultimately be recommended to the Board at the conclusion of the process.

Critical Time Frames

To the extent the Board ultimately approves a new regulation, or amendments to existing Distilled Spirits Regulations, these changes need to be fully operative by the end of October 2011 to avoid the possibility of potential statute of limitations problems as to reporting periods commencing on and after October 1, 2008 (i.e., the operative date of the existing Distilled Spirits Regulations).

Preparation and Reviews

Prepared by Special Taxes and Fees Division, Property and Special Taxes Department.

Current as of: November 2, 2010

BEFORE THE CALIFORNIA STATE BOARD OF EQUALIZATION.

450 N STREET

SACRAMENTO, CALIFORNIA

REPORTER'S TRANSCRIPT

NOVEMBER 16, 2010

BUSINESS TAXES COMMITTEE

REPORTED BY: Kathleen Skidgel

CSR NO. 9039

P R E S E N T

1
2
3 For The Board
of Equalization:

Betty T. Yee
Chair

4
5 Jerome E. Horton
Vice-Chair

6 Barbara Alby
Acting Member

7
8 Michelle Steel
Member

9 Marcy Jo Mandel
10 Appearing for John Chiang
State Controller
11 (per Government Code
Section 7.9)

12 Diane G. Olson
Chief
13 Board Proceedings Division

14 For Board of
Equalization Staff:

Suzanne Buehler
Sales & Use Tax Department

16 Randy Ferris
Legal Department

17
18 Phillip Bishop
Property & Special Taxes Department

19 Also Present:

Bruce Nissen
Fox Barrel Cider

20
21 ---oOo---

1 450 N STREET
2 SACRAMENTO, CALIFORNIA
3 NOVEMBER 16, 2010

4 ---o0o---

5 MS. YEE: Good morning. Let's convene this Board
6 of Equalization meeting.

7 Ms. Olson, our first item, please.

8 MS. OLSON: Our first item for this morning's
9 agenda is the Business Tax Committee, Ms. Yee.

10 MS. YEE: Thank you very much.

11 Members, we have one item before the Business Taxes
12 Committee. And this relates to classifying wine-based
13 products for taxation purposes. And let me have the staff
14 introduce the issue for us. Good morning.

15 MS. BUEHLER: Good morning. I am Suzanne Buehler
16 with the Sales and Use Tax Department. With me today are
17 Randy Ferris of our Legal Department, and Phil Bishop of
18 our Property and Special Taxes Department.

19 We have one agenda item for the committee this
20 morning. Staff is seeking your approval to begin an
21 interested parties process to clarify the alcoholic
22 beverage tax treatment for wine-based products containing
23 distilled alcohol. I would like to turn it over to
24 Mr. Ferris and Mr. Bishop to provide you with more
25 information.

26 We also have a visual presentation to help
27 illustrate the issue. Following the presentation, I
28 believe we have some speakers and we will be available to

1 answer any questions you may have.

2 MS. YEE: Okay. Very well. I think we have one
3 speaker signed up for this item, and it's Mr. Nissen. Are
4 you in the audience?

5 MR. NISSEN: Yes.

6 MS. YEE: Okay. If you'll come forward and have a
7 seat here, and then we'll proceed with the presentation and
8 have you speak.

9 Thank you. Mr. Ferris.

10 MR. FERRIS: All right. As the Board is aware, a
11 couple years ago the Board promulgated some regulations
12 that helped address a product that was unusual on the
13 market that was a beer-based product was the main focus,
14 that used flavorings to -- that had the effect of
15 fortifying or strengthening the alcoholic content of the
16 beer-based beverage. And the Board promulgated rules that
17 made it clear that while you can use a diminimus or a very
18 small amount of distilled spirits or distilled alcohol to
19 carry a flavor, it has to be under .5 percent of alcohol in
20 that beverage. If you exceed that, you're basically
21 fortifying, you're strengthening the alcoholic content of
22 the beer-based beverage through that flavoring. That's not
23 permissible for the tax classification.

24 In essence, if you're adding enough distilled
25 alcohol to the alcoholic beverage, such that it would be an
26 alcoholic beverage just from the distilled alcohol that you
27 added, it's a distilled spirit. You've added enough
28 distilled alcohol to make it an alcoholic beverage, and on

1 that basis alone it's a distilled spirit. So that was the
2 logic of the rulemaking.

3 Again, that whole process was focused on beer-based
4 products. And toward the very end of the rulemaking
5 process, some questions were raised as to how it might
6 affect wine-based products. There are similar types of
7 products that are made from a wine base as well. But at
8 that time no specific products were brought to the Board's
9 attention for consideration, and it was decided to go ahead
10 and make sure that we were making it clear that wine, as
11 it's defined in Business and Professions Code 23007, was
12 excluded from the Board's rulemaking, but leaving for
13 another day in a sense whether or not there might be some
14 tweener types of products as well that are wine-based that
15 might kind of run afoul of this same sort of fortification
16 versus flavoring distinction that the Board established
17 through the distilled spirits regulations.

18 So as staff has been out in the field and looking
19 at what's going on in the industry, we are becoming aware
20 that there are some of these products that are wine-based
21 but are not what you would call a traditional wine and are
22 more similar to these flavored malt beverage products, and
23 that there may be some issues with respect to fortifying
24 through flavoring that need to be addressed and clarified.

25 One thing that's very important to understand with
26 respect to the wine-based products is, because of the
27 definition of wine in Business and Professions Code 23007,
28 there is a distinction between wine-based products and

1 beer-based product and that the legislature permits
2 fortification of wine under very limited and specific
3 circumstances.

4 The legislature permits fortification of a
5 wine-based product if the distilled alcohol that's added to
6 create the fortified wine base is from the same
7 agricultural product of which the wine is made. So if it's
8 a grape wine, you could use spirits of grape to fortify the
9 wine. That's permissible. It's still wine as long as you
10 don't exceed 24 percent alcohol by volume. And so the
11 legislature treats wine differently than beer. Okay.

12 But the problem can arise in that you can also add
13 other things to the wine base. And the legislature has
14 said you can add up to 15 percent of colorings, flavorings,
15 and other blending material. So when you're adding
16 flavorings, care has to be taken that if distilled alcohol
17 is being used to carry those flavors, that it is from the
18 same agricultural product of which the product is made.
19 And for ease of expression we're going to refer to that as
20 conforming distilled alcohol, because it's too cumbersome
21 to keep saying distilled alcohol from the same agricultural
22 product of which the wine is made. That's too much of a
23 mouthful.

24 So we'll just call that conforming distilled
25 alcohol. That's the kind the legislature says you can add.
26 And we'll distinguish that from foreign distilled alcohol.
27 That's from a different agricultural product. That's the
28 kind that you're not supposed to be adding. You're not

1 supposed to be fortifying the wine base with foreign
2 distilled alcohol.

3 But consistent with how the Board is treating the
4 beer-based products, it seems right that a diminimus amount
5 of distilled alcohol could be added for flavoring purposes,
6 as long as it doesn't exceed the .5 percent threshold that
7 the Board has already established.

8 With that as background, let's look at a flow
9 chart.

10 MS. YEE: Okay. And this is consistent with the
11 handout that we have before us?

12 MR. FERRIS: Yes.

13 MS. YEE: Okay.

14 MR. FERRIS: And so what we're doing right now --
15 again, we're not asking for approval of any of the concepts
16 that we're going to discuss here, but we're just giving you
17 a sense of where staff is at as we've been trying to figure
18 out. As we've been out in the field looking at these
19 products, coming to grips with how the Board's distilled
20 spirits regulation should be evenhandedly applied,
21 consistently applied, to this other universe of products,
22 this is our current best understanding of how that should
23 be applied.

24 MS. YEE: Okay.

25 MR. FERRIS: So in this flow chart, you start at
26 the top, and that's the beginning of the base, the wine
27 base. And let's assume that it's a grape wine. The two
28 middle diamonds have to do with the issue I was talking

1 about before, you're fortifying by adding foreign distilled
2 alcohol, and also whether or not you are adding flavorings
3 and whether or not those flavorings contain foreign
4 distilled alcohol.

5 On the far right we've got a diamond that's
6 addressing the issue that you can't add more than 15
7 percent other stuff, flavorings, colorings, other blending
8 material.

9 The diamond at the very bottom, in the middle, is
10 addressing the issue under Business and Professions Code
11 Section 23007 you can't have, at the end of the day, more
12 than 24 percent alcohol by volume.

13 So all of those diamonds, when you follow the flow
14 chart -- and we're going to break it down and make it
15 easier to see how this all works -- will lead you either to
16 reporting the product in question as a wine or reporting it
17 as a distilled spirit.

18 So let's break it down. This slide, again, is
19 emphasizing the fact that conforming alcohol is from the
20 same -- is distilled alcohol from the same agricultural
21 product. And for all these slides we're assuming that when
22 you're fortifying, you're adding at least .5 percent
23 alcohol, when you're fortifying with a conforming distilled
24 spirit. And again, foreign distilled spirit is from a
25 different agricultural product.

26 All right. So let's break it down. Here's the
27 first example. Start with your wine base. And you have to
28 ask if you're going to fortify it with conforming alcohol?

1 No, it's not fortified based. But you still have to ask,
2 are you adding foreign distilled alcohol through flavoring?
3 No. Is it more than 24 percent alcohol by volume? No. So
4 it meets all the requirements to be a wine under 23007, so
5 it's reported as wine.

6 Here's another example. Again, you start with your
7 wine base. Is it fortified with a conforming distilled
8 alcohol? Yes, it is. That's permissible. Then you have
9 to ask whether or not more than 15 percent extra stuff has
10 been added? No. So you're still good. What about foreign
11 distilled spirits through flavoring? No. More than 24
12 percent alcohol by volume? No. So, again, it meets all of
13 the statutory requirements to be a wine under 23007.

14 Now we're going to see some examples that would run
15 afoul of staff's understanding of the requirements of
16 23007, that would cause it to fall into the distilled
17 spirit category for tax classification purposes.

18 Here we go. Again, you'd begin with the wine base.
19 Is it fortified with conforming distilled alcohol? No,
20 it's not. However, I believe we're going to see the --
21 okay. And it doesn't have foreign distilled alcohol in it.
22 But it's more than 24 percent alcohol by volume. That's a
23 clear violation of 23007, and therefore it should be
24 reported as a distilled spirit.

25 Again, start with the wine base. Ask if the wine
26 base is being fortified. In this example it's not. Now
27 you look at the flavorings or other things that are added.
28 Yes, it exceeded a diminimus amount of foreign distilled

1 alcohol. So on that basis, just from the foreign
2 distilled -- the impermissibly added distilled alcohol, it
3 would be a alcoholic beverage on that basis alone. You
4 would report it as a distilled spirit.

5 Another example. The wine base. Is it fortified
6 with a conforming distilled alcohol? Yes, it is. That's
7 okay. You can do that. But more than 15 percent added
8 stuff came into play which violates 23007. You can only
9 add 15 percent coloring, blending material, that type of
10 thing. So again, since we know that there's a lot of
11 distilled alcohol in this, because the wine base was
12 fortified, and it doesn't meet the plain language of 23007,
13 it's going -- it's not a wine under 23007. It's got a lot
14 of distilled alcohol in it. It should be reported as a
15 distilled spirit.

16 I think this is the final example. Start with the
17 wine base. The wine base is being fortified properly.
18 There was not lots of water added or something like that,
19 so no problem there. But foreign distilled spirits in
20 excess of .5 percent were added through flavorings, again,
21 that's not permissible. There basically the formula is
22 fortifying the alcoholic content of the wine through
23 foreign distilled spirits. That's not permitted. So it
24 would be reported as a distilled spirit.

25 And that's just, again, an overview of all of the
26 flow chart.

27 So in conclusion, based on staff's experiences out
28 in the field and conversations we've had with those that

1 make some of these wine-based products, we believe that
2 there is a need for clarification with respect to the tax
3 consequences of adding distilled alcohol to wine-based
4 products. And we think an interested parties process would
5 be very helpful in understanding the industry more and
6 hearing their concerns and making sure that we provide
7 proper guidance through the proposed rulemaking that we
8 would anticipate bringing back to the Board. And again,
9 we're not presently seeking any approval of language or
10 concepts, but just permission to go ahead and talk with
11 interested parties.

12 MS. YEE: Okay. Thank you very much Mr. Ferris.
13 Any further comment at this point?

14 Okay. Let me hear from Mr. Nissen. But at the
15 outset I just want to thank the -- particularly those in
16 the wine industry that have brought this issue to our
17 attention.

18 I know certainly during the rulemaking process I
19 think there was a sense that all wine is wine, and we
20 really began to delve into the particulars of the various
21 products as we were able to meet with the various
22 representatives from the wine industry and really help us
23 clarify the confusion and certainly understand the
24 confusion that exists given the traditional sense of how
25 wine ought to be treated under the current statutory
26 framework.

27 Let's hear from Mr. Nissen, and then I have a
28 proposal with respect to how we should proceed.

1 Mr. Nissen.

2 MR. NISSEN: Thank you very much. I represent a
3 very, very tiny part of the wine industry.

4 MS. YEE: Will you do me a favor? Introduce
5 yourself formally for the record.

6 MR. NISSEN: Oh, I'm sorry. My name's Bruce
7 Nissen. I'm the owner of Fox Barrel Cider Company --

8 MS. YEE: Okay.

9 MR. NISSEN: -- Colfax, California. By definition
10 we are an O2 wine grower. We make products that are very
11 low alcohol that are from naturally fermented apples and
12 pears.

13 I'm here representing not only the Fox Barrel
14 interests but also Crispin Cider Company of Minneapolis and
15 Green Mountain Beverage Company in Vermont.

16 Essentially, it's my feeling from the presentation
17 that it's not the intent of the Board, you know, to not
18 understand the way that cider's made and the way it's
19 produced. It's a natural product. Two of the three
20 largest cideries in the US are located here in California.
21 On Fox Barrel's behalf we use about seven million pounds of
22 fruit a year to ferment.

23 There are certain elements of this proposal that we
24 just want to monitor in terms of one of the topics openly
25 discussed is considering water as an additive. And in the
26 cider-making process, because we're not making a normal
27 wine strength product at the end of the day, there's an
28 introduction of water essentially to dilute the product

1 down to the five percent or six percent that is presented
2 to the public. And if that were viewed as an additive, all
3 of a sudden now we're looking at legislation that could
4 move us into a distilled spirit classification. And I
5 don't believe that makes sense within the spirit of what
6 you're trying to achieve.

7 MS. YEE: No pun intended.

8 MR. NISSEN: So, you know, like I said, I believe
9 from what you presented, that's not your intent. We just
10 wanted to make sure that, as we're not an organized group
11 with a large lobby, that somebody came down and just said,
12 hey, please be aware that we're kind of tucked into this
13 category and sometimes the rules, you know, can overlook
14 the fact that we exist.

15 MS. YEE: Yeah.

16 MR. NISSEN: Let me see if there's anything else I
17 wanted really to address. That was primarily it. I mean,
18 my interest here is just to ensure that as the rules are
19 written, they cover all the different types of O2s that
20 operate within the state.

21 MS. YEE: Sure. Thank you very much. And we
22 appreciate your concern. And thank you for being here.

23 I really would encourage your participation in the
24 interested parties process that I'm going to be suggesting
25 that we pursue here. And coincidentally, I think the
26 confusion really -- or the need to clarify the confusion
27 that's been raised began with the -- how the addition of
28 water as a blending material ought to be treated. So it's

1 definitely germane to what we're going to be looking at in
2 the rulemaking process. Thank you.

3 Questions or comments, Members?

4 MS. STEEL: Question.

5 MS. YEE: Yes, Ms. Steel.

6 MS. STEEL: For that foreign object, whatever put
7 it in, what exactly foreign? How we define that language
8 right there? Because I just heard about the water, .5
9 percent. And how about like apple wine or how about
10 pineapple wine from, you know, other area? So how does
11 foreign define that you know -- we define that language?

12 MR. FERRIS: Right. Yeah, basically it's just --
13 and maybe it wasn't the most helpful of words used,
14 conforming versus foreign. But really we're just trying to
15 get at the concept that Business and Professions Code
16 23007, which defines wine for California, says you can add
17 distilled alcohol if it's from the same agricultural
18 product of which the wine is made.

19 So if it's an apple wine, you could add spirits of
20 apple to it. That would be fine. But you couldn't add
21 spirits of orange because then you'd be mixing apples and
22 oranges. That wouldn't be permitted.

23 So it would have to be from the same agricultural
24 product. So if it's --

25 MS. STEEL: So it has to be just one kind, if it's
26 made by grapes, and then has to be grapes but not other
27 stuff that you can put in as -- it has to be less than .5
28 percent.

1 MR. FERRIS: Correct.

2 MS. STEEL: How about the water part?

3 MR. FERRIS: Well, the water part is, I think, the
4 most interesting question. And, in general, if you're
5 making a traditional wine or a traditional cider, typically
6 you wouldn't be adding a lot of distilled alcohol to it
7 through flavorings, you know. So you wouldn't have to
8 worry about it.

9 So if you just used -- if you didn't add distilled
10 alcohol from another agricultural source, right, then even
11 if you added more than 15 percent water, you still would be
12 a wine because there wouldn't be enough distilled alcohol
13 in the product to make it a distilled spirit.

14 So you can exceed the 15 percent threshold with
15 water, as long as you're not adding foreign distilled
16 spirits into the product. And it will always default back
17 to wine because that product will be able to rebut the
18 presumption that it's a distilled spirit under the Board's
19 distilled spirit regulations because we allow it to be
20 rebutted. And if you can show that there isn't more than
21 .5 percent distilled alcohol in the product, and with wine,
22 we would also say from a foreign source, then you're going
23 to be able to rebut the presumption. That means you're not
24 a distilled spirit, you're going to be a wine.

25 MS. STEEL: That's really complicated. Let me ask
26 just really basic question. Why we are even considering
27 regulations for wine when we have so much problems with the
28 F&B regulations?

1 MR. FERRIS: I think with the flavored malt
2 beverage industry, they've all -- they've understood our
3 regulations to the extent they wanted to. They have
4 reformulated, and our experience out in the field is that
5 there is widespread compliance with the regulations that
6 the Board promulgated. And there doesn't seem to be a
7 problem in the industry with it. They may not be happy
8 that they had to reformulate, but they have reformulated if
9 they felt that they wanted to.

10 The reason why we are addressing the wine-based
11 products is because folks from this industry are coming to
12 us saying we need more clarification. We don't
13 understand --

14 MS. STEEL: You mean wine industry is --

15 MR. FERRIS: Yeah, is coming and saying, do we have
16 to reformulate or not? And if so, how can we reformulate
17 in a way to make sure that we're not taxed as a distilled
18 spirit?

19 So we think we want to help them to understand how
20 to apply these regulations to their industry.

21 MS. STEEL: So make more complicated then ever?

22 MS. YEE: Actually to hopefully make it easier so
23 they can make commercial decisions with an understanding of
24 how the reg applies.

25 MS. STEEL: I'm not sure this is going to be easier
26 though. Because another part of my question is that when
27 we did F&B regulations, the way set it up that I voted no,
28 our department came out that our estimate income was

1 revenue was \$41 million. As of date -- as of today we
2 collected only \$225,000. Is that cost effective for this
3 regulations that we going forward?

4 MR. FERRIS: Well, I think that the Board -- my
5 understanding is the Board made the decision that it did
6 with respect to the distilled spirits regulations because
7 the Board wanted to give clear guidance for tax
8 classification purposes as to what the definition of beer
9 is. And these were products that, even though the
10 Department of Alcoholic Beverage Control for California was
11 acquiescing to federal standards, the federal standards
12 that were being acquiesced to for labeling and licensing
13 purposes really weren't following the California statute.
14 So the Board said we have to follow the California
15 statutes, not the federal rules.

16 MS. STEEL: But that's really interesting because
17 federal regulation US Code Section 5041, it's much more
18 simple. It's only for excess of 24 percent of alcohol by
19 volume. I mean, that's very, very clean, very simple.

20 And then we are making these that, you know, when
21 we heard about the estimate revenue for 41 million, and a
22 lot of Board Members went for it because, you know, we
23 thought we going to bring more, but I think the industries
24 undershoot so much and they reformulate their alcohol so
25 they are not paying taxes. It's going to make these
26 industries much more complicated to change the alcohol
27 level, and it's not really helping businesses in
28 California, especially under the recession. And every

1 regulation that we make it gets tougher and tougher to ask
2 them actually move out of California to build a business,
3 to bring the wine in here. I don't know how much they can
4 bring it in.

5 And -- you know, it seems like, you know, for me
6 that F&B the regulation's been passed by BOE was not right
7 means that, you know, we -- and then we are going through
8 the wine regulations now, that two wrongs don't make a
9 right.

10 So I hope -- you know, I was hoping that our income
11 is not even quite close. It was just very minimal.
12 Actually we are paying more for our employees here than,
13 you know, what we are bringing in. I thought that instead
14 of proposing regulations for wine, I believe that we should
15 repeal the F&B regulation. That's the way I thought we
16 were going to move. I didn't know we were going through
17 now wine after beer, and this is making much, much more
18 complicated.

19 You keep going -- I know you guys did a great job,
20 tried to really make it clear. But there is a lot of
21 language, especially foreign, you know, we don't know
22 exactly what foreign means. Now when they come up to the
23 Board it's going to be very tough to make decisions that,
24 you know, how are we going to make is this foreign or not.

25 And I really like the US code better because it's
26 very simple, over 24 percent, than, you know, you put that
27 as a hard liquor, you know, taxes.

28 So this is another way to raise taxes from 20 cents

1 per gallon to \$3.30 per gallon. So I am totally, totally
2 against it.

3 I know, you know, even wine vendor came out, I
4 heard a lot of beer industries were complaining that why
5 only beer and wine. Why don't we just get rid of beer and
6 wine, everything is the same rate taxes here.

7 So that's my opinion. Thank you.

8 MS. YEE: Thank you, Ms. Steel.

9 Just let me address a couple of points. When this
10 regulation was first initially before us, flavor malt
11 beverages really were products that didn't fit squarely
12 within the definition of beer and wine. And I think this
13 Board, certainly for taxation purposes, had an obligation
14 to provide that clarification, which we did through the
15 regulation.

16 We did have a wine exception in that regulation,
17 and that is what we're trying to clarify now. Actually, I
18 think with the clarification the wine industry can proceed,
19 and even as it relates to the cider-based products there
20 will be much more clarification.

21 I will say for the record, I for one did not vote
22 for that regulation for its revenue impact. I think the
23 response that we've gotten and the compliance that we've
24 seen certainly speaks to the clarity of the regulation.
25 And we are here now to try to provide additional clarity
26 with respect to equitable application of the regulation as
27 it relates to wine-related products.

28 I've had a number of different visits from

1 different wine wineries and wine manufacturers who really
2 are looking forward to the Board clarifying this
3 regulation. As I said, there are commercial decisions that
4 are on hold as a result of what product development ought
5 to be proceeding pending clarification of this. And I
6 think the last thing I want to see this Board do is to
7 really impinge upon commercial activity in that way.

8 Ms. Mandel.

9 MS. MANDEL: I didn't really have anything further.
10 We had heard some time ago from the Wine Institute that
11 there was an interest in clarifying the exclusion of wine.
12 But I think there was a desire to, you know, see how it
13 played out in the field with more information. I guess
14 that's what's going on now, staff went out and has more
15 information.

16 MS. YEE: Mr. Horton, did you have a comment?

17 MR. HORTON: (Shaking head.)

18 MS. YEE: Okay. What I'd like to do, and really
19 this is with sensitivity to --

20 Oh, I'm sorry. Ms. Alby, please.

21 MS. ALBY: Thank you, Madam Chair.

22 I have a couple questions. One is, who in the
23 industry is asking for this process?

24 MS. YEE: I'm not sure the folks I met with are
25 wanting to be disclosed. But several wine manufacturers.

26 MS. ALBY: But we don't get to know that?

27 MS. YEE: They've been, I think, meeting with
28 various Members of this Board.

1 MR. FERRIS: They've been asking us questions in
2 their capacity as a taxpayer. So, I mean, I think they do
3 have some interest in their -- their information about how
4 they're reporting their taxes being held confidential.

5 I assume -- we can say with certainty, and it's a
6 matter of public record, that there are three major
7 producers of these wine-based alcopops. I mean, you know
8 that there are three main producers of wine-based alcopops,
9 and those are Gallo, Constellation and The Wine Group.

10 MS. ALBY: Great. Thank you.

11 The other thing I wanted to ask staff, if I could,
12 do you remember what the estimate was that we'd be
13 receiving as a result of the F&B regs, what that estimate
14 was?

15 MR. BISHOP: I think it was annually 41 million.

16 MR. FERRIS: If there was no reformulation.

17 MR. BISHOP: Right.

18 MS. ALBY: Right, if there was no reformulation.
19 Do you know what we actually received as a result of those?

20 MR. FERRIS: I think Ms. Steel was correct in the
21 200 --

22 MS. STEEL: I'll give you exact figure.
23 \$225,806.

24 MS. ALBY: Do you have any idea what it cost us to
25 implement that, the process?

26 MR. BISHOP: I don't believe there was an
27 accounting done. I know some of the staffing that we
28 requested, we did not receive. So it was done with

1 existing staff.

2 MR. FERRIS: It has been an absorbed cost.

3 MS. ALBY: Well, I can remember those discussions
4 clearly when Mr. Leonard was here, and I think one of the
5 things that both he and Ms. Steel said that this was going
6 to be a useless process, a costly process because the
7 industry would just reformulate. And they did.

8 And I guess I would associate my remarks with Ms.
9 Steel. I mean I learned at an early age if the stove is
10 hot, you get burned if you put your hand on it. And I feel
11 like we sort of learned a lesson here. So I am concerned
12 about going forward with this process, costing money, days
13 of furloughs deficits. So I have great concerns.

14 So thank you very much.

15 MS. YEE: Thank you, Ms. Alby.

16 I guess what I would say to that in response is
17 there is a process for how we repeal regulations and
18 there's a process for how we make statutory change. And I
19 will remind the Members we did have a bill that was vetoed
20 by this current Governor that looked at these products in
21 terms of how they ought to be classified, and the veto
22 message essentially appointed the authority of this Board
23 to make that determination with respect to how to look at
24 flavored malt beverages.

25 So it is a regulation that's in place. It's
26 effective. And, again, I really don't want to hold up the
27 wine industry and any other industry with respect to not
28 doing our due diligence in providing this clarification.

1 And what I'd like to do is to actually expedite the
2 interested parties process so that we can hopefully have an
3 interested parties meeting before the end of the calendar
4 year. I know I'm pushing the staff, but I really want to
5 be sensitive to, you know, the wine manufacturers and the
6 decisions that are pending this clarification, so that it
7 comes before this committee again back in February.

8 Okay. Other comments, Members?

9 MR. HORTON: Um --

10 MS. YEE: Mr. Horton.

11 MR. HORTON: Thank you, Madam Chair.

12 I kind of wanted just to speak to the legislative
13 intent as it related to these items. The intent was not
14 revenue base. The intent was to try to control the use of
15 this product, to minimize the use of this product. And the
16 debate was over whether or not young folks actually used
17 this product because of its flavoring and so forth and so
18 on. And so the essence was to try to restrict the volume
19 of alcohol.

20 Of course the debate kind of -- one of the
21 underlying tones was this is not a -- whether or not it was
22 a beer or wine and so forth, but the real essence of it was
23 to try to restrict the item, to limit the content of the
24 item. And it's gone a little bit beyond that, but I just
25 thought I'd sort of share that.

26 And I would say to the extent that the
27 legislature's given us some direction and somewhat autonomy
28 to meet the legislative intent, we should attempt to do

1 that, with not only the guidance of the law, but also the
2 guidance of the industry and how this is impacting the
3 industry.

4 I agreed with Mr. Leonard at the time that what
5 would ultimately happen would be a reformulation of the
6 product. And in and of itself, many within the legislature
7 felt that was success. A greater success was to take the
8 product off the market altogether, which wasn't a -- wasn't
9 possible legislatively in order to get the majority of the
10 legislature and the government to concur with that thought
11 process.

12 I just share that.

13 MS. YEE: Thank you, Mr. Horton. Thank you for
14 that perspective.

15 Ms. Steel, please.

16 MS. STEEL: One quick question. Did we have any
17 study that how many young kids stopped drinking because we
18 raised taxes?

19 MR. FERRIS: No. I mean, although a lot of the
20 folks that initiated the petition to begin with were very
21 concerned about the social policy issues. And so that was
22 always a part of the discussion. But from staff's point of
23 view, and I think from the action the Board took, it
24 wasn't -- it was -- we were focused on construing the
25 statutes.

26 MS. YEE: Right.

27 MR. FERRIS: And applying them properly for tax
28 classification purposes. So because staff was not

1 motivated by the social policy, we haven't done any social
2 policy studies.

3 MS. STEEL: So if we are not thinking about social
4 policy -- because I remember the Girl Scout members were
5 out there and picketing against me that I was for teenage
6 drinkers, and I was raising two teenager kids at that time.
7 And I was not happy with it because Girl Scout has to be
8 501(c) non-profit organizations they supposed to not get
9 involved within politics.

10 And second thing is, that, you know, if we are not
11 even thinking about the tax revenue on this, then why we
12 are even going through it? Because there is a simple law,
13 over 24 percent of the alcohol has to be charged for hard
14 liquor for \$3.30 instead of 20 cents. That's my comment.

15 So it doesn't really make any sense here that we
16 are making everything really complicated and we are going
17 nowhere and we are having so much trouble. So we are not
18 getting even revenues, and we don't even know how many kids
19 stopped drinking because of tax raise.

20 And, you know, just don't understand it's going to
21 hurt small businesses that they have to charge more taxes.
22 I'm not talking about those big franchise markets, but I'm
23 talking about small Mom and Pop, small liquor stores that
24 they going to be in big trouble because every time you
25 raise from 20 cents gallon to \$3.30 a gallon, that's a lot
26 of money.

27 That's my comments. Thank you.

28 MS. YEE: Thank you, Ms. Steel.

1 Mr. Horton, please.

2 MR. HORTON: I would somewhat concur with Ms.
3 Steel's comments. As Chair of the governmental
4 organizations, when I sort of looked at the legislation, at
5 the end of the day -- and I think I'm being somewhat
6 redundant -- at the end of the day we sort of anticipated
7 that the manufacturers, they would just reformulate. And
8 the end results would be a lot of work that wouldn't have a
9 real social impact or a financial impact.

10 However, without some clarification, it could have
11 a negative impact on the industry in that the clarification
12 would be a condition subsequent, subsequent to an audit,
13 subsequent to a liability, subsequent to the debate before
14 this body. So to the extent that we can provide that
15 clarification, I'm supportive of providing clarification.

16 I concur that it's one of those pieces of
17 legislation that at the end of the day, because of the
18 chemistry that's involved, at the end of the day it just
19 ends up with a reformulation. Hopefully, hopefully the
20 smaller operations can be made aware of what they need to
21 do in order to have their product fit not only their market
22 scheme, but also fit the tax scheme as established by the
23 legislature.

24 We didn't -- we don't necessarily pass laws here.
25 We try to bring clarity to it, and guidance based on the
26 law itself and the intent.

27 MS. YEE: Thank you, Mr. Horton.

28 Other questions or comments, Members?

1 Okay. Hearing none, let me put a motion on the
2 table. I'd like to move to direct staff to begin the
3 interested parties process to hold, on an expedited basis,
4 with an interested parties meeting to be scheduled before
5 the end of the calendar year. And this matter back before
6 us for action on the clarification, clarifying language,
7 hopefully that is developed during that process for our
8 February 2011 Board meeting. Is there a second?

9 MR. HORTON: I would second the motion.

10 MS. YEE: Okay. Second by Mr. Horton. Further
11 discussion?

12 Please call the roll.

13 MS. OLSON: Madam Chair.

14 MS. YEE: Aye.

15 MS. OLSON: Ms. Alby.

16 MS. ALBY: No.

17 MS. OLSON: Ms. Steel.

18 MS. STEEL: No.

19 MS. OLSON: Mr. Horton.

20 MR. HORTON: Aye.

21 MS. OLSON: Ms. Mandel.

22 MS. MANDEL: Aye.

23 MS. OLSON: Motion carries.

24 MS. YEE: Okay. Thank you very much. The Business
25 Taxes Committee is adjourned.

26 (The matter concluded at 10:42 a.m.)

