BEFORE THE CALIFORNIA STATE BOARD OF EQUALIZATION

450 N Street, Room 121

Sacramento, California

REPORTER'S TRANSCRIPT

AUGUST 14, 2007

BUSINESS TAXES COMMITTEE

FLAVORED MALT BEVERAGES

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Government Code
Section 7.9)

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Sacramento, California

August 14, 2007

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MR. EVANS: Next item is the Business Taxes Committee. Ms. Yee is the Committee Chairman.

MS. YEE: Thank you, Mr. Evans. Good morning, Ladies and Gentlemen.

Let me just spend a little time talking about the structure of the committee this morning.

What I'd like to do is first just talk about how we will proceed with the introduction of the issue and the discussion. For those of you in the audience that are awaiting your individual appeals case, I expect this discussion will last for at least an hour. So, just in terms of a time check.

What I intend to do is to have the staff introduce the issue, and while the issue is being introduced I would like to ask both proponents and opponents on the issue before us to coordinate among themselves.

We will allow 30 minutes for public comment by the proponents, as well as 30 minutes by the opponents, of the rule change in this matter. I believe, Mr. Evans, is there a room set up to -- where the proponents

can gather and -- and organize themselves?

MR. EVANS: Yes, I believe the Dronenburg room is open.

MS. YEE: Okay. And is someone from your staff already coordinating that particular group?

MR. HALE: Mike Hale, Excise Taxes. I believe that group has already coordinated their presentation.

MS. YEE: Very good. Very well. Thank you. And then we'll open it up for discussion with the Board Members.

And with that in mind, after the discussion and any potential action on this issue we will take a ten-minute break before proceeding with the remainder of the Board meeting. Okay.

Good morning, Mr. McGuire and Ms. Bartolo. Do you want to proceed to introduce the issue.

MR. MCGUIRE: Good morning. I'm Jeff McGuire with the Sales and Use Tax. With me today is Lynn Bartolo and Mike Hale of our Excise Tax Division. And Randy Ferris and Monica Brisbane of our Legal Department.

We have one agenda item for your consideration today concerning the taxation and classification under the Alcoholic Beverage Tax Law of flavored malt beverages, also known as FMBs.

This issue was initiated by an October 2006 letter from the California Friday Night Live Partnership, the Students Making a Community Change

and the California Youth Council, which was petitioning the Board to adopt a regulation to tax FMBs as distilled spirits and/or amend Regulation 2530.

FMBs, as you know, are currently classified and taxed at the same rate as beer, which is lower than the rate for distilled spirits. In response to the petition, in December of 2006 the Board voted to direct staff to initiate the rulemaking process and to hold a series of public meetings with interested parties to discuss the classification and taxation of FMBs for the purpose of offering alternatives, and to prepare draft regulatory language for consideration by the Board.

Interested parties meetings were held on February 22nd and June 6th of this year. Approximately 100 written submissions have been received that reiterate and expand upon the oral presentations at the interested parties meetings.

As a result we have three alternatives for your consideration today. Alternative 1 would create new regulations 2558, 2559, 2559.1, .3 and .5 so that flavored malt beverages would be taxed as distilled spirits while traditional beer products would still be taxed as beer.

Alternative 2, which is proposed by the plaintiffs in the County of Santa Clara, et al versus Board of Equalization, recommends revisions to Regulation 2500 that appears to presume that any alcoholic beverage with any amount of alcohol derived

from the distillation process would meet the definition of distilled spirits for tax purposes.

Finally, Alternative 3, which is consistent with the Department of Alcoholic Beverage Control's current classification practices for licensing purposes, would make no regulatory change and continue to tax flavored malt beverages as beer.

Following the comments by the interested parties today, staff is available to answer any questions you may have.

MS. YEE: Thank you very much. Let me first call for public comment by the proponents of the rule change. And you'll have a total of 30 minutes.

Mr. Evans, if you'll set the clock at 30 minutes we will notify you at ten-minute increments of your time left

MR. EVANS: And if you'd please state your name and who you represent.

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JIMMYJORDAN

JIMMY JORDAN: Okay. Good morning. My name is Jimmy Jordan. I am part of the California Council. And I'm here to represent the California Council by being one -- one of the original petitioners. I would like to say -- see the properly taxed -- oh, sorry, I'd like to see the -- the tax properly taxed on distilled spirits.

Our petition is not meant to alter the current classification of additional beer. Our petition was meant for one reason, to correctly tax alcopops the way they should be, as distilled spirits and not what they're being taxed now, as beer.

We did not write this petition to create a new tax, but to enforce one that's already in place. Our petition is about the classification of alcopops and not at all about the tax on food coloring and rubbing alcohol.

I don't think I've ever seen or heard my peers trying to get drunk off these products. It's just industry trying to distract the Board from the real problem, which is alcopops. These drinks are clearly distilled spirits under California law. Therefore, they must be regulated as such. By being taxed as a beer, California is losing well-needed -- well-needed tax

revenue estimated around $40 million, which could be easily used for educational systems or prevention efforts to enforce -- ensure the young people of California have a safe environment to grow up in. After all, we are the future.

We know -- we believe California regulation states it clearly, any amount of distilled spirits should be taxed as a distilled spirit.

I have been part of this issue for about a year now. Through this process the Board has been more than willing to assist us on this issue. I would like to thank you guys for everything you have done so far, and everything you guys hopefully will do in the future.

We know it's your job to correctly tax alcopops. The right thing is never the easy thing to do.

Thank you.

MS. YEE: Thank you very much. Ms. Steel.

MS. STEEL: How old are you, if it's okay to ask?

JIMMY JORDAN: I'm 18.

MS. STEEL: Do you drink?

JIMMY JORDAN: No

MS. STEEL: Okay.

MS. YEE: Thank you. Next speaker, please. Next speaker, please.

MR. EVANS: Please move to the -- to the microphone, the next speaker.

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K. SCOTT DICKEY

MR. DICKEY: Good morning. My name is Scott Dickey. I'm an attorney with the Public Law Group in San Francisco. I represent the interested parties of the County of Santa Clara and Patricia Treasline (phonetic), who are the petitioners in the County of Santa Clara versus the State Board of Equalization.

I'd like to talk to you today a little bit about the -- the legal framework behind the -- the regulations that -- that we and the petitioners -- the youth petitioners are -- are advancing today.

The California Constitution imposes upon the Board the responsibility for the assessment and collection of taxes on the sale, manufacture and distribution of alcoholic beverages. The Board is the only agency in California that is responsible for doing that, and the Board has -- admits that its -- its purpose is to interpret and apply tax laws correctly.

Relevant to that purpose here are -- are two sections or two -- two legal frameworks in -- in California. The Alcoholic Control Act, which defines what these beverages are. And the Alcoholic Beverage Tax Law, which I'm sure you're very familiar with.

The Act defines an alcoholic beverage as any

alcohol, whether it's a spirit -- alcohol spirit, beer or wine, that contains more than one half of one percent of alcohol by volume. And it can be in any form. It can be a liquid. It can be a solid. It doesn't have to have to be a beverage to be considered an alcoholic beverage in California. All it has to happen is at some point if it can be mixed with something else or diluted or something to be added to it so that it's something you would actually drink, it is an alcoholic beverage even if it isn't something you would even traditionally think of drinking, like a powder or a -- a gelatin.

The Legislature then breaks down the types of alcoholic beverages that you can have into three very distinct categories. There are only three types of alcoholic beverages in California. There's beer. There's wine. There's distilled spirits. These categories are set forth in Business and Profession Code Sections 23,005 through 23,007. And they are mutually exclusive.

A beer has to be a product that is made from malt or hops or barley or other ordinary beer ingredients and fermented in water. A wine is something that is fermented from the juice of grapes or certain types of fruits. Wine can also include distillations of wine so that you can raise like four to five wines, brandies, cognacs, that sort of thing. And then there's distilled spirits which are not fermented products but products that are developed through the distillation of

another alcohol. And they are -- are typically -- a distilled spirit is anything that is distilled from an agricultural product. And it includes whiskey, rum, brandy and gin. And also according to the State law all dilutions and mixtures thereof.

