



STATE BOARD OF EQUALIZATION

450 N STREET, SACRAMENTO, CALIFORNIA
PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-0063
TELEPHONE (916)445-1516
FAX (916)323-8765
www.boe.ca.gov

May 14, 2010

BETTY T. YEE
First District, San Francisco

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Fourth District, Los Angeles

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State Controller

BARBARA ALBY
Acting Member
Second District, Sacramento

RAMON J. HIRSIG
Executive Director

Dear Interested Party:

Enclosed are the Agenda, Issue Paper, and Revenue Estimate for the May 26, 2010 Business Taxes Committee meeting. This meeting will address proposed Regulation 4076, *Wholesale Cost of Tobacco Products*, under the Cigarette and Tobacco Products Tax Law. The Agenda concerns approval of proposed new Regulation 4076 to implement, interpret, and make specific Revenue and Taxation Code section 30017.

If you are interested in other topics to be considered by the Business Taxes Committee, you may refer to the "Business Taxes Committee" page on the Board's Internet web site (<http://www.boe.ca.gov/meetings/btcommittee.htm>) for copies of Committee discussion or issue papers, minutes, a procedures manual, and a materials preparation and review schedule arranged according to subject matter and meeting date.

Thank you for your input on these issues and I look forward to seeing you at the Business Taxes Committee meeting at **9:30 a.m.** on **May 26, 2010**, in Room 121 at the address shown above.

Sincerely,

David Gau, Deputy Director
Property and Special Taxes Department

DG: caw

Enclosures

cc: Honorable Betty T. Yee, Chairwoman, First District (MIC 71)
Honorable Jerome E. Horton, Vice Chair, Fourth District
Honorable Michelle Steel, Member, Third District
Honorable John Chiang, State Controller, c/o Ms. Marcy Jo Mandel (via e-mail)
Ms. Barbara Alby, Acting Board Member (MIC 78)

Via email:

Mr. Alan LoFaso, Board Member's Office, First District
Mr. Gary Qualset, Board Member's Office, First District
Ms. Mengjun He, Board Member's Office, First District
Mr. Doug Anderson, Board Member's Office, Fourth District
Ms. Regina V. Evans, Board Member's Office, Fourth District
Ms. Cynthia Suero, Board Member's Office, Fourth District
Mr. Lee Williams, Board Member's Office, Second District
Ms. Sue Blake, Board Member's Office, Second District
Mr. Ken Maddox, Board Member's Office, Third District
Mr. Neil Shah, Board Member's Office, Third District
Ms. Elizabeth Maeng, Board Member's Office, Third District
Ms. Natasha Ralston Ratcliff, State Controller's Office
Mr. Ramon J. Hirsig
Ms. Kristine Cazadd
Mr. Randy Ferris
Mr. Robert Lambert
Mr. Robert Tucker
Ms. Carolee Johnstone
Mr. Brad Heller
Mr. Bill Kimsey
Mr. Dave McKillip
Mr. Phil Bishop
Mr. Todd Gilman
Ms. Lauren Simpson
Mr. Robert Ingenito Jr.
Mr. Jeffrey McGuire
Mr. Bill Benson
Ms. Cecilia Watkins

AGENDA — May 26, 2010 Business Taxes Committee Meeting
Proposal for New Regulation 4076, Wholesale Cost of Tobacco Products

<p>Action 1 — Proposed Regulation 4076, Wholesale Cost of Tobacco Products</p> <p>Issue Paper Alternative 1 – Staff proposal See Agenda pages 2 -7, and Issue Paper Exhibit 2D – Comparison Table</p> <p>Issue Paper Alternative 2 – Mr. Chris McCalla, International Premium Cigar & Pipe Retailers Association’s proposal. See Agenda pages 8 -12, and Issue Paper Exhibit 2D – Comparison Table</p> <p>Issue Paper Alternative 3 – Mr. Adam Wall of Wall and Welch’s Cigars proposal. See Agenda pages 13 -18, and Issue Paper Exhibit 2D – Comparison Table</p> <p>Issue Paper Alternative 4 - Ms. Amy Silverstein, on behalf of Philip Morris USA, John Middleton Company, and U.S. Smokeless Tobacco Brands, Inc., and Mr. Dennis Loper, on behalf of the California Distributors Association.</p>	<p>Approve and authorize publication one of the following alternatives:</p> <p>Alternative 1 Staff’s proposed language to clarify: (1) how distributors of tobacco products should compute and report the wholesale cost of the tobacco products, other than cigarettes, they distribute; and (2) how the Board may determine the wholesale cost of these tobacco products in those situations where a distributor has not reported accurate wholesale cost amounts on which the calculation of the tax due on tobacco products is based.</p> <p align="center">OR</p> <p>Alternative 2 Same as Alternative 1, except delete subparagraph (d)(3)(C) of the proposed regulation and the last sentence of paragraphs (e)(3) and (e)(4).</p> <p align="center">OR</p> <p>Alternative 3 Same as Alternative 1, except clarify that federal excise taxes should not be included in the calculation of the tobacco products distributor’s wholesale cost.</p> <p align="center">OR</p> <p>Alternative 4 Do not approve proposed Regulation 4076.</p>
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AGENDA — May 26, 2010 Business Taxes Committee Meeting
Proposal for New Regulation 4076, *Wholesale Cost of Tobacco Products*

<p>Action 1 — Proposed Regulation 4076</p> <p>Issue Paper Alternative 1 – Staff proposal</p>	<p>Regulation 4076. WHOLESAL COST OF TOBACCO PRODUCTS.</p> <p>(a) General.</p> <p>(1) Revenue & Taxation Code § 30017. This regulation interprets, clarifies, and makes specific Revenue and Taxation Code Section 30017, which provides that the “wholesale cost” of tobacco products is “the cost of tobacco products to the distributor prior to any discounts or trade allowances.” The wholesale cost of tobacco products to the distributor for arm’s-length transactions involving finished tobacco products is the price of the finished tobacco products as shown on complete and reliable invoices for those products before any discounts and trade allowances have been applied, inclusive of federal excise tax but exclusive of freight-in costs.</p> <p>(2) Definitions. The following definitions shall apply for purposes of this regulation:</p> <p>(A) Arm’s-length. An “arm’s-length” transaction means a purchase or other business transaction entered into in good faith and for valuable consideration that reflects the fair market value in the open market between two informed and willing parties, neither under any compulsion to participate in the transaction.</p> <p>(B) Discounts or trade allowances. “Discounts or trade allowances” means and includes any discounts, price reductions, or allowances of any kind, whether stated or unstated, made by the supplier in setting a price, including, without limitation, any discounts applied to a supplier’s price list, such as for prompt payment, payment in cash, bulk purchases, related-party transactions, or favored customer status.</p> <p>(C) Distribution; distribute. “Distribution” and “distribute” mean: (i) the sale of untaxed tobacco products in the state; (ii) the use or consumption of untaxed tobacco products in the state; or (iii) the placing of untaxed tobacco products in retail stock in the state for the purpose of selling the tobacco products to consumers.</p> <p>(D) Distributor. “Distributor” means every person that: (i) distributes tobacco products; or (ii) sells or accepts an order for tobacco products that are to be transported from a point outside the state to a consumer within the state, excluding original importers, as described in Revenue and Taxation Code Section 30105.</p> <p>(E) Finished tobacco products; finished condition. “Finished tobacco products” and tobacco products in “finished condition” mean and include tobacco products that will not be subject to any additional processing before first distribution in the state.</p> <p>(F) Production; produce; processing. “Production,” “produce,” and “processing” mean and include a fabrication process, or a step in a fabrication process, leading to the production of a finished tobacco product.</p>
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Proposal for New Regulation 4076, *Wholesale Cost of Tobacco Products*

- (G) **Profit.** “Profit” means the positive gain from an investment or business operation after subtracting all costs and expenses determined in accordance with generally accepted accounting principles.
- (H) **Similarly situated distributors.** “Similarly situated distributors” means distributors operating under reasonably similar economic and market circumstances, which may include consideration of such factors as: the location of the distributor; the location of the distributor’s customers; whether the distributor is a manufacturer, wholesaler, or retailer; or the nature of the presentation or marketing of the tobacco products.
- (I) **Supplier.** “Supplier” means any manufacturer, seller, or transferor that sold or transferred tobacco products to the distributor whose wholesale costs are being determined.
- (J) **Tobacco product costs.** “Tobacco product costs” means and includes the cost of tobacco products to the distributor, inclusive of federal excise taxes but exclusive of freight-in costs, determined as set forth below in paragraph (d), as of either (i) the date the distributor acquires finished tobacco products or (ii) the date the distributor completes production of finished tobacco products.
- (K) **Tobacco products.** “Tobacco products” includes, but is not limited to, all forms of cigars, smoking tobacco, chewing tobacco, snuff, and any other articles or products made of, or containing at least 50 percent, tobacco, but does not include cigarettes.
- (L) **Wholesale cost.** “Wholesale cost” means tobacco product costs, prior to and exclusive of any discounts or trade allowances. “Wholesale cost does not include the cost of tobacco products that were returned by a customer during the same reporting period in which the tobacco products were distributed if the distributor refunds the entire amount the customer paid for the tobacco products either in cash or credit. For purposes of this subparagraph, refund or credit of the entire amount shall be deemed to be given when the purchase price less rehandling and restocking costs is refunded or credited to the customer. The amount withheld for rehandling and restocking costs may be a percentage of the sales price determined by the average cost of rehandling and restocking returned merchandise during the previous accounting cycle.

(b) Presumption – not-at-arm’s length.

(1) **Presumption.** Sales, purchases, and transfers of tobacco products are rebuttably presumed to be not at arm’s length if they are between related parties such as: relatives (by blood or marriage, which relationships include, but are not limited to, spouses, parents, children and siblings); partners or a partnership and its partners; a limited liability company or association and its members; commonly controlled corporations; a corporation and its shareholders; or persons, as defined in Revenue and Taxation Code Section 30010, and entities under their control or between commonly controlled entities.

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Proposal for New Regulation 4076, *Wholesale Cost of Tobacco Products*

(2) **Rebuttal of Presumption.** If the board determines that a sale, purchase, or transfer of tobacco products was between related parties as set forth in paragraph (1), the distributor may rebut the presumption that the sale, purchase, or transfer was not at arm's length by showing that the price, terms, and conditions of the transaction were substantially equivalent to those that would have been negotiated between unrelated parties in an arm's-length transaction.

(c) **Calculation of the taxable wholesale cost of tobacco products.** For purposes of the tax set forth in Revenue and Taxation Code Section 30123, subdivision (b), and Section 30131.2, subdivision (b), the taxable wholesale cost of tobacco products shall be the "tobacco product costs," as determined pursuant to subdivision (d) below, exclusive of any discounts or trade allowances.

(d) **Calculation of tobacco product costs.** The board shall determine tobacco product costs in accordance with the following:

(1) **Standard methods for determining tobacco product costs.** Except as provided in paragraphs (2) and (3) below, tobacco product costs shall be determined as follows:

(A) **Tobacco product costs to a distributor that acquires finished tobacco products from a supplier.** When a distributor acquires tobacco products in finished condition from a supplier, tobacco product costs shall be equal to the cumulative costs paid or incurred by the distributor for and with respect to the acquisition of the finished tobacco products, inclusive of federal excise tax but exclusive of freight-in costs.

(B) **Tobacco product costs to a distributor that produces finished tobacco products.** When a distributor produces finished tobacco products, tobacco product costs shall be equal to the sum of all direct and indirect costs that the distributor paid or incurred with respect to the production of finished tobacco products. Such costs include, without limitation, all of the distributor's outlays and expenditures, such as amounts paid to suppliers for raw tobacco, the costs of overhead, labor, other materials, and their related freight-in costs, paid or incurred in the production process and also include the costs of advertising and marketing the finished tobacco product to purchasers and customers and prospective purchasers and customers, as well as the federal excise tax.

(C) **Tobacco product costs to a distributor that imports tobacco products or finished tobacco products from outside the United States.** In addition to the costs described in subparagraphs (A) and (B) above, a distributor's tobacco product costs for finished tobacco products that the distributor acquires or produces shall also include customs fees and federal excise taxes on finished tobacco products and tobacco products that the distributor imports from outside the United States.

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(D) **Tobacco product costs to a distributor that acquires finished tobacco products free of charge, or as a free sample, from a supplier.** Where a distributor acquires finished tobacco products free of charge, or as a free sample, from a supplier, the distributor shall be considered to have acquired the finished tobacco products at a 100 percent discount. In such event, the board may determine the tobacco product costs of those finished tobacco products in accordance with one or more of the alternative methods for determining tobacco product costs set forth in paragraph (3) below.

(2) **Addition of discount and trade allowance amounts to tobacco product costs to calculate wholesale cost.** If the board determines that, instead of reporting wholesale costs, the distributor reported tobacco product costs that included express, implicit, or unstated discounts or trade allowances, and complete and reliable information is available to the board allowing it to reasonably estimate the amounts of such discounts or trade allowances, then the board may rely upon such information to reasonably estimate the distributor's correct wholesale costs, prior to and exclusive of discounts and trade allowances, by adding such estimated discount and trade allowance amounts to the tobacco product costs reported by the distributor or otherwise determined under paragraph (1).

(3) **Alternative methods of estimating or calculating tobacco product costs.**

(A) If the board determines that (i) the distributor reported tobacco product costs that included express, implicit, or unstated discounts or trade allowances and complete and reliable information sufficient to reasonably estimate the amounts of such discounts or trade allowances is not available to the board or (ii) the distributor purchased or acquired tobacco products in one or more not-at-arm's-length transactions, then the board may determine tobacco product costs by relying upon one or more of the methods set forth in subparagraphs (B) and (C) below.

(B) The board may rely upon a publicly or commercially available price list that the distributor used to determine the prices of tobacco products sold to customers in arm's-length transactions during the time period at issue, less a reasonable estimate of the distributor's or a similarly situated distributor's profit.

(C) If a publicly or commercially available price list is not available to the board, the board may reasonably estimate tobacco product costs by relying upon industry data from the time period at issue that provide reasonable evidence of typical or normal tobacco product costs during such time period, including, but not limited to:

(i) evidence reasonably indicative of the typical costs of the same or similar tobacco products for similarly situated distributors, with appropriate adjustments to such costs as indicated by all the facts and circumstances;

(ii) all the direct and indirect costs that the supplier paid or incurred with respect to acquisition, production, marketing, and sale of the tobacco products sold by the supplier to the distributor, with appropriate adjustments to

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such costs as indicated by all the facts and circumstances, plus a reasonable estimate of the supplier's profit;

- (iii) the price of the same or similar tobacco products as reflected in a supplier's price list, with appropriate adjustments to such price as indicated by all the facts and circumstances; or
- (iv) the retail price of the same or similar tobacco products as reflected in a retailer's price list, with appropriate adjustments to such price as indicated by all the facts and circumstances, less reasonable estimates of the retailer's and distributor's profits.

(e) Examples:

(1) **Example 1:** Distributor A purchases a finished tobacco product from a domestic supplier in an arm's-length transaction. A's wholesale cost of the tobacco product is the amount A paid to the supplier for the tobacco product, inclusive of federal excise tax, but exclusive of any freight costs, discounts, and trade allowances.

(2) **Example 2:** Distributor B produces handmade cigars. B's tobacco product costs include all of the direct and indirect costs that B paid or incurred with respect to the production, plus packaging, advertising, and marketing of the cigars and federal excise tax.

(3) **Example 3:** Distributor C purchases tobacco products from a subsidiary corporation in which it owns or controls more than 50 percent of the voting stock. Due to this corporate relationship between seller and buyer, the board presumes that the sale and purchase were not at arm's length, and the presumption is not rebutted by C. In the absence of more reliable cost information, if a publicly or commercially available price list that C used during the time period to determine its prices to unrelated customers is available, then the board may use that price list, less a reasonable estimate of C's or a similarly situated distributor's profit, to estimate C's tobacco product costs. If, however, no such publicly or commercially available price list is available, then the board may determine tobacco product costs by relying upon any information available, including other industry data, such as (A) supplier costs plus a reasonable estimate of supplier profit, (B) the price lists of other similarly situated distributors less a reasonable estimate of the distributors' profits, (C) supplier price lists, or (D) retailer price lists less a reasonable estimate of retailer and distributor profits, as described in subparagraph (d)(3)(C).

(4) **Example 4:** Distributor D acquires tobacco product free of charge and reports no wholesale cost for the product on its Tobacco Products Distributor Tax Return. The board determines that D acquired such tobacco product at a 100 percent discount or trade allowance. If a publicly or commercially available price list that D used during the time period to determine its sales prices to unrelated customers is available, then the board may use that price list, less a reasonable estimate of D's profit, to estimate D's tobacco product costs. If, however, no such publicly or commercially available price list is available, then the board may determine tobacco product costs by relying upon other industry data, such as (A) supplier costs plus a reasonable estimate of supplier profit, (B) the price lists of other similarly situated distributors less a reasonable estimate of

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the distributors' profits, (C) supplier price lists, or (D) retailer price lists less a reasonable estimate of retailer and distributor profits, as described in subparagraph (d)(3)(C).

(5) **Example 5:** Distributor E acquires tobacco products or finished tobacco products from a supplier outside the United States. E's tobacco product costs include, in addition to all other production or acquisition costs, the costs of all customs fees and federal excise taxes paid or incurred by E with respect to such tobacco products.

(6) **Example 6:** The board questions whether the amount Distributor F has reported as its wholesale cost is correct, and Distributor F provides the board with complete and reliable information that supports its costs and the discount amount that was applied. The board reviews the information and determines that it is satisfied with the costs, including the discount amount, as reported and that no further action is needed.

Note: *Authority:* Section 30451, Revenue and Taxation Code. *Reference:* Sections 30008, 30010, 30011, 30017, 30105, 30121, 30123, 30131.2, 30201, and 30221, Revenue and Taxation Code.

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Proposal for New Regulation 4076, *Wholesale Cost of Tobacco Products*

**Action 1 —
Proposed
Regulation
4076**

**Issue Paper
Alternative 2 –
Mr. Chris
McCalla,
International
Premium Cigar
& Pipe
Retailers
Association’s
proposal.**

Regulation 4076. WHOLESALE COST OF TOBACCO PRODUCTS.

(a) **General.**

(1) **Revenue & Taxation Code § 30017.** This regulation interprets, clarifies, and makes specific Revenue and Taxation Code Section 30017, which provides that the “wholesale cost” of tobacco products is “the cost of tobacco products to the distributor prior to any discounts or trade allowances.” The wholesale cost of tobacco products to the distributor for arm’s-length transactions involving finished tobacco products is the price of the finished tobacco products as shown on complete and reliable invoices for those products before any discounts and trade allowances have been applied, inclusive of federal excise tax but exclusive of freight-in costs.

(2) **Definitions.** The following definitions shall apply for purposes of this regulation:

- (A) **Arm’s-length.** An “arm’s-length” transaction means a purchase or other business transaction entered into in good faith and for valuable consideration that reflects the fair market value in the open market between two informed and willing parties, neither under any compulsion to participate in the transaction.
- (B) **Discounts or trade allowances.** “Discounts or trade allowances” means and includes any discounts, price reductions, or allowances of any kind, whether stated or unstated, made by the supplier in setting a price, including, without limitation, any discounts applied to a supplier’s price list, such as for prompt payment, payment in cash, bulk purchases, related-party transactions, or favored customer status.
- (C) **Distribution; distribute.** “Distribution” and “distribute” mean: (i) the sale of untaxed tobacco products in the state; (ii) the use or consumption of untaxed tobacco products in the state; or (iii) the placing of untaxed tobacco products in retail stock in the state for the purpose of selling the tobacco products to consumers.
- (D) **Distributor.** “Distributor” means every person that: (i) distributes tobacco products; or (ii) sells or accepts an order for tobacco products that are to be transported from a point outside the state to a consumer within the state, excluding original importers, as described in Revenue and Taxation Code Section 30105.
- (E) **Finished tobacco products; finished condition.** “Finished tobacco products” and tobacco products in “finished condition” mean and include tobacco products that will not be subject to any additional processing before first distribution in the state.
- (F) **Production; produce; processing.** “Production,” “produce,” and “processing” mean and include a fabrication process, or a step in a fabrication process, leading to the production of a finished tobacco product.

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Proposal for New Regulation 4076, *Wholesale Cost of Tobacco Products*

- (G) **Profit.** “Profit” means the positive gain from an investment or business operation after subtracting all costs and expenses determined in accordance with generally accepted accounting principles.
- (H) **Similarly situated distributors.** “Similarly situated distributors” means distributors operating under reasonably similar economic and market circumstances, which may include consideration of such factors as: the location of the distributor; the location of the distributor’s customers; whether the distributor is a manufacturer, wholesaler, or retailer; or the nature of the presentation or marketing of the tobacco products.
- (I) **Supplier.** “Supplier” means any manufacturer, seller, or transferor that sold or transferred tobacco products to the distributor whose wholesale costs are being determined.
- (J) **Tobacco product costs.** “Tobacco product costs” means and includes the cost of tobacco products to the distributor, inclusive of federal excise taxes but exclusive of freight-in costs, determined as set forth below in paragraph (d), as of either (i) the date the distributor acquires finished tobacco products or (ii) the date the distributor completes production of finished tobacco products.
- (K) **Tobacco products.** “Tobacco products” includes, but is not limited to, all forms of cigars, smoking tobacco, chewing tobacco, snuff, and any other articles or products made of, or containing at least 50 percent, tobacco, but does not include cigarettes.
- (L) **Wholesale cost.** “Wholesale cost” means tobacco product costs, prior to and exclusive of any discounts or trade allowances. “Wholesale cost does not include the cost of tobacco products that were returned by a customer during the same reporting period in which the tobacco products were distributed if the distributor refunds the entire amount the customer paid for the tobacco products either in cash or credit. For purposes of this subparagraph, refund or credit of the entire amount shall be deemed to be given when the purchase price less rehandling and restocking costs is refunded or credited to the customer. The amount withheld for rehandling and restocking costs may be a percentage of the sales price determined by the average cost of rehandling and restocking returned merchandise during the previous accounting cycle.

(b) Presumption – not-at-arm’s length.

- (1) **Presumption.** Sales, purchases, and transfers of tobacco products are rebuttably presumed to be not at arm’s length if they are between related parties such as: relatives (by blood or marriage, which relationships include, but are not limited to, spouses, parents, children and siblings); partners or a partnership and its partners; a limited liability company or association and its members; commonly controlled corporations; a corporation and its shareholders; or persons, as defined in Revenue

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and Taxation Code Section 30010, and entities under their control or between commonly controlled entities.

(2) **Rebuttal of Presumption.** If the board determines that a sale, purchase, or transfer of tobacco products was between related parties as set forth in paragraph (1), the distributor may rebut the presumption that the sale, purchase, or transfer was not at arm's length by showing that the price, terms, and conditions of the transaction were substantially equivalent to those that would have been negotiated between unrelated parties in an arm's-length transaction.

(c) **Calculation of the taxable wholesale cost of tobacco products.** For purposes of the tax set forth in Revenue and Taxation Code Section 30123, subdivision (b), and Section 30131.2, subdivision (b), the taxable wholesale cost of tobacco products shall be the "tobacco product costs," as determined pursuant to subdivision (d) below, exclusive of any discounts or trade allowances.

(d) **Calculation of tobacco product costs.** The board shall determine tobacco product costs in accordance with the following:

(1) **Standard methods for determining tobacco product costs.** Except as provided in paragraphs (2) and (3) below, tobacco product costs shall be determined as follows:

(A) **Tobacco product costs to a distributor that acquires finished tobacco products from a supplier.** When a distributor acquires tobacco products in finished condition from a supplier, tobacco product costs shall be equal to the cumulative costs paid or incurred by the distributor for and with respect to the acquisition of the finished tobacco products, inclusive of federal excise tax but exclusive of freight-in costs.

(B) **Tobacco product costs to a distributor that produces finished tobacco products.** When a distributor produces finished tobacco products, tobacco product costs shall be equal to the sum of all direct and indirect costs that the distributor paid or incurred with respect to the production of finished tobacco products. Such costs include, without limitation, all of the distributor's outlays and expenditures, such as amounts paid to suppliers for raw tobacco, the costs of overhead, labor, other materials, and their related freight-in costs, paid or incurred in the production process and also include the costs of advertising and marketing the finished tobacco product to purchasers and customers and prospective purchasers and customers, as well as the federal excise tax.

(C) **Tobacco product costs to a distributor that imports tobacco products or finished tobacco products from outside the United States.** In addition to the costs described in subparagraphs (A) and (B) above, a distributor's tobacco product costs for finished tobacco products that the distributor acquires or produces shall also include customs fees and federal excise taxes on finished tobacco products and tobacco products that the distributor imports from outside the United States.

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(D) **Tobacco product costs to a distributor that acquires finished tobacco products free of charge, or as a free sample, from a supplier.** Where a distributor acquires finished tobacco products free of charge, or as a free sample, from a supplier, the distributor shall be considered to have acquired the finished tobacco products at a 100 percent discount. In such event, the board may determine the tobacco product costs of those finished tobacco products in accordance with one or more of the alternative methods for determining tobacco product costs set forth in paragraph (3) below.

(2) **Addition of discount and trade allowance amounts to tobacco product costs to calculate wholesale cost.** If the board determines that, instead of reporting wholesale costs, the distributor reported tobacco product costs that included express, implicit, or unstated discounts or trade allowances, and complete and reliable information is available to the board allowing it to reasonably estimate the amounts of such discounts or trade allowances, then the board may rely upon such information to reasonably estimate the distributor's correct wholesale costs, prior to and exclusive of discounts and trade allowances, by adding such estimated discount and trade allowance amounts to the tobacco product costs reported by the distributor or otherwise determined under paragraph (1).

(3) **Alternative methods of estimating or calculating tobacco product costs.**

(A) If the board determines that (i) the distributor reported tobacco product costs that included express, implicit, or unstated discounts or trade allowances and complete and reliable information sufficient to reasonably estimate the amounts of such discounts or trade allowances is not available to the board or (ii) the distributor purchased or acquired tobacco products in one or more not-at-arm's-length transactions, then the board may determine tobacco product costs by relying upon one or more of the methods set forth in subparagraphs (B) and (C) below.

(B) The board may rely upon a publicly or commercially available price list that the distributor used to determine the prices of tobacco products sold to customers in arm's-length transactions during the time period at issue, less a reasonable estimate of the distributor's or a similarly situated distributor's profit.

(e) **Examples:**

(1) **Example 1:** Distributor A purchases a finished tobacco product from a domestic supplier in an arm's-length transaction. A's wholesale cost of the tobacco product is the amount A paid to the supplier for the tobacco product, inclusive of federal excise tax, but exclusive of any freight costs, discounts, and trade allowances.

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(2) **Example 2:** Distributor B produces handmade cigars. B's tobacco product costs include all of the direct and indirect costs that B paid or incurred with respect to the production, plus packaging, advertising, and marketing of the cigars and federal excise tax.

(3) **Example 3:** Distributor C purchases tobacco products from a subsidiary corporation in which it owns or controls more than 50 percent of the voting stock. Due to this corporate relationship between seller and buyer, the board presumes that the sale and purchase were not at arm's length, and the presumption is not rebutted by C. In the absence of more reliable cost information, if a publicly or commercially available price list that C used during the time period to determine its prices to unrelated customers is available, then the board may use that price list, less a reasonable estimate of C's or a similarly situated distributor's profit, to estimate C's tobacco product costs.

(4) **Example 4:** Distributor D acquires tobacco product free of charge and reports no wholesale cost for the product on its Tobacco Products Distributor Tax Return. The board determines that D acquired such tobacco product at a 100 percent discount or trade allowance. If a publicly or commercially available price list that D used during the time period to determine its sales prices to unrelated customers is available, then the board may use that price list, less a reasonable estimate of D's profit, to estimate D's tobacco product costs.

(5) **Example 5:** Distributor E acquires tobacco products or finished tobacco products from a supplier outside the United States. E's tobacco product costs include, in addition to all other production or acquisition costs, the costs of all customs fees and federal excise taxes paid or incurred by E with respect to such tobacco products.

(6) **Example 6:** The board questions whether the amount Distributor F has reported as its wholesale cost is correct, and Distributor F provides the board with complete and reliable information that supports its costs and the discount amount that was applied. The board reviews the information and determines that it is satisfied with the costs, including the discount amount, as reported and that no further action is needed.

Note: *Authority:* Section 30451, Revenue and Taxation Code. *Reference:* Sections 30008, 30010, 30011, 30017, 30105, 30121, 30123, 30131.2, 30201, and 30221, Revenue and Taxation Code.

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**Action 1 —
Proposed
Regulation
4076**

**Issue Paper
Alternative 3 –
Mr. Adam Wall
of Wall and
Welch’s Cigars
proposal.**

Regulation 4076. WHOLESALE COST OF TOBACCO PRODUCTS.

