



STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

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January 6, 2017

To Interested Parties:

Notice of Proposed Regulatory Action
The State Board of Equalization Proposes to Adopt
Amendments to California Code of Regulations,
Title 18,
Section 4001, *Retail Stock*

NOTICE IS HEREBY GIVEN that the State Board of Equalization (Board), pursuant to the authority vested in it by Revenue and Taxation Code (RTC) section 30451, proposes to adopt California Code of Regulations, title 18, section (Regulation or Reg.) 4001, *Retail Stock*. Proposed Regulation 4001 defines the term “retail stock,” as used in RTC section 30008, provides non-exhaustive examples of secured areas where non-retail stock may be separated and segregated from retail stock, explains that a person who is both a licensed retailer and a licensed distributor and only makes retail sales to consumers holds all inventory in retail stock, and explains that all cigarettes and tobacco products placed into retail stock are deemed to have been distributed in accordance with RTC section 30008. Proposed Regulation 4001 also explains the presumption of distribution in RTC section 30109, provides a non-exhaustive list of examples of evidence that may be provided to overcome the presumption of distribution, and requires that such evidence include timely police reports and purchase invoices.

PUBLIC HEARING

The Board will conduct a meeting in Room 207 at 5901 Green Valley Circle, Culver City, California, on February 22-24, 2017. The Board will provide notice of the meeting to any person who requests that notice in writing and make the notice, including the specific agenda for the meeting, available on the Board’s Website at www.boe.ca.gov at least 10 days in advance of the meeting.

A public hearing regarding the proposed regulatory action will be held at 9:00 a.m. or as soon thereafter as the matter may be heard on February 22, 23, or 24, 2017. At the hearing, any

interested person may present or submit oral or written statements, arguments, or contentions regarding the adoption of proposed Regulation 4001.

AUTHORITY

RTC section 30451

REFERENCE

RTC sections 30008 and 30109

INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW

Current Law

In November 1988, California voters passed Proposition 99, known as the “Tobacco and Health Protection Act of 1988” (Prop. 99). Among other things, Prop. 99 imposed a surtax on every distributor (as defined in RTC, § 30011) of cigarettes at the rate of 12.5 mills (\$0.0125) per cigarette or \$0.25 per pack (\$0.0125 x 20 cigarettes) distributed. Prop. 99 also imposed a tax on every distributor of tobacco products (as defined in RTC, § 30121, subd. (b)) other than cigarettes (collectively referred to as “other tobacco products” or “OTP”), including, for example, cigars, smoking and chewing tobacco, and snuff, at a rate equivalent to the combined rate of the tax imposed on cigarettes, under various provisions of the Cigarette and Tobacco Products Tax Law (RTC, § 30001 et seq.). Prop. 99’s surtax on the distribution of cigarettes and equivalent tax on the distribution of OTP are both codified in RTC section 30123 and they apply to the “distribution” (as defined in RTC, § 30008) of cigarettes or OTP.

In 1998, California voters passed Proposition 10, known as “The Children and Families First Act” (Prop. 10). The purpose of Prop. 10 was to create county commissions to provide early childhood medical care and education. Prop. 10 imposed an additional tax on every distributor of cigarettes at the rate of 25 mills (\$0.025) per cigarette or \$0.50 per pack, as well as an equivalent tax on every distributor of OTP (as defined in RTC, § 30131.1, subd. (b), which was identical to RTC, § 30121, subd. (b), prior to its amendment in 2016 (discussed below)). Prop. 10’s tax on the distribution of cigarettes and equivalent tax on the distribution of OTP are both codified in RTC section 30131.2.

In 2016, California voters passed Proposition 56, known as “The California Healthcare, Research and Prevention Tobacco Tax Act of 2016” (Prop. 56). The purpose of Prop. 56 was to provide funding for existing healthcare programs, tobacco use prevention and control programs, tobacco-related disease research, law enforcement, University of California physician training, dental disease prevention programs, and administration. As relevant here, Prop. 56 imposes an additional tax on every distributor of cigarettes at the rate of 100 mills (\$0.100) per cigarette or \$2.00 per pack, as well as an equivalent tax on every distributor of OTP, effective April 1, 2017. Prop. 56’s additional tax on the distribution of cigarettes is codified in RTC section 30130.51,

subdivision (a), and the equivalent tax on the distribution of OTP is imposed under the existing provisions of RTC section 30123, subdivision (b). (Prop. 56 also amended the Cigarette and Tobacco Products Tax Law to impose an equivalent tax on “electronic cigarettes,” effective April 1, 2017, and amended the definitions of OTP in RTC sections 30121 and 30131.1, but the equivalent tax on electronic cigarettes and the amendments to the definition of OTP are not relevant here.)

The taxes codified in and imposed on cigarettes and OTP under the Cigarette and Tobacco Products Tax Law do not apply to the sale of cigarettes or OTP “by the manufacturer to a licensed distributor” (as provided in RTC, § 30103) or “the sale of cigarettes or tobacco products by the original importer to a licensed distributor if the cigarettes or tobacco products are manufactured outside the United States” (as provided by RTC, § 30105). In addition, RTC section 30109 provides that “[u]nless the contrary is established, it shall be presumed that all cigarettes or tobacco products acquired by a distributor are untaxed cigarettes or tobacco products, and that all cigarettes or tobacco products manufactured in this state or transported to this state, and no longer in the possession of the distributor, have been distributed.”

RTC sections 30005 and 30005.5, subdivision (a), respectively define the terms “untaxed cigarette” and “untaxed tobacco product” to mean any cigarette or tobacco product which has not yet been distributed in such manner as to result in a tax liability under the Cigarette and Tobacco Products Tax Law. RTC section 30008 defines “distribution” to include: (a) the sale of untaxed cigarettes or tobacco products in this state; (b) the use or consumption of untaxed cigarettes or tobacco products in this state; and (c) the placing in this state of untaxed cigarettes or tobacco products in a vending machine or in *retail stock* for the purpose of selling the cigarettes or tobacco products to consumers. In addition, RTC section 30009 provides that the phrase “‘use or consumption’ includes the exercise of any right or power over cigarettes or tobacco products incident to the ownership thereof, other than the sale of the cigarettes or tobacco products or the keeping or retention thereof by a licensed distributor for the purpose of sale.”

The Board is responsible for the administration and enforcement of the Cigarette and Tobacco Products Tax Law, including the taxes imposed on distributors of cigarettes and OTP. (RTC, § 30451.) And, to ensure compliance with the Cigarette and Tobacco Products Tax Law, Board employees are authorized to inspect “[a]ny building, facility, site, or place at which cigarette or tobacco products are sold, produced, or stored” (RTC, § 30435) and seize distributed cigarettes and OTP upon which the taxes imposed on distributors under RTC sections 30123 and 30131.2 have not been paid. (RTC, § 30436.)

