

**Initial Statement of Reasons for the
Proposed Adoption of California Code of Regulations,
Title 18, Section 4076, *Wholesale Cost of Tobacco Products***

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

Current Law

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

In 1998, California voters passed Proposition 10, known as “The Children and Families First Act” (Prop. 10). The purpose of Prop. 10 was to create county commissions to provide early childhood medical care and education. Prop. 10 imposed an additional tax on every distributor of cigarettes at the rate of 25 mills (\$0.025) per cigarette or \$0.50 per pack, as well as an equivalent tax on every distributor of OTP (as defined in RTC, § 30131.1, subd. (b), which is identical to RTC, § 30121, subd. (b)). Prop. 10’s tax on the distribution of cigarettes and equivalent tax on the distribution of OTP are both codified in RTC section 30131.2. The taxes codified in and imposed by RTC sections 30123 and 30131.2 do not apply to “the sale of cigarettes or tobacco products by the original importer to a licensed distributor if the cigarettes or tobacco products are manufactured outside the United States” (as provided by RTC, § 30105).

The State Board of Equalization (Board) is responsible for enforcing the Cigarette and Tobacco Products Tax Law, including the taxes imposed on distributors of OTP under RTC sections 30123 and 30131.2. (RTC, § 30451.) Pursuant to RTC sections 30123, 30126, 30131.2, and 30131.5, the Board is required to calculate the combined tax rate on OTP on an annual basis based on the wholesale cost of tobacco products as of March 1 and the rate determined by the Board is effective during the state’s next fiscal year, which begins on July 1. This combined rate is applied by distributors to the “wholesale cost” of distributed OTP to calculate the amount of excise tax due (RTC, §§ 30123, 30131.2) and the resulting tax is then required to be reported and paid to the Board under chapter 4 of the Cigarette and Tobacco Products Tax Law. RTC section 30017 defines “wholesale cost” as “the cost of tobacco products to the distributor prior to any discounts or trade allowances.”

Currently, there are no other statutes or regulations that further define the term “wholesale cost” of OTP or clarify how the wholesale cost of OTP should be calculated. However, the Board is still required to audit distributors, determine if they have correctly reported the taxes due on the wholesale cost of OTP they have distributed, and the Board may determine the wholesale cost of such OTP (as defined in RTC, § 30017) based upon any information available to the Board for such purposes. (RTC, §§ 30201, 30221.) Therefore, the Board’s Legal Department has previously concluded that:

- When a retailer purchases raw goods at wholesale and manufactures its own tobacco products, the wholesale cost of the finished products must include the cost of the raw goods, plus amounts for labor, overhead, and a markup, and may be determined by reference to the wholesale cost of similar size and quality products that are available for purchase at the wholesale level, in an annotation¹ dated February 9, 1996; and
- The wholesale cost of OTP does not include charges for the domestic shipping of finished products from a supplier to a distributor, in an annotation dated April 20, 1989.

Also, the Board has historically concluded that, under RTC section 30017, the wholesale cost of OTP includes any amounts a distributor pays to a supplier for OTP, including any federal excise tax and any United States Customs taxes paid, other than charges for domestic shipping (discussed above).

In addition, the Board’s Legal Department has previously opined that, based upon the express provisions of RTC section 30017, the wholesale cost of OTP sold in so called “buy one, get one free” promotions is the cost of each retail unit of OTP to the distributor prior to any discounts or allowances. This means that when a supplier’s price list shows that the supplier sells cigars that are individually packaged for retail sale for \$10 each and the supplier agrees to give a distributor one of the cigars for free if the distributor buys one cigar at full price, then the wholesale cost of each cigar to the distributor is \$10 because each cigar is a separate unit of OTP for retail purposes, the distributor actually paid \$10 for one of the cigars, and the distributor would have paid \$10 for the other cigar prior to receiving a 100 percent discount on the price of that retail unit from the supplier. However, when the supplier actually combines two of the same cigars in one package labelled with a single UPC barcode for purposes of retail sale, and offers to sell the retail unit to distributors for \$10 before any discounts or allowances, then the wholesale cost of the two-cigar retail unit to the distributor is \$10.

Proposed Regulation

Need for Clarification

The wholesale cost of OTP depends on a variety of factors. The statutory definition of “wholesale cost” is very general and provides little guidance to distributors as to how the wholesale cost of OTP should be determined in specific circumstances. The lack of statutory guidance regarding whether certain manufacturing costs, shipping charges, and federal excise

¹ Annotations are published in the Board’s Business Taxes Law Guide and are summaries of the conclusions reached in selected legal rulings of the Board’s Legal Department. (Cal. Code Regs., tit. 18, § 5700.)

taxes should be included in the calculation of wholesale cost has caused misinterpretation and confusion among taxpayers, and it has made it difficult for taxpayers to accurately report amounts subject to the excise tax. This is especially true when a distributor is also the manufacturer of the product. Therefore, the Board's Business Taxes Committee (BTC) staff determined that there is an issue (or problem within the meaning of Gov. Code, § 11346.2, subd. (b)(1)) as there currently is not a regulation that further defines "wholesale cost" of OTP and provides sufficient examples to illustrate how wholesale cost should be computed in various situations in which OTP is distributed.