The distinct nature of each of these definitions is clear from a number of factors. First, the Board understands this. Back in 1997 the Board was approached by a manufacturer who wanted to know how to tax and classify a product that would be a combination of beer and distilled spirits. After looking at the definitions in the Business and Professions Code, Board staff advised, and I'm quoting here, that the definition of beer does not include any circumstances under which beer mixed with distilled spirits will still come within the definition of beer. Therefore, a product including beer in any amount or kind of distilled spirits will not meet the definition of beer and will instead be a distilled spirit and taxed as such.

Eight years later this Board went to the Attorney General and asked the Attorney General for a position on that same question; what would happen if you had a beer mixed with a distilled spirit? And the Attorney General, after looking at the definitions in the -- in the Business and Profession Code, and looking at some cases against the State Board of Equalization or involving the State Board of Equalization, involving the question of what happens when you mix a distilled spirit

with other forms of alcohol, came to the same conclusion and said that a product that includes beer in any amount or kind of distilled spirits is a distilled spirit or dilution or mixture thereof and must be taxed and classified in California as a distilled spirit.

So, we have those sources to tell us these are distinct categories and it can only be beer or a distilled spirit. We know from the legislation that it can only be that because of the definitions and because of the way the California Legislature treats these different types of products.

Beer and wine products are regulated much more loosely than distilled spirits. The taxes are a lot lower. Beer and wine is taxed at 20 cents a gallon. Distilled spirits is $3.30 a gallon if it's under 100 proof. If it's over 100 proof it's $6.60 a gallon.

They can be sold in -- distilled spirits can only be sold in -- in certain locations. Beer and wine can be sold in far -- far more places within the State and by far more classes of people within the State.

So, what we've come to is that we have a classification system that only allows these flavored malt beverages, which we call alcopops, to be classified in one way, and the Board's sort of acceptance of the Department of Alcoholic Beverage Control's passive acceptance of the -- the manufacturer's marketing of those things as beer products.

But we have a lot of information at this point

that suggests that they aren't beer products. We know from a study conducted by the United States Tax and Trade Bureau -- Alcohol and Tobacco Tax and Trade Bureau in 2003 that of the 114 alcopops on -- on the market at the time, 96 percent of them got more than three-quarters of their alcohol from distilled spirits. That may have changed because the Federal regulations have changed in a way that allow a -- a malt beverage, which is the Federal word for beer, to be a malt beverage even if it has up to 49 percent of its alcohol from distilled spirits.

But nevertheless we know that these things contain a lot from that study. The State of Maine in 2005 passed -- passed legislation that just created a new class -- category of flavored malt beverages called low alcohol spirits, where if it derived more than half a percent of it -- no, I'm sorry, low alcohol spirits, if it has any distilled spirits at all, as long as it's under 6 percent alcohol then it's -- it would qualify as a low alcohol spirit. And the manufacturers voluntarily working with the scheme produced a list of the products that they produce that they say have distilled spirits in them. And there are over a hundred of them and I believe that most, if not all of them, are sold in California.

We also have the manufacturers here today who -- whose representatives have over time in -- in this process, either admitted or not denied that

their -- their products contained distilled spirits. They disagree as to the consequences of that or the nature of the distilled spirits that are put in there, but they don't -- they don't dispute that they actulaly have distilled spirits flavorings in them.

So, we are at a juncture where we need to move the -- the process forward. The Board needs to adopt regulations that in some way aid the -- assist the Board in identifying those products that are being sold that contain distilled spirits, that are currently being classified as beer so that they can properly tax and regulate these things going forward.

MR. EVANS: 20 minutes remaining.

MR. DICKEY: I have a few things that I'd like to say before I pass the mike off to my colleagues about the -- some of the things that have been raised by the -- by the alcohol industry.

First, I understand that it's industry's position that if the -- if the Board adopts new regulations that create .5 percent standard, that they will simply remanufacture the products so that they all fall underneath that -- that level.

That is we think a red herring but ultimately irrelevant, because if they do reformulate their products to fall within the standards, if the Board adopts a .5 percent standard, then those products are going to be fine. We're not interested in pulling alcopops from the shelves; we want them to be taxed

properly. And if they can do it in a way that doesn't involve significant amounts of distilled spirits, then -- and falls within the standards set by this Board, then I think that we would be okay with that.

And in -- in any event, material they presented to the Board suggests that the reformulation to that level would both be extremely costly and very speculative because they worry about the loss of the flavor profile of the product in -- in the food industry. That -- that means a possibility it will drop off in the marketability and salability of the products.

The second point that I want to address is they -- they challenge the exemption of wine from the regulation, and I point out as I did in the very beginning that the -- the laws involving wine specifically permit the use of certain types of distilled spirits, and so it is appropriate that wine not be included and the presumption that the product is a distilled spirit.

And, finally, the industry argues that the Department of Alcoholic Beverage Control is the classifying agency here. That isn't true. I mean, it's true for purposes of licensing and who can sell these things, but for purposes of taxation this Board is the -- the agency that has to figure out what it's taxing. And it's encumbent upon the industry to tell you what it is that they are producing so that you can tax it properly.

The regulations that we have presented, the ones that staff has presented, both get to that ultimate goal and we would urge you to vote in favor of those regulations.

Before I pass the microphone to my colleagues, I'd like to -- I'd be happy to answer any questions you have, but I'd also be happy to come back after the -- the parties have given their -- their speech, if you have any.

MS. YEE: Mr. Leonard.

MR. LEONARD: I -- I did have one question. I'm glad you brought it up because I was going to ask. I have not had a chance to research what Maine did and it seems like kind of a reasonable alternative to this. Was it the -- who did it? Was it done by legislation and statute or was it done by regulation of a Tax Board?

MR. DICKEY: It was -- it was a revision of the -- of the statutes.

MR. LEONARD: Of the statute. By the Maine Legislature?

MR. DICKEY: Yes.

I'm sorry. I'm -- (inaudible)

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FREDJONES

FRED JONES: Mr. Leonard, Fred Jones, California Council on Alcohol Problems.

Actually, after the TTB'S ruling of this 51/49 percent, the Maine Attorney General, because they don't have an ABC Department like we do, made a decision that their existing laws, which includes low alcohol spirits category, was sufficient. So, they in fact did not pass any new laws.

In fact, I have a letter --

MR. LEONARD: So, the A.G. didn't define the current regulatory scheme to fit the new rule. So, it may not be parallel to our situation then.

MR. JONES: Well --

MS. YEE: Mr. Leonard, maybe I can clarify. There are four classifications in the Maine statute --

MR. LEONARD: Right

MS. YEE: -- for alcoholic beverages.

MR. LEONARD: There always have been then.

MS. YEE: But with the reclassification of flavored malt beverages it was deemed appropriate to fit those under the --

MR. LEONARD: Okay.

MS. YEE: -- low alcohol --

MR. LEONARD: And those four categories are created by legislation.

MS. YEE: Statutory by legislation. Thank you.

MR. LEONARD: Somewhat previously.

Thank you. Thank you much.

MR. EVANS: If I could remind the speakers to speak into the microphone, please.

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MICHELESIMON

MS. SIMON: Thank you. My name is Michele Simon and I'm the Research and Policy Director for the Marin Institute. I'd like to thank the Board for this opportunity to speak and I'd like to help put this issue into more of a global context. Something we don't often do is think about how our tax schemes compare to other countries. And in a report that the Marin Institute put out last month we did exactly that and we did provide this report to you. And I just want to drew your attention to the chart which shows the comparison of tax rates on alcopops in other countries to both the current California rate and what we're proposing to do here today, which is to increase the rate.

In the UK the tax rate is about eight times as much as the current tax rate. In Germany it's 16 times. In Switzerland it's a whopping 20 times higher than the current California tax rate.

Even if we were to properly classify alcopops in California as distilled spirits, these other countries would still have much higher tax rates. The UK's tax would still be twice as high. The German tax four times as high. And the Swiss tax five times as high. So, that's just to put this into some context of

what we're asking for is really not much of an increase if we look at the context globally.

What's interesting is that both Germany and Switzerland went even further than what we're asking for in that they created a separate category for taxing alcopops, and that tax rate was higher than their current distilled spirits rate. So, then that's going over and above what we're asking for. And yet in these countries industry chose not to reformulate, the regulatory sky did not fall. The government regulators there just figured out how to do it.