(a) General.

(1) **Revenue & Taxation Code § 30017.** This regulation interprets, clarifies, and makes specific Revenue and Taxation Code Section 30017, which provides that the “wholesale cost” of tobacco products is “the cost of tobacco products to the distributor prior to any discounts or trade allowances.” The wholesale cost of tobacco products to the distributor for arm’s-length transactions involving finished tobacco products is the price of the finished tobacco products as shown on complete and reliable invoices for those products before any discounts and trade allowances have been applied, exclusive of federal excise tax and freight-in costs.

(2) **Definitions.** The following definitions shall apply for purposes of this regulation:

- (A) **Arm’s-length.** An “arm’s-length” transaction means a purchase or other business transaction entered into in good faith and for valuable consideration that reflects the fair market value in the open market between two informed and willing parties, neither under any compulsion to participate in the transaction.
- (B) **Discounts or trade allowances.** “Discounts or trade allowances” means and includes any discounts, price reductions, or allowances of any kind, whether stated or unstated, made by the supplier in setting a price, including, without limitation, any discounts applied to a supplier’s price list, such as for prompt payment, payment in cash, bulk purchases, related-party transactions, or favored customer status.
- (C) **Distribution; distribute.** “Distribution” and “distribute” mean: (i) the sale of untaxed tobacco products in the state; (ii) the use or consumption of untaxed tobacco products in the state; or (iii) the placing of untaxed tobacco products in retail stock in the state for the purpose of selling the tobacco products to consumers.
- (D) **Distributor.** “Distributor” means every person that: (i) distributes tobacco products; or (ii) sells or accepts an order for tobacco products that are to be transported from a point outside the state to a consumer within the state, excluding original importers, as described in Revenue and Taxation Code Section 30105.
- (E) **Finished tobacco products; finished condition.** “Finished tobacco products” and tobacco products in “finished condition” mean and include tobacco products that will not be subject to any additional processing before first distribution in the state.
- (F) **Production; produce; processing.** “Production,” “produce,” and “processing” mean and include a fabrication process, or a step in a fabrication process, leading to the production of a finished tobacco product.

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- (G) **Profit.** “Profit” means the positive gain from an investment or business operation after subtracting all costs and expenses determined in accordance with generally accepted accounting principles.
- (H) **Similarly situated distributors.** “Similarly situated distributors” means distributors operating under reasonably similar economic and market circumstances, which may include consideration of such factors as: the location of the distributor; the location of the distributor’s customers; whether the distributor is a manufacturer, wholesaler, or retailer; or the nature of the presentation or marketing of the tobacco products.
- (I) **Supplier.** “Supplier” means any manufacturer, seller, or transferor that sold or transferred tobacco products to the distributor whose wholesale costs are being determined.
- (J) **Tobacco product costs.** “Tobacco product costs” means and includes the cost of tobacco products to the distributor, exclusive of federal excise taxes and freight-in costs, determined as set forth below in paragraph (d), as of either (i) the date the distributor acquires finished tobacco products or (ii) the date the distributor completes production of finished tobacco products.
- (K) **Tobacco products.** “Tobacco products” includes, but is not limited to, all forms of cigars, smoking tobacco, chewing tobacco, snuff, and any other articles or products made of, or containing at least 50 percent, tobacco, but does not include cigarettes.
- (L) **Wholesale cost.** “Wholesale cost” means tobacco product costs, prior to and exclusive of any discounts or trade allowances. “Wholesale cost does not include the cost of tobacco products that were returned by a customer during the same reporting period in which the tobacco products were distributed if the distributor refunds the entire amount the customer paid for the tobacco products either in cash or credit. For purposes of this subparagraph, refund or credit of the entire amount shall be deemed to be given when the purchase price less rehandling and restocking costs is refunded or credited to the customer. The amount withheld for rehandling and restocking costs may be a percentage of the sales price determined by the average cost of rehandling and restocking returned merchandise during the previous accounting cycle.

(b) Presumption – not-at-arm’s length.

- (1) **Presumption.** Sales, purchases, and transfers of tobacco products are rebuttably presumed to be not at arm’s length if they are between related parties such as: relatives (by blood or marriage, which relationships include, but are not limited to, spouses, parents, children and siblings); partners or a partnership and its partners; a limited liability company or association and its members; commonly controlled corporations; a corporation and its shareholders; or persons, as defined in Revenue

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and Taxation Code Section 30010, and entities under their control or between commonly controlled entities.

(2) **Rebuttal of Presumption.** If the board determines that a sale, purchase, or transfer of tobacco products was between related parties as set forth in paragraph (1), the distributor may rebut the presumption that the sale, purchase, or transfer was not at arm's length by showing that the price, terms, and conditions of the transaction were substantially equivalent to those that would have been negotiated between unrelated parties in an arm's-length transaction.

(c) **Calculation of the taxable wholesale cost of tobacco products.** For purposes of the tax set forth in Revenue and Taxation Code Section 30123, subdivision (b), and Section 30131.2, subdivision (b), the taxable wholesale cost of tobacco products shall be the "tobacco product costs," as determined pursuant to subdivision (d) below, exclusive of any discounts or trade allowances.

(d) **Calculation of tobacco product costs.** The board shall determine tobacco product costs in accordance with the following:

(1) **Standard methods for determining tobacco product costs.** Except as provided in paragraphs (2) and (3) below, tobacco product costs shall be determined as follows:

(A) **Tobacco product costs to a distributor that acquires finished tobacco products from a supplier.** When a distributor acquires tobacco products in finished condition from a supplier, tobacco product costs shall be equal to the cumulative costs paid or incurred by the distributor for and with respect to the acquisition of the finished tobacco products, exclusive of federal excise tax and freight-in costs.

(B) **Tobacco product costs to a distributor that produces finished tobacco products.** When a distributor produces finished tobacco products, tobacco product costs shall be equal to the sum of all direct and indirect costs that the distributor paid or incurred with respect to the production of finished tobacco products. Such costs include, without limitation, all of the distributor's outlays and expenditures, such as amounts paid to suppliers for raw tobacco, the costs of overhead, labor, other materials, and their related freight-in costs, paid or incurred in the production process and also include the costs of advertising and marketing the finished tobacco product to purchasers and customers and prospective purchasers and customers, but not the federal excise tax.

(C) **Tobacco product costs to a distributor that imports tobacco products or finished tobacco products from outside the United States.** In addition to the costs described in subparagraphs (A) and (B) above, a distributor's tobacco product costs for finished tobacco products that the distributor acquires or produces shall also include customs fees and federal excise taxes on finished tobacco products and tobacco products that the distributor imports from outside the United States.

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(D) **Tobacco product costs to a distributor that acquires finished tobacco products free of charge, or as a free sample, from a supplier.** Where a distributor acquires finished tobacco products free of charge, or as a free sample, from a supplier, the distributor shall be considered to have acquired the finished tobacco products at a 100 percent discount. In such event, the board may determine the tobacco product costs of those finished tobacco products in accordance with one or more of the alternative methods for determining tobacco product costs set forth in paragraph (3) below.

(2) **Addition of discount and trade allowance amounts to tobacco product costs to calculate wholesale cost.** If the board determines that, instead of reporting wholesale costs, the distributor reported tobacco product costs that included express, implicit, or unstated discounts or trade allowances, and complete and reliable information is available to the board allowing it to reasonably estimate the amounts of such discounts or trade allowances, then the board may rely upon such information to reasonably estimate the distributor's correct wholesale costs, prior to and exclusive of discounts and trade allowances, by adding such estimated discount and trade allowance amounts to the tobacco product costs reported by the distributor or otherwise determined under paragraph (1).

(3) **Alternative methods of estimating or calculating tobacco product costs.**

(A) If the board determines that (i) the distributor reported tobacco product costs that included express, implicit, or unstated discounts or trade allowances and complete and reliable information sufficient to reasonably estimate the amounts of such discounts or trade allowances is not available to the board or (ii) the distributor purchased or acquired tobacco products in one or more not-at-arm's-length transactions, then the board may determine tobacco product costs by relying upon one or more of the methods set forth in subparagraphs (B) and (C) below.

(B) The board may rely upon a publicly or commercially available price list that the distributor used to determine the prices of tobacco products sold to customers in arm's-length transactions during the time period at issue, less a reasonable estimate of the distributor's or a similarly situated distributor's profit.

(C) If a publicly or commercially available price list is not available to the board, the board may reasonably estimate tobacco product costs by relying upon industry data from the time period at issue that provide reasonable evidence of typical or normal tobacco product costs during such time period, including, but not limited to:

(i) evidence reasonably indicative of the typical costs of the same or similar tobacco products for similarly situated distributors, with appropriate adjustments to such costs as indicated by all the facts and circumstances;

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- (ii) all the direct and indirect costs that the supplier paid or incurred with respect to acquisition, production, marketing, and sale of the tobacco products sold by the supplier to the distributor, with appropriate adjustments to such costs as indicated by all the facts and circumstances, plus a reasonable estimate of the supplier's profit;
- (iii) the price of the same or similar tobacco products as reflected in a supplier's price list, with appropriate adjustments to such price as indicated by all the facts and circumstances; or
- (iv) the retail price of the same or similar tobacco products as reflected in a retailer's price list, with appropriate adjustments to such price as indicated by all the facts and circumstances, less reasonable estimates of the retailer's and distributor's profits.

(e) Examples:

(1) **Example 1:** Distributor A purchases a finished tobacco product from a domestic supplier in an arm's-length transaction. A's wholesale cost of the tobacco product is the amount A paid to the supplier for the tobacco product, exclusive of federal excise tax, freight costs, discounts, and trade allowances.

(2) **Example 2:** Distributor B produces handmade cigars. B's tobacco product costs include all of the direct and indirect costs that B paid or incurred with respect to the production, plus packaging, advertising, and marketing of the cigars but not federal excise tax.

(3) **Example 3:** Distributor C purchases tobacco products from a subsidiary corporation in which it owns or controls more than 50 percent of the voting stock. Due to this corporate relationship between seller and buyer, the board presumes that the sale and purchase were not at arm's length, and the presumption is not rebutted by C. In the absence of more reliable cost information, if a publicly or commercially available price list that C used during the time period to determine its prices to unrelated customers is available, then the board may use that price list, less a reasonable estimate of C's or a similarly situated distributor's profit, to estimate C's tobacco product costs. If, however, no such publicly or commercially available price list is available, then the board may determine tobacco product costs by relying upon any information available, including other industry data, such as (A) supplier costs plus a reasonable estimate of supplier profit, (B) the price lists of other similarly situated distributors less a reasonable estimate of the distributors' profits, (C) supplier price lists, or (D) retailer price lists less a reasonable estimate of retailer and distributor profits, as described in subparagraph (d)(3)(C).

(4) **Example 4:** Distributor D acquires tobacco product free of charge and reports no wholesale cost for the product on its Tobacco Products Distributor Tax Return. The board determines that D acquired such tobacco product at a 100 percent

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discount or trade allowance. If a publicly or commercially available price list that D used during the time period to determine its sales prices to unrelated customers is available, then the board may use that price list, less a reasonable estimate of D's profit, to estimate D's tobacco product costs. If, however, no such publicly or commercially available price list is available, then the board may determine tobacco product costs by relying upon other industry data, such as (A) supplier costs plus a reasonable estimate of supplier profit, (B) the price lists of other similarly situated distributors less a reasonable estimate of the distributors' profits, (C) supplier price lists, or (D) retailer price lists less a reasonable estimate of retailer and distributor profits, as described in subparagraph (d)(3)(C).

(5) **Example 5:** Distributor E acquires tobacco products or finished tobacco products from a supplier outside the United States. E's tobacco product costs include, in addition to all other production or acquisition costs, the costs of all customs fees and federal excise taxes paid or incurred by E with respect to such tobacco products.

(6) **Example 6:** The board questions whether the amount Distributor F has reported as its wholesale cost is correct, and Distributor F provides the board with complete and reliable information that supports its costs and the discount amount that was applied. The board reviews the information and determines that it is satisfied with the costs, including the discount amount, as reported and that no further action is needed.

Note: *Authority:* Section 30451, Revenue and Taxation Code. *Reference:* Sections 30008, 30010, 30011, 30017, 30105, 30121, 30123, 30131.2, 30201, and 30221, Revenue and Taxation Code.

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

Wholesale Cost of Tobacco Products

I. Issue

Should the Board of Equalization (Board) authorize publication of a regulation that would clarify how the wholesale cost of the tobacco products is determined under the Cigarette and Tobacco Products Tax Law?

II. Alternative 1 – Staff Recommendation

Staff recommends that the Board authorize the publication of proposed Regulation 4076 to be added to the Cigarette and Tobacco Products Tax Regulations. Regulation 4076 would implement, interpret, and make specific Revenue and Taxation Code section 30017, which defines “wholesale cost” to mean “the cost of tobacco products to the distributor prior to any discounts or trade allowances.” Regulation 4076 would clarify: (1) how distributors of tobacco products should compute and report the wholesale cost of the tobacco products, other than cigarettes, they distribute; and (2) how the Board may determine the wholesale cost of these tobacco products in those situations where a distributor has not reported accurate wholesale cost amounts on which the calculation of the tax due on tobacco products is based. (See Exhibit 2A.)

III. Other Alternatives Considered

- A. Alternative 2** - As proposed by Mr. Chris McCalla, Legislative Director of the International Premium Cigar & Pipe Retailers Association (IPCPR), on behalf of 96 premium retail tobacco shop owners, amend the language recommended by staff to delete subparagraph (d)(3)(C) of the proposed regulation. (See Exhibit 2B.)
- B. Alternative 3** - As proposed by Mr. Adam Wall of Wall and Welch’s Cigars, amend the language recommended by staff to clarify that federal excise taxes should not be included in the calculation of the tobacco products distributor’s wholesale cost. (See Exhibit 2C.)
- C. Alternative 4** - As proposed by Ms. Amy Silverstein, on behalf of Philip Morris USA, John Middleton Company, and U.S. Smokeless Tobacco Brands, Inc., and Mr. Dennis Loper, on behalf of the California Distributors Association (CDA), do not adopt proposed Cigarette and Tobacco Products Tax Regulation 4076.

A chart showing, in underlined and strikethrough text, revisions suggested by interested parties and accepted by staff, as well as further refinements by staff to the initial draft submitted to the Board Members on December 16, 2009, is included as Exhibit 2D. This chart also provides a comparison of the proposals submitted by interested parties, described above as alternatives 2 and 3, with staff-recommended alternative 1.

IV. Background

Proposition 99, known as the Tobacco and Health Protection Act of 1988 (Prop. 99), was passed by the voters of California in November 1988, to be effective January 1, 1989. Among other things, Prop. 99 added Article 2 (commencing with section 30121) to the Cigarette and Tobacco Products Tax Law (part 13 (commencing with section 30001) of division 2 of the Revenue and Taxation Code) (hereafter Law), which imposed a surtax on the distribution of cigarettes of 12.5 mills per cigarette (\$0.25 per pack) and, for the first time, imposed a tax on the distribution of tobacco products, other than cigarettes, including, for example, cigars, smoking and chewing tobacco, and snuff (hereafter, collectively, tobacco products), at a rate equivalent to the combined rate of tax imposed, under various provisions of the Law, on cigarettes. The tax due was to be calculated by applying this tax rate to the “wholesale cost” of the tobacco products.

Revenue and Taxation Code (R&TC) section 30017, which provides the definition of “wholesale cost,” was added to the Law effective September 21, 1989, by Senate Bill No. (SB) 87 (Stats. 1989, ch. 634), which added and amended a number of provisions of the Law to enable the Board to implement and administer the tax imposed on tobacco products by Prop. 99. R&TC section 30017 reads the same today as it did when it was enacted in 1989. During the over 20 years that section 30017 has been in force, a number of questions have arisen as to how the “wholesale cost” of tobacco products should be determined, as evidenced by subsequently published Board annotations and enacted legislation. First, in April 1989, after passage of Prop. 99, the Board’s Legal Department opined, in response to inquiries from distributors, that incoming freight charges on deliveries of finished tobacco products (i.e., “freight-in costs”) should not be included when determining the wholesale cost of tobacco products. (Board Annotation, “Tobacco Products,” 4/20/89, Business Taxes Law Guide (BTLG), vol. 3.)

Further, in February 1996, the Board’s Legal Department responded to an inquiry about how to determine the wholesale cost of a cigar that a retailer manufactured on his premises, from raw goods he purchased at wholesale, and then sold at retail as a finished product. The Legal Department noted that the wholesale cost to a distributor of cigars that were purchased as a finished product would include the manufacturer’s costs, including the material used to manufacture the cigar, the labor and overhead costs in the manufacturing process, and the manufacturer’s markup, or profit. Accordingly, a determination of the wholesale cost of the cigar manufactured by the retailer must include not only the cost of the raw goods, but also what would be considered labor, overhead, and markup. It was opined that one way to compute the wholesale cost of the cigar manufactured by the retailer would be to determine the wholesale cost of a cigar of similar size and quality available for purchase at the wholesale level. (Board Annotation, “Rate of Tax; Tobacco Products,” 2/7/96, BTLG, vol. 3.) In addition to these formal inquiries, Excise Tax Division staff has received numerous other inquiries over the years from distributors and other members of the industry about how to compute, and what should be included in computing, the wholesale cost of tobacco products.

Additionally, in 2001, in response to a perceived inconsistency between the law and the practicalities associated with computing the tax due on tobacco products, the Legislature clarified existing law by codifying the method used by distributors to claim a refund of or credit for tax paid on returned tobacco products, which included a clarification that the wholesale cost of such returned products should not be included in the distributor’s calculation of the wholesale cost of tobacco products used to calculate the amount of tax due on the tobacco products he or she distributed. (SB 312 (Stats. 2001, ch. 426) [adding, among other things, subdivision (c) to R&TC section 30123].)

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Most recently, the question of how the wholesale cost of tobacco products should be determined was raised in *U.S. Smokeless Tobacco Brands, Inc. v. State Board of Equalization* (Super. Ct. San Francisco County, 2009, No. CGC 07-463592) (UST case). In this case, the plaintiff, U.S. Smokeless Tobacco Brands, Inc. (UST Sales), argued that the amount of wholesale cost it should report to the Board, and on which it should calculate the amount of tax due, is the amount UST Sales reportedly paid for the purchase of tobacco products (in this case, principally name-brand moist snuff) from its sister subsidiary company, U.S. Smokeless Tobacco Manufacturing Company (UST Manufacturing). UST Sales and UST Manufacturing were one company prior to 1990, and UST Sales and UST Manufacturing are both wholly-owned subsidiaries of U.S. Smokeless Tobacco Company (Parent Company). The amount UST Sales reportedly paid to UST Manufacturing for the tobacco products, which is referred to as the “transfer price,” was set by Parent Company and is considerably lower, as much as 82 percent lower, than previous wholesale cost amounts that UST Sales/UST Manufacturing reported as one company for similar products prior to 1990. (The case involves the period January 1994 through November 1996.) The Board argues that the “transfer price” between the two subsidiary companies is the price after discounts have been applied, not the wholesale cost as defined in R&TC section 30017, and is, therefore, not an accurate measure for determining the correct amount of tax due. Plaintiff’s method of determining wholesale cost is contrary to the Board’s longstanding practices with regard to calculating the proper measure of tax.

Numerous other issues have come up over the years that staff and taxpayers have resolved before they rose to the level of legal opinions and litigation, such as questions regarding inclusion of federal excise tax or U.S. customs tax, the measure of tax for original importers, how the “costs” for Shisha¹ and in-state production of cigars should be determined, and the correct measure of tax in situations involving promotions such as “buy one, get one free.” It is staff’s objective, in proposing Regulation 4076, to provide guidance and clarification uniformly to all affected taxpayers in advance of potential audit activities.

V. Discussion

This issue involves the proper calculation of a distributor’s “wholesale cost,” as defined in R&TC section 30017 of the Law. The amount of tax due on tobacco products under the Law is determined by multiplying the wholesale cost of the tobacco products by the applicable tax rate. (R&TC, § 30123, subd. (b).) The Board has collected the tax on tobacco products based on the wholesale cost of these products for over 20 years, during which time it has adopted appropriate practices to compensate for the fact that the statutory definition of “wholesale cost” provides little guidance as to how the wholesale cost of a tobacco product should be computed, other than to specify that such cost must not be reduced by “discounts or trade allowances” received. Proposed Regulation 4076 codifies the longstanding practices the Board has used to properly determine a distributor’s wholesale tobacco products cost, i.e., the distributor’s cost before any discounts or trade allowances received.

At the December 16, 2009, Board meeting, staff requested the Board Members’ authorization to begin the formal rulemaking process to adopt proposed Regulation 4076. At that time, the Board directed staff to meet with interested parties prior to commencing formal rulemaking. An interested parties meeting was held on February 17, 2010. At the interested parties meeting, representatives from various cigarette and tobacco products manufacturers, distributors, retailers, and their respective associations, including the California Distributors Association and the IPCPRA, were in attendance, either in person or

¹ Shisha is a product that is a mix of molasses and fruit flavors, which is laced with tobacco, and is smoked in a Hookah (water pipe).

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telephonically, to discuss staff's proposed language. Written comments have been received² from four persons, representing a broad spectrum of interested parties, identified above with respect to Alternatives 2, 3, and 4, which are addressed below. In addition, staff considered the oral comments made during the meeting and has made appropriate revisions to the proposed regulation language, which are reflected by the strikethrough and underlined text in the attached proposed regulation, Exhibit 2D. Staff recommends that the Board adopt proposed Regulation 4076, as revised, in order to interpret, clarify, and make specific R&TC section 30017.

Comments by interested parties, both written and oral, fall into two groups: (1) those from interested parties who offered specific suggestions for amending staff's proposed language but who do not appear to be generally adverse to adoption of the regulation; and (2) those from interested parties who apparently do not presently support adoption of a regulation that interprets, clarifies, and makes specific R&TC section 30017. Following are staff's responses to the written comments that were submitted.

Comment 1: Proposed subparagraph (d)(3)(C) should be deleted.

Mr. Chris McCalla, who submitted comments on behalf of the IPCPRA (Exhibit 5), is concerned that the proposed regulation be easily comprehensible for those businesses and parties that will ultimately be responsible for proper compliance, in particular with respect to subparagraph (d)(3)(C), which he says the IPCPRA feels may prove ambiguous and susceptible to unintended miscalculations by the Board when determining final costs.

In response to Mr. McCalla's comment, staff has reviewed the text of subparagraph (d)(3)(C) and, while it does not agree that the provision should be deleted in its entirety, has made revisions to the format and the language that it believes provide clarification, as indicated by the strikethrough and underlined text in the proposed regulation, Exhibit 2D.

Comment 2: Federal excise taxes are not related to the production and distribution of tobacco products and should not be included when determining the wholesale cost of tobacco products.

Adam Wall, of Wall and Welch's Cigars, comments that federal excise taxes are presently included in the cost of all tobacco products but are not included in the definition of tobacco product costs to a distributor that produces finished tobacco products, as set forth in subparagraph (d)(1)(B) of the initial draft of the proposed regulation (Exhibit 4). Staff is indebted to Mr. Wall for pointing out this deficiency, and staff has revised the definition to include federal excise tax in the calculation of the cost of finished tobacco products produced by the distributor, as indicated by the strikethrough and underlined text in paragraphs (a)(1), (a)(2)(J), (d)(1)(A) and (B), and (e)(1) and (2) of the proposed regulation, Exhibit 2D.

Mr. Wall contends, however, that federal excise tax should never be included in the determination of the cost of tobacco products and, consequently, should not be included in the wholesale cost of the tobacco products. However, federal excise tax has historically and consistently been correctly included in the bases (e.g., gross receipts, sales price, wholesale cost) or measure upon which state taxes are applied to determine the amount of tax due (e.g., sales or use tax, tobacco products tax).

Manufacturers and importers of tobacco products, which include, for federal purposes, cigars, cigarettes, smokeless tobacco, pipe tobacco, and roll-your-own tobacco, are liable for payment of the federal excise tax imposed on tobacco products upon removal from the factory or internal revenue bond or upon release from customs custody. (26 U.S.C.A. §§ 5702(c) & (j), 5703(a)(1) & (b)(1).) Although not expressly mentioned in the Law, taxes imposed by the United States are specifically addressed in the

² The original due date for comments was extended from February 26, 2010, to March 26, 2010.

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laws governing three other taxes administered by the Board – the sales and use taxes and the emergency telephone users (911) surcharge.³ With respect to the tobacco products tax, the Legislature intended that the wholesale cost of tobacco products to which the tax is applied means, in relevant part, the cost of those tobacco products to the distributor, which would include any federal excise tax the distributor paid to its supplier. (R&TC, § 30017.) As demonstrated by the exclusion of federal tax from charges on which the 911 surcharge is imposed under R&TC, § 41011, subd. (b)(1), the Legislature knows how to exclude federal tax from a tax base when it intends to do so. Thus, it is evident that the Legislature intended that the federal excise tax on tobacco products (as defined for our purposes) be included when calculating the wholesale cost of tobacco products under the Law.

Furthermore, staff notes that, despite tax return instructions (e.g., Form BOE-501-CT, under *Wholesale Cost*) stating that federal excise tax should be included in the wholesale cost of tobacco products being reported, omission of the federal excise tax continues to rank among the top reasons for audit-identified deficiencies. Thus, Mr. Wall’s comment provides a clear example of the need for the kind of clarification provided by this regulation.

Comment 3: Proposed Regulation 4076 conflicts with R&TC section 30017, the statute the regulation is meant to implement, interpret, and make specific.

Mr. Dennis Loper, on behalf of the California Distributors Association (CDA), and Ms. Amy Silverstein, on behalf of Philip Morris USA, John Middleton Company, and U.S. Smokeless Tobacco Brands, Inc., comment that proposed Regulation 4076 conflicts with R&TC section 30017, the statute that Regulation 4076 is meant to implement, interpret, and make specific. (Exhibits 6 and 7, respectively.) Staff does not agree.

R&TC section 30017 states simply that “[w]holesale cost’ means the cost of tobacco products to the distributor prior to any discounts or trade allowances.” Under R&TC section 30451, the Board is directed to enforce the provisions of the Law “and may prescribe, adopt and enforce rules and regulations relating to the administration and enforcement of [the Law].” When it exercises the power conferred by this statute, the Board is governed by the Administrative Regulations and Rulemaking provisions contained in Chapter 3.5 (commencing with section 11340) of part 1 of division 3 of the Government Code, which require, among other things, that a regulation adopted by the Board to implement, interpret, and make specific a statute⁴ must be “consistent and not in conflict with the statute and reasonably necessary to effectuate the purpose of the statute” in order to be valid. (Gov. Code, §§ 11342.2, 11346, subd. (a).)

The Board has administered the Law, and specifically R&TC section 30017, for over 20 years, during which time it has gained the expertise and technical knowledge necessary for its effective administration. In keeping with the authority granted by the Legislature to the Board to implement the Law, proposed Regulation 4076 is reasonably necessary to effectuate the purpose of R&TC section 30017 by addressing numerous misunderstandings and questions that have arisen with regard to

³ With respect to the 911 surcharge, the reason the federal tax is mentioned is because the tax imposed by the United States is expressly excluded from the charges (the tax base) on which the tax is imposed. (R&TC, § 41011, subd. (b)(1).) With respect to the sales and use taxes, the reason the federal tax is mentioned is, first, to exclude from gross receipts and sales price, respectively, tax imposed, with respect to retail sales, on the retailer or consumer and, second, to except federal excise tax imposed on manufacturers and importers from that exclusion. (R&TC, §§ 6011, subd. (c)(4)(A), 6012, subd. (c)(4)(A).) In other words, if there were no exclusion of federal tax imposed on retailers and consumers, federal excise tax imposed on manufacturers and importers would not be specifically mentioned but would simply be another expense that must be included in gross receipts or sales price. (R&TC, §§ 6011, subd. (a)(2), 6012, subd. (a)(2).)

⁴ A “regulation” is defined as “every rule, regulation, order, or standard of general application . . . adopted by any state agency to implement, interpret, or make specific the law enforced or administered by it, or to govern its procedure.” (Gov. Code, § 11342.600.)

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construing the statutory phrases “the cost of tobacco products to the distributor” and “prior to any discounts or trade allowances.” Proposed Regulation 4076 clarifies and provides guidance regarding the application of these phrases in accordance with the Board’s longstanding and well-founded practices. In short, staff is confident that proposed Regulation 4076 is not in “conflict” with R&TC section 30017.

Comment 4: The Board should not adopt Regulation 4076.

Mr. Dennis Loper, on behalf of the California Distributors Association (CDA), and Ms. Amy Silverstein, on behalf of Philip Morris USA, John Middleton Company, and U.S. Smokeless Tobacco Brands, Inc., comment that, for several reasons, the Board should not adopt proposed Regulation 4076. Staff does not agree.

