

Rulemaking File
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Title18. Public Revenue
Cigarette and Tobacco Products Tax Regulation 4076,
Wholesale Cost of Tobacco Products

OAL Approval

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**State of California
Office of Administrative Law**

RECEIVED
JUL 28 2016
Board Proceedings

In re:
Board of Equalization

Regulatory Action:

Title 18, California Code of Regulations

Adopt sections: 4076

Amend sections:

Repeal sections:

**NOTICE OF APPROVAL OF REGULATORY
ACTION**

Government Code Section 11349.3

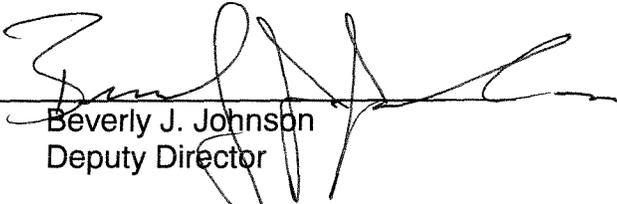
OAL Matter Number: 2016-0614-01

OAL Matter Type: Regular (S)

This rulemaking by the State Board of Equalization adopts section 4076 in Title 18 of the California Code of Regulations to further define the wholesale cost of "Other Than Tobacco Products" (OTP) and clarify how the wholesale cost of OTP should be calculated.

OAL approves this regulatory action pursuant to section 11349.3 of the Government Code. This regulatory action becomes effective on 10/1/2016.

Date: July 27, 2016


Beverly J. Johnson
Deputy Director

For: Debra M. Cornez
Director

Original: David J. Gau
Copy: Richard Bennion

OFFICE OF ADMINISTRATIVE LAW

300 Capitol Mall, Suite 1250
Sacramento, CA 95814
(916) 323-6225 FAX (916) 323-6826



DEBRA M. CORNEZ
Director

MEMORANDUM

TO: Richard Bennion
FROM: OAL Front Desk
DATE: July 27, 2016
RE: Return of Rulemaking Materials *LW*
OAL Matter Number 2016-0614-01
OAL Matter Type Regular (S)

OAL hereby returns the rulemaking record your agency submitted for review regarding “Wholesale Cost of Tobacco Products.”

If this is an approved matter, it contains a copy of the regulation(s) stamped “ENDORSED APPROVED” by the Office of Administrative Law and “ENDORSED FILED” by the Secretary of State. The effective date of an approved regulation is specified on the Form 400 (see item B.5). **Beginning January 1, 2013**, unless an exemption applies, Government Code section 11343.4 states the effective date of an approved regulation is determined by the date the regulation is filed with the Secretary of State (see the date the Form 400 was stamped “ENDORSED FILED” by the Secretary of State) as follows:

- (1) **January 1** if the regulation or order of repeal is filed on September 1 to November 30, inclusive.
- (2) **April 1** if the regulation or order of repeal is filed on December 1 to February 29, inclusive.
- (3) **July 1** if the regulation or order of repeal is filed on March 1 to May 31, inclusive.
- (4) **October 1** if the regulation or order of repeal is filed on June 1 to August 31, inclusive.

If an exemption concerning the effective date of the regulation approved in this matter applies, then it will be specified on the Form 400. The Notice of Approval that OAL sends to the agency will include the effective date of the regulation. The history note that will appear at the end of the regulation section in the California Code of Regulations will also include the regulation’s effective date. Additionally, the effective date of the regulation will be noted on OAL’s web site after OAL posts the Internet Web site link to the full text of the regulation that is received from the agency. (Gov. Code, secs. 11343 and 11344.)

Please note this new requirement: Unless an exemption applies, Government Code section 11343 now requires:

1. Section 11343(c)(1): Within 15 days of OAL filing a state agency’s regulation with the Secretary of State, the state agency is required to post the regulation on its Internet Web site in an easily marked and identifiable location. The state agency shall keep the regulation posted on its Internet Web site for at least six months from the date the regulation is filed with the Secretary of State.
2. Section 11343(c)(2): Within five (5) days of posting its regulation on its Internet Web site, the state agency shall send to OAL the Internet Web site link of each regulation that the agency posts on its Internet Web site pursuant to section 11343(c)(1).

OAL has established an email address for state agencies to send the Internet Web site link to for each regulation the agency posts. Please send the Internet Web site link for each regulation posted to OAL at postedregslink@oal.ca.gov.

NOTE ABOUT EXEMPTIONS. Posting and linking requirements do not apply to emergency regulations; regulations adopted by FPPC or Conflict of Interest regulations approved by FPPC; or regulations not subject to OAL/APA review. However, an exempt agency may choose to comply with these requirements, and OAL will post the information accordingly.

DO NOT DISCARD OR DESTROY THIS FILE

Due to its legal significance, you are required by law to preserve this rulemaking record. Government Code section 11347.3(d) requires that this record be available to the public and to the courts for possible later review. Government Code section 11347.3(e) further provides that "...no item contained in the file shall be removed, altered, or destroyed or otherwise disposed of." See also the State Records Management Act (Government Code section 14740 et seq.) and the State Administrative Manual (SAM) section 1600 et seq. regarding retention of your records.

If you decide not to keep the rulemaking records at your agency/office or at the State Records Center, you may transmit it to the State Archives with instructions that the Secretary of State shall not remove, alter, or destroy or otherwise dispose of any item contained in the file. See Government Code section 11347.3(f).