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REPORTER'S CERTIFICATE

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State of California)
) ss
County of Sacramento)

I, KATHLEEN SKIDGEL, Hearing Reporter for the California State Board of Equalization certify that on November 16, 2010 I recorded verbatim, in shorthand, to the best of my ability, the proceedings in the above-entitled hearing; that I transcribed the shorthand writing into typewriting; and that the preceding pages 1 through 27 constitute a complete and accurate transcription of the shorthand writing.

Dated: December 17, 2010

KATHLEEN SKIDGEL, CSR #9039
Hearing Reporter



BOARD OF EQUALIZATION

BUSINESS TAXES COMMITTEE MEETING MINUTES

HONORABLE BETTY T. YEE, COMMITTEE CHAIR

450 N STREET, SACRAMENTO

MEETING DATE: FEBRUARY 23, 2011, TIME: 9:30 A.M.

ACTION ITEMS & STATUS REPORT ITEMS

Agenda Item No: 1

Title: Proposed amendments to Regulations 1598, *Motor Vehicle and Aircraft Fuels*, and 1533.2, *Diesel Fuel Used in Farming Activities or Food Processing*

Issue/Topic:

Action 1:

Request approval and authorization to publish proposed amendments to Regulation 1598 to incorporate the provisions of Revenue and Taxation Code sections 6051.8, 6201.8, and 6357.3 related to the 1.75 percent tax increase to sales of diesel fuel beginning July 1, 2011.

Action 2:

Request approval and authorization to publish proposed amendments to Regulation 1533.2 to provide that the partial exemption from tax includes an exemption from the additional tax imposed on sales of diesel fuel.

Committee Discussion:

Action 1:

Staff presented the amendments to Regulation 1598. Ms. Steel asked how Proposition 26 impacts the regulation. Staff explained that the full impact of the proposition is unknown at this time but that staff is moving forward with the regulation based on current law. Staff also stated that the Legal Department is looking into the effect of the proposition. Ms. Yee stated staff should look at all areas that may be affected by the proposition.

Action 2:

None.

Committee Action:

Action 1:

Upon motion by Ms. Mandel, seconded by Mr. Horton, the Committee unanimously approved and authorized for publication amendments to regulation 1598. The amendments would be operative July 1, 2011. A copy of the proposed amendments is attached.

Action 2:

Upon motion by Ms. Mandel, seconded by Mr. Horton, the Committee unanimously approved and authorized for publication amendments to regulation 1533.2. The amendments would be operative July 1, 2011. A copy of the proposed amendments is attached.

Agenda Item No: 2**Title: Proposed Regulation 2558.1, *Wine*****Issue/Topic:**

Request approval and authorization to publish proposed Regulation 2558.1 to clarify the application of tax to wine-based products that contain distilled spirits.

Committee Discussion:

Mr. Richard Grey of E&J Gallo, addressed the Committee stating that although his previously submitted language is preferred, he recognized the simplicity and clarity of staff's proposed regulation and therefore supported staff's language.

Ms. Steel expressed opposition to any proposed regulation because of its business costs to industry and to the Board. In addition, Ms. Steel believes that the regulation represents an expansion of taxes imposed on wineries.

Staff and Mr. Grey responded to Board member questions and comments regarding the impact of not approving a regulation and the operative date of January 1, 2012, as recommended by staff. Staff and Mr. Grey explained that without a regulation clarifying the Board's interpretation for "wine as defined by Business and Professions Code section 23007" the current ambiguity and inconsistencies would continue. In regard to the operative date, staff clarified that January 1, 2012 was based on input from interested parties and provides ample time for wineries to comply with the provisions of the regulation.

Committee Action/Recommendation/Direction:

Upon motion by Ms. Mandel, seconded by Mr. Horton, the Committee approved and authorized for publication the proposed regulation. A copy of the proposed Regulation 2558.1 is attached.

The vote was as follows:

MEMBER	Horton	Steel	Yee	Runner	Mandel
VOTE	Y	N	Y	Y	Y

/s/ Betty T. Yee

Honorable Betty T. Yee, Committee Chair

/s/ Kristine Cazadd

Kristine Cazadd, Interim Executive Director

BOARD APPROVED

at the February 23, 2011 Board Meeting

/s/ Diane Olson

Diane Olson, Chief
Board Proceedings Division

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

Action Item	Alternative 1 Staff's Proposed Language	Alternative 2 Ms. Barbara Alby's Proposed Language	Alternative 3 E&J Gallo's Proposed Language
Action 1 - Regulation 2558.1, <i>Wine</i>	(a) Effective January 1, 2012, wine as defined by Business and Professions Code section 23007, does not include any alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made.	<p>(a) Effective October 1, 2008, for purposes of the Alcoholic Beverage Tax Law (Revenue and Taxation Code section 32001 et seq.) and subject to the limitations set forth in subdivisions (b) and (c), wine, as defined by Section 23007 of the Business and Professions Code, includes:</p> <p>(1) Any alcoholic beverage obtained from normal alcoholic fermentation of the juice of sound ripe grapes or other agricultural products containing natural or added sugar;</p> <p>(2) Any such alcoholic beverage to which is added grape brandy, fruit brandy or spirits of wine, which is distilled from the particular</p>	<p>(a) Effective October 1, 2008, for purposes of the Alcoholic Beverage Tax Law (Revenue and Taxation Code section 32001 et seq.) and subject to the limitation set forth in subdivisions (b) and (c), wine, as defined by Section 23007 of the Business and Professions Code, includes:</p> <p>(1) Any alcoholic beverage obtained from normal alcoholic fermentation of the juice of sound ripe grapes or other agricultural products containing natural or added sugar and produced in accordance with the Alcohol and Tobacco Tax and Trade Bureau regulations in 27 CFR Subparts F and G (natural wine) or in 27 CFR Subpart I (agricultural wine), in either case with the treatment and materials permitted for such wine in 27 CFR Subpart L and subject to the applicable requirements of the California wine standards in 17 CCR Sections 17001 et seq. (hereinafter referred to as a "wine base");</p> <p>(2) Any alcoholic beverage consisting of a wine base to which is added grape brandy, fruit brandy or spirits of wine, which is distilled from the particular</p>

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

Action Item	Alternative 1 Staff's Proposed Language	Alternative 2 Ms. Barbara Alby's Proposed Language	Alternative 3 E&J Gallo's Proposed Language
	<p>(b) Except as provided in subdivision (a), wine-based products authorized for sale as wine by the Department of Alcoholic Beverage Control are deemed to be wine as defined by Business and Professions Code section 23007 for purposes of the Alcoholic Beverage Tax Law.</p>	<p>agricultural product or products of which the wine is made; and</p> <p>(3) Any other rectified wine products, by whatever name, which do not contain more than 15 percent added flavoring, coloring, and blending material, and which do not contain 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made.</p> <p>(b) The following wine-based products are excluded from the definition of wine and shall be classified as distilled spirits for tax purposes:</p> <p>(1) Any wine-based alcoholic beverage containing more than 24 percent alcohol by volume;</p> <p>(2) Any rectified wine-based alcoholic beverage that contains 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made;</p>	<p>agricultural product or products of which the wine base is made; and</p> <p>(3) Any other alcoholic beverage made from a wine base, by whatever name, that does not contain more than 15 percent added flavoring, coloring, and blending material, and does not contain 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine base is made.</p> <p>(b) The following alcoholic beverages are excluded from the definition of wine and shall be classified as distilled spirits for tax purposes:</p> <p>(1) Any alcoholic beverage made from a wine base and containing more than 24 percent alcohol by volume;</p> <p>(2) Any alcoholic beverage made from a wine base containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made;</p>

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

Action Item	Alternative 1 Staff's Proposed Language	Alternative 2 Ms. Barbara Alby's Proposed Language	Alternative 3 E&J Gallo's Proposed Language
		<p>(3) Any rectified wine-based alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products from the particular agricultural product or products of which the wine is made, and that contains more than 15 percent added flavoring, coloring, and blending material; and</p> <p>(4) Any rectified wine-based alcoholic beverage that contains a combined total of 0.5 percent or more alcohol by volume obtained both from the distillation of fermented agricultural products from the particular agricultural product or products of which the wine is made and from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made, and that contains more than 15 percent added flavoring, coloring, and blending material.</p> <p>(c) For purposes of this section, flavoring, coloring and blending material includes ingredients added during the rectification process. The addition of unadulterated water or the</p>	<p>(3) Any alcoholic beverage made from a wine base containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products from the particular agricultural product or products of which the wine is made, and also containing more than 15 percent added flavoring, coloring, and blending material; and</p> <p>(4) Any alcoholic beverage made from a wine base containing a combined total of 0.5 percent or more alcohol by volume obtained both from the distillation of fermented agricultural products from the particular agricultural product or products of which the wine is made and from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made, and also containing more than 15 percent added flavoring, coloring, and blending material.</p> <p>(c) For purposes of this section, flavoring, coloring and blending material includes water and any other ingredient added after production of the wine base other than alcohol. The</p>

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

Action Item	Alternative 1 Staff's Proposed Language	Alternative 2 Ms. Barbara Alby's Proposed Language	Alternative 3 E&J Gallo's Proposed Language
		<p>unfermented juices from the particular agricultural product or products from which the wine is made shall not be treated as flavoring, coloring or blending materials, no matter when they are added, whether concentrated or not, and whether exceeding 15 percent of the volume of the final product or not. Flavoring, coloring and blending material may not contain 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made.</p>	<p>volume and source of any alcohol contained in flavoring, coloring and blending material shall be included in the determination whether an alcoholic beverage made from a wine base is classified as a distilled spirit for tax purposes in accordance with subdivisions (b)(2), (b)(3), and (b)(4) of this regulation.</p>

Issue Paper Number 11-001

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



Classifying Wine-Based Products for Taxation Purposes

I. Issue

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

II. Alternative 1 - Staff Recommendation

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

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

III. Other Alternative(s) Considered

A. Alternative 2

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

B. Alternative 3

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

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

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IV. Background

In a letter dated October 25, 2006, California Friday Night Live Partnership, Students Making a Community Change, and the California Youth Council filed a petition pursuant to Government Code Section 11340.6 requesting the Board adopt a regulation to tax flavored malt beverages (FMBs) as distilled spirits and/or amend Alcoholic Beverage Tax Regulation 2530. At the time of the petition, all FMBs were classified and taxed as beer in California. In December 2006, the Board granted this petition, directing staff to initiate the rulemaking process and to hold a series of public meetings with interested parties to discuss the classification of FMBs for taxation purposes and to return with regulatory alternatives for the Board's consideration. After considering the alternatives generated by the interested parties process, at the August 14, 2007 Board meeting, the Board approved publication of Regulation 2558, *Distilled Spirits*; Regulation 2559, *Presumption-Distilled Spirits*; Regulation 2559.1, *Rebuttable Presumption-Distilled Spirits*; Regulation 2559.3, *Internet List*; and Regulation 2559.5, *Correct Classification* (collectively, Distilled Spirits Regulations). Due to the focus of the petition, the Distilled Spirits Regulations were promulgated primarily to address the proper classification of FMBs for taxation purposes.

The Distilled Spirits Regulations, attached as Exhibit 5, were approved by the Office of Administrative Law (OAL) with an effective date of July 10, 2008, and became fully operational on October 1, 2008.

Although general questions were raised during the interested parties meetings and at the Board meeting regarding wine-based products that may or may not meet the BPC section 23007 definition of wine and that may contain added distilled alcohol from a nonconforming source, no specific circumstances or products were identified or discussed.

Staff was advised to draft the necessary forms, develop the website, prepare the notices to affected parties, and to work with industry on implementing the Distilled Spirits Regulations. Beginning with the effective date of the Distilled Spirits Regulations, pursuant to Regulation 2559.1, staff began receiving sworn statements (reports) for purposes of rebutting the distilled spirits presumption from manufacturers and brewers. Staff selected numerous products to review and requested from the manufacturers or brewers copies of their "Statement of Process" or "Formula" filed with the federal Alcohol and Tobacco Tax and Trade Bureau (TTB) to determine if they had successfully rebutted the distilled spirits presumption. Along with working with the manufacturers and brewers of FMBs, staff also was in communication with wine growers and importers regarding wine-based products that may not meet the BPC section 23007 definition for wine. Staff prepared two Special Notices specific to the wine industry for clarification purposes, which are attached as Exhibits 6 and 7.

The first notice, dated December 2008, titled *Special Notice to Wine Growers and Importers*, and mailed to wine grower and wine importer registrants, addressed wine that does not meet the statutory definition in BPC section 23007. This notice advised that if a registrant produces and/or imports an alcoholic beverage that does not meet the statutory definition for wine, the registrant should consider filing form BOE 505, *Alcoholic Beverage Tax Report for Rebutting Regulation 2559 Presumption*. Summaries of the Distilled Spirits Regulations were included with this notice. The second notice, dated December 2009, titled *Alcoholic Beverages Taxed as Wine for Federal Purposes, May Not Meet California's Definition of Wine and Therefore May be Subject to Tax as Distilled Spirits for California Tax Purposes*, was mailed to all Alcoholic Beverage program accounts, and advised that certain types of alcoholic beverages that may qualify as wine for federal classification purposes, namely wine specialties, flavored table wine, wine cocktails, wine coolers or other wine-based products or blends of wine from different fruits, may not meet California's definition of wine under

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BPC section 23007 and, therefore, may be considered a distilled spirit and be taxed accordingly. The notice advised each manufacturer, grower or importer to review California's wine definition, and if their product(s) did not meet California's definition of wine, to file form BOE-505, if appropriate, to rebut the distilled spirits presumption.

BPC section 23007 defines wine to mean:

[T]he product obtained from normal alcoholic fermentation of the juice of sound ripe grapes or other agricultural products containing natural or added sugar or any such alcoholic beverage to which is added grape brandy, fruit brandy, or spirits of wine, which is distilled from the particular agricultural product or products of which the wine is made and other rectified wine products and by whatever name and which does not contain more than 15 percent added flavoring, coloring, and blending material and which contains not more than 24 percent of alcohol by volume, and includes vermouth and sake, known as Japanese rice wine.

Title 27 Code of Federal Regulations (C.F.R.) Part 24.10 provides the following general definition of wine for federal purposes: "*Wine*. When used without qualification, the term includes every kind (class and type) of product produced on bonded wine premises from grapes, other fruit (including berries), or other suitable agricultural products and containing not more than 24 percent alcohol by volume. The term includes all imitation, other than standard, or artificial wine and compounds sold as wine. A wine product containing less than one-half of one percent alcohol by volume is not taxable as wine when removed from the bonded wine premises."

Title 26 United States Code section 5041, *Imposition and rate of tax*, provides that there is imposed on "all wines (including imitation, substandard, or artificial wine, and compounds sold as wine) having not in excess of 24 percent of alcohol by volume, in bond in, produced in, or imported into, the United States, taxes at the rates shown in subsection (b), such taxes to be determined as of the time of removal for consumption or sale. All wines containing more than 24 percent of alcohol by volume shall be classed as distilled spirits and taxed accordingly." The federal rates under subdivision (b) are based on alcohol content and whether the wine is still, naturally sparkling, artificially carbonated, or hard cider. California's rates are based on the same basic criteria along with the distilled spirits designation for wine-based products that contain in excess of 24 percent of alcohol by volume. However, California's wine definition differs from the federal definitions in a couple of ways, namely in the requirement that added distilled alcohol that fortifies the alcoholic strength of the beverage must come from distilled alcohol of the same agricultural product of which the wine is made, as opposed to a nonconforming source, and in the requirement that the added flavoring, coloring and blending material for all rectified wine can be no more than 15 percent by volume.

By way of contrasting example, for federal purposes, certain classes of wine known as citrus wines, fruit wine and aperitif wine have no similar restriction relating to the origin of the distilled alcohol added.

It should be noted that the Department of Alcoholic Beverage Control (ABC) treats all wine-based products classified as wine for federal purposes as wine for labeling and licensing purposes in California, regardless of whether added foreign distilled alcohol meets or exceeds 0.5 percent by volume or whether the blending material exceeds 15 percent by volume. ABC maintains that this acquiescence to federal standards is permissible under section 32152 of the Alcoholic Beverage Tax Law (Rev. & Tax. Code, § 32001 et seq.) and is consistent with ABC's position with regard to all FMBs, which ABC continues to classify as beer for labeling and licensing purposes, even when the

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particular FMB is considered a distilled spirit for California tax purposes pursuant to the Distilled Spirits Regulations. By approving the Distilled Spirits Regulations, OAL confirmed that the Board has the authority to diverge from ABC's approach of federal acquiescence for tax classification purposes.

V. Discussion

The intent behind the existing Distilled Spirits Regulations and the issuance of the Special Notices was to provide guidance for the proper classification for tax purposes of all alcoholic beverages, including wine-based products. However, based on field visits to major producers of wine-based products, staff is aware that significant differences of opinion exist as to the proper application of the Distilled Spirits Regulations to nonstandard, wine-based products. Specifically, disagreement exists as to whether water is regarded as a blending material for purposes of BPC section 23007. The inclusion or exclusion of water as a blending material may affect whether a product contains more than 15 percent by volume of added blending material. In other words, whether water is characterized as a blending material may affect whether a product is considered to be a wine as defined by BPC section 23007 or not. Confusion also exists as to the rules governing, and the tax consequences of, introducing to wine-based products distilled alcohol that may not be derived from a conforming source.

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

Regulation 2558.1. WINE.

(a) [Effective xxx xx, xxxx,] for purposes of the Alcoholic Beverage Tax Law (Revenue and Taxation Code section 32001 et seq.) and subject to the limitations set forth in subdivisions (b) and (c), wine, as defined by Section 23007 of the Business and Professions Code includes:

(1) Any alcoholic beverage obtained from normal alcoholic fermentation of the juice of sound ripe grapes or other agricultural products containing natural or added sugar;

(2) Any such alcoholic beverage to which is added grape brandy, fruit brandy or spirits of wine, which is distilled from the particular agricultural product or products of which the wine is made; and

(3) Any other rectified wine products, by whatever name, which do not contain more than 15 percent added flavoring, coloring, and blending material, and which do not contain 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made.

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

(1) Any wine-based alcoholic beverage containing more than 24 percent alcohol by volume;

(2) Any rectified wine-based alcoholic beverage that contains 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made;

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(3) Any rectified wine-based alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products from the particular agricultural product or products of which the wine is made, and that contains more than 15 percent added flavoring, coloring, and blending material; and

(4) Any rectified wine-based alcoholic beverage that contains a combined total of 0.5 percent or more alcohol by volume obtained both from the distillation of fermented agricultural products from the particular agricultural product or products of which the wine is made and from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made, and that contains more than 15 percent added flavoring, coloring, and blending material.

(c) For purposes of this section, flavoring, coloring and blending material includes any ingredient added during the rectification process, including water. Flavoring, coloring and blending material may not contain 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made.

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

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

One view: Water is not a blending material

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

For purposes of this section, flavoring, coloring and blending material includes ~~any ingredients added during the rectification process, including water.~~ The addition of unadulterated water or the unfermented juices from the particular agricultural product or products from which the wine is made shall not be treated as flavoring, coloring or blending materials, no matter when they are added, whether concentrated or not, and whether exceeding 15 percent of the volume of the final product or not. Flavoring, coloring and blending material may not contain 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made.

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

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

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

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

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

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

Another view: Water is a blending material

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

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

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materials permitted for such wine in 27 CFR Subpart L and subject to the applicable requirements of the California wine standards in 17 CCR Sections 17001 et seq. (hereinafter referred to as a “wine base”).” E&J Gallo further proposes to revise the initial draft of Regulation 2558.1 (c) to read: “For purposes of this section, flavoring, coloring and blending material includes ~~any water and any other ingredient added during the rectification process, including water after production of the wine base other than alcohol.~~ Flavoring, coloring and blending material may not contain 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made. The volume and source of any alcohol contained in flavoring, coloring, and blending material shall be included in the determination whether an alcoholic beverage made from a wine base is classified as a distilled spirit for tax purposes in accordance with subdivision (b)(2), (b)(3), and (b)(4) of this regulation.”

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

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

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

Additional comments and concerns from interested parties

Regulatory action is not necessary and/or is unlawful

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

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

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

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

Expedited Rulemaking

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

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

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

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

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

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

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

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

VI. Alternative 1 - Staff Recommendation

A. Description of Alternative 1

Staff recommends adoption of the following proposed regulation:

Regulation 2558.1.WINE.

- (a) Effective January 1, 2012, wine as defined by Business and Professions Code section 23007 does not include any alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made.

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

Authority: Section 32451, Revenue and Taxation Code.

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

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

B. Pros of Alternative 1

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

C. Cons of Alternative 1

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

D. Statutory or Regulatory Change for Alternative 1

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

E. Operational Impact of Alternative 1

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

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

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

F. Administrative Impact of Alternative 1

1. Cost Impact

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

2. Revenue Impact

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

G. Taxpayer/Customer Impact of Alternative 1

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

H. Critical Time Frames of Alternative 1

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

VII. Alternative 2

A. Description of Alternative 2

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

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

B. Pros of Alternative 2

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

C. Cons of Alternative 2

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

D. Statutory or Regulatory Change for Alternative 2

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

E. Operational Impact of Alternative 2

Same as Alternative 1.

F. Administrative Impact of Alternative 2**1. Cost Impact**

Same as Alternative 1.

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2. Revenue Impact

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

G. Taxpayer/Customer Impact of Alternative 2

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

H. Critical Time Frames of Alternative 2

Same as Alternative 1.

VIII Alternative 3

A. Description of Alternative 3

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

B. Pros of Alternative 3

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

C. Cons of Alternative 3

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

D. Statutory or Regulatory Change for Alternative 3

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

E. Operational Impact of Alternative 3

Same as Alternative 1.

F. Administrative Impact of Alternative 3**1. Cost Impact**

Same as Alternative 1.

2. Revenue Impact

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

G. Taxpayer/Customer Impact of Alternative 3

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

H. Critical Time Frames of Alternative 3

Same as Alternative 2.

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Preparer/Reviewer Information

Prepared by: Special Taxes and Fees Division

Current as of: February 4, 2011

REVENUE ESTIMATE

STATE OF CALIFORNIA
BOARD OF EQUALIZATIONBOARD OF EQUALIZATION
REVENUE ESTIMATE

Classifying Wine-Based Products for Taxation Purposes

Alternative 1 – Staff Recommendation

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

Other Alternative(s) Considered

Alternative 2

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

Alternative 3

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

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

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

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

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

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

Alternative 3

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

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

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

Revenue Summary

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

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

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

Preparation

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

Current as of February 3, 2011.

Alternative 1 - Staff Recommendation

Regulation 2558.1. WINE.

- (a) Effective January 1, 2012, wine as defined by Business and Professions Code section 23007 does not include any alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made.
- (b) Except as provided in subdivision (a), wine-based products authorized for sale as wine by the Department of Alcoholic Beverage Control are deemed to be wine as defined by Business and Professions Code section 23007 for purposes of the Alcoholic Beverage Tax Law.

Authority: Section 32451, Revenue and Taxation Code.

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

Alternative 2**Regulation 2558.1. WINE.**

(a) Effective October 1, 2008, for purposes of the Alcoholic Beverage Tax Law (Revenue and Taxation Code section 32001 et seq.) and subject to the limitations set forth in subdivisions (b) and (c), wine, as defined by Section 23007 of the Business and Professions Code includes:

- (1) Any alcoholic beverage obtained from normal alcoholic fermentation of the juice of sound ripe grapes or other agricultural products containing natural or added sugar;
- (2) Any such alcoholic beverage to which is added grape brandy, fruit brandy or spirits of wine, which is distilled from the particular agricultural product or products of which the wine is made; and
- (3) Any other rectified wine products, by whatever name, which do not contain more than 15 percent added flavoring, coloring, and blending material, and which do not contain 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made.

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

- (1) Any wine-based alcoholic beverage containing more than 24 percent alcohol by volume;
- (2) Any rectified wine-based alcoholic beverage that contains 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made;
- (3) Any rectified wine-based alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products from the particular agricultural product or products of which the wine is made, and that contains more than 15 percent added flavoring, coloring, and blending material; and
- (4) Any rectified wine-based alcoholic beverage that contains a combined total of 0.5 percent or more alcohol by volume obtained both from the distillation of fermented agricultural products from the particular agricultural product or products of which the wine is made and from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made, and that contains more than 15 percent added flavoring, coloring, and blending material.

(c) For purposes of this section, flavoring, coloring and blending material includes any ingredients added during the rectification process, ~~including water~~. The addition of unadulterated water or the unfermented juices from the particular agricultural product or products from which the wine is made shall not be treated as flavoring, coloring or blending materials, no matter when they are added, whether concentrated or not, and whether exceeding 15 percent of the volume of the final product or not. Flavoring, coloring and blending material may not contain 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made.

Alternative 2

Authority: Section 32451, Revenue and Taxation Code.

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

Alternative 3**Regulation 2558.1 WINE.**

(a) Effective October 1, 2008, for purposes of the Alcoholic Beverage Tax Law (Revenue and Taxation Code section 32001 et seq.) and subject to the limitation set forth in subdivisions (b) and (c), wine, as defined by Section 23007 of the Business and Professions Code includes:

(1) Any alcoholic beverage obtained from normal alcoholic fermentation of the juice of sound ripe grapes or other agricultural products containing natural or added sugar and produced in accordance with the Alcohol and Tobacco Tax and Trade Bureau regulations in 27 CFR Subparts F and G (natural wine) or in 27 CFR Subpart I (agricultural wine), in either case with the treatment and materials permitted for such wine in 27 CFR Subpart L and subject to the applicable requirements of the California wine standards in 17 CCR Sections 17001 et seq. (hereinafter referred to as a "wine base");

(2) Any ~~such~~ alcoholic beverage consisting of a wine base to which is added grape brandy, fruit brandy or spirits of wine, which is distilled from the particular agricultural product or products of which the wine base is made; and

(3) Any other ~~rectified wine products~~ alcoholic beverage made from a wine base, by whatever name, which ~~do~~ that does not contain more than 15 percent added flavoring, coloring, and blending material, and which ~~do~~ does not contain 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine base is made.

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

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

(2) Any ~~rectified wine based~~ alcoholic beverage made from a wine base ~~that contains~~ containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made;

(3) Any ~~rectified wine based~~ alcoholic beverage made from a wine base containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products from the particular agricultural product or products of which the wine is made, and ~~that contains~~ also containing more than 15 percent added flavoring, coloring, and blending material; and

(4) Any ~~rectified wine based~~ alcoholic beverage made from a wine base containing a combined total of 0.5 percent or more alcohol by volume obtained both from the distillation of fermented agricultural products from the particular agricultural product or products of which the wine is made and from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made, and ~~that contains~~ also containing more than 15 percent added flavoring, coloring, and blending material.

(c) For purposes of this section, flavoring, coloring and blending material includes ~~any water and any other ingredient added during the rectification process, including water~~ after production of the wine base other than alcohol. ~~Flavoring, coloring and blending material may not contain 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is~~

Alternative 3

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

Authority: Section 32451, Revenue and Taxation Code.

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

State of California
BOARD OF EQUALIZATION
ALCOHOLIC BEVERAGE TAX REGULATIONS

Regulation 2558. DISTILLED SPIRITS.

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

Effective October 1, 2008, any alcoholic beverage, except wine as defined by Business and Professions Code section 23007, which contains 0.5 percent or more alcohol by volume derived from flavors or other ingredients containing alcohol obtained from the distillation of fermented agricultural products, is a distilled spirit.

History: Adopted April 8, 2008, effective July 10, 2008.

Regulation 2559. PRESUMPTION - DISTILLED SPIRITS.

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

Effective October 1, 2008, any alcoholic beverage, except wine as defined by Business and Professions Code section 23007, is presumed to contain 0.5 percent or more alcohol by volume derived from flavors or other ingredients containing alcohol obtained from the distillation of fermented agricultural products, unless this presumption is rebutted pursuant to Regulation 2559.1.

History: Adopted April 8, 2008, effective July 10, 2008.

Regulation 2559.1. REBUTTABLE PRESUMPTION - DISTILLED SPIRITS.

Reference: Sections 32002, 32452, 32453, Revenue and Taxation Code; Sections 23004, 23005, 23006, 23007, Business and Professions Code.

(a) On or after July 10, 2008, the presumption in Regulation 2559 may be rebutted by the manufacturer of the alcoholic beverage filing a report, under penalty of perjury, with the Board stating that the alcoholic beverage contains less than 0.5 percent alcohol by volume derived from flavors or other ingredients containing alcohol obtained from the distillation of fermented agricultural products and specifying the sources of the alcohol content of the alcoholic beverage, including the alcohol by volume derived from flavors or other ingredients containing alcohol obtained by distillation.

(b) The Board shall require a manufacturer's "Statement of Process" or "Formula" filed with the Alcohol and Tobacco Tax Trade Bureau, its predecessor agency or successor, under the following circumstances: (1) if the Board obtains information that casts doubt on the accuracy or truthfulness of a report filed under subdivision (a); or (2) for purposes of verifying any report filed under subdivision (a).

(c) (1) If the Board determines that a manufacturer has not successfully rebutted the presumption in Regulation 2559, the Board shall notify the manufacturer of such determination, and the manufacturer may petition for a redetermination.

(2) Upon receiving notice from the Board, the manufacturer may petition the Board's determination within 30 days. If a petition for redetermination is not filed within the 30-day period, the determination becomes final at the expiration of the 30-day period.

(3) Every petition for redetermination shall be in writing and shall state the specific grounds upon which the petition is founded.

(4) The Board shall reconsider the determination pursuant to its administrative appeals process set forth in California Code of Regulations, title 18, sections 5260-5271 and shall grant the applicant an oral hearing if timely requested within 30 days of the date the Decision and Recommendation issued by the Appeals Division is mailed to the manufacturer. Any Board hearing will be governed by the rules set forth in California Code of Regulations, title 18, sections 5510-5576.

(5) The order or decision of the Board upon a petition for redetermination becomes final 30 days after the date notice thereof is mailed to the manufacturer, except as provided in California Code of Regulations, title 18, section 5560.

(6) Any notice required by this section shall be placed in a sealed envelope, with postage paid, addressed to the manufacturer at the manufacturer's last known address as it appears in the records of the Board. The giving of notice shall be deemed complete at the time of deposit of the notice at a United States Post Office, mailbox, sub-post office, substation, mail chute, or other facility regularly maintained or provided by the United States Postal Service, without extension of time for any reason. In lieu of mailing, notice may be served personally by delivery to the person to be served and service shall be deemed complete at the time of such delivery. Personal delivery to a corporation may be made by delivery of a notice to any person designated to be served for the corporation with summons and complaint in a civil action, pursuant to the Code of Civil Procedure, title 5, chapter 4 (§416.10 et seq.).

History: Adopted April 8, 2008, effective July 10, 2008.

Regulation 2559.3. INTERNET LIST.

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

(a) Not later than October 1, 2008, and updated on a quarterly basis thereafter to add or remove from the list, the Board shall develop, publish and maintain on its Internet site a listing of all alcoholic beverages that have been found to have successfully rebutted the presumption set forth in Regulation 2559.

(b) Notwithstanding the addition of an alcoholic beverage to the list, the Board shall require a manufacturer's "Statement of Process" or "Formula" filed with the Alcohol and Tobacco Tax Trade Bureau, its predecessor agency or successor, under the following circumstances: (1) if the Board obtains information that casts doubt on the accuracy or truthfulness of a report filed under Regulation 2559.1, subdivision (a); or (2) for purposes of verifying any report filed under Regulation 2559.1, subdivision (a).

(c) The Board shall remove from the list an alcoholic beverage that is finally determined under subdivision (d) to contain 0.5 percent or more alcohol by volume derived from flavors or other ingredients containing alcohol obtained from the distillation of fermented agricultural products, as set forth in Regulation 2558. Before the removal may take effect, the Board shall notify the manufacturer of this determination.

(d) (1) Upon receiving notice from the Board, the manufacturer may petition the Board's determination within 30 days. If a petition for redetermination is not filed within the 30-day period, the determination becomes final at the expiration of the 30-day period.

(2) Every petition for redetermination shall be in writing and shall state the specific grounds upon which the petition is founded.

(3) The Board shall reconsider the determination pursuant to its administrative appeals process set forth in California Code of Regulations, title 18, sections 5260-5271 and shall grant the applicant an oral hearing if timely requested within 30 days of the date the Decision and Recommendation issued by the Appeals Division is mailed to the manufacturer. Any Board hearing will be governed by the rules set forth in California Code of Regulations, title 18, sections 5510-5576.