And as a result of these increases they have seen dramatic drops in consumption in these countries. In the UK, sales dropped by 43 percent over four years. In Germany, alcopop consumption went down 50 percent among teenagers according to a survey because alcopops became too expensive.

So we wanted to look at what would such a tax increase -- what kind of impact would a tax increase have here in California. What we did was we used data from those countries, again way ahead of us, have several years of experience in how these increased taxes have actually in--- affected consumption.

So, to do that we first actually calculated the current impact of underage consumption of these products. This isn't just a theoretical issue. Underage drinking is a significant public health problem. And by our estimates, California spends a

whopping $1.25 billion every year -- this is both in public and private money -- dealing with the various harm caused by underage consumption of alcopops.

More importantly, 60 lives a year are lost. 60 underage youth die each year as a result of drinking these products. But the good news is that if we were to increase the tax, if we were to correctly classify these products, we could actually save money and lives. By our calculation consumption would drop because we know youth are so sensitive to price. With the increased tax prices go up, consumption goes down.

We estimate that consump -- that drop in consumption would be 35 percent. Applying that 35 percent to those figures I just gave, that translates to a savings of $437 million a year.

More importantly, we could save the lives of 21 youth, every single year. Now, industry has done its own economic analysis which they provided and they say that an increased tax would burden them to the extent of $28 million a year. The reformulation that they say they would undergo would cost them $28 million over four years.

Now, we're not disputing their analysis. Let's just take that figure and compare it to what we estimate, which I just described. $7 million for one year compared to a savings of $437 million a year. 62 times as much or net gain of $430 million, not to mention saving the lives of 21 youth and preventing

countless harm.

A really interesting thing is when you look at this from a global perspective is that this category that industry likes to call flavored malt beverages is basically invented for the U. S. market. And I want to give you some evidence of that.

The first piece of evidence comes from an article from this year in the Seattle Times, which describes and is talking about Mike's Hard Lemonade. And they say in Canada Mike's spikes its drinks with vodka. But in the U. S., because of tax and distribution issues, it uses a malt base that tastes clean enough to stay out of the way of other flavors.

Another piece of evidence we have comes from a industry trade journal called Beverage Industry News, again earlier this year. And this whole article is about this category, flavored malt beverages. And they explain how in the U. S. the beverages are made with barley malt due to regulatory abuses. Outside the U. S. actual vodka is used.

This allows FMBs to be classified as beer, which has advantages. There are less restrictions about where they can be sold. The beverages have a lower tax rate. And they can be distributed as beer.

The final piece of evidence I'd like to draw your attention to, which is in the packet that you were handed, is a screen shot from Smirnoff.com. This is Smirnoff Ice. This is one of the top selling products

in the U. S. but it comes from the UK. So, this is a screen shot that touts the fact that this product, Smirnoff Ice, is made with Smirnoff vodka. But the funny thing is there's a little asterisk here and the disclaimer says, "Except in the U. S. and the U. S. supplied markets where Smirnoff Ice is a malt beverage."

We're asking this Board to not allow industry to continue to engage in this shameless charade of exploiting the regulatory process, taking advantage of lower tax rates, not to mention the exploitation of our young people.

Please do the right thing and tax alcopops as distilled spirits. The future of our youth depends upon it. Thank you.

MS. YEE: Thank you very much. Next speaker.

MR. EVANS: You -- you have ten minutes remaining.

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FREDJONES

MR. JONES: Board, my name is Fred Jones again. California Council on Alcohol Problems. I'm here actually to discuss a little bit about the State of Maine, Mr. Leonard, and related specifically to the staff comments about this effort possibly having non-absorbable costs of 5.5 staffers with BOE.

I'm at a loss knowing what Maine has already gone through justifying where five and half staffers will be needed by BOE to implement this change. We had sent your staff a two-page letter from the Special Assistant to the Attorney General of Maine that I think is directly on point.

Ms. Yee, you mention that how they have four categories. There are two distilled spirit categories depending on how much alcohol by content. So they basically have two distilled spirits.

If it's less than 6 percent by content, then they call it a low alcohol spirits. If it's more than that then it's just a spirit. But nevertheless they have two spirits classifications.

And some of the FMBs have more than 6 percent by volume. So, some of them are considered spirits, some of them are considered low alcohol spirits.

A little background from their letter. Basically in 2003, when the TTB made their ruling, it caught all the states off guard. In fact, it caught a lot of the industry off guard, who were -- actually the biggest producers were fine with a .5 percent standard for distilled spirits. And so, it was kind of surprising when the TTB said, no, we'll allow it to half, the 49 percent.

So it surprised not only states but even the industry, some of the biggest players. When that happened, this was the first time Maine officials learned that the labeling of these beverages as malt beverages was inconsistent with how these beverages should be classified and taxed under Maine law. And by the way, I would say this is very consistent with California law.

Before taking action, State officials waited to see if TTB would reclassify these beverages. When TTB failed to take the step, Maine decided it was necessary to reclassify these beverages to be consistent with State law.

And I really want to highlight some of these phrases. Maine's process of reclassification was essentially seamless. They sent a letter out on March 2005 to all the manufacturers and said, "If you have distilled spirits in your products, you're going to be considered a distilled spirit for taxing purposes." As well as for licensing. But for purposes of today taxing

is sufficient.

The entire process was concluded in the fall of 2005 without any problems. That's a quote from the Attorney General's office. So, they started in spring and by fall they had a registry of all the FMBs that were on the market that were being sold in Maine. And I have the four-page -- you can go on line right now, there's four pages on the Maine home page -- A. G's home page that shows you the list of their FMB products.

So that everybody knows. The retailers, the wholesalers, the public knows exactly which products.

And the manufacturers willingly and voluntarily submitted that list. No formal -- again I'm quoting directly from Ms. Miler's letter. "No formal challenge to the reclassification was mounted by the industry. No suits were filed to block the reclassification. Our process was relatively simple and did not involve the creation of a new class of beverage or a new license."

So, they did it within existing regs. and existing law, and simply looking at our California law, which is consistent with theirs, it appears this will be just as essentially seamless and therefore I'm not quite sure how much absorbable cost to your staff will be incurred by pursuing this new either Alternative 1 or Alternative 2. Thank you.

MS. YEE: Thank you very much. Next speaker, please.

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VANESSAMADLIN

MS. MADLIN: Hi. I'm Vanessa -- Vanessa Madlin and I'm here with the California Youth Council.

MS. YEE: Vanessa, can you speak right into the microphone, please. Thank you.

MS. MADLIN: The only thing that we're asking for you today is to please do the right thing and tax these products appropriately. This petition really means a lot not only to our youth but also to the State of California. $40 million can really make a difference in a variety of areas. So, please, take an extra minute and think about the difference your vote can make for the State of California.

We do recognize the implementation may be hard, but we all know that the right thing isn't always the easiest thing. We do believe you have the skills to implement this petition and the ability to do the right thing.

Here are many postcards, thousands, from many youth throughout the State just like me that ask you to please do the right thing and vote yes to this petition. They're from youth and adults. Actually, throughout the State.

Thank you.

MS. YEE: Thank you very much.

Mr. McGuire, do you want to accept those so that we can actually have them as part of the record?

Thank you very much.

Next speaker, please.

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JUDY WALSH-JACKSON

MS. WALSH-JACKSON: Good morning. My name is Judy Walsh-Jackson and I'm the chair of the California Coalition on Alcopops and Youth. And the speakers who have come before you this morning are members of this coalition. And many of the coalition members are in the audience with us today.

We're a broad coalition that's very diverse, that includes community groups, faith-based groups. We have someone from the medical community with us today. Parents. Teachers. The PTA. Girl Scouts. And a lot of young people. Law enforcement. And those are just a few of our partners that I've mentioned.

We've come together to address the problem -- the growing problem of underage drinking in general and specifically alcopops, which as you know flavored malt beverages that are marketed to and popular with the underage drinkers, particularly girls.

We commend the young people from the California Friday Night Live Partnership, Students for a Community Change and the California Youth Council for submitting the petition to the Board on October 25, 2006. We would

also like to commend and thank the Board for accepting their petition, and the staff for undergoing this process to address and respond to the young people's important request.