Mr. Loper maintains that he does not see a need for a regulation such as proposed Regulation 4076 and that he has not been given any concrete reasons for adopting the regulation. Staff provided numerous examples to Mr. Loper of the need for the regulation during the interested parties meeting, and these examples, among others, are summarized above.

Ms. Silverstein maintains that proposed Regulation 4076 is not needed because the trial court in the UST case (discussed above) opined that the phrase “cost of tobacco products to the distributor” in R&TC section 30017 means that “wholesale cost” is defined as the “actual cost” of the tobacco products sold to the distributor. Staff notes that proposed Regulation 4076 focuses, for the most part, on what costs a distributor should include in determining his or her “actual costs” (in the trial court’s parlance) of a finished tobacco product, whether purchased as a finished tobacco product or fabricated by the distributor. What is missing from the trial court’s statement is that, in order to determine the correct “wholesale cost,” the “cost . . . to the distributor” (i.e., the “actual cost” in the trial court’s parlance) must be adjusted for any discounts or trade allowances received, as mandated by R&TC section 30017. When the distributor has not accurately computed its wholesale costs by failing to add back in any discounts or trade allowances received to its “actual costs,” proposed Regulation 4076 illustrates various alternative means for properly determining the wholesale cost of the tobacco products in question. Proposed Regulation 4076 does not replace the distributor’s “actual costs” with a “constructive price” (as suggested by the trial court) but, instead, provides a way to determine the distributor’s wholesale costs by looking to other sources of relevant information to determine what the wholesale cost would be if the distributor had properly adjusted his or her “actual cost” to add back any discounts or trade allowances received, as mandated by R&TC section 30017. In other words, proposed Regulation 4076 is not inconsistent with the trial court’s decision but is, instead, consistent with and builds on the trial court’s finding that a discount may be “any discount” (emphasis added), whether expressly stated or not.

Finally, we note that the trial court’s decision is not a final decision and does not constitute binding judicial precedent. Under the constitutional principle of separation of powers, the Board may, itself, use its delegated authority to interpret, clarify, and make specific tobacco products tax statutes, as long as its interpretations are not in conflict with these statutes. This is particularly true here because there is no way to tell when the pending litigation in this case will be completed. Further, there is no way to be certain that no new litigation will commence before the pending litigation is completed, and, furthermore, it is unlikely that any one judicial decision will fully resolve all legal issues. Thus, a Board regulation is timely and necessary to clarify the law.

Ms. Silverstein also comments that the Board does not have the authority to adopt proposed Regulation 4076. However, not only has the Legislature granted to the Board authority to promulgate such regulations under R&TC section 30451, discussed above, the Legislature has also granted to the Board explicit authority to determine the amount of tax a taxpayer owes. First, R&TC section 30201 provides that, “[i]f the board is dissatisfied with the report or return filed by any person, it may compute and

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determine the amount to be paid upon the basis of any information available to it” (emphasis added) and may issue one or more deficiency determinations for the amount of tax due. Further:

If any person fails to make a report or return, the board shall make an estimate of . . . the wholesale cost of tobacco products distributed by him or her. The estimate shall be made for the month or months in respect to which the person failed to make a report or return and shall be based upon any information available to the board. Upon the basis of this estimate the board shall compute and determine the amount required to be paid to the state (R&TC, § 30221 [emphasis added].)

Consequently, proposed Regulation 4076 does not impart any more authority to the Board than it already has, as set forth in R&TC sections 30201 and 30221, to determine the correct wholesale cost of tobacco products distributed by a taxpayer and, accordingly, the amount of tax the taxpayer owes. Proposed Regulation 4076 provides clarity and consistency by illustrating the manner in which these determinations can be made so that compliant taxpayers may avoid additional audit determinations.

Ms. Silverstein comments further that the Board does not have the authority to adopt proposed Regulation 4076 because it conflicts with views expressed by the trial court in the UST case concerning the disregard of corporate separateness. Staff notes that proposed Regulation 4076 does not rely on alter ego, disregard of corporate separateness (i.e., “piercing the corporate veil”), or any other such theory. The regulation instead describes what constitutes a relationship between parties (not just corporations, but also individuals and partners, among others) to a transaction where it should be presumed that the transaction did not occur under circumstances that could be considered to constitute an arm’s-length transaction and where, therefore, the transaction may have included an unstated, related-party discount or trade allowance.

Moreover, the Board has previously promulgated regulations addressing similar arm’s-length concerns. Statutes enacted pursuant to the Cigarette and Tobacco Products Licensing Act of 2003 (division 8.6 (commencing with section 22970) of the Business and Professions Code) (Licensing Act) require that applicants for licenses demonstrate that they acquired the business for which the license is sought in an arm’s-length transaction. (Bus. & Prof. Code, §§ 22973.1, subd. (a)(2)(B) & 22977.2, subd. (a)(2)(B).) Consequently, the Board adopted regulations to assist it in administering the Licensing Act, several of which contain language regarding arm’s-length transactions similar to the arm’s-length transaction language in proposed Regulation 4076. (See, e.g., Cal. Code Regs., tit. 18, §§ 4500, subd. (d) [defining “arm’s-length transaction”] & 4505 [establishing the presumption that a transaction between related parties is not at arm’s length].) In addition, regardless of the type of legal entity, in a situation where the shareholders or owners of one party to the transaction are also shareholders or owners of the other party to the transaction, those parties “may not be said [to be] dealing at arm’s length with [each other]”⁵ and would be considered to be related for purposes of proposed Regulation 4076, again with no reliance on alter ego, piercing of the corporate veil, or other such theories.

It should be noted that, in proposed Regulation 4076, a supplier may apply a discount to its sales price for a tobacco product for a variety of reasons (see subdivision (a)(2)(B) [definition of “discounts” and “trade allowances”]), including for a favored customer, such as where two companies have an agreement to deal exclusively with one another, regardless of whether they are related to one another for purposes of the “arm’s-length” presumption.

⁵ *Rosen v. E.C. Losch Co., Inc.* (2d App.Dist. 1965) 234 Cal.App.2d 324, 333 [stating that “appellants were the sole shareholders, officers and directors of the corporation. In addition, they held interests in the corporations with which [the corporation] was doing business, so that it may not be said that [the corporation] was dealing at arm’s length with such companies”].

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In sum, the Legislature granted to the Board the authority to adopt regulations under R&TC section 30451 to assist it in administering the Law. Furthermore, the Legislature granted to the Board explicit authority to determine, by any information available to it, the wholesale cost of tobacco products distributed by a taxpayer and, accordingly, the amount of tax on the tobacco products the distributor is required to pay. Moreover, by assuring proper calculation of the wholesale cost of tobacco products, based on an accurate computation of the cost of those products to the distributor and the amount of discount or trade allowance that was included in that cost, adoption of proposed Regulation 4076 is consistent with the objective of the California voters in passing Prop. 99.⁶ Proposed Regulation 4076 is necessary to maintain the integrity of the tobacco products tax base mandated by law.

VI. Alternative 1 – Staff Recommendation

A. Description of the Staff Recommendation

Staff proposes adoption of Regulation 4076, *Wholesale Cost of Tobacco Products*, to clarify and make specific how the wholesale cost of the tobacco products is determined under the Cigarette and Tobacco Products Tax Law, including, but not limited to, providing various acceptable options that a distributor and the Board may use to calculate the distributor’s wholesale costs, pursuant to R&TC section 30017, in situations where that amount may not be easily determined due to the application of discounts and trade allowances, or where a distributor has not reported accurate wholesale cost amounts (e.g., by reporting as the “wholesale cost” the distributor’s “actual cost” without adjusting for discounts or trade allowances received). (See Exhibit 2A.) Proposed Regulation 4076 codifies the Board’s longstanding practices and clarifies the factors that are to be considered when determining the wholesale cost of tobacco products under various circumstances and specifies how these factors will be used. Specifically:

- Subdivision (a)(1) describes the application of law to the typical transaction involving finished tobacco products purchased in an arm’s-length transaction by a distributor.
- Subdivision (a)(2) provides definitions of significant terms used in the regulation, including: arm’s-length; discounts or trade allowances; distribution and distribute; distributor; finished tobacco products and finished condition; production, produce, and processing; profit; similarly situated distributors; supplier; tobacco product costs; tobacco products; and wholesale cost.
- Subdivision (b) describes the situations where the Board will presume that a transaction between the specified parties was not at arm’s length and provides that a party may rebut this presumption by showing, by a preponderance of the evidence, that the transaction was at arms length.⁷
- Subdivision (c) specifies that, for purposes of the tax imposed under the Law, the taxable wholesale cost of tobacco products shall be the “tobacco product costs,” as defined, exclusive of any discounts or trade allowances.
- Subdivision (d) specifies the various methods by which tobacco product costs should be computed, depending on the circumstances involved. Paragraph (1) describes four situations: (1) when a distributor purchases finished tobacco products from its supplier; (2) when a distributor

⁶ The intent of the voters of California, in enacting Prop. 99, was to increase the state tax on cigarettes and tobacco products and to thereby: (1) reduce smoking and other tobacco use among children; (2) support medical research into tobacco-related cancer, heart, and lung diseases; (3) treat people suffering from tobacco-related diseases; and (4) in recognition of the uncompensated costs of tobacco-related illness, support treatment of patients who cannot afford to pay for services. (Prop. 99, § 2, subd. (e).)

⁷ The initial draft of the proposed regulation required the distributor to rebut the presumption by clear and convincing evidence. However, in response to several oral comments made during the interested parties meeting, staff has revised the text to remove this phrase, resulting in the application of the typical preponderance of the evidence standard. (See Exhibit 2.)

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produces finished tobacco products from raw materials; (3) when a distributor imports tobacco products from outside the United States; and (4) when a distributor receives free samples of tobacco products from his or her supplier.

Paragraph (2) clarifies that, in situations where a distributor incorrectly reports wholesale costs of tobacco products that include discounts and trade allowances, and where complete and reliable information is available to the Board, the Board may rely on this information to compute the correct wholesale cost and not utilize the alternative methods described in paragraph (3) to determine the correct wholesale cost.

Paragraph (3) provides alternative methods that the Board may use (and that distributors may rely on for guidance) for determining tobacco product costs where a distributor incorrectly reports wholesale costs of tobacco products that include discounts and trade allowances and when complete and reliable information is not available or where the Board determines that a distributor purchased or acquired tobacco products in transactions that were not at arm's length. Under such circumstances, paragraph (3) explains that the Board may rely on a publicly or commercially available price list used by the distributor to determine the prices of tobacco products it sold to its customers in arm's-length transactions, or the Board may rely on industry data relevant to the time during which the transactions occurred.

- Subdivision (e) provides examples that describe how wholesale cost will be determined under various circumstances, pursuant to the various provisions of the regulation.

B. Pros of the Staff Recommendation

1. The proposed regulation will provide clarification and additional guidance to distributors to assist them in complying with the tobacco products tax law. It is anticipated that the clarification provided will increase proper reporting by distributors of tobacco products taxes and decrease reporting errors, which will enable the distributors to avoid audit deficiencies.
2. The proposed regulation will clarify and provide clear guidance to staff in its administration of the tobacco products tax and will provide accurate and consistent direction to taxpayers.
3. The proposed regulation effectively addresses numerous misunderstandings and disputes that arise in the administration of the tobacco products tax with respect to the determination of the wholesale cost of a distributor's tobacco products, such as application of discounts and trade allowances, whether federal excise tax and other costs should be included, and what costs should be included when the distributor produces a finished tobacco product.
4. The proposed regulation interprets, clarifies, and makes specific the tobacco products tax statutory scheme consistent with the Legislature's intent that wholesale tobacco costs, which do not include discounts or trade allowances, be taxed and, further assists distributors in accurately determining their correct tobacco products tax liability when transactions occur between related entities.
5. Proposed Regulation 4076 will insure that distributors are properly taxed, consistent with the Legislature's mandate, on the wholesale cost of their tobacco products, not on costs that include discounts or trade allowances, stated or unstated.

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C. Cons of the Staff Recommendation

1. If the proposed regulation is adopted, some distributors may find that they must change how they determine the amount of wholesale cost they report to the Board.
2. Based on some of the comments received, if proposed Regulation 4076 is adopted, its validity may be challenged in court.

D. Statutory or Regulatory Change for the Staff Recommendation

No statutory or other regulatory change is required at this time with respect to adoption and implementation of proposed Regulation 4076.

E. Operational Impact of the Staff Recommendation

Upon approval by the Office of Administrative Law (OAL), staff will be required to notify taxpayers, in particular the distributor community, of the new regulation through special notices sent in conjunction with their next several returns, through articles in the Sales and Use Tax Information Bulletin and Excise Taxes Newsletter, and through alerts posted on the Board's Web site. Additional outreach efforts by staff will include electronic notification to persons (e.g., distributors and their representatives) who subscribe to the Board's electronic update service (a "LISTSERV" notice) and mailing of a special notice to distributors. Further, publication 15, *California Cigarette and Tobacco Products Tax – Regulations Issued Pursuant to Part 13, Division 2*, will need to be updated to include Regulation 4076 and appropriate references to it, as will volume 3 of the Business Taxes Law Guide (BTLG). In addition, staff will conduct one or more training sessions for auditors and other persons who interact with tobacco products distributors to ensure that questions received from taxpayers about the provisions of Regulation 4076 are responded to accurately and consistently. Lastly, staff will be available to answer questions from distributors about how Regulation 4076 affects their particular situations.

F. Administrative Impact of the Staff Recommendation

1. Cost Impact

The costs associated with adoption of Regulation 4076 would be minimal and absorbable. The costs of updating tax returns and publications to reference the new regulation, of updating the Board's Web site, and mailing notices and newsletters are provided for in the program's budget. Staff training is done on an ongoing basis.

2. Revenue Impact

None. (See Exhibit 1.)

G. Taxpayer/Customer Impact of the Staff Recommendation

Distributors of tobacco products will need to review their business operations to ensure that they correctly applying the provisions of Regulation 4076 as they relate to their particular businesses – e.g., what costs to include and not include in determining their tobacco products costs, what constitutes a discount or trade allowance, when the presumption that a transaction was not at arm's length applies, etc. Distributors are encouraged to contact Excise Taxes Division staff if they are unsure how these provisions affect how and what they report to the Board, or if they have any questions or wish to obtain additional information.

H. Critical Time Frames of the Staff Recommendation

None.

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VII. Alternative 2

A. Description of Alternative 2

As proposed by Mr. Chris McCalla, Legislative Director, International Premium Cigar & Pipe Retailers Association (IPCPRA), on behalf of 96 premium retail tobacco shop owners, amend the language recommended by staff to delete subparagraph (d)(3)(C) of the proposed regulation. (See Exhibit 2B.)

B. Pros of Alternative 2

Would delete language that may be ambiguous and lead to unintended miscalculations by the Board when determining final cost. Otherwise, same as the pros listed under the staff recommendation.

C. Cons of Alternative 2

Would delete language that illustrates additional methods available to the Board for determining a distributor's correct wholesale cost. Otherwise, same as the cons listed under the staff recommendation.

D. Statutory or Regulatory Change for Alternative 2

None.

E. Operational Impact of Alternative 2

Same as staff's recommendation.

F. Administrative Impact of Alternative 2

1. Cost Impact

Same as staff's recommendation.

2. Revenue Impact

None. (See Exhibit 1.)

G. Taxpayer/Customer Impact of Alternative 2

Same as staff's recommendation.

H. Critical Time Frames of Alternative 2

None.

VIII. Alternative 3

A. Description of Alternative 3

As proposed by Mr. Adam Wall, Wall and Welch's Cigars, amend the language recommended by staff to clarify that federal excise taxes should not be included in the calculation of the distributor's wholesale cost. (See Exhibit 2C.)

B. Pros of Alternative 3

Removal of federal excise taxes from the calculation of tobacco products costs and, consequently, from the wholesale costs a distributor reports to the Board could be considered by some distributors to establish a fairer measure of tax. Otherwise, same as the pros listed under the staff recommendation.

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C. Cons of Alternative 3

The removal of federal excise taxes from the calculation of tobacco products costs and, consequently, from the wholesale costs a distributor reports to the Board would improperly reduce the taxable measure distributors should report to the Board since, historically, federal excise taxes have correctly been included in the measure of tax. Otherwise, same as the cons listed under the staff recommendation.

D. Statutory or Regulatory Change for Alternative 3

None. However, this alternative may have unintended consequences with respect to the tobacco products rate setting methodology – i.e., if federal excise taxes are excluded from the wholesale cost calculations, the tobacco products tax rate would increase.

E. Operational Impact of Alternative 3

Same as staff's recommendation.

F. Administrative Impact of Alternative 3

1. Cost Impact

Same as staff's recommendation.

2. Revenue Impact

None. (See Exhibit 1.)

G. Taxpayer/Customer Impact of Alternative 3

Same as staff's recommendation.

H. Critical Time Frames of Alternative 3

None.

IX. Alternative 4

A. Description of Alternative 4

As proposed by Ms. Amy Silverstein, on behalf of Philip Morris USA, John Middleton Company, and U.S. Smokeless Tobacco Brands, Inc., and Mr. Dennis Loper, on behalf of the California Distributors Association (CDA), do not adopt proposed Cigarette and Tobacco Products Tax Regulation 4076.

B. Pros of Alternative 4

Does not require regulatory changes, notification to taxpayers, or revisions to Board publications.

C. Cons of Alternative 4

1. Misunderstandings and disputes, including unintended and unforeseen audit deficiencies, will continue to occur regarding what constitutes the cost of tobacco products to the distributor, such as the application of discounts and trade allowances – particularly in situations involving non-arm's-length transactions between related parties, whether federal excise tax and other costs should be included, and what costs should be included when the distributor produces a finished tobacco product. Confusion as to the proper measure of tax affects the calculation of the proper tax amount a distributor should report to the Board.

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2. The Board has a duty to identify areas of noncompliance and to educate taxpayers and assist them in understanding their obligations and lessen their compliance burden under the tax law. Additionally, the Board is responsible for ensuring that there is uniform application and treatment under the laws it administers. Failure to address the issues identified in this paper would permit tobacco products distributors to continue to, often inadvertently, incorrectly report their taxes, which will result in future audit deficiencies, plus interest and penalties.
3. Failure to address, by way of this regulation, the emerging issue of unstated discounts in transactions between related parties would permit some tobacco products distributors to engage in related-party transactions in an attempt to artificially lower the wholesale costs below the undiscounted tax base provided for by the Legislature.

D. Statutory or Regulatory Change for Alternative 4

None.

E. Operational Impact of Alternative 4

None.

F. Administrative Impact of Alternative 4

1. Cost Impact

None.

2. Revenue Impact

None. (See Exhibit 1.)

G. Taxpayer/Customer Impact of Alternative 4

None.

H. Critical Time Frames of Alternative 4

None.

Preparer/Reviewer Information

Prepared by: Tax and Fee Programs Division, Legal Department
Excise Taxes Division, Property and Special Taxes Department

Current as of: May 6, 2010

Regulation 4076 – Wholesale Cost of Tobacco Products

LIST OF EXHIBITS

<u>Description</u>	<u>Exhibit No.</u>
Revenue Estimate	Exhibit 1
Regulation 4076 – Wholesale Cost of Tobacco Products	
Alternative 1 – Staff Recommendation	Exhibit 2A
Alternative 2	Exhibit 2B
Alternative 3	Exhibit 2C
Comparison Table	Exhibit 2D
Submission from Amy L. Silverstein Silverstein & Pomerantz, LLP Attorneys at Law (2/16/10)	Exhibit 3
Submission from Adam Wall, Wall and Welch’s Cigars (3/9/10)	Exhibit 4
Submission from Chris McCalla, Legislative Director International Premium Cigar & Pipe Retailers Association (IPCRA) (3/17/10)	Exhibit 5
Submission from Dennis L. Loper, Executive Director California Distributors Association (3/26/10)	Exhibit 6
Submission from Amy L. Silverstein Silverstein & Pomerantz, LLP Attorneys at Law (3/26/10)	Exhibit 7

REVENUE ESTIMATE

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

**Wholesale Cost of Tobacco Products
Proposed Regulation 4076****Alternative 1 – Staff Recommendation**

Staff recommends that the Board authorize the publication of proposed Regulation 4076 to be added to the Cigarette and Tobacco Products Tax Regulations. Regulation 4076 would implement, interpret, and make specific Revenue and Taxation Code section 30017, which defines “wholesale cost” to mean “the cost of tobacco products to the distributor prior to any discounts or trade allowances.” Regulation 4076 would clarify and make specific: (1) how distributors of tobacco products should compute and report the wholesale cost of the tobacco products, other than cigarettes, they distribute; and (2) how the Board may determine the wholesale cost of these tobacco products in those situations where a distributor has not reported accurate wholesale cost amounts upon which the calculation of the tax due on tobacco products is based.

Other Alternative Considered**Alternative 2**

As proposed by Mr. Chris McCalla, Legislative Director of the International Premium Cigar & Pipe Retailers Association (IPCPR), on behalf of 96 premium retail tobacco shop owners, amend the language recommended by staff to delete subparagraph (d)(3)(C) of the proposed regulation.

Alternative 3

As proposed by Mr. Adam Wall of Wall and Welch’s Cigars, amend the language recommended by staff to clarify that federal excise taxes should not be included in the calculation of the tobacco products distributor’s wholesale cost.

Alternative 4

As proposed by Ms. Amy Silverstein, on behalf of Philip Morris USA, John Middleton Company, and U.S. Smokeless Tobacco Brands, Inc., and Mr. Dennis Loper, on behalf of the California Distributors Association (CDA), do not adopt proposed Cigarette and Tobacco Products Tax Regulation 4076.

Background, Methodology, and Assumptions

Alternative 1 – Staff Recommendation

There is nothing in the staff recommendation that would impact excise tax revenue because it reflects the Board's current interpretation and construction of Revenue and Taxation Code section 30017, and also staff's long-term policies and practices in applying this statute. The staff recommendation further clarifies and makes specific how the wholesale cost of the tobacco products is determined under the Cigarette and Tobacco Products Tax Law, including, but not limited to, situations where a distributor has not reported accurate wholesale cost amounts pursuant to R&TC section 30017 (e.g., by reporting as the "wholesale cost" the distributors "actual cost" without adjusting for discounts or trade allowances received). Proposed Regulation 4076 codifies the Board's longstanding practices and clarifies the factors that are to be considered when determining the wholesale cost of tobacco products under various circumstances and specifies how these factors will be used.

Other Alternatives Considered

Alternative 2 - Mr. Chris McCalla

There is nothing in the alternative 2 that would impact excise tax revenue. Mr. McCalla's recommendation would delete language that may be ambiguous and lead to unintended miscalculations by the Board when determining final cost. Conversely, staff argues that the suggestion proposed in alternative 2 would delete language that illustrates additional methods available to the Board for determining a distributor's correct wholesale cost in the absence of reliable and accurate cost data. Neither position would impact excise revenue collections.

Alternative 3 - Mr. Adam Wall

Alternative 3 will not have an impact on excise tax revenues. Mr. Adam Wall's recommendation would amend the language recommended by staff to clarify that federal excise taxes should not be included in the calculation of the distributor's wholesale cost. The incremental revenue loss that would result by excluding the excise tax from the distributor's wholesale cost would be offset by the increase that would occur in the tobacco products rate from this exclusion.

Alternative 4 – Various Proponents

Alternative 4 will not have an impact on excise tax revenues. The various proponents of alternative 4 recommend that the Board do not adopt the proposed Cigarette and Tobacco Products Tax Regulation 4076.

Revenue Estimate

Revenue Summary

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

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

Alternative 3 – alternative 3 does not have a revenue impact.

Alternative 4 – alternative 4 does not have a revenue impact.

Preparation

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

Current as of May 5, 2010

Regulation 4076. WHOLESALE COST OF TOBACCO PRODUCTS.

(a) General.

(1) **Revenue & Taxation Code § 30017.** This regulation interprets, clarifies, and makes specific Revenue and Taxation Code Section 30017, which provides that the “wholesale cost” of tobacco products is “the cost of tobacco products to the distributor prior to any discounts or trade allowances.” The wholesale cost of tobacco products to the distributor for arm’s-length transactions involving finished tobacco products is the price of the finished tobacco products as shown on complete and reliable invoices for those products before any discounts and trade allowances have been applied, inclusive of federal excise tax but exclusive of freight-in costs.

(2) **Definitions.** The following definitions shall apply for purposes of this regulation:

(A) **Arm’s-length.** An “arm’s-length” transaction means a purchase or other business transaction entered into in good faith and for valuable consideration that reflects the fair market value in the open market between two informed and willing parties, neither under any compulsion to participate in the transaction.

(B) **Discounts or trade allowances.** “Discounts or trade allowances” means and includes any discounts, price reductions, or allowances of any kind, whether stated or unstated, made by the supplier in setting a price, including, without limitation, any discounts applied to a supplier’s price list, such as for prompt payment, payment in cash, bulk purchases, related-party transactions, or favored customer status.

(C) **Distribution; distribute.** “Distribution” and “distribute” mean: (i) the sale of untaxed tobacco products in the state; (ii) the use or consumption of untaxed tobacco products in the state; or (iii) the placing of untaxed tobacco products in retail stock in the state for the purpose of selling the tobacco products to consumers.

(D) **Distributor.** “Distributor” means every person that: (i) distributes tobacco products; or (ii) sells or accepts an order for tobacco products that are to be transported from a point outside the state to a consumer within the state, excluding original importers, as described in Revenue and Taxation Code Section 30105.

(E) **Finished tobacco products; finished condition.** “Finished tobacco products” and tobacco products in “finished condition” mean and include tobacco products that will not be subject to any additional processing before first distribution in the state.

(F) **Production; produce; processing.** “Production,” “produce,” and “processing” mean and include a fabrication process, or a step in a fabrication process, leading to the production of a finished tobacco product.

(G) **Profit.** “Profit” means the positive gain from an investment or business operation after subtracting all costs and expenses determined in accordance with generally accepted accounting principles.

- (H) **Similarly situated distributors.** “Similarly situated distributors” means distributors operating under reasonably similar economic and market circumstances, which may include consideration of such factors as: the location of the distributor; the location of the distributor’s customers; whether the distributor is a manufacturer, wholesaler, or retailer; or the nature of the presentation or marketing of the tobacco products.
- (I) **Supplier.** “Supplier” means any manufacturer, seller, or transferor that sold or transferred tobacco products to the distributor whose wholesale costs are being determined.
- (J) **Tobacco product costs.** “Tobacco product costs” means and includes the cost of tobacco products to the distributor, inclusive of federal excise taxes but exclusive of freight-in costs, determined as set forth below in paragraph (d), as of either (i) the date the distributor acquires finished tobacco products or (ii) the date the distributor completes production of finished tobacco products.
- (K) **Tobacco products.** “Tobacco products” includes, but is not limited to, all forms of cigars, smoking tobacco, chewing tobacco, snuff, and any other articles or products made of, or containing at least 50 percent, tobacco, but does not include cigarettes.
- (L) **Wholesale cost.** “Wholesale cost” means tobacco product costs, prior to and exclusive of any discounts or trade allowances. “Wholesale cost does not include the cost of tobacco products that were returned by a customer during the same reporting period in which the tobacco products were distributed if the distributor refunds the entire amount the customer paid for the tobacco products either in cash or credit. For purposes of this subparagraph, refund or credit of the entire amount shall be deemed to be given when the purchase price less rehandling and restocking costs is refunded or credited to the customer. The amount withheld for rehandling and restocking costs may be a percentage of the sales price determined by the average cost of rehandling and restocking returned merchandise during the previous accounting cycle.

(b) Presumption – not-at-arm’s length.

(1) **Presumption.** Sales, purchases, and transfers of tobacco products are rebuttably presumed to be not at arm’s length if they are between related parties such as: relatives (by blood or marriage, which relationships include, but are not limited to, spouses, parents, children and siblings); partners or a partnership and its partners; a limited liability company or association and its members; commonly controlled corporations; a corporation and its shareholders; or persons, as defined in Revenue and Taxation Code Section 30010, and entities under their control or between commonly controlled entities.

(2) **Rebuttal of Presumption.** If the board determines that a sale, purchase, or transfer of tobacco products was between related parties as set forth in paragraph (1), the distributor may rebut the presumption that the sale, purchase, or transfer was not at arm’s length by showing that the price, terms, and conditions of the transaction were substantially equivalent to those that would have been negotiated between unrelated parties in an arm’s-length transaction.

(c) Calculation of the taxable wholesale cost of tobacco products. For purposes of the tax set forth in Revenue and Taxation Code Section 30123, subdivision (b), and Section 30131.2, subdivision (b), the taxable wholesale cost of tobacco products shall be the “tobacco product costs,” as determined pursuant to subdivision (d) below, exclusive of any discounts or trade allowances.