In addition, the Cigarette and Tobacco Products Tax Law requires “distributors” and “wholesalers” of cigarettes and tobacco products in California to register with the Board for a distributor’s license or wholesaler’s license, whichever is applicable. (RTC, § 30140 and 30155.) Also, the Cigarette and Tobacco Products Licensing Act of 2003 (Bus. & Prof. Code, § 22970 et seq.) requires the Board to administer a statewide program to license manufacturers, importers, distributors, wholesalers, and retailers of cigarettes and OTP. (Bus. & Prof. Code, § 22970.2.) And, for such licensing purposes, a retailer is defined as “a person who engages in this

state in the sale of cigarettes or tobacco products directly to the public from a retail location,” including a vending machine from which cigarettes or tobacco products are sold (Bus. & Prof. Code, § 22971, subd. (p)) and a retailer is required to have in place and maintain a separate license to engaged in the sale of cigarette and tobacco products at each of the retailer’s retail locations. (Bus. & Prof. Code, § 22972.)

Currently, there are no statutes or regulations that define the term “retail stock,” as used in RTC section 30008. Therefore, the Board’s Legal Department has previously opined that retail stock includes inventory located at the taxpayer’s retail place of business such as product displayed for retail sale, stored beneath sales counters in back room offices, or in any other place on the premises of the retail establishment. (See, e.g., Cigarette and Tobacco Products Tax Annotation entitled “Retail Stock” (7/18/97), available on the Board’s website at www.boe.ca.gov.)

Proposed Regulation

Need for Clarification

The lack of a statutory definition for the term “retail stock,” as well as the lack of detailed regulatory guidance regarding whether certain product is considered retail stock and therefore distributed, has caused misinterpretation and confusion among distributors and retailers of cigarettes and tobacco products, and it has made it difficult for distributors to accurately report amounts subject to the taxes imposed by RTC sections 30123 and 30131.2. This is especially true for distributors who are also retailers, particularly when they store cigarettes and OTP in walk-in humidors where cigarettes and OTP are displayed for retail sale to consumers. Therefore, the Board’s Business Taxes Committee (BTC) staff determined that there is an issue (or problem within the meaning of Gov. Code, § 11346.2, subd. (b)(1)) as there currently is not a regulation that defines “retail stock.”

Interested Parties Process

As a result, the Board’s BTC staff drafted Regulation 4001, *Retail Stock*, to address the issue described above by defining the term “retail stock” as used in RTC section 30008 and implementing, interpreting, and making specific the presumption of distribution in RTC section 30109, and staff prepared an initial discussion paper explaining the new proposed regulation. Both were provided to interested parties. (BTC staff proposed Regulation 4001 and new Regulation 4076, *Wholesale Cost of Tobacco Products*, at the same time, and both regulations were discussed during the interested parties process (described below), however, at the January 26, 2016, BTC meeting, the rulemaking process for the proposed regulations was bifurcated. Therefore, this initial statement of reasons only discusses proposed Regulation 4001.)

For purposes of persons who only hold retailer’s licenses and only sell cigarettes and OTP directly to the public, subdivision (a)(1) of staff’s proposed Regulation 4001 defined the term “retail stock” to mean all “cigarettes and tobacco products intended and available for sale . . . to

customers.” For purposes of persons who concurrently hold a distributor’s license and a retailer’s license and may have untaxed cigarettes and OTP for sale to other licensees for resale directly to the public, subdivision (a)(2) of staff’s proposed Regulation 4001 defined the term “retail stock” to mean all “cigarettes and tobacco products intended and available for sale . . . at the same location to customers other than licensed distributors, wholesalers, and retailers.” Subdivision (a)(2) further clarified that products stored in the “area where retail sales are made are deemed to be in retail stock” and products “that are not stored in the general area where retail sales are made (e.g., in separate storage rooms or offices) are not deemed to be in retail stock.” Subdivision (a)(2)(A) also clarified that products “inside a walk-in humidor displayed for sale to consumers are retail stock” and products that are “segregated and separated from retail stock, stored in a walk-in humidor for sale to licensed distributors, wholesalers, or retailers, but not displayed for sale to consumers, are wholesale stock.” (There was no subdivision (a)(2)(B) in the original draft of staff’s proposed regulation.) Subdivision (b) of staff’s proposed Regulation 4001 explained that all cigarettes and tobacco products placed into retail stock are deemed to have been distributed (in accordance with RTC, § 30008). Subdivisions (c) of staff’s proposed Regulation 4001 provided that tobacco products no longer in a distributor’s possession or lost through theft or unexplainable disappearance are deemed to have been distributed (in accordance with RTC, § 30109).

On August 4, 2015, BTC staff conducted an interested parties meeting to discuss proposed Regulation 4001. At the meeting, questions were raised about the proper way to distinguish between retail stock and non-retail stock and how to ensure that there was no comingling of tax-paid product with untaxed product. Therefore, BTC staff revised proposed Regulation 4001 to address the questions. In subdivision (a)(2), staff clarified that products are not deemed to be in retail stock only if they are segregated and separated from retail inventory, they are in the original manufacturer’s container with an unbroken seal, and they are not stored in the area where retail sales are made. Staff also clarified in subdivision (a)(2)(A) that to be “non-retail stock” products stored in a walk-in humidor for sale to licensed distributors, wholesalers, or retailers, must be “in the original manufacturer’s packaging with an unbroken seal.” Staff also added a new subdivision (a)(2)(B) to the proposed regulation for the inclusion of examples of retail and non-retail stock after further discussions with the interested parties.

BTC staff also received a letter dated August 25, 2015, from Mr. James Dumler on behalf of McClellan Davis, LLC, in response to the initial discussion paper. The letter included proposed alternative language to change subdivision (c) of staff’s proposed Regulation 4001 into a rebuttable presumption regarding distribution, but staff did not agree to incorporate the alternative language into its proposed draft regulation in response to the August 25, 2015, letter.

BTC staff’s revised draft of proposed Regulation 4001 and staff’s second discussion paper regarding the revised draft were subsequently provided to the interested parties. On October 20, 2015, BTC staff conducted a second interested parties meeting to discuss the revised draft of the proposed regulation. There were continued questions about the proper way to distinguish between retail stock and non-retail stock and how to ensure that there was no comingling of tax-paid and untaxed product. Therefore, BTC staff revised subdivision (a)(2) of proposed

Regulation 4001 to further clarify that store rooms/closets, back offices and safes, are not “areas” where retail sales are made.

Staff also received a letter dated November 12, 2015, from Mr. Dumler. Again, the letter included proposed alternative language to change subdivision (c) of staff’s proposed Regulation 4001 to be a rebuttable presumption that products no longer in a distributor’s possession have been distributed and also included non-exclusive examples of evidence that may be provided to overcome the presumption, such as police reports and insurance claims. After reconsidering the alternative language, staff agreed to include the alternative language and examples in staff’s revised draft of proposed Regulation 4001, subdivision (b)(2), and delete staff’s prior draft of subdivision (c).