Enclosures

NOTICE PUBLICATION/REGULATIONS SUBMISSION

REGULAR

(See instructions on reverse)

For use by Secretary of State only

STD. 400 (REV. 01-2013)

OAL FILE NUMBERS	NOTICE FILE NUMBER Z-2016-0329-01	REGULATORY ACTION NUMBER 2016-0614-015	EMERGENCY NUMBER
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ENDORSED - FILED
in the office of the Secretary of State
of the State of California

JUL 27 2016

1:41 PM

For use by Office of Administrative Law (OAL) only

2016 JUN 14 A 8:39
OFFICE OF ADMINISTRATIVE LAW

NOTICE	REGULATIONS
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AGENCY WITH RULEMAKING AUTHORITY
State Board of Equalization

AGENCY FILE NUMBER (if any)

A. PUBLICATION OF NOTICE (Complete for publication in Notice Register)

1. SUBJECT OF NOTICE		TITLE(S)	FIRST SECTION AFFECTED	2. REQUESTED PUBLICATION DATE
3. NOTICE TYPE <input type="checkbox"/> Notice re Proposed Regulatory Action <input type="checkbox"/> Other		4. AGENCY CONTACT PERSON	TELEPHONE NUMBER	FAX NUMBER (Optional)
OAL USE ONLY	ACTION ON PROPOSED NOTICE <input type="checkbox"/> Approved as Submitted <input type="checkbox"/> Approved as Modified <input type="checkbox"/> Disapproved/Withdrawn		NOTICE REGISTER NUMBER 2016, 15-2	PUBLICATION DATE 4/8/2016

B. SUBMISSION OF REGULATIONS (Complete when submitting regulations)

1a. SUBJECT OF REGULATION(S) Wholesale Cost of Tobacco Products	1b. ALL PREVIOUS RELATED OAL REGULATORY ACTION NUMBER(S)
--	--

2. SPECIFY CALIFORNIA CODE OF REGULATIONS TITLE(S) AND SECTION(S) (Including title 26, if toxics related)

SECTION(S) AFFECTED (List all section number(s) individually. Attach additional sheet if needed.)	ADOPT 4076
	AMEND
	REPEAL 18

3. TYPE OF FILING

<input checked="" type="checkbox"/> Regular Rulemaking (Gov. Code §11346)	<input type="checkbox"/> Certificate of Compliance: The agency officer named below certifies that this agency complied with the provisions of Gov. Code §§11346.2-11347.3 either before the emergency regulation was adopted or within the time period required by statute.	<input type="checkbox"/> Emergency Readopt (Gov. Code, §11346.1(h))	<input type="checkbox"/> Changes Without Regulatory Effect (Cal. Code Regs., title 1, §100)
<input type="checkbox"/> Resubmittal of disapproved or withdrawn nonemergency filing (Gov. Code §§11349.3, 11349.4)	<input type="checkbox"/> Resubmittal of disapproved or withdrawn emergency filing (Gov. Code, §11346.1)	<input type="checkbox"/> File & Print	<input type="checkbox"/> Print Only
<input type="checkbox"/> Emergency (Gov. Code, §11346.1(b))	<input type="checkbox"/> Other (Specify) _____		

4. ALL BEGINNING AND ENDING DATES OF AVAILABILITY OF MODIFIED REGULATIONS AND/OR MATERIAL ADDED TO THE RULEMAKING FILE (Cal. Code Regs. title 1, §44 and Gov. Code §11347.1)

5. EFFECTIVE DATE OF CHANGES (Gov. Code, §§ 11343.4, 11346.1(d); Cal. Code Regs., title 1, §100)

<input checked="" type="checkbox"/> Effective January 1, April 1, July 1, or October 1 (Gov. Code §11343.4(a))	<input type="checkbox"/> Effective on filing with Secretary of State	<input type="checkbox"/> §100 Changes Without Regulatory Effect	<input type="checkbox"/> Effective other (Specify) _____
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6. CHECK IF THESE REGULATIONS REQUIRE NOTICE TO, OR REVIEW, CONSULTATION, APPROVAL OR CONCURRENCE BY, ANOTHER AGENCY OR ENTITY

<input type="checkbox"/> Department of Finance (Form STD. 399) (SAM §6660)	<input type="checkbox"/> Fair Political Practices Commission	<input type="checkbox"/> State Fire Marshal
<input type="checkbox"/> Other (Specify) _____		

7. CONTACT PERSON Richard E. Bennion	TELEPHONE NUMBER (916) 445-2130	FAX NUMBER (Optional) (916) 324-3984	E-MAIL ADDRESS (Optional) rbennion@boe.ca.gov
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8. I certify that the attached copy of the regulation(s) is a true and correct copy of the regulation(s) identified on this form, that the information specified on this form is true and correct, and that I am the head of the agency taking this action, or a designee of the head of the agency, and am authorized to make this certification.

SIGNATURE OF AGENCY HEAD OR DESIGNEE <i>Joann Richmond</i>	DATE June 13, 2016
TYPED NAME AND TITLE OF SIGNATORY Joann Richmond, Chief, Board Proceedings Division	

For use by Office of Administrative Law (OAL) only

ENDORSED APPROVED

JUL 27 2016

Office of Administrative Law

Final Text of
California Code of Regulations, Title 18, Section 4076,
Wholesale Cost of Tobacco Products

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

4076. Wholesale Cost of Tobacco Products.

(a) Definitions.

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

(2) Discounts or trade allowances. "Discounts or trade allowances" are price reductions, or allowances of any kind, whether stated or unstated, and include, without limitation, any price reduction applied to a supplier's price list. The discounts may be for prompt payment, payment in cash, bulk purchases, related-party transactions, or "preferred-customer" status.

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

(b) Wholesale cost.

(1) If finished tobacco products are purchased by a distributor from a supplier in an arm's-length transaction, the "wholesale cost" of the tobacco product is the amount paid for the tobacco product, including any federal excise tax, but excluding any transportation charges for shipment originating within the United States. Discounts and trade allowances must be added back when determining "wholesale cost."

(2) If a manufacturer or an importer is also the distributor, the wholesale cost of tobacco includes all manufacturing costs, the cost of raw materials (including waste materials not incorporated into the finished tobacco product) prior to any discounts or trade allowances, the cost of labor, any direct (including freight-in) and indirect overhead costs, and any federal excise and/or U.S. Customs taxes paid. Wholesale cost includes all freight or transportation charges for shipment of materials and/or unfinished product from the supplier to the manufacturer concurrently licensed as a distributor, but excludes domestic freight or transportation charges for shipment of finished tobacco products as defined in subdivision (a)(3).

