

INITIAL STATEMENT OF REASONS NON-CONTROLLING SUMMARY

Adopt the following regulations: 2558. *Distilled Spirits*, 2559. *Presumption – Distilled Spirits*, 2559.1. *Rebuttable Presumption – Distilled Spirits*, 2559.3. *Internet List* and 2559.5. *Correct Classification*.

Introduction

Through a petition for rulemaking, it was brought to the Board of Equalization's (the Board) attention that the definitions of "beer" and "distilled spirits" require clarity with respect to the classification for tax purposes of certain alcoholic beverages commonly referred to as flavored malt beverages (FMB). Neither California law, nor federal law, has a specific definition of FMB. According to the federal Alcohol and Tobacco Tax and Trade Bureau:

"Flavored malt beverages are brewery products that differ from traditional malt beverages such as beer, ale, lager, porter, stout, or malt liquor in several respects. Flavored malt beverages exhibit little or no traditional beer or malt beverage character. Their flavor is derived primarily from added flavors rather than from malt and other materials used in fermentation. At the same time, flavored malt beverages are marketed in traditional beer-type bottles and cans and distributed to the alcohol beverage market through beer and malt beverage wholesalers, and their alcohol content is similar to other malt beverages - in the 4-6% alcohol by volume range.

"Although flavored malt beverages are produced at breweries, their method of production differs significantly from the production of other malt beverages and beer. In producing flavored malt beverages, brewers brew a fermented base of beer from malt and other brewing materials. Brewers then treat this base using a variety of processes in order to remove malt beverage character from the base. For example, they remove the color, bitterness, and taste generally associated with beer, ale, porter, stout, and other malt beverages. This leaves a base product to which brewers add various flavors, which typically contain distilled spirits, to achieve the desired taste profile and alcohol level.

"While the alcohol content of flavored malt beverages is similar to that of most traditional malt beverages, the alcohol in many of them is derived primarily from the distilled spirits component of the added flavors rather than from fermentation." (See 27 C.F.R. §§ 7 & 25 (2005).)

Under California law, FMB do not neatly fit into either the statutory definition of "distilled sprits" (Bus. & Prof. Code, § 23005) or the statutory definition of "beer" (Bus. & Prof. Code, § 23006):¹

¹ Revenue and Taxation Code section 32002 provides that the definitions set forth in the Alcoholic Beverage Control Act (Bus. & Prof. Code, § 23000 et seq.) govern the Alcoholic Beverage Tax Law. (Rev. & Tax. Code, § 32001 et seq.)

23005. “Distilled spirits” means an alcoholic beverage obtained by 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.

For example, the final six words of the statutory definition of “distilled spirits” (i.e., “including all dilutions and mixtures thereof”) could be read to establish that FMB are “distilled spirits.” (See Bus. & Prof. Code, § 23005.) Under this reading of the statute whenever alcohol obtained from the distillation of fermented agricultural products is mixed, for beverage use, into an alcoholic beverage, the resulting beverage would, by definition, be a “distilled spirit” under California law. However, “beer” is defined by statute as “any alcoholic beverage obtained by fermentation of any infusion or decoction of barley, malt, hops, or any other similar product, or any combination thereof in water” (emphasis added). (See Bus. & Prof. Code, § 23006.) Accordingly, assuming that FMB retain enough alcohol from the initial fermentation process to cause them, on that basis alone, to qualify as alcoholic beverages (see Bus. & Prof. Code, § 23004), then it could also be reasonably argued that FMB fit California’s statutory definition of “beer” because they are alcoholic beverages obtained by the requisite fermentation. Therefore, because FMB could potentially meet the statutory definition of either “beer” or “distilled spirits,” interpretive action by the Board is required to resolve ambiguity for taxpayers subject to the Alcoholic Beverage Tax Law.

The ambiguity is problematic because under current law, Sections 32151, 32201, 32220 of the Alcoholic Beverage Tax Law impose the following different taxes and surcharges on the sale of “beer” and “distilled spirits”:

	Per Gallon Tax	Per Gallon Surcharge	Total
Beer	\$0.04	\$0.16	\$0.20
Distilled spirits (\leq 100 proof)	\$2.00	\$1.30	\$3.30
Distilled spirits (100+ proof)	\$4.00	\$2.60	\$6.60

Without clarification regarding which alcoholic beverages are “beer” and which are “distilled spirits” taxpayers may report and pay incorrect amounts.

