

INITIAL DISCUSSION PAPER

Flavored Malt Beverages

I. Issue

Should the Board of Equalization authorize publication of a regulation to tax flavored malt beverages as distilled spirits?

II. Background

The Board has voted to initiate the rulemaking process with respect to the taxation and classification of flavored malt beverages (FMB). In a letter dated October 25, 2006, Friday Night Live, Students Making a Community Change (SMACC) and the California Youth Council filed a petition pursuant to Government Code section 11340.6, requesting the Board adopt a regulation to tax FMB as distilled spirits and/or amend Regulation 2530. FMB are currently taxed at the same rate as beer. In response to the petition, the Board directed staff to initiate the rulemaking process and to hold a series of public meetings with interested parties to discuss the classification and taxation of FMB and to offer alternatives for subsequent Board action.

Revenue and Taxation Code section 32451 sets forth the Board's authority to promulgate regulations relating to the administration and enforcement of the Alcoholic Beverage Tax Law. Business and Professions Code section 25750 authorizes the Department of Alcoholic Beverage Control (ABC) to make rules regarding, among other things, the classification of alcoholic beverages for licensing purposes. In its administration of the Alcoholic Beverage Tax Law (Rev. & Tax. Code, § 32001 et seq.), the Board has historically deferred to the ABC to interpret the Alcoholic Beverage Control Act (Bus. & Prof. Code, § 23000 et seq.), including the statutory definitions for the terms "distilled spirits," "beer," and "wine." Section 22 of article XX of the California Constitution expressly provides that the ABC shall have the exclusive power to license the manufacture, importation, and sale of alcoholic beverages in California. For licensing purposes, which have a direct effect on the Board's duties to assess and collect the excise taxes at issue, the ABC classifies flavored malt beverages as "beer" under the Alcoholic Beverage Control Act (see Bus. & Prof. Code, § 23006). The ABC has advised Board staff that the ABC's classification of alcoholic beverages for licensing purposes would be unaffected by any action the Board may take on this issue. In other words, from the ABC's perspective, even if FMB were taxed as distilled spirits, this would not prohibit retailers with only a license to sell beer and wine from selling FMB.

During the 2005 legislative session, Assemblyman Aghazarian introduced Assembly Bill (AB) 417 to amend section 23006 of the Business and Professions Code to include in the definition of beer "any alcoholic beverage that qualifies as a malt beverage under the Federal Alcohol Administration Act (27 U.S.C. Sec. 201 et seq.) and any amendments thereto . . ." AB 417 was passed by both the Senate (September 6, 2005) and the Assembly (September 8, 2005), but was vetoed by the Governor (October 7, 2005). The Governor vetoed the bill "to allow a full discussion of the issues surrounding flavored malt beverages, not to suggest that the State's regulatory administration of flavored malt beverages is flawed." (Governor's veto message, October 7, 2005, regarding AB 417.) Subsequent to the Governor's veto, the Senate Committee on Governmental Organization held an informational hearing in Sacramento on

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February 14, 2006, on the subject of flavored malt beverages. Specifically, the hearing was entitled, “Flavored Malt Beverages: Are They Beer or Distilled Spirits?” At that time, the Senate Committee acknowledged that the classification of flavored malt beverages was a complex issue, but took no other action. A transcript of the Senate Committee testimony can be obtained online at http://sinet2.sen.ca.gov/htbin/testbin/seninfo_dated?sen.committee.standing.go.transcripts.

On November 15, 2006, the County of Santa Clara and Patricia L. Drieslein filed a Petition for Writ of Mandate and Complaint for Declaratory Relief (Writ) against the Board in the Superior Court of California, in the County of San Francisco (Case No. CPF 06-506789). The Writ alleges that the Board has failed to discharge a mandatory duty by failing to properly classify and tax flavored malt beverages as distilled spirits and seeks declaratory and injunctive relief. This civil action is currently stayed while the Board is engaged in the rulemaking process.

The California statutes defining beer and distilled spirits are contained in the Alcoholic Beverage Control Act found in the Business and Professions Code beginning with section 23000. The relevant sections which apply to the imposition of the Alcoholic Beverage Tax, pursuant to Revenue and Taxation Code section 32002, provide as follows:

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.

Further, Revenue and Taxation Code section 32152 provides that “the board [Board of Equalization] shall adopt such rules and regulations as may be necessary to coordinate so far as permitted by the provisions of this part [the California Alcoholic Beverage Tax Law] the system of beer and wine taxation imposed by this part with the system of beer and wine taxation imposed by the internal revenue laws of the United States.”

Under current law, Sections 32151, 32201, 32220 of the Alcoholic Beverage Tax Law impose the following 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

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The Business Taxes Committee is scheduled to discuss this issue at its meeting on August 14, 2007.

III. Grounds for the Petition

The grounds advanced in the petition are as follows:

1. "Alcopops," which are also known as flavored malt beverages, contain distilled spirits and, accordingly, should be taxed as distilled spirits under Revenue and Taxation Code section 32201, not as beer under Revenue and Taxation Code section 32151.¹
2. Taxpayers are not properly reporting under Regulation 2530. Regulation 2530 requires every distilled spirits taxpayer to furnish to the Board a statement of the gallonage of finished packaged distilled spirits on hand. Since flavored malt beverages contain distilled spirits, distilled spirits taxpayers should be reporting the gallonage. Therefore, petitioner's request that the Board amend the language of Regulation 2530 to define distilled spirits to specifically include flavored malt beverages that contain distilled spirits, and place the burden on the taxpayer to provide sufficient evidence to prove a claim that its flavored malt beverage product does not contain distilled spirits.