(4) The order or decision of the Board upon a petition for redetermination becomes final 30 days after the date notice thereof is mailed to the manufacturer, except as provided in California Code of Regulations, title 18, section 5560.

(5) Any notice required by this section shall be placed in a sealed envelope, with postage paid, addressed to the manufacturer at the manufacturer's last known address as it appears in the records of the Board. The giving of notice shall be deemed complete at the time of deposit of the notice at a United States Post Office, mailbox, sub-post office, substation, mail chute, or other facility regularly maintained or provided by the United States Postal Service, without extension of time for any reason. In lieu of mailing, notice may be served personally by delivery to the person to be served and service shall be deemed complete at the time of such delivery. Personal delivery to a corporation may be made by delivery of a notice to any person designated to be served for the corporation with summons and complaint in a civil action, pursuant to the Code of Civil Procedure, title 5, chapter 4 (§ 416.10 et seq.).

History: Adopted April 8, 2008, effective July 10, 2008.

Regulation 2559.5. CORRECT CLASSIFICATION.

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

Effective October 1, 2008, for purposes of tax reporting, a taxpayer will be deemed to have correctly classified an alcoholic beverage as not being a distilled spirit, as defined by Business and Professions Code section 23005, if at the time taxes are imposed, as set forth in the Revenue and Taxation Code, division 2, part 14, chapters 4, 5, and 5.5, the alcoholic beverage was included on the Board's list pursuant to Regulation 2559.3.

History: Adopted April 8, 2008, effective July 10, 2008.



Special Notice

CALIFORNIA STATE
BOARD OF EQUALIZATION

450 N STREET
SACRAMENTO, CA 95814

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SECTION
800-404-7115
TDD/TTY:
800-735-2929



December 2008
L-214

Special Notice to Wine Growers and Importers

The Board of Equalization (BOE) approved regulations necessary to clarify the definition of "distilled spirits" under the Alcoholic Beverage Tax Law. The regulations were approved by the Office of Administrative Law (OAL) and became fully operative on October 1, 2008.

The regulations create a rebuttable presumption that all alcoholic beverages, except wine, as defined by Business and Professions Code section 23007, contain 0.5 percent or more alcohol by volume derived from flavors or other ingredients containing alcohol obtained from the distillation of fermented agricultural products and are "distilled spirits." The regulations also prescribe a procedure for rebutting this presumption.

Accordingly, unless a manufacturer files the attached BOE-505, *Alcoholic Beverage Tax Report for Rebutting Regulation 2559 Presumption*, to rebut the presumption, any product (including any wine-based products) that does not meet the definition of wine under Business and Professions Code section 23007, is presumed to be a distilled spirit for purposes of the Alcoholic Beverage Tax Law.

Please carefully review the statutory definition of wine and the new Alcoholic Beverage Tax Regulations. In the event you determine that the alcoholic beverages you produce and/or import may not meet the definition of wine, you should consider whether a report to rebut the presumption (BOE-505) should be filed.

For your convenience, the definition of wine is provided below, along with a summary of the new Alcoholic Beverage Tax Regulations 2558, 2559, 2559.1, 2559.3, and 2559.5. For the full text of the regulations, visit www.boe.ca.gov/sptaxprog/sptaxregs.htm.

Business and Professions Code section 23007. "Wine"

"Wine" means the product obtained from normal alcoholic fermentation of the juice of sound ripe grapes or other agricultural products containing natural or added sugar or any such alcoholic beverage to which is added grape brandy, fruit brandy, or spirits of wine, which is distilled from the particular agricultural product or products of which the wine is made and other rectified wine products and by whatever name and which does not contain more than 15 percent added flavoring, coloring, and blending material and which contains not more than 24 percent of alcohol by volume, and includes vermouth and sake, known as Japanese rice wine.

Nothing contained in this section affects or limits the power, authority, or duty of the State Department of Health Services in the enforcement of the laws directed toward preventing the manufacture, production, sale, or transportation of adulterated, misbranded, or mislabeled alcoholic beverages, and the definition of "wine" contained in this section is limited strictly to the purposes of this division and does not extend to, or repeal by implication, any adulterated, misbranded, or mislabeled alcoholic beverages.

Regulation 2558. Distilled Spirits

This regulation clarifies that, effective October 1, 2008, distilled spirits include any alcoholic beverage, except wine as defined by Business and Professions Code section 23007, which contains 0.5 percent or more alcohol by volume from flavors or ingredients containing alcohol obtained from the distillation of fermented agricultural products. The purpose of this regulation is to establish a bright line to determine when an alcoholic beverage is a "distilled spirit" under the Alcoholic Beverage Tax Law.

Regulation 2559. Presumption - Distilled Spirits

Effective October 1, 2008, this regulation established a rebuttable presumption that alcoholic beverages, except wine as defined by Business and Professions Code section 23007, contain 0.5 percent or more alcohol by volume from flavors or ingredients containing alcohol obtained from the distillation of fermented agricultural products. If a manufacturer does not rebut the presumption as provided in Regulation 2559.1, the alcoholic beverage will be presumed to meet the definition of "distilled spirits."

Regulation 2559.1. Rebuttable Presumption - Distilled Spirits

This regulation, effective July 10, 2008, allows the manufacturer to rebut the presumption set forth in Regulation 2559 with respect to any alcoholic beverage by filing a report, under penalty of perjury, that specifies the sources and amount of the alcohol content of the beverage. The regulation additionally provides that the BOE may require a copy of the manufacturer's Statement of Process or Formula filed with the Federal Alcohol and Tobacco Tax and Trade Bureau, or its predecessor agency or successor agency, only if the BOE obtains information that casts a doubt on the accuracy or truthfulness of a report filed or for purposes of verifying any report filed.

Regulation 2559.3. Internet List

Effective October 1, 2008, this regulation requires the BOE to establish and maintain a listing of alcoholic beverages that have successfully rebutted the presumption on its website. The current list can be accessed on the BOE's website at www.boe.ca.gov/sptaxproglpdf/product_list.pdf.

Regulation 2559.5. Correct Classification

This regulation provides that effective October 1, 2008, taxpayers who rely for reporting purposes on the BOE Internet list required by Regulation 2559.3 will be afforded a "safe harbor" from potential tax liabilities.

If you have any questions regarding this notice, please call our Taxpayer Information Section at 800-400-7115 (TDD/TTY: 800-735-2929). Or you may contact the Excise Taxes Division directly at 916-327-4208. Staff are available weekdays from 8:00 a.m. to 5:00 p.m., Pacific time, except state holidays.



Special Notice

STATE BOARD OF EQUALIZATION

460 N STREET
SACRAMENTO, CA 95814

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DECEMBER 2009
L-241

Alcoholic Beverages Taxed as Wine for Federal Purposes, May Not Meet California's Definition of Wine and Therefore May be Subject to Tax as Distilled Spirits for California Tax Purposes

Alcoholic beverages taxed as wine for federal tax purposes may not meet California's wine definition under Business and Professions Code section 23007, if the wine has **more than 15 percent added flavoring, coloring, and blending material.**

The types of alcoholic beverages that may not meet California's definition of wine may fall under the following federal tax classifications such as wine specialties, flavored table wine, wine cocktails, wine coolers or other wine-based products or blends of wine from different fruits. Such products may be taxed as a distilled spirit in California.

The Board of Equalization's (BOE) Alcoholic Beverage Regulation 2559 creates a rebuttable presumption that **all alcoholic beverages, except wine as defined by Business and Professions Code section 23007, contain 0.5 percent or more alcohol by volume derived from flavors or other ingredients containing alcohol obtained from the distillation of fermented agricultural products and are "distilled spirits."** Regulation 2559.1 prescribes procedures for rebutting this presumption.

According to Business and Professions Code section 23007:

Wine means the product obtained from normal alcoholic fermentation of the juice of sound ripe grapes or other agricultural products containing natural or added sugar or any such alcoholic beverage to which is added grape brandy, fruit brandy, or spirits of wine, which is distilled from the particular agricultural product or products of which the wine is made and other rectified wine products and by whatever name and which **does not contain more than 15 percent added flavoring, coloring, and blending material and which contains not more than 24 percent of alcohol by volume, and includes vermouth and sake, known as Japanese rice wine.**

Accordingly, unless a manufacturer files the attached BOE-505, *Alcoholic Beverage Tax Report for Rebutting Regulation 2559 Presumption*, to rebut the presumption, any alcoholic beverage (including any wine-based products) that does not meet the definition of wine under Business and Professions Code section 23007 is presumed to be a distilled spirit for purposes of the Alcoholic Beverage Tax Law.

If the alcoholic beverage meets the definition of wine under Business and Profession Code section 23007, no action is required.

Alcoholic beverages that have rebutted the presumption are listed on BOE's website at www.boe.ca.gov/sptaxprog/alcoholicbeverage.htm.

As part of the BOE audit and compliance program, manufacturers may be required to provide the BOE with a copy of their Statement of Process or Formula and Batch reports filed with the Federal Alcohol and Tobacco Tax and Trade Bureau for our review, to ensure the correct tax amounts are being reported.

For your convenience, attached is a summary of the new Alcoholic Beverage Tax Regulations 2558, 2559, 2559.1, 2559.3, and 2559.5. For the full text of the regulations, visit www.boe.ca.gov/sptaxprog/sptaxregs.htm. If you have any questions regarding this notice, please contact the Excise Tax Division at 800-400-7115.

STATE BOARD
OF EQUALIZATION

*Special Notice
Alcoholic
Beverages Taxed
as Wine for
Federal Purposes,
May Not Meet
California's
Definition
of Wine and
Therefore May be
Subject to Tax as
Distilled Spirits
for California
Tax Purposes*

Regulation 2558. Distilled Spirits

This regulation clarifies that, effective October 1, 2008, distilled spirits include any alcoholic beverage, except wine as defined by Business and Professions Code section 23007, which contains 0.5 percent or more alcohol by volume from flavors or ingredients containing alcohol obtained from the distillation of fermented agricultural products. The purpose of this regulation is to establish a bright line to determine when an alcoholic beverage is a "distilled spirit" under the Alcoholic Beverage Tax Law.

Regulation 2559. Presumption—Distilled Spirits

Effective October 1, 2008, this regulation established a rebuttable presumption that alcoholic beverages, except wine as defined by Business and Professions Code section 23007, contain 0.5 percent or more alcohol by volume from flavors or ingredients containing alcohol obtained from the distillation of fermented agricultural products. If a manufacturer does not rebut the presumption as provided in Regulation 2559.1, the alcoholic beverage will be presumed to meet the definition of "distilled spirits."

Regulation 2559.1. Rebuttable Presumption—Distilled Spirits

This regulation, effective July 10, 2008, allows the manufacturer to rebut the presumption set forth in Regulation 2559 with respect to any alcoholic beverage by filing a report, under penalty of perjury, that specifies the sources and amount of the alcohol content of the beverage. The regulation additionally provides that the BOE may require a copy of the manufacturer's Statement of Process or Formula filed with the Federal Alcohol and Tobacco Tax and Trade Bureau, or its predecessor agency or successor agency, only if the BOE obtains information that casts a doubt on the accuracy or truthfulness of a report filed or for purposes of verifying any report filed.

Regulation 2559.3. Internet List

Effective October 1, 2008, this regulation requires the BOE to establish and maintain a listing of alcoholic beverages that have successfully rebutted the presumption on its website. The current list can be accessed on the BOE's website at www.boe.ca.gov/sptaxprog/pdf/product_list.pdf.

Regulation 2559.5. Correct Classification

This regulation provides that effective October 1, 2008, taxpayers who rely for reporting purposes on the BOE Internet list required by Regulation 2559.3 will be afforded a "safe harbor" from potential tax liabilities.

If you would like to know more about your rights as a taxpayer or if you have not been able to resolve a problem through normal channels (for example, by speaking to a supervisor), please see publication 70, *Understanding Your Rights as a California Taxpayer*, or contact the Taxpayers' Rights Advocate Office for help at 916-324-2798 (or toll-free, 888-324-2798). Their fax number is 916-323-3319. If you prefer, you can write to: Taxpayers' Rights Advocate, MIC:70; State Board of Equalization; P.O. Box 942879; Sacramento, CA 94279-0070.

REGULATION HISTORY

TYPE OF REGULATION: Alcoholic Beverage Tax
REGULATION: 2558.1
TITLE: *Wine*
PREPARATION: Phillip Bishop/Robert Zivkovich
LEGAL CONTACT: Randy Ferris/Stephen Smith

Proposed Regulation 2558.1 clarifies the application of tax to wine-based products that contain distilled alcohol.

HISTORY OF AMENDMENTS:

February 23, 2011: Business Taxes Committee (BTC) Meeting
December 17, 2010: 1st Interested Parties Meeting
November 19, 2010: Topic Placed on BTC Calendar
January 1, 2012: Effective date

Sponsor: Board Staff

Support: None

Oppose: Family Wine Makers, E&J Gallo

BEFORE THE CALIFORNIA STATE BOARD OF EQUALIZATION

450 N Street, Room 121

Sacramento, California

REPORTER'S TRANSCRIPT

FEBRUARY 23, 2011

BUSINESS TAXES COMMITTEE

Reported by: Beverly D. Toms

No. CSR 1662

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P R E S E N T

For the Committee:

Betty T. Yee
Chair

Michelle Steel
Member

Jerome E. Horton
Member

George Runner
Member

Marcy Jo Mandel
Appearing for John Chiang
State Controller
(per Government Code
Section 7.9)

Diane Olson, Chief
Board Proceedings Division

Board of Equalization
Staff:

Susanne Buehler
Sales and Use Tax Department

Cary Huxsoll
Legal Department

Randy Ferris
Legal Administration

Phil Bishop
Special Taxes and Fees
Division

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1 AGENDA ITEM 1

2 Sacramento, California

3 February 23, 2011

4 ---oOO---

5 MS. OLSON: Our next item is the Business Taxes
6 Committee. Ms. Yee is the Chair of that committee. Ms.
7 Yee.

8 MS. YEE: Thank you very much, Ms. Olson.
9 Members, we have two items before the Business Taxes
10 Committee this morning. The first item relates to
11 proposed amendments to Regulation 1598 relating to motor
12 vehicle and aircraft fuels; and 1533.2, diesel fuel used
13 in farming activities or food processing.

14 Let me have staff introduce the issue. Good
15 morning.

16 MS. BUEHLER: Good morning. I am Susanne
17 Buehler with the Sales and Use Tax Department, and with
18 me right now is Cary Huxsoll from our Legal Department.

19 We do have two agenda items for your
20 consideration this morning. Agenda item 1 requires two
21 actions and votes on your part. In Action 1 /we're
22 asking that you approve and authorize for publication
23 staff's proposed amendments to Regulation 1598, motor
24 vehicle and aircraft fuels, or alternatively do not
25 approve amendments to the regulation.

26 The proposed amendments incorporate the
27 provisions of the Revenue and Taxation Code that relate
28 to the 1.75 tax rate increase on sales of diesel fuel

1 beginning July 1, 2011. And the corresponding exemption
2 certificate for sales that are exempt from additional
3 tax.

4 MS. YEE: Okay. Thank you very much.

5 Discussion, Members?

6 MS. STEEL: Just a question. Proposition 26,
7 how it's going to affect this?

8 MR. HUXSOLL: We don't know the full impact of
9 Proposition 26 at this time. So we recommend moving
10 forward with the amendments because this is consistent
11 with law as it is -- the law as it is now. But we do
12 not know what will happen with regards to Proposition
13 26.

14 MS. STEEL: So after Proposition 26 outcome
15 then it's going to be changed or it doesn't really
16 affect anything?

17 MS. YEE: I think, Ms. Steel, you raise a
18 really good point. My own belief about Prop. 26 and its
19 effect on this is that it probably is not going to
20 affect this particular area, but you raise a point with
21 respect to perhaps really being proactive and maybe
22 asking our Legal Department to look at where we are
23 going to have some impacts relative to taxes and fees
24 that will be affected by the provisions of the
25 proposition. I know we've done that in the income tax
26 area but I think it would be proper to look at that with
27 respect to this.

28 But I'm speculating, I'm not an attorney, but

1 that's my gut sense with respect to this regulation.

2 Any other thoughts on that, Mr. Huxsoll?

3 MR. HUXSOLL: We will look into that. We
4 can --

5 MR. RUNNER: I think we have another item come
6 up later, too --

7 MS. YEE: Yes.

8 MR. RUNNER: -- which we can --

9 MS. YEE: Yeah. But it would be, I think,
10 appropriate to perhaps inventory our tax and fee areas
11 just to see where there will be some potential impacts,
12 and I think that would be information the Legislature
13 would be interested in, as well.

14 Okay. So we have before us the proposed
15 amendments. Other discussion, Members?

16 Hearing none, is there a motion?

17 MS. MANDEL: Move authorization and
18 publication. It's a formal rulemaking process.

19 MS. YEE: Okay.

20 MR. HORTON: Second.

21 MS. YEE: I have a motion by Ms. Mandel to
22 authorize and publish the proposed amendments. Second
23 by Mr. Horton.

24 Without objection, motion carries. Thank you
25 very much.

26 MS. BUEHLER: In Action 2 we're asking that you
27 either approve and authorize for publication staff's
28 proposed amendments to Regulation 1533.2, diesel fuel

1 used in farming activities or food processing; or
2 alternatively do not approve amendments to the
3 regulation.

4 The proposed amendments provide that the
5 partial exemption from tax includes an exemption from
6 the additional tax imposed on the sales of diesel fuel.

7 MS. YEE: Thank you, Ms. Buehler. Any
8 discussion?

9 Okay, can we apply the same motion?

10 MS. MANDEL: Same motion.

11 MS. YEE: Same second? Same outcome?

12 Without objection, such will be the order.

13 Thank you.

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1 AGENDA ITEM 2.

2 MS. BUEHLER: In the Agenda Item 2 we're
3 seeking your approval and authorization to publish
4 proposed Regulation 2558.1, Wine, to clarify the
5 application of tax to wine-based products that contain
6 distilled alcohol.

7 I believe we have one speaker on this, Mr.
8 Richard Grey from E & J Gallo Winery.

9 MS. YEE: Okay, let me have Mr. Grey come
10 forward.

11 Please. Yes, right there, that would be great.
12 Thanks. If you'll introduce yourself formally for the
13 record, you have three minutes.

14 MR. GREY: Certainly. Thank you. Good
15 morning, Ladies and Gentlemen. Thank you for the
16 opportunity to speak. I'm Richard Grey. I'm a
17 Vice-President and the General Counsel of the E & J
18 Gallo Winery.

19 The -- the winery has previously suggested an
20 alternative to the Board to clarify the Board's
21 exemption of wine from the special distilled spirits tax
22 on flavored malt beverages. The -- although we believe
23 that our alternative was preferable to the staff
24 proposal here, we recognize that the staff proposal has
25 the virtue of simplicity and would clarify the existing
26 regulation, which is the most important thing to us.

27 As a result, in my letter to you of February 18
28 we withdrew our -- our alternative and now we urge the

1 Board to support the staff alternative. It is easy to
2 understand and is simple. It regulates only the
3 addition of non-conforming spirits and it avoids debate
4 over the other parts of the wine definition.

5 We think it would have minimal impact on the
6 wine industry. We believe that industry members can
7 easily substitute conforming spirits for non-conforming
8 spirits, and it also appears to be consistent with the
9 Board's overall approach for flavored malt beverages,
10 which focuses on the addition of distilled spirits
11 rather than on other aspects of the way these products
12 are made.

13 It's important, we think, that the Board
14 clarify the existing regulation. Otherwise,
15 manufacturers of these products will not be able to
16 determine whether their products are or are not subject
17 to the special tax.

18 For many reasons it's important that all
19 manufacturers have a clear understanding of the Board's
20 tax rules. Consequently, the winery would request that
21 the Board proceed as expeditiously as possible to
22 rulemaking with the staff proposal.

23 MS. YEE: Thank you very much, Mr. Grey. Thank
24 you.

25 Members, this was the effort that -- and I want
26 to thank the staff for its diligence and really terrific
27 work on a very, very complex issue that really required
28 understanding of the manufacturing of wine pretty

1 extensively. But this -- the purpose of this regulation
2 is really to try to ensure equitable treatment between
3 alcoholic beverage -- beverage products that contain
4 distilled spirit-based flavorings regardless of whether
5 they're labeled as wine or beer. And this is an issue
6 that came up after the original regulation was enacted
7 and I believe that the staff recommendation is, as Mr.
8 Grey has alluded to, a simple way for wine manufacturers
9 to now understand what products they produce may be
10 subject to the special tax that was authorized by the
11 original regulation.

12 Discussion?

13 MS. STEEL: Question.

14 MS. YEE: Ms. Steel.

15 MS. STEEL: Like when FMB came up to the Board
16 that you had revenue projection for -- for this time
17 that I didn't see any numbers there. So can you explain
18 or -- did you study and how much we going to get?

19 MR. BISHOP: We -- we expect that there will be
20 reformulation, given -- this is Phil Bishop with the
21 Special Taxes and Fees Division. If industry is given
22 enough time to reformulate, the flavorings that they use
23 they can alter the source for the distilled spirit and
24 avoid the tax treatment for -- as a distilled spirit.

25 So, we think that there won't be any revenue
26 associated with this, or if there is it will be
27 diminimus. We did not --

28 MS. STEEL: That --

1 MR. BISHOP: We did not see much revenue with
2 respect to the FMBs, as you know, and --

3 MS. STEEL: Because when FMB came up to the
4 Board to vote your income projection was \$41 million and
5 so far we received what, quarter million, 250,000?
6 So --

7 MR. BISHOP: Just a little over 200,000.

8 MS. STEEL: -- I'm just -- I'm just really
9 worried that we might gonna have more expenses than
10 revenue. That's first.

11 And second thing is that the business cost is
12 going to be really rising for these wineries, for
13 winemake -- makers because they try to reformulate.
14 And it's not really helping that underage alcohol
15 consumption, that they were worried, you know, for under
16 FMB that we were going through and even Girl Scout came
17 out that, you know, I was against -- actually I was for
18 teenage drinkers drinking, but that was not really true.

19 And this is kind of expansion for another tax
20 increase for the businesses in California. Under the
21 recession like this we keep making tougher regulations
22 for the businesses. I don't think it's going to be
23 right because I thought we learned our lessons from FMB
24 regulations that it was not really helping much for
25 income, but -- the revenue for the State at the same
26 time that we are just making everything really tougher
27 for the businesses. I don't think that's the right
28 direction that we are, you know, putting these

1 regulations on for the businesses.

2 So I really cannot go for it. Thank you.

3 MS. YEE: Thank you very much.

4 Mr. Runner.

5 MR. RUNNER: Yeah, I have a question, just
6 following up on a couple of those issues. One is -- and
7 I actually may have the gentleman from Gallo step back
8 up again. Just to clarify -- because, again, I'm --
9 I'm -- I'm struck between this issue in regards to
10 creating clarity in regulation versus keeping the
11 current regulation that's in place in place.

12 You know, there's some argument I think on --
13 on either side of those. It sounds to me like we
14 have -- have a business -- wine business folks on either
15 side of that discussion.

16 So, the issue of cost -- additional cost in
17 regards to moving forward or not moving forward,
18 let's -- since -- since you're the only -- since you're
19 the only winemaker who has come forth to testify --

20 MR. GREY: I'm just a lawyer.

21 MR. RUNNER: -- representing a winemaker --

22 MR. GREY: Right.

23 MR. RUNNER: -- let me just ask, what are
24 the -- what -- as you look in terms of the alternatives,
25 either Alternative 1 or doing nothing, what are the
26 business risks either way for -- for -- for you -- I
27 don't know if -- you probably can't speak for other
28 wineries.

1 MR. GREY: Correct. Let me just first say that
2 we -- we certainly do support the principles that Ms.
3 Steel just expressed. We opposed the adoption of this
4 tax when it was adopted. But the tax has been adopted
5 and to us as long as it's there it's important that the
6 tax be clarified.

7 While it will cost us probably something in
8 comparison to had the tax never been adopted, it's not
9 a -- not a substantial cost and to us it's most
10 important that the rule be clear, because we --

11 MR. RUNNER: And if it is not clear what
12 happens?

13 MR. GREY: Well, if it's not clear we probably
14 adopt a conservative interpretation of it and spend
15 additional money complying with it, whereas other people
16 who adopt a less conservative interpretation, who aren't
17 quite as visible publicly as the Gallo Winery is, might
18 choose to be -- adopt a more aggressive interpretation
19 and -- and in our view cut corners.

20 And we want to make sure that the playing field
21 is level among those who are competing for this
22 business. And so we want the rule to be clear so that
23 everybody understands what it is.

24 MR. RUNNER: Okay, thank you. Let me just go
25 quick to -- to Legal then. And if indeed we have
26 ambiguity in the -- in the regulation and there is an
27 interpretation clarifying that ambiguity say some time
28 in the future, what exposure do those -- do those --

1 those winemakers have that have not gone through the
2 re -- a reformulation process in terms of exposure to
3 tax?

4 MR. FERRIS: Yeah. In part that's the -- the
5 reason why staff recommended a January 1, 2012 effective
6 date for this regulatory change, so that there would
7 be -- based on our conversations with the interested
8 parties that would be more than sufficient time for
9 the -- the winemakers to make whatever formulation
10 adjustments they need to make.

11 So that -- so, part of our -- we had kind of
12 dual concerns. We wanted to provide clarity and we also
13 wanted to make sure that -- that the affected parties
14 would have --

15 MR. RUNNER: If we didn't provide clarity?

16 MR. FERRIS: Huh?

17 MR. RUNNER: If we didn't provide clarity --

18 MR. FERRIS: Oh.

19 MR. RUNNER: -- and we -- and we -- and we
20 moved forward with -- with -- with what is currently the
21 rule at that point, what does that do if in the
22 future -- is there a future exposure then if indeed
23 later on somebody decides to enforce the rule in a
24 different manner because the rule is ambiguous right
25 now?

26 MR. FERRIS: Oh, if the Board were to deny?

27 MR. RUNNER: Yeah.

28 MR. FERRIS: Yes, there would be a potential

1 exposure.

2 MR. RUNNER: And what -- and --

3 MR. FERRIS: It -- for example, if a -- a
4 future Board were to decide that it was proper for the
5 Board to get into the issue of what is a blending agent
6 and get into the manufacturing processes -- processes of
7 winemakers, you could potentially be looking at tens to
8 hundreds of millions of dollars in tax liabilities.

9 MR. RUNNER: If we don't clarify?

10 MR. FERRIS: A future Board could take --

11 MR. RUNNER: Could change that?

12 MR. FERRIS: -- could change that and take
13 actions that could have a very substantial impact on --

14 MR. RUNNER: And those could be done
15 retroactively back to the rule?

16 MR. FERRIS: Yes.

17 MR. RUNNER: Okay, thank you.

18 MS. YEE: Okay, thank you, Mr. Runner. Other
19 discussion, Members?

20 MR. HORTON: Yeah.

21 MS. YEE: Mr. Horton.

22 MR. HORTON: I mean, currently there's an
23 imbalance in the industry where different entities are
24 treating this differently and that the blends are -- you
25 know, process -- the wine, itself, is processed
26 differently in the products themselves there is no
27 delineation as to which product is really classified as
28 wine.

1 And so, another inherent danger is that our
2 Audit Department could very well take the position that
3 they're going to take the existing regulation, combine
4 that with the interpretations that do exist and then
5 thereby say or conclude that a certain segment of this
6 market should be paying \$3.20 as opposed to the lesser
7 amount.

8 And so -- and then if those -- if that -- if
9 that comes before the Board then we're forced to act --
10 and then we're forced to act in the presence of a
11 statute, itself, that has no clarity, whatsoever, and
12 then you expose the taxpayer to potential subsequent
13 litigation if the Board in fact rules against them and
14 not necessarily in their favor.

15 So I think it's incumbent upon us to level the
16 playing field, provide clarity so everyone knows what
17 the rules are and so that everyone can play by the
18 rules, and provide the industry adequate enough time to
19 adjust in such a way that it minimizes the burden on
20 them that they're able to adjust in the natural scheme
21 of things as far as how they process their product.

22 MS. STEEL: Madam Chair.

23 MS. YEE: Yes, Ms. Steel.

24 MS. STEEL: Two wrongs don't make a right. The
25 Federal government regulations are much more simple
26 because by the alcohol level that you decide that, you
27 know, what's hard liquor and what's not. So, I think we
28 really should not go forward with wine regulations but

1 we have to repeal that FMB regulations that we passed
2 because it was not doing what it's supposed to do. And
3 I think we -- if it's bad then I think we should repeal
4 it and then, you know, we have to change the law because
5 this regulations we are kind -- this is another
6 expansion of taxes. And I don't think this is right for
7 businesses.

8 And especially wine industry that we are the
9 Number One in the whole world. That's the way I think.
10 And they been going up, and they are making very good
11 wine.

12 I think more regulations is going to hurt
13 businesses in California and I don't think that's the
14 right direction. Thank you.

15 MS. YEE: Thank you, Ms. Steel.

16 Mr. Horton.

17 MR. HORTON: I mean -- let me share with the --
18 with the body that -- I chaired the Government
19 Organization Committee when this came through and the
20 author and the force behind the regula -- or the law was
21 actually to raise the tax on a large segment of this
22 industry. And it was the intent, I would argue, of the
23 Legislature that there would be a tax increase.

24 It wasn't until with some caveat that would
25 allow them to sort of reformulate, if you will -- but it
26 wasn't until the Board promulgated the legislation that
27 the Legislature realized that there wasn't going to be a
28 significant amount of tax revenue.

1 The projections are much larger than the
2 reality and that was because of the regulation by the
3 Board. If you take away that regulation you go back to
4 the intent of the Legislature or the legislators who
5 authored the bill, it was clearly their intent to have
6 an increase of -- a significant increase, somewhere
7 around 3,000 percent, on the industry, despite the fact
8 that a number of us opposed the law for the mere reason
9 that Ms. Steel has articulated, but it wasn't sufficient
10 to stop the law from passing because the larger concern
11 about this product being in the hands of children and
12 the method of controlling it, which I certainly disagree
13 with, was to raise the taxes on the product and
14 therefore make it so expensive that no one could buy it.

15 Well, that's not necessarily how you control
16 behavior. You just shift it to the underground economy
17 or you shift it to the parents or you shift it to them
18 taking it out of the ice box or a number -- in fact, I
19 share the -- in the -- in the discussion I share that
20 sit -- personal situation where we had -- here in
21 Sacramento we had purchased some wine coolers, and my
22 son was visiting with me and I came home and they were
23 all gone. He was sitting on the couch out of it.

24 And so I saw all these bottles down there and
25 he says, well, he said, "They said lemonade," you know,
26 and so I shared that example in support that we need to
27 do something about it. There has to be tighter controls
28 over it.

1 But raising taxes on an industry -- or taxing
2 an industry out of business is not the way to go about
3 correcting a behavior -- a behavior modification.

4 So one would argue if I was the author of the
5 bill and those who supported the bill and the Governor
6 who signed the bill, I would argue in the absence of the
7 regulation that was passed by the Board of Equalization
8 that the taxes that we projected as a Legislature should
9 have been collected and the taxes should be higher on
10 the industry instead of lower.

11 But there was a caveat in the -- in the bill
12 that -- that allowed this notion of reformulating and
13 the industry, thank God from my perspective, was able to
14 reformulate and adjust accordingly.

15 But now we've got this -- this unclarity that
16 exists and -- and I'm just -- I'm personally concerned
17 that without taking some action ultimately you're going
18 to end up with a -- with a -- you know, an enormous
19 amount of tax on this industry.

20 So, the reverse of the intent is going to
21 happen because the original legislative intent was to
22 have a \$3.20 tax on a segment of this industry that they
23 wanted to control, they wanted to isolate and segregate
24 as wine as not being wine at all, but being a distilled
25 spirit.

26 And it didn't happen because of the regulation
27 of the Board from many of our perspectives. But --

28 MS. YEE: Thank you, Mr. Horton. Let me just

1 make a couple of comments.

2 The original regulation in focusing on flavored
3 malt beverages really arose out of the necessity to
4 really look at how we were going to classify these
5 products, since they really didn't get under the
6 definition of beer or wine.

7 And as we proceeded to have that regulation
8 promulgated it became clear that how we had treated wine
9 really was without consideration as to some of the
10 manufacturing processes that go into making of wine.