(3) If tobacco product costs include express, implicit, or unstated discounts or trade allowances, the correct wholesale costs to be reported by the distributor may be determined using any of the methods provided in subdivision (c).

(4) If tobacco products are not purchased in an arm's-length transaction, the correct wholesale costs to be reported by the distributor may be determined using any of the methods provided in subdivision (c).

(c) Alternative methods of estimating or calculating wholesale cost.

The following resources or methods may be used.

(1) 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 an estimate based on best available information of the distributor's or a similarly situated distributor's profit.

(2) If a publicly or commercially available price list is not available, industry data from the time period to be estimated or calculated that provides reasonable evidence of typical tobacco product costs during such time period, including, but not limited to:

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

(B) All the direct and indirect costs that the supplier paid or incurred with respect to acquisition, production, marketing, and sale of the tobacco products sold by the supplier to the distributor, with appropriate adjustments to such costs as indicated by all the facts and circumstances, plus a reasonable estimate of the supplier's profit.

(C) The price of the same or similar tobacco products as reflected in a supplier's price list, with appropriate adjustments to such price as indicated by all the facts and circumstances.

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

(E) Additional methods not mentioned above, with Board approval.

(d) Sales not made at arm's-length.

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

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

(e) Examples of estimating or calculating the wholesale cost of tobacco:

(1) Example 1: Distributor B produces handmade cigars. B's tobacco product costs include: all manufacturing costs, the cost of raw materials (including waste materials not incorporated into the final product), the cost of labor, any direct and indirect overhead costs, and any federal excise and/or U.S. Customs taxes paid. The cost does not include freight or transportation charges for shipment from the supplier to the distributor.

(2) Example 2: Distributor C purchases tobacco products from a subsidiary corporation in which it owns or controls more than 50 percent of the voting stock. Due to this corporate relationship between seller and buyer, the Board presumes that the sale and purchase were not at arm's-length, and the presumption is not rebutted by C. In the absence of an arm's-length transaction, the methods discussed in subdivision (c) may be used to determine the correct wholesale cost.

(3) Example 3: Distributor D acquires tobacco product free of charge and reports no wholesale cost for the product on its Tobacco Products Distributor Tax Return. However, D acquired such tobacco product at a 100 percent discount or trade allowance. In the absence of an arm's-length transaction, the methods discussed in subdivision (c) may be used to determine the correct wholesale cost.

(4) Example 4: Distributor E, with a tobacco products importers license, acquires tobacco products or finished tobacco products from a supplier outside the United States. E's tobacco product costs include, in addition to all other production or acquisition costs, the costs of all U.S. Customs fees and federal excise taxes paid or incurred by E with respect to such tobacco products.

(5) Example 5: Distributor F receives three tobacco products packaged as one unit, as a "three for the price of two" promotional package, labeled with a single UPC barcode. As the products are packaged together as one inseparable unit, tax is based on the total package price.

(6) Example 6: Distributor G receives 2 units, to sell as a "buy one, get one free" promotion. Each unit is separately packaged and each unit is labeled with a UPC barcode. Because one unit is being provided for free, tax would apply to the wholesale cost of each separate unit as calculated by a method discussed in subdivision (c).

(7) Example 7: Distributor H receives a three percent discount for paying their supplier within 10 days of receipt of their items. To calculate the wholesale cost, Distributor H must add the three percent discount to the price paid for the products.

(f) Rate Setting. The Board's annual determination of the rate of tax that applies to other tobacco products shall be made based on the wholesale cost of tobacco products as of March 1 of the current calendar year and shall be effective during the next fiscal year, beginning July 1.

Note: Authority cited: Section 30451, Revenue and Taxation Code. Reference: Sections 30008, 30010, 30011, 30017, 30105, 30121, 30123, 30126, 30131.1, 30131.2, 30131.5, 30201, and 30221, Revenue and Taxation Code.

Any changes made to the regulation text to address the clarity issues discussed above must be made available for at least 15 days for public comment pursuant to Government Code section 11346.8 and section 44 of title 1 of the CCR prior to adoption by the Board. The Board must document in the rulemaking file its approval of the final text after consideration of all public comments and relevant information, as well as resolve all other issues raised in this Decision of Disapproval, before resubmitting to OAL.

If you have any questions, please contact me at (916) 322-3761.

Date: July 25, 2016

Eric Partington
Attorney

For: Debra M. Cornez
Director

Original: Virginia Herold
Copy: Debbie Damoth

<p>SUMMARY OF REGULATORY ACTIONS</p>

**REGULATIONS FILED WITH
SECRETARY OF STATE**

This Summary of Regulatory Actions lists regulations filed with the Secretary of State on the dates indicated. Copies of the regulations may be obtained by contacting the agency or from the Secretary of State, Archives, 1020 O Street, Sacramento, CA 95814, (916) 653-7715. Please have the agency name and the date filed (see below) when making a request.

File# 2016-0610-01
AIR RESOURCES BOARD
On-Board Diagnostic System Requirements (OBDII)

The Air Resources Board (Board) amended sections 1900, 1956.8, 1968.2, 1968.5, 1971.5, and 2485 of title 13 of the California Code of Regulations, amended sections 95302 and 95662 of title 17 of the California Code of Regulations, and updated 24 incorporated by reference documents. This action updates and clarifies on-board diagnostic (OBD II) systems requirements and related enforcement provisions for passenger cars, light-duty trucks, and medium-duty vehicles and engines to account for Low Emission Vehicle III applications. This action also streamlines procedures for certification of these vehicles and engines for sale and distri-

bution in California, provides greater compliance flexibility for manufacturers, and establishes ongoing tracking procedures for the Board to monitor OBD II systems to assure they detect emission control malfunctions in real-world conditions.

Title 13, 17
AMEND: 1900, 1956.8, 1968.2, 1968.5, 1971.1, 1971.5, 2485, 95302, 95662
Filed 07/25/2016
Effective 07/25/2016
Agency Contact:
Trini Balcazar (916) 445-9564

File# 2016-0614-01
BOARD OF EQUALIZATION
Wholesale Cost of Tobacco Products

This rulemaking by the State Board of Equalization adopts section 4076 in Title 18 of the California Code of Regulations to further define the wholesale cost of "Other Than Tobacco Products" (OTP) and clarify how the wholesale cost of OTP should be calculated.