The coalition supports taxing alcopops as distilled spirits, obviously, and the draft regulatory language accomplishes this goal. Alternative 1 would help to reduce, as you've heard, youth alcohol consumption and the problems related to it. We appreciate the efforts of the BOE staff to craft regulations that achieve the goals of the young people's petition.

And as you have heard over and over this morning, we need regulatory change. And there are thousands and thousands and thousands of Californians across this great State. The great citizens of our State support the proper taxation of alcopops as distilled spirits. Thousands of Californians have sent postcards asking for your yes vote.

Schools -- school districts, including the San Diego Unified school District and many other districts across the State have passed resolutions in support of this. Counties have passed resolutions. City Councils have passed resolutions. And even the American Medical Association passed a resolution last summer issuing a call to stop alcoholic beverages with special appeal to youth.

And I quote, "Our Surgeon General has stated

that underage alcohol consumption is a major problem facing our country and results in enormous health and safety consequences in all sectors of our community. Underage drinking has remained at consistently high levels. Our AMA, the American Medical Association," and we actually have someone here this morning from U. C. Davis to represent the medical community -- "Our AMA urges producers and distributors of alcoholic beverages to discontinue advertising directed toward youth and supports policies to address alcohol industry marketing and manufacturing and that our American Medical Association advocate for a ban on products such as alcopops that have special appeal to youths under the age of 21."

We know that there is trepidation among the Board. This is a new thing. And we ask that -- that you remember there's as much risk in doing nothing as in doing something. And we reiterate the young people's request, that the desire to do the thing right does not prevent you from doing the right thing, and we really appreciate all the time and resources that you've spent looking at this issue, discussing it, supporting the young people by accepting the petition.

MR. EVANS: You have one minute remaining.

MS. WALSH-JACKSON: And thank you for your time. Please vote yes.

MS. YEE: Thank you very much. Next speaker, please.

Does that conclude the speakers on the proponent side?

Okay, could -- could I just -- maybe by display of a show of hands, how many are in the audience that are supporting the rule change today?

Very good. Thank you very much.

Okay. We will now start the public comment from the opponents of the proposed regulation -- proposed regulation.

Will the speakers come forward.

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MARC E.SORINI

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MS. YEE: Okay, we'll now start the public comments from the opponents of the proposed regulation. Have the speakers come forward.
First speaker, please?

MR. EVANS: Please introduce yourself for the record and who you represent.
And you'll have 3 minutes.

MR. SORINI: Good morning, Members of the Board and staff. My name is Marc Sorini and I'm here on behalf of the Flavored Malt Beverage Coalition.
Is this working?

MS. YEE: Speak right into it, Marc, please.

MR. SORINI: I'm here on behalf of the Flavored Malt Beverage Coalition.

Let me do this -- the Elvis thing.

Marc Sorini on behalf of the Flavored Malt Beverage Coalition. And we appreciate this time to once again present our views to the Board and to the staff. As you know, the Coalition represents companies that produce approximately three-quarters of the flavored malt beverages distributed and sold throughout the United States. And so, obviously, this issue has great

importance to the Coalition's members.

Now, you've already heard from us in several submissions to the Board why we think this is a -- both Alternative 1 and Alternative 2 are deeply flawed, both legally and factually. And I am going to rest on those submissions for a lot of my detail.

But I do want to highlight a few points, five in particular. First, we believe -- just to run down the five and then I'm going to elaborate a little further.

But first, we believe very strongly that the law is clear, except that we don't agree with it. So, I guess me and the proponents of Alternative 2 agree on that one thing, but we think the law compels something very differently. A product that is a beer product cannot be transformed into a distilled spirit product by the addition of something that is not a distilled spirit but is, in fact, a non beverage flavor exempted from the California Alcohol Code by the -- I think it's Section 22112.

But, No. 2, we believe that the -- we believe that Code Section 32152, which compels this Board, as a matter of California law, to follow federal law in the case where the Board has discretion is directly applicable here.

And I'm going to explain why we think the issue paper in itself really supports that position quite strongly.

Point 3, we believe that -- the we believe that the issues here, underage drinking, are very important and we certainly want to work with the State of California, the members of -- the member companies want to work with State of California in a variety of ways, work with the petitioners to address underage drinking.

But this is not the forum, it's not the time, it's not the place. Instead the legislature was quite clear, we believe, when the legislature invested the ABC with the discretion and with the regulatory authority to administer the ABC Act and interpret the ABC Act. And that this Board, by essentially trying to do policy making with respect to that Act, is -- is acting in a way that violates or steps upon the exclusive jurisdiction of the ABC.

Fourth, we think that -- we think that the wine distinction is unsupportable, notwithstanding some of the comments in the issue paper, we believe that they misconstrued both the facts concerning the production of wine and the production of flavors.

Because of that, we think that there is a significant constitutional issue here, a commerce clause issue, which is that by exempting flavored wines -- and there are quite a few flavored wines, virtually all of them made in the State of California -- and yet imposing a massive tax increase on the flavored beers, most of which are made outside of California, we think that's a disparate impact on interstate commerce that violates

the commerce clause.

And then finally, and I will let one of colleagues address the study that was presented here by the -- by some of the petitioners, but certainly we believe the record is clear this is going to have a substantial adverse economic interest, economic impact on California businesses to the tune of $28 million. We think that's an important consideration here.

So, point 1, why is the law clear? The definition of an alcoholic beverage, notwithstanding -- and I heard Mr. Dickey that it includes anything that, if it's diluted, can be rendered into something that is potable.

Well, that's clearly not true. And, of course, every flavor, any vanilla extract, any product that's made for consumption in a food product is capable of being rendered potable. The code is very clear, flavors, which do contain distilled alcohol, are specifically exempted.

So, then we go to the definition of beer. Well, beer is any product made from, essentially, fermented grain, which all flavored malt beverages have at least -- at least the majority of their alcohol from the fermented beer base, particularly for products that are over 6 percent, which the higher strength, something a little bit higher in strength than beer, then the percentage is a very high percentage of the alcohol in those products coming from fermented beer.

If you take a distilled spirit, a distilled spirit is defined as an alcoholic beverage. In other words, it can't be a flavor. As a matter of law, flavors have been cut out.

And then it does have that dilutions and mixtures. But it says, "dilutions and mixtures therof." In other words, you've got to have an alcoholic beverage -- a gin, a vodka, a rum to start with for the addition of some dilution or mixture of that liquid into something else to render that liquid a distilled spirit.

So, we think the law is absolutely clear here. We simply do not see, and frankly haven't seen anything in the issue paper, that would convince us otherwise. We think the law is very clear as a matter of law these products are beer.

But even -- even if one accepts what the tentative conclusion supporting Alternative 1 was, which is that -- that there is some discretion here on the part of the Board to try to interpret the law and make a classification based on what are allegedly ambiguous products within the current system, well, then, we think the answer is still clear.

Government Code Section 32152 directs this Board to follow federal law. And here's what the issue paper had to say on that, which I thought was very telling, it says,

"A Section 32152 would not apply to the taxation of FMBs if the Board were to conclude

as a matter of law that FMBs are not properly classified as a beer or wine for tax purposes."

And I did a little bit of emphasis there, as a matter of law. We would agree with that.

Of course, the legislature can decide that if a product -- if they don't want to follow federal law, and makes a clear directive to that effect, then this Board is -- does not have to follow federal law. We would agree with that.

But the key is whether the legislature has spoken clearly and directed this Board to depart from federal law. Here the issue paper, as well as the pleadings in the Santa Clara County litigation, are very clear -- are very clear in saying that the law is not clear. The position of this Board has been that, in fact, it has discretion when looking at how to the tax these products.

Where there is discretion, in other words, where there is something that's not compelled as a matter of law, we think Section 32152 then compels the result that this Board needs to follow and act consistently with federal law.

The third point, in 1955 -- up until 1955, as most of you -- I am sure all of you know, excuse me -- the Board had the exclusive jurisdiction over both the regulation and the taxation of alcoholic beverages. In that year the -- in that year the legislature saw fit to amend the very constitution of the State and give

virtually all of those regulatory functions over to -- over to the ABC.