11 I think this -- this particular clarification
12 is needed. Frankly, the clarification has been
13 requested by the wine industry. They want the
14 clarification going forward.

15 There are processes that many of them are
16 sitting on, waiting to see how this Board will act in
17 this regard and which then prompts me to look at the
18 effective date of this regulation that staff is
19 proposing.

20 I know that there is a desire to be sure the
21 wine industry is properly notified with respect to the
22 enactment of this regulation. On the other hand, I also
23 know that probably every winemaker in California has
24 eyes on this regulation right now. So I think we
25 continue to do our outreach to the industry, that is
26 there a reason why the effective date couldn't be any
27 time sooner, say October? Just so -- the original input
28 that we had gotten from the industry was that they

1 really were sitting on some decisions about how to
2 proceed with certain products, and so I want to be sure
3 we're sensitive to that, as well.

4 MR. FERRIS: During the interested parties
5 meeting that we had in December I did ask the various
6 winemakers that were there how long it would take them
7 to reformulate and none of them were able or perhaps
8 willing to give specifics about that. And so the only
9 date that was given by any of the interested parties
10 that they thought would be a fair date was the January
11 1, 2012 date. So staff went with that.

12 In support of -- of the Board's desire to
13 expedite getting to resolution on this we -- we -- we
14 felt that if we started getting into discussions with
15 them about -- that they weren't willing to -- really to
16 tell us how long it would take them to -- to do these
17 reformulations and we just picked another date it
18 potentially could drag this thing out if we picked a
19 date that one of them said, "Ooh, that -- that's a
20 problem for me because my suppliers that are going to
21 provide certain ingredients are going to be necessary
22 for this reformulation, I've got contracts a particular
23 way." I think the one interested party that did bring
24 up the January 1, 2012 date did it on the basis of
25 contracts they had in place for certain ingredients.
26 So --

27 MS. YEE: Okay. Mr. Grey, would you mind
28 coming up and speaking on this issue. I'm -- I'm

1 hearing different scenarios and I just wanted to be
2 clear in understanding how the effective date may affect
3 decisions that --

4 MR. GREY: We -- we would support the earliest
5 date possible, from the effective date of it. We can't
6 speak for other wineries, of course, but the issue has
7 been in the -- in the radar -- on the radar of the wine
8 industry for some time. And a date of October 1, which
9 coincidentally was the effective date of the original
10 tax seems to me would -- ought to give people plenty of
11 time to make their plans

12 MS. YEE: All right.

13 MS. MANDEL: Can I ask a question?

14 MS. YEE: Ms. Mandel, please.

15 MS. MANDEL: From here to final adoption -- I
16 guess it's two questions, to final -- to anticipated
17 final adoption and effectiveness through OAL it's not
18 instantaneous, it's going to take a few months.

19 MS. YEE: Right.

20 MR. BISHOP: Right. We have a tentative date
21 of July 27th that the regulation promulgated today would
22 be approved. And then it's 30 days later it's
23 effective.

24 So, an October 1st date can fit --

25 MS. MANDEL: So --

26 MR. BISHOP: -- in that time frame.

27 MS. MANDEL: Well, --

28 MR. FERRIS: But that would assume --

1 MS. MANDEL: -- because October --

2 MR. FERRIS: That would assume that it goes
3 without a hitch.

4 MS. MANDEL: Right, that --

5 MR. FERRIS: The first time we did this we got
6 it bounced back --

7 MS. MANDEL: We got it -- yes.

8 MR. FERRIS: -- back from OAL and --

9 MS. MANDEL: -- right. Right, and that --
10 and -- and is this a -- is this a tax that's quarterly
11 or --

12 MR. BISHOP: Most of the taxpayers are
13 monthly.

14 MS. MANDEL: Monthly returns, monthly payments?

15 MR. BISHOP: Uh-huh.

16 MS. MANDEL: Okay. But July, that takes you to
17 the end of August, then you have to maybe still do the
18 outreach. Yeah.

19 MR. BISHOP: We prefer the beginning of a
20 quarter, because most --

21 MS. YEE: Right.

22 MS. MANDEL: Because most of our systems --

23 MS. YEE: Right.

24 MS. MANDEL: -- are --

25 MS. YEE: Right.

26 MS. MANDEL: Yeah.

27 MR. RUNNER: Madam Chair.

28 MS. YEE: Yes, Mr. Runner.

1 MR. RUNNER: A quick question. I guess I'm
2 becoming uneasy right now trying to come up with a new
3 date in light of the fact that the date that has -- that
4 we've already established a date to which comments have
5 already been made, people have already written their
6 letters on, and so I'm a bit uncomfortable I think than
7 by way of trying to find three months one place or
8 another.

9 MS. MANDEL: Yeah, October sounds potentially
10 tight from what I'm hearing. So -- and the only
11 interested party comment was the January 1st in light
12 of --

13 MR. BISHOP: Right, they mentioned their
14 growing season and the main production time period,
15 which tends to occur after the summer, after the
16 picking.

17 MR. RUNNER: Yeah, I -- I think I don't see a
18 compelling reason to go back up those months.

19 MS. YEE: Okay. Let me ask then, how are we
20 going to treat wine producers that perhaps are using
21 non-compliant formulas, either before or after the
22 enactment of this regulation?

23 MR. BISHOP: Well, that -- subsequent to the
24 effective date or operative date we would assess it at a
25 distilled spirits rate if they were greater than a half
26 percent non-conforming --

27 MS. YEE: Okay. And what about --

28 MR. BISHOP: -- alcohol spirit.

1 MS. YEE: -- while the regulation is pending?

2 MR. BISHOP: While the regulation is pending --

3 MR. FERRIS: Reasonable notice on its abeyance.

4 MR. BISHOP: We would -- yeah.

5 MS. MANDEL: Because it's an operative date.

6 MS. YEE: Okay.

7 MR. BISHOP: Is it the current -- 23007 in the
8 Business and Professions Code does contemplate grape
9 spirits and, you know, rectified wine products and it --
10 it doesn't state that you can -- you know, the
11 non-conforming alcohol cannot be considered at a later
12 stage in the production process. So there is -- I mean,
13 we presume that there is that inconsistency or confusion
14 in the industry. So this would clarify that for Board
15 purposes and for tax purposes that non-conforming
16 distilled spirits cannot be used from this point
17 forward.

18 MS. YEE: Okay. I'm sorry, so in terms of the
19 audits that are being held in abeyance that's currently
20 happening pending the outcome of this regulation?

21 MR. BISHOP: Yes.

22 MS. YEE: Okay.

23 MR. HORTON: Madam -- Madam Chair?

24 MS. YEE: Mr. Horton.

25 MR. HORTON: The audit's held in abeyance. Can
26 you tell us a little more about that.

27 MR. BISHOP: Actually, they are -- there was
28 some investigations as a result of the FMBs. Formulas

1 come in and they would review the formulas and they took
2 a look at some of the manufacturers, most with regard to
3 the beer manufacturers, but there were some wineries
4 looked at. And so the -- the formulas were examined and
5 they realized there was -- there was some inconsistency
6 and staff really didn't know how to proceed, so in terms
7 of do we have a development on it in-house, no, we
8 don't. We have some ideas of potential products that
9 may have run afoul and depending on the effective date
10 of any regulation and the direction of the Board's, that
11 would be our staff's direction, also.

12 MS. MANDEL: And it was my understanding that
13 part of what the genesis for this issue coming forward
14 was the discovery of differences that were out there and
15 confusion and not -- not clarity in the regulations.
16 And that's kind of part of how it percolated up.

17 MR. FERRIS: That's correct.

18 MS. YEE: Okay. Other comments, Members?
19 Hearing none, is there a motion, please?

20 MS. MANDEL: I'll -- I'll move the staff
21 recommendation.

22 MR. HORTON: Second.

23 MS. YEE: Motion by Ms. Mandel to adopt the
24 staff recommendation. Second by Mr. Horton. Please
25 call the roll.

26 MS. OLSON: Madam Chair?

27 MS. YEE: Aye.

28 MS. OLSON: Mr. Horton.

1 MR. HORTON: Aye.

2 MS. OLSON: Ms. Steel.

3 MS. STEEL: No.

4 MS. OLSON: Mr. Runner.

5 MR. RUNNER: Aye.

6 MS. OLSON: Ms. Mandel.

7 MS. MANDEL: Aye.

8 MS. OLSON: Motion carries.

9 MS. YEE: Okay. Thank you very much.

10 Thank you, staff, for your great work on this.

11 ---oOo---

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REPORTER'S CERTIFICATE

1
2
3 State of California)
4) ss
5 County of Sacramento)
6

7 I, BEVERLY D. TOMS, Hearing Reporter for the
8 California State Board of Equalization certify that on
9 February 23, 2011 I recorded verbatim, in shorthand, to
10 the best of my ability, the proceedings in the
11 above-entitled hearing; that I transcribed the shorthand
12 writing into typewriting; and that the preceding 27
13 pages constitute a complete and accurate transcription
14 of the shorthand writing.
15

16 Dated: March 14, 2011.
17



21 *Beverly D Toms*

22 BEVERLY D. TOMS
23 Hearing Reporter
24
25
26
27
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**ESTIMATE OF COST OR SAVINGS RESULTING
FROM PROPOSED REGULATORY ACTION**

Proposed Amendment of Special Tax Regulation 2558.1, *Wine*

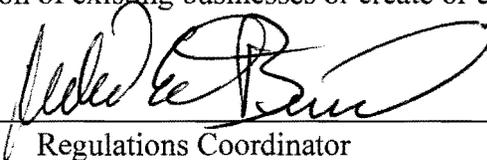
STATEMENT OF COST OR SAVINGS FOR NOTICE OF PUBLIC HEARING

The State Board of Equalization has determined that the proposed action does not impose a mandate on local agencies or school districts. Further, the Board has determined that the action will result in no direct or indirect cost or savings to any State agency, any local agency or school district that is required to be reimbursed under Part 7 (commencing with Section 17500) of Division 4 of Title 2 of the Government Code or other non-discretionary cost or savings imposed on local agencies, or cost or savings in Federal funding to the State of California.

The cost impact on private persons or businesses will be insignificant. This proposal will not have a significant adverse economic impact on businesses.

This proposal will not be detrimental to California businesses in competing with businesses in other states.

This proposal will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses or create or expand business in the State of California.

Statement Prepared by  Date 3/22/11
Regulations Coordinator

Approved by  Date 3/22/11
Acting Chief Counsel

If Costs or Savings are Identified, Signatures of Chief, Fiscal Management Division, and Chief, Board Proceedings Division, are Required

Approved by _____ Date _____
Chief, Financial Management Division

Approved by _____ Date _____
Chief, Board Proceedings Division

NOTE: SAM Section 6660 requires that estimates resulting in cost or savings be submitted for Department of Finance concurrence before the notice of proposed regulatory action is released.

ECONOMIC AND FISCAL IMPACT STATEMENT**(REGULATIONS AND ORDERS)**

STD. 399 (REV. 12/2008)

See SAM Section 6601 - 6616 for Instructions and Code Citations

DEPARTMENT NAME State Board of Equalization	CONTACT PERSON Richard E. Bennion	TELEPHONE NUMBER 916-445-2130
DESCRIPTIVE TITLE FROM NOTICE REGISTER OR FORM 400 Title 18, Section 2558.1, Wine		NOTICE FILE NUMBER Z

ECONOMIC IMPACT STATEMENT**A. ESTIMATED PRIVATE SECTOR COST IMPACTS (Include calculations and assumptions in the rulemaking record.)**

1. Check the appropriate box(es) below to indicate whether this regulation:

- | | |
|---|--|
| <input type="checkbox"/> a. Impacts businesses and/or employees | <input type="checkbox"/> e. Imposes reporting requirements |
| <input type="checkbox"/> b. Impacts small businesses | <input type="checkbox"/> f. Imposes prescriptive instead of performance |
| <input type="checkbox"/> c. Impacts jobs or occupations | <input type="checkbox"/> g. Impacts individuals |
| <input type="checkbox"/> d. Impacts California competitiveness | <input checked="" type="checkbox"/> h. None of the above (Explain below. Complete the Fiscal Impact Statement as appropriate.) |

h. (cont.) No significant adverse economic impact on business or employees, small business, jobs or occupations.

(If any box in Items 1 a through g is checked, complete this Economic Impact Statement.)

2. Enter the total number of businesses impacted: _____ Describe the types of businesses (Include nonprofits.): _____

Enter the number or percentage of total businesses impacted that are small businesses: _____

3. Enter the number of businesses that will be created: _____ eliminated: _____

Explain: _____

4. Indicate the geographic extent of impacts: Statewide Local or regional (List areas.): _____

5. Enter the number of jobs created: _____ or eliminated: _____ Describe the types of jobs or occupations impacted: _____

6. Will the regulation affect the ability of California businesses to compete with other states by making it more costly to produce goods or services here?

 Yes No If yes, explain briefly: _____**B. ESTIMATED COSTS (Include calculations and assumptions in the rulemaking record.)**

1. What are the total statewide dollar costs that businesses and individuals may incur to comply with this regulation over its lifetime? \$ _____

a. Initial costs for a small business: \$ _____ Annual ongoing costs: \$ _____ Years: _____

b. Initial costs for a typical business: \$ _____ Annual ongoing costs: \$ _____ Years: _____

c. Initial costs for an individual: \$ _____ Annual ongoing costs: \$ _____ Years: _____

d. Describe other economic costs that may occur: _____

ECONOMIC AND FISCAL IMPACT STATEMENT cont. (STD. 399, Rev. 12/2008)

2. If multiple industries are impacted, enter the share of total costs for each industry: _____

3. If the regulation imposes reporting requirements, enter the annual costs a typical business may incur to comply with these requirements. (Include the dollar costs to do programming, record keeping, reporting, and other paperwork, whether or not the paperwork must be submitted.): \$ _____

4. Will this regulation directly impact housing costs? Yes No If yes, enter the annual dollar cost per housing unit: _____ and the number of units: _____

5. Are there comparable Federal regulations? Yes No Explain the need for State regulation given the existence or absence of Federal regulations: _____

Enter any additional costs to businesses and/or individuals that may be due to State - Federal differences: \$ _____

C. ESTIMATED BENEFITS (Estimation of the dollar value of benefits is not specifically required by rulemaking law, but encouraged.)

1. Briefly summarize the benefits that may result from this regulation and who will benefit: _____

2. Are the benefits the result of : specific statutory requirements, or goals developed by the agency based on broad statutory authority?
Explain: _____

3. What are the total statewide benefits from this regulation over its lifetime? \$ _____

D. ALTERNATIVES TO THE REGULATION (include calculations and assumptions in the rulemaking record. Estimation of the dollar value of benefits is not specifically required by rulemaking law, but encouraged.)

1. List alternatives considered and describe them below. If no alternatives were considered, explain why not: _____

2. Summarize the total statewide costs and benefits from this regulation and each alternative considered:

Regulation:	Benefit: \$ _____	Cost: \$ _____
Alternative 1:	Benefit: \$ _____	Cost: \$ _____
Alternative 2:	Benefit: \$ _____	Cost: \$ _____

3. Briefly discuss any quantification issues that are relevant to a comparison of estimated costs and benefits for this regulation or alternatives: _____

4. Rulemaking law requires agencies to consider performance standards as an alternative, if a regulation mandates the use of specific technologies or equipment, or prescribes specific actions or procedures. Were performance standards considered to lower compliance costs? Yes No
Explain: _____

E. MAJOR REGULATIONS (Include calculations and assumptions in the rulemaking record.) Cal/EPA boards, offices, and departments are subject to the following additional requirements per Health and Safety Code section 57005.

ECONOMIC AND FISCAL IMPACT STATEMENT cont. (STD. 399, Rev. 12/2008)

1. Will the estimated costs of this regulation to California business enterprises exceed \$10 million? Yes No (If No, skip the rest of this section.)

Briefly describe each equally as an effective alternative, or combination of alternatives, for which a cost-effectiveness analysis was performed:

Alternative 1: _____

Alternative 2: _____

3. For the regulation, and each alternative just described, enter the estimated total cost and overall cost-effectiveness ratio:

Regulation:	\$ _____	Cost-effectiveness ratio: \$ _____
Alternative 1:	\$ _____	Cost-effectiveness ratio: \$ _____
Alternative 2:	\$ _____	Cost-effectiveness ratio: \$ _____

FISCAL IMPACT STATEMENT

A. FISCAL EFFECT ON LOCAL GOVERNMENT (Indicate appropriate boxes 1 through 6 and attach calculations and assumptions of fiscal impact for the current year and two subsequent Fiscal Years.)

1. Additional expenditures of approximately \$ _____ in the current State Fiscal Year which are reimbursable by the State pursuant to Section 6 of Article XIII B of the California Constitution and Sections 17500 et seq. of the Government Code. Funding for this reimbursement:

a. is provided in _____, Budget Act of _____ or Chapter _____, Statutes of _____

b. will be requested in the _____ Governor's Budget for appropriation in Budget Act of _____
(FISCAL YEAR)

2. Additional expenditures of approximately \$ _____ in the current State Fiscal Year which are not reimbursable by the State pursuant to Section 6 of Article XIII B of the California Constitution and Sections 17500 et seq. of the Government Code because this regulation:

a. implements the Federal mandate contained in _____

b. implements the court mandate set forth by the _____
court in the case of _____ vs. _____

c. implements a mandate of the people of this State expressed in their approval of Proposition No. _____ at the _____
election; (DATE)

d. is issued only in response to a specific request from the _____
_____, which is/are the only local entity(s) affected;

e. will be fully financed from the _____ authorized by Section _____
(FEES, REVENUE, ETC.)
_____ of the _____ Code;

f. provides for savings to each affected unit of local government which will, at a minimum, offset any additional costs to each such unit;

g. creates, eliminates, or changes the penalty for a new crime or infraction contained in _____

3. Savings of approximately \$ _____ annually.

4. No additional costs or savings because this regulation makes only technical, non-substantive or clarifying changes to current law regulations.

ECONOMIC AND FISCAL IMPACT STATEMENT cont. (STD. 399, Rev. 2-98)

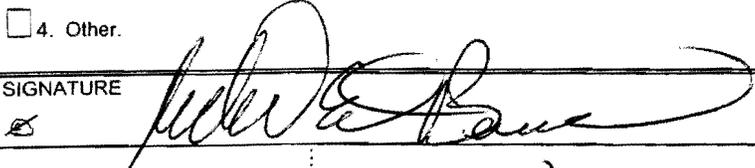
5. No fiscal impact exists because this regulation does not affect any local entity or program.
6. Other.

B. FISCAL EFFECT ON STATE GOVERNMENT *(Indicate appropriate boxes 1 through 4 and attach calculations and assumptions of fiscal impact for the current year and two subsequent Fiscal Years.)*

1. Additional expenditures of approximately \$ _____ in the current State Fiscal Year. It is anticipated that State agencies will:
- a. be able to absorb these additional costs within their existing budgets and resources.
- b. request an increase in the currently authorized budget level for the _____ fiscal year.
2. Savings of approximately \$ _____ in the current State Fiscal Year.
3. No fiscal impact exists because this regulation does not affect any State agency or program.
4. Other.

C. FISCAL EFFECT ON FEDERAL FUNDING OF STATE PROGRAMS *(Indicate appropriate boxes 1 through 4 and attach calculations and assumptions of fiscal impact for the current year and two subsequent Fiscal Years.)*

1. Additional expenditures of approximately \$ _____ in the current State Fiscal Year.
2. Savings of approximately \$ _____ in the current State Fiscal Year.
3. No fiscal impact exists because this regulation does not affect any federally funded State agency or program.
4. Other.

SIGNATURE	TITLE
	Regulations Coordinator
AGENCY SECRETARY ¹	DATE
APPROVAL/CONCURRENCE	 PROGRAM BUDGET MANAGER
DEPARTMENT OF FINANCE ²	DATE
APPROVAL/CONCURRENCE	Exempt under SAM section 6660

1. The signature attests that the agency has completed the STD. 399 according to the instructions in SAM sections 6600-6680, and understands the impacts of the proposed rulemaking. State boards, offices, or departments not under an Agency Secretary must have the form signed by the highest ranking official in the organization.

2. Finance approval and signature is required when SAM sections 6600-6670 require completion of the Fiscal Impact Statement in the STD. 399.

NOTICE PUBLICATION/REGULATIONS SUBMISSION

(See instructions on reverse)

For use by Secretary of State only

STD. 400 (REV. 01-09)

OAL FILE NUMBERS	NOTICE FILE NUMBER Z-2011-0310-02	REGULATORY ACTION NUMBER	EMERGENCY NUMBER
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For use by Office of Administrative Law (OAL) only

RECEIVED FOR FILING PUBLICATION DATE MAR 10 '11 MAR 25 '11 Office of Administrative Law NOTICE	REGULATIONS
--	-------------

AGENCY WITH RULEMAKING AUTHORITY State Board of Equalization	AGENCY FILE NUMBER (if any)
---	-----------------------------

A. PUBLICATION OF NOTICE (Complete for publication in Notice Register)

1. SUBJECT OF NOTICE Wine	TITLE(S) 18	FIRST SECTION AFFECTED 2558.1	2. REQUESTED PUBLICATION DATE March 25, 2011
3. NOTICE TYPE <input checked="" type="checkbox"/> Notice re Proposed Regulatory Action <input type="checkbox"/> Other	4. AGENCY CONTACT PERSON Rick Bennion	TELEPHONE NUMBER (916) 445-2130	FAX NUMBER (Optional) (916) 324-3984
OAL USE ONLY	ACTION ON PROPOSED NOTICE <input type="checkbox"/> Approved as Submitted <input type="checkbox"/> Approved as Modified <input type="checkbox"/> Disapproved/Withdrawn	NOTICE REGISTER NUMBER	PUBLICATION DATE

B. SUBMISSION OF REGULATIONS (Complete when submitting regulations)

1a. SUBJECT OF REGULATION(S)	1b. ALL PREVIOUS RELATED OAL REGULATORY ACTION NUMBER(S)
------------------------------	--

2. SPECIFY CALIFORNIA CODE OF REGULATIONS TITLE(S) AND SECTION(S) (including title 26, if toxics related)

SECTION(S) AFFECTED (List all section number(s) individually. Attach additional sheet if needed.)	ADOPT
	AMEND
	REPEAL
TITLE(S)	

3. TYPE OF FILING

<input type="checkbox"/> Regular Rulemaking (Gov. Code §11346)	<input type="checkbox"/> Certificate of Compliance: The agency officer named below certifies that this agency complied with the provisions of Gov. Code §911346.2-11347.3 either before the emergency regulation was adopted or within the time period required by statute.	<input type="checkbox"/> Emergency Readopt (Gov. Code, §11346.1(h))	<input type="checkbox"/> Changes Without Regulatory Effect (Cal. Code Regs., title 1, §100)
<input type="checkbox"/> Resubmittal of disapproved or withdrawn nonemergency filing (Gov. Code §511349.3, 11349.4)	<input type="checkbox"/> Resubmittal of disapproved or withdrawn emergency filing (Gov. Code, §11346.1)	<input type="checkbox"/> File & Print	<input type="checkbox"/> Print Only
<input type="checkbox"/> Emergency (Gov. Code, §11346.1(b))		<input type="checkbox"/> Other (Specify) _____	

4. ALL BEGINNING AND ENDING DATES OF AVAILABILITY OF MODIFIED REGULATIONS AND/OR MATERIAL ADDED TO THE RULEMAKING FILE (Cal. Code Regs. title 1, §44 and Gov. Code §11347.1)

5. EFFECTIVE DATE OF CHANGES (Gov. Code, §§ 11343.4, 11346.1(d); Cal. Code Regs., title 1, §100)

<input type="checkbox"/> Effective 30th day after filing with Secretary of State	<input type="checkbox"/> Effective on filing with Secretary of State	<input type="checkbox"/> §100 Changes Without Regulatory Effect	<input type="checkbox"/> Effective other (Specify) _____
--	--	---	--

6. CHECK IF THESE REGULATIONS REQUIRE NOTICE TO, OR REVIEW, CONSULTATION, APPROVAL OR CONCURRENCE BY, ANOTHER AGENCY OR ENTITY

<input type="checkbox"/> Department of Finance (Form STD. 399) (SAM §6660)	<input type="checkbox"/> Fair Political Practices Commission	<input type="checkbox"/> State Fire Marshal
<input type="checkbox"/> Other (Specify) _____		

7. CONTACT PERSON	TELEPHONE NUMBER	FAX NUMBER (Optional)	E-MAIL ADDRESS (Optional)
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8. I certify that the attached copy of the regulation(s) is a true and correct copy of the regulation(s) identified on this form, that the information specified on this form is true and correct, and that I am the head of the agency taking this action, or a designee of the head of the agency, and am authorized to make this certification.

For use by Office of Administrative Law (OAL) only

SIGNATURE OF AGENCY HEAD OR DESIGNEE	DATE
--------------------------------------	------

TYPED NAME AND TITLE OF SIGNATORY

Notice of Proposed Regulatory Action
The State Board of Equalization Proposes to Adopt
California Code of Regulations, Title 18,
Section 2558.1, *Wine*

NOTICE IS HEREBY GIVEN

The State Board of Equalization (Board), pursuant to the authority vested in it by article XX, section 22 of the California Constitution and Revenue and Taxation Code (RTC) section 32451, proposes to adopt California Code of Regulations, title 18, section (Regulation) 2558.1, *Wine*. The proposed regulation clarifies that for purposes of the Alcoholic Beverage Tax Law (RTC § 32001 et seq.) wine, as defined by Business and Professions Code (BPC) section 23007, does not include any alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made and establishes January 1, 2012, as the prospective date for compliance with the clarified definition of wine.

PUBLIC HEARING

A public hearing on the proposed regulatory action will be held in Room 121, 450 N Street, Sacramento, at 9:30 a.m., or as soon thereafter as the matter may be heard, on May 24, 2011. At the hearing, any interested person may present or submit oral or written statements, arguments, or contentions regarding the adoption of proposed Regulation 2558.1.

AUTHORITY

California Constitution, article XX, section 22 and RTC section 32451.

REFERENCES

BPC section 23007 and RTC sections 32002 and 32152.

INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW

Current Law

Article XX, section 22 of the California Constitution authorizes and requires the Board to assess and collect all excise taxes that are or may be imposed on the manufacture, importation, and sale of alcoholic beverages. RTC section 32451 expressly authorizes the Board to administer the Alcoholic Beverage Tax Law and adopt regulations relating to its administration and enforcement. And RTC section 32152 authorizes the Board to

adopt regulations to coordinate California's and the federal government's systems for taxing beer and wine, so far as permitted by the express provisions of the Alcoholic Beverage Tax Law.

The Alcoholic Beverage Tax Law imposes different excise taxes on distilled spirits, beer, and wine, and the rates of the excise tax on distilled spirits are substantially higher than the rates of the excise tax imposed on beer and wine. (See RTC §§ 32151 (beer and wine) and 32201 (distilled spirits).) Still wines are taxed at a rate of one or two cents per gallon, beer is taxed at a rate of \$1.24 per 31 gallon barrel (or approximately 4.5 cents per gallon), and liquid distilled spirits are taxed at a rate of \$2 or \$4 per gallon.

RTC section 32002 provides that the definitions contained in chapter 1 (sections 23001-23047) of division 9 of the BPC apply to the terms used in the Alcoholic Beverage Tax Law. This includes the definitions in BPC sections 23005, 23006, and 23007, which define "distilled spirits," "beer," and "wine," respectively, and provide that:

23005. "Distilled spirits" means an alcoholic beverage obtained by the distillation of fermented agricultural products, and includes alcohol for beverage use, spirits of wine, whiskey, rum, brandy, and gin, including all dilutions and mixtures thereof.

23006. "Beer" means any alcoholic beverage obtained by the fermentation of any infusion or decoction of barley, malt, hops, or any other similar product, or any combination thereof in water, and includes ale, porter, brown, stout, lager beer, small beer, and strong beer but does not include sake, known as Japanese rice wine.

23007. "Wine" means the product obtained from normal alcoholic fermentation of the juice of sound ripe grapes or other agricultural products containing natural or added sugar or any such alcoholic beverage to which is added grape brandy, fruit brandy, or spirits of wine, which is distilled from the particular agricultural product or products of which the wine is made and other rectified wine products and by whatever name and which does not contain more than 15 percent added flavoring, coloring, and blending material and which contains not more than 24 percent of alcohol by volume, and includes vermouth and sake, known as Japanese rice wine.

Therefore, the Board must determine whether an alcoholic beverage is a distilled spirit, beer, or wine in order to determine which excise tax and which excise tax rate applies to that beverage under the Alcoholic Beverage Tax Law.

In late 2006, the Board received information that there were alcoholic beverages being sold as beer in California because they were made from the fermentation of malt or similar products, but which might also contain alcohol derived from the distillation of fermented agricultural products. This was because the federal government adopted

alcoholic beverage regulations allowing “flavored malt beverages” to be labeled, advertised, and taxed like beer for federal purposes, and also allowing flavored malt beverages to contain specified amounts of alcohol from the distillation of fermented agricultural products. (See 27 C.F.R. §§ 7.1-7.81, 25.15.)

The Board determined that the definition for “beer” set forth in BPC section 23006 did not allow beer to contain alcohol from the distillation of fermented agricultural products. The Board also determined that beverages containing alcohol from the distillation of fermented agricultural products had to be classified as either distilled spirits or wine because the definitions for distilled spirits and wine in BPC sections 23005 and 23007 do allow those beverages to contain alcohol from the distillation of fermented agricultural products.

Based upon these determinations, the Board concluded that flavored malt beverages that are derived from the fermentation of malt or similar products and only contain a de minimis amount of alcohol from flavorings that are derived from the distillation of fermented agricultural products could consistently be classified as beer for federal and California purposes. However, the Board also concluded that flavored malt beverages containing more than a de minimis amount of alcohol from the distillation of fermented agricultural products had to be classified as a distilled spirits for California tax purposes because the beverages were “obtained from the distillation of fermented agricultural products” as provided in BPC section 23005 and were clearly not wine. Therefore, the Board adopted Regulations 2558 through 2559.5 to prospectively clarify that alcoholic beverages are classified as distilled spirits under BPC section 23005 if they contain “0.5 percent or more alcohol by volume derived from flavors or other ingredients containing alcohol obtained from the distillation of fermented agricultural products” (Regulation 2558), regardless of the alcoholic beverages’ classification for federal purposes, and create a rebuttable presumption that all alcoholic beverages are distilled spirits for California tax purposes, effective October 1, 2008. (Regulations 2559-2559.5.) However, the distilled spirits regulations (Regulations 2558-2559.5) did not apply to wine, as defined in BPC section 23007, which may contain alcohol that is distilled from the particular agricultural product or products of which the wine is made.

Proposed Regulation

Part 24.10 of title 27 of the Code of Federal Regulations provides the general definition of wine for federal purposes and provides that: “When used without qualification, the term [wine] includes every kind (class and type) of product produced on bonded wine premises from grapes, other fruit (including berries), or other suitable agricultural products and containing not more than 24 percent alcohol by volume. The term includes all imitation, other than standard, or artificial wine and compounds sold as wine. A wine product containing less than one-half of one percent alcohol by volume is not taxable as wine when removed from the bonded wine premises.”

While Board staff was working with the manufacturers and brewers of flavored malt beverages to implement the distilled spirits regulations, staff was also in communication

with wine growers and importers regarding wine-based products that are classified as wine for federal purposes, but may not meet the BPC section 23007 definition for wine. This is because BPC section 23007 expressly allows alcoholic beverages to be classified as wine if they include grape brandy, fruit brandy, or spirits of wine, which is distilled from the particular agricultural product or products of which the wine is made, but does not expressly allow alcoholic beverages to be classified as wine if they include alcohol derived from the distillation of other fermented agricultural products; and BPC section 23007 limits the amount of flavoring, coloring, and blending materials that can be added to wine. However, federal law allows alcoholic beverages to be classified as wine regardless of the source of their alcohol and federal law does not limit the amount of flavoring, coloring, and blending materials that can be added to wine.

As a result, Board staff issued two Special Notices to the wine industry, which both clarified that the distilled spirits regulations apply to all alcoholic beverages that do not meet the BPC section 23007 definition for wine. The first notice was dated December 2008, entitled *Special Notice to Wine Growers and Importers*, and mailed to wine grower and wine importer registrants. The notice advised producers and importers of wine-based alcoholic beverages that might not meet the statutory definition for wine, but which do not contain 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products to consider rebutting the presumption in Regulation 2559 by filing form BOE 505, *Alcoholic Beverage Tax Report for Rebutting Regulation 2559 Presumption*. Summaries of the distilled spirits regulations were included with this notice.