January 26, 2016, BTC Meeting

Subsequently, staff prepared Formal Issue Paper 15-013 and distributed it to the Board Members for consideration at the Board’s January 26, 2016, BTC meeting. Formal Issue Paper 15-013 recommended that the Board propose to adopt revised Regulation 4001 (discussed above) in order to address the issue (or problem) referred to above by:

- Defining the term “retail stock,” as used in RTC section 30008.
- Providing examples of areas, such as store rooms/closets, back offices and safes, which are not “areas” where retail sales are made and are areas where non-retail stock may be stored.
- Explaining that all cigarettes and tobacco products placed into retail stock are deemed to have been distributed in accordance with RTC section 30008.
- Explaining the presumption of distribution in RTC section 30109.
- Including a non-exclusive list of examples of evidence that may be provided to overcome the presumption of distribution.

During the January 26, 2016, BTC meeting, Mr. Randall Cheek with SEIU Local 1000 was present, and he expressed concerns about the regulation on behalf of the SEIU Local 1000 members that are Board inspectors who inspect retail locations. Mr. Cheek’s concerns were specifically regarding products stored in walk-in humidors and he stated that tax-paid product and untaxed product potentially may be comingled in such humidors and without clear guidelines about separating the products, inspectors would not know what product was tax-paid and what was untaxed. Therefore, the Board Members unanimously voted to postpone the further consideration of proposed Regulation 4001 until the March BTC meeting, and directed staff and SEIU Local 1000 to work together on proposed language to address Mr. Cheek’s concerns.

On February 9, 2016, staff received a submission from Ms. Yvette Stowers, Deputy Controller. This included proposed alternative language to add a new subdivision (b) to proposed Regulation 4001 to state that a person who is both a licensed retailer and a licensed distributor, but who only makes retail sales to consumers and does not make any sales for resale to other licensees, holds

all inventory intended for sale in retail stock, and renumber revised subdivision (b) (discussed above) as subdivision (c).

On February 11, 2016, BTC staff conducted a third interested parties meeting to discuss staff's revised draft of the proposed regulation. There were continued questions about the proper way to distinguish between retail stock and non-retail stock and how to ensure that there was no comingling of tax-paid and untaxed product. Ms. Stowers' proposed alternative language was well-received; however, Mr. Cheek asked for time to present the proposed language to other members of SEIU Local 1000.

On February 18, 2016, staff received a written submission from Mr. Cheek. Mr. Cheek indicated that SEIU Local 1000 supported Ms. Stowers' proposed language. However, Mr. Cheek's written submission recommended adding language to subdivision (a)(2) of the proposed regulation to generally require that non-retail stock be "secured," meaning behind a "locked door," away from the retail area and that untaxed product must be segregated and separated from tax-paid product away from the retail area. Mr. Cheek's written submission recommended adding language to subdivision (a)(2)(A) to require non-retail stock to be "secured" and separated and segregated from retail stock in walk-in humidors. Mr. Cheek's written submission also recommended alternative language to require that police reports, insurance claims, insurance reimbursements, and cigarette and OTP purchase invoices be provided to overcome the presumption of distribution in renumbered subdivision (c).

However, as suggested by Ms. Stowers, new subdivision (b) would not apply to a person who is both a licensed retailer and a licensed distributor, and makes any sales for resale to other licensees. So, Mr. Cheek later revised his written submission to include alternative language for new subdivision (b) to state that a person who is both a licensed retailer and a licensed distributor and makes substantially all sales as retail sales to consumers holds all inventory intended for sale in the retail location in retail stock. Mr. Cheek's revised written submission further stated that for the purposes of the proposed regulation, "substantially all" means "80 percent or more of gross sales during the previous 12 month reported period." In addition, Mr. Cheek's revised his written submission so renumbered subdivision (c) only required timely police reports and cigarette and OTP purchase invoices to be provided to overcome the presumption of distribution, but no longer required insurance claims and insurance reimbursements to be provided to overcome the presumption.

Staff agreed to revise proposed Regulation 4001 to include the new language provided by Ms. Stowers for new subdivision (b), and staff agreed to present the language in Mr. Cheek's revised submission (SEIU's proposed language) as an alternative for the Board's consideration.

Subsequently, staff prepared Formal Issue Paper 16-05 and distributed it to the Board Members for consideration at the Board's March 30, 2016, BTC meeting. Formal Issue Paper 16-05 recommended that the Board propose to adopt revised Regulation 4001 (discussed above) in order to address the issue (or problem) referred to above by:

- Defining the term “retail stock,” as used in RTC section 30008.
- Providing examples of areas, such as store rooms/closets, back offices and safes, which are not “areas” where retail sales are made and are areas where non-retail stock may be stored.
- Explaining that a person who is both a licensed retailer and a licensed distributor and only makes retail sales to consumers holds all inventory in retail stock.
- Explaining that all cigarettes and tobacco products placed into retail stock are deemed to have been distributed in accordance with RTC section 30008.
- Explaining the presumption of distribution in RTC section 30109.
- Including a list of examples of evidence that may be provided to overcome the presumption of distribution and requiring that timely police reports and cigarette and OTP purchase invoices be provided to overcome the presumption.

During the March 30, 2016, BTC meeting, Mr. Dumler, Mr. Cheek, and Mr. Steven Alari from SEUI Local 1000 were present. Mr. Cheek and Mr. Alari expressed concerns with staff’s proposed language, but expressed support for SEIU Local 1000’s alternative language because it created a “bright line” test and also created less opportunity for tax evasion. Mr. Dumler expressed his support for staff’s proposed language. Based on the statements by Mr. Cheek and Mr. Alari, Ms. Stowers expressed an interest in amending some of staff proposed language; however, she and other Board Members had questions about the meaning of “substantially all” as used in Mr. Cheek’s revised written submission, and the Board deferred the matter so that all of the parties involved could work together to develop one recommendation for the proposed regulation that they all agreed upon.

As a result, BTC staff further revised proposed Regulation 4001 to address Mr. Cheek’s remaining concerns regarding subdivisions (a) and (c). BTC staff clarified, in subdivision (a)(2), that cigarettes and OTP that “are securely stored away from the area where retail sales are made are not considered retail stock” and provided non-exhaustive examples of “secured areas” where non-retail stock may be securely “separated and segregated from retail stock,” including a store room, closet, back office, locked cabinet, safe or similar container, or behind a locked wire-cage door or similar encumbrance. BTC staff clarified, in subdivision (a)(2), that untaxed tobacco products must be segregated and secured separately from tax-paid tobacco products away from the retail area. BTC staff clarified, in subdivision (a)(2)(A), that non-retail stock in walk-in humidors must be “secured,” segregated and separated from retail stock, and provided non-exhaustive examples of secured areas in humidors where non-retail stock may be separated and segregated from retail stock, including inside a locked cabinet, safe or other similar secured storage container, or behind a locked wire-cage door or similar encumbrance. BTC staff also clarified in subdivision (c) that timely police reports and cigarettes and OTP purchase invoices are required to be provided to overcome the presumption of distribution. However, BTC staff did not revise subdivision (b) because SEIU Local 1000 eventually agreed with the wording of subdivision (b) as originally proposed by Ms. Stowers.