IV. Discussion of Issues Relating to the Classification of Flavored Malt Beverages

It is generally accepted that flavored malt beverages sold as alcoholic lemonades, alcoholic colas, cooler-type products and other flavored alcohol beverages, may contain distilled spirits. As currently marketed and labeled, these products are sold as alternatives to beer without indication that they contain distilled spirits. The ABC issues licenses to persons selling these products, and the Board has, in turn, used this license information as its basis to send tax returns for reporting flavored malt beverages as a beer product.

Recent regulations adopted by the federal Alcohol and Tobacco Tax and Trade Bureau (TTB) reflects that many flavored malt beverages contain distilled spirits. The revised federal rulings, which went into effect January 3, 2006, provide that malt beverages that contain less than 6 percent alcohol by volume may derive no more than 49 percent of their alcoholic content from flavors and other nonbeverage materials² (see 27 C.F.R. §§ 7 & 25 (2005)). These federal regulations are not controlling with respect to California's statutory definitions of "beer" and "distilled spirits."

¹ Petitioners reference an Alcoholic Beverage Tax Annotation (M98-1, Am. 2000-1) as further support that the Board should classify and tax FMB as distilled spirits. This annotation was withdrawn in December 2005 and has been scheduled for deletion. The ultimate disposition of this annotation will be determined by the outcome of the regulatory process the Board has initiated.

² Additionally, malt beverages that contain more than 6 percent alcohol by volume may derive no more than 1.5 percent of the volume of its finished product from flavors and other nonbeverage ingredients containing alcohol.

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The ABC currently treats FMB as beer and intends to continue to conform to the TTB classification. The Board receives information regarding licensees who are registered by operation of law as taxpayers directly from the ABC. Therefore the Board's ability to properly register taxpayers will become complicated if flavored malt beverages are distilled spirits for California tax purposes given that, by statute, the issuance of a license by ABC constitutes the registration of the person to whom the license is issued as a taxpayer. (Rev. & Tax. Code, § 32101).

California's former Attorney General has also written to Board staff indicating that a task force of state deputy attorneys general has begun to address a number of issues relating to alcohol use by youth. The letter opines that flavored malt beverages, under California law, should be classified as "distilled spirits" if they contain any amount of distilled spirits or dilutions or mixtures thereof.

A fundamental classification issue to be addressed is that many other beer products, which are not associated with the FMB products currently under consideration, may also run afoul of the statutory interpretation advocated by petitioners. Specifically, distilled spirits are a potentially common base for flavoring agents in traditional beer products (e.g., flavoring agents like hops extract), so an interpretation that *any* amount of distilled spirits in a beer product causes the product to be classified as a distilled spirit could raise substantial compliance and enforcement problems for industry and governmental agencies.

In any case, if the Board were to implement a change in the taxation of flavored malt beverages, staff would be unable to analyze particular flavored malt beverages without substantial effort and assistance. It is expected, therefore, that staff would continue to look to the ABC or the federal government for such guidance. Additionally, staff is unaware of any testing equipment that would effectively verify whether a particular beverage derived any of its alcohol content from a distillation process.

V. Discussion of the Federal Alcohol Administration Act (27 U.S.C. Sec. 201 et seq.)

Federal law defines the term "malt beverage" to mean "a beverage made by the alcoholic fermentation of an infusion or decoction, or combination of both, in potable brewing water, of malted barley with hops, or their parts, or their products, and with or without malted cereals, and with or without the addition of unmalted or prepared cereals, other carbohydrates or products prepared therefrom, and with or without the addition of carbon dioxide, and with or without other wholesome products suitable for human food consumption" (27 U.S.C. § 211(a)(7)).

As stated above, the TTB adopted regulations restricting the alcoholic makeup of flavored malt beverages. These regulations which are published in the Federal Register, January 3, 2005, generally require that, in order to continue to be taxed and treated as a beer or brewed beverage, the majority (51 percent or more) of the alcohol in a flavored malt beverage must be the product of brewing. No more than 49 percent of the alcohol may come from other flavorings added to the product. The regulation was effective January 3, 2006 (27 C.F.R. §§ 7 & 25 (2005)).

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VI. Areas for Comment

A nonexhaustive list of potential areas for comment is set forth below. The topics listed are provided for purposes of example only. All comments are welcome. Written submissions received on or before February 20, 2007, will be copied and prepared for distribution at the interested parties meeting scheduled for February 22, 2007. There will also be an opportunity to submit written comments after the initial interested parties meeting. Topics for comment include:

- Avoiding overbroad FMB definitions;
- The Board's jurisdiction and authority to classify and tax FMB as distilled spirits;
- Impact of potential Board actions on ABC licensing and FMB retail sales locations;
- Proposals for draft regulatory language; and,
- Board administrative issues such as audit and/or compliance concerns.

VII. Summary

Board of Equalization staff are just beginning the rulemaking process and the foregoing information identifies only some of the issues and concerns related to the classification and taxation of flavored malt beverages. Taxpayers and other interested parties are welcome to submit comments or suggestions on this issue and are invited to participate in the interested parties meeting that is scheduled for 10:00 a.m. on February 22, 2007, in Sacramento.

Prepared by the Excise Taxes Division, Property and Special Taxes Department.

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