Title 18
ADOPT: 4076
Filed 07/27/2016
Effective 10/01/2016
Agency Contact: Richard Bennion (916) 445-2130

File# 2016-0615-02
BOARD OF EQUALIZATION
Miscellaneous Service Enterprises

This action by the Board of Equalization makes changes without regulatory effect to section 1506, subdivision (g), in title 18 of the California Code of Regulations by replacing the reference to the "Hearing Aid Dispensers Examining Committee" with "Speech-Language Pathology and Audiology and Hearing Aid Dispensers Board" consistent with Statutes 2009, chapter 309 (AB 1535).

Title 18
AMEND: 1506
Filed 07/27/2016
Agency Contact: Richard Bennion (916) 445-2130

File# 2016-0613-03
CALIFORNIA COASTAL COMMISSION
Permit Application Fee, Annual Increase

The California Coastal Commission submitted this action amending section 13055 of Title 14, to adjust the fees for permit applications and other filings as prescribed in section 13055(c). The Consumer Price Index for Urban Consumers base year for calculations is 2008. For the 2016 increase, the change is 13.3%.

Rulemaking File Index

Title 18. Public Revenue

Cigarette and Tobacco Products Tax Regulation 4076,

Wholesale Cost of Tobacco Products

1. [Final Statement of Reasons](#)
2. [Updated Informative Digest](#)
3. [Business Tax Committee Minutes, January 26, 2016](#)
 - Minutes
 - Chief, Tax Policy Division memo dated January 15, 2016
 - BTC Agenda
 - Formal Issue Paper Number 15-013
 - Exhibit 1 Revenue Estimate
 - Exhibit 2 Text Regulation 4076
 - Exhibit 3 Text Regulation 4001
 - Exhibit 4 Submission From McClellan Davis, Dated November 12, 2015
4. [Reporter's Transcript Business Taxes Committee, January 26, 2016](#)
5. [Estimate of Cost or Savings, May 9, 2016](#)
6. [Economic and Fiscal Impact Statements, March 28, 2016](#)
7. [Notice of Publications](#)
 - Form 400 and Notice, Publication Date April 8, 2016
 - Email sent to Interested Parties, April 8, 2016
 - CA Regulatory Notice Register 2016, Volume No. 15-Z
8. [Notice to Interested Parties, April 8, 2016](#)

The following items are exhibited:

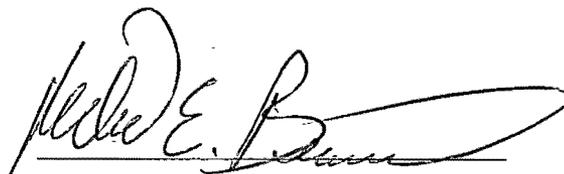
 - Notice of Hearing
 - Initial Statement of Reasons
 - Proposed Text of Regulation 4076
 - Regulation History
9. [Statement of Compliance](#)
10. [Reporter's Transcript, Item F1, May 24, 2016](#)
11. [Draft Minutes, May 24, 2016, and Exhibits](#)
 - Notice of Proposed Regulatory Action
 - Initial Statement of Reasons
 - Proposed Text of Regulation 4076
 - Regulation History

VERIFICATION

I, Richard E. Bennion, Regulations Coordinator of the State Board of Equalization, state that the rulemaking file of which the contents as listed in the index is complete, and that the record was closed on June 13, 2016 and that the attached copy is complete.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

June 13, 2016

A handwritten signature in black ink, appearing to read "Richard E. Bennion", written over a horizontal line.

Richard E. Bennion
Regulations Coordinator
State Board of Equalization

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

UPDATE OF INFORMATION IN THE INITIAL STATEMENT OF REASONS

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.

The factual basis, specific purpose, and necessity for, the problem to be addressed by, and the anticipated benefits from the adoption of proposed Regulation 4076 are the same as provided in the initial statement of reasons.

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 proposed Regulation 4076.

The Board did not rely on any data or any technical, theoretical, or empirical study, report, or similar document in proposing or adopting Regulation 4076 that was not identified in the initial statement of reasons, or which was otherwise not identified or made available for public review prior to the close of the public comment period.

In addition, the factual basis has not changed for the Board's initial determination that the proposed regulatory action will not have a significant adverse economic impact on business, the Board's determination that the proposed regulatory action is not a major regulation, as defined in Government Code section 11342.548 and California Code of Regulations, title 1, section 2000, and the Board's economic impact assessment, which determined that the Board's proposed regulatory action:

- Will neither create nor eliminate jobs in the State of California;
- Nor result in the elimination of existing businesses;
- Nor create or expand business in the State of California; and
- Will not affect the benefits of Regulation 4076 to the health and welfare of California residents, worker safety, or the state's environment.

The adoption of proposed Regulation 4076 may affect small businesses.

No Mandate on Local Agencies or School Districts

The Board has determined that the adoption of proposed Regulation 4076 does not impose a mandate on local agencies or school districts.

Public Comments

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.

Determination Regarding Alternatives

By its motion on May 24, 2016, the Board determined that no alternative to the adoption of proposed Regulation 4076 would be more effective in carrying out the purposes for which the regulation is proposed, would be as effective and less burdensome to affected private persons than the adopted regulation, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provisions of law.

The Board did not reject any reasonable alternative to proposed Regulation 4076 that would lessen any adverse impact the proposed regulatory action may have on small business.

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.

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.



BOARD OF EQUALIZATION

BUSINESS TAXES COMMITTEE MEETING MINUTES

HONORABLE DIANE L. HARKEY, COMMITTEE CHAIR

450 N STREET, SACRAMENTO

MEETING DATE: JANUARY 26, 2016, TIME: 10:00 A.M.

