

**Updated Informative Digest for the State Board of Equalization’s
Adoption of California Code of Regulations,
Title 18, Section 4076, *Wholesale Cost of Tobacco Products***

The State Board of Equalization (Board) held a public hearing regarding the proposed adoption of California Code of Regulations, title 18, section (Regulation) 4076, *Wholesale Cost of Tobacco Products*, on May 24, 2016. During the public hearing, the Board unanimously voted to adopt proposed Regulation 4076 without making any changes.

The Board did not receive any written public comments regarding the proposed regulatory action. Mr. Dennis Loper from the California Distributors Association appeared at the May 24, 2016, public hearing and stated that he had reviewed proposed Regulation 4076 and supported its adoption. The Board considered Mr. Loper’s comments prior to the adoption of proposed Regulation 4076. Mr. Loper was the only interested party who appeared at the public hearing on May 24, 2016, to comment on the proposed regulatory action.

There have not been any changes to the applicable laws or the effect of, the objective of, and anticipated benefits from the adoption of proposed Regulation 4076 described in the informative digest included in the notice of proposed regulatory action. The informative digest included in the notice of proposed regulation action provides:

Current Law

In November 1988, California voters passed Proposition 99, known as the “Tobacco and Health Protection Act of 1988” (Prop. 99). Among other things, Prop. 99 imposed a surtax on every distributor (as defined in RTC, § 30011) of cigarettes at the rate of 12.5 mills (\$0.0125) per cigarette or \$0.25 per pack (\$0.0125 x 20 cigarettes) distributed. Prop. 99 also imposed a tax on every distributor of other tobacco products or OTP (as defined in RTC, § 30121, subd. (b)), 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 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 annotation 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. (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. (Reg. 5700.))

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 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 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. (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 notice only discusses proposed Regulation 4076.)

Subdivision (a) of staff's proposed Regulation 4076 defined the terms "arm's-length transaction," "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 transaction negotiated between unrelated parties. 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 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 to have the effect and accomplish the objective 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 Board has performed an evaluation of whether proposed Regulation 4076 is inconsistent or incompatible with existing state regulations and determined that proposed Regulation 4076 is not inconsistent or incompatible with existing state regulations. This is because proposed Regulation 4076 is the only state regulation that provides additional clarification regarding and implements, interprets, and makes specific the meaning of "wholesale cost" as defined by RTC section 30017. In addition, the Board has determined that there are no comparable federal regulations or statutes to proposed Regulation 4076.