BTC staff subsequently prepared a memorandum dated May 25, 2016, and distributed it to the Board Members for consideration at the Board’s June 14, 2016, BTC meeting. In the

memorandum, staff recommended that the Board propose to adopt revised Regulation 4001 (discussed above) in order to address the issue (or problem) referred to above by:

- Defining the term “retail stock,” as used in RTC section 30008, including providing non-exhaustive examples of secured areas where non-retail stock may be separated and segregated from retail stock.
- Explaining that a person who is both a licensed retailer and a licensed distributor and only makes retail sales to consumers holds all inventory in retail stock.
- Explaining that all cigarettes and tobacco products placed into retail stock are deemed to have been distributed in accordance with RTC section 30008.
- Explaining the presumption of distribution in RTC section 30109.
- Including a non-exhaustive list of examples of evidence that may be provided to overcome the presumption of distribution, and requiring that such evidence include timely police reports and cigarettes and OTP purchase invoices.

During the June 14, 2016, BTC meeting, Mr. Cheek and Mr. Dumler expressed full support for the proposed regulation. The Board Members unanimously voted to propose Regulation 4001 as recommended in the memorandum. The Board determined that proposed Regulation 4001 is reasonably necessary to have the effect and accomplish the objective of addressing the issue (or problem) created because there is no statute or regulation that defines the term “retail stock,” as used in RTC section 30008, by defining the term retail stock, providing examples of secured areas where non-retail stock may be separated and segregated from retail stock, explaining the presumption of distribution in RTC section 30109, and providing examples of evidence that can be provided to overcome the presumption of distribution.

The Board anticipates that proposed Regulation 4001 will promote fairness and benefit taxpayers, Board staff, and the Board by providing additional clarification regarding and implementing, interpreting, and making specific the meaning of the term retail stock as used in RTC section 30008, and explaining the presumption of distribution in RTC section 30109.

The Board has performed an evaluation of whether proposed Regulation 4001 is inconsistent or incompatible with existing state regulations and determined that proposed Regulation 4001 is not inconsistent or incompatible with existing state regulations. This is because proposed Regulation 4001 is the only state regulation that defines the term “retail stock,” as used in RTC section 30008, and explains the presumption of distribution in RTC section 30109. In addition, the Board has determined that there are no comparable federal regulations or statutes to proposed Regulation 4001.

NO MANDATE ON LOCAL AGENCIES AND SCHOOL DISTRICTS

The Board has determined that the adoption of proposed Regulation 4001 will not impose a mandate on local agencies or school districts, including a mandate that requires state reimbursement 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 4001 will result in no direct or indirect cost or savings to any state agency, no cost to 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, no other non-discretionary cost or savings imposed on local agencies, and no cost or savings in federal funding to the State of California.

NO SIGNIFICANT STATEWIDE ADVERSE ECONOMIC IMPACT DIRECTLY AFFECTING BUSINESS

The Board has made an initial determination that the adoption of proposed Regulation 4001 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 4001 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 ECONOMIC IMPACT ASSESSMENT REQUIRED BY GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)

The Board has determined that proposed Regulation 4001 is not a major regulation, as defined in Government Code section 11342.548 and California Code of Regulations, title 1, section 2000. Therefore, the Board has prepared the economic impact assessment required by Government Code section 11346.3, subdivision (b)(1), and included it in the initial statement of reasons. The Board has determined that the adoption of proposed Regulation 4001 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. Furthermore, the Board has determined that the adoption of proposed Regulation 4001 will not affect the benefits of Regulation 4001 to the health and welfare of California residents, worker safety, or the state's environment.

NO SIGNIFICANT EFFECT ON HOUSING COSTS

The adoption of proposed Regulation 4001 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 the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

CONTACT PERSONS

Questions regarding the substance of the proposed regulation should be directed to Ms. Pamela Mash, Tax Counsel, by telephone at (916) 323-3248, by e-mail at Pamela.Mash@boe.ca.gov, or by mail at State Board of Equalization, Attn: Pamela Mash, 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. Mr. Bennion is the designated backup contact person to Ms. Mash.

WRITTEN COMMENT PERIOD

The written comment period ends at 9:00 a.m. on February 22, 2017, or as soon thereafter as the Board begins the public hearing regarding the adoption of proposed Regulation 4001 during the February 22-24, 2017, Board meeting. Written comments received by Mr. Rick Bennion at the postal address, email address, or fax number provided above, prior to the close of the written comment period, will be presented to the Board and the Board will consider the statements, arguments, and/or contentions contained in those written comments before the Board decides whether to adopt proposed Regulation 4001. 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 a copy of the text of proposed Regulation 4001 illustrating its express terms; however, the proposed regulation is not illustrated in underline or italics format because California Code of Regulations, title 1, section 8, subdivision (b) provides that "[u]nderline or italic is not required for the adoption of a new regulation or set of regulations if the final text otherwise clearly indicates that all of the final text submitted to OAL for filing is added to the California Code of Regulations." The Board has also prepared an initial statement of reasons for

the adoption of proposed Regulation 4001, which includes the economic impact assessment required by Government Code section 11346.3, subdivision (b)(1). These documents and all the information on which the proposed regulation are 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.

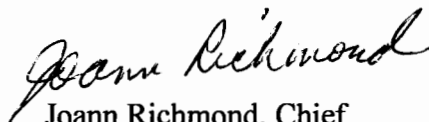
SUBSTANTIALLY RELATED CHANGES PURSUANT TO GOVERNMENT CODE SECTION 11346.8

The Board may adopt proposed Regulation 4001 with changes that are non-substantial 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 original 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 4001, 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,


Joann Richmond, Chief
Board Proceedings Division

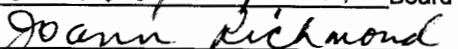
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STATE BOARD OF EQUALIZATION

BOARD APPROVED



At the February 22, 2017 Board Meeting


Joann Richmond, Chief
Board Proceedings Division

**Initial Statement of Reasons for the
Proposed Adoption of California Code of Regulations,
Title 18, Section 4001, *Retail Stock***

**SPECIFIC PURPOSE, PROBLEM INTENDED TO BE ADDRESSED, NECESSITY, AND
ANTICIPATED BENEFITS**

Current Law

In November 1988, California voters passed Proposition 99, known as the “Tobacco and Health Protection Act of 1988” (Prop. 99). Among other things, Prop. 99 imposed a surtax on every distributor (as defined in Rev. & Tax. Code (RTC), § 30011) of cigarettes at the rate of 12.5 mills (\$0.0125) per cigarette or \$0.25 per pack (\$0.0125 x 20 cigarettes) distributed. Prop. 99 also imposed a tax on every distributor of tobacco products (as defined in RTC, § 30121, subd. (b)) other than cigarettes (collectively referred to as “other tobacco products” or “OTP”), including, for example, cigars, smoking and chewing tobacco, and snuff, at a rate equivalent to the combined rate of the tax imposed on cigarettes, under various provisions of the Cigarette and Tobacco Products Tax Law (RTC, § 30001 et seq.). Prop. 99’s surtax on the distribution of cigarettes and equivalent tax on the distribution of OTP are both codified in RTC section 30123 and they apply to the “distribution” (as defined in RTC, § 30008) of cigarettes or OTP.