ACTION ITEMS & STATUS REPORT ITEMS**Agenda Item No: 1****Title: Proposed revisions to Regulation 1590, *Newspapers and Periodicals*****Issue/Topic:**

Whether the Board should amend Regulation 1590, *Newspapers and Periodicals*, to clarify the application of tax to subscriptions of newspapers that include or combine access to digital content.

Committee Discussion:

Staff introduced the issue.

Committee Action/Recommendation/Direction:

Upon motion by Mr. Runner and seconded by Ms. Stowers without objection, the Committee approved and authorized for publication the proposed amendments to Regulation 1590, *Newspapers and Periodicals*. A copy of the proposed amendments to Regulation 1590 is attached.

Agenda Item No.: 2**Title: Proposed Cigarette and Tobacco Products Tax Regulations 4076, *Wholesale Cost of Tobacco Products*, and 4001, *Retail Stock*****Issue:**

Whether the Board should approve proposed Regulation 4076, *Wholesale Cost of Tobacco Products*, and Regulation 4001, *Retail Stock* to provide definitions for "wholesale cost of tobacco products" and "retail stock."

Committee Discussion:

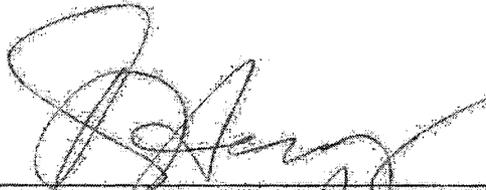
Staff introduced the proposed Regulation 4076 and Regulation 4001 which define and clarify the wholesale cost and retail stock, as they relate to cigarette and tobacco products tax. Mr. Randall Check of SEIU Local 1000 stated that they had concerns with Regulation 4001. Specifically, he expressed a concern regarding the possible commingling of taxed and untaxed tobacco products maintained in a walk-in humidor. Mr. Parrott of the Special Taxes and Fees Division responded that staff believes its proposed language made clear the differences between tobacco products held in retail and wholesale inventories.

Mr. Cheek explained that he did not believe his organization participated in the interested parties' process. The members discussed continuing the interested parties' process to allow further discussion on the Regulation 4001 issue.

Committee Action:

Upon motion by Mr. Runner, seconded by Ms. Stowers, without objection, the Committee approved and authorized for publication proposed Regulation 4076. A copy of proposed Regulation 4076 is attached.

Upon motion by Mr. Horton, seconded by Ms. Ma, without objection, the Committee decided to postpone proposed Regulation 4001 to the March 29, 2016 Business Taxes Committee meeting to allow staff to work with interested parties to address their concerns.



Honorable Diane L. Harkey, Committee Chair



David Gau, Chief Deputy Director

BOARD APPROVED

at the 1-26-16 Board Meeting



Joann Richmond, Chief
Board Proceedings Division

Regulation 1590. Newspapers and Periodicals.

Reference: Sections 6005, 6006, 6007, 6010, 6015, 6361.5, 6362-3, 6362.7, and 6362.8, Revenue and Taxation Code.

(a) Definitions.

(1) "Newspaper." The term "newspaper" as used herein conforms to the definition of a newspaper as set forth in a ruling of the United States Treasury Department published in the Federal Register, December 29, 1960. Under this definition, the term is limited to those publications which are commonly understood to be newspapers and which are printed and distributed periodically at daily, weekly, or other short intervals for the dissemination of news of a general character and of a general interest. The term does not include handbills, circulars, flyers, or the like, unless distributed as a part of a publication which constitutes a newspaper within the meaning of this subparagraph. Neither does the term include any publication which is issued to supply information on certain subjects of interest to particular groups, unless such publication otherwise qualifies as a newspaper within the meaning of this subparagraph. For purposes of this subparagraph, advertising is not considered to be news of a general character and of a general interest.

(2) "Periodical." The term "periodical" as used herein is limited to those publications which appear at stated intervals, each issue of which contains news or information of general interest to the public, or to some particular organization or group of persons. Each issue must bear a relationship to prior or subsequent issues in respect to continuity of literary character or similarity of subject matter, and there must be some connection between the different issues of the series in the nature of the articles appearing in them.* Each issue must be sufficiently similar in style and format to make it evident that it is one of a series. An annual report of a corporation which is substantially different in style and format from the corporation's quarterly reports is not part of a series with the quarterly reports. The term "periodical" does not include books complete in themselves, even those that are issued at stated intervals, for example, books sold by the Book-of-the-Month Club or similar organizations; so-called "pocket books," a new one of which may be issued once a month or some other interval; or so-called "one-shot" magazines that have no literary or subject matter connection or continuity between prior or subsequent issues. The term does not include catalogs, programs, score-cards, handbills, price lists, order forms or maps. Neither does it include shopping guides or other publications of which the advertising portion, including product publicity, exceeds 90 percent of the printed area of the entire issue in more than one-half of the issues during any 12-month period.

(3) "Ingredient or Component Part of a Newspaper or Periodical." The term "ingredient or component part of a newspaper or periodical" includes only those items that become physically incorporated into the publication and not those which are merely consumed or used in the production of the publication. For example, newsprint and ink are ingredients of a newspaper; however, a photograph does not become an ingredient or component part of a

* This definition is based upon *Business Statistics Organization, Inc. v. Joseph*, 299 N.Y. 443, 87 N.E. 2d 505, and *Houghton v. Payne*, 194 U.S. 88, 48 L.Ed 888.

newspaper or periodical merely because the image of the photograph is reproduced in the publication.

Handbills, circulars, flyers, order forms, reply envelopes, maps or the like are considered as component parts of a newspaper or periodical when attached to or inserted in and distributed with the newspaper or periodical.

(4) "Publisher." "Publisher" means and includes any person who owns the rights to produce, market, and distribute printed literature and information.

(5) "Distributor." "Distributor" means any person who acquires newspapers or periodicals for subsequent distribution to retailers or newspaper carriers.

(6) "Newspaper Carrier." "Newspaper carrier" means any person who acquires newspapers from a publisher or distributor to deliver to consumers. The term includes a hawker. A "hawker" is an individual who sells single copies of newspapers to passersby on a street corner or other trafficked area. "Newspaper carrier" does not include persons selling newspapers or periodicals from a fixed place of business.