The second notice was dated December 2009, entitled *Alcoholic Beverages Taxed as Wine for Federal Purposes, May Not Meet California's Definition of Wine and Therefore May be Subject to Tax as Distilled Spirits for California Tax Purposes*, and was mailed to all of the Board's alcoholic beverage program accounts. The second notice advised that certain types of alcoholic beverages that may qualify as wine for federal classification purposes, namely wine specialties, flavored table wine, wine cocktails, wine coolers or other wine-based products or blends of wine from different fruits, may not meet California's definition of wine under BPC section 23007 and, therefore, may be considered distilled spirits and be taxed accordingly for California purposes. The notice also advised each manufacturer, grower, or importer to review California's wine definition, and if their product(s) did not meet California's definition of wine, to file form BOE-505, if appropriate, to rebut the distilled spirits presumption.

However, based on field visits to major producers of wine-based alcoholic beverages in 2010, staff became aware that significant differences of opinion and confusion still existed as to the proper classification of nonstandard, wine-based products after the 2008 and 2009 notices were issued. Specifically, disagreement existed in the wine industry as to whether water constituted a blending material subject to BPC section 23007's limitation on blending materials. And confusion existed in the wine industry as to the rules governing, and the tax consequences of, introducing distilled alcohol to wine-based products. Therefore, Board staff prepared an Informal Issue Paper dated November 2,

2010, and submitted it to the Board Members for consideration at the Board's November 16, 2010, meeting.

The Informal Issue Paper summarized the information provided above, requested the Board's authorization for staff to initiate an interested parties process to discuss the two issues affecting the classification of wine more thoroughly, and included the following exhibits:

1. Regulations 2558 through 2559.5;
2. Formal Issue Paper 07-007 dated August 3, 2007, regarding the classification of flavored malt beverages and recommending that the Board begin the formal rulemaking process to adopt Regulations 2558 through 2559.5, which was submitted to the Board Members for consideration at the Board's August 14, 2007, meeting;
3. The minutes from the Board's August 14, 2007, meeting showing that the Board authorized staff to begin the formal rulemaking process to adopt Regulations 2558 through 2559.5;
4. The December 2008 Special Notice (discussed above);
5. The December 2009 Special Notice (discussed above); and
6. An initial draft of Regulation 2558.1, *Wine*, that staff wanted to discuss with interested parties because it raised various issues with regard to the classification of wine-based products.

As relevant here, the initial draft of Regulation 2558.1 included as exhibit 6 to the Informal Issue Paper indicated that wine-based alcoholic beverages that only contain a de minimis amount of alcohol from flavorings, colorings, or blending materials that are derived from the distillation of fermented agricultural products other than the particular agricultural product or products of which the wine is made could consistently be classified as wine for federal and California purposes. However, wine-based alcoholic beverages containing more than a de minimis amount of alcohol (0.5% or more by volume) from the distillation of fermented agricultural products other than the particular agricultural product or products of which the wine is made had to be classified as distilled spirits for California tax purposes because the beverages were "obtained from the distillation of fermented agricultural products" as provided in BPC section 23005 and were clearly not wine within the meaning of BPC section 23007.

On November 16, 2010, the Board authorized staff to conduct an interested parties meeting to discuss the draft of Regulation 2558.1 included as exhibit 6 to the Informal Issue Paper. During the interested parties process, including the interested parties meeting on December 17, 2010, Board staff learned that there was considerable disagreement in the wine industry regarding whether water should be treated as a blending material. Staff determined that the addition of any amount of water to a wine-based alcoholic beverage would not make that beverage into a distilled spirit within the meaning of BPC section 23005, assuming that the wine-based alcoholic beverage did not contain alcohol from the distillation of fermented agricultural products other than the particular agricultural product or products of which the wine is made. And staff found

that there appeared to be a general acceptance among the interested parties that, notwithstanding any objections they have, in general, to the existence of the distilled spirits regulations themselves, a wine-based alcoholic beverage containing distilled alcohol from a foreign source of 0.5 percent or more by volume would not be considered a wine under BPC section 23007 and would be classified as a distilled spirit under BPC section 23005 and Regulations 2558 through 2559.5 for tax purposes.

Following the interested parties meeting, Board staff prepared Formal Issue Paper 11-001 dated February 4, 2011, and submitted it to the Board Members for consideration at the Board's February 23, 2011, meeting. The Formal Issue Paper recommended that the Board authorize staff to begin the formal rulemaking process to adopt alternative 1 for Regulation 2558.1, which provided as follows:

- (a) Effective January 1, 2012, wine as defined by Business and Professions Code section 23007 does not include any alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made.
- (b) Except as provided in subdivision (a), wine-based products authorized for sale as wine by the Department of Alcoholic Beverage Control are deemed to be wine as defined by Business and Professions Code section 23007 for purposes of the Alcoholic Beverage Tax Law.

The proposed language of alternative 1 focused solely on the addition of alcohol derived from the distillation of agricultural products to wine-based alcoholic beverages and expressly clarified that wine does not include any wine-based alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made so that these types of wine-based alcoholic beverages will clearly be classified as distilled spirits under Regulation 2558. The proposed language included a January 1, 2012, effective date to permit wine growers and importers who had been relying on federal law and/or the Department of Alcoholic Beverage Control's (ABC's) classification of their wine-based alcoholic beverages for California tax purposes time, without being penalized due to any prior confusion in the industry, to determine whether their wine-based alcoholic beverages are wine or distilled spirits under the Board's regulations, reformulate any of their wine-based alcoholic beverages so that they can continue to qualify as wine for California tax purposes, if necessary and desired, and begin to report and pay the applicable wine or distilled spirits excise tax on their wine-based alcoholic beverages.

The Formal Issue Paper also included two other alternative proposals for Regulation 2558.1, which were both based upon the draft of Regulations 2558.1 included as exhibit 6 to the Informal Issue Paper. Alternative 2, which was supported by former Acting Board Member Barbara Alby, contained proposed language that would clarify that water and juice from the same agricultural products from which the wine is made are not flavorings, colorings, or blending materials. Alternative 3, which was supported by E & J Gallo,

contained proposed language that would define the term “wine base” and clarify that water is a blending material when added to a wine base. However, Board staff did not recommend that the Board choose these alternatives over Board staff’s alternative 1 because of the dispute within the industry as to whether water should be treated as a flavoring, coloring, or blending material and because the addition of water was not crucial to the classification of an alcoholic beverage as either a wine or distilled spirit for California tax purposes. And alternatives 2 and 3 were withdrawn from the Board’s consideration by their sponsors prior to the February 23, 2011, meeting. After hearing public comments, including E & J Gallo’s comments supporting staff’s alternative 1, and discussing staff’s recommendation, the Board voted to authorize staff to begin the formal rulemaking process to adopt Board staff’s alternative 1 during its February 23, 2011, meeting.

Finally, it should be noted that ABC treats all wine-based alcoholic beverages as wine for California labeling and licensing purposes if the beverages are classified as wine for federal purposes, regardless of whether the beverages contain 0.5 percent or more by volume of alcohol obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made or whether the blending material exceeds 15 percent by volume. Also, ABC treats all flavored malt beverages classified as beer for federal purposes as beer for California labeling and licensing purposes, regardless of whether the beverages contain alcohol derived from the distillation of fermented agricultural products and would be classified as distilled spirits under BPC section 23005 and the distilled spirits regulations. However, the Board has its own independent constitutional and statutory authority to adopt regulations implementing, interpreting, and making specific the provisions of BPC sections 23005, 23006, and 23007 as they apply to the classification of alcoholic beverages under the Alcoholic Beverage Tax Law, the Office of Administrative Law has recognized that authority by approving the distilled spirits regulations, and ABC has not identified any binding or persuasive authority requiring the Board to acquiesce to the federal government’s classification of alcoholic beverages where the federal classification conflicts with the express language of the BPC.

NO MANDATE ON LOCAL AGENCIES AND SCHOOL DISTRICTS

The Board has determined that the adoption of proposed Regulation 2558.1 will not impose a mandate on local agencies or school districts, including a mandate that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code.

NO COST OR SAVINGS TO STATE AGENCIES, LOCAL AGENCIES, AND SCHOOL DISTRICTS

The Board has determined that the adoption of proposed Regulation 2558.1 will result in no direct or indirect cost or savings to any state agency, any cost to local agencies or school districts that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code, other non-discretionary cost or

savings imposed on local agencies, or cost or savings in federal funding to the State of California.

NO SIGNIFICANT STATEWIDE ADVERSE ECONOMIC IMPACT DIRECTLY AFFECTING BUSINESS

The Board has determined that the adoption of proposed Regulation 2558.1 merely clarifies when the addition of alcohol derived from the distillation of fermented agricultural products to wine-based alcoholic beverages will cause the beverages to be classified a distilled spirits, instead of wine, under the express definitions of distilled spirits and wine found in BPC sections 23005 and 23007, respectively. Furthermore, the proposed regulation includes an effective date to give wine growers and importers an opportunity to reformulate their nonconforming, wine-based alcoholic beverages so that they can continue to be classified as wine for California tax purposes after the regulation becomes effective. Therefore, the Board has made an initial determination that the adoption of proposed Regulation 2558.1 will not have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states.

The adoption of proposed Regulation 2558.1 may affect small business.

NO COST IMPACTS TO PRIVATE PERSONS OR BUSINESSES

The Board is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

RESULTS OF THE ASSESSMENT REQUIRED BY GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)

The Board has determined that the adoption of proposed Regulation 2558.1 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California.

NO SIGNIFICANT EFFECT ON HOUSING COSTS

Adoption of proposed Regulation 2558.1 will not have a significant effect on housing costs.

DETERMINATION REGARDING ALTERNATIVES

The Board must determine that no reasonable alternative considered by it or that has been otherwise identified and brought to its attention would be more effective in carrying out the purpose for which this action is proposed, or be as effective as and less burdensome to affected private persons than the proposed action.

CONTACT PERSONS

Questions regarding the substance of the proposed regulation should be directed to Bradley M. Heller, Tax Counsel III (Specialist), by telephone at (916) 323-3091, by e-mail at Bradley.Heller@boe.ca.gov, or by mail at State Board of Equalization, Attn: Bradley M. Heller, MIC:82, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0082.

Written comments for the Board's consideration, notice of intent to present testimony or witnesses at the public hearing, and inquiries concerning the proposed administrative action should be directed to Mr. Rick Bennion, Regulations Coordinator, by telephone at (916) 445-2130, by fax at (916) 324-3984, by e-mail at Richard.Bennion@boe.ca.gov, or by mail at State Board of Equalization, Attn: Rick Bennion, MIC:81, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0080.

WRITTEN COMMENT PERIOD

The written comment period ends when the public hearing begins at 9:30 a.m., or as soon thereafter as the matter may be heard, on May 24, 2011. If the Board receives written comments prior to the close of the written comment period, the statements, arguments, and/or contentions contained in those comments will be presented to and considered by the Board before the Board decides whether to adopt proposed Regulation 2558.1. The Board will only consider written comments received by that time.

AVAILABILITY OF INITIAL STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATION

The Board has prepared an Initial Statement of Reasons for and an underscored version of proposed Regulation 2558.1 illustrating its express terms. These documents and all the information on which the proposed regulation is based are available to the public upon request. The rulemaking file is available for public inspection at 450 N Street, Sacramento, California. The express terms of the proposed regulation and the Initial Statement of Reasons are also available on the Board's Website at www.boe.ca.gov.

SUBSTANTIALLY RELATED CHANGES PURSUANT TO GOVERNMENT CODE SECTION 11346.8

The Board may adopt proposed Regulation 2558.1 with changes that are nonsubstantial or solely grammatical in nature, or sufficiently related to the original proposed text that the public was adequately placed on notice that the changes could result from the originally proposed regulatory action. If a sufficiently related change is made, the Board will make the full text of the proposed regulation, with the change clearly indicated, available to the public for at least 15 days before adoption. The text of the resulting regulation will be mailed to those interested parties who commented on the proposed regulation orally or in writing or who asked to be informed of such changes. The text of the resulting regulation will also be available to the public from Mr. Bennion. The Board

will consider written comments on the resulting regulation that are received prior to adoption.

AVAILABILITY OF FINAL STATEMENT OF REASONS

If the Board adopts proposed Regulation 2558.1 the Board will prepare a Final Statement of Reasons, which will be made available for inspection at 450 N Street, Sacramento, California, and available on the Board's Website at www.boe.ca.gov.

**Proposed Text of
California Code of Regulations, Title 18, Section 2558.1**

Section 2558.1. Wine.

(a) Effective January 1, 2012, wine as defined by Business and Professions Code section 23007 does not include any alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made.

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

Note: Authority cited: California Constitution, Article XX, Section 22; and Section 32451, Revenue and Taxation Code. Reference: Section 23007, Business and Professions Code; and Sections 32002, 32152, Revenue and Taxation Code.

Bennion, Richard

From: Scott, Megan [Megan.Scott@BOE.CA.GOV]
Sent: Friday, March 25, 2011 2:12 PM
To: BOE_REGULATIONS@LISTSERV.STATE.CA.GOV
Subject: State Board of Equalization - Announcement of Regulatory Change 2558.1

The State Board of Equalization proposes to adopt Regulation 2558.1, *Wine*, to clarify the application of tax to wine-based alcoholic beverages. A public hearing regarding the adoption of the proposed regulation will be held in Room 121, 450 N Street, Sacramento, at 10:00 a.m., or as soon thereafter as the matter may be heard, on Tuesday, May 24, 2011.

The proposed regulation prospectively clarifies that for purposes of the Alcoholic Beverage Tax Law the term "wine" does not include any wine-based alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made, effective January 1, 2012.

To view the notice of hearing, initial statement of reasons, proposed text, and history click on the following link: http://www.boe.ca.gov/regs/reg_2558.1.htm.

Questions regarding the substance of the proposed regulation should be directed to: Mr. Bradley Heller, Tax Counsel, at 450 N Street, MIC:82, Sacramento, CA 94279-0082, email Bradley.Heller@boe.ca.gov, telephone (916) 323-3091, or FAX (916) 323-3387.

Written comments for the Board's consideration, notices of intent to present testimony or witnesses at the public hearing, and inquiries concerning the proposed regulatory action should be directed to Rick Bennion, Regulations Coordinator, telephone (916) 445-2130, fax (916) 324-3984, e-mail Richard.Bennion@boe.ca.gov or by mail to: State Board of Equalization, Attn: Rick Bennion, MIC: 80, P.O. Box 942879-0080, Sacramento, CA 94279-0080.

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(916) 561-8260
(916) 263-2560 — Fax Number
Rebecca.Marco@dca.ca.gov

Website Access: Materials regarding this proposal can be found at www.ptb.ca.gov.

TITLE 18. STATE BOARD OF EQUALIZATION

California Code of Regulations, Title 18, Section 2558.1, *Wine*

Notice of Proposed Regulatory Action

NOTICE IS HEREBY GIVEN

The State Board of Equalization (Board), pursuant to the authority vested in it by article XX, section 22 of the California Constitution and Revenue and Taxation Code (RTC) section 32451, proposes to adopt California Code of Regulations, title 18, section (Regulation) 2558.1, *Wine*. The proposed regulation clarifies that for purposes of the Alcoholic Beverage Tax Law (RTC 32001 et seq.) wine, as defined by Business and Professions Code (BPC) section 23007, does not include any alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made and establishes January 1, 2012, as the prospective date for compliance with the clarified definition of wine.

PUBLIC HEARING

A public hearing on the proposed regulatory action will be held in Room 121, 450 N Street, Sacramento, at 10:00 a.m., or as soon thereafter as the matter may be heard, on May 24, 2011. At the hearing, any interested person may present or submit oral or written statements,

arguments, or contentions regarding the adoption of proposed Regulation 2558.1.

AUTHORITY

California Constitution, article XX, section 22 and RTC section 32451.

REFERENCES

BPC section 23007 and RTC sections 32002 and 32152.

INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW

Current Law

Article XX, section 22 of the California Constitution authorizes and requires the Board to assess and collect all excise taxes that are or may be imposed on the manufacture, importation, and sale of alcoholic beverages. RTC section 32451 expressly authorizes the Board to administer the Alcoholic Beverage Tax Law and adopt regulations relating to its administration and enforcement. And RTC section 32152 authorizes the Board to adopt regulations to coordinate California's and the federal government's systems for taxing beer and wine, so far as permitted by the express provisions of the Alcoholic Beverage Tax Law.

The Alcoholic Beverage Tax Law imposes different excise taxes on distilled spirits, beer, and wine, and the rates of the excise tax on distilled spirits are substantially higher than the rates of the excise tax imposed on beer and wine. (See RTC §§ 32151 (beer and wine) and 32201 (distilled spirits).) Still wines are taxed at a rate of one or two cents per gallon, beer is taxed at a rate of \$1.24 per 31 gallon barrel (or approximately 4.5 cents per gallon), and liquid distilled spirits are taxed at a rate of \$2 or \$4 per gallon.

RTC section 32002 provides that the definitions contained in chapter 1 (sections 23001-23047) of division 9 of the BPC apply to the terms used in the Alcoholic Beverage Tax Law. This includes the definitions in BPC sections 23005, 23006, and 23007, which define "distilled spirits," "beer," and "wine," respectively, and provide that:

23005. "Distilled spirits" means an alcoholic beverage obtained by the distillation of fermented agricultural products, and includes alcohol for beverage use, spirits of wine, whiskey, rum, brandy, and gin, including all dilutions and mixtures thereof.

23006. "Beer" means any alcoholic beverage obtained by the fermentation of any infusion or

decoction of barley, malt, hops, or any other similar product, or any combination thereof in water, and includes ale, porter, brown, stout, lager beer, small beer, and strong beer but does not include sake, known as Japanese rice wine.

23007. "Wine" means the product obtained from normal alcoholic fermentation of the juice of sound ripe grapes or other agricultural products containing natural or added sugar or any such alcoholic beverage to which is added grape brandy, fruit brandy, or spirits of wine, which is distilled from the particular agricultural product or products of which the wine is made and other rectified wine products and by whatever name and which does not contain more than 15 percent added flavoring, coloring, and blending material and which contains not more than 24 percent of alcohol by volume, and includes vermouth and sake, known as Japanese rice wine.

Therefore, the Board must determine whether an alcoholic beverage is a distilled spirit, beer, or wine in order to determine which excise tax and which excise tax rate applies to that beverage under the Alcoholic Beverage Tax Law.

In late 2006, the Board received information that there were alcoholic beverages being sold as beer in California because they were made from the fermentation of malt or similar products, but which might also contain alcohol derived from the distillation of fermented agricultural products. This was because the federal government adopted alcoholic beverage regulations allowing "flavored malt beverages" to be labeled, advertised, and taxed like beer for federal purposes, and also allowing flavored malt beverages to contain specified amounts of alcohol from the distillation of fermented agricultural products. (See 27 C.F.R. § 7.1–7.81, 25.15.)

The Board determined that the definition for "beer" set forth in BPC section 23006 did not allow beer to contain alcohol from the distillation of fermented agricultural products. The Board also determined that beverages containing alcohol from the distillation of fermented agricultural products had to be classified as either distilled spirits or wine because the definitions for distilled spirits and wine in BPC sections 23005 and 23007 do allow those beverages to contain alcohol from the distillation of fermented agricultural products.

Based upon these determinations, the Board concluded that flavored malt beverages that are derived from the fermentation of malt or similar products and only contain a de minimis amount of alcohol from flavorings that are derived from the distillation of fermented agricultural products could consistently be classified as beer for federal and California purposes. How-

ever, the Board also concluded that flavored malt beverages containing more than a de minimis amount of alcohol from the distillation of fermented agricultural products had to be classified as distilled spirits for California tax purposes because the beverages were "obtained from the distillation of fermented agricultural products" as provided in BPC section 23005 and were clearly not wine. Therefore, the Board adopted Regulations 2558 through 2559.5 to prospectively clarify that alcoholic beverages are classified as distilled spirits under BPC section 23005 if they contain "0.5 percent or more alcohol by volume derived from flavors or other ingredients containing alcohol obtained from the distillation of fermented agricultural products" (Regulation 2558), regardless of the alcoholic beverages' classification for federal purposes, and create a rebuttable presumption that all alcoholic beverages are distilled spirits for California tax purposes, effective October 1, 2008. (Regulations 2559–2559.5.) However, the distilled spirits regulations (Regulations 2558–2559.5) did not apply to wine, as defined in BPC section 23007, which may contain alcohol that is distilled from the particular agricultural product or products of which the wine is made.

Proposed Regulation

Part 24.10 of title 27 of the Code of Federal Regulations provides the general definition of wine for federal purposes and provides that: "When used without qualification, the term [wine] includes every kind (class and type) of product produced on bonded wine premises from grapes, other fruit (including berries), or other suitable agricultural products and containing not more than 24 percent alcohol by volume. The term includes all imitation, other than standard, or artificial wine and compounds sold as wine. A wine product containing less than one-half of one percent alcohol by volume is not taxable as wine when removed from the bonded wine premises."

While Board staff was working with the manufacturers and brewers of flavored malt beverages to implement the distilled spirits regulations, staff was also in communication with wine growers and importers regarding wine-based products that are classified as wine for federal purposes, but may not meet the BPC section 23007 definition for wine. This is because BPC section 23007 expressly allows alcoholic beverages to be classified as wine if they include grape brandy, fruit brandy, or spirits of wine, which is distilled from the particular agricultural product or products of which the wine is made, but does not expressly allow alcoholic beverages to be classified as wine if they include alcohol derived from the distillation of other fermented agricultural products; and BPC section 23007 limits the amount of flavoring, coloring, and blending materials that can be

added to wine. However, federal law allows alcoholic beverages to be classified as wine regardless of the source of their alcohol and federal law does not limit the amount of flavoring, coloring, and blending materials that can be added to wine.

As a result, Board staff issued two Special Notices to the wine industry, which both clarified that the distilled spirits regulations apply to all alcoholic beverages that do not meet the BPC section 23007 definition for wine. The first notice was dated December 2008, entitled *Special Notice to Wine Growers and Importers*, and mailed to wine grower and wine importer registrants. The notice advised producers and importers of wine-based alcoholic beverages that might not meet the statutory definition for wine, but which do not contain 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products to consider rebutting the presumption in Regulation 2559 by filing form BOE 505, *Alcoholic Beverage Tax Report for Rebutting Regulation 2559 Presumption*. Summaries of the distilled spirits regulations were included with this notice.

The second notice was dated December 2009, entitled *Alcoholic Beverages Taxed as Wine for Federal Purposes, May Not Meet California's Definition of Wine and Therefore May be Subject to Tax as Distilled Spirits for California Tax Purposes*, and was mailed to all of the Board's alcoholic beverage program accounts. The second notice advised that certain types of alcoholic beverages that may qualify as wine for federal classification purposes, namely wine specialties, flavored table wine, wine cocktails, wine coolers or other wine-based products or blends of wine from different fruits, may not meet California's definition of wine under BPC section 23007 and, therefore, may be considered distilled spirits and be taxed accordingly for California purposes. The notice also advised each manufacturer, grower, or importer to review California's wine definition, and if their product(s) did not meet California's definition of wine, to file form BOE-505, if appropriate, to rebut the distilled spirits presumption.

However, based on field visits to major producers of wine-based alcoholic beverages in 2010, staff became aware that significant differences of opinion and confusion still existed as to the proper classification of non-standard, wine-based products after the 2008 and 2009 notices were issued. Specifically, disagreement existed in the wine industry as to whether water constituted a blending material subject to BPC section 23007's limitation on blending materials. And confusion existed in the wine industry as to the rules governing, and the tax consequences of, introducing distilled alcohol to wine-based products. Therefore, Board staff prepared an Informal Issue Paper dated November 2, 2010, and submitted it to the Board Members for consideration at the Board's November 16, 2010, meeting.

The Informal Issue Paper summarized the information provided above, requested the Board's authorization for staff to initiate an interested parties process to discuss the two issues affecting the classification of wine more thoroughly, and included the following exhibits:

1. Regulations 2558 through 2559.5;
2. Formal Issue Paper 07-007 dated August 3, 2007, regarding the classification of flavored malt beverages and recommending that the Board begin the formal rulemaking process to adopt Regulations 2558 through 2559.5, which was submitted to the Board Members for consideration at the Board's August 14, 2007, meeting;
3. The minutes from the Board's August 14, 2007, meeting showing that the Board authorized staff to begin the formal rulemaking process to adopt Regulations 2558 through 2559.5;
4. The December 2008 Special Notice (discussed above);
5. The December 2009 Special Notice (discussed above); and
6. An initial draft of Regulation 2558.1, *Wine*, that staff wanted to discuss with interested parties because it raised various issues with regard to the classification of wine-based products.

As relevant here, the initial draft of Regulation 2558.1 included as exhibit 6 to the Informal Issue Paper indicated that wine-based alcoholic beverages that only contain a de minimis amount of alcohol from flavorings, colorings, or blending materials that are derived from the distillation of fermented agricultural products other than the particular agricultural product or products of which the wine is made could consistently be classified as wine for federal and California purposes. However, wine-based alcoholic beverages containing more than a de minimis amount of alcohol (0.5% or more by volume) from the distillation of fermented agricultural products other than the particular agricultural product or products of which the wine is made had to be classified as distilled spirits for California tax purposes because the beverages were "obtained from the distillation of fermented agricultural products" as provided in BPC section 23005 and were clearly not wine within the meaning of BPC section 23007.

On November 16, 2010, the Board authorized staff to conduct an interested parties meeting to discuss the draft of Regulation 2558.1 included as exhibit 6 to the Informal Issue Paper. During the interested parties process, including the interested parties meeting on December 17, 2010, Board staff learned that there was considerable disagreement in the wine industry regarding whether water should be treated as a blending material. Staff determined that the addition of any amount of

water to a wine-based alcoholic beverage would not make that beverage into a distilled spirit within the meaning of BPC section 23005, assuming that the wine-based alcoholic beverage did not contain alcohol from the distillation of fermented agricultural products other than the particular agricultural product or products of which the wine is made. And staff found that there appeared to be a general acceptance among the interested parties that, notwithstanding any objections they have, in general, to the existence of the distilled spirits regulations themselves, a wine-based alcoholic beverage containing distilled alcohol from a foreign source of 0.5 percent or more by volume would not be considered a wine under BPC section 23007 and would be classified as a distilled spirit under BPC section 23005 and Regulations 2558 through 2559.5 for tax purposes.

Following the interested parties meeting, Board staff prepared Formal Issue Paper 11-001 dated February 4, 2011, and submitted it to the Board Members for consideration at the Board's February 23, 2011, meeting. The Formal Issue Paper recommended that the Board authorize staff to begin the formal rulemaking process to adopt alternative 1 for Regulation 2558.1, which provided as follows:

- (a) Effective January 1, 2012, wine as defined by Business and Professions Code section 23007 does not include any alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made.
- (b) Except as provided in subdivision (a), wine-based products authorized for sale as wine by the Department of Alcoholic Beverage Control are deemed to be wine as defined by Business and Professions Code section 23007 for purposes of the Alcoholic Beverage Tax Law.

The proposed language of alternative 1 focused solely on the addition of alcohol derived from the distillation of agricultural products to wine-based alcoholic beverages and expressly clarified that wine does not include any wine-based alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made so that these types of wine-based alcoholic beverages will clearly be classified as distilled spirits under Regulation 2558. The proposed language included a January 1, 2012, effective date to permit wine growers and importers who had been relying on federal law and/or the Department of Alcoholic Beverage Control's (ABC's) classification of

their wine-based alcoholic beverages for California tax purposes time, without being penalized due to any prior confusion in the industry, to determine whether their wine-based alcoholic beverages are wine or distilled spirits under the Board's regulations, reformulate any of their wine-based alcoholic beverages so that they can continue to qualify as wine for California tax purposes, if necessary and desired, and begin to report and pay the applicable wine or distilled spirits excise tax on their wine-based alcoholic beverages.

The Formal Issue Paper also included two other alternative proposals for Regulation 2558.1, which were both based upon the draft of Regulations 2558.1 included as exhibit 6 to the Informal Issue Paper. Alternative 2, which was supported by former Acting Board Member Barbara Alby, contained proposed language that would clarify that water and juice from the same agricultural products from which the wine is made are not flavorings, colorings, or blending materials. Alternative 3, which was supported by E & J Gallo, contained proposed language that would define the term "wine base" and clarify that water is a blending material when added to a wine base. However, Board staff did not recommend that the Board choose these alternatives over Board staff's alternative 1 because of the dispute within the industry as to whether water should be treated as a flavoring, coloring, or blending material and because the addition of water was not crucial to the classification of an alcoholic beverage as either a wine or distilled spirit for California tax purposes. And alternatives 2 and 3 were withdrawn from the Board's consideration by their sponsors prior to the February 23, 2011, meeting. After hearing public comments, including E & J Gallo's comments supporting staff's alternative 1, and discussing staff's recommendation, the Board voted to authorize staff to begin the formal rulemaking process to adopt Board staff's alternative 1 during its February 23, 2011, meeting.

Finally, it should be noted that ABC treats all wine-based alcoholic beverages as wine for California labeling and licensing purposes if the beverages are classified as wine for federal purposes, regardless of whether the beverages contain 0.5 percent or more by volume of alcohol obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made or whether the blending material exceeds 15 percent by volume. Also, ABC treats all flavored malt beverages classified as beer for federal purposes as beer for California labeling and licensing purposes, regardless of whether the beverages contain alcohol derived from the distillation of fermented agricultural products and would be classified as distilled spirits under BPC section 23005 and the distilled spirits regulations. Howev-

er, the Board has its own independent constitutional and statutory authority to adopt regulations implementing, interpreting, and making specific the provisions of BPC sections 23005, 23006, and 23007 as they apply to the classification of alcoholic beverages under the Alcoholic Beverage Tax Law, the Office of Administrative Law has recognized that authority by approving the distilled spirits regulations, and ABC has not identified any binding or persuasive authority requiring the Board to acquiesce to the federal government's classification of alcoholic beverages where the federal classification conflicts with the express language of the BPC.

NO MANDATE ON LOCAL AGENCIES AND SCHOOL DISTRICTS

The Board has determined that the adoption of proposed Regulation 2558.1 will not impose a mandate on local agencies or school districts, including a mandate that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code.

NO COST OR SAVINGS TO STATE AGENCIES, LOCAL AGENCIES, AND SCHOOL DISTRICTS

The Board has determined that the adoption of proposed Regulation 2558.1 will result in no direct or indirect cost or savings to any state agency, any cost to local agencies or school districts that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code, other non-discretionary cost or savings imposed on local agencies, or cost or savings in federal funding to the State of California.

NO SIGNIFICANT STATEWIDE ADVERSE ECONOMIC IMPACT DIRECTLY AFFECTING BUSINESS

The Board has determined that the adoption of proposed Regulation 2558.1 merely clarifies when the addition of alcohol derived from the distillation of fermented agricultural products to wine-based alcoholic beverages will cause the beverages to be classified a distilled spirits, instead of wine, under the express definitions of distilled spirits and wine found in BPC sections 23005 and 23007, respectively. Furthermore, the proposed regulation includes an effective date to give wine growers and importers an opportunity to reformulate their nonconforming, wine-based alcoholic beverages so that they can continue to be classified as wine for California tax purposes after the regulation becomes effective. Therefore, the Board has made an initial de-

termination that the adoption of proposed Regulation 2558.1 will not have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states.

The adoption of proposed Regulation 2558.1 may affect small business.

NO COST IMPACTS TO PRIVATE PERSONS OR BUSINESSES

The Board is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

RESULTS OF THE ASSESSMENT REQUIRED BY GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)

The Board has determined that the adoption of proposed Regulation 2558.1 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California.

NO SIGNIFICANT EFFECT ON HOUSING COSTS

Adoption of proposed Regulation 2558.1 will not have a significant effect on housing costs.

DETERMINATION REGARDING ALTERNATIVES

The Board must determine that no reasonable alternative considered by it or that has been otherwise identified and brought to its attention would be more effective in carrying out the purpose for which this action is proposed, or be as effective as and less burdensome to affected private persons than the proposed action.

CONTACT PERSONS

Questions regarding the substance of the proposed regulation should be directed to Bradley M. Heller, Tax Counsel III (Specialist), by telephone at (916) 323-3091, by e-mail at Bradley.Heller@boe.ca.gov, or by mail at State Board of Equalization, Attn: Bradley M. Heller, MIC:82, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0082.