Interested Parties Process

As a result, the Board's BTC staff drafted California Code of Regulations, title 18, section (Regulation) 4076, *Wholesale Cost of Tobacco Products*, to address the issue described above, and staff prepared a discussion paper explaining the new proposed regulation. Both were provided to interested parties.²

Subdivision (a) of staff's proposed Regulation 4076 defined the terms "arm's-length transaction,"³ "discounts or trade allowances," "finished tobacco products," and "finished condition." Subdivision (b) of staff's proposed Regulation 4076 explained how to determine the wholesale cost of OTP a distributor purchased from a supplier in an arms-length transaction and how to determine the wholesale cost of OTP when a manufacturer is also the distributor. Subdivisions (b) and (c) of staff's proposed Regulation 4076 provided that when a distributor receives discounts or trade allowances or does not purchase OTP in an arms-length transaction, then the wholesale cost of the OTP may be determined by: (1) looking to 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;" or (2) if a publicly or commercially available price list is not available, using industry data from the time period to be estimated or calculated that provides reasonable evidence of typical tobacco product costs during such time period. Subdivision (c) also provided a non-exhaustive list of industry data that can provide such evidence and how that data may be used to determine the wholesale cost of OTP with appropriate adjustments. Subdivision (d) of staff's proposed Regulation 4076 established a presumption that sales, purchases, and transfers between related parties, including between spouses and between persons (as defined in RTC section 30010) and entities under their control, are not at arm's-length and provided that a distributor may rebut the presumption by showing that the price, terms and conditions of a transaction were substantially equivalent to a

² BTC staff proposed Regulation 4076 and new Regulation 4001, *Retail Stock*, at the same time, and both regulations were discussed during the interested parties process (described below). At the January 26, 2016, BTC meeting, however, the rulemaking process for the proposed regulations was bifurcated. Therefore, this initial statement of reasons only discusses proposed Regulation 4076.

³ BTC staff defined the term "arm's-length transaction" in the proposed regulation because the price at which property is sold in an "arm's length transaction" generally establishes the fair market value of that property. (See, e.g., RTC, § 110 [providing a rebuttable presumption that the sales price of real property establishes the property's fair market value if the terms of the transaction were negotiated at arm's-length].) Staff based the definition for the term "arm's-length transaction" on the definitions for the same term provided in Business and Professions Code (BPC) sections 22973.1, subdivision (a)(2)(B), and 22977.2, subdivision (a)(2)(B), which are applicable to sales of businesses for which licenses to sell cigarettes or OTP are required.

transaction negotiated between unrelated parties.⁴ Subdivision (e) of staff's proposed Regulation 4076 also provided examples of how to estimate or calculate the wholesale cost of OTP when the distributor is also the manufacturer or importer, when OTP is not purchased in an arm's-length transaction, and when OTP is acquired free of charge (or at a 100% discount or trade allowance).

On August 4, 2015, BTC staff conducted an interested parties meeting to discuss proposed Regulation 4076. At the meeting, questions were raised about the proper way to estimate or calculate the wholesale cost of OTP when multiple items of OTP are packaged as a unit, two items of OTP are sold in a "buy one, get one free" promotion, and OTP is sold at a discount and it was suggested that the Board allow trade discounts to be exempted from the "wholesale cost." Also, at the meeting, Mr. Dennis Loper from the California Distributors Association provided staff with a submission of proposed regulatory language for Regulation 4076. Mr. Loper's submission agreed that the alternative methods for determining wholesale cost provided in subdivision (c) "should not be exclusive." Therefore, his submission alternatively suggested that the word "non-exclusive" be added to subdivision (c) or that a new subdivision (c)(2)(E) be added to the proposed regulation to allow "any other reasonable method" to be used when calculating the wholesale cost of OTP. Mr. Loper's submission also suggested adding a subdivision (f) to the proposed regulation to clarify that the Board uses the wholesale cost of OTP on March 1 of the "current calendar year" to determine the OTP tax rate for the next fiscal year, under RTC sections 30123, 30126, 30131.2, and 30131.5.

On August 19, 2015, Mr. Ron Michelson, representing Briar Patch, provided a submission to BTC staff. Mr. Michelson's submission indicated that he had an issue with the definition of "wholesale cost" because, in his opinion, the "net price paid for tobacco products by licensed California Distributors should be the basis for computing" wholesale cost and therefore some discounts should not be included in wholesale cost. Mr. Michelson's submission also included "a somewhat more detailed definition of fair market value . . . from businessdictionary.com."