(7) "Third Party Retailer." "Third party retailer" means and includes any person who sells at retail subscriptions to newspapers and periodicals who is not the publisher of the newspapers or periodicals. Typically, third party retailers solicit subscriptions in a single offering for a large number of different publications, require that payment be made to the account of the third party retailer, and undertake to resolve subscription problems. The term includes persons commonly known as direct mail, school, paid during service, cash, catalog, and telephone agents. "Third party retailer" does not include persons who solicit renewals of subscriptions on behalf of individual publishers.

(8) "Mixed Newspaper Subscription." "Mixed newspaper subscription" means and includes a subscription for a tangible newspaper combined with a subscription for the right to access digital content.

(9) "Digital-Only Subscription Rate." "Digital-only subscription rate" means the price a customer would pay to access digital content from a newspaper publisher, exclusive of any promotions or discounts, without any print delivery.

(10) "Print-Only Subscription Rate." "Print-only subscription rate" means the price a customer would pay to have the print edition of a newspaper delivered to their home, exclusive of any promotions or discounts, without any access to digital content.

(b) Application of Tax.

(1) In General. ~~Effective July 15, 1991,~~ The sale of newspapers and periodicals, including sales by third party retailers, is subject to tax unless otherwise exempt.

Tax does not apply to sales of tangible personal property to persons who purchase the property for incorporation as a component part of a newspaper or periodical which will be sold notwithstanding that the purchaser is not the seller of the newspaper or periodical.

See Regulation 1574 (18 CCR 1574) for the application of tax to sales through vending machines and Regulation 1628 (18 CCR 1628) for the application of tax to transportation charges.

(2) Distributions of Newspapers and Periodicals Without Charge. ~~Effective October 2, 1991,~~ Tax does not apply to the sale or use of tangible personal property which becomes an ingredient or component part of a copy of a newspaper or periodical regularly issued at average intervals not exceeding three months when that copy of such newspaper or periodical is distributed without charge, nor does tax apply to such distribution.

Newspapers and periodicals distributed on a voluntary pay basis shall be considered as distributed without charge. Newspapers and periodicals are distributed on a voluntary pay basis when payment is requested from the consumer but is not required.

(3) Subscriptions. ~~The sale or use of newspapers and periodicals is exempt from tax during the term of a prepaid subscription if the purchaser ordered and paid for the subscription prior to July 15, 1991.~~

~~Effective November 1, 1992, t~~

(A) Exempt Subscriptions. Tax does not apply to the sale or use of a periodical, including a newspaper, which appears at least four, but not more than 60 times each year, which is sold by subscription, and which is delivered by mail or common carrier. For example, a daily newspaper is not a periodical for the purposes of this subdivision (b)(3). Tax does not apply to the sale or use of tangible personal property which becomes an ingredient or component part of such a periodical.

~~Sales tax reimbursement collected on the sale of a periodical subscription prior to the November 1, 1992 effective date of the exemption for the sale of issues delivered on or after November 1, 1992 constitutes excess tax reimbursement. The retailer must refund the tax reimbursement to the customer or pay it to the state in accordance with subdivision (b) of Regulation 1700 (18 CCR 1700).~~

(B) Mixed Newspaper Subscriptions. In the sale of a mixed newspaper subscription, tax is applied to the tangible personal property portion of the transaction (unless otherwise exempt or excluded) and the right to access the digital content is not subject to tax.

1. For sales of mixed newspaper subscriptions made on and after October 1, 2016, forty-seven (47) percent of the charge for the mixed newspaper subscription is presumed to be the taxable measure from the sale of tangible personal property and tax applies to that amount; the remaining fifty-three (53) percent is presumed to be the nontaxable sale of the right to access the digital content.

2. This presumption may be overcome by evidence demonstrating to the satisfaction of the board that the digital-only subscription rate divided by the sum of the print-only subscription rate and the digital-only subscription rate is greater than fifty-three (53) percent. Taxpayers shall maintain records to substantiate a nontaxable allocation

greater than fifty-three (53) percent. Rates shall not be computed more often than once per quarter.

(C) Reporting Subscription Sales. Each delivery of a newspaper or periodical pursuant to a subscription sale is a separate sale transaction. When the sale is subject to tax, the retailer must report and pay the tax based upon the reporting period within which the delivery is made. The subscription price shall be prorated over the term of the subscription period.

(4) Membership Organizations. Generally, tax applies to sales of newspapers and periodicals by membership organizations. If the price is separately stated, tax applies to that amount. If the price is not separately stated, the measure of tax is the fair retail selling price of the publication.

The application of tax to distributions of newspapers and periodicals by nonprofit organizations is provided at subdivision (b)(5). The application of tax to sales of periodicals by subscription is provided at subdivision (b)(3).

(5) Nonprofit Organizations.

(A) Internal Revenue Code Section 501(c)(3) Organizations. ~~Effective November 1, 1991, until October 31, 1992, tax does not apply to the sale or use of any newspaper or periodical distributed by an organization that qualifies for tax exempt status under section 501(c)(3) of the Internal Revenue Code, nor tangible personal property which becomes an ingredient or component part of any such newspaper or periodical, regularly issued at average intervals not exceeding three months only as to issues and distributed under either of the following circumstances:~~

1. The issues are distributed to the organization's members in consideration of the organization's membership fee; or
2. The issues are of a newspaper or periodical which neither receives revenue from, nor accepts, any commercial advertising.

~~Effective November 1, 1992, the exemption is applicable only as to a newspaper or periodical regularly issued at average intervals not exceeding three months.~~

For purposes of this subdivision, any governmental entity established and administered for the purposes provided in Internal Revenue Code Section 501(c)(3) shall be considered to be an organization that qualifies for tax exempt status under that section.