In 1998, California voters passed Proposition 10, known as “The Children and Families First Act” (Prop. 10). The purpose of Prop. 10 was to create county commissions to provide early childhood medical care and education. Prop. 10 imposed an additional tax on every distributor of cigarettes at the rate of 25 mills (\$0.025) per cigarette or \$0.50 per pack, as well as an equivalent tax on every distributor of OTP (as defined in RTC, § 30131.1, subd. (b), which was identical to RTC, § 30121, subd. (b), prior to its amendment in 2016 (see footnote 1)). Prop. 10’s tax on the distribution of cigarettes and equivalent tax on the distribution of OTP are both codified in RTC section 30131.2.

In 2016, California voters passed Proposition 56, known as “The California Healthcare, Research and Prevention Tobacco Tax Act of 2016” (Prop. 56). The purpose of Prop. 56 was to provide funding for existing healthcare programs, tobacco use prevention and control programs, tobacco-related disease research, law enforcement, University of California physician training, dental disease prevention programs, and administration. As relevant here, Prop. 56 imposes an additional tax on every distributor of cigarettes at the rate of 100 mills (\$0.100) per cigarette or \$2.00 per pack, as well as an equivalent tax on every distributor of OTP, effective April 1, 2017. Prop. 56’s additional tax on the distribution of cigarettes is codified in RTC section 30130.51, subdivision (a), and the equivalent tax on the distribution of OTP is imposed under the existing provisions of RTC section 30123, subdivision (b).¹

¹ Prop. 56 also amended the Cigarette and Tobacco Products Tax Law to impose an equivalent tax on “electronic cigarettes,” effective April 1, 2017, and amended the definitions of OTP in RTC sections 30121 and 30131.1, but the equivalent tax on electronic cigarettes and the amendments to the definition of OTP are not relevant here.

The taxes codified in and imposed on cigarettes and OTP under the Cigarette and Tobacco Products Tax Law do not apply to the sale of cigarettes or OTP “by the manufacturer to a licensed distributor” (as provided in RTC, § 30103) or “the sale of cigarettes or tobacco products by the original importer to a licensed distributor if the cigarettes or tobacco products are manufactured outside the United States” (as provided by RTC, § 30105). In addition, RTC section 30109 provides that “[u]nless the contrary is established, it shall be presumed that all cigarettes or tobacco products acquired by a distributor are untaxed cigarettes or tobacco products, and that all cigarettes or tobacco products manufactured in this state or transported to this state, and no longer in the possession of the distributor, have been distributed.”

RTC sections 30005 and 30005.5, subdivision (a), respectively define the terms “untaxed cigarette” and “untaxed tobacco product” to mean any cigarette or tobacco product which has not yet been distributed in such manner as to result in a tax liability under the Cigarette and Tobacco Products Tax Law. RTC section 30008 defines “distribution” to include: (a) the sale of untaxed cigarettes or tobacco products in this state; (b) the use or consumption of untaxed cigarettes or tobacco products in this state; and (c) the placing in this state of untaxed cigarettes or tobacco products in a vending machine or in *retail stock* for the purpose of selling the cigarettes or tobacco products to consumers. In addition, RTC section 30009 provides that the phrase “‘use or consumption’ includes the exercise of any right or power over cigarettes or tobacco products incident to the ownership thereof, other than the sale of the cigarettes or tobacco products or the keeping or retention thereof by a licensed distributor for the purpose of sale.”

The State Board of Equalization (Board) is responsible for the administration and enforcement of the Cigarette and Tobacco Products Tax Law, including the taxes imposed on distributors of cigarettes and OTP. (RTC, § 30451.) And, to ensure compliance with the Cigarette and Tobacco Products Tax Law, Board employees are authorized to inspect “[a]ny building, facility, site, or place at which cigarette or tobacco products are sold, produced, or stored” (RTC, § 30435) and seize distributed cigarettes and OTP upon which the taxes imposed on distributors under RTC sections 30123 and 30131.2 have not been paid. (RTC, § 30436.)

In addition, the Cigarette and Tobacco Products Tax Law requires “distributors” and “wholesalers” of cigarettes and tobacco products in California to register with the Board for a distributor’s license or wholesaler’s license, whichever is applicable. (RTC, § 30140 and 30155.) Also, the Cigarette and Tobacco Products Licensing Act of 2003 (Bus. & Prof. Code, § 22970 et seq.) requires the Board to administer a statewide program to license manufacturers, importers, distributors, wholesalers, and retailers of cigarettes and OTP. (Bus. & Prof. Code, § 22970.2.) And, for such licensing purposes, a retailer is defined as “a person who engages in this state in the sale of cigarettes or tobacco products directly to the public from a retail location,” including a vending machine from which cigarettes or tobacco products are sold (Bus. & Prof. Code, § 22971, subd. (p)) and a retailer is required to have in place and maintain a separate license to engaged in the sale of cigarette and tobacco products at each of the retailer’s retail locations. (Bus. & Prof. Code, § 22972.)

Currently, there are no statutes or regulations that define the term “retail stock,” as used in RTC section 30008. Therefore, the Board’s Legal Department has previously opined that retail stock

includes inventory located at the taxpayer's retail place of business such as product displayed for retail sale, stored beneath sales counters in back room offices, or in any other place on the premises of the retail establishment. (See, e.g., Cigarette and Tobacco Products Tax Annotation entitled "Retail Stock" (7/18/97).)²

Proposed Regulation

Need for Clarification

The lack of a statutory definition for the term "retail stock," as well as the lack of detailed regulatory guidance regarding whether certain product is considered retail stock and therefore distributed, has caused misinterpretation and confusion among distributors and retailers of cigarettes and tobacco products, and it has made it difficult for distributors to accurately report amounts subject to the taxes imposed by RTC sections 30123 and 30131.2. This is especially true for distributors who are also retailers, particularly when they store cigarettes and OTP in walk-in humidors where cigarettes and OTP are displayed for retail sale to consumers. Therefore, the Board's Business Taxes Committee (BTC) staff determined that there is an issue (or problem within the meaning of Gov. Code, § 11346.2, subd. (b)(1)) as there currently is not a regulation that defines "retail stock."

Interested Parties Process

As a result, the Board's BTC staff drafted California Code of Regulations, title 18, section (Regulation) 4001, *Retail Stock*, to address the issue described above by defining the term "retail stock" as used in RTC section 30008 and implementing, interpreting, and making specific the presumption of distribution in RTC section 30109, and staff prepared an initial discussion paper explaining the new proposed regulation. Both were provided to interested parties.³

For purposes of persons who only hold retailer's licenses and only sell cigarettes and OTP directly to the public, subdivision (a)(1) of staff's proposed Regulation 4001 defined the term "retail stock" to mean all "cigarettes and tobacco products intended and available for sale . . . to customers." For purposes of persons who concurrently hold a distributor's license and a retailer's license and may have untaxed cigarettes and OTP for sale to other licensees for resale directly to the public, subdivision (a)(2) of staff's proposed Regulation 4001 defined the term "retail stock" to mean all "cigarettes and tobacco products intended and available for sale . . . at the same location to customers other than licensed distributors, wholesalers, and retailers." Subdivision (a)(2) further clarified that products stored in the "area where retail sales are made are deemed to be in retail stock" and products "that are not stored in the general area where retail sales are made (e.g., in separate storage rooms or offices) are not deemed to be in retail stock." Subdivision (a)(2)(A) also clarified that products "inside a walk-in humidor displayed

² Annotations are summaries of the conclusions reached in selected legal rulings of Board counsel. All of the Cigarette and Tobacco Products Tax Annotations are available on the Board's website at www.boe.ca.gov.