Now there was, and I, of course, agree with some of the petitioners that you do have the power to assess taxes, but if you look at the language -- if you look at the language both in the constitution and in the enabling legislation, it seems to envision a fairly narrow role for the Board. It is to assess taxes on account of the regulatory things that the agency has exclusive jurisdiction over. So, I would suggest that that did not -- that did not imply that the Board was to exercise independent rulemaking or independent policy making judgments, particularly where that independent policy making decisions really aren't tied to sort of classic tax jurisdiction issues.

And what we're talking about here and what, of course, the petitioners -- what you have heard here are social policy issues -- certainly not something that one would expect a tax board to be leading the policy making on. This is something that, frankly, the legislature ought to be doing. But if the legislature hasn't, then we believe that the legislature has commanded that the body to be dealing with this is the ABC and certainly not the BOE.

So, we think that's a very relevant, relevant consideration for you to think about when you are -- when you are looking at that.

Moreover, it is very difficult to believe, in

my mind, that any legislature -- when you try to go back and read the minds of the legislature in 1955 and think about what they were saying, it's inconceivable to me that they would have ever considered that the fundamental definitions in the ABC Act would be applied and interpreted in two very different ways by the two boards or the two administrative agencies that were interpreting them.

So, we think that for all those reasons the Board really should not act here. It would be violating the exclusive jurisdiction of the ABC as commanded by the legislature.

MR. EVANS: Twenty minutes remaining.

MR. SORINI: Next I'd like to talk a little bit about this wine issue because the issue paper does point out correctly that wine can be fortified.

Wine can be fortified, however, with what federally I would call wine spirits, because most wine is made from grapes -- that means brandy.

And the statute is quite clear here. It's that wine can be fortified with distallates distilled from the particular agriculture product or products of which the wine is made. That's a very narrow exception when it comes to spirits.

And, by the way, the reason that was necessary was because those are really distilled spirits, they're fit for beverage use, they're not flavors, they're not otherwise exempted from the -- from the ABC Act. And,

therefore, in order to allow that fortification to take place, adding spirits to an otherwise fermented product, you had to have an explicit statutory exception. But note that it's a narrow one.

Now the suggestion here and the suggestion made by Mr. Dickey earlier was, "Well, that really then takes the flavored wines off the table."

Well, I'd submit to you that that's definitely not the case. Nobody in the flavor industry is making wine -- is making flavors from brandy.

In fact, for example, in the record you'll see the TTB tutorial, the TTB tutorial on the addition -- or on how you register and file flavors. That presumes -- the presumption when you're clicking through that is that you're using grain neutral spirits. And from a cost perspective and from what's available on an industry perspective, you know that flavors are being made by grain neutral spirits, so, they would not be covered by this very narrow exception.

Now we think that that doesn't matter because, of course, our position is that the flavors don't render any fermented product into a distilled spirit.

But if you make the presumption for one, you have to make the presumption for the other. Because you are both interpreting the distilled spirit definition. And therein, we think, is where you have a commerce clause issue.

The issue paper says, "Well, we can

constitutionally make distinctions between beer, wine, and spirits." The Coalition doesn't agree with that. The point is, though, that you are making a discriminatory distinction as to how the distilled spirit definition is being applied to products that are like from the criteria that has been set up in Alternatives No. 1 and 2, which is whether there is alcohol from flavors in these products.

So, somehow that same alcohol in flavors has one effect when applied to beer and another effect or no effect when applied to wine. We think that the net effect is that you're exempting a vast majority of competitive products that have to virtually be made in California at the expense of the products that are almost invariably imported into California from outside the state. We think that has commerce clause implications.

And then finally, I'd like to further highlight the study that was submitted. We went and asked ECS, which is a very reputable and well-known economic firm in Washington, D. C. to take a look at the rulemaking. Poll members -- this was not based on speculation -- they polled both California wholesalers as well as flavored malt beverage manufacturers and concluded that there would be a $28 million dollar impact, negative impact, on businesses within California.

The law in California does require this Board to consider that impact when assessing any new rule.

And we would urge that you do that as well,

Well, I've droned on for quite a long time. So, if you have any questions, I'd happy to answer any of them.

MS. YEE: Thank you, Mr. Sorini.

MR. SORINI: Thank you.

MS. YEE: Okay, let's move to the next speaker, please?

LARADUNBAR.

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MS. DUNBAR: Good morning, Lara Diaz Dunbar on behalf of the California Restaurant Association. And I am here today on behalf of the CRA to express our -- urge you to keep on classifying FMBs, flavored malt beverages, as beer as opposed to distilled spirits. Specifically, we oppose Alternatives No. 1 and 2 and do support Alternative 3. We do this for many reasons.

The CRA represents more than 22,000 members. A large portion of our membership are the smaller, independently owned restaurants and smaller mom and pops, who, in many instances, can only obtain beer and wine licenses. And so, offering these flavored malt beverages is a way for them to remain competitive with larger outfits, larger chains who may have on sale general licenses, which typically are harder to obtain, more expensive, et cetera. And so, you know, this really does go to the heart of the smaller mom and pop restaurants.

Certainly restauranteurs in general make very narrow profit margins. The labor costs are high, the liability issues are high and on average the earn only between 3 to 5 percent out of every dollar that they

bring in.

So, this increase of a tax burden from 20 cents a gallon, if it's classified as a beer, to, you know, $3.30 a gallon as a distilled spirit, would certainly have an impact and make it quite unaffordable for many restauranteurs.

I do want to address the issue of underage drinking. Some of the proponents may say that alcopops may lead to underage drinking, it's geared towards youth. But we certainly don't see that as the case in the restaurant industry particularly. FMBs, I think, since they've been around, underage drinking has increased, but has decreased. And most of them are sold for off premises consumption, not in restaurants.

And the restaurant industry takes the underage drinking laws very seriously. There is a lot of liability consequences. Certainly our restauranteurs, you know, treat any sale of alcohol the same -- whether you are selling a glass of wine, a beer or Smirnoff Ice, they're going to card you. And, you know, it's not that we -- so, in our industry, you know, the underage issue has not come into play. We do a lot to curb underage drinking.

And the CRA sponsors a safe class which is geared towards training alcohol -- responsible training for alcoholic beverage service, which is the same as the ABC lead training class. So, we encourage our members and all their employees to take this training class.

Just last year we partnered with the ABC on their minor decoy operations, their sting operations when they received increased funding last summer. And we reached out to all our members and all of our nonmember restaurants and really encouraged them on tips and red flags on identifying underage drinkers to really, you know, take either the service aid class or the lead class to train their employees to properly serve alcohol.

Thirdly, I don't want to be duplicative, but I think it's important to point out of the policy reasons why we feel that it should be -- remain classified as a beer. Certainly the federal government treats it as a beer. The ABC treats it as a beer. And it has basically the same alcohol content as a beer, 3 to 5 percent and the fermentation requisite is there, it's a malt-based beverage.

So, for those reasons and others, we respectfully urge you to keep on classifying it as a beer.

Thank you.

MS. YEE: Thank you very much.

Next speaker, please?

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KRISTINPOWER

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MS. POWER: Good morning, Kristin Power, California Grocers Association. We represent supermarkets, regional chains, as well as mass merchandisers and convenience store operators.

As such, we are very concerned about prevention of underage drinking. We are partnering with ABC and the local law enforcement agencies wit h the lead training as well as conducting training within our own markets.

And it is imperative for us to be sure we are operating within compliance with the State regulatory statutes with respect to licensing and sale of all alcoholic beverages.

With that being said, we believe that this is not it is appropriate way of addressing the age -- the issue of underage drinking.

We ask your support of Alternative 3.

MS. YEE: Thank you very much.

Next speaker?

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HEIDI BARSUGLIA

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MS. BARSUGLIA: Heidi Barsuglia on behalf of the California Retailers Association.

Our members support the current classification of the flavored malt beverages as beer. Our members are certainly supportive of vigorously enforcing the current law, which prohibits the sale of alcohol to minors of any kind, regardless of how that alcohol is classified.

Because of this and for the reasons already articulated today, we ask your support on Alternative 3.

MS. YEE: Thank you very much.

Next speaker?

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DENNISLOPER

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MR. LOPER: Dennis Loper, representing the California Beer and Beverage Distributors Association, here in support of Alternative 3.