Written comments for the Board's consideration, notice of intent to present testimony or witnesses at the public hearing, and inquiries concerning the proposed

administrative action should be directed to Mr. Rick Bennion, Regulations Coordinator, by telephone at (916) 445-2130, by fax at (916) 324-3984, by e-mail at Richard.Bennion@boe.ca.gov, or by mail at State Board of Equalization, Attn: Rick Bennion, MIC:80, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0080.

WRITTEN COMMENT PERIOD

The written comment period ends when the public hearing begins at 10:00 a.m., or as soon thereafter as the matter may be heard, on May 24, 2011. If the Board receives written comments prior to the close of the written comment period, the statements, arguments, and/or contentions contained in those comments will be presented to and considered by the Board before the Board decides whether to adopt proposed Regulation 2558.1. The Board will only consider written comments received by that time.

AVAILABILITY OF INITIAL STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATION

The Board has prepared an Initial Statement of Reasons for and an underscored version of proposed Regulation 2558.1 illustrating its express terms. These documents and all the information on which the proposed regulation is based are available to the public upon request. The rulemaking file is available for public inspection at 450 N Street, Sacramento, California. The express terms of the proposed regulation and the Initial Statement of Reasons are also available on the Board's Website at www.boe.ca.gov.

SUBSTANTIALLY RELATED CHANGES PURSUANT TO GOVERNMENT CODE SECTION 11346.8

The Board may adopt proposed Regulation 2558.1 with changes that are nonsubstantial or solely grammatical in nature, or sufficiently related to the original proposed text that the public was adequately placed on notice that the changes could result from the originally proposed regulatory action. If a sufficiently related change is made, the Board will make the full text of the proposed regulation, with the change clearly indicated, available to the public for at least 15 days before adoption. The text of the resulting regulation will be mailed to those interested parties who commented on the proposed regulation orally or in writing or who asked to be informed of such changes. The text of the resulting regulation will also be available to the public from Mr.

Bennion. The Board will consider written comments on the resulting regulation that are received prior to adoption.

AVAILABILITY OF FINAL STATEMENT OF REASONS

If the Board adopts proposed Regulation 2558.1 the Board will prepare a Final Statement of Reasons, which will be made available for inspection at 450 N Street, Sacramento, California, and available on the Board's Website at www.boe.ca.gov.

TITLE 18. STATE BOARD OF EQUALIZATION

Amendments to California Code of Regulations, Title 18, Section 1533.2, Diesel Fuel Used in Farming Activities or Food Processing, and Section 1598, Motor Vehicle and Aircraft Fuels

Notice of Proposed Regulatory Action

NOTICE IS HEREBY GIVEN

The State Board of Equalization (Board), pursuant to the authority vested in it by Revenue and Taxation Code (RTC) section 7051, proposes to adopt amendments to California Code of Regulations, title 18, sections (Regulations) 1533.2, *Diesel Fuel Used in Farming Activities or Food Processing*, and 1598, *Motor Vehicle and Aircraft Fuels*. The amendments to Regulation 1598 reflect the additional 1.75 percent Sales and Use Tax on diesel fuel imposed by RTC sections 6051.8 and 6201.8, effective July 1, 2011; incorporate the two exemptions from the additional 1.75 percent tax on diesel fuel provided by RTC section 6357.3; and prescribe the content of exemption certificate that must be used in conjunction with sales and purchases of diesel fuel that are exempt under RTC section 6357.3. The amendments to Regulation 1533.2 clarify that the partial exemption for diesel fuel used in farming activities or food processing provided by RTC section 6357.1 applies to the additional 1.75 percent Sales and Use Tax imposed under RTC sections 6051.8 and 6201.8, effective July 1, 2011, and that the partial exemption will no longer apply to the one percent Sales and Use Tax imposed under RTC sections 6051.7 and 6201.7 after that tax ceases to be operative on July 1, 2011.

PUBLIC HEARING

A public hearing on the adoption of the proposed regulatory action will be held in Room 121, 450 N Street,



STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
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Fourth District, Los Angeles

JOHN CHIANG
State Controller

KRISTINE CAZADD
Interim Executive Director

March 25, 2011

To Interested Parties:

**Notice of Proposed Regulatory Action
by the
State Board of Equalization**

**California Code of Regulations, Title 18,
Section 2558.1, *Wine***

Notice of Proposed Regulatory Action

**The State Board of Equalization Proposes to Adopt
California Code of Regulations, Title 18,
Section 2558.1, *Wine***

NOTICE IS HEREBY GIVEN

The State Board of Equalization (Board), pursuant to the authority vested in it by article XX, section 22 of the California Constitution and Revenue and Taxation Code (RTC) section 32451, proposes to adopt California Code of Regulations, title 18, section (Regulation) 2558.1, *Wine*. The proposed regulation clarifies that for purposes of the Alcoholic Beverage Tax Law (RTC § 32001 et seq.) wine, as defined by Business and Professions Code (BPC) section 23007, does not include any alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made and establishes January 1, 2012, as the prospective date for compliance with the clarified definition of wine.

PUBLIC HEARING

A public hearing on the proposed regulatory action will be held in Room 121, 450 N Street, Sacramento, at 9:30 a.m., or as soon thereafter as the matter may be heard, on May 24, 2011. At the hearing, any interested person may present or submit oral or written statements, arguments, or contentions regarding the adoption of proposed Regulation 2558.1.

AUTHORITY

California Constitution, article XX, section 22 and RTC section 32451.

Item F3
05/25/11

REFERENCES

BPC section 23007 and RTC sections 32002 and 32152.

INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW

Current Law

Article XX, section 22 of the California Constitution authorizes and requires the Board to assess and collect all excise taxes that are or may be imposed on the manufacture, importation, and sale of alcoholic beverages. RTC section 32451 expressly authorizes the Board to administer the Alcoholic Beverage Tax Law and adopt regulations relating to its administration and enforcement. And RTC section 32152 authorizes the Board to adopt regulations to coordinate California's and the federal government's systems for taxing beer and wine, so far as permitted by the express provisions of the Alcoholic Beverage Tax Law.

The Alcoholic Beverage Tax Law imposes different excise taxes on distilled spirits, beer, and wine, and the rates of the excise tax on distilled spirits are substantially higher than the rates of the excise tax imposed on beer and wine. (See RTC §§ 32151 (beer and wine) and 32201 (distilled spirits).) Still wines are taxed at a rate of one or two cents per gallon, beer is taxed at a rate of \$1.24 per 31 gallon barrel (or approximately 4.5 cents per gallon), and liquid distilled spirits are taxed at a rate of \$2 or \$4 per gallon.

RTC section 32002 provides that the definitions contained in chapter 1 (sections 23001-23047) of division 9 of the BPC apply to the terms used in the Alcoholic Beverage Tax Law. This includes the definitions in BPC sections 23005, 23006, and 23007, which define "distilled spirits," "beer," and "wine," respectively, and provide that:

23005. "Distilled spirits" means an alcoholic beverage obtained by the distillation of fermented agricultural products, and includes alcohol for beverage use, spirits of wine, whiskey, rum, brandy, and gin, including all dilutions and mixtures thereof.

23006. "Beer" means any alcoholic beverage obtained by the fermentation of any infusion or decoction of barley, malt, hops, or any other similar product, or any combination thereof in water, and includes ale, porter, brown, stout, lager beer, small beer, and strong beer but does not include sake, known as Japanese rice wine.

23007. "Wine" means the product obtained from normal alcoholic fermentation of the juice of sound ripe grapes or other agricultural products containing natural or added sugar or any such alcoholic beverage to which is added grape brandy, fruit brandy, or spirits of wine, which is distilled from the particular agricultural

product or products of which the wine is made and other rectified wine products and by whatever name and which does not contain more than 15 percent added flavoring, coloring, and blending material and which contains not more than 24 percent of alcohol by volume, and includes vermouth and sake, known as Japanese rice wine.

Therefore, the Board must determine whether an alcoholic beverage is a distilled spirit, beer, or wine in order to determine which excise tax and which excise tax rate applies to that beverage under the Alcoholic Beverage Tax Law.

In late 2006, the Board received information that there were alcoholic beverages being sold as beer in California because they were made from the fermentation of malt or similar products, but which might also contain alcohol derived from the distillation of fermented agricultural products. This was because the federal government adopted alcoholic beverage regulations allowing “flavored malt beverages” to be labeled, advertised, and taxed like beer for federal purposes, and also allowing flavored malt beverages to contain specified amounts of alcohol from the distillation of fermented agricultural products. (See 27 C.F.R. §§ 7.1-7.81, 25.15.)

The Board determined that the definition for “beer” set forth in BPC section 23006 did not allow beer to contain alcohol from the distillation of fermented agricultural products. The Board also determined that beverages containing alcohol from the distillation of fermented agricultural products had to be classified as either distilled spirits or wine because the definitions for distilled spirits and wine in BPC sections 23005 and 23007 do allow those beverages to contain alcohol from the distillation of fermented agricultural products.

Based upon these determinations, the Board concluded that flavored malt beverages that are derived from the fermentation of malt or similar products and only contain a de minimis amount of alcohol from flavorings that are derived from the distillation of fermented agricultural products could consistently be classified as beer for federal and California purposes. However, the Board also concluded that flavored malt beverages containing more than a de minimis amount of alcohol from the distillation of fermented agricultural products had to be classified as a distilled spirits for California tax purposes because the beverages were “obtained from the distillation of fermented agricultural products” as provided in BPC section 23005 and were clearly not wine. Therefore, the Board adopted Regulations 2558 through 2559.5 to prospectively clarify that alcoholic beverages are classified as distilled spirits under BPC section 23005 if they contain “0.5 percent or more alcohol by volume derived from flavors or other ingredients containing alcohol obtained from the distillation of fermented agricultural products” (Regulation 2558), regardless of the alcoholic beverages’ classification for federal purposes, and create a rebuttable presumption that all alcoholic beverages are distilled spirits for California tax purposes, effective October 1, 2008. (Regulations 2559-2559.5.) However, the distilled spirits regulations (Regulations 2558-2559.5) did not apply to wine, as defined in BPC section 23007, which may contain alcohol that is distilled from the particular agricultural product or products of which the wine is made.

Proposed Regulation

Part 24.10 of title 27 of the Code of Federal Regulations provides the general definition of wine for federal purposes and provides that: “When used without qualification, the term [wine] includes every kind (class and type) of product produced on bonded wine premises from grapes, other fruit (including berries), or other suitable agricultural products and containing not more than 24 percent alcohol by volume. The term includes all imitation, other than standard, or artificial wine and compounds sold as wine. A wine product containing less than one-half of one percent alcohol by volume is not taxable as wine when removed from the bonded wine premises.”

While Board staff was working with the manufacturers and brewers of flavored malt beverages to implement the distilled spirits regulations, staff was also in communication with wine growers and importers regarding wine-based products that are classified as wine for federal purposes, but may not meet the BPC section 23007 definition for wine. This is because BPC section 23007 expressly allows alcoholic beverages to be classified as wine if they include grape brandy, fruit brandy, or spirits of wine, which is distilled from the particular agricultural product or products of which the wine is made, but does not expressly allow alcoholic beverages to be classified as wine if they include alcohol derived from the distillation of other fermented agricultural products; and BPC section 23007 limits the amount of flavoring, coloring, and blending materials that can be added to wine. However, federal law allows alcoholic beverages to be classified as wine regardless of the source of their alcohol and federal law does not limit the amount of flavoring, coloring, and blending materials that can be added to wine.

As a result, Board staff issued two Special Notices to the wine industry, which both clarified that the distilled spirits regulations apply to all alcoholic beverages that do not meet the BPC section 23007 definition for wine. The first notice was dated December 2008, entitled *Special Notice to Wine Growers and Importers*, and mailed to wine grower and wine importer registrants. The notice advised producers and importers of wine-based alcoholic beverages that might not meet the statutory definition for wine, but which do not contain 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products to consider rebutting the presumption in Regulation 2559 by filing form BOE 505, *Alcoholic Beverage Tax Report for Rebutting Regulation 2559 Presumption*. Summaries of the distilled spirits regulations were included with this notice.

The second notice was dated December 2009, entitled *Alcoholic Beverages Taxed as Wine for Federal Purposes, May Not Meet California’s Definition of Wine and Therefore May be Subject to Tax as Distilled Spirits for California Tax Purposes*, and was mailed to all of the Board’s alcoholic beverage program accounts. The second notice advised that certain types of alcoholic beverages that may qualify as wine for federal classification purposes, namely wine specialties, flavored table wine, wine cocktails, wine coolers or other wine-based products or blends of wine from different fruits, may not meet California’s definition of wine under BPC section 23007 and, therefore, may be considered distilled spirits and be taxed accordingly for California purposes. The notice also advised each manufacturer, grower, or importer to review California’s wine

definition, and if their product(s) did not meet California's definition of wine, to file form BOE-505, if appropriate, to rebut the distilled spirits presumption.

However, based on field visits to major producers of wine-based alcoholic beverages in 2010, staff became aware that significant differences of opinion and confusion still existed as to the proper classification of nonstandard, wine-based products after the 2008 and 2009 notices were issued. Specifically, disagreement existed in the wine industry as to whether water constituted a blending material subject to BPC section 23007's limitation on blending materials. And confusion existed in the wine industry as to the rules governing, and the tax consequences of, introducing distilled alcohol to wine-based products. Therefore, Board staff prepared an Informal Issue Paper dated November 2, 2010, and submitted it to the Board Members for consideration at the Board's November 16, 2010, meeting.

The Informal Issue Paper summarized the information provided above, requested the Board's authorization for staff to initiate an interested parties process to discuss the two issues affecting the classification of wine more thoroughly, and included the following exhibits:

1. Regulations 2558 through 2559.5;
2. Formal Issue Paper 07-007 dated August 3, 2007, regarding the classification of flavored malt beverages and recommending that the Board begin the formal rulemaking process to adopt Regulations 2558 through 2559.5, which was submitted to the Board Members for consideration at the Board's August 14, 2007, meeting;
3. The minutes from the Board's August 14, 2007, meeting showing that the Board authorized staff to begin the formal rulemaking process to adopt Regulations 2558 through 2559.5;
4. The December 2008 Special Notice (discussed above);
5. The December 2009 Special Notice (discussed above); and
6. An initial draft of Regulation 2558.1, *Wine*, that staff wanted to discuss with interested parties because it raised various issues with regard to the classification of wine-based products.

As relevant here, the initial draft of Regulation 2558.1 included as exhibit 6 to the Informal Issue Paper indicated that wine-based alcoholic beverages that only contain a de minimis amount of alcohol from flavorings, colorings, or blending materials that are derived from the distillation of fermented agricultural products other than the particular agricultural product or products of which the wine is made could consistently be classified as wine for federal and California purposes. However, wine-based alcoholic beverages containing more than a de minimis amount of alcohol (0.5% or more by volume) from the distillation of fermented agricultural products other than the particular agricultural product or products of which the wine is made had to be classified as distilled spirits for California tax purposes because the beverages were "obtained from the distillation of fermented agricultural products" as provided in BPC section 23005 and were clearly not wine within the meaning of BPC section 23007.

On November 16, 2010, the Board authorized staff to conduct an interested parties meeting to discuss the draft of Regulation 2558.1 included as exhibit 6 to the Informal Issue Paper. During the interested parties process, including the interested parties meeting on December 17, 2010, Board staff learned that there was considerable disagreement in the wine industry regarding whether water should be treated as a blending material. Staff determined that the addition of any amount of water to a wine-based alcoholic beverage would not make that beverage into a distilled spirit within the meaning of BPC section 23005, assuming that the wine-based alcoholic beverage did not contain alcohol from the distillation of fermented agricultural products other than the particular agricultural product or products of which the wine is made. And staff found that there appeared to be a general acceptance among the interested parties that, notwithstanding any objections they have, in general, to the existence of the distilled spirits regulations themselves, a wine-based alcoholic beverage containing distilled alcohol from a foreign source of 0.5 percent or more by volume would not be considered a wine under BPC section 23007 and would be classified as a distilled spirit under BPC section 23005 and Regulations 2558 through 2559.5 for tax purposes.

Following the interested parties meeting, Board staff prepared Formal Issue Paper 11-001 dated February 4, 2011, and submitted it to the Board Members for consideration at the Board's February 23, 2011, meeting. The Formal Issue Paper recommended that the Board authorize staff to begin the formal rulemaking process to adopt alternative 1 for Regulation 2558.1, which provided as follows:

- (a) Effective January 1, 2012, wine as defined by Business and Professions Code section 23007 does not include any alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made.
- (b) Except as provided in subdivision (a), wine-based products authorized for sale as wine by the Department of Alcoholic Beverage Control are deemed to be wine as defined by Business and Professions Code section 23007 for purposes of the Alcoholic Beverage Tax Law.

The proposed language of alternative 1 focused solely on the addition of alcohol derived from the distillation of agricultural products to wine-based alcoholic beverages and expressly clarified that wine does not include any wine-based alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made so that these types of wine-based alcoholic beverages will clearly be classified as distilled spirits under Regulation 2558. The proposed language included a January 1, 2012, effective date to permit wine growers and importers who had been relying on federal law and/or the Department of Alcoholic Beverage Control's (ABC's) classification of their wine-based alcoholic beverages for California tax purposes time, without being penalized due to any prior confusion in the industry, to determine whether their wine-based alcoholic beverages are wine or distilled spirits under the Board's regulations, reformulate any of their wine-based alcoholic beverages so that they can continue to

qualify as wine for California tax purposes, if necessary and desired, and begin to report and pay the applicable wine or distilled spirits excise tax on their wine-based alcoholic beverages.

The Formal Issue Paper also included two other alternative proposals for Regulation 2558.1, which were both based upon the draft of Regulations 2558.1 included as exhibit 6 to the Informal Issue Paper. Alternative 2, which was supported by former Acting Board Member Barbara Alby, contained proposed language that would clarify that water and juice from the same agricultural products from which the wine is made are not flavorings, colorings, or blending materials. Alternative 3, which was supported by E & J Gallo, contained proposed language that would define the term “wine base” and clarify that water is a blending material when added to a wine base. However, Board staff did not recommend that the Board choose these alternatives over Board staff’s alternative 1 because of the dispute within the industry as to whether water should be treated as a flavoring, coloring, or blending material and because the addition of water was not crucial to the classification of an alcoholic beverage as either a wine or distilled spirit for California tax purposes. And alternatives 2 and 3 were withdrawn from the Board’s consideration by their sponsors prior to the February 23, 2011, meeting. After hearing public comments, including E & J Gallo’s comments supporting staff’s alternative 1, and discussing staff’s recommendation, the Board voted to authorize staff to begin the formal rulemaking process to adopt Board staff’s alternative 1 during its February 23, 2011, meeting.

Finally, it should be noted that ABC treats all wine-based alcoholic beverages as wine for California labeling and licensing purposes if the beverages are classified as wine for federal purposes, regardless of whether the beverages contain 0.5 percent or more by volume of alcohol obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made or whether the blending material exceeds 15 percent by volume. Also, ABC treats all flavored malt beverages classified as beer for federal purposes as beer for California labeling and licensing purposes, regardless of whether the beverages contain alcohol derived from the distillation of fermented agricultural products and would be classified as distilled spirits under BPC section 23005 and the distilled spirits regulations. However, the Board has its own independent constitutional and statutory authority to adopt regulations implementing, interpreting, and making specific the provisions of BPC sections 23005, 23006, and 23007 as they apply to the classification of alcoholic beverages under the Alcoholic Beverage Tax Law, the Office of Administrative Law has recognized that authority by approving the distilled spirits regulations, and ABC has not identified any binding or persuasive authority requiring the Board to acquiesce to the federal government’s classification of alcoholic beverages where the federal classification conflicts with the express language of the BPC.

NO MANDATE ON LOCAL AGENCIES AND SCHOOL DISTRICTS

The Board has determined that the adoption of proposed Regulation 2558.1 will not impose a mandate on local agencies or school districts, including a mandate that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code.

NO COST OR SAVINGS TO STATE AGENCIES, LOCAL AGENCIES, AND SCHOOL DISTRICTS

The Board has determined that the adoption of proposed Regulation 2558.1 will result in no direct or indirect cost or savings to any state agency, any cost to local agencies or school districts that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code, other non-discretionary cost or savings imposed on local agencies, or cost or savings in federal funding to the State of California.

NO SIGNIFICANT STATEWIDE ADVERSE ECONOMIC IMPACT DIRECTLY AFFECTING BUSINESS

The Board has determined that the adoption of proposed Regulation 2558.1 merely clarifies when the addition of alcohol derived from the distillation of fermented agricultural products to wine-based alcoholic beverages will cause the beverages to be classified a distilled spirits, instead of wine, under the express definitions of distilled spirits and wine found in BPC sections 23005 and 23007, respectively. Furthermore, the proposed regulation includes an effective date to give wine growers and importers an opportunity to reformulate their nonconforming, wine-based alcoholic beverages so that they can continue to be classified as wine for California tax purposes after the regulation becomes effective. Therefore, the Board has made an initial determination that the adoption of proposed Regulation 2558.1 will not have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states.

The adoption of proposed Regulation 2558.1 may affect small business.

NO COST IMPACTS TO PRIVATE PERSONS OR BUSINESSES

The Board is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

RESULTS OF THE ASSESSMENT REQUIRED BY GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)

The Board has determined that the adoption of proposed Regulation 2558.1 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California.

NO SIGNIFICANT EFFECT ON HOUSING COSTS

Adoption of proposed Regulation 2558.1 will not have a significant effect on housing costs.

DETERMINATION REGARDING ALTERNATIVES

The Board must determine that no reasonable alternative considered by it or that has been otherwise identified and brought to its attention would be more effective in carrying out the purpose for which this action is proposed, or be as effective as and less burdensome to affected private persons than the proposed action.

CONTACT PERSONS

Questions regarding the substance of the proposed regulation should be directed to Bradley M. Heller, Tax Counsel III (Specialist), by telephone at (916) 323-3091, by e-mail at Bradley.Heller@boe.ca.gov, or by mail at State Board of Equalization, Attn: Bradley M. Heller, MIC:82, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0082.

Written comments for the Board's consideration, notice of intent to present testimony or witnesses at the public hearing, and inquiries concerning the proposed administrative action should be directed to Mr. Rick Bennion, Regulations Coordinator, by telephone at (916) 445-2130, by fax at (916) 324-3984, by e-mail at Richard.Bennion@boe.ca.gov, or by mail at State Board of Equalization, Attn: Rick Bennion, MIC:81, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0080.

WRITTEN COMMENT PERIOD

The written comment period ends when the public hearing begins at 9:30 a.m., or as soon thereafter as the matter may be heard, on May 24, 2011. If the Board receives written comments prior to the close of the written comment period, the statements, arguments, and/or contentions contained in those comments will be presented to and considered by the Board before the Board decides whether to adopt proposed Regulation 2558.1. The Board will only consider written comments received by that time.

AVAILABILITY OF INITIAL STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATION

The Board has prepared an Initial Statement of Reasons for and an underscored version of proposed Regulation 2558.1 illustrating its express terms. These documents and all the information on which the proposed regulation is based are available to the public upon request. The rulemaking file is available for public inspection at 450 N Street, Sacramento, California. The express terms of the proposed regulation and the Initial Statement of Reasons are also available on the Board's Website at www.boe.ca.gov.

SUBSTANTIALLY RELATED CHANGES PURSUANT TO GOVERNMENT CODE SECTION 11346.8

The Board may adopt proposed Regulation 2558.1 with changes that are nonsubstantial or solely grammatical in nature, or sufficiently related to the original proposed text that the public was

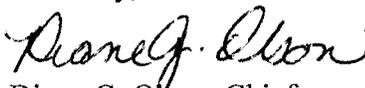
March 25, 2011

adequately placed on notice that the changes could result from the originally proposed regulatory action. If a sufficiently related change is made, the Board will make the full text of the proposed regulation, with the change clearly indicated, available to the public for at least 15 days before adoption. The text of the resulting regulation will be mailed to those interested parties who commented on the proposed regulation orally or in writing or who asked to be informed of such changes. The text of the resulting regulation will also be available to the public from Mr. Bennion. The Board will consider written comments on the resulting regulation that are received prior to adoption.

AVAILABILITY OF FINAL STATEMENT OF REASONS

If the Board adopts proposed Regulation 2558.1 the Board will prepare a Final Statement of Reasons, which will be made available for inspection at 450 N Street, Sacramento, California, and available on the Board's Website at www.boe.ca.gov.

Sincerely,



Diane G. Olson, Chief
Board Proceedings Division

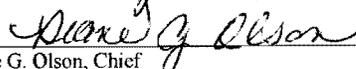
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STATE BOARD OF EQUALIZATION



BOARD APPROVED

At the May 25, 2011 Board Meeting



Diane G. Olson, Chief
Board Proceedings Division

Initial Statement of Reasons

Proposed Adoption of California Code of Regulations, Title 18, Section 2558.1, *Wine*

SPECIFIC PURPOSE AND NECESSITY

Current Law

Article XX, section 22 of the California Constitution authorizes and requires the Board to assess and collect all excise taxes that are or may be imposed on the manufacture, importation, and sale of alcoholic beverages. RTC section 32451 expressly authorizes the Board to administer the Alcoholic Beverage Tax Law and adopt regulations relating to its administration and enforcement. And RTC section 32152 authorizes the Board to adopt regulations to coordinate California's and the federal government's systems for taxing beer and wine, so far as permitted by the express provisions of the Alcoholic Beverage Tax Law.

The Alcoholic Beverage Tax Law imposes different excise taxes on distilled spirits, beer, and wine, and the rates of the excise tax on distilled spirits are substantially higher than the rates of the excise tax imposed on beer and wine. (See RTC §§ 32151 (beer and wine) and 32201 (distilled spirits).) Still wines are taxed at a rate of one or two cents per gallon, beer is taxed at a rate of \$1.24 per 31 gallon barrel (or approximately 4.5 cents per gallon), and liquid distilled spirits are taxed at a rate of \$2 or \$4 per gallon.

RTC section 32002 provides that the definitions contained in chapter 1 (sections 23001-23047) of division 9 of the BPC apply to the terms used in the Alcoholic Beverage Tax Law. This includes the definitions in BPC sections 23005, 23006, and 23007, which define "distilled spirits," "beer," and "wine," respectively, and provide that:

23005. "Distilled spirits" means an alcoholic beverage obtained by the distillation of fermented agricultural products, and includes alcohol for beverage use, spirits of wine, whiskey, rum, brandy, and gin, including all dilutions and mixtures thereof.

23006. "Beer" means any alcoholic beverage obtained by the fermentation of any infusion or decoction of barley, malt, hops, or any other similar product, or any combination thereof in water, and includes ale, porter, brown, stout, lager beer, small beer, and strong beer but does not include sake, known as Japanese rice wine.

23007. "Wine" means the product obtained from normal alcoholic fermentation of the juice of sound ripe grapes or other agricultural products containing natural or added sugar or any such alcoholic beverage to which is added grape brandy, fruit brandy, or spirits of wine, which is

distilled from the particular agricultural product or products of which the wine is made and other rectified wine products and by whatever name and which does not contain more than 15 percent added flavoring, coloring, and blending material and which contains not more than 24 percent of alcohol by volume, and includes vermouth and sake, known as Japanese rice wine.

Therefore, the Board must determine whether an alcoholic beverage is a distilled spirit, beer, or wine in order to determine which excise tax and which excise tax rate applies to that beverage under the Alcoholic Beverage Tax Law.

In late 2006, the Board received information that there were alcoholic beverages being sold as beer in California because they were made from the fermentation of malt or similar products, but which might also contain alcohol derived from the distillation of fermented agricultural products. This was because the federal government adopted alcoholic beverage regulations allowing “flavored malt beverages” to be labeled, advertised, and taxed like beer for federal purposes, and also allowing flavored malt beverages to contain specified amounts of alcohol from the distillation of fermented agricultural products. (See 27 C.F.R. §§ 7.1-7.81, 25.15.)

The Board determined that the definition for “beer” set forth in BPC section 23006 did not allow beer to contain alcohol from the distillation of fermented agricultural products. The Board also determined that beverages containing alcohol from the distillation of fermented agricultural products had to be classified as either distilled spirits or wine because the definitions for distilled spirits and wine in BPC sections 23005 and 23007 do allow those beverages to contain alcohol from the distillation of fermented agricultural products.

Based upon these determinations, the Board concluded that flavored malt beverages that are derived from the fermentation of malt or similar products and only contain a de minimis amount of alcohol from flavorings that are derived from the distillation of fermented agricultural products could consistently be classified as beer for federal and California purposes. However, the Board also concluded that flavored malt beverages containing more than a de minimis amount of alcohol from the distillation of fermented agricultural products had to be classified as a distilled spirits for California tax purposes because the beverages were “obtained from the distillation of fermented agricultural products” as provided in BPC section 23005 and were clearly not wine. Therefore, the Board adopted Regulations 2558 through 2559.5 to prospectively clarify that alcoholic beverages are classified as distilled spirits under BPC section 23005 if they contain “0.5 percent or more alcohol by volume derived from flavors or other ingredients containing alcohol obtained from the distillation of fermented agricultural products” (Regulation 2558), regardless of the alcoholic beverages’ classification for federal purposes, and create a rebuttable presumption that all alcoholic beverages are distilled spirits for California tax purposes, effective October 1, 2008. (Regulations 2559-2559.5.) However, the distilled spirits regulations (Regulations 2558-2559.5) did not apply to

wine, as defined in BPC section 23007, which may contain alcohol that is distilled from the particular agricultural product or products of which the wine is made.

Proposed Regulation

Part 24.10 of title 27 of the Code of Federal Regulations provides the general definition of wine for federal purposes and provides that: “When used without qualification, the term [wine] includes every kind (class and type) of product produced on bonded wine premises from grapes, other fruit (including berries), or other suitable agricultural products and containing not more than 24 percent alcohol by volume. The term includes all imitation, other than standard, or artificial wine and compounds sold as wine. A wine product containing less than one-half of one percent alcohol by volume is not taxable as wine when removed from the bonded wine premises.”

While Board staff was working with the manufacturers and brewers of flavored malt beverages to implement the distilled spirits regulations, staff was also in communication with wine growers and importers regarding wine-based products that are classified as wine for federal purposes, but may not meet the BPC section 23007 definition for wine. This is because BPC section 23007 expressly allows alcoholic beverages to be classified as wine if they include grape brandy, fruit brandy, or spirits of wine, which is distilled from the particular agricultural product or products of which the wine is made, but does not expressly allow alcoholic beverages to be classified as wine if they include alcohol derived from the distillation of other fermented agricultural products; and BPC section 23007 limits the amount of flavoring, coloring, and blending materials that can be added to wine. However, federal law allows alcoholic beverages to be classified as wine regardless of the source of their alcohol and federal law does not limit the amount of flavoring, coloring, and blending materials that can be added to wine.

As a result, Board staff issued two Special Notices to the wine industry, which both clarified that the distilled spirits regulations apply to all alcoholic beverages that do not meet the BPC section 23007 definition for wine. The first notice was dated December 2008, entitled *Special Notice to Wine Growers and Importers*, and mailed to wine grower and wine importer registrants. The notice advised producers and importers of wine-based alcoholic beverages that might not meet the statutory definition for wine, but which do not contain 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products to consider rebutting the presumption in Regulation 2559 by filing form BOE 505, *Alcoholic Beverage Tax Report for Rebutting Regulation 2559 Presumption*. Summaries of the distilled spirits regulations were included with this notice.

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other wine-based products or blends of wine from different fruits, may not meet California's definition of wine under BPC section 23007 and, therefore, may be considered distilled spirits and be taxed accordingly for California purposes. The notice also advised each manufacturer, grower, or importer to review California's wine definition, and if their product(s) did not meet California's definition of wine, to file form BOE-505, if appropriate, to rebut the distilled spirits presumption.

However, based on field visits to major producers of wine-based alcoholic beverages in 2010, staff became aware that significant differences of opinion and confusion still existed as to the proper classification of nonstandard, wine-based products after the 2008 and 2009 notices were issued. Specifically, disagreement existed in the wine industry as to whether water constituted a blending material subject to BPC section 23007's limitation on blending materials. And confusion existed in the wine industry as to the rules governing, and the tax consequences of, introducing distilled alcohol to wine-based products. Therefore, Board staff prepared an Informal Issue Paper dated November 2, 2010, and submitted it to the Board Members for consideration at the Board's November 16, 2010, meeting.