(d) Calculation of tobacco product costs. The board shall determine tobacco product costs in accordance with the following:

(1) **Standard methods for determining tobacco product costs.** Except as provided in paragraphs (2) and (3) below, tobacco product costs shall be determined as follows:

(A) Tobacco product costs to a distributor that acquires finished tobacco products from a supplier. When a distributor acquires tobacco products in finished condition from a supplier, tobacco product costs shall be equal to the cumulative costs paid or incurred by the distributor for and with respect to the acquisition of the finished tobacco products, inclusive of federal excise tax but exclusive of freight-in costs.

(B) Tobacco product costs to a distributor that produces finished tobacco products. When a distributor produces finished tobacco products, tobacco product costs shall be equal to the sum of all direct and indirect costs that the distributor paid or incurred with respect to the production of finished tobacco products. Such costs include, without limitation, all of the distributor’s outlays and expenditures, such as amounts paid to suppliers for raw tobacco, the costs of overhead, labor, other materials, and their related freight-in costs, paid or incurred in the production process and also include the costs of advertising and marketing the finished tobacco product to purchasers and customers and prospective purchasers and customers, as well as the federal excise tax.

(C) Tobacco product costs to a distributor that imports tobacco products or finished tobacco products from outside the United States. In addition to the costs described in subparagraphs (A) and (B) above, a distributor’s tobacco product costs for finished tobacco products that the distributor acquires or produces shall also include customs fees and federal excise taxes on finished tobacco products and tobacco products that the distributor imports from outside the United States.

(D) Tobacco product costs to a distributor that acquires finished tobacco products free of charge, or as a free sample, from a supplier. Where a distributor acquires finished tobacco products free of charge, or as a free sample, from a supplier, the distributor shall be considered to have acquired the finished tobacco products at a 100 percent discount. In such event, the board may determine the tobacco product costs of those finished tobacco products in accordance with one or more of the alternative methods for determining tobacco product costs set forth in paragraph (3) below.

(2) **Addition of discount and trade allowance amounts to tobacco product costs to calculate wholesale cost.** If the board determines that, instead of reporting wholesale costs, the distributor reported tobacco product costs that included express, implicit, or unstated discounts or trade allowances, and complete and reliable information is available to the board allowing it to

reasonably estimate the amounts of such discounts or trade allowances, then the board may rely upon such information to reasonably estimate the distributor's correct wholesale costs, prior to and exclusive of discounts and trade allowances, by adding such estimated discount and trade allowance amounts to the tobacco product costs reported by the distributor or otherwise determined under paragraph (1).

(3) Alternative methods of estimating or calculating tobacco product costs.

(A) If the board determines that (i) the distributor reported tobacco product costs that included express, implicit, or unstated discounts or trade allowances and complete and reliable information sufficient to reasonably estimate the amounts of such discounts or trade allowances is not available to the board or (ii) the distributor purchased or acquired tobacco products in one or more not-at-arm's-length transactions, then the board may determine tobacco product costs by relying upon one or more of the methods set forth in subparagraphs (B) and (C) below.

(B) The board may rely upon a publicly or commercially available price list that the distributor used to determine the prices of tobacco products sold to customers in arm's-length transactions during the time period at issue, less a reasonable estimate of the distributor's or a similarly situated distributor's profit.

(C) If a publicly or commercially available price list is not available to the board, the board may reasonably estimate tobacco product costs by relying upon industry data from the time period at issue that provide reasonable evidence of typical or normal tobacco product costs during such time period, including, but not limited to:

- (i) evidence reasonably indicative of the typical costs of the same or similar tobacco products for similarly situated distributors, with appropriate adjustments to such costs as indicated by all the facts and circumstances;
- (ii) all the direct and indirect costs that the supplier paid or incurred with respect to acquisition, production, marketing, and sale of the tobacco products sold by the supplier to the distributor, with appropriate adjustments to such costs as indicated by all the facts and circumstances, plus a reasonable estimate of the supplier's profit;
- (iii) the price of the same or similar tobacco products as reflected in a supplier's price list, with appropriate adjustments to such price as indicated by all the facts and circumstances; or
- (iv) the retail price of the same or similar tobacco products as reflected in a retailer's price list, with appropriate adjustments to such price as indicated by all the facts and circumstances, less reasonable estimates of the retailer's and distributor's profits.

(e) Examples:

(1) **Example 1:** Distributor A purchases a finished tobacco product from a domestic supplier in an arm's-length transaction. A's wholesale cost of the tobacco product is the amount A paid to the supplier for the tobacco product, inclusive of federal excise tax, but exclusive of any freight costs, discounts, and trade allowances.

(2) **Example 2:** Distributor B produces handmade cigars. B's tobacco product costs include all of the direct and indirect costs that B paid or incurred with respect to the production, plus packaging, advertising, and marketing of the cigars and federal excise tax.

(3) **Example 3:** Distributor C purchases tobacco products from a subsidiary corporation in which it owns or controls more than 50 percent of the voting stock. Due to this corporate relationship between seller and buyer, the board presumes that the sale and purchase were not at arm's length, and the presumption is not rebutted by C. In the absence of more reliable cost information, if a publicly or commercially available price list that C used during the time period to determine its prices to unrelated customers is available, then the board may use that price list, less a reasonable estimate of C's or a similarly situated distributor's profit, to estimate C's tobacco product costs. If, however, no such publicly or commercially available price list is available, then the board may determine tobacco product costs by relying upon any information available, including other industry data, such as (A) supplier costs plus a reasonable estimate of supplier profit, (B) the price lists of other similarly situated distributors less a reasonable estimate of the distributors' profits, (C) supplier price lists, or (D) retailer price lists less a reasonable estimate of retailer and distributor profits, as described in subparagraph (d)(3)(C).

(4) **Example 4:** Distributor D acquires tobacco product free of charge and reports no wholesale cost for the product on its Tobacco Products Distributor Tax Return. The board determines that D acquired such tobacco product at a 100 percent discount or trade allowance. If a publicly or commercially available price list that D used during the time period to determine its sales prices to unrelated customers is available, then the board may use that price list, less a reasonable estimate of D's profit, to estimate D's tobacco product costs. If, however, no such publicly or commercially available price list is available, then the board may determine tobacco product costs by relying upon other industry data, such as (A) supplier costs plus a reasonable estimate of supplier profit, (B) the price lists of other similarly situated distributors less a reasonable estimate of the distributors' profits, (C) supplier price lists, or (D) retailer price lists less a reasonable estimate of retailer and distributor profits, as described in subparagraph (d)(3)(C).

(5) **Example 5:** Distributor E acquires tobacco products or finished tobacco products from a supplier outside the United States. E's tobacco product costs include, in addition to all other production or acquisition costs, the costs of all customs fees and federal excise taxes paid or incurred by E with respect to such tobacco products.

(6) **Example 6:** The board questions whether the amount Distributor F has reported as its wholesale cost is correct, and Distributor F provides the board with complete and reliable information that supports its costs and the discount amount that was applied. The board reviews the information and determines that it is satisfied with the costs, including the discount amount, as reported and that no further action is needed.

Note: *Authority:* Section 30451, Revenue and Taxation Code. *Reference:* Sections 30008, 30010, 30011, 30017, 30105, 30121, 30123, 30131.2, 30201, and 30221, Revenue and Taxation Code.

Remove from staff's proposal subparagraph (d)(3)(C) and the last sentence of both paragraphs (e)(3) and (e)(4), starting with "If, however,".

Regulation 4076. WHOLESALE COST OF TOBACCO PRODUCTS.**(a) General.**

(1) **Revenue & Taxation Code § 30017.** This regulation interprets, clarifies, and makes specific Revenue and Taxation Code Section 30017, which provides that the "wholesale cost" of tobacco products is "the cost of tobacco products to the distributor prior to any discounts or trade allowances." The wholesale cost of tobacco products to the distributor for arm's-length transactions involving finished tobacco products is the price of the finished tobacco products as shown on complete and reliable invoices for those products before any discounts and trade allowances have been applied, inclusive of federal excise tax but exclusive of freight-in costs.

(2) **Definitions.** The following definitions shall apply for purposes of this regulation:

(A) **Arm's-length.** An "arm's-length" transaction means a purchase or other business transaction entered into in good faith and for valuable consideration that reflects the fair market value in the open market between two informed and willing parties, neither under any compulsion to participate in the transaction.

(B) **Discounts or trade allowances.** "Discounts or trade allowances" means and includes any discounts, price reductions, or allowances of any kind, whether stated or unstated, made by the supplier in setting a price, including, without limitation, any discounts applied to a supplier's price list, such as for prompt payment, payment in cash, bulk purchases, related-party transactions, or favored customer status.

(C) **Distribution; distribute.** "Distribution" and "distribute" mean: (i) the sale of untaxed tobacco products in the state; (ii) the use or consumption of untaxed tobacco products in the state; or (iii) the placing of untaxed tobacco products in retail stock in the state for the purpose of selling the tobacco products to consumers.

(D) **Distributor.** "Distributor" means every person that: (i) distributes tobacco products; or (ii) sells or accepts an order for tobacco products that are to be transported from a point outside the state to a consumer within the state, excluding original importers, as described in Revenue and Taxation Code Section 30105.

(E) **Finished tobacco products; finished condition.** "Finished tobacco products" and tobacco products in "finished condition" mean and include tobacco products that will not be subject to any additional processing before first distribution in the state.

(F) **Production; produce; processing.** "Production," "produce," and "processing" mean and include a fabrication process, or a step in a fabrication process, leading to the production of a finished tobacco product.

Remove from staff's proposal subparagraph (d)(3)(C) and the last sentence of both paragraphs (e)(3) and (e)(4), starting with "If, however,".

- (G) **Profit.** "Profit" means the positive gain from an investment or business operation after subtracting all costs and expenses determined in accordance with generally accepted accounting principles.
- (H) **Similarly situated distributors.** "Similarly situated distributors" means distributors operating under reasonably similar economic and market circumstances, which may include consideration of such factors as: the location of the distributor; the location of the distributor's customers; whether the distributor is a manufacturer, wholesaler, or retailer; or the nature of the presentation or marketing of the tobacco products.
- (I) **Supplier.** "Supplier" means any manufacturer, seller, or transferor that sold or transferred tobacco products to the distributor whose wholesale costs are being determined.
- (J) **Tobacco product costs.** "Tobacco product costs" means and includes the cost of tobacco products to the distributor, inclusive of federal excise taxes but exclusive of freight-in costs, determined as set forth below in paragraph (d), as of either (i) the date the distributor acquires finished tobacco products or (ii) the date the distributor completes production of finished tobacco products.
- (K) **Tobacco products.** "Tobacco products" includes, but is not limited to, all forms of cigars, smoking tobacco, chewing tobacco, snuff, and any other articles or products made of, or containing at least 50 percent, tobacco, but does not include cigarettes.
- (L) **Wholesale cost.** "Wholesale cost" means tobacco product costs, prior to and exclusive of any discounts or trade allowances. "Wholesale cost does not include the cost of tobacco products that were returned by a customer during the same reporting period in which the tobacco products were distributed if the distributor refunds the entire amount the customer paid for the tobacco products either in cash or credit. For purposes of this subparagraph, refund or credit of the entire amount shall be deemed to be given when the purchase price less rehandling and restocking costs is refunded or credited to the customer. The amount withheld for rehandling and restocking costs may be a percentage of the sales price determined by the average cost of rehandling and restocking returned merchandise during the previous accounting cycle.

(b) Presumption – not-at-arm's length.

(1) **Presumption.** Sales, purchases, and transfers of tobacco products are rebuttably presumed to be not at arm's length if they are between related parties such as: relatives (by blood or marriage, which relationships include, but are not limited to, spouses, parents, children and siblings); partners or a partnership and its partners; a limited liability company or association and its members; commonly controlled corporations; a corporation and its shareholders; or persons, as defined in Revenue and Taxation Code Section 30010, and entities under their control or between commonly controlled entities.

Remove from staff's proposal subparagraph (d)(3)(C) and the last sentence of both paragraphs (e)(3) and (e)(4), starting with "If, however,".

(2) **Rebuttal of Presumption.** If the board determines that a sale, purchase, or transfer of tobacco products was between related parties as set forth in paragraph (1), the distributor may rebut the presumption that the sale, purchase, or transfer was not at arm's length by showing that the price, terms, and conditions of the transaction were substantially equivalent to those that would have been negotiated between unrelated parties in an arm's-length transaction.

(c) **Calculation of the taxable wholesale cost of tobacco products.** For purposes of the tax set forth in Revenue and Taxation Code Section 30123, subdivision (b), and Section 30131.2, subdivision (b), the taxable wholesale cost of tobacco products shall be the "tobacco product costs," as determined pursuant to subdivision (d) below, exclusive of any discounts or trade allowances.

(d) **Calculation of tobacco product costs.** The board shall determine tobacco product costs in accordance with the following:

(1) **Standard methods for determining tobacco product costs.** Except as provided in paragraphs (2) and (3) below, tobacco product costs shall be determined as follows:

(A) **Tobacco product costs to a distributor that acquires finished tobacco products from a supplier.** When a distributor acquires tobacco products in finished condition from a supplier, tobacco product costs shall be equal to the cumulative costs paid or incurred by the distributor for and with respect to the acquisition of the finished tobacco products, inclusive of federal excise tax but exclusive of freight-in costs.

(B) **Tobacco product costs to a distributor that produces finished tobacco products.** When a distributor produces finished tobacco products, tobacco product costs shall be equal to the sum of all direct and indirect costs that the distributor paid or incurred with respect to the production of finished tobacco products. Such costs include, without limitation, all of the distributor's outlays and expenditures, such as amounts paid to suppliers for raw tobacco, the costs of overhead, labor, other materials, and their related freight-in costs, paid or incurred in the production process and also include the costs of advertising and marketing the finished tobacco product to purchasers and customers and prospective purchasers and customers, as well as the federal excise tax.

(C) **Tobacco product costs to a distributor that imports tobacco products or finished tobacco products from outside the United States.** In addition to the costs described in subparagraphs (A) and (B) above, a distributor's tobacco product costs for finished tobacco products that the distributor acquires or produces shall also include customs fees and federal excise taxes on finished tobacco products and tobacco products that the distributor imports from outside the United States.

(D) **Tobacco product costs to a distributor that acquires finished tobacco products free of charge, or as a free sample, from a supplier.** Where a distributor acquires finished tobacco products free of charge, or as a free sample, from a supplier, the distributor shall be considered to have acquired the finished tobacco products at a 100 percent discount.

Remove from staff's proposal subparagraph (d)(3)(C) and the last sentence of both paragraphs (e)(3) and (e)(4), starting with "If, however,".

In such event, the board may determine the tobacco product costs of those finished tobacco products in accordance with one or more of the alternative methods for determining tobacco product costs set forth in paragraph (3) below.

(2) **Addition of discount and trade allowance amounts to tobacco product costs to calculate wholesale cost.** If the board determines that, instead of reporting wholesale costs, the distributor reported tobacco product costs that included express, implicit, or unstated discounts or trade allowances, and complete and reliable information is available to the board allowing it to reasonably estimate the amounts of such discounts or trade allowances, then the board may rely upon such information to reasonably estimate the distributor's correct wholesale costs, prior to and exclusive of discounts and trade allowances, by adding such estimated discount and trade allowance amounts to the tobacco product costs reported by the distributor or otherwise determined under paragraph (1).

(3) **Alternative methods of estimating or calculating tobacco product costs.**

(A) If the board determines that (i) the distributor reported tobacco product costs that included express, implicit, or unstated discounts or trade allowances and complete and reliable information sufficient to reasonably estimate the amounts of such discounts or trade allowances is not available to the board or (ii) the distributor purchased or acquired tobacco products in one or more not-at-arm's-length transactions, then the board may determine tobacco product costs by relying upon one or more of the methods set forth in subparagraphs (B) and (C) below.

(B) The board may rely upon a publicly or commercially available price list that the distributor used to determine the prices of tobacco products sold to customers in arm's-length transactions during the time period at issue, less a reasonable estimate of the distributor's or a similarly situated distributor's profit.

(e) **Examples:**

(1) **Example 1:** Distributor A purchases a finished tobacco product from a domestic supplier in an arm's-length transaction. A's wholesale cost of the tobacco product is the amount A paid to the supplier for the tobacco product, inclusive of federal excise tax, but exclusive of any freight costs, discounts, and trade allowances.

(2) **Example 2:** Distributor B produces handmade cigars. B's tobacco product costs include all of the direct and indirect costs that B paid or incurred with respect to the production, plus packaging, advertising, and marketing of the cigars and federal excise tax.

(3) **Example 3:** Distributor C purchases tobacco products from a subsidiary corporation in which it owns or controls more than 50 percent of the voting stock. Due to this corporate relationship between seller and buyer, the board presumes that the sale and purchase were not at arm's length, and the presumption is not rebutted by C. In the absence of more reliable cost information, if a publicly or commercially available price list that C used during the time period

Remove from staff's proposal subparagraph (d)(3)(C) and the last sentence of both paragraphs (e)(3) and (e)(4), starting with "If, however,".

to determine its prices to unrelated customers is available, then the board may use that price list, less a reasonable estimate of C's or a similarly situated distributor's profit, to estimate C's tobacco product costs.

(4) **Example 4:** Distributor D acquires tobacco product free of charge and reports no wholesale cost for the product on its Tobacco Products Distributor Tax Return. The board determines that D acquired such tobacco product at a 100 percent discount or trade allowance. If a publicly or commercially available price list that D used during the time period to determine its sales prices to unrelated customers is available, then the board may use that price list, less a reasonable estimate of D's profit, to estimate D's tobacco product costs.

(5) **Example 5:** Distributor E acquires tobacco products or finished tobacco products from a supplier outside the United States. E's tobacco product costs include, in addition to all other production or acquisition costs, the costs of all customs fees and federal excise taxes paid or incurred by E with respect to such tobacco products.

(6) **Example 6:** The board questions whether the amount Distributor F has reported as its wholesale cost is correct, and Distributor F provides the board with complete and reliable information that supports its costs and the discount amount that was applied. The board reviews the information and determines that it is satisfied with the costs, including the discount amount, as reported and that no further action is needed.

Note: *Authority:* Section 30451, Revenue and Taxation Code. *Reference:* Sections 30008, 30010, 30011, 30017, 30105, 30121, 30123, 30131.2, 30201, and 30221, Revenue and Taxation Code.

Remove from staff's version language in paragraphs (a)(1), (a)(2)(J), (d)(1)(A), (d)(1)(B), (e)(1), and (e)(2) that includes federal excise tax and replace with language that excludes federal excise tax in the calculation of the tobacco product costs.

Regulation 4076. WHOLESALE COST OF TOBACCO PRODUCTS.

(a) General.

(1) **Revenue & Taxation Code § 30017.** This regulation interprets, clarifies, and makes specific Revenue and Taxation Code Section 30017, which provides that the “wholesale cost” of tobacco products is “the cost of tobacco products to the distributor prior to any discounts or trade allowances.” The wholesale cost of tobacco products to the distributor for arm’s-length transactions involving finished tobacco products is the price of the finished tobacco products as shown on complete and reliable invoices for those products before any discounts and trade allowances have been applied, exclusive of federal excise tax and freight-in costs.

(2) **Definitions.** The following definitions shall apply for purposes of this regulation:

(A) **Arm’s-length.** An “arm’s-length” transaction means a purchase or other business transaction entered into in good faith and for valuable consideration that reflects the fair market value in the open market between two informed and willing parties, neither under any compulsion to participate in the transaction.

(B) **Discounts or trade allowances.** “Discounts or trade allowances” means and includes any discounts, price reductions, or allowances of any kind, whether stated or unstated, made by the supplier in setting a price, including, without limitation, any discounts applied to a supplier’s price list, such as for prompt payment, payment in cash, bulk purchases, related-party transactions, or favored customer status.

(C) **Distribution; distribute.** “Distribution” and “distribute” mean: (i) the sale of untaxed tobacco products in the state; (ii) the use or consumption of untaxed tobacco products in the state; or (iii) the placing of untaxed tobacco products in retail stock in the state for the purpose of selling the tobacco products to consumers.

(D) **Distributor.** “Distributor” means every person that: (i) distributes tobacco products; or (ii) sells or accepts an order for tobacco products that are to be transported from a point outside the state to a consumer within the state, excluding original importers, as described in Revenue and Taxation Code Section 30105.

(E) **Finished tobacco products; finished condition.** “Finished tobacco products” and tobacco products in “finished condition” mean and include tobacco products that will not be subject to any additional processing before first distribution in the state.

(F) **Production; produce; processing.** “Production,” “produce,” and “processing” mean and include a fabrication process, or a step in a fabrication process, leading to the production of a finished tobacco product.

Proposed by Mr. Adam Wall, Wall and Welch's Cigars

Remove from staff's version language in paragraphs (a)(1), (a)(2)(J), (d)(1)(A), (d)(1)(B), (e)(1), and (e)(2) that includes federal excise tax and replace with language that excludes federal excise tax in the calculation of the tobacco product costs.

- (G) **Profit.** "Profit" means the positive gain from an investment or business operation after subtracting all costs and expenses determined in accordance with generally accepted accounting principles.
- (H) **Similarly situated distributors.** "Similarly situated distributors" means distributors operating under reasonably similar economic and market circumstances, which may include consideration of such factors as: the location of the distributor; the location of the distributor's customers; whether the distributor is a manufacturer, wholesaler, or retailer; or the nature of the presentation or marketing of the tobacco products.
- (I) **Supplier.** "Supplier" means any manufacturer, seller, or transferor that sold or transferred tobacco products to the distributor whose wholesale costs are being determined.
- (J) **Tobacco product costs.** "Tobacco product costs" means and includes the cost of tobacco products to the distributor, exclusive of federal excise taxes and freight-in costs, determined as set forth below in paragraph (d), as of either (i) the date the distributor acquires finished tobacco products or (ii) the date the distributor completes production of finished tobacco products.
- (K) **Tobacco products.** "Tobacco products" includes, but is not limited to, all forms of cigars, smoking tobacco, chewing tobacco, snuff, and any other articles or products made of, or containing at least 50 percent, tobacco, but does not include cigarettes.
- (L) **Wholesale cost.** "Wholesale cost" means tobacco product costs, prior to and exclusive of any discounts or trade allowances. "Wholesale cost does not include the cost of tobacco products that were returned by a customer during the same reporting period in which the tobacco products were distributed if the distributor refunds the entire amount the customer paid for the tobacco products either in cash or credit. For purposes of this subparagraph, refund or credit of the entire amount shall be deemed to be given when the purchase price less rehandling and restocking costs is refunded or credited to the customer. The amount withheld for rehandling and restocking costs may be a percentage of the sales price determined by the average cost of rehandling and restocking returned merchandise during the previous accounting cycle.

(b) Presumption – not-at-arm's length.

(1) **Presumption.** Sales, purchases, and transfers of tobacco products are rebuttably presumed to be not at arm's length if they are between related parties such as: relatives (by blood or marriage, which relationships include, but are not limited to, spouses, parents, children and siblings); partners or a partnership and its partners; a limited liability company or association and its members; commonly controlled corporations; a corporation and its shareholders; or persons, as defined in Revenue and Taxation Code Section 30010, and entities under their control or between commonly controlled entities.

Proposed by Mr. Adam Wall, Wall and Welch's Cigars

Remove from staff's version language in paragraphs (a)(1), (a)(2)(J), (d)(1)(A), (d)(1)(B), (e)(1), and (e)(2) that includes federal excise tax and replace with language that excludes federal excise tax in the calculation of the tobacco product costs.

(2) **Rebuttal of Presumption.** If the board determines that a sale, purchase, or transfer of tobacco products was between related parties as set forth in paragraph (1), the distributor may rebut the presumption that the sale, purchase, or transfer was not at arm's length by showing that the price, terms, and conditions of the transaction were substantially equivalent to those that would have been negotiated between unrelated parties in an arm's-length transaction.

(c) **Calculation of the taxable wholesale cost of tobacco products.** For purposes of the tax set forth in Revenue and Taxation Code Section 30123, subdivision (b), and Section 30131.2, subdivision (b), the taxable wholesale cost of tobacco products shall be the "tobacco product costs," as determined pursuant to subdivision (d) below, exclusive of any discounts or trade allowances.

(d) **Calculation of tobacco product costs.** The board shall determine tobacco product costs in accordance with the following:

(1) **Standard methods for determining tobacco product costs.** Except as provided in paragraphs (2) and (3) below, tobacco product costs shall be determined as follows:

(A) **Tobacco product costs to a distributor that acquires finished tobacco products from a supplier.** When a distributor acquires tobacco products in finished condition from a supplier, tobacco product costs shall be equal to the cumulative costs paid or incurred by the distributor for and with respect to the acquisition of the finished tobacco products, exclusive of federal excise tax and freight-in costs.

(B) **Tobacco product costs to a distributor that produces finished tobacco products.** When a distributor produces finished tobacco products, tobacco product costs shall be equal to the sum of all direct and indirect costs that the distributor paid or incurred with respect to the production of finished tobacco products. Such costs include, without limitation, all of the distributor's outlays and expenditures, such as amounts paid to suppliers for raw tobacco, the costs of overhead, labor, other materials, and their related freight-in costs, paid or incurred in the production process and also include the costs of advertising and marketing the finished tobacco product to purchasers and customers and prospective purchasers and customers, but not the federal excise tax.

(C) **Tobacco product costs to a distributor that imports tobacco products or finished tobacco products from outside the United States.** In addition to the costs described in subparagraphs (A) and (B) above, a distributor's tobacco product costs for finished tobacco products that the distributor acquires or produces shall also include customs fees and federal excise taxes on finished tobacco products and tobacco products that the distributor imports from outside the United States.

(D) **Tobacco product costs to a distributor that acquires finished tobacco products free of charge, or as a free sample, from a supplier.** Where a distributor acquires finished tobacco products free of charge, or as a free sample, from a supplier, the distributor shall

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Remove from staff's version language in paragraphs (a)(1), (a)(2)(J), (d)(1)(A), (d)(1)(B), (e)(1), and (e)(2) that includes federal excise tax and replace with language that excludes federal excise tax in the calculation of the tobacco product costs.

be considered to have acquired the finished tobacco products at a 100 percent discount. In such event, the board may determine the tobacco product costs of those finished tobacco products in accordance with one or more of the alternative methods for determining tobacco product costs set forth in paragraph (3) below.

(2) Addition of discount and trade allowance amounts to tobacco product costs to calculate wholesale cost. If the board determines that, instead of reporting wholesale costs, the distributor reported tobacco product costs that included express, implicit, or unstated discounts or trade allowances, and complete and reliable information is available to the board allowing it to reasonably estimate the amounts of such discounts or trade allowances, then the board may rely upon such information to reasonably estimate the distributor's correct wholesale costs, prior to and exclusive of discounts and trade allowances, by adding such estimated discount and trade allowance amounts to the tobacco product costs reported by the distributor or otherwise determined under paragraph (1).

(3) Alternative methods of estimating or calculating tobacco product costs.

(A) If the board determines that (i) the distributor reported tobacco product costs that included express, implicit, or unstated discounts or trade allowances and complete and reliable information sufficient to reasonably estimate the amounts of such discounts or trade allowances is not available to the board or (ii) the distributor purchased or acquired tobacco products in one or more not-at-arm's-length transactions, then the board may determine tobacco product costs by relying upon one or more of the methods set forth in subparagraphs (B) and (C) below.

(B) The board may rely upon a publicly or commercially available price list that the distributor used to determine the prices of tobacco products sold to customers in arm's-length transactions during the time period at issue, less a reasonable estimate of the distributor's or a similarly situated distributor's profit.

(C) If a publicly or commercially available price list is not available to the board, the board may reasonably estimate tobacco product costs by relying upon industry data from the time period at issue that provide reasonable evidence of typical or normal tobacco product costs during such time period, including, but not limited to:

- (i) evidence reasonably indicative of the typical costs of the same or similar tobacco products for similarly situated distributors, with appropriate adjustments to such costs as indicated by all the facts and circumstances;
- (ii) all the direct and indirect costs that the supplier paid or incurred with respect to acquisition, production, marketing, and sale of the tobacco products sold by the supplier to the distributor, with appropriate adjustments to such costs as indicated by all the facts and circumstances, plus a reasonable estimate of the supplier's profit;

Proposed by Mr. Adam Wall, Wall and Welch's Cigars

Remove from staff's version language in paragraphs (a)(1), (a)(2)(J), (d)(1)(A), (d)(1)(B), (e)(1), and (e)(2) that includes federal excise tax and replace with language that excludes federal excise tax in the calculation of the tobacco product costs.

- (iii) the price of the same or similar tobacco products as reflected in a supplier's price list, with appropriate adjustments to such price as indicated by all the facts and circumstances; or
- (iv) the retail price of the same or similar tobacco products as reflected in a retailer's price list, with appropriate adjustments to such price as indicated by all the facts and circumstances, less reasonable estimates of the retailer's and distributor's profits.