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

On and after January 1, 1955, the department shall succeed to all of the powers, duties, purposes, responsibilities, and jurisdiction now conferred on the State Board of Equalization under Section 22 or Article XX of the Constitution and this division, except the power to assess and collect such excise taxes as are or may be imposed by law on account of the manufacture, importation, and sale of alcoholic beverages in this State, which shall remain the exclusive power of the State Board of Equalization. All other laws heretofore or hereafter applicable to the State Board of Equalization with respect to alcoholic beverages, except as to excise taxes, shall hereafter be construed to apply to the department.

As a result of this, it is the ABC that is assigned the responsibility for the licensing of retail locations that sell alcoholic beverages in California and the Board is responsible for the taxation of alcoholic beverages. Therefore, this rulemaking process pertains only to the classification of FMB for tax purposes under the Alcoholic Beverage Tax Law.

Therefore, pursuant to its authority to promulgate regulations under the Alcoholic Beverage Tax Law (Rev. & Tax Code, § 32451), the Board proposes to adopt the following new regulations in order to clarify when an alcoholic beverage meets the definition of a “distilled spirit” or a “beer.”

The specific purpose of each adoption, and the rationale for the determination that each adoption is reasonably necessary to carry out the purpose for which it is proposed, is as follows:

Regulation 2558. Distilled Spirits.

The proposed regulation clarifies that distilled spirits include an 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 proposed regulation is to provide a bright line for when an alcoholic beverage is a “distilled spirit” under the Alcoholic Beverage Tax Law. Clarity is necessary because alcoholic beverages can reasonably fall under both the definition of “beer” and “distilled spirits.”

The 0.5 percent threshold was selected for two reasons. First, a bright line was needed to assist taxpayers in properly reporting and paying taxes. Therefore, since California law uses a 0.5 percent threshold to establish what beverage products contain a sufficient percentage of alcohol by volume to qualify as alcoholic beverages (See Bus. & Prof. Code, § 23004.), if an alcoholic beverage contains 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products (whether added via flavors or other ingredients containing such alcohol, or otherwise), then that alcoholic beverage should be classified as a distilled spirit for taxation purposes. This standard allows for a de minimis or negligible amount of alcohol from distillation to be allowed in products obtained from fermentation as a result of adding a diminutive amount of flavorings and thereby preserves the definition of “beer” since the use of small amounts of alcohol based flavorings (e.g. hops extract) can occur even in the manufacture of traditional beer products; but, at the same time, this standard recognizes that alcoholic beverages with the requisite amounts of alcohol from distillation meet the definition of “distilled spirits.” Second, the federal Alcohol and Tobacco Tax and Trade Bureau during its rulemaking process addressing FMB considered a 0.5 percent threshold. (70 Fed. Reg. 194 et seq. (January

3, 2005).) During the federal rulemaking process traditional beer companies indicated that their products were generally under this threshold.

Wine as defined by Business and Professions Code section 23007 was excluded from the proposed regulation because the definition of “wine” (Bus. & Prof. Code, § 23007) specifically allows for the inclusion of certain distilled products, if the added products are “distilled from the particular agricultural product or products of which the wine is made....” Therefore, unlike the definition of “beer,” the definition of “wine” specifically provides for certain mixtures or additions of alcohol obtained from distillation. No similar clarification is required with respect to which products are within the definition of “wine.”

This regulation is necessary to provide clear, objective guidance to taxpayers with respect to which alcoholic beverages meet the definition of “beer” and which ones meet the definition of “distilled spirits” under the Alcoholic Beverage Tax Law.

Regulation 2559. Presumption – Distilled Spirits.

This regulation establishes 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 proposed Regulation 2559.1, the alcoholic beverage will be presumed to meet the definition of “distilled spirits.”

This regulation is necessary in order to assist the Board with classifying products that meet the 0.5 threshold provided in proposed regulation 2558. In the interest of administrative feasibility, this regulation rebuttably presumes that alcoholic beverages contain 0.5 percent or more alcohol by volume from flavors or ingredients containing alcohol. The Board understands that there are potentially thousands of alcoholic beverages which may meet the clarifying standard set forth in proposed Regulation 2558. Neither the Board nor the ABC possesses the necessary expertise to chemically analyze alcoholic beverages. Therefore, this presumption was utilized to place the burden of establishing which alcoholic beverages contain the requisite amount of alcohol from distillation on the parties with the actual knowledge of the contents of these beverages. This presumption also eliminates the undue delay and minimizes the administrative inefficiencies that would result from requiring the Board to analyze or review each and every alcoholic beverage sold in this state before tax could properly be imposed. This regulation is necessary to provide clear, objective guidance to taxpayers with respect to which alcoholic beverages meet the definition of “beer” and which ones meet the definition of “distilled spirits” under the Alcoholic Beverage Tax Law.

Regulation 2559.1. Rebuttable Presumption – Distilled Spirits.