BTC staff considered the interested parties' comments and submissions and revised proposed Regulation 4076. Staff clarified, in subdivision (b)(1), that the wholesale cost of OTP does not include transportation charges for shipments "originating" in the United States. Staff clarified that the provisions of subdivision (b)(2) apply to "importers" that are distributors, not just manufacturers that are distributors. Staff clarified how to determine wholesale cost using publicly or commercially available price lists by replacing "less a reasonable estimate" of the distributor's profit with "less an estimate based upon best available information" of the distributor's profit, in subdivision (c)(1). In response to Mr. Loper's submission, new subdivision (c)(2)(E) was added to allow additional methods of estimating or calculating wholesale cost to be used, provided that the methods are approved by the Board. In response to the questions raised at the interested parties meeting, staff added subdivision (e)(5), (6), and (7) to provide additional examples of how to estimate or calculate the wholesale cost of OTP when

⁴ BTC staff included the rebuttable presumption that related party transactions are not at arm's-length because BPC sections 22973.1, subdivision (a)(2)(B), and 22977.2, subdivision (a)(2)(B), include similar presumptions regarding sales of business between related parties (relatives, related companies, and partners). Many of the provisions staff included in subdivision (d) were based upon Regulations 4505, *Transfers or Sales Between Related Parties*, and 4506, *Evidence of a Non-Arm's Length Transaction*, which the Board previously adopted to implement, interpret, and make specific the presumptions in BPC sections 22973.1, subdivision (a)(2)(B), and 22977.2, subdivision (a)(2)(B).

multiple items of OTP are packaged as a unit for retail sale, two items of OTP are separately packaged and sold in a “buy one, get one free” promotion, and OTP is sold at a discount. All three examples were based on current opinions from the Board’s Legal Department. Also, subdivision (f) was added, in response to Mr. Loper’s submission, to clarify that the Board will use the price of tobacco products as of March 1st of the current year to determine the OTP tax rate for the next fiscal year.

Staff did not agree to revise proposed Regulation 4076 to allow trade discounts to be deducted from wholesale cost because RTC section 30017 expressly defines wholesale cost as the cost to the distributor “prior to any discounts or trade allowances.” Also, staff was concerned that OTP could be sold at retail without tax having been properly paid on its “wholesale cost” to the distributor if discounts were subtracted from the wholesale cost of OTP to the distributor. For example, if a supplier’s price list showed that the supplier sells cigars that are individually packaged for retail sale for \$10 each, the supplier agreed to give a distributor one cigar for free (or at a 100% discount) if the distributor buys one cigar at full price, and the Board agreed that the 100 percent discount could be deducted from the regular price charged for the first cigar, then the wholesale cost of the first cigar would be zero and no tax would be paid on the distribution of the first cigar. Staff determined that allowing a situation where no tax is paid on some units of distributed OTP would potentially create a loophole and invite fraud. Further, allowing discounts and trade allowances to be deducted from the price indicated on a supplier’s price list would make it difficult to use the price list to determine the wholesale cost of the supplier’s products. Furthermore, by allowing trade discounts, which may be as high as 100 percent, the special funds that benefit from the taxes collected could potentially receive substantially fewer tax dollars. Finally, small distributors that may not qualify for suppliers’ discounts could potentially be at a further competitive disadvantage.

On October 20, 2015, BTC staff conducted a second interested parties meeting to discuss the revised draft of the proposed regulation. There were no additional comments at the meeting, and no other submissions were received that related to proposed Regulation 4076.

January 26, 2016, BTC Meeting

Subsequently, staff prepared Formal Issue Paper 15-013 and distributed it to the Board Members for consideration at the Board’s January 26, 2016, BTC meeting. Formal Issue Paper 15-013 recommended that the Board propose to adopt revised Regulation 4076 (discussed above) in order to address the issue (or problem) referred to above and clarify how tobacco product distributors can determine the wholesale cost of OTP by:

- Defining the terms “arm’s-length transaction,” “discounts or trade allowances,” “finished tobacco products” and “finished condition.”
- Explaining how to determine the wholesale cost of OTP a distributor purchased from a supplier in an arm’s-length transaction.
- Explaining how to determine the wholesale cost of OTP when a manufacturer or importer is also a distributor.

- Providing alternative methods for estimating or calculating the wholesale cost of OTP when a distributor receives discounts or trade allowances or does not purchase OTP in an arm's-length transaction, and permitting other methods to be used with Board approval.
- Establishing a rebuttable presumption that sales, purchases, and transfers of OTP between related parties are not made at arm's-length and providing that the presumption may be rebutted by evidence showing that the price, terms and conditions of a transaction were substantially equivalent to a transaction negotiated between unrelated parties.
- Providing seven examples illustrating of how to estimate or calculate the wholesale cost of OTP when the distributor is a manufacturer or importer, when OTP is not purchased in an arm's-length transaction, when OTP is acquired free of charge, when multiple items of OTP are packaged as a unit, when two items of OTP are sold in a "buy one, get one free" promotion, and when OTP is sold at a discount.
- Clarifying that only current-year tobacco product prices may be used to determine the OTP tax rate for the next fiscal year.