(B) Other Nonprofit Organizations. ~~Effective November 1, 1991, tax does not apply to the sale or use of any newspaper or periodical regularly issued at average intervals not exceeding three months and distributed by a nonprofit organization, nor tangible personal property that becomes an ingredient or component part of or any such newspaper or periodical, only as to issues distributed pursuant to both of the following requirements:~~

1. The issues are distributed to the organization's members in consideration, in whole, or in part, of the organization's membership fee;
2. The amount paid or incurred by the nonprofit organization for the cost of printing the newspaper or periodical is less than ten percent of the membership fee attributable to the period for which the newspaper or periodical is distributed, whether the publication is printed within or without this state. The cost of printing shall be determined as follows.

The cost of printing includes costs of tangible personal property purchased to become an ingredient or component part of the newspaper or periodical (e.g., ink and paper) and costs of labor to print the newspaper or periodical. The cost of printing does not include costs not attributable to actual printing, such as costs of special printing aids, typography, and preparation of layouts.

If the organization contracts with an outside printer to print the newspaper or periodical, the organization shall obtain and retain documentation segregating the costs of printing from the printer's other charges.

If the organization is the printer of the newspaper or periodical, the cost of printing includes the aggregate of the cost of tangible personal property purchased to become an ingredient or component part of the newspaper or periodical; labor of printing, including fringe benefits and payroll taxes; and other costs attributable to the actual printing of the newspaper or periodical.

If an organization has published the newspaper or periodical for a period exceeding twelve months and the method of printing has not changed, the organization may elect to consider the cost of printing for a reporting period to be equal to the amount paid or incurred for the same reporting period for the previous fiscal or calendar year.

(6) Newspaper Carriers. A newspaper carrier is not a retailer. The publisher or distributor for whom the carrier delivers is the retailer of the newspapers delivered. The publisher or distributor shall report and pay tax measured by the price charged to the customer by the carrier.

(7) Consumption of Property. Tax applies to the sale to or use by a newspaper or periodical publisher of tangible personal property consumed in the manufacturing process. Tax does not apply to the cost of tangible personal property lost or wasted in the manufacturing process when that property was purchased for the purpose of incorporation into a newspaper or periodical to be sold or to be distributed in accordance with subdivision (b)(2).

~~(8) Fixed-Price Contracts. The sale or use of newspapers and periodicals is exempt from tax during the term of a prepaid subscription if the purchaser ordered and paid for the subscription prior to July 15, 1991.~~

(98) School Catalogs and Yearbooks. Public or private schools, county offices of education, school districts, or student organizations are the consumers of catalogs and yearbooks

prepared for or by them, and tax does not apply to their receipts from the distribution of the publications to students.

Tax applies to charges for the preparation of such publications made to public or private schools, county offices of education, school districts, or student organizations by printers, engravers, photographers and the like.

(c) Exemption Certificates. Any seller claiming a transaction as exempt from sales tax pursuant to Revenue and Taxation Code sections 6362.7 or 6362.8 should timely obtain an exemption certificate in writing from the purchaser. The exemption certificate will be considered timely if obtained by the seller at any time before the seller bills the purchaser for the property, or any time within the seller's normal billing and payment cycle, or any time at or prior to delivery of the property.

(1) Certificate A. Certificate to be used for purchases of tangible personal property for incorporation into newspapers or periodicals for sale in accordance with subdivisions (b)(1) or (b)(3), above.

(2) Certificate B. Certificate to be used for purchases of tangible personal property that becomes an ingredient or component part of newspapers or periodicals that are distributed without charge in accordance with subdivision (b)(2), above.

(3) Certificate C. Certificate to be used for purchases of tangible personal property that becomes an ingredient or component part of newspapers or periodicals that are distributed by organizations which qualify for tax-exempt status under Internal Revenue Code section 501(c)(3) in accordance with subdivision (b)(5)(A), above.

(4) Certificate D. Certificate to be used for purchases of tangible personal property that becomes an ingredient or component part of newspapers or periodicals that are distributed by nonprofit organizations in accordance with subdivision (b)(5)(B), above.

Certificate A

California Sales Tax Exemption Certificate

Sales of tangible personal property for incorporation into a newspaper or periodical for sale

(Name of Purchaser)

(Address of Purchaser)

I HEREBY CERTIFY:

Initial one of the following:

That I hold valid seller's permit No. issued pursuant to the Sales and Use Tax Law.

That I do not hold a seller's permit issued pursuant to the Sales and Use Tax Law. I do not sell any tangible personal property for which a permit is required.

I further certify that the tangible personal property described herein which I shall purchase from

(Name of Vendor)

will become a component part of the newspaper or periodical *

and sold as a component part of the publication.

I understand that in the event any such property is sold or used other than as specified above or used other than for retention, demonstration, or display while holding it for sale in the regular course of business, I am required by the Sales and Use Tax Law to report and pay any applicable sales or use tax. Description of the property to be purchased:

Date: , 19

(Signature of Purchaser or Authorized Agent)

(Title)

* Insert name and type of newspaper or periodical

Certificate B

California Sales Tax Exemption Certificate

Sales of tangible personal property which becomes an ingredient or component part of newspapers or periodicals that are distributed without charge

(Name of Purchaser)

(Address of Purchaser)

I HEREBY CERTIFY:

Initial one of the following:

____ That I hold valid seller's permit No. _____ issued pursuant to the Sales and Use Tax Law.

____ That I do not hold a seller's permit issued pursuant to the Sales and Use Tax Law. I do not sell any tangible personal property for which a permit is required.

I further certify that I am engaged in the business of publishing *

which is regularly issued at average intervals not exceeding three months and distributed without charge by me. The tangible personal property described herein which I shall purchase from

(Name of Vendor)

will become a component part of the publication listed above. I understand that if I use any of the property purchased for any other purpose I am required by the Sales and Use Tax Law to report and pay tax, measured by the purchase price of the such property.
Description of property to be purchased:

Date: _____, 19 _____

(Signature of Purchaser or Authorized Agent)

(Title)

* Insert name and type of newspaper or periodical

Certificate C

California Sales Tax Exemption Certificate

Sales of tangible personal property that becomes an ingredient or component of newspapers or periodicals that are distributed by organizations which qualify for tax-exempt status under Internal Revenue Code section 501(c)(3)

(Name of Purchaser)

(Address of Purchaser)

I HEREBY CERTIFY:

Initial one of the following:

____ That I hold valid seller's permit No. _____ issued pursuant to the Sales and Use Tax Law.

____ That the purchaser does not hold a seller's permit issued pursuant to the Sales and Use Tax Law. The purchaser does not sell any tangible personal property for which a permit is required.