This regulation allows the manufacturer to rebut the presumption set forth in proposed Regulation 2559 with respect to any alcoholic beverage by filing a statement, under penalty of perjury, that specifies the sources and amount of the alcohol content of the beverage. If necessary, the regulation additionally provides that the Board may require a copy of the manufacturer’s “Statement of Process” or “Formula” filed with the Alcohol and Tobacco Tax and Trade Bureau, its predecessor agency or successor agency. This regulation is proposed

because the Board recognizes that many products may contain less than 0.5 percent alcohol by volume from flavors or ingredients containing alcohol and a manufacturer should be allowed to provide the Board with verifying information. Additionally, the statement under penalty of perjury mechanism for rebuttal was selected in order to afford a minimum burden to a manufacturer. This regulation is necessary in order to provide the mechanism for a manufacturer to rebut the presumption that its alcoholic beverage is a distilled spirit and furthers the necessity of providing clear, objective guidance to taxpayers with respect to which alcoholic beverages meet the definition of “beer” and which ones meet the definition of “distilled spirits” under the Alcoholic Beverage Tax Law.

Regulation 2559.3. Internet List.

This regulation requires the Board to establish and maintain on its Internet site a listing of alcoholic beverages that have been found, in the Board’s discretion, to have successfully rebutted the presumption. An Internet list was selected because it is the most efficient way to provide taxpayers with the most current information for reporting and paying any tax amounts due under the Alcoholic Beverage Tax Law. This regulation is necessary to assist taxpayers in classifying products as “beer” or “distilled spirits” for purposes of reporting and paying any taxes due under the Alcoholic Beverage Tax Law.

Regulation 2559. Correct Classification.

This regulation provides that taxpayers who rely on the information provided on the Internet list for reporting purposes will be afforded a safe harbor from potential tax liabilities. This proposed regulation is necessary because the Board recognizes that in many instances the taxpayer is not the manufacturer of the alcoholic beverage and therefore the taxpayer should be able to rely on the Board’s Internet list when reporting and paying taxes under the Alcoholic Beverage Tax Law. This ability to rely on the Board’s Internet list furthers the necessity of providing clear, objective guidance to taxpayers with respect to which alcoholic beverages meet the definition of “beer” and which ones meet the definition of “distilled spirits” under the Alcoholic Beverage Tax Law.

Alternatives Considered

The following two alternatives were considered:

1. The first alternative, proposed by interested parties in the Board’s interested parties process, proposed to revise current Regulation 2500, *Records*. The proposed regulatory language, as written, appears to assume that any alcoholic beverage with any amount of alcohol derived from distillation processes would meet the definition of distilled spirits for tax purposes. The following is the language submitted:

Regulation 2500 – *Records*.

A taxpayer shall maintain and make available for examination on request by the board or its authorized representatives, records in the manner set forth at California Code of Regulations, Title 18, Section 4901. In addition to the records described therein, commencing July 1, 2004, a taxpayer that manufactures any

alcoholic beverage shall annually submit a statement for each of the taxpayer's alcoholic beverage products indicating whether that beverage product contains alcohol produced through distillation, and if so, stating the percentage of such product's total alcohol content derived from distilled spirits. The taxpayer shall make this statement under penalty of perjury.

This alternative was not chosen because it appears to assume that any alcoholic beverage with any amount of alcohol derived from distillation processes would meet the definition of distilled spirits for tax purposes. Since the use of small amounts of alcohol-based flavorings (e.g. hops extract) can occur even in the manufacture of traditional beer products, this alternative would likely include many beer products and could leave the definition of "beer" (Bus. & Prof. Code, § 23006) obsolete. Additionally, this alternative does not provide a bright line for taxpayers to determine which alcoholic beverages meet the definition of "beer" or which ones meet the definition of "distilled spirits."

2. The second alternative proposed no regulatory change, which would result in continuing to tax FMB as "beer." This alternative was not chosen because, while FMB do not fit neatly in either the "beer" category or the "distilled spirit" category, the Board determined that the most reasonable approach was to tax FMB as distilled spirits. Therefore, this alternative would not provide the clarification needed regarding which alcoholic beverages meet the respective definitions of "beer" and "distilled spirits." (Bus. & Prof. Code, §§ 23005 and 23006).

Initial Determination

The Board has made an initial determination that the proposed amendments will not have a significant adverse economic impact on private business or persons. The regulations are proposed to interpret, implement, and make specific the authorizing statutes. These regulations will provide a bright line for determining which alcoholic beverages meet the definition of "beer" and which ones meet the definition of "distilled spirit" for purposes of the Alcoholic Beverage Tax Law.