³ BTC staff proposed Regulation 4001 and new Regulation 4076, *Wholesale Cost of Tobacco Products*, at the same time, and both regulations were discussed during the interested parties process (described below). At the January 26, 2016, BTC meeting, however, the rulemaking process for the proposed regulations was bifurcated. Therefore, this initial statement of reasons only discusses proposed Regulation 4001.

for sale to consumers are retail stock” and products that are “segregated and separated from retail stock, stored in a walk-in humidor for sale to licensed distributors, wholesalers, or retailers, but not displayed for sale to consumers, are wholesale stock.” (There was no subdivision (a)(2)(B) in the original draft of staff’s proposed regulation.) Subdivision (b) of staff’s proposed Regulation 4001 explained that all cigarettes and tobacco products placed into retail stock are deemed to have been distributed (in accordance with RTC, § 30008). Subdivisions (c) of staff’s proposed Regulation 4001 provided that tobacco products no longer in a distributor’s possession or lost through theft or unexplainable disappearance are deemed to have been distributed (in accordance with RTC, § 30109).

On August 4, 2015, BTC staff conducted an interested parties meeting to discuss proposed Regulation 4001. At the meeting, questions were raised about the proper way to distinguish between retail stock and non-retail stock and how to ensure that there was no comingling of tax-paid product with untaxed product. Therefore, BTC staff revised proposed Regulation 4001 to address the questions. In subdivision (a)(2), staff clarified that products are not deemed to be in retail stock only if they are segregated and separated from retail inventory, they are in the original manufacturer’s container with an unbroken seal, and they are not stored in the area where retail sales are made. Staff also clarified in subdivision (a)(2)(A) that to be “non-retail stock” products stored in a walk-in humidor for sale to licensed distributors, wholesalers, or retailers, must be “in the original manufacturer’s packaging with an unbroken seal.” Staff also added a new subdivision (a)(2)(B) to the proposed regulation for the inclusion of examples of retail and non-retail stock after further discussions with the interested parties.

BTC staff also received a letter dated August 25, 2015, from Mr. James Dumler on behalf of McClellan Davis, LLC, in response to the initial discussion paper. The letter included proposed alternative language to change subdivision (c) of staff’s proposed Regulation 4001 into a rebuttable presumption regarding distribution, but staff did not agree to incorporate the alternative language into its proposed draft regulation in response to the August 25, 2015, letter.

BTC staff’s revised draft of proposed Regulation 4001 and staff’s second discussion paper regarding the revised draft were subsequently provided to the interested parties. On October 20, 2015, BTC staff conducted a second interested parties meeting to discuss the revised draft of the proposed regulation. There were continued questions about the proper way to distinguish between retail stock and non-retail stock and how to ensure that there was no comingling of tax-paid and untaxed product. Therefore, BTC staff revised subdivision (a)(2) of proposed Regulation 4001 to further clarify that store rooms/closets, back offices and safes, are not “areas” where retail sales are made.

Staff also received a letter dated November 12, 2015, from Mr. Dumler. Again, the letter included proposed alternative language to change subdivision (c) of staff’s proposed Regulation 4001 to be a rebuttable presumption that products no longer in a distributor’s possession have been distributed and also included non-exclusive examples of evidence that may be provided to overcome the presumption, such as police reports and insurance claims. After reconsidering the alternative language, staff agreed to include the alternative language and examples in staff’s revised draft of proposed Regulation 4001, subdivision (b)(2), and delete staff’s prior draft of subdivision (c).

January 26, 2016, BTC Meeting

Subsequently, staff prepared Formal Issue Paper 15-013 and distributed it to the Board Members for consideration at the Board's January 26, 2016, BTC meeting. Formal Issue Paper 15-013 recommended that the Board propose to adopt revised Regulation 4001 (discussed above) in order to address the issue (or problem) referred to above by:

- Defining the term "retail stock," as used in RTC section 30008.
- Providing examples of areas, such as store rooms/closets, back offices and safes, which are not "areas" where retail sales are made and are areas where non-retail stock may be stored.
- Explaining that all cigarettes and tobacco products placed into retail stock are deemed to have been distributed in accordance with RTC section 30008.
- Explaining the presumption of distribution in RTC section 30109.
- Including a non-exclusive list of examples of evidence that may be provided to overcome the presumption of distribution.

During the January 26, 2016, BTC meeting, Mr. Randall Cheek with SEIU Local 1000 was present, and he expressed concerns about the regulation on behalf of the SEIU Local 1000 members that are Board inspectors who inspect retail locations. Mr. Cheek's concerns were specifically regarding products stored in walk-in humidors and he stated that tax-paid product and untaxed product potentially may be comingled in such humidors and without clear guidelines about separating the products, inspectors would not know what product was tax-paid and what was untaxed. Therefore, the Board Members unanimously voted to postpone the further consideration of proposed Regulation 4001 until the March BTC meeting, and directed staff and SEIU Local 1000 to work together on proposed language to address Mr. Cheek's concerns.

On February 9, 2016, staff received a submission from Ms. Yvette Stowers, Deputy Controller. This included proposed alternative language to add a new subdivision (b) to proposed Regulation 4001 to state that a person who is both a licensed retailer and a licensed distributor, but who only makes retail sales to consumers and does not make any sales for resale to other licensees, holds all inventory intended for sale in retail stock, and renumber revised subdivision (b) (discussed above) as subdivision (c).

On February 11, 2016, BTC staff conducted a third interested parties meeting to discuss staff's revised draft of the proposed regulation. There were continued questions about the proper way to distinguish between retail stock and non-retail stock and how to ensure that there was no comingling of tax-paid and untaxed product. Ms. Stowers' proposed alternative language was well-received; however, Mr. Cheek asked for time to present the proposed language to other members of SEIU Local 1000.

On February 18, 2016, staff received a written submission from Mr. Cheek. Mr. Cheek indicated that SEIU Local 1000 supported Ms. Stowers' proposed language. However, Mr. Cheek's written submission recommended adding language to subdivision (a)(2) of the proposed

regulation to generally require that non-retail stock be “secured,” meaning behind a “locked door,” away from the retail area and that untaxed product must be segregated and separated from tax-paid product away from the retail area. Mr. Cheek’s written submission recommended adding language to subdivision (a)(2)(A) to require non-retail stock to be “secured” and separated and segregated from retail stock in walk-in humidors. Mr. Cheek’s written submission also recommended alternative language to require that police reports, insurance claims, insurance reimbursements, and cigarette and OTP purchase invoices be provided to overcome the presumption of distribution in renumbered subdivision (c).