Mr. Sorini referred to the ECS study, which is an economic study. He pointed out that the wholesales, which are my members, would he severely disadvantaged by Alternatives 1 and 2.

We also think that there is some major administrative problems for our members.

And we ask for your support of No. 3.

MS. YEE: Thank you very much.

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ROBERT MICHAELS

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MR. MICHAELS: Thank you.

My name is Robert Michaels. i am a professor of economics at California State University Fullerton.

And I was asked to look at the Marin Institute's reports on the alleged effects of raising taxes on FMBs in particular.

Among other things I do as a professor, I co-edit a major economic academic journal. And I see literally Hundreds of research papers a year go past my desk. This paper would not pass the most minimal standards for acceptable research. This paper is, in fact, impossible to track down where most of its data comes from. Where you can track down where its data comes from, what you find out is that almost every piece of data that they use certainly is biased in a direction that seems to favor the pro tax point of view.

MR. EVANS: Ten minutes remaining.

MR. MICHAELS: What?

MR. EVANS: You have ten minutes remaining in your time.

MR. MICHAELS: They overestimate California's consumption of FMBs, which could be easily estimated

from just looking at shipment data, by close to 200 percent.

They estimate costs of FMB use by minors. They are overestimating the cost by a factor of probably 4 or 500 percent.

I detailed the derivation of these figures in the report that I have. Some of them were impossible to reconstruct, but even if you wanted to accept those figures at face value, the report makes a claim that I suspect most of us would find was incredible.

Essentially what it is saying is that on the basis of European experience that raising the taxes on FMBs in particular is not going to be inducing any substitution by underage drinkers to other alcoholic beverages.

They have one piece of information for that, which is a survey taken in Germany in 2005. In 2004 Germany raised its tax rate on FMBs by a fairly substantial amount. And they then repeated the survey of drinkers that they took in 2004. They found that underage drinkers were consuming a very large amount less of FMBs and, in fact, they were also consuming less in the way of other beverages.

So far so good, except oddly enough, the Marin study is missing a much more important piece of data. Exactly that same survey was taken in 2007, underage drinkers, looking at the longer term effect of an FMB tax increase. And what they found out was, in fact,

yes, FMBs were still down, but total alcohol consumption by people under age 18 was, in fact, up by about 15 percent. The substitutions had been towards beer and, to a lesser extent, towards stronger beverages. It's odd that they did not choose to mention this evidence.

Their other -- they take a trip to England and try to use statistics from there. It turns out that the statistics they use have nothing to do with underage drinking. They are all about total liquor shipments of various types, total alcohol shipments of various types, to the entire population of England. They can make no inferences at all.

Other countries they look at, Switzerland, essentially their study is based on a single newspaper article. And when you go beyond that newspaper article, you, in fact, find evidence that there is substitution and that's actually in official Swiss government documents.

So, I don't know what's going on with the study, but it does not meet any minimal standards of quality. It uses data in an incredibly selective way.

And what's really interesting is that partway through the study, when its authors are trying to tell you why it is that they believe that increasing the tax on FMBs will decrease underage drinking of all alcoholic beverages and there will be no other effect, they refer to it as a speculation on their part. That's their actual words.

That it is. It is a demonstrably empty speculation. Any data that go against it, they chose not to present. Any data on the background of the problem in the US is, in fact, either impossible to reconstruct or appears to be quite strongly biased.

On this basis I urge you to reject that study as any guidance whatsoever to what the policy should be that this commission offers on FMB taxation. Thank you.

MS. YEE: Thank you very much.

Next speaker, please?

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JOHN HANDLEY

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MR. HANDLEY: Madam Chair, Members, John Handley, with the California Independent Grocers Association.

And in respective remedy, I ask your support for Alternative 3.

Thank you.

MS. YEE: Thank you very much.

Other speakers?

Accordingly, may I have a show of hands of those in the audience that are opposed to any rule change in this matter?

Okay, very well, thank you very much. Members, I do want to open it up for discussion and questions.

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MS. YEE: Let me begin by making a brief statement, if I could. First I want to thank the staff for doing a tremendous job in terms of bringing this issue forward before us in formulating a regulation that you had to put together not under the most desirable of circumstances. Certainly the vagueness of the existing statutes and the potential litigation.

And so, I want to commend you for the focus of the work that you've done and what's before us today.

We've heard a great deal of comment from both sides of this issue and let -- let me just say from the outset that -- that I intend to support the proposed regulation as developed by staff because it is an important element that can make a difference in the human toll and suffering, particularly among our youth, for underage drinking.

I also want to acknowledge the advocacy movement that's been created around this issue involving our youth. Several of us on the Board have had the opportunity to meet with dozens of youth over the last several months to hear their perspectives and experiences among their peers around the consumption of flavored malt beverages.

And I also want to thank the representatives

from the alcoholic beverage industry, the retail industry and the restaurant and bar industry for their input. I think all of them, I believe, have provided information in good faith in furthering our staff's understanding of the challenges of the alternatives that are before us. And, quite frankly, even when not necessarily in your best interest.

The Board's action here today, if we decide to adopt the reg -- any of the regulations before us calling for a change is really just the begin -- beginning of the work to minimize access to and consumption of flavored malt beverages by underage drinkers. I have chosen -- I have chosen amidst great criticism for not instead participating in public rallies and press conferences to focus for the last six months on how a Board adopted regulation could work successfully.

And at the end of the day if we're going to do something here, I feel a great deal about how to make it work to make sure it does make a difference in the lives of our youth and their health.

And I say this with a separate deal of seriousness and -- because this is tough. This is tough. And I take great issue with the testimony around the lack of need for additional resources to make this successful. We are not Maine and we are not the ABC.

I think staff has appropriately identified several implementation concerns in its issue paper and I

really want to highlight those today because I think it sets the stage for what's to come in terms of future challenges, and I hope that proponents who are in favor of a change here will step up to the plate and continue your commitment to be sure that we get all of the clarification and the tools that we need to have a successful program here.

Let me first speak about the authority. I think the staff appropriately found, as articulated in the issue paper, that this Board doesn't have authority in the form of specific legislative authorization to classify flavored malt beverages. And I know in meetings with both sides of this issue I think there have been statements made about how flavored malt beverages don't neatly fit within the definition of beer and flavored malt beverages do not neatly fit within the definition of distilled spirits.

And I think it's really because of the vagueness of the statute on that question that the staff has found that this Board can go either way in classifying flavored malt beverages as either beer or distilled spirits.

However, it is the basis of our authority which is also the basis of our challenges. All of the disagreement I believe during the interested parties process regarding the meaning of beverage purpose, where the industry argues it only applies before dilution and the proponents say it applies after dilution, sets us up

for some real challenges in classifying flavored malt beverages either way under the current statutory scheme.

This Board is not a Court, in the sense that we don't simply rule on the question extractly. We are going to need to administer this decision we make if in fact it is to make a regulatory change on the basis of this vague statute. So, really the legal question is how we classify flavored malt beverages based on the source of the alcohol.

There generally has been no debate that most flavored malt beverages, at least the ones that were focused on, contain roughly the same volume of alcohol as beer. The issue in essence is whether the alcohol is from fermentation or distillation and how much.

That leaves us with the challenge of administering a standard that examines the source of the alcohol in flavored malt beverages, and as I understand its position, even the Department of Alcoholic Beverage Control finds the statute ambiguous but relies on the Federal government's classification. And in doing that, of course, avails the agency of tremendous assistance from the Feds. ABC gets a lot of assistance from the Feds in classifying these beverages; expertise to examine the chemical sources of the alcohol that even ABC advises it does not have.

So, in fact Alternative 1 before us today begins with the other agency's classification as beer, throws it out, presumes it to be the opposite and leaves

this Board with the requirement to implement a new classification system that does not currently exist. That's the reality.

Not an excuse not to move forward, but that is the reality. We don't know the extent to which the industry will provide all the information we need to develop the list of flavored malt beverages to tax as distilled spirits. Even if they do not provide the information, this agency needs to be able to verify the information and no agency can compel a standard and base a tax rate on it and not be prepared to independently verify the information forwarded to it by industry. That is how we ensure that we have successful implementation.