During the January 26, 2016, BTC meeting, the Board Members unanimously voted to propose Regulation 4076 as recommended in the formal issue paper. The Board determined that proposed Regulation 4076 is reasonably necessary for the specific purpose of addressing the issue (or problem) created because there is no statute or regulation that further defines RTC section 30017's general definition of "wholesale cost" by clarifying the meaning of the wholesale cost of OTP and providing methods for estimating and calculating wholesale cost.

The Board anticipates that proposed Regulation 4076 will promote fairness and benefit taxpayers, Board staff, and the Board by providing additional clarification regarding and implementing, interpreting, and making specific the meaning of wholesale cost.

The adoption of proposed Regulation 4076 is not mandated by federal law or regulations. There is no previously adopted or amended federal regulation that is identical to Regulation 4076.

DOCUMENTS RELIED UPON

The Board relied upon Formal Issue Paper 15-013, the exhibits to the issue paper, and the comments made during the Board's discussion of the issue paper during its January 26, 2016, BTC meeting in deciding to propose Regulation 4076, as described above.

ALTERNATIVES CONSIDERED

The Board considered whether to begin the formal rulemaking process to adopt proposed Regulation 4076 at this time or, alternatively, whether to take no action at this time. The Board decided to begin the formal rulemaking process to adopt proposed Regulation 4076 at this time because the Board determined that the proposed regulation is reasonably necessary for the reasons set forth above.

The Board did not reject any reasonable alternative to proposed Regulation 4076 that would lessen any adverse impact the proposed action may have on small business or that would be less burdensome and equally effective in achieving the purposes of the proposed action. No

reasonable alternative has been identified and brought to the Board's attention that would lessen any adverse impact the proposed action may have on small business, be more effective in carrying out the purposes for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

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

As explained in more detail above, RTC sections 30123 and 30131.2 currently impose taxes on distributors based upon the "wholesale cost" of OTP distributed, and distributors are currently required to determine such wholesale cost and then report and pay such taxes to the Board under chapter 4 of the Cigarette and Tobacco Products Tax Law. RTC section 30017 defines "wholesale cost" as "the cost of tobacco products to the distributor prior to any discounts or trade allowances." However, this definition is very general and has caused misinterpretation and confusion among taxpayers.

As explained in more detail above, proposed Regulation 4076 further defines "wholesale cost," provides alternative methods for estimating or calculating wholesale cost, and contains several examples to show how wholesale cost is determined in common situations. The provisions of proposed Regulation 4076 are fully consistent with the statutory definition of wholesale cost, they are consistent with the Board's Legal Department's historical and current opinions regarding the meaning of wholesale cost, they provide distributors with the flexibility to use other methods that are not included in the regulation to determine wholesale cost with Board approval, and they do not require distributors to do anything to determine wholesale cost that is not currently required.

As a result, proposed Regulation 4076 does not mandate that individuals or businesses do anything that is not already required by the RTC, and there is nothing in the proposed regulation that would significantly change how individuals and businesses would generally behave in the absence of the proposed regulatory action or that would impact revenue. Therefore, the Board estimates that proposed regulation will not have a measurable economic impact on individuals and businesses. The Board has determined that proposed Regulation 4076 is not a major regulation, as defined in Government Code section 11342.548 and California Code of Regulations, title 1, section 2000, because the Board has estimated that the proposed regulation will not have an economic impact on California business enterprises and individuals in an amount exceeding fifty million dollars (\$50,000,000) during any 12-month period. And, the Board anticipates that proposed Regulation 4076 will promote fairness and benefit taxpayers, Board staff, and the Board by providing additional notice regarding and implementing, interpreting, and making specific the meaning of wholesale cost.

In addition, based on these facts and all of the information in the rulemaking file, the Board has determined that the adoption of proposed Regulation 4076 will neither create nor eliminate jobs in the State of California nor result in the creation of new business or the elimination of existing

businesses, and will not affect the expansion of businesses currently doing business in the State of California.

Furthermore, Regulation 4076 does not regulate the health and welfare of California residents, worker safety, or the state's environment. Therefore, the adoption of proposed Regulation 4076 will not affect the benefits of the regulation to the health and welfare of California residents, worker safety, or the state's environment.

The forgoing information also provides the factual basis for the Board's initial determination that the adoption of proposed Regulation 4076 will not have a significant adverse economic impact on business.

Proposed Regulation 4076 may affect small businesses.