However, as suggested by Ms. Stowers, new subdivision (b) would not apply to a person who is both a licensed retailer and a licensed distributor, and makes any sales for resale to other licensees. So, Mr. Cheek later revised his written submission to include alternative language for new subdivision (b) to state that a person who is both a licensed retailer and a licensed distributor and makes substantially all sales as retail sales to consumers holds all inventory intended for sale in the retail location in retail stock. Mr. Cheek’s revised written submission further stated that for the purposes of the proposed regulation, “substantially all” means “80 percent or more of gross sales during the previous 12 month reported period.” In addition, Mr. Cheek’s revised his written submission so renumbered subdivision (c) only required timely police reports and cigarette and OTP purchase invoices to be provided to overcome the presumption of distribution, but no longer required insurance claims and insurance reimbursements to be provided to overcome the presumption.

Staff agreed to revise proposed Regulation 4001 to include the new language provided by Ms. Stowers for new subdivision (b), and staff agreed to present the language in Mr. Cheek’s revised submission (SEIU’s proposed language) as an alternative for the Board’s consideration.

Subsequently, staff prepared Formal Issue Paper 16-05 and distributed it to the Board Members for consideration at the Board’s March 30, 2016, BTC meeting. Formal Issue Paper 16-05 recommended that the Board propose to adopt revised Regulation 4001 (discussed above) in order to address the issue (or problem) referred to above by:

- Defining the term “retail stock,” as used in RTC section 30008.
- Providing examples of areas, such as store rooms/closets, back offices and safes, which are not “areas” where retail sales are made and are areas where non-retail stock may be stored.
- Explaining that a person who is both a licensed retailer and a licensed distributor and only makes retail sales to consumers holds all inventory in retail stock.
- Explaining that all cigarettes and tobacco products placed into retail stock are deemed to have been distributed in accordance with RTC section 30008.
- Explaining the presumption of distribution in RTC section 30109.
- Including a list of examples of evidence that may be provided to overcome the presumption of distribution and requiring that timely police reports and cigarette and OTP purchase invoices be provided to overcome the presumption.

During the March 30, 2016, BTC meeting, Mr. Dumler, Mr. Cheek, and Mr. Steven Alari from SEUI Local 1000 were present. Mr. Cheek and Mr. Alari expressed concerns with staff’s

proposed language, but expressed support for SEIU Local 1000's alternative language because it created a "bright line" test and also created less opportunity for tax evasion. Mr. Dumler expressed his support for staff's proposed language. Based on the statements by Mr. Cheek and Mr. Alari, Ms. Stowers expressed an interest in amending some of staff proposed language; however, she and other Board Members had questions about the meaning of "substantially all" as used in Mr. Cheek's revised written submission, and the Board deferred the matter so that all of the parties involved could work together to develop one recommendation for the proposed regulation that they all agreed upon.

As a result, BTC staff further revised proposed Regulation 4001 to address Mr. Cheek's remaining concerns regarding subdivisions (a) and (c). BTC staff clarified, in subdivision (a)(2), that cigarettes and OTP that "are securely stored away from the area where retail sales are made are not considered retail stock" and provided non-exhaustive examples of "secured areas" where non-retail stock may be securely "separated and segregated from retail stock," including a store room, closet, back office, locked cabinet, safe or similar container, or behind a locked wire-cage door or similar encumbrance. BTC staff clarified, in subdivision (a)(2), that untaxed tobacco products must be segregated and secured separately from tax-paid tobacco products away from the retail area. BTC staff clarified, in subdivision (a)(2)(A), that non-retail stock in walk-in humidors must be "secured," segregated and separated from retail stock, and provided non-exhaustive examples of secured areas in humidors where non-retail stock may be separated and segregated from retail stock, including inside a locked cabinet, safe or other similar secured storage container, or behind a locked wire-cage door or similar encumbrance. BTC staff also clarified in subdivision (c) that timely police reports and cigarettes and OTP purchase invoices are required to be provided to overcome the presumption of distribution. However, BTC staff did not revise subdivision (b) because SEIU Local 1000 eventually agreed with the wording of subdivision (b) as originally proposed by Ms. Stowers.

BTC staff subsequently prepared a memorandum dated May 25, 2016, and distributed it to the Board Members for consideration at the Board's June 14, 2016, BTC meeting. In the memorandum, staff recommended that the Board propose to adopt revised Regulation 4001 (discussed above) in order to address the issue (or problem) referred to above by:

- Defining the term "retail stock," as used in RTC section 30008, including providing non-exhaustive examples of secured areas where non-retail stock may be separated and segregated from retail stock.
- Explaining that a person who is both a licensed retailer and a licensed distributor and only makes retail sales to consumers holds all inventory in retail stock.
- Explaining that all cigarettes and tobacco products placed into retail stock are deemed to have been distributed in accordance with RTC section 30008.
- Explaining the presumption of distribution in RTC section 30109.
- Including a non-exhaustive list of examples of evidence that may be provided to overcome the presumption of distribution, and requiring that such evidence include timely police reports and cigarettes and OTP purchase invoices.

During the June 14, 2016, BTC meeting, Mr. Cheek and Mr. Dumler expressed full support for the proposed regulation. The Board Members unanimously voted to propose Regulation 4001 as

recommended in the memorandum. The Board determined that proposed Regulation 4001 is reasonably necessary for the specific purpose of addressing the issue (or problem) created because there is no statute or regulation that defines the term “retail stock,” as used in RTC section 30008, by defining the term retail stock, providing examples of secured areas where non-retail stock may be separated and segregated from retail stock, explaining the presumption of distribution in RTC section 30109, and providing examples of evidence that can be provided to overcome the presumption of distribution.⁴

The Board anticipates that proposed Regulation 4001 will promote fairness and benefit taxpayers, Board staff, and the Board by providing additional clarification regarding and implementing, interpreting, and making specific the meaning of the term retail stock as used in RTC section 30008, and explaining the presumption of distribution in RTC section 30109.

The adoption of proposed Regulation 4001 is not mandated by federal law or regulations. There is no previously adopted or amended federal regulation that is identical to Regulation 4001.

DOCUMENTS RELIED UPON

The Board relied upon the May 25, 2016, memorandum, Formal Issue Paper 16-05, Formal Issue Paper 15-013, the exhibits to the issue papers, and the comments made during the Board’s discussions of the memorandum and issue papers during its January 26, 2016, March 30, 2016, and June 14, 2016, BTC meetings in deciding to propose Regulation 4001, as described above.

ALTERNATIVES CONSIDERED

The Board considered whether to begin the formal rulemaking process to adopt proposed Regulation 4001 at this time or, alternatively, whether to take no action at this time. The Board decided to begin the formal rulemaking process to adopt proposed Regulation 4001 at this time because the Board determined that the proposed regulation is reasonably necessary for the reasons set forth above.