We have looked at the State of Maine as suggested by the Senator for the Study of Law and Enforcement Policy, which notes that Maine's reclassification of flavored malt beverages as distilled spirits was seamless.

As we have already heard, Maine's statutes provide much clearer authority than do California's. Specifically, its various classification of alcoholic beverages, including low alcohol spirit products under which most flavored malt beverages fit.

And, more importantly, its product registration requirement which really gives the State of Maine and its enforcers a lot of information about how to look at these products.

Again, not a reason not to move forward with the regulation before us today.

Staff will continue to work on examining Maine's program as well as seek assistance from the ABC here in California.

One issue that was not mentioned that I do want to raise because this is a little bit of a tax administration's -- tax administrator's nightmare is the point of taxation is not the same for products classified as beer and distilled spirits. Simply put, the lesser rate of tax for beer is paid at the manufacturer or importer level and the higher distilled spirits tax is passed down through documented exempt wholesale transactions at or near the point of sale to the retailer.

In other words, the tax on beer is paid at the beginning of the distribution chain by the manufacturer and the higher tax on distilled spirits is paid near the end by the last vendor who sells to the retailer, who makes the final retail sale to the customer.

Again, not a reason not to go forward with the regulation today.

But this will entail an increased workload to perform systems and forms revisions to account for the new transactions and reporting of flavored malt beverages.

In essence, the point of taxation for flavored malt beverages defined as distilled spirits moves up the

distribution chain to be paid by the original manufacturer or importer. And this is unique to flavored malt beverages that are treated as distilled spirits for taxation and licensed as beer.

Finally, I think our staff would wholeheartedly agree that this agency is wading in uncharted territory to attempt a regulation which we currently do not have the resources available or resources to be able to direct to do so.

The first priority among our challenges is to secure the funding necessary to do the work leading up to the July 1, 2008 effective date as proposed in the regulation.

As I stated earlier, the Board's action is just the beginning of the work ahead to successfully implement a program that will protect the future of our youth. I am sure that with the commitment and ongoing advocacy of the proponents here and specifically, Ms. Chu, your leadership as our Legislative Committee Chair and formerly as Fiscal Policy Leader in the State Assembly, this agency will secure the necessary funding for this important program.

I want to just lay that out, we've had numerous meetings. I think many of us up on the dais have had numerous meetings with both sides, certainly with staff and this is not an easy task but I do think on balance we ought not lose sight of the overarching policy concern.

Thank you very much. Other Members?

Ms. Chu.

MS. CHU: Well, I support Alternative 1. I think Alternative 1 is reasonable. It requires that alcoholic beverages with a .5 percent or more distilled liquor flavoring be classified as distilled liquor. And it will clearly place flavored malt beverages in that category and they will then be taxed at $3.30 a gallon versus the beer rate of 20 cents a gallon.

I think it's really important to take this step. When flavored malt beverages were invented in the '90s they did not come under scrutiny. They remained in the gray area all these years. And yet they start with a fermented base of beer and then are infused with a distilled liquor flavoring.

And so, what is it? Is it beer or is it distilled liquor? Clarity is needed and this alternative says that these products are indeed distilled spirits.

It's critical for the BOE to provide accuracy on this issue and to issue a ruling so that there is a taxation ruling that -- that reflects its true makeup as a beverage.

Now, the opposition says that we don't have the authority and says that -- that we in the State must follow Federal law according to Government Code 32152, but I look at the Revenue and Taxation Code 32451, which says that the Board has the authority to promulgate

regulations relating to the administration and enforcement of the Alcoholic Beverage Tax Law. And that while we have generally deferred to ABC regarding the classification of alcoholic beverages, the Board retains the ability to classify such beverages for purposes of taxation.

Now, we can choose, however, to diverge from the ABC classification system and we are not bound to follow Federal law in this regard. And that's what I think we should do, diverge from Federal law and diverge from the ABC. I wish the ABC would come along with us, but I think this is an important first step.

Now, let me say that this issue has come a long way. I am actually voting in a consistent way to when the issue was brought up in the Assembly in the summer of 2005. I thought that it should have been classified as distilled liquor then. But it didn't go anywhere, and thank goodness the young people did not give up.

They brought the issue to the Board of Equalization in December 2006, and have followed through every step of the way in these nine months. Though the issue that is before us has to do with accurate taxation of flavored malt beverages, I believe that the ultimate effect of this taxation will be very positive. The ruling will send a signal to youth that these drinks are hard liquor because these drinks will have costs that are similar to hard liquor. It will make it harder for young people to access this drink, and that can only be

helpful in reducing underage drinking.

MS. YEE: Thank you very much, Ms. Chu. Other comments? Ms. Steel.

MS. STEEL: Well, it's great to hear so many who are sharing their views here that including Girl Scouts. They were rallying yesterday in front of BOE building and, you know, my mother actually has a diamond cross trophy over the -- that was been given every three years to the leaders in Girl Scouts. And plus I was raised as a Girl Scout for all my life when I was teenage -- you know, teenager.

And it was really hard to see them -- that involved in politics. Having said that, underage drinking is a serious problem in California that, you know, as a mother of two teenage daughters, this issue is very close and personal to me. And I want to make sure that my daughters, like the rest of California teenagers, are not able to legally purchase alcoholic beverages.

However, raising taxes by over 1500 percent of some alcoholic beverages will not stop underage drinking. The Board of Equalization shouldn't create a new tax on taste.

Studies prove that underage drinkers consume all different types of alcohol, including hard alcohol, which is already subject to this higher tax. And simply put, higher taxes won't stop underage drinking.

While this new tax increase won't stop underage

drinking, it will hurt thousands of small businesses. Here in California there are 35,000 small restaurants and family-owned markets have beverage licenses to distribute beer and wine. This tax increase make it more difficult for these small business to comply with California's alcohol and tax law.

This taste tax makes it more difficult for small business to compete with large corporate restaurant chains. Small businesses are the backbone of our State economy. Our tax policy needs to encourage these businesses, not create obstacles to compete.

The Board of Equalization shouldn't create a new tax on taste. And having said that, this issue isn't a tax matter. Santa Clara County versus BOE, the Court said that this is an issue of legislative interpretation. It's not the Board of Equalization job to decide this issue. Only the State Legislature can address an issue of this magnitude with such wide range and policy implications.

That's why I recommend that Board oppose this new taste tax and send it back to the Legislature.

MS. YEE: Thank you, Ms. Steel.

Other comments?

Mr. Leonard. Ms. Mandel.

MS. MANDEL: I have a statement that I'd like to read on behalf of State Controller John Chiang. "Flavored malt beverages should be taxed as distilled spirits because they fall under the category of

distilled spirits as written in California law.

"The Attorney General has found that beer is any alcoholic beverage obtained by fermentation while distilled spirits are beverages that contain any amount, mixture or dilution of distilled spirits.

"This is where the argument over whether alcopops should be treated as liquor or beer begins and ends. Specifically, alcopops include alcohol from a distillation process as opposed to being solely from fermentation. That puts these alcoholic beverages in the distilled spirit category rather than the beer category. Especially as the BOE regulations would use the basic .5 percent alcohol content threshold as the governing standard for classification.

"While today's vote," which I'm anticipating based on the comments -- "While today's vote is about fair taxation, taxing flavored malt beverages as liquor will also help reduce their popularity with young people by simply pricing the product out of their reach. Taxing alcopops as liquor doesn't address all the impacts or the treatment of underage drinking and there is more work to do.

"The State's Department of Alcoholic Beverage Control should move to classify alcopops as distilled spirits to step up our enforcement against underage drinking and alcohol abuse."

MS. YEE: Thank you, Ms. Mandel.

Mr. Leonard.

MR. LEONARD: I really appreciate the discussion that's gone on today and I'm -- I wish I were a legislator because I think the five of us might be able to actually write a law that made sense that was least burdensome on manufacturers and retailers and easy to understand by the public and had a fair taxation scheme.

Unfortunately, we're -- we're not legislators and I'm -- I'm concerned about the path that the majority is -- is about to take. At the same time, being very sympathetic with the issues that have been raised.

As many of you know, I was the author of the legislation to lower the drunk driving standard to .08. I tried to go to .05 and didn't get there. Still like to see that, but I'm no longer a legislator.