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agricultural product or products of which the wine is made had to be classified as distilled spirits for California tax purposes because the beverages were “obtained from the distillation of fermented agricultural products” as provided in BPC section 23005 and were clearly not wine within the meaning of BPC section 23007.

On November 16, 2010, the Board authorized staff to conduct an interested parties meeting to discuss the draft of Regulation 2558.1 included as exhibit 6 to the Informal Issue Paper. During the interested parties process, including the interested parties meeting on December 17, 2010, Board staff learned that there was considerable disagreement in the wine industry regarding whether water should be treated as a blending material. Staff determined that the addition of any amount of water to a wine-based alcoholic beverage would not make that beverage into a distilled spirit within the meaning of BPC section 23005, assuming that the wine-based alcoholic beverage did not contain alcohol from the distillation of fermented agricultural products other than the particular agricultural product or products of which the wine is made. And staff found that there appeared to be a general acceptance among the interested parties that, notwithstanding any objections they have, in general, to the existence of the distilled spirits regulations themselves, a wine-based alcoholic beverage containing distilled alcohol from a foreign source of 0.5 percent or more by volume would not be considered a wine under BPC section 23007 and would be classified as a distilled spirit under BPC section 23005 and Regulations 2558 through 2559.5 for tax purposes.

Following the interested parties meeting, Board staff prepared Formal Issue Paper 11-001 dated February 4, 2011, and submitted it to the Board Members for consideration at the Board’s February 23, 2011, meeting. The Formal Issue Paper recommended that the Board authorize staff to begin the formal rulemaking process to adopt alternative 1 for Regulation 2558.1, which provided as follows:

- (a) Effective January 1, 2012, wine as defined by Business and Professions Code section 23007 does not include any alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made.
- (b) Except as provided in subdivision (a), wine-based products authorized for sale as wine by the Department of Alcoholic Beverage Control are deemed to be wine as defined by Business and Professions Code section 23007 for purposes of the Alcoholic Beverage Tax Law.

The proposed language of alternative 1 focused solely on the addition of alcohol derived from the distillation of agricultural products to wine-based alcoholic beverages and expressly clarified that wine does not include any wine-based alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made so that these types of wine-based alcoholic beverages will clearly be classified as distilled spirits under Regulation 2558. The proposed language included a January 1, 2012, effective date to permit wine growers and importers

who had been relying on federal law and/or the Department of Alcoholic Beverage Control's (ABC's) classification of their wine-based alcoholic beverages for California tax purposes time, without being penalized due to any prior confusion in the industry, to determine whether their wine-based alcoholic beverages are wine or distilled spirits under the Board's regulations, reformulate any of their wine-based alcoholic beverages so that they can continue to qualify as wine for California tax purposes, if necessary and desired, and begin to report and pay the applicable wine or distilled spirits excise tax on their wine-based alcoholic beverages.

The Formal Issue Paper also included two other alternative proposals for Regulation 2558.1, which were both based upon the draft of Regulations 2558.1 included as exhibit 6 to the Informal Issue Paper. Alternative 2, which was supported by former Acting Board Member Barbara Alby, contained proposed language that would clarify that water and juice from the same agricultural products from which the wine is made are not flavorings, colorings, or blending materials. Alternative 3, which was supported by E & J Gallo, contained proposed language that would define the term "wine base" and clarify that water is a blending material when added to a wine base. However, Board staff did not recommend that the Board choose these alternatives over Board staff's alternative 1 because of the dispute within the industry as to whether water should be treated as a flavoring, coloring, or blending material and because the addition of water was not crucial to the classification of an alcoholic beverage as either a wine or distilled spirit for California tax purposes. And alternatives 2 and 3 were withdrawn from the Board's consideration by their sponsors prior to the February 23, 2011, meeting.

After hearing public comments, including E & J Gallo's comments supporting staff's alternative 1, during its February 23, 2011, meeting, the Board determined that it was necessary to adopt Regulation 2558.1 to clarify the rules governing, and the tax consequences of, introducing distilled alcohol to wine-based products, and the Board authorized staff to begin the formal rulemaking process for the Board to adopt staff's alternative 1 for Regulation 2558.1 for the specific purposes of:

1. Clarifying that for purposes of the Alcoholic Beverage Tax Law wine, as defined by BPC section 23007, does not include any alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made; and
2. Establishing January 1, 2012, as the prospective date for compliance with the clarified definition of wine.

Finally, it should be noted that ABC treats all wine-based alcoholic beverages as wine for California labeling and licensing purposes if the beverages are classified as wine for federal purposes, regardless of whether the beverages contain 0.5 percent or more by volume of alcohol obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made or whether the blending material exceeds 15 percent by volume. Also, ABC treats all flavored malt beverages classified as beer for federal purposes as beer for California

labeling and licensing purposes, regardless of whether the beverages contain alcohol derived from the distillation of fermented agricultural products and would be classified as distilled spirits under BPC section 23005 and the distilled spirits regulations. However, the Board has its own independent constitutional and statutory authority to adopt regulations implementing, interpreting, and making specific the provisions of BPC sections 23005, 23006, and 23007 as they apply to the classification of alcoholic beverages under the Alcoholic Beverage Tax Law, the Office of Administrative Law has recognized that authority by approving the distilled spirits regulations, and ABC has not identified any binding or persuasive authority requiring the Board to acquiesce to the federal government's classification of alcoholic beverages where the federal classification conflicts with the express language of the BPC.

DOCUMENTS RELIED UPON

The Board relied upon the Informal Issue Paper dated November 2, 2010 (discussed above), including the exhibits thereto, and Formal Issue Paper 11-001 dated February 4, 2011 (discussed above), including the exhibits thereto, in deciding to propose the adoption of Regulation 2558.1. The Board also relied upon comments made by Board staff and interested parties during its discussions of proposed Regulation 2558.1 at its November 16, 2010, and February 23, 2011, meetings.

ALTERNATIVES CONSIDERED

The Board did consider alternative 2 for Regulation 2558.1 (discussed above), which would have clarified that water is not a flavoring, coloring, or blending material for purposes of BPC section 23007. And the Board also considered alternative 3 for Regulation 2558.1 (discussed above), which would have defined the term "wine base" and clarified that water is a blending material when added to a wine base. However, the Board did not agree with either alternative because there is still general disagreement in the wine industry as to whether water should be classified as a blending material and the Board has determined that it is not necessary to determine whether water is or is not a blending material in order to determine whether a wine-based alcoholic beverage is or is not a distilled spirit for tax purposes.

NO ADVERSE ECONOMIC IMPACT ON BUSINESS

The Board has determined that the adoption of proposed Regulation 2558.1 merely clarifies when the addition of alcohol derived from the distillation of fermented agricultural products to wine-based alcoholic beverages will cause the beverages to be classified a distilled spirits, instead of wine, under the express definitions of "distilled spirits" and "wine" found in BPC sections 23005 and 23007, respectively. Furthermore, the proposed regulation includes an effective date to give wine growers and importers an opportunity to reformulate their nonconforming, wine-based alcoholic beverages so that they can continue to be classified as wine for California tax purposes after the regulation becomes effective. Therefore, the Board has made an initial determination that the

adoption of proposed Regulation 2558.1 will not have a significant adverse economic impact on business.

The proposed regulation may affect small business.

**Proposed Text of
California Code of Regulations, Title 18, Section 2558.1**

Section 2558.1. Wine.

(a) Effective January 1, 2012, wine as defined by Business and Professions Code section 23007 does not include any alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made.

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

Note: Authority cited: California Constitution, Article XX, Section 22; and Section 32451, Revenue and Taxation Code. Reference: Section 23007, Business and Professions Code; and Sections 32002, 32152, Revenue and Taxation Code.

Regulation History

Type of Regulation: Special Tax

Regulation: 2558.1

Title: 2558.1, *Wine*

Preparation: Brad Heller

Legal Contact: Brad Heller

Board proposes to adopt Regulation 2558.1, *Wine*, for the specific purpose of clarifying the application of tax to wine-based products that contain distilled alcohol.

History of Proposed Regulation:

May 24, 2011	Public Meeting
May 9, 2011	45-day public comment period ends
March 25, 2011	OAL publication date; 45-day public comment period begins; Interested Parties mailing
March 10, 2011	Notice to OAL
February 23, 2011	Business Tax Committee, Board Authorized Publication (Vote 4-1)

Sponsor: NA

Support: NA

Oppose: NA

Statement of Compliance

The State Board of Equalization, in process of adopting Special Taxes Regulation 2558.1, *Wine*, did comply with the provision of Government Code section 11346.4(a)(1) through (4). A notice to interested parties was mailed on March 25, 2011, 61 days prior to the public hearing.

May 27, 2011



Richard Bennion
Regulations Coordinator
State Board of Equalization

E. & J. GALLO WINERY • Modesto, California



May 23, 2011

Ms. Lynn Bartolo
Chief, Special Taxes and Fees Division
Property and Special Taxes Department
California State Board of Equalization
P.O. Box 942879
Sacramento, CA 94279-0057

Re: Classifying Wine-Based Products for Taxation Purposes

Dear Ms. Bartolo:

As stated in our correspondence of February 18, 2011, E. & J. Gallo Winery is in support of the proposed Regulation 2558.1 as submitted by the Board of Equalization Staff. We reiterate our position stated during our testimony at the February 23 hearing and continue to believe it is important that the Board of Equalization clarify the existing regulation. The Staff's proposal is straightforward and should be easy to enforce. Consequently, E. & J. Gallo Winery respectfully urges the Board to adopt proposed Regulation 2558.1.

Thank you for your consideration.

Sincerely,

A handwritten signature in cursive script that reads "Richard S. Grey".

Richard S. Grey
Vice President – General Counsel
(209) 341-3791
(209) 341-5030 (Fax)



May 25, 2011

FAMILY
WINEMAKERS
of CALIFORNIA®

The Honorable Jerome Horton
Chair
Board of Equalization
450 N Street
Sacramento, California 95814

520 Capitol Mall

Suite 260

Sacramento, CA

95814

916.498.7500 tel

916.498.7505 fax

Re: Proposed Regulation 2558.1 Wine

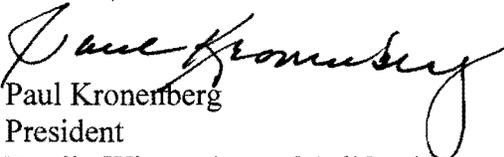
Dear Chairman Horton,

Family Winemakers of California (“FWC”) submits the following comments in opposition to the California State Board of Equalization’s (“BOE”) proposed adoption of California Code of Regulations, Title 18, Section 2558.1. FWC represents 650 wine producers throughout California. The regulation proposed by BOE would classify certain wine products as “distilled spirits” for purposes of taxation.

FWC continues to be opposed to the proposed regulation. The testimony offered at the May 25 hearing is limited to the association’s ongoing objection to the BOE’s assertion that it has the authority to regulate in this area. FWC raised that objection in the original flavored malt beverage regulations and raised it again in its January 3, 2011 submission on this pending regulation. Family Winemakers wants to ensure that the official hearing record reflect the basis for its objection since the public notice did not acknowledge the ongoing court case on the question of the BOE’s authority. Citing the Office of Administrative Law’s ministerial approval is not, in FWC’s view, determinative.

FWC would urge the board to defer adopting the regulation until the authority issue has been fully adjudicated. The *Diageo-Guinness USA and Flavored Malt Beverage Coalition v. California State Board of Equalization* case is still pending at the 3rd District Court of Appeals. It is waiting the scheduling of oral arguments. FWC doesn’t believe there is any urgency in adopting the clarification proposed by the regulation given the extensive discussion over many months among the affected stakeholders.

Sincerely,


Paul Kronenberg
President
Family Winemakers of California

BEFORE THE CALIFORNIA STATE BOARD OF EQUALIZATION

450 N Street, Room 121

Sacramento, California

REPORTER'S TRANSCRIPT

MAY 25, 2011

ITEM F3

PUBLIC HEARINGS

PROPOSED ADOPTION OF REGULATION 2558.1, WINE

Reported by: Beverly D. Toms

No. CSR 1662

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P R E S E N T

For the Board
of Equalization:

Jerome E. Horton
Chairman

Michelle Steel
Vice-Chairwoman

Betty T. Yee
Member

George Runner
Member

Marcy Jo Mandel
Appearing for John Chiang
State Controller
(per Government Code
Section 7.9)

Diane Olson, Chief
Board Proceedings Division

Board of Equalization
Staff:

Bradley Heller
Legal Department

---oOo---

1 Sacramento, California

2 May 25, 2011

3 ---oOO---

4 MR. HORTON: Ms. Olson, what's the next matter?

5 MS. OLSON: Our next matter --

6 MR. HORTON: One second, Ms. Olson.

7 I notice that there might be individuals who
8 want to testify on this. I would ask them to come
9 forward. And particularly Paul Kronenberg with the
10 Family Winemakers of California. And Mr. Heller will be
11 presenting this matter, as well.

12 Mr. Heller, please commence with your -- oh,
13 Ms. Olson, please introduce the matter.

14 MS. OLSON: Okay.

15 MR. HORTON: My apologies.

16 MS. OLSON: It's okay. It's F3, Proposed
17 Adoption of Regulation 2558.1, Wine.

18 MR. HORTON: Mr. Heller.

19 MR. HELLER: Thank you, Mr. Chairman Horton.
20 I'm Bradley Heller with the Board's Legal Department,
21 and I'm here to request that the Board adopt proposed
22 alcoholic beverage tax Regulation 2558.1, Wine.

23 The new regulation clarifies that alcoholic
24 beverage -- excuse me, clarifies that for alcoholic
25 beverage tax purposes the term "wine" does not include
26 any alcoholic beverage containing 0.5 percent or more
27 alcohol by volume obtained from the distillation of
28 fermented agricultural products other than those from

1 the particular agricultural product or products of which
2 the wine is made.

3 The new regulation also contains a prospective
4 January 1, 2012 effective date in order to give wine
5 growers and wine importers time without being penalized
6 to determine whether any of their wine-based alcoholic
7 beverages constitute distilled spirits for alcoholic
8 beverage tax purposes reformulate any wine-based
9 alcoholic beverage -- beverages so they can continue to
10 qualify as wine for tax purposes, if necessary, and
11 begin to report and pay the applicable wine or distilled
12 spirits excise tax on their wine-based alcoholic
13 beverages.

14 MR. HORTON: Thank you very much.

15 ---oOo---

1 PAULKRONENBERG

2 MR. HORTON: Mr. Kronenberg, would you please
3 introduce yourself for the record. Welcome.

4 MR. KRONENBERG: Chairman Horton, Members of
5 the Board. Paul Kronenberg on behalf of Family
6 Winemakers of California.

7 Family Winemakers represents about 650 wine
8 producers across the State. We continue to be opposed
9 to the proposed regulation before you today. Our
10 testimony is limited to an ongoing objection to the
11 Board of Equalization's assertion that it has the
12 authority to regulate in this area.

13 We raised that objection in the original
14 flavored malt beverage regulations and raised it again
15 in our January 3, 2011 submission to the Board on this
16 pending regulation.

17 We wanted to ensure that the record reflect the
18 basis of our objection since the public notice did not
19 acknowledge the ongoing Court case on the question of
20 authority, citing the Office of Administrative Law's
21 ministerial approval we don't believe is determinative
22 in this case.

23 We would urge the Board to defer adoption of
24 the regulation until the authority issue has been fully
25 adjudicated. As you know, the Diageo-Guinness USA and
26 Flavored Malt Beverage Coalition case against the Board
27 is still pending in the 3rd District Court of Appeals.
28 It's awaiting the scheduling of oral arguments.

1 We don't believe there's any urgency in
2 adopting the clarification proposed by the regulation
3 given the extensive discussion over many months among
4 the affected stakeholders. I think the people that make
5 these beverages clearly know what potentially might be
6 before them and if they haven't already taken a look at
7 reformulating that doesn't seem to suggest the normal
8 business model that goes forward.

9 We thank you for the opportunity to testify.

10 MR. HORTON: Thank you very much.

11 Mr. Heller, any comments on the witness's
12 testimony?

13 MR. HELLER: Thank you, Chairman Horton.

14 Briefly, I just wanted to also mention that E & J Gallo
15 Wineries -- Winery submitted a -- a written comment in
16 support of the -- the proposed regulation and that also
17 the Legal Department has looked at the -- at the Family
18 Winemakers of California's concerns about the authority
19 for this regulation and -- and we're pretty confident
20 that Article 22, Section 20 -- excuse me, Article 20,
21 Section 22 of the California Constitution gives the
22 Board the exclusive authority to administer any
23 alcoholic beverage taxes imposed by the Legislature, and
24 that Revenue and Taxation Code Section 32451 expressly
25 authorizes the Board to adopt regulations for the
26 administration and enforcement of the alcoholic beverage
27 tax law and including Regulation 2558.2 proposed today.

28 MR. HORTON: What's the current status of the

1 Court case?

2 MR. HELLER: It was correctly presented that
3 it's -- it's at the 3rd District Court of Appeal. It's
4 already been briefed and it has not been set for oral
5 argument at this time.

6 MR. HORTON: Any indication that they might
7 have a difference of opinion?

8 MR. HELLER: There's no indication at this
9 point and the appeal is from a decision that affirmed
10 the Board's authority at the Superior Court.

11 MR. HORTON: Okay.
12 Discussion, Members?

13 Member Yee.

14 MS. YEE: Thank you, Mr. Horton. I just wanted
15 to clarify, Mr. Kronenberg, that your objection today is
16 challenging the Board's authority to move in this area.
17 You had other concerns that you raised in your January
18 3rd submission. I wanted to be sure that those weren't
19 before us for discussion.

20 MR. KRONENBERG: Ms. Yee, as you know -- well,
21 to -- to answer your question directly, yes, the
22 objection today is -- is the ongoing question of
23 authority.

24 MR. HORTON: Okay. All right.

25 MR. KRONENBERG: Our submission on January 3rd
26 really dealt with the original proposal that the staff
27 had come forward and as you know it has morphed since
28 then --

1 MS. YEE: Yes.

2 MR. KRONENBERG: -- based upon a lot of
3 discussion.

4 MS. YEE: Uh-huh.

5 MR. KRONENBERG: We don't really have an
6 objection -- setting aside our authority question we
7 don't have an objection to the clarification that has
8 been achieved in the proposed regulation. It seems to
9 make a lot more sense than what the original staff
10 proposal was.

11 MS. YEE: Okay. I just wanted to be sure that
12 we were --

13 MR. KRONENBERG: Yeah.

14 MS. YEE: -- encompassing all of your concerns
15 today. Thank you.

16 MS. STEEL: Comment.

17 MR. HORTON: Member Steel.

18 MS. STEEL: Well, on February -- February 23rd
19 for Business Tax Committee that I opposed this
20 regulation and I commented the same thing that I'm going
21 to do it today; two wrongs don't make a right. And this
22 is another unnecessary burden to the small business
23 owners. Not only that -- that we didn't collect as much
24 as we thought we going to collect from this tax -- from
25 these taxes, that I don't think it's really necessary
26 that we really have to change and, you know, amendment
27 to this regulation.

28 So I'm opposed to it. Thank you.

1 MR. HORTON: Further discussion?

2 Mr. Runner.

3 MR. RUNNER: You know, these are always tough
4 when you've got industry who's split on their under --
5 understanding of the issue in terms of the regulation.

6 And now it's my understanding, just to clarify,
7 that -- that we've not attributed any -- any additional
8 revenue as a result of this regulation, is that correct?

9 MR. HELLER: That is correct, Mr. Runner.

10 MR. RUNNER: Okay. So we're not projecting if
11 we do this then this will happen in terms of new
12 revenue?

13 MS. YEE: Right.

14 MR. HELLER: Not at all. We -- there's a --

15 MS. STEEL: We -- we did -- I remember that we
16 supposed to get \$42 million but we didn't get it.

17 MR. RUNNER: But -- but that's not on this -- I
18 don't believe that's on this regulation, is that
19 correct?

20 MR. HELLER: Senator Runner, that's correct,
21 not on this regulation.

22 And as to Ms. Steel's comment, that was with
23 regard to the adoption of the -- I believe it was --

24 MS. STEEL: Flavored --

25 MR. HELLER: -- Regulation 2558, 2559 2599.1
26 dealing is with the distilled spirits presumption.

27 MR. RUNNER: Right. And -- and I would agree,
28 that was one where again we didn't anticipate well --

1 what the reaction was going to be and indeed the
2 revenues were not received as anticipated because of the
3 change of behavior in regards to those in the industry.

4 But in this case we're not anticipating any of
5 that in terms of its recognition.

6 And again I'm torn because I had plenty -- I
7 had a number of industry folks, including the port
8 industry who said if you do this -- if you don't do this
9 we'll be out of business in the State of California, I
10 understand the regulation.

11 So I think that's where we struggle in regards
12 to this particular issue. So, you know, I -- I -- I'm
13 anxious to see how the Court moves forward on the issue
14 but at this point I think it -- in terms of a fairness
15 for all industry the best we can, even when we got
16 people on both sides of the argument, it seems to me
17 that this regulation helps clarify.

18 MS. STEEL: Can I just make one simple --

19 MR. HORTON: Sure.

20 MS. STEEL: -- comment? Well, the flavored
21 malt beverage regulations, when we changed it we did the
22 revenue estimation at that time, and then we didn't
23 really -- made not even closely to what we did.

24 So for this proposed amendment to Regulation
25 2558.1 we didn't even do the estimate -- revenue
26 estimation for this one because you know that we not
27 going to get it. That's another reason that we didn't
28 get it.

1 MR. HELLER: Ms. Steel, my understanding was --

2 MR. HORTON: I believe it was a statement.

3 MS. STEEL: That's -- that's just my statement.

4 MR. HORTON: Yeah.

5 MS. STEEL: So, you know, I am -- totally
6 oppose this.

7 MR. HORTON: Further discussion, Members?

8 My concern is for the industry. If we don't
9 clarify this ultimately the measure of tax would be
10 higher, audits would result and different industries
11 would have to make huge adjustments and so forth.

12 And so I think it's in the best interests of
13 the industry that we provide this clarification.

14 In effect, it will actually reduce the burden
15 on the winemakers in the industry. And certainly
16 sympathetic of the -- of the position of the Family
17 Winemakers relative to the Court case. And that process
18 will certainly work itself out and we'll adjust
19 accordingly.

20 Is there a motion, Members?

21 MS. MANDEL: Move adoption.

22 MS. YEE: Second.

23 MR. HORTON: It's been moved by Ms. Mandel,
24 second by Ms. Yee to adopt.

25 With -- objection?

26 MS. STEEL: Objection.

27 MR. HORTON: Ms. Olson, please call the roll.

28 MS. OLSON: Mr. Horton.

1 MR. HORTON: Aye.

2 MS. OLSON: Ms. Steel.

3 MS. STEEL: No.

4 MS. OLSON: Mr. Runner.

5 MR. RUNNER: Aye.

6 MS. OLSON: Ms. Yee.

7 MS. YEE: Aye.

8 MS. OLSON: Ms. Mandel.

9 MS. MANDEL: Aye.

10 MS. OLSON: Motion carries.

11 MR. HORTON: Thank you very much. Appreciate
12 that.

13 ---oOo---

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REPORTER'S CERTIFICATE.

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State of California)
) ss
County of Sacramento)

I, BEVERLY D. TOMS, Hearing Reporter for the California State Board of Equalization certify that on May 25, 2011 I recorded verbatim, in shorthand, to the best of my ability, the proceedings in the above-entitled hearing; that I transcribed the shorthand writing into typewriting; and that the preceding 12 pages constitute a complete and accurate transcription of the shorthand writing.

Dated: June 7, 2011.



Beverly D Toms

BEVERLY D. TOMS
Hearing Reporter

Wednesday, May 25, 2011

Proposed Adoption of Regulation 2558.1, Wine

Bradley Heller, Tax Counsel, Tax and Fee Programs Division, Legal Department, made introductory remarks regarding proposed adoption of Alcoholic Beverage Tax Regulation 2558.1, *Wine*, which clarifies that for purposes of the Alcoholic Beverage Tax Law (RTC § 32001 et seq.) wine, as defined by Business and Professions Code (BPC) section 23007, does not include any alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made and establishes January 1, 2012, as the prospective date for compliance with the clarified definition of wine (Exhibit 5.6).

Speaker: Paul Kronenberg, President, Family Winemakers of California

Action: Upon motion of Ms. Mandel, seconded by Ms. Yee and duly carried, Mr. Horton, Ms. Yee, Mr. Runner and Ms. Mandel voting yes, Ms. Steel voting no, the Board adopted Regulation 2558.1, *Wine*, as recommended by staff.

Proposed Amendments to Regulation 6001, General Provisions

Bradley Heller, Tax Counsel, Tax and Fee Programs Division, Legal Department, made introductory remarks regarding the proposed amendments to the Board's Conflict of Interest Code Regulation 6001, *General Provisions*, appendices A and B. The proposed amendments update the designated positions listed in appendix A, the disclosure categories assigned to the designated positions listed in appendix A, and the disclosure categories described in appendix B. The proposed amendments are necessary due to changes in the Board's internal structure, the addition of new Board positions and the elimination of some previously designated positions, and changes in the duties assigned to some existing Board positions (Exhibit 5.7).

Speakers were invited to address the Board, but there were none.

Action: Upon motion of Ms. Steel, seconded by Ms. Yee and unanimously carried, Mr. Horton, Ms. Steel, Ms. Yee, Mr. Runner and Ms. Mandel voting yes, the Board adopted the amendments to Regulation 6001, *General Provisions*, appendices A and B, as recommended by staff.

LEGAL APPEALS MATTERS, CONSENT

The Board deferred consideration of the following matter: *Graphics Concept, Inc.*, 444651.

With respect to the Legal Appeals Matters Consent Agenda, upon a single motion of Mr. Runner, seconded by Ms. Yee and unanimously carried, Mr. Horton, Ms. Steel, Ms. Yee, Mr. Runner and Ms. Mandel voting yes, the Board made the following orders:

The C.I.T. Group/Equipment Financing, Inc., 457742, 557442 (OH)
4-1-02 to 3-31-05, \$594,600.00 Tax

Action: Redetermine as recommended by the Appeals Division.



STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

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BETTY T. YEE
First District, San Francisco

SEN. GEORGE RUNNER (Ret.)
Second District, Lancaster

MICHELLE STEEL
Third District, Rolling Hills Estates

JEROME E. HORTON
Fourth District, Los Angeles

JOHN CHIANG
State Controller

KRISTINE CAZADD
Interim Executive Director

March 25, 2011

To Interested Parties:

**Notice of Proposed Regulatory Action
by the
State Board of Equalization**

**California Code of Regulations, Title 18,
Section 2558.1, *Wine***

Notice of Proposed Regulatory Action

**The State Board of Equalization Proposes to Adopt
California Code of Regulations, Title 18,
Section 2558.1, *Wine***

NOTICE IS HEREBY GIVEN

The State Board of Equalization (Board), pursuant to the authority vested in it by article XX, section 22 of the California Constitution and Revenue and Taxation Code (RTC) section 32451, proposes to adopt California Code of Regulations, title 18, section (Regulation) 2558.1, *Wine*. The proposed regulation clarifies that for purposes of the Alcoholic Beverage Tax Law (RTC § 32001 et seq.) wine, as defined by Business and Professions Code (BPC) section 23007, does not include any alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made and establishes January 1, 2012, as the prospective date for compliance with the clarified definition of wine.

PUBLIC HEARING

A public hearing on the proposed regulatory action will be held in Room 121, 450 N Street, Sacramento, at 9:30 a.m., or as soon thereafter as the matter may be heard, on May 24, 2011. At the hearing, any interested person may present or submit oral or written statements, arguments, or contentions regarding the adoption of proposed Regulation 2558.1.

AUTHORITY

California Constitution, article XX, section 22 and RTC section 32451.

Item F3
05/25/11

REFERENCES

BPC section 23007 and RTC sections 32002 and 32152.

INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW

Current Law

Article XX, section 22 of the California Constitution authorizes and requires the Board to assess and collect all excise taxes that are or may be imposed on the manufacture, importation, and sale of alcoholic beverages. RTC section 32451 expressly authorizes the Board to administer the Alcoholic Beverage Tax Law and adopt regulations relating to its administration and enforcement. And RTC section 32152 authorizes the Board to adopt regulations to coordinate California's and the federal government's systems for taxing beer and wine, so far as permitted by the express provisions of the Alcoholic Beverage Tax Law.

The Alcoholic Beverage Tax Law imposes different excise taxes on distilled spirits, beer, and wine, and the rates of the excise tax on distilled spirits are substantially higher than the rates of the excise tax imposed on beer and wine. (See RTC §§ 32151 (beer and wine) and 32201 (distilled spirits).) Still wines are taxed at a rate of one or two cents per gallon, beer is taxed at a rate of \$1.24 per 31 gallon barrel (or approximately 4.5 cents per gallon), and liquid distilled spirits are taxed at a rate of \$2 or \$4 per gallon.

RTC section 32002 provides that the definitions contained in chapter 1 (sections 23001-23047) of division 9 of the BPC apply to the terms used in the Alcoholic Beverage Tax Law. This includes the definitions in BPC sections 23005, 23006, and 23007, which define "distilled spirits," "beer," and "wine," respectively, and provide that:

23005. "Distilled spirits" means an alcoholic beverage obtained by the distillation of fermented agricultural products, and includes alcohol for beverage use, spirits of wine, whiskey, rum, brandy, and gin, including all dilutions and mixtures thereof.

23006. "Beer" means any alcoholic beverage obtained by the fermentation of any infusion or decoction of barley, malt, hops, or any other similar product, or any combination thereof in water, and includes ale, porter, brown, stout, lager beer, small beer, and strong beer but does not include sake, known as Japanese rice wine.

23007. "Wine" means the product obtained from normal alcoholic fermentation of the juice of sound ripe grapes or other agricultural products containing natural or added sugar or any such alcoholic beverage to which is added grape brandy, fruit brandy, or spirits of wine, which is distilled from the particular agricultural

product or products of which the wine is made and other rectified wine products and by whatever name and which does not contain more than 15 percent added flavoring, coloring, and blending material and which contains not more than 24 percent of alcohol by volume, and includes vermouth and sake, known as Japanese rice wine.

Therefore, the Board must determine whether an alcoholic beverage is a distilled spirit, beer, or wine in order to determine which excise tax and which excise tax rate applies to that beverage under the Alcoholic Beverage Tax Law.

In late 2006, the Board received information that there were alcoholic beverages being sold as beer in California because they were made from the fermentation of malt or similar products, but which might also contain alcohol derived from the distillation of fermented agricultural products. This was because the federal government adopted alcoholic beverage regulations allowing “flavored malt beverages” to be labeled, advertised, and taxed like beer for federal purposes, and also allowing flavored malt beverages to contain specified amounts of alcohol from the distillation of fermented agricultural products. (See 27 C.F.R. §§ 7.1-7.81, 25.15.)

The Board determined that the definition for “beer” set forth in BPC section 23006 did not allow beer to contain alcohol from the distillation of fermented agricultural products. The Board also determined that beverages containing alcohol from the distillation of fermented agricultural products had to be classified as either distilled spirits or wine because the definitions for distilled spirits and wine in BPC sections 23005 and 23007 do allow those beverages to contain alcohol from the distillation of fermented agricultural products.

Based upon these determinations, the Board concluded that flavored malt beverages that are derived from the fermentation of malt or similar products and only contain a de minimis amount of alcohol from flavorings that are derived from the distillation of fermented agricultural products could consistently be classified as beer for federal and California purposes. However, the Board also concluded that flavored malt beverages containing more than a de minimis amount of alcohol from the distillation of fermented agricultural products had to be classified as a distilled spirits for California tax purposes because the beverages were “obtained from the distillation of fermented agricultural products” as provided in BPC section 23005 and were clearly not wine. Therefore, the Board adopted Regulations 2558 through 2559.5 to prospectively clarify that alcoholic beverages are classified as distilled spirits under BPC section 23005 if they contain “0.5 percent or more alcohol by volume derived from flavors or other ingredients containing alcohol obtained from the distillation of fermented agricultural products” (Regulation 2558), regardless of the alcoholic beverages’ classification for federal purposes, and create a rebuttable presumption that all alcoholic beverages are distilled spirits for California tax purposes, effective October 1, 2008. (Regulations 2559-2559.5.) However, the distilled spirits regulations (Regulations 2558-2559.5) did not apply to wine, as defined in BPC section 23007, which may contain alcohol that is distilled from the particular agricultural product or products of which the wine is made.