The Board did not reject any reasonable alternative to proposed Regulation 4001 that would lessen any adverse impact the proposed action may have on small business or that would be less burdensome and equally effective in achieving the purposes of the proposed action. No reasonable alternative has been identified and brought to the Board’s attention that would lessen any adverse impact the proposed action may have on small business, be more effective in carrying out the purposes for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

⁴ The Board subsequently determined that it was necessary to reformat and make minor grammatical changes to subdivision (a)(2) of proposed Regulation 4001. The Board also determined that it was necessary to revise the proposed regulation’s authority note to refer to RTC section 30451 and add a reference note to the regulation that refers to RTC sections 30008 and 30109.

INFORMATION REQUIRED BY GOVERNMENT CODE SECTION 11346.2,
SUBDIVISION (b)(5) AND ECONOMIC IMPACT ASSESSMENT REQUIRED BY
GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)

As explained in more detail above, proposed Regulation 4001 is the result of a collaborative effort by the Board, Board staff, and the interested parties to clearly define the term “retail stock,” as used in RTC section 30008. The proposed regulation includes non-exhaustive examples of “secured” areas inside and outside of walk-in humidors where the non-retail stock of persons who hold both a distributor’s license and a retailer’s license may be separated and segregated from retail stock and explains that a person who is both a licensed retailer and a licensed distributor and only makes retail sales to consumers holds all inventory in retail stock. In addition, the proposed regulation explains the presumption of distribution set forth in RTC section 30109, it includes a non-exhaustive list of examples of evidence that may be provided to overcome the presumption of distribution, and it requires that such evidence include timely police reports and cigarettes and OTP purchase invoices.

The provisions of proposed Regulation 4001 are fully consistent with the Board’s Legal Department’s historical and current opinions regarding the meaning of retail stock. They are fully consistent with the provisions of RTC sections 30008 and 30109 being implemented, interpreted, and made specific by the proposed regulation. And, they provide a person who holds both a distributor’s license and a retailer’s license with the flexibility to determine the best “secured” area for that person to store its non-retail stock so that it is separated and segregated from its retail stock, rather than mandating the use of a specific type of secured area. As a result, proposed Regulation 4001 does not mandate that individuals or businesses do anything that is not already required by the RTC to differentiate non-retail stock from retail stock, and there is nothing in the proposed regulation that would significantly change how individuals and businesses would generally behave in the absence of the proposed regulatory action or that would impact revenue. Therefore, the Board estimates that proposed Regulation 4001 will not have a measurable economic impact on individuals and businesses. The Board has determined that proposed Regulation 4001 is not a major regulation, as defined in Government Code section 11342.548 and California Code of Regulations, title 1, section 2000, because the Board has estimated that the proposed regulation will not have an economic impact on California business enterprises and individuals in an amount exceeding fifty million dollars (\$50,000,000) during any 12-month period. And, the Board anticipates that proposed Regulation 4001 will promote fairness and benefit taxpayers, Board staff, and the Board by providing additional notice regarding and implementing, interpreting, and making specific the meaning of the term retail stock as used in RTC section 30008, and explaining the presumption of distribution in RTC section 30109.

In addition, based on these facts and all of the information in the rulemaking file, the Board has determined that the adoption of proposed Regulation 4001 will neither create nor eliminate jobs in the State of California nor result in the creation of new business or the elimination of existing businesses, and will not affect the expansion of businesses currently doing business in the State of California.

Furthermore, Regulation 4001 does not regulate the health and welfare of California residents, worker safety, or the state's environment. Therefore, the Board has also determined that the adoption of proposed Regulation 4001 will not affect the benefits of the regulation to the health and welfare of California residents, worker safety, or the state's environment.

The forgoing information also provides the factual basis for the Board's initial determination that the adoption of proposed Regulation 4001 will not have a significant adverse economic impact on business.

Proposed Regulation 4001 may affect small businesses.

Proposed Text of
California Code of Regulations, Title 18, Section 4001,
Retail Stock

(A new regulation to be added to the California Code of Regulations)

4001. Retail Stock.

(a) “Retail stock” means and includes:

(1) All cigarettes and tobacco products intended and available for sale to consumers by a person who holds a retailer license; and

(2) All cigarettes and tobacco products displayed for sale to consumers by a person who concurrently holds a distributor license and a retailer license at the same location.

(A) Cigarettes and tobacco products that are stored in the area where retail sales are made are deemed to be retail stock. Cigarettes and tobacco products that are securely stored away from the area where retail sales are made are not considered retail stock.

(i) Examples of areas that are separated and segregated from retail stock include, but are not limited to, the following secured areas:

- store room or closet,
- back office,
- inside a locked cabinet, safe, or other similar storage container, or
- behind a locked wire-cage door or similar encumbrance.

(ii) Untaxed cigarettes and tobacco products must be in the original manufacturer packaging, with an unbroken seal, and they must be secured, segregated, and separated from inventory accessible by consumers. Untaxed tobacco products must be segregated and secured separately from tax-paid tobacco products away from the retail area.

(B) Walk-in humidors. Tobacco products inside a walk-in humidor displayed for sale to consumers are retail stock. Tobacco products inside a walk-in humidor in the original manufacturer packaging with an unbroken seal, secured, segregated and separated from retail stock, and not displayed for sale to consumers are not retail stock. Examples of areas that are separated and segregated from retail stock include, but are not limited to, the following secured areas:

- inside a locked cabinet, safe, or other similar secured storage container, or
- behind a locked wire-cage door or similar encumbrance.

(b) A person who is both a licensed retailer and a licensed distributor, but who only makes retail sales to consumers and does not make any sales for resale to other licensees, holds all inventory intended for sale in retail stock.

(c) Presumption of Distribution.

(1) All cigarettes and tobacco products placed in retail stock have been distributed. Tax is due upon distribution.

(2) Unless the contrary is established, it shall be presumed that all cigarettes and tobacco products no longer in a distributor's possession, including when they have been lost through an unexplainable disappearance, have been distributed. The presumption may be rebutted by a preponderance of the evidence demonstrating that an explainable disappearance, such as theft, has occurred.

Examples of evidence that may overcome the presumption include, but are not limited to, the following:

- (A) Police reports (Required and must have been filed timely)
- (B) Insurance claims
- (C) Insurance reimbursements
- (D) Video surveillance
- (E) Photographs
- (F) Detailed tobacco inventory reports
- (G) Cigarette and tobacco purchase invoices (Required)
- (H) Proof of prosecution related to charges of theft of cigarettes or tobacco products.

Note: Authority cited: Section 30451, Revenue and Taxation Code. Reference: Sections 30008 and 30109, Revenue and Taxation Code.

Regulation History

Type of Regulation: Cigarette and Tobacco Products Tax

Regulation: 4001

Title: *Retail Stock*

Preparation: Pamela Mash

Legal Contact: Pamela Mash

The State Board of Equalization proposes to adopt Regulation 4001 to define the term “retail stock” and explain the presumption of distribution.

History of Proposed Regulation:

February 22-24, 2017	Public Hearing
January 6, 2017	OAL publication date; 45-day public comment period begins; Interested Parties mailing
December 22, 2016	Notice to OAL
June 14, 2016	Business Tax Committee, Board Authorized Publication (Vote 5-0)

Sponsor: NA

Support: NA

Oppose: NA