There is in my research about drunk driving, the truth that it's beer and wine that's the greater consumption that causes the drunk driving violations. Without absolving distilled spirits drinkers from responsibility, they're -- they're a smaller piece of the problem.

To the extent that by tax policy we change social behavior, if the majority is right in increasing the taxes on flavored malt beverages I hope it's -- and I know it's not -- not the majority's intent but it seems to me an obvious unintended consequence is to drive teenage drinkers, so to speak, to beer and wine,

which because they appear to be diluted almost are in some people's mind less dangerous to consume and get behind the wheel. And the truth is they're not.

It also strikes me that the taxation scheme, the classification scheme of alcohol that the Legislature did in the 1930s is no longer relevant. Not just the new product creation, but the whole culture, how those products are marketed has all changed so much that the taxation difference that we live with today doesn't make sense.

Beer and wine are not 11 times less dangerous than vodka and gin. Or vice versa. And so, I -- that the Legislature really to get into this. Whether or not this Board goes forward, I -- I think -- and we do it with its own regulatory process, I think we should ask the Legislature to take a look at the evidence we've collected, the information presented today by all parties, and to really look at rewriting all of the State's laws, sitting down with us and ABC, of how we classify these alcohols. How we license the establishments. How we tax it. How it's distributed and controlled as a -- as a product.

Because no matter what we do today, the scheme still won't make sense. It still will be irrational, be hard to understand. And that's part of the resource issue I think the Chairman alluded to that we'll have to make some distinctions that aren't based on good chemistry, but based on what we think is -- is good

social policy, which is right at the edge of our authority, if not beyond it, as a taxing agency.

So, my -- my support today is -- is for actually an Alternative 4. I think we should aggressively ask the Legislature to intervene. To do nothing is not responsible. But to help deal with all the interest groups, go to the Legislature and to do something as quickly as possible. It seems the most reasonable to me.

For example, one of the issues is we're talking about alcohol content and trying to find where that molecule came from, either a distilled spirit or a fermented spirit -- a fermented molecule, which chemistry can't tell the difference but we can supposedly because of where it came from.

But the truth is, is what we're after is -- is the consumption of it, particularly when it rates the issues like alcoholism and drunk driving. If the product is diluted, and I know some people that -- cover your ears, those that like wine -- actually dilute their wine.

If the product is diluted, the consumption is a different level of alcohol than if it's not. A lot of the distilled spirits are designed and marketed to be diluted with water or soda or others before they're consumed, which makes the consumption point in some cases less alcoholic than wine or beer. Now, which is not as easily or -- marketed or designed or culturally

arranged to be diluted.

So, we have -- we have a real issue here which it's -- so many aspects of it are beyond our scope. I -- I would really urge the Board to create an Alternative 4, to sit down with our legislative committee and work to sponsor legislation to deal with the whole issue of classification of alcohols; beers, wines and distilled spirits. I'm intrigued with the Maine scheme that talks about alcohol percent levels of the product as sold as -- and maybe even go beyond that of not even care where it came from.

The -- the Federal model is -- is not a good one to follow. I don't know our extent of our authority to ignore it. I wish I could. Hope we could find out more how we could -- how we could do that, or seek waivers, if necessary.

But I would propose to the Board an Alternative 4, that we aggressively seek legislation to deal with this important issue.

MS. YEE: Very well. Thank you, Mr. Leonard.

Other questions or comments, Members?

Okay. Maybe I could just ask the staff, if I could, to address some of the resource problems. And this is, as I said, the beginning of the process. And if the Board were to adopt a rule change today, I believe the calendar takes us into the early part of next year --

MS. BARTOLO: Yes.

MS. YEE: -- when the rule would become effective. Do you believe the July 1, 2008 date is still workable?

MS. BARTOLO: Because the draft regs. -- this is Lynn Bartolo, Excise Taxes Division. The draft regs. cast a broad rebuttable presumption affecting all non-wine alcoholic beverages. This creates a substantial work -- new workload for us. The volume of submissions will be at least initially -- because we do not know how many products are out in the market.

I think the July '08 date is quite ambitious for us to accomplish, knowing that we wouldn't get rolling with the final regs. out of OAL until March.

So, -- and the -- and the other aspect of that, not just the staffing concerns, I have 14 staff currently who administer the Alcoholic Beverage Program. We -- we do not have discretionary time to absorb the work. We do not have the costs -- funding to absorb what we'll need to have for revisions and our system changes.

But more importantly we need to provide the taxpayers with sufficient time to understand the new requirements and do an outreach. We also need to give them every opportunity to submit their product statements. And then we'll need lead time to process all of that.

The ABC does not have a database tracking these products so we will be tasked with creating the first

database to catalog and classify these products and make it available on the internet to all of the industry, who will be required to -- to verify the rate of tax to charge.

So, if -- with the adequate -- with inadequate staffing and funding, I'm -- I'm very concerned that we may not make a July '08 implementation date.

MS. YEE: Okay. Let me ask you, it seems to me that there are some existing sources of information that could be helpful here. And the reason I talk about the Maine product registration requirement is that I don't believe we have such a counterpart requirement here in California, and that all ABC keeps in its files are copies of product labels. Which don't really --

MS. BARTOLO: Yes.

MS. YEE: -- take us to the amount of level and detail that we need to really examine.

So, it looks as if -- but at least they may in part be able to help us identify some of the products that are in the marketplace. Certainly the State of Maine has done that. So, that's kind of a beginning. I guess --

MS. BARTOLO: ABC does not track this product. They do not classify or require product information from their licensees.

MS. YEE: Okay. All right. So, it sounds like the resource issue is really the critical one in terms of being sure that you have additional bodies to

essentially start this new workload.

MS. BARTOLO: We -- I have contacted the -- the Federal Tobacco -- Alcohol, Tobacco Tax and Trade Bureau and they pointed me to the label submission web site. So, I did just a check yesterday, pointing out the alcoholic beverage categories that we're looking at for the State of California, and 14,000 new products were submitted to the TTB just in the first seven months of this year.

So, those are the new products that we will be -- coming under our examination. And we still have the current products that are on our -- on the shelves here in the -- the marketplace that we'll have to deal with.

MS. YEE: All right, very well. Thank you.

Other questions or comments, Members?

Is there a motion?

MS. CHU: Well, I make a motion to support Alternative 1.

MS. YEE: Okay. We have a motion by Ms. Chu to support Alternative 1. Is there a second?

MS. MANDEL: Second.

MS. YEE: Second by Ms. Mandel. Please call the roll.

MR. EVANS: Madam Chairwoman.

MS. YEE: Aye.

MR. EVANS: Ms. Steel.

MS. STEEL: No.

MR. EVANS: Mr. Leonard.

MR. LEONARD: No.

MR. EVANS: Ms. Mandel.

MS. MANDEL: Aye.

MR. EVANS: Ms. Chu.

MS. CHU: Aye.

MR. EVANS: Motion passes.

MS. YEE: Okay. Could I just ask staff if you could take note of Mr. Leonard's Alternative 4? It may be as we're trying to figure out this implementation that there may be some additional issues that might warrant some legislative clarification versus kind of opening up the whole statutory scheme.

Okay. Thank you all very much.

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REPORTER'S CERTIFICATE

State of California)
) ss.
County of Sacramento)

I, BEVERLY D. TOMS, Hearing Reporter for the California State Board of Equalization certify that on August 14, 2007 I recorded verbatim, in shorthand, to the best of my ability, the proceedings in the above-entitled hearing; that I transcribed the shorthand writing into typewriting; and that pages 1 through 32 and 55 through 74 constitute a complete and accurate transcription of the shorthand writing.

Dated: August 31, 2007.

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BEVERLY D. TOMS.

REPORTER'S CERTIFICATE.

State of California)
) ss
County of Sacramento)

I, JULI PRICE JACKSON Hearing Reporter for the California State Board of Equalization certify that on August 14, 2007, I recorded verbatim, in shorthand, to the best of my ability, the proceedings in the above-entitled hearing; that I transcribed the shorthand writing into typewriting; and that the preceding pages 33 through 54 constitute a complete and accurate transcription of the shorthand writing.

Dated: August 30, 2007.

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JULI PRICE JACKSON
Hearing Reporter