Proposed Regulation

Part 24.10 of title 27 of the Code of Federal Regulations provides the general definition of wine for federal purposes and provides that: "When used without qualification, the term [wine] includes every kind (class and type) of product produced on bonded wine premises from grapes, other fruit (including berries), or other suitable agricultural products and containing not more than 24 percent alcohol by volume. The term includes all imitation, other than standard, or artificial wine and compounds sold as wine. A wine product containing less than one-half of one percent alcohol by volume is not taxable as wine when removed from the bonded wine premises."

While Board staff was working with the manufacturers and brewers of flavored malt beverages to implement the distilled spirits regulations, staff was also in communication with wine growers and importers regarding wine-based products that are classified as wine for federal purposes, but may not meet the BPC section 23007 definition for wine. This is because BPC section 23007 expressly allows alcoholic beverages to be classified as wine if they include grape brandy, fruit brandy, or spirits of wine, which is distilled from the particular agricultural product or products of which the wine is made, but does not expressly allow alcoholic beverages to be classified as wine if they include alcohol derived from the distillation of other fermented agricultural products; and BPC section 23007 limits the amount of flavoring, coloring, and blending materials that can be added to wine. However, federal law allows alcoholic beverages to be classified as wine regardless of the source of their alcohol and federal law does not limit the amount of flavoring, coloring, and blending materials that can be added to wine.

As a result, Board staff issued two Special Notices to the wine industry, which both clarified that the distilled spirits regulations apply to all alcoholic beverages that do not meet the BPC section 23007 definition for wine. The first notice was dated December 2008, entitled *Special Notice to Wine Growers and Importers*, and mailed to wine grower and wine importer registrants. The notice advised producers and importers of wine-based alcoholic beverages that might not meet the statutory definition for wine, but which do not contain 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products to consider rebutting the presumption in Regulation 2559 by filing form BOE 505, *Alcoholic Beverage Tax Report for Rebutting Regulation 2559 Presumption*. Summaries of the distilled spirits regulations were included with this notice.

The second notice was dated December 2009, entitled *Alcoholic Beverages Taxed as Wine for Federal Purposes, May Not Meet California's Definition of Wine and Therefore May be Subject to Tax as Distilled Spirits for California Tax Purposes*, and was mailed to all of the Board's alcoholic beverage program accounts. The second notice advised that certain types of alcoholic beverages that may qualify as wine for federal classification purposes, namely wine specialties, flavored table wine, wine cocktails, wine coolers or other wine-based products or blends of wine from different fruits, may not meet California's definition of wine under BPC section 23007 and, therefore, may be considered distilled spirits and be taxed accordingly for California purposes. The notice also advised each manufacturer, grower, or importer to review California's wine

definition, and if their product(s) did not meet California's definition of wine, to file form BOE-505, if appropriate, to rebut the distilled spirits presumption.

However, based on field visits to major producers of wine-based alcoholic beverages in 2010, staff became aware that significant differences of opinion and confusion still existed as to the proper classification of nonstandard, wine-based products after the 2008 and 2009 notices were issued. Specifically, disagreement existed in the wine industry as to whether water constituted a blending material subject to BPC section 23007's limitation on blending materials. And confusion existed in the wine industry as to the rules governing, and the tax consequences of, introducing distilled alcohol to wine-based products. Therefore, Board staff prepared an Informal Issue Paper dated November 2, 2010, and submitted it to the Board Members for consideration at the Board's November 16, 2010, meeting.

The Informal Issue Paper summarized the information provided above, requested the Board's authorization for staff to initiate an interested parties process to discuss the two issues affecting the classification of wine more thoroughly, and included the following exhibits:

1. Regulations 2558 through 2559.5;
2. Formal Issue Paper 07-007 dated August 3, 2007, regarding the classification of flavored malt beverages and recommending that the Board begin the formal rulemaking process to adopt Regulations 2558 through 2559.5, which was submitted to the Board Members for consideration at the Board's August 14, 2007, meeting;
3. The minutes from the Board's August 14, 2007, meeting showing that the Board authorized staff to begin the formal rulemaking process to adopt Regulations 2558 through 2559.5;
4. The December 2008 Special Notice (discussed above);
5. The December 2009 Special Notice (discussed above); and
6. An initial draft of Regulation 2558.1, *Wine*, that staff wanted to discuss with interested parties because it raised various issues with regard to the classification of wine-based products.

As relevant here, the initial draft of Regulation 2558.1 included as exhibit 6 to the Informal Issue Paper indicated that wine-based alcoholic beverages that only contain a de minimis amount of alcohol from flavorings, colorings, or blending materials that are derived from the distillation of fermented agricultural products other than the particular agricultural product or products of which the wine is made could consistently be classified as wine for federal and California purposes. However, wine-based alcoholic beverages containing more than a de minimis amount of alcohol (0.5% or more by volume) from the distillation of fermented agricultural products other than the particular agricultural product or products of which the wine is made had to be classified as distilled spirits for California tax purposes because the beverages were "obtained from the distillation of fermented agricultural products" as provided in BPC section 23005 and were clearly not wine within the meaning of BPC section 23007.

On November 16, 2010, the Board authorized staff to conduct an interested parties meeting to discuss the draft of Regulation 2558.1 included as exhibit 6 to the Informal Issue Paper. During the interested parties process, including the interested parties meeting on December 17, 2010, Board staff learned that there was considerable disagreement in the wine industry regarding whether water should be treated as a blending material. Staff determined that the addition of any amount of water to a wine-based alcoholic beverage would not make that beverage into a distilled spirit within the meaning of BPC section 23005, assuming that the wine-based alcoholic beverage did not contain alcohol from the distillation of fermented agricultural products other than the particular agricultural product or products of which the wine is made. And staff found that there appeared to be a general acceptance among the interested parties that, notwithstanding any objections they have, in general, to the existence of the distilled spirits regulations themselves, a wine-based alcoholic beverage containing distilled alcohol from a foreign source of 0.5 percent or more by volume would not be considered a wine under BPC section 23007 and would be classified as a distilled spirit under BPC section 23005 and Regulations 2558 through 2559.5 for tax purposes.

Following the interested parties meeting, Board staff prepared Formal Issue Paper 11-001 dated February 4, 2011, and submitted it to the Board Members for consideration at the Board's February 23, 2011, meeting. The Formal Issue Paper recommended that the Board authorize staff to begin the formal rulemaking process to adopt alternative 1 for Regulation 2558.1, which provided as follows:

- (a) Effective January 1, 2012, wine as defined by Business and Professions Code section 23007 does not include any alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made.
- (b) Except as provided in subdivision (a), wine-based products authorized for sale as wine by the Department of Alcoholic Beverage Control are deemed to be wine as defined by Business and Professions Code section 23007 for purposes of the Alcoholic Beverage Tax Law.

The proposed language of alternative 1 focused solely on the addition of alcohol derived from the distillation of agricultural products to wine-based alcoholic beverages and expressly clarified that wine does not include any wine-based alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made so that these types of wine-based alcoholic beverages will clearly be classified as distilled spirits under Regulation 2558. The proposed language included a January 1, 2012, effective date to permit wine growers and importers who had been relying on federal law and/or the Department of Alcoholic Beverage Control's (ABC's) classification of their wine-based alcoholic beverages for California tax purposes time, without being penalized due to any prior confusion in the industry, to determine whether their wine-based alcoholic beverages are wine or distilled spirits under the Board's regulations, reformulate any of their wine-based alcoholic beverages so that they can continue to

qualify as wine for California tax purposes, if necessary and desired, and begin to report and pay the applicable wine or distilled spirits excise tax on their wine-based alcoholic beverages.

The Formal Issue Paper also included two other alternative proposals for Regulation 2558.1, which were both based upon the draft of Regulations 2558.1 included as exhibit 6 to the Informal Issue Paper. Alternative 2, which was supported by former Acting Board Member Barbara Alby, contained proposed language that would clarify that water and juice from the same agricultural products from which the wine is made are not flavorings, colorings, or blending materials. Alternative 3, which was supported by E & J Gallo, contained proposed language that would define the term "wine base" and clarify that water is a blending material when added to a wine base. However, Board staff did not recommend that the Board choose these alternatives over Board staff's alternative 1 because of the dispute within the industry as to whether water should be treated as a flavoring, coloring, or blending material and because the addition of water was not crucial to the classification of an alcoholic beverage as either a wine or distilled spirit for California tax purposes. And alternatives 2 and 3 were withdrawn from the Board's consideration by their sponsors prior to the February 23, 2011, meeting. After hearing public comments, including E & J Gallo's comments supporting staff's alternative 1, and discussing staff's recommendation, the Board voted to authorize staff to begin the formal rulemaking process to adopt Board staff's alternative 1 during its February 23, 2011, meeting.

Finally, it should be noted that ABC treats all wine-based alcoholic beverages as wine for California labeling and licensing purposes if the beverages are classified as wine for federal purposes, regardless of whether the beverages contain 0.5 percent or more by volume of alcohol obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made or whether the blending material exceeds 15 percent by volume. Also, ABC treats all flavored malt beverages classified as beer for federal purposes as beer for California labeling and licensing purposes, regardless of whether the beverages contain alcohol derived from the distillation of fermented agricultural products and would be classified as distilled spirits under BPC section 23005 and the distilled spirits regulations. However, the Board has its own independent constitutional and statutory authority to adopt regulations implementing, interpreting, and making specific the provisions of BPC sections 23005, 23006, and 23007 as they apply to the classification of alcoholic beverages under the Alcoholic Beverage Tax Law, the Office of Administrative Law has recognized that authority by approving the distilled spirits regulations, and ABC has not identified any binding or persuasive authority requiring the Board to acquiesce to the federal government's classification of alcoholic beverages where the federal classification conflicts with the express language of the BPC.

NO MANDATE ON LOCAL AGENCIES AND SCHOOL DISTRICTS

The Board has determined that the adoption of proposed Regulation 2558.1 will not impose a mandate on local agencies or school districts, including a mandate that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code.

NO COST OR SAVINGS TO STATE AGENCIES, LOCAL AGENCIES, AND SCHOOL DISTRICTS

The Board has determined that the adoption of proposed Regulation 2558.1 will result in no direct or indirect cost or savings to any state agency, any cost to local agencies or school districts that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code, other non-discretionary cost or savings imposed on local agencies, or cost or savings in federal funding to the State of California.

NO SIGNIFICANT STATEWIDE ADVERSE ECONOMIC IMPACT DIRECTLY AFFECTING BUSINESS

The Board has determined that the adoption of proposed Regulation 2558.1 merely clarifies when the addition of alcohol derived from the distillation of fermented agricultural products to wine-based alcoholic beverages will cause the beverages to be classified a distilled spirits, instead of wine, under the express definitions of distilled spirits and wine found in BPC sections 23005 and 23007, respectively. Furthermore, the proposed regulation includes an effective date to give wine growers and importers an opportunity to reformulate their nonconforming, wine-based alcoholic beverages so that they can continue to be classified as wine for California tax purposes after the regulation becomes effective. Therefore, the Board has made an initial determination that the adoption of proposed Regulation 2558.1 will not have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states.

The adoption of proposed Regulation 2558.1 may affect small business.

NO COST IMPACTS TO PRIVATE PERSONS OR BUSINESSES

The Board is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

RESULTS OF THE ASSESSMENT REQUIRED BY GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)

The Board has determined that the adoption of proposed Regulation 2558.1 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California.

NO SIGNIFICANT EFFECT ON HOUSING COSTS

Adoption of proposed Regulation 2558.1 will not have a significant effect on housing costs.

DETERMINATION REGARDING ALTERNATIVES

The Board must determine that no reasonable alternative considered by it or that has been otherwise identified and brought to its attention would be more effective in carrying out the purpose for which this action is proposed, or be as effective as and less burdensome to affected private persons than the proposed action.

CONTACT PERSONS

Questions regarding the substance of the proposed regulation should be directed to Bradley M. Heller, Tax Counsel III (Specialist), by telephone at (916) 323-3091, by e-mail at Bradley.Heller@boe.ca.gov, or by mail at State Board of Equalization, Attn: Bradley M. Heller, MIC:82, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0082.

Written comments for the Board's consideration, notice of intent to present testimony or witnesses at the public hearing, and inquiries concerning the proposed administrative action should be directed to Mr. Rick Bennion, Regulations Coordinator, by telephone at (916) 445-2130, by fax at (916) 324-3984, by e-mail at Richard.Bennion@boe.ca.gov, or by mail at State Board of Equalization, Attn: Rick Bennion, MIC:81, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0080.

WRITTEN COMMENT PERIOD

The written comment period ends when the public hearing begins at 9:30 a.m., or as soon thereafter as the matter may be heard, on May 24, 2011. If the Board receives written comments prior to the close of the written comment period, the statements, arguments, and/or contentions contained in those comments will be presented to and considered by the Board before the Board decides whether to adopt proposed Regulation 2558.1. The Board will only consider written comments received by that time.

AVAILABILITY OF INITIAL STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATION

The Board has prepared an Initial Statement of Reasons for and an underscored version of proposed Regulation 2558.1 illustrating its express terms. These documents and all the information on which the proposed regulation is based are available to the public upon request. The rulemaking file is available for public inspection at 450 N Street, Sacramento, California. The express terms of the proposed regulation and the Initial Statement of Reasons are also available on the Board's Website at www.boe.ca.gov.

SUBSTANTIALLY RELATED CHANGES PURSUANT TO GOVERNMENT CODE SECTION 11346.8

The Board may adopt proposed Regulation 2558.1 with changes that are nonsubstantial or solely grammatical in nature, or sufficiently related to the original proposed text that the public was

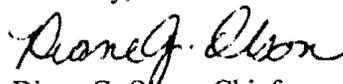
March 25, 2011

adequately placed on notice that the changes could result from the originally proposed regulatory action. If a sufficiently related change is made, the Board will make the full text of the proposed regulation, with the change clearly indicated, available to the public for at least 15 days before adoption. The text of the resulting regulation will be mailed to those interested parties who commented on the proposed regulation orally or in writing or who asked to be informed of such changes. The text of the resulting regulation will also be available to the public from Mr. Bennion. The Board will consider written comments on the resulting regulation that are received prior to adoption.

AVAILABILITY OF FINAL STATEMENT OF REASONS

If the Board adopts proposed Regulation 2558.1 the Board will prepare a Final Statement of Reasons, which will be made available for inspection at 450 N Street, Sacramento, California, and available on the Board's Website at www.boe.ca.gov.

Sincerely,



Diane G. Olson, Chief
Board Proceedings Division

DGO:reb

Initial Statement of Reasons

Proposed Adoption of California Code of Regulations, Title 18, Section 2558.1, *Wine*

SPECIFIC PURPOSE AND NECESSITY

Current Law

Article XX, section 22 of the California Constitution authorizes and requires the Board to assess and collect all excise taxes that are or may be imposed on the manufacture, importation, and sale of alcoholic beverages. RTC section 32451 expressly authorizes the Board to administer the Alcoholic Beverage Tax Law and adopt regulations relating to its administration and enforcement. And RTC section 32152 authorizes the Board to adopt regulations to coordinate California's and the federal government's systems for taxing beer and wine, so far as permitted by the express provisions of the Alcoholic Beverage Tax Law.

The Alcoholic Beverage Tax Law imposes different excise taxes on distilled spirits, beer, and wine, and the rates of the excise tax on distilled spirits are substantially higher than the rates of the excise tax imposed on beer and wine. (See RTC §§ 32151 (beer and wine) and 32201 (distilled spirits).) Still wines are taxed at a rate of one or two cents per gallon, beer is taxed at a rate of \$1.24 per 31 gallon barrel (or approximately 4.5 cents per gallon), and liquid distilled spirits are taxed at a rate of \$2 or \$4 per gallon.

RTC section 32002 provides that the definitions contained in chapter 1 (sections 23001-23047) of division 9 of the BPC apply to the terms used in the Alcoholic Beverage Tax Law. This includes the definitions in BPC sections 23005, 23006, and 23007, which define "distilled spirits," "beer," and "wine," respectively, and provide that:

23005. "Distilled spirits" means an alcoholic beverage obtained by the distillation of fermented agricultural products, and includes alcohol for beverage use, spirits of wine, whiskey, rum, brandy, and gin, including all dilutions and mixtures thereof.

23006. "Beer" means any alcoholic beverage obtained by the fermentation of any infusion or decoction of barley, malt, hops, or any other similar product, or any combination thereof in water, and includes ale, porter, brown, stout, lager beer, small beer, and strong beer but does not include sake, known as Japanese rice wine.

23007. "Wine" means the product obtained from normal alcoholic fermentation of the juice of sound ripe grapes or other agricultural products containing natural or added sugar or any such alcoholic beverage to which is added grape brandy, fruit brandy, or spirits of wine, which is

distilled from the particular agricultural product or products of which the wine is made and other rectified wine products and by whatever name and which does not contain more than 15 percent added flavoring, coloring, and blending material and which contains not more than 24 percent of alcohol by volume, and includes vermouth and sake, known as Japanese rice wine.

Therefore, the Board must determine whether an alcoholic beverage is a distilled spirit, beer, or wine in order to determine which excise tax and which excise tax rate applies to that beverage under the Alcoholic Beverage Tax Law.

In late 2006, the Board received information that there were alcoholic beverages being sold as beer in California because they were made from the fermentation of malt or similar products, but which might also contain alcohol derived from the distillation of fermented agricultural products. This was because the federal government adopted alcoholic beverage regulations allowing “flavored malt beverages” to be labeled, advertised, and taxed like beer for federal purposes, and also allowing flavored malt beverages to contain specified amounts of alcohol from the distillation of fermented agricultural products. (See 27 C.F.R. §§ 7.1-7.81, 25.15.)

The Board determined that the definition for “beer” set forth in BPC section 23006 did not allow beer to contain alcohol from the distillation of fermented agricultural products. The Board also determined that beverages containing alcohol from the distillation of fermented agricultural products had to be classified as either distilled spirits or wine because the definitions for distilled spirits and wine in BPC sections 23005 and 23007 do allow those beverages to contain alcohol from the distillation of fermented agricultural products.

Based upon these determinations, the Board concluded that flavored malt beverages that are derived from the fermentation of malt or similar products and only contain a de minimis amount of alcohol from flavorings that are derived from the distillation of fermented agricultural products could consistently be classified as beer for federal and California purposes. However, the Board also concluded that flavored malt beverages containing more than a de minimis amount of alcohol from the distillation of fermented agricultural products had to be classified as a distilled spirits for California tax purposes because the beverages were “obtained from the distillation of fermented agricultural products” as provided in BPC section 23005 and were clearly not wine. Therefore, the Board adopted Regulations 2558 through 2559.5 to prospectively clarify that alcoholic beverages are classified as distilled spirits under BPC section 23005 if they contain “0.5 percent or more alcohol by volume derived from flavors or other ingredients containing alcohol obtained from the distillation of fermented agricultural products” (Regulation 2558), regardless of the alcoholic beverages’ classification for federal purposes, and create a rebuttable presumption that all alcoholic beverages are distilled spirits for California tax purposes, effective October 1, 2008. (Regulations 2559-2559.5.) However, the distilled spirits regulations (Regulations 2558-2559.5) did not apply to

wine, as defined in BPC section 23007, which may contain alcohol that is distilled from the particular agricultural product or products of which the wine is made.

Proposed Regulation

Part 24.10 of title 27 of the Code of Federal Regulations provides the general definition of wine for federal purposes and provides that: “When used without qualification, the term [wine] includes every kind (class and type) of product produced on bonded wine premises from grapes, other fruit (including berries), or other suitable agricultural products and containing not more than 24 percent alcohol by volume. The term includes all imitation, other than standard, or artificial wine and compounds sold as wine. A wine product containing less than one-half of one percent alcohol by volume is not taxable as wine when removed from the bonded wine premises.”

While Board staff was working with the manufacturers and brewers of flavored malt beverages to implement the distilled spirits regulations, staff was also in communication with wine growers and importers regarding wine-based products that are classified as wine for federal purposes, but may not meet the BPC section 23007 definition for wine. This is because BPC section 23007 expressly allows alcoholic beverages to be classified as wine if they include grape brandy, fruit brandy, or spirits of wine, which is distilled from the particular agricultural product or products of which the wine is made, but does not expressly allow alcoholic beverages to be classified as wine if they include alcohol derived from the distillation of other fermented agricultural products; and BPC section 23007 limits the amount of flavoring, coloring, and blending materials that can be added to wine. However, federal law allows alcoholic beverages to be classified as wine regardless of the source of their alcohol and federal law does not limit the amount of flavoring, coloring, and blending materials that can be added to wine.

As a result, Board staff issued two Special Notices to the wine industry, which both clarified that the distilled spirits regulations apply to all alcoholic beverages that do not meet the BPC section 23007 definition for wine. The first notice was dated December 2008, entitled *Special Notice to Wine Growers and Importers*, and mailed to wine grower and wine importer registrants. The notice advised producers and importers of wine-based alcoholic beverages that might not meet the statutory definition for wine, but which do not contain 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products to consider rebutting the presumption in Regulation 2559 by filing form BOE 505, *Alcoholic Beverage Tax Report for Rebutting Regulation 2559 Presumption*. Summaries of the distilled spirits regulations were included with this notice.

The second notice was dated December 2009, entitled *Alcoholic Beverages Taxed as Wine for Federal Purposes, May Not Meet California’s Definition of Wine and Therefore May be Subject to Tax as Distilled Spirits for California Tax Purposes*, and was mailed to all of the Board’s alcoholic beverage program accounts. The second notice advised that certain types of alcoholic beverages that may qualify as wine for federal classification purposes, namely wine specialties, flavored table wine, wine cocktails, wine coolers or

other wine-based products or blends of wine from different fruits, may not meet California's definition of wine under BPC section 23007 and, therefore, may be considered distilled spirits and be taxed accordingly for California purposes. The notice also advised each manufacturer, grower, or importer to review California's wine definition, and if their product(s) did not meet California's definition of wine, to file form BOE-505, if appropriate, to rebut the distilled spirits presumption.

However, based on field visits to major producers of wine-based alcoholic beverages in 2010, staff became aware that significant differences of opinion and confusion still existed as to the proper classification of nonstandard, wine-based products after the 2008 and 2009 notices were issued. Specifically, disagreement existed in the wine industry as to whether water constituted a blending material subject to BPC section 23007's limitation on blending materials. And confusion existed in the wine industry as to the rules governing, and the tax consequences of, introducing distilled alcohol to wine-based products. Therefore, Board staff prepared an Informal Issue Paper dated November 2, 2010, and submitted it to the Board Members for consideration at the Board's November 16, 2010, meeting.

The Informal Issue Paper summarized the information provided above, requested the Board's authorization for staff to initiate an interested parties process to discuss the two issues affecting the classification of wine more thoroughly, and included the following exhibits:

1. Regulations 2558 through 2559.5;
2. Formal Issue Paper 07-007 dated August 3, 2007, regarding the classification of flavored malt beverages and recommending that the Board begin the formal rulemaking process to adopt Regulations 2558 through 2559.5, which was submitted to the Board Members for consideration at the Board's August 14, 2007, meeting;
3. The minutes from the Board's August 14, 2007, meeting showing that the Board authorized staff to begin the formal rulemaking process to adopt Regulations 2558 through 2559.5;
4. The December 2008 Special Notice (discussed above);
5. The December 2009 Special Notice (discussed above); and
6. An initial draft of Regulation 2558.1, *Wine*, that staff wanted to discuss with interested parties because it raised various issues with regard to the classification of wine-based products.

As relevant here, the initial draft of Regulation 2558.1 included as exhibit 6 to the Informal Issue Paper indicated that wine-based alcoholic beverages that only contain a de minimis amount of alcohol from flavorings, colorings, or blending materials that are derived from the distillation of fermented agricultural products other than the particular agricultural product or products of which the wine is made could consistently be classified as wine for federal and California purposes. However, wine-based alcoholic beverages containing more than a de minimis amount of alcohol (0.5% or more by volume) from the distillation of fermented agricultural products other than the particular

agricultural product or products of which the wine is made had to be classified as distilled spirits for California tax purposes because the beverages were “obtained from the distillation of fermented agricultural products” as provided in BPC section 23005 and were clearly not wine within the meaning of BPC section 23007.

On November 16, 2010, the Board authorized staff to conduct an interested parties meeting to discuss the draft of Regulation 2558.1 included as exhibit 6 to the Informal Issue Paper. During the interested parties process, including the interested parties meeting on December 17, 2010, Board staff learned that there was considerable disagreement in the wine industry regarding whether water should be treated as a blending material. Staff determined that the addition of any amount of water to a wine-based alcoholic beverage would not make that beverage into a distilled spirit within the meaning of BPC section 23005, assuming that the wine-based alcoholic beverage did not contain alcohol from the distillation of fermented agricultural products other than the particular agricultural product or products of which the wine is made. And staff found that there appeared to be a general acceptance among the interested parties that, notwithstanding any objections they have, in general, to the existence of the distilled spirits regulations themselves, a wine-based alcoholic beverage containing distilled alcohol from a foreign source of 0.5 percent or more by volume would not be considered a wine under BPC section 23007 and would be classified as a distilled spirit under BPC section 23005 and Regulations 2558 through 2559.5 for tax purposes.

Following the interested parties meeting, Board staff prepared Formal Issue Paper 11-001 dated February 4, 2011, and submitted it to the Board Members for consideration at the Board’s February 23, 2011, meeting. The Formal Issue Paper recommended that the Board authorize staff to begin the formal rulemaking process to adopt alternative 1 for Regulation 2558.1, which provided as follows:

- (a) Effective January 1, 2012, wine as defined by Business and Professions Code section 23007 does not include any alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made.
- (b) Except as provided in subdivision (a), wine-based products authorized for sale as wine by the Department of Alcoholic Beverage Control are deemed to be wine as defined by Business and Professions Code section 23007 for purposes of the Alcoholic Beverage Tax Law.

The proposed language of alternative 1 focused solely on the addition of alcohol derived from the distillation of agricultural products to wine-based alcoholic beverages and expressly clarified that wine does not include any wine-based alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made so that these types of wine-based alcoholic beverages will clearly be classified as distilled spirits under Regulation 2558. The proposed language included a January 1, 2012, effective date to permit wine growers and importers

who had been relying on federal law and/or the Department of Alcoholic Beverage Control's (ABC's) classification of their wine-based alcoholic beverages for California tax purposes time, without being penalized due to any prior confusion in the industry, to determine whether their wine-based alcoholic beverages are wine or distilled spirits under the Board's regulations, reformulate any of their wine-based alcoholic beverages so that they can continue to qualify as wine for California tax purposes, if necessary and desired, and begin to report and pay the applicable wine or distilled spirits excise tax on their wine-based alcoholic beverages.

The Formal Issue Paper also included two other alternative proposals for Regulation 2558.1, which were both based upon the draft of Regulations 2558.1 included as exhibit 6 to the Informal Issue Paper. Alternative 2, which was supported by former Acting Board Member Barbara Alby, contained proposed language that would clarify that water and juice from the same agricultural products from which the wine is made are not flavorings, colorings, or blending materials. Alternative 3, which was supported by E & J Gallo, contained proposed language that would define the term "wine base" and clarify that water is a blending material when added to a wine base. However, Board staff did not recommend that the Board choose these alternatives over Board staff's alternative 1 because of the dispute within the industry as to whether water should be treated as a flavoring, coloring, or blending material and because the addition of water was not crucial to the classification of an alcoholic beverage as either a wine or distilled spirit for California tax purposes. And alternatives 2 and 3 were withdrawn from the Board's consideration by their sponsors prior to the February 23, 2011, meeting.

After hearing public comments, including E & J Gallo's comments supporting staff's alternative 1, during its February 23, 2011, meeting, the Board determined that it was necessary to adopt Regulation 2558.1 to clarify the rules governing, and the tax consequences of, introducing distilled alcohol to wine-based products, and the Board authorized staff to begin the formal rulemaking process for the Board to adopt staff's alternative 1 for Regulation 2558.1 for the specific purposes of:

1. Clarifying that for purposes of the Alcoholic Beverage Tax Law wine, as defined by BPC section 23007, does not include any alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made; and
2. Establishing January 1, 2012, as the prospective date for compliance with the clarified definition of wine.

Finally, it should be noted that ABC treats all wine-based alcoholic beverages as wine for California labeling and licensing purposes if the beverages are classified as wine for federal purposes, regardless of whether the beverages contain 0.5 percent or more by volume of alcohol obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made or whether the blending material exceeds 15 percent by volume. Also, ABC treats all flavored malt beverages classified as beer for federal purposes as beer for California

labeling and licensing purposes, regardless of whether the beverages contain alcohol derived from the distillation of fermented agricultural products and would be classified as distilled spirits under BPC section 23005 and the distilled spirits regulations. However, the Board has its own independent constitutional and statutory authority to adopt regulations implementing, interpreting, and making specific the provisions of BPC sections 23005, 23006, and 23007 as they apply to the classification of alcoholic beverages under the Alcoholic Beverage Tax Law, the Office of Administrative Law has recognized that authority by approving the distilled spirits regulations, and ABC has not identified any binding or persuasive authority requiring the Board to acquiesce to the federal government's classification of alcoholic beverages where the federal classification conflicts with the express language of the BPC.

DOCUMENTS RELIED UPON

The Board relied upon the Informal Issue Paper dated November 2, 2010 (discussed above), including the exhibits thereto, and Formal Issue Paper 11-001 dated February 4, 2011 (discussed above), including the exhibits thereto, in deciding to propose the adoption of Regulation 2558.1. The Board also relied upon comments made by Board staff and interested parties during its discussions of proposed Regulation 2558.1 at its November 16, 2010, and February 23, 2011, meetings.

ALTERNATIVES CONSIDERED

The Board did consider alternative 2 for Regulation 2558.1 (discussed above), which would have clarified that water is not a flavoring, coloring, or blending material for purposes of BPC section 23007. And the Board also considered alternative 3 for Regulation 2558.1 (discussed above), which would have defined the term "wine base" and clarified that water is a blending material when added to a wine base. However, the Board did not agree with either alternative because there is still general disagreement in the wine industry as to whether water should be classified as a blending material and the Board has determined that it is not necessary to determine whether water is or is not a blending material in order to determine whether a wine-based alcoholic beverage is or is not a distilled spirit for tax purposes.

NO ADVERSE ECONOMIC IMPACT ON BUSINESS

The Board has determined that the adoption of proposed Regulation 2558.1 merely clarifies when the addition of alcohol derived from the distillation of fermented agricultural products to wine-based alcoholic beverages will cause the beverages to be classified a distilled spirits, instead of wine, under the express definitions of "distilled spirits" and "wine" found in BPC sections 23005 and 23007, respectively. Furthermore, the proposed regulation includes an effective date to give wine growers and importers an opportunity to reformulate their nonconforming, wine-based alcoholic beverages so that they can continue to be classified as wine for California tax purposes after the regulation becomes effective. Therefore, the Board has made an initial determination that the

adoption of proposed Regulation 2558.1 will not have a significant adverse economic impact on business.

The proposed regulation may affect small business.

**Proposed Text of
California Code of Regulations, Title 18, Section 2558.1**

Section 2558.1. Wine.

(a) Effective January 1, 2012, wine as defined by Business and Professions Code section 23007 does not include any alcoholic beverage containing 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products other than from the particular agricultural product or products of which the wine is made.

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

Note: Authority cited: California Constitution, Article XX, Section 22; and Section 32451, Revenue and Taxation Code. Reference: Section 23007, Business and Professions Code; and Sections 32002, 32152, Revenue and Taxation Code.

Regulation History

Type of Regulation: Special Tax

Regulation: 2558.1

Title: 2558.1, *Wine*

Preparation: Brad Heller

Legal Contact: Brad Heller

Board proposes to adopt Regulation 2558.1, *Wine*, for the specific purpose of clarifying the application of tax to wine-based products that contain distilled alcohol.

History of Proposed Regulation:

May 24, 2011	Public Meeting
May 9, 2011	45-day public comment period ends
March 25, 2011	OAL publication date; 45-day public comment period begins; Interested Parties mailing
March 10, 2011	Notice to OAL
February 23, 2011	Business Tax Committee, Board Authorized Publication (Vote 4-1)

Sponsor: NA

Support: NA

Oppose: NA