(e) Examples:

(1) **Example 1:** Distributor A purchases a finished tobacco product from a domestic supplier in an arm's-length transaction. A's wholesale cost of the tobacco product is the amount A paid to the supplier for the tobacco product, exclusive of federal excise tax, freight costs, discounts, and trade allowances.

(2) **Example 2:** Distributor B produces handmade cigars. B's tobacco product costs include all of the direct and indirect costs that B paid or incurred with respect to the production, plus packaging, advertising, and marketing of the cigars but not federal excise tax.

(3) **Example 3:** Distributor C purchases tobacco products from a subsidiary corporation in which it owns or controls more than 50 percent of the voting stock. Due to this corporate relationship between seller and buyer, the board presumes that the sale and purchase were not at arm's length, and the presumption is not rebutted by C. In the absence of more reliable cost information, if a publicly or commercially available price list that C used during the time period to determine its prices to unrelated customers is available, then the board may use that price list, less a reasonable estimate of C's or a similarly situated distributor's profit, to estimate C's tobacco product costs. If, however, no such publicly or commercially available price list is available, then the board may determine tobacco product costs by relying upon any information available, including other industry data, such as (A) supplier costs plus a reasonable estimate of supplier profit, (B) the price lists of other similarly situated distributors less a reasonable estimate of the distributors' profits, (C) supplier price lists, or (D) retailer price lists less a reasonable estimate of retailer and distributor profits, as described in subparagraph (d)(3)(C).

(4) **Example 4:** Distributor D acquires tobacco product free of charge and reports no wholesale cost for the product on its Tobacco Products Distributor Tax Return. The board determines that D acquired such tobacco product at a 100 percent discount or trade allowance. If a publicly or commercially available price list that D used during the time period to determine its sales prices to unrelated customers is available, then the board may use that price list, less a reasonable estimate of D's profit, to estimate D's tobacco product costs. If, however, no such publicly or commercially available price list is available, then the board may determine tobacco product costs by relying upon other industry data, such as (A) supplier costs plus a reasonable estimate of supplier profit, (B) the price lists of other similarly situated distributors less a reasonable estimate of the distributors' profits, (C) supplier price lists, or (D) retailer price lists less a reasonable estimate of retailer and distributor profits, as described in subparagraph (d)(3)(C).

Remove from staff's version language in paragraphs (a)(1), (a)(2)(J), (d)(1)(A), (d)(1)(B), (e)(1), and (e)(2) that includes federal excise tax and replace with language that excludes federal excise tax in the calculation of the tobacco product costs.

(5) **Example 5:** Distributor E acquires tobacco products or finished tobacco products from a supplier outside the United States. E's tobacco product costs include, in addition to all other production or acquisition costs, the costs of all customs fees and federal excise taxes paid or incurred by E with respect to such tobacco products.

(6) **Example 6:** The board questions whether the amount Distributor F has reported as its wholesale cost is correct, and Distributor F provides the board with complete and reliable information that supports its costs and the discount amount that was applied. The board reviews the information and determines that it is satisfied with the costs, including the discount amount, as reported and that no further action is needed.

Note: *Authority:* Section 30451, Revenue and Taxation Code. *Reference:* Sections 30008, 30010, 30011, 30017, 30105, 30121, 30123, 30131.2, 30201, and 30221, Revenue and Taxation Code.

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Proposed by Staff	Proposed by Mr. Chris McCalla, International Premium Cigar & Pipe Retailers Association	Proposed by Mr. Adam Wall, Wall and Welch's Cigars
<p>Regulation 4076. WHOLESALE COST OF TOBACCO PRODUCTS.</p>	<p>Regulation 4076. WHOLESALE COST OF TOBACCO PRODUCTS.</p> <p><i>Remove from staff's proposal subparagraph (d)(3)(C) and the last sentence of both paragraphs (e)(3) and (e)(4), starting with "If, however,".</i></p>	<p>Regulation 4076. WHOLESALE COST OF TOBACCO PRODUCTS.</p> <p><i>Remove from staff's version language in paragraphs (a)(1), (a)(2)(J), (d)(1)(A), (d)(1)(B), (e)(1), and (e)(2) that includes federal excise tax and replace with language that excludes federal excise tax in the calculation of the tobacco product costs.</i></p>
<p><u>(a) General.</u></p> <p><u>(1) Revenue & Taxation Code § 30017.</u> This regulation interprets, clarifies, and makes specific Revenue and Taxation Code Section 30017, which provides that the "wholesale cost" of tobacco products is "the cost of tobacco products to the distributor prior to any discounts or trade allowances." The wholesale cost of tobacco products to the distributor for arm's-length transactions involving finished tobacco products is the price of the finished tobacco products as shown on complete and reliable invoices for those products before any discounts and trade allowances have been applied, inclusive of federal excise tax but exclusive of freight-in costs.</p> <p><u>(2a) Definitions.</u>Definition of terms.The following definitions shall apply for purposes of this regulation:</p> <p>(A) Arm's-length. An "arm's-length" transaction means a purchase or other business transaction entered into in good faith and for valuable consideration that reflects the fair market value in the open market between two informed and willing parties, neither under any compulsion to participate in the transaction.</p>	<p><u>(a) General.</u></p> <p><u>(1) Revenue & Taxation Code § 30017.</u> This regulation interprets, clarifies, and makes specific Revenue and Taxation Code Section 30017, which provides that the "wholesale cost" of tobacco products is "the cost of tobacco products to the distributor prior to any discounts or trade allowances." The wholesale cost of tobacco products to the distributor for arm's-length transactions involving finished tobacco products is the price of the finished tobacco products as shown on complete and reliable invoices for those products before any discounts and trade allowances have been applied, inclusive of federal excise tax but exclusive of freight-in costs.</p> <p><u>(2a) Definitions.</u>Definition of terms.The following definitions shall apply for purposes of this regulation:</p> <p>(A) Arm's-length. An "arm's-length" transaction means a purchase or other business transaction entered into in good faith and for valuable consideration that reflects the fair market value in the open market between two informed and willing parties, neither under any compulsion to participate in the transaction.</p>	<p><u>(a) General.</u></p> <p><u>(1) Revenue & Taxation Code § 30017.</u> This regulation interprets, clarifies, and makes specific Revenue and Taxation Code Section 30017, which provides that the "wholesale cost" of tobacco products is "the cost of tobacco products to the distributor prior to any discounts or trade allowances." The wholesale cost of tobacco products to the distributor for arm's-length transactions involving finished tobacco products is the price of the finished tobacco products as shown on complete and reliable invoices for those products before any discounts and trade allowances have been applied, inclusiveexclusive of federal excise tax but exclusive of and freight-in costs.</p> <p><u>(2a) Definitions.</u>Definition of terms.The following definitions shall apply for purposes of this regulation:</p> <p>(A) Arm's-length. An "arm's-length" transaction means a purchase or other business transaction entered into in good faith and for valuable consideration that reflects the fair market value in the open market between two informed and willing parties, neither under any compulsion to participate in the transaction.</p>

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<p>(B) Discounts or trade allowances. “Discounts or trade allowances” means and includes any discounts, price reductions, or allowances of any kind, <u>whether stated or unstated</u>, made by the supplier in setting a price, including, without limitation, any discounts applied to a supplier’s price list, such as for prompt payment, payment in cash, bulk purchases, <u>related-party transactions</u>, or favored customer status.</p> <p>(C) Distribution; distribute. “Distribution” and “distribute” mean: (iA) the sale of untaxed tobacco products in the state; (iiB) the use or consumption of untaxed tobacco products in the state; or (iiiC) the placing of untaxed tobacco products in retail stock in the state for the purpose of selling the tobacco products to consumers.</p> <p>(D) Distributor. “Distributor” means every person that: (iA) distributes tobacco products; or (iiB) sells or accepts an order for tobacco products that are to be transported from a point outside the state to a consumer within the state, <u>excluding original importers, as described in Revenue and Taxation Code Section 30105</u>.</p> <p>(E) Finished tobacco products; finished condition. “Finished tobacco products” and tobacco products in “finished condition” mean and include tobacco products that will not be subject to any additional processing before first distribution in the state.</p> <p>(F) Production; produce; processing. “Production,” “produce,” and “processing” mean and include a</p>	<p>(B) Discounts or trade allowances. “Discounts or trade allowances” means and includes any discounts, price reductions, or allowances of any kind, <u>whether stated or unstated</u>, made by the supplier in setting a price, including, without limitation, any discounts applied to a supplier’s price list, such as for prompt payment, payment in cash, bulk purchases, <u>related-party transactions</u>, or favored customer status.</p> <p>(C) Distribution; distribute. “Distribution” and “distribute” mean: (iA) the sale of untaxed tobacco products in the state; (iiB) the use or consumption of untaxed tobacco products in the state; or (iiiC) the placing of untaxed tobacco products in retail stock in the state for the purpose of selling the tobacco products to consumers.</p> <p>(D) Distributor. “Distributor” means every person that: (iA) distributes tobacco products; or (iiB) sells or accepts an order for tobacco products that are to be transported from a point outside the state to a consumer within the state, <u>excluding original importers, as described in Revenue and Taxation Code Section 30105</u>.</p> <p>(E) Finished tobacco products; finished condition. “Finished tobacco products” and tobacco products in “finished condition” mean and include tobacco products that will not be subject to any additional processing before first distribution in the state.</p> <p>(F) Production; produce; processing. “Production,” “produce,” and “processing” mean and include a</p>	<p>(B) Discounts or trade allowances. “Discounts or trade allowances” means and includes any discounts, price reductions, or allowances of any kind, <u>whether stated or unstated</u>, made by the supplier in setting a price, including, without limitation, any discounts applied to a supplier’s price list, such as for prompt payment, payment in cash, bulk purchases, <u>related-party transactions</u>, or favored customer status.</p> <p>(C) Distribution; distribute. “Distribution” and “distribute” mean: (iA) the sale of untaxed tobacco products in the state; (iiB) the use or consumption of untaxed tobacco products in the state; or (iiiC) the placing of untaxed tobacco products in retail stock in the state for the purpose of selling the tobacco products to consumers.</p> <p>(D) Distributor. “Distributor” means every person that: (iA) distributes tobacco products; or (iiB) sells or accepts an order for tobacco products that are to be transported from a point outside the state to a consumer within the state, <u>excluding original importers, as described in Revenue and Taxation Code Section 30105</u>.</p> <p>(E) Finished tobacco products; finished condition. “Finished tobacco products” and tobacco products in “finished condition” mean and include tobacco products that will not be subject to any additional processing before first distribution in the state.</p> <p>(F) Production; produce; processing. “Production,” “produce,” and “processing” mean and include a</p>

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<p>fabrication process, or a step in a fabrication process, leading to the production of a finished tobacco product</p> <p>(G) Profit. “Profit” means the positive gain from an investment or business operation after subtracting all costs and expenses determined in accordance with generally accepted accounting principles.</p> <p>(H) Similarly situated distributors. “Similarly situated distributors” means distributors operating under reasonably similar economic and market circumstances, <u>which may include consideration of such factors as: the location of the distributor; the location of the distributor’s customers; whether the distributor is a manufacturer, wholesaler, or retailer; or the nature of the presentation or marketing of the tobacco products.</u></p> <p>(I) Supplier. “Supplier” means any manufacturer, seller, or transferor that sold or transferred tobacco products to the distributor whose wholesale costs are being determined.</p> <p>(J) Tobacco product costs. “Tobacco product costs” means and includes the cost of tobacco products to the distributor, <u>inclusive of federal excise taxes but exclusive of freight-in costs,</u> determined as set forth below in paragraph (d), as of either (iA) the date the distributor acquires finished tobacco products or (iiB) the date the distributor completes production of finished tobacco products.</p>	<p>fabrication process, or a step in a fabrication process, leading to the production of a finished tobacco product.</p> <p>(G) Profit. “Profit” means the positive gain from an investment or business operation after subtracting all costs and expenses determined in accordance with generally accepted accounting principles.</p> <p>(H) Similarly situated distributors. “Similarly situated distributors” means distributors operating under reasonably similar economic and market circumstances, <u>which may include consideration of such factors as: the location of the distributor; the location of the distributor’s customers; whether the distributor is a manufacturer, wholesaler, or retailer; or the nature of the presentation or marketing of the tobacco products.</u></p> <p>(I) Supplier. “Supplier” means any manufacturer, seller, or transferor that sold or transferred tobacco products to the distributor whose wholesale costs are being determined.</p> <p>(J) Tobacco product costs. “Tobacco product costs” means and includes the cost of tobacco products to the distributor, <u>inclusive of federal excise taxes but exclusive of freight-in costs,</u> determined as set forth below in paragraph (d), as of either (iA) the date the distributor acquires finished tobacco products or (iiB) the date the distributor completes production of finished tobacco products.</p>	<p>fabrication process, or a step in a fabrication process, leading to the production of a finished tobacco product.</p> <p>(G) Profit. “Profit” means the positive gain from an investment or business operation after subtracting all costs and expenses determined in accordance with generally accepted accounting principles.</p> <p>(H) Similarly situated distributors. “Similarly situated distributors” means distributors operating under reasonably similar economic and market circumstances, <u>which may include consideration of such factors as: the location of the distributor; the location of the distributor’s customers; whether the distributor is a manufacturer, wholesaler, or retailer; or the nature of the presentation or marketing of the tobacco products.</u></p> <p>(I) Supplier. “Supplier” means any manufacturer, seller, or transferor that sold or transferred tobacco products to the distributor whose wholesale costs are being determined.</p> <p>(J) Tobacco product costs. “Tobacco product costs” means and includes the cost of tobacco products to the distributor, <u>inclusiveexclusive of federal excise taxes but exclusive of and freight-in costs,</u> determined as set forth below in paragraph (d), as of either (iA) the date the distributor acquires finished tobacco products or (iiB) the date the distributor completes production of finished tobacco products.</p>

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<p>(K) Tobacco products. “Tobacco products” includes, but is not limited to, all forms of cigars, smoking tobacco, chewing tobacco, snuff, and any other articles or products made of, or containing at least 50 percent, tobacco, but does not include cigarettes.</p> <p>(L) Wholesale cost. “Wholesale cost” means tobacco product costs, prior to and exclusive of any discounts or trade allowances. <u>“Wholesale cost does not include but excluding the cost of tobacco products that were returned by a customer during the same reporting period in which the tobacco products were distributed if the distributor refunds the entire amount the customer paid for the tobacco products either in cash or credit. For purposes of this subparagraph, refund or credit of the entire amount shall be deemed to be given when the purchase price less rehandling and restocking costs is refunded or credited to the customer. The amount withheld for rehandling and restocking costs may be a percentage of the sales price determined by the average cost of rehandling and restocking returned merchandise during the previous accounting cycle.</u></p> <p>(b) Presumption – not-at-arm’s length.</p> <p><u>(1) Presumption.</u> Sales, purchases, and transfers of tobacco products are rebuttably presumed to be not at arm’s length if they are between related parties such as: and among relatives (by blood or marriage, which relationships include, but are not limited to, spouses, parents, children and siblings); partners or a partnership and its partners; a limited liability company or association and its members; <u>commonly</u></p>	<p>(K) Tobacco products. “Tobacco products” includes, but is not limited to, all forms of cigars, smoking tobacco, chewing tobacco, snuff, and any other articles or products made of, or containing at least 50 percent, tobacco, but does not include cigarettes.</p> <p>(L) Wholesale cost. “Wholesale cost” means tobacco product costs, prior to and exclusive of any discounts or trade allowances. <u>“Wholesale cost does not include but excluding the cost of tobacco products that were returned by a customer during the same reporting period in which the tobacco products were distributed if the distributor refunds the entire amount the customer paid for the tobacco products either in cash or credit. For purposes of this subparagraph, refund or credit of the entire amount shall be deemed to be given when the purchase price less rehandling and restocking costs is refunded or credited to the customer. The amount withheld for rehandling and restocking costs may be a percentage of the sales price determined by the average cost of rehandling and restocking returned merchandise during the previous accounting cycle.</u></p> <p>(b) Presumption – not-at-arm’s length.</p> <p><u>(1) Presumption.</u> Sales, purchases, and transfers of tobacco products are rebuttably presumed to be not at arm’s length if they are between related parties such as: and among relatives (by blood or marriage, which relationships include, but are not limited to, spouses, parents, children and siblings); partners or a partnership and its partners; a limited liability company or association and its members; <u>commonly</u></p>	<p>(K) Tobacco products. “Tobacco products” includes, but is not limited to, all forms of cigars, smoking tobacco, chewing tobacco, snuff, and any other articles or products made of, or containing at least 50 percent, tobacco, but does not include cigarettes.</p> <p>(L) Wholesale cost. “Wholesale cost” means tobacco product costs, prior to and exclusive of any discounts or trade allowances. <u>“Wholesale cost does not include but excluding the cost of tobacco products that were returned by a customer during the same reporting period in which the tobacco products were distributed if the distributor refunds the entire amount the customer paid for the tobacco products either in cash or credit. For purposes of this subparagraph, refund or credit of the entire amount shall be deemed to be given when the purchase price less rehandling and restocking costs is refunded or credited to the customer. The amount withheld for rehandling and restocking costs may be a percentage of the sales price determined by the average cost of rehandling and restocking returned merchandise during the previous accounting cycle.</u></p> <p>(b) Presumption – not-at-arm’s length.</p> <p><u>(1) Presumption.</u> Sales, purchases, and transfers of tobacco products are rebuttably presumed to be not at arm’s length if they are between related parties such as: and among relatives (by blood or marriage, which relationships include, but are not limited to, spouses, parents, children and siblings); partners or a partnership and its partners; a limited liability company or association and its members; <u>commonly</u></p>

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<p>controlled corporations; a corporation and its shareholders; and persons, as defined in Revenue and Taxation Code Section 30010, and entities under their control <u>or between commonly controlled entities</u>; are rebuttably presumed to be not at arm's length transactions.</p> <p>(2) Rebuttal of Presumption. If the Board determines that a sale, purchase, or transfer of tobacco products was between or among any of the related parties as set forth in this paragraph (1), the distributor may rebut the presumption <u>that the sale, purchase, or transfer was not at arm's length</u> only by showing by clear and convincing evidence that the transaction was, in fact, at arm's length or, alternatively that the price, terms, and conditions of the transaction were substantially equivalent to those that would have been negotiated between unrelated parties in an arm's-length transaction.</p> <p>(c) Calculation of the taxable wholesale cost of tobacco products. For purposes of the tax set forth in Revenue and Taxation Code Section 30123, subdivision (b), and Section 30131.2, subdivision (b), the taxable wholesale cost of tobacco products shall be the "tobacco product costs," as determined pursuant to subdivision (d) below, exclusive of any discounts or trade allowances.</p> <p>(d) Calculation of tobacco product costs. The Board shall determine tobacco product costs in accordance with the following:</p>	<p>controlled corporations; a corporation and its shareholders; and persons, as defined in Revenue and Taxation Code Section 30010, and entities under their control <u>or between commonly controlled entities</u>; are rebuttably presumed to be not at arm's length transactions.</p> <p>(2) Rebuttal of Presumption. If the Board determines that a sale, purchase, or transfer of tobacco products was between or among any of the related parties as set forth in this paragraph (1), the distributor may rebut the presumption <u>that the sale, purchase, or transfer was not at arm's length</u> only by showing by clear and convincing evidence that the transaction was, in fact, at arm's length or, alternatively that the price, terms, and conditions of the transaction were substantially equivalent to those that would have been negotiated between unrelated parties in an arm's-length transaction.</p> <p>(c) Calculation of the taxable wholesale cost of tobacco products. For purposes of the tax set forth in Revenue and Taxation Code Section 30123, subdivision (b), and Section 30131.2, subdivision (b), the taxable wholesale cost of tobacco products shall be the "tobacco product costs," as determined pursuant to subdivision (d) below, exclusive of any discounts or trade allowances.</p> <p>(d) Calculation of tobacco product costs. The Board shall determine tobacco product costs in accordance with the following:</p>	<p>controlled corporations; a corporation and its shareholders; and persons, as defined in Revenue and Taxation Code Section 30010, and entities under their control <u>or between commonly controlled entities</u>; are rebuttably presumed to be not at arm's length transactions.</p> <p>(2) Rebuttal of Presumption. If the Board determines that a sale, purchase, or transfer of tobacco products was between or among any of the related parties as set forth in this paragraph (1), the distributor may rebut the presumption <u>that the sale, purchase, or transfer was not at arm's length</u> only by showing by clear and convincing evidence that the transaction was, in fact, at arm's length or, alternatively that the price, terms, and conditions of the transaction were substantially equivalent to those that would have been negotiated between unrelated parties in an arm's-length transaction.</p> <p>(c) Calculation of the taxable wholesale cost of tobacco products. For purposes of the tax set forth in Revenue and Taxation Code Section 30123, subdivision (b), and Section 30131.2, subdivision (b), the taxable wholesale cost of tobacco products shall be the "tobacco product costs," as determined pursuant to subdivision (d) below, exclusive of any discounts or trade allowances.</p> <p>(d) Calculation of tobacco product costs. The Board shall determine tobacco product costs in accordance with the following:</p>

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<p>(1) Standard methods for determining tobacco product costs. Except as provided in paragraphs (2) and (3) below, tobacco product costs shall be determined as follows:</p> <p>(A) Tobacco product costs to a distributor that acquires finished tobacco products from a supplier. When a distributor acquires tobacco products in finished condition from a supplier, tobacco product costs shall be equal to the cumulative costs paid or incurred by the distributor for and with respect to the acquisition of the finished tobacco products, <u>inclusive of federal excise tax but exclusive of</u> freight-in costs.</p> <p>(B) Tobacco product costs to a distributor that produces finished tobacco products. When a distributor produces finished tobacco products, tobacco product costs shall be equal to the sum of all direct and indirect costs that the distributor paid or incurred with respect to the production of finished tobacco products. Such costs include, without limitation, all of the distributor's outlays and expenditures, such as amounts paid to suppliers for raw tobacco, the costs of overhead, labor, other materials, and their related freight-in costs, paid or incurred in the production process; and <u>also include</u> the costs of <u>advertising and</u> marketing the finished tobacco product to <u>purchasers and</u> customers and prospective <u>purchasers and</u> customers, <u>as well as the federal excise tax.</u></p>	<p>(1) Standard methods for determining tobacco product costs. Except as provided in paragraphs (2) and (3) below, tobacco product costs shall be determined as follows:</p> <p>(A) Tobacco product costs to a distributor that acquires finished tobacco products from a supplier. When a distributor acquires tobacco products in finished condition from a supplier, tobacco product costs shall be equal to the cumulative costs paid or incurred by the distributor for and with respect to the acquisition of the finished tobacco products, <u>inclusive of federal excise tax but exclusive of</u> freight-in costs.</p> <p>(B) Tobacco product costs to a distributor that produces finished tobacco products. When a distributor produces finished tobacco products, tobacco product costs shall be equal to the sum of all direct and indirect costs that the distributor paid or incurred with respect to the production of finished tobacco products. Such costs include, without limitation, all of the distributor's outlays and expenditures, such as amounts paid to suppliers for raw tobacco, the costs of overhead, labor, other materials, and their related freight-in costs, paid or incurred in the production process; and <u>also include</u> the costs of <u>advertising and</u> marketing the finished tobacco product to <u>purchasers and</u> customers and prospective <u>purchasers and</u> customers, <u>as well as the federal excise tax.</u></p>	<p>(1) Standard methods for determining tobacco product costs. Except as provided in paragraphs (2) and (3) below, tobacco product costs shall be determined as follows:</p> <p>(A) Tobacco product costs to a distributor that acquires finished tobacco products from a supplier. When a distributor acquires tobacco products in finished condition from a supplier, tobacco product costs shall be equal to the cumulative costs paid or incurred by the distributor for and with respect to the acquisition of the finished tobacco products, <u>inclusiveexclusive</u> of federal excise tax <u>but exclusive ofand</u> freight-in costs.</p> <p>(B) Tobacco product costs to a distributor that produces finished tobacco products. When a distributor produces finished tobacco products, tobacco product costs shall be equal to the sum of all direct and indirect costs that the distributor paid or incurred with respect to the production of finished tobacco products. Such costs include, without limitation, all of the distributor's outlays and expenditures, such as amounts paid to suppliers for raw tobacco, the costs of overhead, labor, other materials, and their related freight-in costs, paid or incurred in the production process; and <u>also include</u> the costs of <u>advertising and</u> marketing the finished tobacco product to <u>purchasers and</u> customers and prospective <u>purchasers and</u> customers, <u>as well asbut not</u> the federal excise tax.</p>

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<p>(C) Tobacco product costs to a distributor that imports tobacco products or finished tobacco products from outside the United States. In addition to the costs described in subparagraphs (A) and (B) above, a distributor's tobacco product costs for finished tobacco products that the distributor acquires or produces shall also include customs fees and federal excise taxes on finished tobacco products and tobacco products that the distributor imports from outside the United States.</p> <p>(D) Tobacco product costs to a distributor that acquires finished tobacco products free of charge, or as a free sample, from a supplier. Where a distributor acquires finished tobacco products free of charge, or as a free sample, from a supplier, the distributor shall be considered to have acquired the finished tobacco products at a 100 percent discount. In such event, the board, in its sole discretion, may determine the tobacco product costs of those finished tobacco products in accordance with one or more of the alternative methods for determining tobacco product costs set forth in paragraph (3) below.</p> <p>(2) Addition of discount and trade allowance amounts to tobacco product costs to calculate wholesale cost. If the board determines that, instead of reporting wholesale costs, the distributor reported tobacco product costs that included express, implicit, or</p>	<p>(C) Tobacco product costs to a distributor that imports tobacco products or finished tobacco products from outside the United States. In addition to the costs described in subparagraphs (A) and (B) above, a distributor's tobacco product costs for finished tobacco products that the distributor acquires or produces shall also include customs fees and federal excise taxes on finished tobacco products and tobacco products that the distributor imports from outside the United States.</p> <p>(D) Tobacco product costs to a distributor that acquires finished tobacco products free of charge, or as a free sample, from a supplier. Where a distributor acquires finished tobacco products free of charge, or as a free sample, from a supplier, the distributor shall be considered to have acquired the finished tobacco products at a 100 percent discount. In such event, the board, in its sole discretion, may determine the tobacco product costs of those finished tobacco products in accordance with one or more of the alternative methods for determining tobacco product costs set forth in paragraph (3) below.</p> <p>(2) Addition of discount and trade allowance amounts to tobacco product costs to calculate wholesale cost. If the board determines that, instead of reporting wholesale costs, the distributor reported tobacco product costs that included express, implicit, or</p>	<p>(C) Tobacco product costs to a distributor that imports tobacco products or finished tobacco products from outside the United States. In addition to the costs described in subparagraphs (A) and (B) above, a distributor's tobacco product costs for finished tobacco products that the distributor acquires or produces shall also include customs fees and federal excise taxes on finished tobacco products and tobacco products that the distributor imports from outside the United States.</p> <p>(D) Tobacco product costs to a distributor that acquires finished tobacco products free of charge, or as a free sample, from a supplier. Where a distributor acquires finished tobacco products free of charge, or as a free sample, from a supplier, the distributor shall be considered to have acquired the finished tobacco products at a 100 percent discount. In such event, the board, in its sole discretion, may determine the tobacco product costs of those finished tobacco products in accordance with one or more of the alternative methods for determining tobacco product costs set forth in paragraph (3) below.</p> <p>(2) Addition of discount and trade allowance amounts to tobacco product costs to calculate wholesale cost. If the board determines that, instead of reporting wholesale costs, the distributor reported tobacco product costs that included express, implicit, or</p>

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<p>unstated discounts or trade allowances, and complete and reliable information is available to the board allowing it to reasonably estimate the amounts of such discounts or trade allowances, then the board may rely upon such information to reasonably estimate the distributor's <u>correct</u> wholesale costs, prior to and exclusive of discounts and trade allowances, by adding such estimated discount and trade allowance amounts to the tobacco product costs reported by the distributor or otherwise determined under paragraph (1).</p> <p>(3) Alternative methods of estimating or calculating tobacco product costs.</p> <p>(A) If the board determines that (i) the distributor reported tobacco product costs that included express, implicit, or unstated discounts or trade allowances and complete and reliable information sufficient to reasonably estimate the amounts of such discounts or trade allowances is not available to the board or (ii) the distributor purchased or acquired tobacco products in one or more not-at-arm's-length transactions, then the board may, in its sole discretion, determine tobacco product costs by relying upon one or more of the methods set forth in subparagraphs (B) and (C) below.</p> <p>(B) The board may rely upon a publicly or commercially available price list that the distributor used to determine the prices of</p>	<p>unstated discounts or trade allowances, and complete and reliable information is available to the board allowing it to reasonably estimate the amounts of such discounts or trade allowances, then the board may rely upon such information to reasonably estimate the distributor's <u>correct</u> wholesale costs, prior to and exclusive of discounts and trade allowances, by adding such estimated discount and trade allowance amounts to the tobacco product costs reported by the distributor or otherwise determined under paragraph (1).</p> <p>(3) Alternative methods of estimating or calculating tobacco product costs.</p> <p>(A) If the board determines that (i) the distributor reported tobacco product costs that included express, implicit, or unstated discounts or trade allowances and complete and reliable information sufficient to reasonably estimate the amounts of such discounts or trade allowances is not available to the board or (ii) the distributor purchased or acquired tobacco products in one or more not-at-arm's-length transactions, then the board may, in its sole discretion, determine tobacco product costs by relying upon one or more of the methods set forth in subparagraphs (B) and (C) below.</p> <p>(B) The board may rely upon a publicly or commercially available price list that the distributor used to determine the prices of</p>	<p>unstated discounts or trade allowances, and complete and reliable information is available to the board allowing it to reasonably estimate the amounts of such discounts or trade allowances, then the board may rely upon such information to reasonably estimate the distributor's <u>correct</u> wholesale costs, prior to and exclusive of discounts and trade allowances, by adding such estimated discount and trade allowance amounts to the tobacco product costs reported by the distributor or otherwise determined under paragraph (1).</p> <p>(3) Alternative methods of estimating or calculating tobacco product costs.</p> <p>(A) If the board determines that (i) the distributor reported tobacco product costs that included express, implicit, or unstated discounts or trade allowances and complete and reliable information sufficient to reasonably estimate the amounts of such discounts or trade allowances is not available to the board or (ii) the distributor purchased or acquired tobacco products in one or more not-at-arm's-length transactions, then the board may, in its sole discretion, determine tobacco product costs by relying upon one or more of the methods set forth in subparagraphs (B) and (C) below.</p> <p>(B) The board may rely upon a publicly or commercially available price list that the distributor used to determine the prices of</p>

Regulation 4076, Wholesale Cost of Tobacco Products
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<p>tobacco products sold to customers in arm's-length transactions during the time period at issue, less a reasonable estimate of the distributor's <u>or a similarly situated distributor's</u> profit.</p> <p>(C) If a publicly or commercially available price list is not available to the board, the board may reasonably estimate tobacco product costs by relying upon industry data from the time period at issue that provide reasonable evidence of typical or normal tobacco product costs during the<u>such</u> time period at issue, including, <u>but not limited to</u> without <u>limitation</u>:</p> <p>(i) evidence reasonably indicative of the typical costs of the same or similar tobacco products for similarly situated distributors, with appropriate adjustments to such costs as indicated by all the facts and circumstances;</p> <p>(ii) all the direct and indirect costs that the supplier paid or incurred with respect to acquisition, production, marketing, and sale of the</p>	<p>tobacco products sold to customers in arm's-length transactions during the time period at issue, less a reasonable estimate of the distributor's <u>or a similarly situated distributor's</u> profit.</p> <p>(C) If a publicly or commercially available price list is not available to the board, the board may reasonably estimate tobacco product costs by relying upon industry data from the time period at issue that provide reasonable evidence of typical or normal tobacco product costs during the<u>such</u> time period at issue, including, <u>but not limited to</u> without <u>limitation</u>:</p> <p>(i) evidence reasonably indicative of the typical costs of the same or similar tobacco products for similarly situated distributors, with appropriate adjustments to such costs as indicated by all the facts and circumstances;</p> <p>(ii) all the direct and indirect costs that the supplier paid or incurred with respect to acquisition, production, marketing, and sale of the</p>	<p>tobacco products sold to customers in arm's-length transactions during the time period at issue, less a reasonable estimate of the distributor's <u>or a similarly situated distributor's</u> profit.</p> <p>(C) If a publicly or commercially available price list is not available to the board, the board may reasonably estimate tobacco product costs by relying upon industry data from the time period at issue that provide reasonable evidence of typical or normal tobacco product costs during the<u>such</u> time period at issue, including, <u>but not limited to</u> without <u>limitation</u>:</p> <p>(i) evidence reasonably indicative of the typical costs of the same or similar tobacco products for similarly situated distributors, with appropriate adjustments to such costs as indicated by all the facts and circumstances;</p> <p>(ii) all the direct and indirect costs that the supplier paid or incurred with respect to acquisition, production, marketing, and sale of the</p>

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<p>tobacco products sold by the supplier to the distributor, with appropriate adjustments to such costs as indicated by all the facts and circumstances, plus a reasonable estimate of the supplier's profit;</p> <p>(iii) the price of the same or similar tobacco products as reflected in a supplier's price list, with appropriate adjustments to such price as indicated by all the facts and circumstances; or</p> <p>(iv) the retail price of the same or similar tobacco products as reflected in a retailer's price list, with appropriate adjustments to such price as indicated by all the facts and circumstances, less reasonable estimates of the retailer's and distributor's profits.</p> <p>(e) Examples:</p> <p>(1) Example 1: Distributor A purchases a finished tobacco product from a domestic supplier in an arm's-length transaction. A's wholesale cost of the tobacco product is the amount A paid to the supplier for the tobacco product, <u>inclusive of federal excise tax, but</u> exclusive of any freight costs, discounts, and trade allowances.</p>	<p>tobacco products sold by the supplier to the distributor, with appropriate adjustments to such costs as indicated by all the facts and circumstances, plus a reasonable estimate of the supplier's profit;</p> <p>(iii) the price of the same or similar tobacco products as reflected in a supplier's price list, with appropriate adjustments to such price as indicated by all the facts and circumstances; or</p> <p>(iv) the retail price of the same or similar tobacco products as reflected in a retailer's price list, with appropriate adjustments to such price as indicated by all the facts and circumstances, less reasonable estimates of the retailer's and distributor's profits.</p> <p>(e) Examples:</p> <p>(1) Example 1: Distributor A purchases a finished tobacco product from a domestic supplier in an arm's-length transaction. A's wholesale cost of the tobacco product is the amount A paid to the supplier for the tobacco product, <u>inclusive of federal excise tax, but</u> exclusive of any freight costs, discounts, and trade allowances.</p>	<p>tobacco products sold by the supplier to the distributor, with appropriate adjustments to such costs as indicated by all the facts and circumstances, plus a reasonable estimate of the supplier's profit;</p> <p>(ii) the price of the same or similar tobacco products as reflected in a supplier's price list, with appropriate adjustments to such price as indicated by all the facts and circumstances; or</p> <p>(iv) the retail price of the same or similar tobacco products as reflected in a retailer's price list, with appropriate adjustments to such price as indicated by all the facts and circumstances, less reasonable estimates of the retailer's and distributor's profits.</p> <p>(e) Examples:</p> <p>(1) Example 1: Distributor A purchases a finished tobacco product from a domestic supplier in an arm's-length transaction. A's wholesale cost of the tobacco product is the amount A paid to the supplier for the tobacco product, <u>inclusive</u> exclusive of federal excise tax, but exclusive of any freight costs, discounts, and trade allowances.</p>

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<p>(2) Example 2: Distributor B produces handmade cigars. B's tobacco product costs include all of the direct and indirect costs that B paid or incurred with respect to the production, <u>plus</u> packaging, <u>advertising</u>, and marketing of the cigars <u>and federal excise tax</u>.</p> <p>(3) Example 3: Distributor C purchases tobacco products from a subsidiary corporation in which it owns or controls more than 50 percent of the voting stock. Due to this corporate relationship between seller and buyer, the board presumes that the sale and purchase were not at arm's length, and the presumption is not rebutted by C. <u>In the absence of more reliable cost information, if</u> a publicly or commercially available price list that C used during the time period to determine its prices to unrelated customers is available, then the board may use that price list, less a reasonable estimate of C's <u>or a similarly situated distributor's</u> profit, to estimate C's tobacco product costs. If, however, no such publicly or commercially available price list is available, then the board may determine tobacco product costs by relying upon <u>any information available, including</u> other industry data, such as (A) supplier costs plus a reasonable estimate of supplier profit, (B) the price lists of other similarly situated distributors less a reasonable estimate of <u>the distributors'</u> profits, (C) supplier price lists, or (D) retailer</p>	<p>(2) Example 2: Distributor B produces handmade cigars. B's tobacco product costs include all of the direct and indirect costs that B paid or incurred with respect to the production, <u>plus</u> packaging, <u>advertising</u>, and marketing of the cigars <u>and federal excise tax</u>.</p> <p>(3) Example 3: Distributor C purchases tobacco products from a subsidiary corporation in which it owns or controls more than 50 percent of the voting stock. Due to this corporate relationship between seller and buyer, the board presumes that the sale and purchase were not at arm's length, and the presumption is not rebutted by C. <u>In the absence of more reliable cost information, if</u> a publicly or commercially available price list that C used during the time period to determine its prices to unrelated customers is available, then the board may use that price list, less a reasonable estimate of C's <u>or a similarly situated distributor's</u> profit, to estimate C's tobacco product costs. <u>If, however, no such publicly or commercially available price list is available, then the board may determine tobacco product costs by relying upon any information available, including other industry data, such as (A) supplier costs plus a reasonable estimate of supplier profit, (B) the price lists of other similarly situated distributors less a reasonable estimate of the distributors' profits, (C) supplier price lists, or (D) retailer price lists less a reasonable estimate of</u></p>	<p>(2) Example 2: Distributor B produces handmade cigars. B's tobacco product costs include all of the direct and indirect costs that B paid or incurred with respect to the production, <u>plus</u> packaging, <u>advertising</u>, and marketing of the cigars, <u>andbut not federal excise tax</u>.</p> <p>(3) Example 3: Distributor C purchases tobacco products from a subsidiary corporation in which it owns or controls more than 50 percent of the voting stock. Due to this corporate relationship between seller and buyer, the board presumes that the sale and purchase were not at arm's length, and the presumption is not rebutted by C. <u>In the absence of more reliable cost information, if</u> a publicly or commercially available price list that C used during the time period to determine its prices to unrelated customers is available, then the board may use that price list, less a reasonable estimate of C's <u>or a similarly situated distributor's</u> profit, to estimate C's tobacco product costs. If, however, no such publicly or commercially available price list is available, then the board may determine tobacco product costs by relying upon <u>any information available, including</u> other industry data, such as (A) supplier costs plus a reasonable estimate of supplier profit, (B) the price lists of other similarly situated distributors less a reasonable estimate of <u>the distributors'</u> profits, (C) supplier price lists, or (D) retailer</p>

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<p>price lists less a reasonable estimate of retailer and distributor profits, as described in <u>subparagraph (d)(3)(C)</u>.</p> <p>(4) Example 4: Distributor D acquires tobacco product free of charge and reports no wholesale cost for the product on its Tobacco Products Distributor Tax Return. The board determines that D acquired such tobacco product at a 100 percent discount or trade allowance. If a publicly or commercially available price list that D used during the time period to determine its sales prices to unrelated customers is available, then the board may use that price list, less a reasonable estimate of D's profit, to estimate D's tobacco product costs. If, however, no such publicly or commercially available price list is available, then the board may determine tobacco product costs by relying upon other industry data, such as (A) supplier costs plus a reasonable estimate of supplier profit, (B) the price lists of other similarly situated distributors less a reasonable estimate of <u>the distributors' profits</u>, (C) supplier price lists, or (D) retailer price lists less a reasonable estimate of retailer and distributor profits, as described in <u>subparagraph (d)(3)(C)</u>.</p> <p>(5) Example 5: Distributor E acquires tobacco products or finished tobacco products from a supplier outside the United States. E's tobacco product costs include, in addition to all other production or acquisition costs, the</p>	<p>retailer and distributor profits, as described in subparagraph (d)(3)(C).</p> <p>(4) Example 4: Distributor D acquires tobacco product free of charge and reports no wholesale cost for the product on its Tobacco Products Distributor Tax Return. The board determines that D acquired such tobacco product at a 100 percent discount or trade allowance. If a publicly or commercially available price list that D used during the time period to determine its sales prices to unrelated customers is available, then the board may use that price list, less a reasonable estimate of D's profit, to estimate D's tobacco product costs. If, however, no such publicly or commercially available price list is available, then the board may determine tobacco product costs by relying upon other industry data, such as (A) supplier costs plus a reasonable estimate of supplier profit, (B) the price lists of other similarly situated distributors less a reasonable estimate of <u>the distributors' profits</u>, (C) supplier price lists, or (D) retailer price lists less a reasonable estimate of retailer and distributor profits, as described in subparagraph (d)(3)(C).</p> <p>(5) Example 5: Distributor E acquires tobacco products or finished tobacco products from a supplier outside the United States. E's tobacco product costs include, in addition to all other production or acquisition costs, the costs of all customs fees and federal excise</p>	<p>price lists less a reasonable estimate of retailer and distributor profits, as described in <u>subparagraph (d)(3)(C)</u>.</p> <p>(4) Example 4: Distributor D acquires tobacco product free of charge and reports no wholesale cost for the product on its Tobacco Products Distributor Tax Return. The board determines that D acquired such tobacco product at a 100 percent discount or trade allowance. If a publicly or commercially available price list that D used during the time period to determine its sales prices to unrelated customers is available, then the board may use that price list, less a reasonable estimate of D's profit, to estimate D's tobacco product costs. If, however, no such publicly or commercially available price list is available, then the board may determine tobacco product costs by relying upon other industry data, such as (A) supplier costs plus a reasonable estimate of supplier profit, (B) the price lists of other similarly situated distributors less a reasonable estimate of <u>the distributors' profits</u>, (C) supplier price lists, or (D) retailer price lists less a reasonable estimate of retailer and distributor profits, as described in <u>subparagraph (d)(3)(C)</u>.</p> <p>(5) Example 5: Distributor E acquires tobacco products or finished tobacco products from a supplier outside the United States. E's tobacco product costs include, in addition to all other production or acquisition costs, the</p>

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<p>costs of all customs fees and federal excise taxes paid or incurred by E with respect to such tobacco products.</p> <p><u>(6) Example 6:</u> The board questions whether the amount Distributor F has reported as its wholesale cost is correct, and Distributor F provides the board with complete and reliable information that supports its costs and the discount amount that was applied. The board reviews the information and determines that it is satisfied with the costs, including the discount amount, as reported and that no further action is needed.</p> <p>Note: <i>Authority:</i> Section 30451, Revenue and Taxation Code. <i>Reference:</i> Sections 30008, 30010, 30011, 30017, <u>30105</u>, 30121, 30123, and 30131.2, 30201, and 30221, Revenue and Taxation Code.</p>	<p>taxes paid or incurred by E with respect to such tobacco products.</p> <p><u>(6) Example 6:</u> The board questions whether the amount Distributor F has reported as its wholesale cost is correct, and Distributor F provides the board with complete and reliable information that supports its costs and the discount amount that was applied. The board reviews the information and determines that it is satisfied with the costs, including the discount amount, as reported and that no further action is needed.</p> <p>Note: <i>Authority:</i> Section 30451, Revenue and Taxation Code. <i>Reference:</i> Sections 30008, 30010, 30011, 30017, <u>30105</u>, 30121, 30123, and 30131.2, <u>30201</u>, and <u>30221</u>, Revenue and Taxation Code.</p>	<p>costs of all customs fees and federal excise taxes paid or incurred by E with respect to such tobacco products.</p> <p><u>(6) Example 6:</u> The board questions whether the amount Distributor F has reported as its wholesale cost is correct, and Distributor F provides the board with complete and reliable information that supports its costs and the discount amount that was applied. The board reviews the information and determines that it is satisfied with the costs, including the discount amount, as reported and that no further action is needed.</p> <p>Note: <i>Authority:</i> Section 30451, Revenue and Taxation Code. <i>Reference:</i> Sections 30008, 30010, 30011, 30017, <u>30105</u>, 30121, 30123, and 30131.2, 30201, and 30221, Revenue and Taxation Code.</p>

Silverstein &
Pomerantz LLP
ATTORNEYS AT LAW

55 HAWTHORNE STREET, SUITE 440
SAN FRANCISCO, CA 94105
PHONE (415) 593-3500
FACSIMILE (415) 593-3501

CALIFORNIA | COLORADO

WWW.SPTAXLAW.COM

Writer's Direct Contact
Telephone: (415) 593-3502
asilverstein@sptaxlaw.com

February 16, 2010

VIA EMAIL

Ms. Carolee Johnstone
Tax Counsel
Legal Department
State Board of Equalization
450 N. Street
Sacramento, California 94279

RE: Interested Parties Hearing (2/17/10) - Comments on Draft California Regulation 4076, determination of "wholesale cost of tobacco products" for purposes of calculating the tax on tobacco products pursuant to California Cigarette and Tobacco Tax Law (the "Proposed Regulation")

To Whom It May Concern:

Please accept these comments regarding Draft California Regulation 4076 on behalf of Philip Morris USA ("PM USA"), John Middleton Company ("JMC") and U.S. Smokeless Tobacco Brands Inc ("USSTB") – (collectively, the Companies"). The Companies are all licensed distributors of tobacco products in the State of California.

The Proposed Regulation purports to "clarify existing law" with respect to the determination of a distributor's "wholesale cost," and, thereby, "to assist distributors...in determining the wholesale cost of their products." The determination of wholesale cost is at issue in *U.S. Smokeless Tobacco Brands Inc. v. State Board of Equalization*, pending in the San Francisco Superior Court. The Court has issued a tentative decision in that case, hereinafter referred to as the "Tentative Decision," and a final decision is expected shortly.

The Companies generally support regulations that, consistent with the law, improve clarity and eliminate confusion, particularly those that clarify the tax base for tobacco products. However, we are very concerned that far from clarifying the law, the Proposed Regulation would increase complexity and confusion, leading to more disputes and ultimately more litigation. In effect, the Proposed Regulation would replace the statutory tax base of actual "cost to the distributor," a tax base that is well settled, and easily understood, with a



55 HAWTHORNE STREET, SUITE 440
SAN FRANCISCO, CA 94105
PHONE (415) 593-3500
FACSIMILE (415) 593-3501

CALIFORNIA | COLORADO

WWW.SPTANLAW.COM

series of vague rules purporting to govern various factual scenarios that might arise, and those vague rules are in turn rife with ambiguous and undefined terms. But what is more troubling than even the complexity and confusion, the Proposed Regulation is contrary to existing law and, thus, would be invalid if promulgated and would likely result in immediate legal challenge.

I. The Proposed Regulation is contrary to existing law and, thus, would be illegal if adopted.

It is a fundamental rule of administrative law that a regulation must be consistent with, and true to, the statutory or other law under which it is promulgated. Thus, Government Code Section 11342.2 provides: “Whenever by the express or implied terms of any statute a state agency has authority to adopt regulations to implement, interpret, make specific or otherwise carry out the provisions of the statute, *no regulation adopted is valid or effective unless consistent and not in conflict with the statute* and reasonably necessary to effectuate the purpose of the statute.” (Emphasis supplied.) *See also Southern Cal. Edison Co. v. Public Utilities Com.*, 85 Cal. App. 4th 1086, 1105 (2000) (“[A]n agency’s interpretation of a regulation or statute does not control if an alternative reading is compelled by the plain language of the provision.”).

The Proposed Regulation would be illegal and invalid because it conflicts with existing law in at least two fundamental ways. First, by establishing a presumption that transactions between affiliated entities are not at arm’s-length, subsection (b) of the Proposed Regulation would conflict with binding California authority that absent extraordinary circumstances separate corporate legal entities must be respected. The fact that the Proposed Regulation would conflict with existing law is underscored by the imposition of the “clear and convincing” standard of proof to rebut the presumption that related party transactions are not arms’-length. In practice, this standard would make it extremely difficult, even impossible in some cases, for taxpayers to rebut the presumption, in effect converting the presumption to an affirmative rule of law.¹

¹ The reason we believe it would be virtually impossible to rebut the presumption that related party transactions are not conducted at arm’s-length is that the Proposed Regulation’s definition of arm’s-length is so vague. Subsection(a)(1) of the Proposed Regulation defines arm’s-length as “a purchase or other business transaction entered into in good faith and for valuable consideration that reflects the fair market value in the open market between two informed and willing parties, neither under any compulsion to participate in the transaction.” However, “fair market value,” “in the open market,” and between “informed and willing parties” are not defined. The standard necessary to rebut the presumption, *i.e.*, “that the terms and conditions of the transaction were substantially equivalent to those that would have been negotiated between unrelated parties in an arm’s-length transaction,” is equally undefined. Distributors cannot be expected to produce clear and convincing evidence to meet a standard that they don’t understand.



55 HAWTHORNE STREET, SUITE 440
SAN FRANCISCO, CA 94105
PHONE (415) 593-3500
FACSIMILE (415) 593-3501

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Such a rule, whether rebuttable or not, would be directly contrary to the settled rule that the separate corporate status of corporate affiliates is disregarded only when the transaction at issue is shown to be a sham and/or common law alter ego (aka, piercing the corporate veil principles) warrant disregard of the corporate entities. *See, e.g., H.A.S. Loan Service, Inc. v McColgan* (1943) 21 Cal. 2d 518, 521; *Northwestern Pacific Railway Co. v. State Board of Equalization* (1943) 21 Cal. 2d 524, 530-531; *Roscoe Terrace v. City of Los Angeles* (1985) 170 Cal. App. 3d 559, 568-569; *Mapo, Inc. v. State Board of Equalization* (1975) 53 Cal. App. 3d 245, 248; *Rexall Drug Co. v. Peterson* (1952) 113 Cal. App. 2d 528, 530. In fact, this is one of the fundamental underpinnings of the Tentative Decision.

Moreover, nothing in California's Cigarette and Tobacco Product Tax Law supports or permits disregarding transactions between separate legal entities. Unlike other areas of California tax law which otherwise specifically provide for treatment of transaction between related entities, (*e.g.*, California's corporate income tax laws requiring the filing of a combined or unitary tax return) the Tobacco Products Tax Law does not require or allow transactions between related entities to be disregarded. Simply, the tax on tobacco products is imposed on the "tobacco product cost...exclusive of discounts or other reductions," whether the tobacco product is purchased from a related or unrelated party.

Second, the statutory language—the "*cost of tobacco products to the distributor prior to any discounts or trade allowances*" Rev. & Tax. Code § 30017—clearly establishes a tax base equal to the distributor's actual cost to acquire the tobacco products. Distributors have long relied on this certainty in planning their affairs and preparing their tax returns. The Court agreed with this interpretation of the plain statutory language in its Tentative Decision.

The Proposed Regulation, by contrast, effectively replaces this objective, easily administered standard with a wordy, subjective standard. While perhaps believing that the additional words and explanation aid in understanding the tax base, what the drafters actually have done is to grant virtually unfettered discretion to the Board to ignore actual cost and to determine what it believes is an appropriate tax base. The mere granting of broad discretion to the Board to determine the tax base, particularly where it deems the product to have been sold at a discount or in the case of free samples, is inconsistent with the plain terms of the governing statute.

The Proposed Regulation even more directly contradicts the plain language of the governing statute when it authorizes inclusion of sales and marketing costs incurred by the distributor in the tax base. In particular, the regulation expressly provides that where a tobacco product is purchased by a distributor that produces finished tobacco products, "tobacco product costs" include, without limitation, all of the distributor's outlays and expenditures, such as amounts paid to suppliers for raw tobacco, the costs of overhead, labor, other materials and their related freight-in costs, paid or incurred in the production process,



55 HAWTHORNE STREET, SUITE 440
SAN FRANCISCO, CA 94105
PHONE (415) 593-3500
FACSIMILE (415) 593-3501

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and the costs of marketing the finished tobacco product to customers and prospective customers.

To the contrary, the statutory “cost of tobacco products to the distributor” standard does not permit inclusion of costs incurred after the production of finished tobacco such as sales and marketing costs in the tax base. As the Court in its Tentative Decision correctly reasoned, use of the word “to” in Section 30017 establishes that the relevant cost is the price charged *to* the distributor for the purchase of the OTP which necessarily excludes costs incurred by the distributor after it purchased the OTP. The Court specifically rejected the use of the distributor’s selling price as inconsistent with the statutory reference to “cost of the tobacco products to the distributor” because the distributor’s selling price includes costs of sales and marketing functions, and profit on those functions, that occur after the sale of OTP. In sum, the Proposed Regulation is invalid and illegal because it does not merely interpret or clarify existing law, but instead it attempts to change the law.

II. The Proposed Regulation constitutes an impermissible delegation of authority to an administrative agency.

It is one thing for a regulation to interpret a statute and to provide clear guidelines to the governmental authorities and citizens as to how the statute applies. It is yet another thing for a regulation to confer virtually unbridled discretion to implement a statute, including in this case to reach a different result than that dictated by the plain terms of the statute. The principles of separation of powers do not allow administrative agencies to disagree with legislative policy and seek a different outcome.

The violation of the separation of powers is unmistakable in a regulation that grants the Board “sole discretion” to make a determination regarding a taxpayer’s tax base.² But even where the Proposed Regulation does not expressly grant “sole discretion,” it gives the Board staff tremendous leeway and authority to make subjective judgments about the proper tax base. In short, California’s Tobacco Tax law is clear that the tax is imposed on the purchase price and does not otherwise authorize the board to determine which costs are included within the definition of “wholesale cost.” Any attempt by the Board to redefine “wholesale cost” by granting itself authority violates the clear and unambiguous reading of the Tobacco Tax Laws.

² The Proposed Regulation (Subsection (d)(1)(D)) would provide the Board with “sole discretion” to determine “wholesale cost” for distributors that acquire finished tobacco products free of charge or as free samples from a supplier. Subsections (2) and (3) of the Proposed Regulation grants the Board broad authority in determining the wholesale cost in the event that the board determines that the distributor reported tobacco product costs that include *express, implicit, or unstated discounts or trade allowances* or the transaction is not at arm’s-length.



55 HAWTHORNE STREET, SUITE 440
SAN FRANCISCO, CA 94105
PHONE (415) 593-3500
FACSIMILE (415) 593-3501

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By way of example, the Alternative Methods set forth in the Proposed Regulations rely on factors that are uncertain and vague, thereby permitting, and even requiring, the Board staff to exercise powers that should have been reserved to the Legislature. Subsection (2) allows the Board to rely on what it deems to be complete and reliable information in determining whether a transaction contains “express, implicit, or unstated discounts.” Nowhere does the Proposed Regulation provide what information constitutes “complete and reliable information.”

In the event that “complete and reliable information” is unavailable, the Proposed Regulation allows the Board staff to rely on a publicly or commercially available price list used by the distributor in selling product to its customers, less a reasonable estimate of distributor’s profit. The Proposed Regulation does not provide any guidance on what is considered a “reasonable estimate of a distributor’s profit,” utterly disregarding the actual language of the statute.

The Proposed Regulation alternatively allows the Board staff to rely on industry data from the relevant time period that provide reasonable evidence of typical or normal tobacco product costs during the time period at issue. However, the Proposed Regulation does not provide any guidance as to what constitutes typical or normal tobacco product cost.

The Proposed Regulation indicates that such industry data includes (but is not limited to) evidence reasonably indicative of the typical costs of the same or similar tobacco products for similarly situated distributors, with appropriate adjustments to such costs as indicated by all the facts and circumstances. The Proposed Regulation however does not provide any guidance as to what constitutes “the same or similar tobacco products” or what constitutes “a similarly situated distributor.” Are distributors who sell to different customers, in different geographical areas or with different overhead costs “similarly situated distributors?” What about distributors that are not in the same level of the distribution chain – direct customers of a manufacturer vs. subjobbers?

The Proposed Regulation does not address what are considered the “same or similar tobacco products” – Are products with different attributes (flavors, textures, pouch vs. loose) sold under the same brand family considered similar products? Are products with the same attributes sold under a different brand family considered similar products? As written, the Board has unlimited discretion to make “appropriate adjustments” as it deems fit.

To be sure, there are examples of legal delegation of authority to an administrative agency to adjust transactions between related parties in both federal and State law which the Board could use as guidance. Perhaps the best example for these purposes is found in the rigorous, well regulated and widely accepted standards issued by the IRS under Section 482 (which are similarly designed to ensure that transactions between related entities are at arm’s-length). The same or a similar approach could be used here, defining with rigor and precision



55 HAWTHORNE STREET, SUITE 440
SAN FRANCISCO, CA 94105
PHONE (415) 593-3500
FACSIMILE (415) 593-3501

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the parameters under which as administrative agency the Board must act to render the delegation in this case lawful.

III. At a bare minimum, the Proposed Regulation should not be issued while there is pending litigation.

Apparently fearing the decision of the Court, the Board appears to be trying to interfere with the judicial process by promulgating a conflicting regulation which the Board hopes will support a different outcome. Assuming the Court's decision and the final regulation are at odds, it is beyond question that both taxpayers and the Board will dispute which of the two rules applies, how they should be reconciled, etc. This can lead to nothing but confusion and ensure that litigation will follow.

There is no other way to describe what the Board is doing here than as bad policy. Plainly the Board should wait for a final decision in the pending litigation before attempting to promulgate a regulation that may overlap and even conflict with the Court's ultimate ruling. With the guidance from the Court, the Board can make a fully informed decision about whether and how to proceed with this regulation.

Conclusion

The Proposed Regulation is contrary to existing law and would be invalid and illegal on that basis alone. Moreover, it is simply bad policy for the Board to proceed down this path while litigation directly on point is pending. The Board's claims that it is trying to clarify existing law and provide guidance to taxpayers, when plainly the regulations are more complicated and vaguely written, and grant excessive authority to the Board, are disingenuous. The Board should halt these proceedings immediately.

However, if this project does go forward, we respectfully request a meeting with the Board Staff to work together in reaching a regulation that narrowly is drafted to be consistent with existing California law, particularly to address situations that by all objective standards are abusive. If you have any questions, comments or would like to discuss further, please do not hesitate to contact me.

Sincerely,

A handwritten signature in black ink, appearing to read "A28" followed by a long horizontal flourish.

Amy L. Silverstein

Issue Paper 10-004
Interested Party Submission

Exhibit 4
1 of 1

From: Adam Wall [mailto:adam@wallandwelchscigars.com]
Sent: Tuesday, March 09, 2010 3:01 PM
To: Bishop, Phil
Subject: Wholesale Tobacco Cost Calculation

Hello Phil,

Please forward this message on. Will all distributors be notified of the outcome of this resolution?

Excise Tax and the Calculation of the Wholesale Cost of Tobacco Products

Under the current definition of the wholesale cost of tobacco products, federal excise taxes are included in the cost of all tobacco products, and therefore present additional state tax cost to the amount paid by licensed distributors. This logic, however, is inconsistent with the Board's own rationale of how the cost is determined. Under the current draft, the definition of tobacco product cost is stated as:

Tobacco product costs shall be equal to the sum of all direct and indirect costs that the distributor paid or incurred with respect to the production of finished tobacco products. Such costs include, without limitation, all of the distributor's outlays and expenditures, such as amounts paid to suppliers for raw tobacco, the costs of overhead, labor, other materials, and their related freight-in costs, paid or incurred in the production process, and the costs of marketing the finished tobacco product to customers and prospective customers.

In essence, the definition exists to ensure that all costs actually related to the production and distribution of the tobacco product are taxable. Federal excise taxes, however, are in no way related to the actual production or marketing of the tobacco products. The new SCHIP tax of \$.40 per cigar has already placed a significant extra cost on the shoulders of manufacturers and distributors that is wholly unrelated to physical production and distribution costs. The state, by charging excise tax on top of the \$.40 per cigar, adds even further to the burden by taxing distributors on taxes. Federal excise tax is not part of the true wholesale cost of tobacco, but is rather an obligation to the federal government that should not be included in the taxable rate, as it has nothing to do with the true cost of production or distribution.

Adam Wall
Wall and Welch's Cigars
www.wallandwelchscigars.com
5999-B Ridge View St.
Camarillo, CA 93012
adam@wallandwelchscigars.com
(805) 427-1152

Issue Paper 10-004
Interested Party Submission

Exhibit 5
1 of 1

JOE ROWE
Executive Director

Gary Pesh, *President*
Curt Diebel, *First Vice President*
Finnie Helmuth, *Second Vice President*
Craig Cass, *Treasurer*
Ken Neumann, *Secretary*

Tom Moran, Ex-Officio



Phone: 706-494-1143
Fax: 706-494-1893
website: www.ipcpr.org
email: info@ipcpr.org

#4 Bradley Park Court Suite 2H
Columbus, Georgia 31904-3637

The Honorable Betty Yee, Chair
State Board of Equalization
450 N Street
Sacramento, CA 95814

March 17, 2010

Dear Chairperson Yee:

Representing 96 premium retail tobacco shops owners in the state of California, I respectfully submit this comment on Proposed Regulation 4076—Wholesale Cost of Tobacco Products.

While the IPCPR understands the Board's desire to clarify its existing regulations, we respectfully ask the Committee be mindful in further drafting and revisions so the draft proposal is easily comprehensible for those businesses and parties that will ultimately be responsible for proper compliance.

Additionally, we feel paragraph (3), Alternative methods of estimating or calculating tobacco product costs, sub-paragraph (C), may prove ambiguous and susceptible to unintended miscalculations and final determined costs on the part of the Board of Equalization. Therefore we respectfully request (3)(C) be stricken from the proposal.

In closing, we ask the Committee to include in its due diligence, directing any questions or needed assistance to our Association as a resource in this review process of Proposed Regulation 4076.

Thank you for your time and attention.

Sincerely,

Chris McCalla
Legislative Director

CALIFORNIA DISTRIBUTORS ASSOCIATION

Executive Director, Dennis L. Loper

March 26, 2010

Honorable Betty Yee
Chair, State Board of Equalization
PO Box 942879
Sacramento, CA 94279-0001

Dear Chairwoman Yee,

The California Distributors Association ("CDA") requests that the Board table consideration of Draft Regulation 4076, "Wholesale Cost of Tobacco Products."

We believe, the draft regulation raises serious legal and policy concerns. Simply, the draft regulation conflicts with the controlling statute (Rev. & Tax Code § 30017) and the final decision in U.S. Smokeless Tobacco Brands v. State Board of Equalization. Therefore, such changes in law are permissible only by legislative amendment. In our opinion the draft the regulation would be invalid if adopted. Second, we question the need for a regulation. The Section 30017 has been in place for nearly 20 years, and no need for a regulation was ever expressed until after the adverse Tentative Decision in U.S. Smokeless Tobacco Brands v. State Board of Equalization. Even now, no concrete reasons have been given for the regulation beyond the subject of the litigation, only vague suggestions of disputes between industry and staff. But, as the leader of the largest organization of California OTP taxpayers, I would likely be aware of such disputes if they were ongoing and numerous. The staff's claims come as a surprise to me, and without more concrete information, I am not yet persuaded by the need for a regulation of broad scope.

Please contact me with any questions.

Sincerely,



Dennis L. Loper

CC:
BOE Members
Excise Tax Staff



55 HAWTHORNE STREET, SUITE 440
SAN FRANCISCO, CA 94105
PHONE (415) 593-3500
FACSIMILE (415) 593-3501

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WWW.SPTAXLAW.COM

March 26, 2010

Writer's Direct Contact
Telephone: (415) 593-3502
asilverstein@sptaxlaw.com

VIA EMAIL AND US MAIL

Ms. Carolee Johnstone
Tax Counsel
Legal Department
State Board of Equalization
450 N. Street
Sacramento, California 94279

RE: Supplemental Comments on Draft California Regulation 4076, determination of "wholesale cost of tobacco products" for purposes of calculating the tax on tobacco products pursuant to California Cigarette and Tobacco Tax Law (the "Draft Regulation")

To Whom It May Concern:

Please accept these supplemental comments regarding Draft California Regulation 4076 on behalf of Philip Morris USA Inc. ("PM USA"), John Middleton Company ("JMC") and U.S. Smokeless Tobacco Brands Inc. ("USSTB") – (collectively, "the Companies"). The Companies are all licensed distributors of tobacco products in the State of California.

By letter dated February 16, 2010, the Companies previously explained the technical reasons that the Draft Regulation is contrary to existing law and, thus, would be illegal if adopted. That analysis has now been confirmed by the Trial Court's Final Decision issued March 23, 2010, in *U.S. Smokeless Tobacco Brands Inc. v. State Board of Equalization*, S.F. Superior Court No. CGC-07-463592.¹

The interested parties (the Board staff and OTP distributors) have been operating under the existing statute (Rev. & Tax. Code § 30017) since the OTP tax was first enacted in 1989, more than 20 years ago. While disputes about the statute may have

¹ A copy of the Final Decision issued on March 23, 2010, is attached for your reference.



Ms. Carolee Johnstone
State Board of Equalization
Page 2
March 26, 2010

arisen from time to time, obviously they were few and far between, as evidenced by the fact that in all of that time, *U.S. Smokeless Tobacco* is the only case to have resulted in litigation regarding Section 30017. What is more, while the Board staff claims now that the statutory language is unclear and in need of regulatory clarification, the Trial Court in *U.S. Smokeless Tobacco* found otherwise. According to the Trial Court, the statutory language is clear and unambiguous, and must be administered just as it reads. Final Decision, at 18. (“[T]he phrase ‘cost . . . to the distributor’ without any modifier for the word ‘cost’ unmistakably evinces the intent to define ‘wholesale cost’ as the actual cost of the OTP sold to the distributor who is subject to the tax imposed by § 30123(b).”). Moreover, the staff’s claims of ambiguity are belied by the fact that it has waited over 20 years since the statutory provisions were enacted before embarking on a regulation project. The timing of the staff’s proposal, issued shortly after the Trial Court’s Tentative Decision, and the apparent rush to promulgate a regulation with minimal scrutiny together suggest a motivation to attempt to influence the Trial Court’s decision and override the plain statutory language.

Furthermore, the Trial Court found no support in the statutory language of Section 30017 for the Board’s attempts to (i) disregard corporate separateness, or (ii) base the OTP tax on a “constructive price” rather than the actual price paid by the distributor for the OTP when the transaction is between related parties. *Id.* at 10 (“There is nothing in the Tobacco Tax Law that requires that transactions between corporate affiliates be disregarded for purposes of that statute.”) and 19 (“The parties have not cited, nor have I located, any California statute . . . that requires or permits the use of a constructive price to determine ‘cost . . . to the distributor’ for purposes of the Tobacco Tax Law.”) As we have previously noted, the Draft Regulation seeks to do both, and is therefore inconsistent with the statutory language and exceeds the Board’s legal authority. The Board lacks the legal authority to modify or amend the plain statutory language by issuing regulations that are inconsistent with that language. *See* Gov. Code § 11342.2 (“Whenever by the express or implied terms of any statute a state agency has authority to adopt regulations to implement, interpret, make specific or otherwise carry out the provisions of the statute, *no regulation adopted is valid or effective unless consistent and not in conflict with the statute* and reasonably necessary to effectuate the purpose of the statute.”) (Emphasis supplied.) Rather, if the Board perceives a need to change the statute, “it is up to the voters or the Legislature to make any needed correct[ion].” Final Decision, at 20.

In short, rushing to promulgate a new regulation to override or attempt to influence a pending court action is bad tax policy and bad tax administration. But more significantly, for the reasons stated in our prior submission and the Final Decision, the

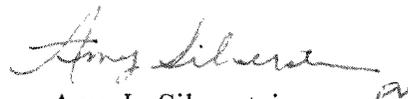
Silverstein &
Pomerantz LLP
ATTORNEYS AT LAW

Ms. Carolee Johnstone
State Board of Equalization
Page 3
March 26, 2010

Board clearly lacks the legal authority to issue the Draft Regulations and should abandon them.

Thank you for your attention.

Sincerely,


Amy L. Silverstein

Enclosure

cc: Leila Helmuth (via email)

1 Prepared by the Court

RECEIVED
MAR 25 2010
BY: _____

ENDORSED
FILED
Superior Court of California
County of San Francisco

MAR 23 2010

CLERK OF THE COURT
BY: AUDREY HUIE
Deputy Clerk

8 SUPERIOR COURT OF CALIFORNIA

9 County Of San Francisco

10 Department No. 604

12 U.S. SMOKELESS TOBACCO BRANDS,
13 INC.,

Plaintiff,

14 vs.

15 STATE BOARD OF EQUALIZATION,

16 Defendant.

Case No.: CGC 07-463592

DECISION AFTER NONJURY TRIAL

19 **Introduction**

20 Plaintiff U.S. Smokeless Tobacco Brands, Inc. (UST Sales), formerly known as United
21 States Tobacco Sales and Marketing Company, Inc., brought this timely action seeking a refund
22 of excise taxes it paid pursuant to the Cigarette and Tobacco Products Tax Law, Rev. & Tax.
23 Code §30001 et seq. (the Tobacco Tax Law). Hereafter all code sections refer to the Rev. &
24 Tax. Code unless otherwise indicated. The defendant is the State Board of Equalization (SBE),
25

1 an agency of the State of California that is empowered to assess and collect taxes and to make
2 refunds of overpayments under the Tobacco Tax Law. UST Sales seeks a refund of taxes it paid
3 for the period January 1, 1994 through November 30, 1996 (the Relevant Period).

4 During the Relevant Period UST Sales provided free samples of its non-cigarette tobacco
5 products – referred to in the Tobacco Tax Law as “tobacco products” (§30121(b)) and by the
6 parties as other tobacco products (OTP) – to individuals in California at various events such as
7 rodeos and automobile races. The OTP involved in this case is principally moist snuff, which
8 was sold in cans under the brand names of Copenhagen and Skoal. The parties agree that the
9 provision of these free samples triggers an excise tax payable by UST Sales under §30123(b).
10 That subdivision provides, in relevant part: “There shall be imposed upon every distributor a tax
11 upon the distribution of tobacco products, based on the wholesale cost of these products.” The
12 parties disagree about what constitutes “wholesale cost” for determination of the amount of taxes
13 owed by UST Sales for its provision of the free samples. Moreover, if I adopt a construction of
14 the phrase “wholesale cost” favorable to UST Sales, the parties further disagree whether UST
15 Sales has met its burden of proving the wholesale cost of the free samples it distributed during
16 the Relevant Period.

17 The parties only dispute the tax “basis” of the OTP samples distributed by UST Sales
18 during the Relevant Period. Significantly, the parties do not dispute whether those samples are
19 taxable, the amount of the samples distributed by UST Sales, or the “rate” at which those
20 samples are taxed. Once the tax basis is determined, the amount of tax that UST Sales is
21 obligated to pay is calculated by the number of samples distributed by UST Sales during the
22 Relevant Period multiplied by the tax basis of those samples multiplied by the tax rate.

1 **Trial and Agreed Post-Trial Procedure**

2 This case was assigned to me for a nonjury trial. UST Sales appeared by its counsel Amy
3 Silverstein and Edwin Antolin. SBE appeared by Deputy Attorney General Julian Standen. The
4 trial was held over the course of four days in September 2008. The parties submitted two
5 stipulations regarding agreed facts entitled “Stipulation of Facts” dated April 2, 2008 and
6 “Second Joint Stipulation of Facts” filed September 8, 2008. Four witnesses – Stuart Harden,
7 Hoy Carman, William Kimsey and Rosemary Coates – testified in person at the trial. In addition,
8 pursuant to the parties’ stipulations, three other witnesses – Kenneth Tamaro, Elizabeth Galvin
9 and Dov Seewald – provided testimony in the form of declarations under penalty of perjury.

10 Numerous exhibits were submitted by the parties, which are identified in documents
11 entitled “Plaintiff’s Exhibit List” and “Defendant’s List of Exhibits,” both of which are dated
12 September 29, 2008. Per letters sent by counsel for both UST Sales and SBE also dated
13 September 29, 2008, with a few specified exceptions, the parties stipulated to the admissibility of
14 all the exhibits identified in the two exhibit lists, while preserving “the right to contest the
15 relevancy of the exhibits.” By letter dated October 6, 2008 from Mr. Standen, SBE objected to
16 the admissibility of UST Sales’ exhibit L (entitled “Supplemental Affidavit of Dov Seewald”) on
17 the ground that it is untimely. Because SBE was subsequently given a full opportunity to contest
18 to respond to Exhibit L and UST Sales provided testimony authenticating that exhibit and
19 otherwise establishing its admissibility, SBE’s objection to Exhibit L is overruled and Exhibit L
20 is admitted into evidence. For clarity of the record, the two exhibit lists and three letters
21 referenced in this paragraph were filed.

22 The parties and I agreed to a procedure to bring this case to a conclusion. That procedure
23 provided for my issuance of a tentative decision, the parties’ filing further briefs, and another
24
25

1 hearing. The agreed procedure also provided the parties an opportunity to request that they be
2 allowed to introduce further evidence.

3 In April 2009 I issued a tentative decision which largely favored the position of UST
4 Sales. Not surprisingly, then, in the parties' briefs filed after the issuance of the tentative decision
5 SBE argued that the tentative decision was wrongly decided and UST Sales took the opposite
6 view. A hearing was held on August 12, 2009 where I rejected all of the arguments made by SBE
7 regarding the tentative decision except for the argument that UST Sales had failed to prove that it
8 actually purchased OTP from UST Manufacturing at the price that it contended it paid for the
9 OTP. In accordance with the agreed post-trial procedure, I then set a hearing on that issue.

10 A short evidentiary hearing solely on the issue of the price that UST Sales purchased the
11 OTP from UST Manufacturing was held on December 15, 2009. At the outset of the hearing
12 SBE filed written objections to UST Sales' Exhibits I, J, K and L. At the hearing UST Sales
13 called two witnesses, John Miscioscia and Dov Seewald, both of whom were examined by each
14 party. UST Sales also offered three new exhibits into evidence, general ledgers and
15 accompanying schedules for the years 1994, 1995 and 1996 respectively, marked as M through
16 O, all of which I admitted over SBE's objections.

17 Because of concerns that SBE had not been provided adequate notice of the testimony of
18 Mr. Miscioscia and Mr. Seewald and it did not have adequate opportunity to review Exhibits M,
19 N and O, at the conclusion of the hearing I gave SBE the opportunity to conduct further cross-
20 examination of Mr. Miscioscia and Mr. Seewald and to call its own witnesses regarding exhibits
21 M, N and O at a mutually agreeable later date. By email dated December 18, 2009, SBE's
22 counsel stated that SBE did not wish to conduct any further cross-examination or introduce any
23 further testimony. Based on the evidence adduced at the December 15 hearing, I now overrule
24
25

1 SBE's objections to Exhibits I, J, K and L. Accordingly, I took the case under submission as of
2 December 18, 2009.

3 Since taking the case under submission, I have done another full review of all of the
4 parties' arguments and the admissible evidence and have concluded that the tentative decision
5 was correct in all respects. Accordingly, with a few exceptions the remainder of this decision is a
6 verbatim repetition of what was in the tentative decision.

7 **Pertinent Stipulated Facts**

8 As noted previously, the parties submitted two stipulations of fact. In one area – the price
9 charged to UST Sales for OTP samples – SBE offered evidence at the trial contrary to some of
10 the facts in the stipulations. However, at no time did either party seek to withdraw from the
11 stipulations or contend that the stipulations were not entered into freely. Under long-settled
12 principles, then, those stipulations are binding on the parties as well as on me as the trier of fact.
13 (*See, e.g., CACI 5002* (the attorneys for both sides have agreed that certain facts are true ... and
14 you must accept those facts as true"); *Mercedes-Benz Corp. Credit Corp. v. Johnson* (2003) 110
15 Cal. App. 4th 53, 59; *Times Mirror Co. v. Franchise Tax Board* (1980) 102 Cal. App. 3d 872,
16 877 (tax agency "is bound by the facts stipulated to, as is the court, even in tax matters");
17 *Mooney v. Pickett* (1972) 26 Cal. App. 3d 431, 437). The pertinent facts from those stipulations
18 are recited here.

19 During the Relevant Period both UST Sales and U.S. Smokeless Tobacco Manufacturing
20 Company (UST Manufacturing), formerly known as United States Tobacco Manufacturing
21 Company Inc., were wholly-owned subsidiaries of U.S. Smokeless Tobacco Company (Parent
22 Corporation), formerly known as United States Tobacco Company.

23 During the Relevant Period UST Sales purchased OTP exclusively from its sister
24 corporation UST Manufacturing. Conversely, all OTP manufactured by UST Manufacturing was
25

1 sold to UST Sales. Stated another way, UST Manufacturing was the sole source of OTP for UST
2 Sales, and UST Sales was UST Manufacturing's sole customer for OTP in the United States.

3 During the Relevant Period, except for its sales of OTP to UST Sales, UST
4 Manufacturing did not engage in any sales or marketing activities. UST Manufacturing did not
5 employ any sales representatives nor did it have any field sales offices.

6 UST Sales purchased OTP for the purpose of reselling it to its customers or distributing it
7 as samples to adult individuals. Typically UST Sales' customers were independent tobacco
8 distributors, not affiliated with UST Sales.

9 UST Manufacturing sold "marked samples" (i.e. on the samples themselves there was an
10 indication that they were samples) to UST Sales. While most of the OTP samples that UST Sales
11 distributed to individuals during the Relevant Period were marked samples, UST Sales also
12 distributed some "unmarked samples" (i.e. samples that bore no indication of being samples) to
13 individuals during the Relevant Period.

14 UST Manufacturing sold unmarked samples to UST Sales at the same price that it sold
15 OTP to UST Sales intended for resale by UST Sales to its customers. Apparently due to
16 terminology used for federal income tax purposes, the parties have referred to this price as the
17 "Transfer Price" (i.e. the price at which OTP was transferred from UST Manufacturing to UST
18 Sales). The Transfer Price was 72.9 cents per can at the beginning of the Relevant Period and
19 80.7 cents per can at the end of the Relevant Period. UST Manufacturing sold marked samples to
20 UST Sales at a significantly lower price than the Transfer Price. Although UST Sales sold
21 approximately fifteen different varieties of OTP during the Relevant Period (e.g. Skoal Long Cut
22 Classic and Skoal Long Cut Straight), the Transfer Price for all the varieties was the same
23 throughout the Relevant Period.

1 The price at which marked samples were sold will be referred to as the “Marked Samples
2 Price.” The Marked Samples Price was calculated as the cost of manufacturing the OTP,
3 including tobacco, packaging materials and overhead. The lower price for marked samples than
4 for other OTP “reflected ... [the] compromised marketability [of the marked samples], i.e. they
5 could not be sold, and were not sold, to third-party customers.” (Stip. of Facts ¶2). Unlike the
6 Transfer Price, there were some differences in the Marked Samples Price among varieties. The
7 Marked Samples Price ranged from 17.3 cents to 29 cents per can at the beginning of the
8 Relevant Period and from 16.6 cents to 29.5 cents per can at the end of the Relevant Period.

9 UST Sales sold OTP to its customers at a set price which the parties have referred to as
10 the “Extended List Price” (List Price). The List Price was \$1.70 per can at the start of the
11 Relevant Period and \$1.96 per can at the end of the Relevant Period. The List Price, like the
12 Transfer Price, was the same for all varieties of OTP.

13 **Pertinent Facts Not in Dispute**

14 Although not within the parties’ stipulations, other pertinent facts are not in dispute and
15 are briefly recited here.

16 Prior to 1990 the operations of UST Sales and UST Manufacturing had been combined in
17 a single corporate entity. In or about 1990 UST Sales and UST Manufacturing “split off” from
18 each other and were separately incorporated. As separate corporations, UST Sales and UST
19 Manufacturing had separate boards of directors and each maintained its own places of business
20 and had its own employees. However, during the Relevant Period the Parent Corporation
21 exercised control over both UST Sales and UST Manufacturing, at least to the extent that it was
22 able to determine the Transfer Price that applied to transactions between UST Sales and UST
23 Manufacturing.

1 The principal function of UST Manufacturing is the manufacture of OTP from raw
2 tobacco materials. During the Relevant Period UST Manufacturing employed approximately 700
3 employees, all of whom performed manufacturing-related tasks.

4 The principal functions of UST Sales are the sales and marketing of OTP that it
5 purchased from UST Manufacturing. During the Relevant Period UST Sales employed
6 approximately 800 employees and had numerous sales offices and sales field locations
7 throughout the United States. UST Sales sold OTP only to distributors. It did not make any retail
8 sales. UST Sales did not perform any manufacturing functions.

9 Because all of the sales of OTP that UST Sales made to its customers during the Relevant
10 Period occurred outside California, UST Sales did not owe or pay any tax under the Tobacco Tax
11 law on those sales during the Relevant Period. If UST Sales' customers distributed the OTP they
12 purchased from UST Sales in California, those customers paid tax per §31023(b) on those sales
13 based on the List Price, the price they paid to UST Sales for that OTP, excluding any discounts
14 off the List Price.

15 During the Relevant Period unmarked samples of the same variety sold by UST
16 Manufacturing to UST Sales were indistinguishable from the OTP of the same variety sold by
17 UST Manufacturing to UST Sales for the purpose of resale to UST Sales' customers. Marked
18 samples differed in appearance from unmarked samples and OTP of the same variety intended
19 for resale to UST Sales' customers only to the extent of the markings, but in all other respects –
20 including the quantity, quality and packaging of the OTP – the marked samples were
21 indistinguishable from the other OTP of the same variety.

22 During the Relevant Period the Transfer Price and Marked Samples Price at which US
23 Manufacturing sold OTP to UST Sales were not reduced or discounted for any reason. These
24
25

1 prices were established among the two companies and the Parent Corporation for a set period of
2 time (typically but not always one year) and did not vary during the set period.

3 The Transfer Price was determined based on an annual “financial model” that, from the
4 perspective of the Parent Corporation, was intended to be a proxy for a market-based (or arm’s-
5 length) price that the OTP would have been sold at had there been no corporate relationship
6 between UST Manufacturing and UST Sales. As pertinent here, the financial model was
7 essentially a budget of the total revenues of OTP expected to be sold by UST Sales and an
8 allocation of that revenue between UST Manufacturing and UST Sales based on the costs
9 incurred by and profits attributable to each company. Thus, the Transfer Price was intended to
10 reflect the cost (including overhead) of manufacturing the OTP incurred by UST Manufacturing
11 plus a profit attributable to the work of UST Manufacturing.

12 UST Manufacturing, UST Sales, the Parent Corporation and their corporate affiliates
13 used the Transfer Price in their financial books and records including, where relevant, documents
14 required to be filed with tax authorities. The Transfer Price was not developed or used solely or
15 primarily for determination of tax due under the Tobacco Tax Law.

16 As noted previously, the List Price was more than 100% greater than the Transfer Price
17 during the Relevant Period. From the perspective of the Parent Corporation, the List Price was
18 intended to recover the costs incurred by both UST Manufacturing and UST Sales as well as
19 achieve a profit attributable to the work of both companies. Because the OTP sold by UST Sales
20 to its customers was sold under arm’s length circumstances between unrelated parties, the List
21 Price represents the fair market value of the OTP at the level of trade between the UST Sales and
22 its customers.

23 Considered together, UST Manufacturing and UST Sales performed all the functions –
24 manufacturing, sales and marketing – typically performed by a manufacturer of tobacco
25

1 products. In the tobacco industry it is typically the manufacturer, not someone later in chain of
2 distribution, who distributes free samples. Had the two companies been combined as they were
3 prior to 1990 and all other things remained unchanged, there would have been no need for either
4 a Transfer Price or Marked Samples Price and the hypothetical combined company (hereafter
5 UST Manufacturing/Sales) would have sold OTP to its customers at the List Price and would
6 have distributed free samples.

7 **Neither the Tobacco Tax Law Nor Application of Sham or Alter Ego Principles Require**
8 **that the Separate Corporations of UST Manufacturing and UST Sales Be Disregarded.**

9 There is nothing in the Tobacco Tax Law that requires that transactions between
10 corporate affiliates be disregarded for purposes of that statute. For instance, nothing in the
11 Tobacco Tax Law imposes any obligation on related companies to file a “unitary” or
12 “consolidated” return regarding the distribution of OTP or otherwise to ignore the separate
13 corporate status of related corporations. In this regard, the Tobacco Tax Law and the State of
14 Washington excise tax on tobacco products are identical, and under both statutes the separate
15 existence of UST Manufacturing and UST Sales is recognized. (*United States Tobacco Sales and*
16 *Marketing Company Inc. v. State of Washington, Department of Revenue* (Wash. App. 1999) 982
17 P.2d 652, 657) (“*U.S. Tobacco I*”) (“The statute makes no distinction between affiliated and
18 nonaffiliated entities” and thus, for purposes of the excise tax on OTP samples distributed by
19 UST Sales, UST Manufacturing is the manufacturer/seller of the OTP and UST Sales is the
20 distributor/buyer of the OTP)).

21 The general rule in California on tax matters is that, absent statutory language requiring
22 or permitting it, the separate corporate status of corporate affiliates is disregarded only when the
23 transaction at issue is shown to be a sham and/or common law alter ego (aka piercing corporate
24 veil) principles warrant disregard of the separate entities. (See, e.g., *H.A.S. Loan Service, Inc. v.*
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1 *McColgan* (1943) 21 Cal. 2d 518, 521; *Northwestern Pacific Railway Co. v. State Board of*
2 *Equalization* (1943) 21 Cal. 2d 524, 530-31; *Roscoe Terrace v. City of Los Angeles* (1985) 170
3 Cal. App. 3d 559, 568-69; *Mapo, Inc. v. State Board of Equalization* (1975) 53 Cal. App. 3d 245,
4 248; *Rexall Drug Co. v. Peterson* (1952) 113 Cal. App. 2d 528, 530). SBE did not contend, nor
5 is there any evidence, that the sales of OTP by UST Manufacturing to UST Sales were sham
6 transaction or that the separate corporate status of UST Manufacturing and UST Sales during the
7 Relevant Period should be disregarded due to alter ego principles. Review of the principles
8 discussed in the case law cited in this paragraph discloses no basis under California law to
9 disregard the separate corporations of UST Manufacturing and UST Sales for purposes of
10 determining the tax basis of the OTP samples distributed by UST Sales during the Relevant
11 Period.

12 **The Provisions of the Tobacco Tax Law Applicable to the “Distribution” of Free Samples**
13 **of OTP.**

14 It is useful to walk through the Tobacco Tax Law to understand how that statute, as it
15 existed during the Relevant Period, applied to the distribution of free samples of OTP.

16 As initially enacted in 1959, the Tobacco Tax Law applied only to cigarettes. (*California*
17 *Association of Retail Tobacconists v. State of California* (2003) 109 Cal. App. 4th 792, 836). In
18 November 1988 the voters passed Proposition 99, which, among other things, made distribution
19 of OTP taxable under the Tobacco Tax Law. (*Id.* at 837; *see generally Kennedy Wholesale, Inc.*
20 *v. State Board of Equalization* (1991) 53 Cal. 3d 245 (rejecting a constitutional challenge to
21 Proposition 99)). As a result of the passage of Proposition 99, the following provisions of the
22 Tobacco Tax became effective in 1989 and remained in effect throughout the Relevant Period:

23 -- §30123(b) imposed a tax on every “distributor” of OTP.

1 -- §30111(b) defined “distributor” to include anyone who engages in the
2 “distribution” of OTP after January 1, 1989.

3 -- §30008 defined “distribution” to include not only the sale of OTP, but also the
4 “use or consumption” of OTP in California.

5 --§30009 defined “use or consumption” to include the “exercise of any right or
6 power over ... [OTP] incident to the ownership thereof.”

7 The parties have stipulated, and it seems to me correctly so, that the provision of free
8 samples of OTP by UST Sales to individuals in California during the Relevant Period constituted
9 “use or consumption” within the meaning of §30009. Therefore, as a result of §30008 and
10 §30111(b), UST Sales was a “distributor” within the meaning of §30123(b) and subject to the tax
11 imposed by that section when it provided free samples to individuals in California. (*Accord* 18
12 Cal. Admin. Code §4081 (SBE regulation promulgated under the authority of the Tobacco Tax
13 Law stating that “The giving away in this state of untaxed ... tobacco products is a taxable
14 distribution”)).

15 Although there is no dispute that the provision of free OTP samples in California is
16 taxable under the Tobacco Tax Law, it is noteworthy that the statute contains only a single
17 mention of samples and it does so in a section (§30108) that has not application to this case. (*See*
18 *California State Board of Equalization v. Chemehuevi Indian Tribe* (1985) 474 US 9 (pre-
19 Proposition 99 case construing §30108 in the context of distribution of cigarettes by an Indian
20 Tribe immune from California taxation)). Nor, despite fairly extensive analyses of Proposition 99
21 that are available on-line or in legal and health science journals, could I find any materials
22 suggesting that anyone – the drafters of Proposition 99, its proponents or opponents – gave any
23 consideration to the fact that Proposition 99 made distribution of OTP samples taxable. Nor have
24 the parties cited to any such materials.

1 However, one thing is clear about the treatment of samples under the Tobacco Tax Law,
2 which existed before the passage of Proposition 99 and was unaffected by that initiative: the tax
3 basis of samples is the same as the tax basis of all taxable distributions of tobacco. This is the
4 result of the excise tax being imposed on “distribution” (§31023(a) and (b)) and “distribution”
5 defined to include both sales of tobacco and the non-sales activities of “use or consumption”
6 (§30008(a) and (b)), the latter being defined broadly enough to include provision of samples.
7 (§30009). (See generally *United States v. 4,432 Mastercases of Cigarettes, More or Less* (9th Cir.
8 2006) 448 F. 3d 1168, 1186-87 (rejecting the argument that “distribution” as defined in §30008
9 should be limited only to sales)). In the case of cigarettes, whether sold or given away as
10 samples, the tax is based on the same per-cigarette amount. (§30123(a)). In the case of OTP,
11 whether sold or given away as samples, the tax basis is the “wholesale cost” of the OTP.
12 (§30123(b)).

13 Because the Tobacco Tax Law establishes the same tax basis for OTP that is sold by a
14 distributor as it does for OTP that is given away for free by that same distributor, it is important
15 to realize that, as to many issues regarding tax basis under the Tobacco Tax Law, the method of
16 distribution is irrelevant. Thus, only after I spent a great deal of time thinking about the
17 economic and other consequences of imposing a tax on a transaction that resulted in no direct
18 revenue, did I realize that most of the issues raised by this case are unaffected by the fact that the
19 taxable transactions were the provision of free samples. Indeed, except for the difference in price
20 charged by UST Manufacturing for marked and unmarked samples, the exact same issues would
21 still need to be resolved – and would be resolved in the same way – had the OTP at issue in this
22 case been sold, instead of given away, by UST Sales in California.

1 **Even Though it is Not What is Commonly Understood by the Phrase “Wholesale Cost,” the**
2 **Transfer Price and the Marked Samples Price are the “Cost ... to the Distributor” of the**
3 **OTP Samples Distributed by UST Sales, as that Latter Phrase is Used in Section 30017.**

4 It is, of course, a basic tenet of statutory construction that when a term is defined in a
5 statute, the definition given in the statute, and not the ordinary meaning of the term, must be
6 given effect. (*Dixon v. Superior Court* (2009) 170 Cal. App. 4th 1271, 1276). Because the phrase
7 “wholesale cost” used in §31023(b) is defined in §30017, the definition in §30017, not the
8 ordinary meaning of the phrase “wholesale cost,” is what determines the meaning of that phrase
9 for purposes of §31023(b). This simple but critical point requires the rejection of SBE’s
10 argument that, in keeping with the commonly understood meaning of “wholesale cost,” the List
11 Price (i.e. the price paid by wholesalers) is the “wholesale cost” of the OTP samples distributed
12 by UST Sales.

13 §30017 defines “wholesale cost” as the “cost of tobacco products [OTP] to the distributor
14 prior to any discounts or trade allowances.” (Emphasis added.) In this section I will focus only
15 on the first portion of this definition (i.e. “cost ... to the distributor”), deferring until the next two
16 sections the remainder of the definition (i.e. “prior to any discounts or trade allowances”).

17 By using the words “cost ... to the distributor,” the definition of wholesale cost in §30017
18 necessarily focuses on the level of trade of the distributor and the “wholesale cost” will vary
19 depending on where that distributor is in the point in the chain of distribution. Thus, for instance,
20 under §30017 there would likely be a different and smaller “wholesale cost” for a large national
21 distributor who re-sells only to regional distributors than for a local distributor who receives OTP
22 after it has passed through the hands (or at least legal title of) several larger distributors. Truly,
23 then, the first part of §30017 establishes the tax basis as “distributor cost,” which may or may
24 not, depending on where the distributor is in the point of distribution, be the same as what is
25 commonly understood by the phrase “wholesale cost.” (*Accord* §30016(b) (“wholesaler” defined

1 as anyone who makes “sales for resale” of OTP and thus potentially includes manufacturers and
2 others who are not normally considered “wholesalers”). *see also R.J. Reynolds Tobacco Co. v.*
3 *Shrewry* (9th Cir. 2004) 423 F.3d 906, 913 (while a “distributor” of cigarettes for purposes of the
4 Tobacco tax Law will usually be a someone who is traditionally considered a wholesaler, it also
5 includes a manufacturer)).

6 Despite the generally understood distinct concepts of manufacturer and wholesaler, in
7 some circumstances the wholesale cost for purposes of §30017 is the manufacturer’s cost.
8 Indeed, typically it is a manufacturer, not a wholesaler (or, as here, a separately incorporated
9 sales and marketing company) who distributes OTP samples, as SBE’s own regulation suggests.
10 (18 Cal. Admin. Code §4081 (“the manufacturer giving away such sample ... tobacco products
11 must report the distribution...”).

12 The key word in §30017 is “to.” In context, the word “to” establishes that the relevant
13 cost is the price charged **to** the distributor for the purchase of the OTP, which excludes any costs
14 **incurred by** the distributor after it purchased the OTP. This point was emphasized in both of the
15 Washington Court of Appeals decisions in the context of the sale of OTP by a manufacturer, and
16 the discussion on this point is fully applicable here, notwithstanding the differences in the
17 California and Washington statutes in other material respects. (*See especially U.S. Tobacco I,*
18 *982 P. 2d at 658* (“The statute imposes the tax ... measured at the time the manufacturer sells the
19 products. This price will reflect the quality, quantity, packaging, and trademark value of the
20 products as provided by the manufacturer ... But it need not include value that is added to the
21 products after the manufacturer sells them”). This point was also the primary rationale for a
22 legal opinion from an SBE tax counsel concerning whether packaging costs of OTP are included
23 in the definition of “wholesale cost” for purposes of §30017. (Plaintiff’s Exhibit F
24 (memorandum dated April 20, 1999 from Susan Y. Bennett) (“packing charges invoiced to
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1 distributors ... are included in the wholesale cost [but] ... the distributors' repackaging charges
2 ... need not be included in the wholesale cost [because] repackaging charges are not part of
3 the cost ... 'to the distributor' since the distributor incurs the charges after receipt of the" OTP)).

4 Had the samples at issue in this case been distributed prior to 1990, when the functions of
5 UST Manufacturing and UST Sales were combined in one company, the "cost ... to the
6 distributor" of the samples would have been the cost of those samples to the combined company
7 prior to any costs incurred in the operations of the combined company, which is presumably little
8 more than the cost of the raw tobacco. Viewed in this light, the separate incorporation of UST
9 Manufacturing and UST Sales results in a higher "cost ... to the distributor" than when the
10 functions were combined into one company because with separate corporations, the sale from
11 one corporation to the other focuses on the cost to the second corporation, which of necessity is a
12 greater amount than the cost to the first corporation alone. This is because with separate
13 corporations the cost to the second corporation (UST Sales) includes the cost for the functions
14 performed by the first (UST Manufacturing), even though if the functions of the two
15 corporations were combined the "cost ... to the distributor" would exclude any costs for the
16 functions of the combined company.

17 SBE's argument that the List Price is the "cost ... to the distributor" is mistaken for two
18 related reasons. First, the List Price is the "cost" of the OTP to UST Sales' customers, not the
19 cost of the OTP to UST Sales. Second, the List Price includes the cost of sales and marketing
20 functions and profit on those functions that occur after the sales of OTP from UST
21 Manufacturing to UST Sales. (*See U.S. Tobacco I*, 982 P.2d at 658) (under State of Washington
22 excise tax statute, the List Price of OTP is not the manufacturer's sales price because the List
23 Price includes sales and marketing functions of UST Sales that occur after the sale of OTP from
24 UST Manufacturing to UST Sales); *United States Tobacco Sales and Marketing Company, Inc.*

1 *v. Washington State Department of Revenue* (Wash. App. 2005) 115 P. 3d 1080, 1083) (UST
2 Sales “increased the value of the OTP through an array of activities including sales, marketing,
3 promotions, product sampling, and distribution. Thus, we reiterate that it is not appropriate to
4 measure the value of OTP sold by” UST Manufacturing “by the price” UST Sales “sold to
5 independent distributors”).

6 It follows from the foregoing that I also reject SBE’s argument that the List Price is the
7 “cost ... to the distributor” because UST Manufacturing is not and cannot be viewed as a true
8 manufacturing company due its lack of sales and marketing functions. This argument, taken to its
9 logical conclusion, seeks to disregard the separate corporate status of UST Manufacturing and
10 UST Sales, which is contrary to the general rule respecting separate incorporations that was
11 discussed earlier in this decision. Moreover, wholly apart from alter ego or sham principles,
12 SBE’s argument would, if accepted, would result in a determination of “cost ... to the
13 distributor” based on the cost to a combined UST Manufacturing/Sales (i.e. the same as the cost
14 to UST Manufacturing if the corporations are treated separately), not on the List Price, which is
15 the cost to the independent distributors who, under this scenario, would be deemed to purchase
16 OTP from UST Manufacturing/Sales.

17 SBE argues that “wholesale cost” as used in §31023(b) should be construed to mean “fair
18 market value,” just as the first Washington Court of Appeal decision construed the phrase
19 “wholesale sales price” to mean “fair market value.” Even though the parties put this case on
20 hold for years pending the conclusion of the Washington litigation because they believed that
21 litigation would be instructive to this resolution of this case, the differences between the
22 language of the Tobacco Tax Law and the language of the Washington statute require that the
23 two statutes be construed dissimilarly. Focusing on the statutory definition of “wholesale sales
24 price” as “the established price ... a manufacturer sells a tobacco product to a distributor,” the
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1 first Washington decision determined that the phrase “established price” required that the
2 Washington tobacco tax be “based upon fair market value rather than the manufacturer’s price to
3 its affiliate.” (*U.S. Tobacco I*, 982 P. 2d at 657). In contrast, §30017 does not define “wholesale
4 cost” to mean “established price,” nor is there any word or phrase in that section that connotes
5 fair market value. Had the drafters of that section intended to import a fair market value concept
6 into §30017, it would have been easy for them to do so. Instead, the phrase “cost ... to the
7 distributor” without any modifier for the word “cost” unmistakably evinces the intent to define
8 “wholesale cost” as the actual cost of the OTP sold to the distributor who is subject to the tax
9 imposed by §31023(b). Even if, contrary to my own view, that phrase could reasonably be read
10 to convey other meanings (such as fair market value) besides actual cost, I would still be
11 compelled to interpret the phrase in favor of UST Sales. (*Agnew v. California State Board of*
12 *Equalization* (1999) 21 Cal. 4th 310, 330 (“if there is ambiguity in a tax statute, the ambiguity
13 must be resolved in favor of the taxpayer”)).

14 SBE’s argument that the List Price is the “cost ... to the distributor” is, effectively an
15 argument that, due to the peculiar circumstances of the separate incorporation of UST
16 Manufacturing and UST Sales and the attendant risk of manipulation by the Parent Corporation
17 of the price at which OTP is sold by UST Manufacturing to UST Sales, it is necessary to
18 establish the List Price (i.e. a market-established price) as the “cost ... to the distributor.” Under
19 this argument, unless the List Price or some other market-established price is used, the UST
20 companies will be in a position, without constraints of the marketplace, to unilaterally set the
21 amount of tax they pay on OTP distributed by UST Sales, rather than the amount of the tax being
22 based on an objective (presumably non-manipulable) fair market value based price.

23 While initially appealing, this argument fails as well for the simple reason that nothing in
24 the Tobacco Tax Law or any other statute precludes the UST companies from organizing
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1 themselves the way they did during the Relevant Period and thus, under the first portion of
2 §30017, the tax on OTP samples distributed by UST Sales is based on the price it paid to UST
3 Manufacturing for the OTP. The drafters of Proposition 99 or the California Legislature could
4 have but chose not to address this issue by inserting language in the Tobacco Tax Law or
5 establishing a more generally applicable rule that any time an excise tax is based on a transaction
6 between related entities a constructive price rather than the price established by the related
7 entities would govern. The federal government has had such a rule in place applicable to certain
8 excise taxes long before the voters passed Proposition 99. Internal Revenue Code §4216(b)
9 provides that, where a product subject to certain excise taxes is “sold (otherwise than through an
10 arm’s length transaction) at less than the fair market price,” the excise tax is based not on the
11 sales price but on a “constructive sales price” which is a fair market value price. (*See generally*
12 *Columbia Products Co. v. United States* (D. SC 1975) (“Section 4216 provides essentially that
13 the correct definition of price varies according to the manner in which a manufacturer structures
14 his business and the nature of the customers to whom he sells”)).

15 The parties have not cited, nor have I located, any California statute that is similar to IRC
16 §4216(b) or that requires or permits the use of a constructive price to determine “cost ... to the
17 distributor” for purposes of the Tobacco Tax Law. In the absence of such a statute and in the
18 absence of the application of alter ego or sham principles, the plain language of §30017 requires
19 that “cost ... to the distributor” of the OTP samples distributed by UST Sales be the actual price
20 paid by UST Sales to UST Manufacturing for those samples, which is the Transfer Price for
21 unmarked samples and the Marked Samples Price for marked samples. Any other construction of
22 §30017 would be to engage in re-writing of that section or to write into the Revenue & Taxation
23 Code a statute akin to IRC §4216(b), both of which clearly exceed the judicial function.

1 If under the facts of this and/or other cases §30017 is subject to perceived or actual abuse
2 or unfair manipulation, it is up to the voters or the Legislature to make any needed corrective, not
3 for a judge to re-write that section. In all events, as observed by a highly-regarded federal
4 appellate judge in a case involving IRC §4216(b), the situation presented by this case of separate
5 incorporation of related companies that sell products subject to an excise tax from one to another
6 is not “per se improper.” (*Crème Manufacturing Co., Inc. v. United States* (5th Cir. 1974)
7 (Wisdom, J.) (“There is nothing per se improper, therefore, with splitting manufacturing and
8 selling functions into distinct corporations. And, furthermore, we consider the motivation of the
9 taxpayer to be irrelevant. Courts have long held that a taxpayer may arrange its business affairs
10 with an eye toward the tax consequences and that it need not maintain a corporate structure so as
11 to pay the highest taxes”).

12 **The Transfer Price is not a Discounted Price as the Term “Discounts” is used in Section**
13 **30017.**

14 Having determined that the Transfer Price is the “cost ... to” UST Sales for the unmarked
15 samples it purchased from UST Manufacturing for the purposes of the first portion of §30017, I
16 now address SBE’s argument that the Transfer Price is a discounted price off the List Price as the
17 term “discounts” is used in the remaining portion of §30017.

18 Nowhere in the Tobacco Tax Law are the words “discount,” “discounts,” “discounted” or
19 anything similar defined. Absent any special definition given to the word “discounts,” a well-
20 established rule of statutory construction requires that “discounts,” as that term is used in
21 §30017, be given its “usual and ordinary meaning.” (*Schatz. v. Allen Matkins Leck Gamble &*
22 *Mallory LLP* (2009) 45 Cal. 4th 557, 571). In *U.S. Tobacco I*, 982 P.2d at 657, the court, quoting
23 a standard dictionary, defined “discount” as “an abatement or reduction made from the gross
24 amount or value of anything” and “reduction from a price made to a specific customer or class of
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1 customers.” Those definitions accord with my understanding of the usual and ordinary meaning
2 of the word “discounts” and thus that is how I will construe that word for the purposes of
3 §30017. (*Accord Koire v. Metro Car Wash* (1985) 40 Cal. 3d 24 (in a civil rights case the court
4 assumed, without explicitly stating, that a “discount” was a price charged to one customer less
5 than a price charged to another customer for the same product or service)).

6 The foregoing common understanding of “discount” necessarily assumes that a discount
7 occurs only when a seller sells the same product for a price higher than the assertedly discounted
8 price. Here, however, the parties stipulated that the Transfer Price is the same price that UST
9 Manufacturing sells all OTP other than marked samples to UST Sales and that marked samples
10 are sold for a lower price than the Transfer price. Accordingly, there is no higher price charged
11 by UST Manufacturing to UST Sales from which the Transfer Price is being reduced or
12 discounted. In sum, because the phrase “prior to any discounts” as used in §31007 clearly
13 connotes a lower price charged by a seller than another price charged by that same seller, SBE’s
14 argument that the Transfer price is a discounted price off the List Price – a price charged not by
15 UST Manufacturing but by UST Sales to its own customers – lacks merit. Even if there was
16 some ambiguity to the word “discounts” as used in §31007 and that word could be construed to
17 include a lesser price charged by someone other than the vendor at issue, which I do not believe
18 there is, such ambiguity would have to be resolved in favor of UST Sales. (*Agnew, supra*).

19 Most or all of what I wrote in the previous section about the “cost ... to the distributor”
20 being pegged to the level of trade between UST Manufacturing and UST and therefore excluding
21 the sales and marketing costs incurred by UST Sales applies to – and requires rejection of –
22 SBE’s argument that the Transfer Price is an “artificial price” and thus a discounted price
23 because it does not reflect any sales or marketing costs. While SBE in its trial brief and at times
24 during the trial couched its arguments that UST Manufacturing’s absence of sales and marketing
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1 functions renders the Transfer Price a “discount” price per the second portion of §30017,
2 analytically I have chosen to deal with those arguments in the context of addressing “cost ... to
3 the distributor” as that phrase is used in the first portion of §30017.

4 Regardless of whether SBE’s arguments are framed in terms of “cost ... to the
5 distributor” or as “discounts,” the analysis set forth in the previous section requires rejection of
6 those arguments. This is because the “discount” that is asserted by SBE is a “reduction in price”
7 due to the Transfer Price not taking into account sales and marketing costs, yet, as explained
8 above, under §30017 the Transfer Price need not cover such costs because at the point in the
9 chain of distribution that it is charged, no sales or marketing costs have been incurred. Stated
10 another way, the Transfer Price cannot be a “discount” due to the fact that it doesn’t reflect the
11 cost of sales and marketing functions when an applicable “undiscounted” price would also not
12 reflect the cost of such functions.

13 **Because the Marked Samples Price is a Discount Off the Transfer Price, the Transfer Price**
14 **is the Tax Basis for all OTP Samples, Both Marked and Unmarked, Distributed by UST**
Sales in California During the Relevant Period.

15 Per the parties’ stipulation and the evidence at trial the only difference between the
16 marked samples and all other OTP, including unmarked samples, is the markings on the former.
17 Per the parties’ stipulation, this marking – and this marking alone – “compromised [the]
18 marketability” of the marked samples and thus UST Manufacturing charged a lower price for the
19 marked samples than it did for all other OTP it sold to UST Sales. Though not argued by the
20 parties, the foregoing facts establish that the “abatement or reduction” in price charged for
21 marked samples is a “discount” off the Transfer Price due to the compromised marketability of
22 marked samples. Indeed, the evidence submitted by UST Sales, and not disputed by SBE, was
23 that the only difference in the way the Transfer Price was calculated from the way the Marked
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1 Samples Price was calculated was that the former included profit and the latter did not, while
2 both prices covered the same costs.

3 That the Marked Samples Price is a discount off the Transfer Price does not necessarily
4 answer the question of whether it is a “discounts” within the meaning of §30017. At least
5 theoretically the word “discount” as used in that section could be limited to discounts based on
6 volume, prompt payment or other customary reason why sellers provide discounts to others in
7 the chain of distribution. Such theory is inapplicable here because §30017 plainly and
8 unambiguously refers to “any discounts,” thereby precluding any construction of that section
9 covering only some discounts. A discount for compromised marketability could only fall outside
10 the scope of §30017 if the word “any” is “construed” out of that section, but to do so runs afoul
11 of a familiar requirement of statutory construction. (*Agnew, supra* (“whenever possible,
12 significance must be given to every word in pursuing the legislative purpose, and the court
13 should avoid a construction that makes some words surplusage”)).

14 Treating the difference in price between the Transfer Price and Marked Samples Price as
15 a “discount” under §30017 is in keeping with the fact that, for purposes of determining tax basis
16 of both cigarettes and OTP, the Tobacco Tax Law equates the giving away of tobacco samples
17 with the sales of tobacco. Since the Marked Samples Price was less than the Transfer Price only
18 because of the “compromised marketability” of the marked samples as a result of their being
19 marked as samples, giving effect to the difference in the prices would result in the distribution of
20 samples having a lower tax basis than other taxable distributions, which is contrary to the equal
21 tax basis treatment in the Tobacco Tax Law of “distributing” samples with all other taxable
22 distributions. Nor is it relevant that, at least theoretically, unmarked samples could be more
23 readily re-sold and thus might not have the same “compromised marketability” as marked
24 samples. Putting aside that the applicable SBE regulation now requires that all samples of OTP
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1 be “marked” (18 Cal. Admin. Code §4081), the marking of samples during the Relevant Period
2 merely designated that certain OTP was intended to be given away as samples and such a
3 designation by itself surely doesn’t warrant departure from the Tobacco Tax Law’s mandate that
4 the distribution of samples have the same tax basis as other taxable distributions.

5 Though not dispositive of the California issues presented in this case, it is worth mention
6 that, as stated in a footnote of the first Washington Court of Appeals decision, UST Sales
7 “acknowledged” that the tax basis for the marked samples it distributed in 1992 in Washington
8 was the same as for unmarked samples, and that UST Sales purchased the marked samples from
9 UST Manufacturing at a “discounted price.” (*U.S. Tobacco I*, 982 P. 2d at 934, n.4).

10 **SBE is Bound by the Stipulation that all OTP Other than Marked Samples was Sold by**
11 **UST Manufacturing to UST Sales at the Transfer Price, and Therefore is Precluded from**
12 **Arguing that the Transfer Price was Not the Wholesale Cost. Even in the Absence of the**
Stipulation, UST Sales Presented Sufficient Evidence to Meet its Burden on this Point.

13 At the trial SBE presented evidence that checks from UST Sales to UST Manufacturing
14 revealed that UST Sales actually paid less for the OTP it purchased from UST Manufacturing
15 during the Relevant Period than was claimed in the invoices issued by UST Manufacturing.
16 Presumably this evidence was presented not only for the purpose of bolstering SBE’s argument
17 that the Transfer Price and the Marked Sales Price were “artificial” contrived prices, but also to
18 show that UST Sales’ actual cost of the OTP was different than what UST Sales claimed. At the
19 time this evidence was presented it was not clear whether the parties recalled that they had
20 previously stipulated that all OTP except marked samples was sold by UST Manufacturing to
21 UST Sales during the Relevant Period at the Transfer Price and all marked samples was sold at
22 the Marked Samples Price. As discussed earlier, this stipulation binds SBE and me, and thus any
23 evidence to the contrary must be disregarded.

1 Even if the parties had not entered into a stipulation that the Transfer Price was the price
2 at which UST Manufacturing sold all OTP other than marked samples to UST Sales during the
3 Relevant Period, the evidence presented at the December 15, 2009 hearing was more than
4 sufficient to establish this fact. In particular, I am satisfied that UST adequately explained the
5 reason why SBE could not reconcile the checks from UST Sales to UST Manufacturing. I now
6 find that UST Sales' books and records do in fact reconcile on this point. Accordingly, I find that
7 UST Sales met its burden of proving the "wholesale cost" of the OTP samples it distributed in
8 California during the Relevant Period, as I have construed that phrase in this decision. The
9 weight of the evidence establishes that UST Sales purchased all its OTP except marked samples
10 during the Relevant Period at the Transfer Price.

11 **Conclusion**

12 For the reasons set forth above, I conclude that during the Relevant Period the tax basis
13 for all samples of OTP, both marked and unmarked, distributed by UST Sales in California was
14 the Transfer Price. As set forth in the attachments to the Stipulation of Facts dated April 2, 2008,
15 that Transfer Price was 72.9 cents per can for all of 1994 for all varieties of OTP that were
16 distributed as samples, 78.3 cents per can for all of 1995 for all varieties of OTP that were
17 distributed as samples, and 80.7 cents per can for the portion of 1996 included within the
18 Relevant Period for all varieties of OTP that were distributed as samples.

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The parties are required to meet and confer regarding the language of a judgment that is in accordance with this decision. If the parties cannot agree on the language of a judgment, each party should submit a proposed judgment.

IT IS SO ORDERED.

Dated: March 22, 2010

HAROLD KAHN

Harold E. Kahn
Judge of the Superior Court

Superior Court of California
County of San Francisco

U.S. SMOKELESS TOBACCO
BRANDS INC.

Plaintiff(s)

vs.

STATE BOARD OF
EQUALIZATION,

Defendant(s)

Case Number: CGC-07-463592

CERTIFICATE OF MAILING
(CCP 1013a (4))

I, **Audrey Huie**, a Deputy Clerk of the Superior Court of the County of San Francisco, certify that I am not a party to the within action.

On **March 23, 2010** I served the attached **Decision after Nonjury trial** by placing a copy thereof in a sealed envelope, addressed as follows:

AMY L. SILVERSTEIN, ESQ.
55 HAWTHORNE STREET, STE. 440
SAN FRANCISCO, CA 94105

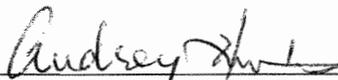
JULIAN O. STANDEN, ESQ.
DEPUTY ATTORNEY GENERAL
455 GOLDEN GATE AVE., STE. 11000
SAN FRANCISCO, CA 94102

and, I then placed the sealed envelopes in the outgoing mail at 400 McAllister Street, San Francisco, CA. 94102 on the date indicated above for collection, attachment of required prepaid postage, and mailing on that date following standard court practices.

Dated: March 23, 2010

CLERK OF THE COURT

By:



Audrey Huie, Deputy Clerk