I further certify that the purchaser is an organization that qualifies for tax-exempt status under Section 501(c)(3) of the Internal Revenue Code and is engaged in the business of selling or publishing *

which is regularly issued at average intervals not exceeding three months.

The tangible personal property described herein which I shall purchase from

(Name of Vendor)

will be sold in the form of tangible personal property or will become a component part of a newspaper or periodical distributed by the organization and (check one or both):

____ The organization will distribute the newspaper or periodical to the members of the organization in consideration of payment of the organization's membership fee or to the organization's contributors,

____ The publication does not receive revenue from or accept any commercial advertising.

I understand that in the event any such property is sold or used other than as specified above or used other than for retention, demonstration, or display while holding it for sale in the regular course of business, I am required by the Sales and Use Tax Law to report and pay any applicable sales or use tax. Description of the property to be purchased:

Date: _____, 19____

(Signature of Purchaser or Authorized Agent)

(Title)

* Insert name and type of newspaper or periodical

Certificate D

California Sales Tax Exemption Certificate

Sales of tangible personal property which becomes an ingredient or component part of newspapers or periodicals that are distributed by nonprofit organizations

(Name of Purchaser)

(Address of Purchaser)

I HEREBY CERTIFY:

Initial one of the following:

That the purchaser holds valid seller's permit No. issued pursuant to the Sales and Use Tax Law.

That the purchaser does not hold a seller's permit issued pursuant to the Sales and Use Tax Law. The purchaser does not sell any tangible personal property for which a permit is required.

I further certify that the purchaser is a nonprofit organization which is engaged in the business of selling or publishing *

which is regularly issued at average intervals not exceeding three months.

The tangible personal property described herein which I shall purchase from

(Name of Vendor)

will be resold by the organization in the form of tangible personal property or will become a component part of a newspaper or periodical distributed by the organization and both of the following apply:

(A) Distribution will be to any member of the nonprofit organization in consideration, in whole or in part, of payment of the organization's membership fee.

(B) The amount paid or incurred by the nonprofit organization for the cost of printing the newspaper or periodical is less than 10 percent of the membership fee attributable to the period for which the newspaper or periodical is distributed.

I understand that in the event any of such property is sold or used other than as specified above or used other than for retention, demonstration, or display while holding it for sale in the regular course of business, I am required by the Sales and Use Tax Law to report and pay any applicable sales or use tax. Description of property to be purchased:

Date: _____, 19____

(Signature of Purchaser or Authorized Agent)

(Title)

* Insert name and type of newspaper or periodical

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

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

(2) Discounts or trade allowances. "Discounts or trade allowances" are price reductions, or allowances of any kind, whether stated or unstated, and include, without limitation, any price reduction applied to a supplier's price list. The discounts may be for prompt payment, payment in cash, bulk purchases, related-party transactions, or "preferred-customer" status.

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

(b) Wholesale cost.

(1) If finished tobacco products are purchased by a distributor from a supplier in an arm's-length transaction, the "wholesale cost" of the tobacco product is the amount paid for the tobacco product, including any federal excise tax, but excluding any transportation charges for shipment originating within the United States. Discounts and trade allowances must be added back when determining "wholesale cost."

(2) If a manufacturer or an importer is also the distributor, the wholesale cost of tobacco includes all manufacturing costs, the cost of raw materials (including waste materials not incorporated into the finished tobacco product) prior to any discounts or trade allowances, the cost of labor, any direct (including freight-in) and indirect overhead costs, and any federal excise and/or U.S. Customs taxes paid. Wholesale cost includes all freight or transportation charges for shipment of materials and/or unfinished product from the supplier to the manufacturer concurrently licensed as a distributor, but excludes domestic freight or transportation charges for shipment of finished tobacco products as defined in subdivision (a)(3).

(3) If tobacco product costs include express, implicit, or unstated discounts or trade allowances, the correct wholesale costs to be reported by the distributor may be determined using any of the methods provided in subdivision (c).

(4) If tobacco products are not purchased in an arm's-length transaction, the correct wholesale costs to be reported by the distributor may be determined using any of the methods provided in subdivision (c).

(c) Alternative methods of estimating or calculating wholesale cost.

The following resources or methods may be used.

The proposed language contained in this document may not be adopted. Any revisions that are adopted may differ from this text.

(1) 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 an estimate based on the best available information of the distributor's or a similarly situated distributor's profit.

(2) If a publicly or commercially available price list is not available, industry data from the time period to be estimated or calculated that provides reasonable evidence of typical tobacco product costs during such time period, including, but not limited to:

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

(B) All the direct and indirect costs that the supplier paid or incurred with respect to acquisition, production, marketing, and sale of the tobacco products sold by the supplier to the distributor, with appropriate adjustments to such costs as indicated by all the facts and circumstances, plus a reasonable estimate of the supplier's profit.

(C) The price of the same or similar tobacco products as reflected in a supplier's price list, with appropriate adjustments to such price as indicated by all the facts and circumstances.

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

(E) Additional methods not mentioned above, with Board approval.

(d) Sales not made at arm's-length.

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

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

(e) Examples of estimating or calculating the wholesale cost of tobacco:

(1) **Example 1:** Distributor B produces handmade cigars. B's tobacco product costs include: all manufacturing costs, the cost of raw materials (including waste materials not incorporated

The proposed language contained in this document may not be adopted. Any revisions that are adopted may differ from this text.

into the final product), the cost of labor, any direct and indirect overhead costs, and any federal excise and/or U.S. Customs taxes paid. The cost does not include freight or transportation charges for shipment from the supplier to the distributor.

(2) Example 2: Distributor C purchases tobacco products from a subsidiary corporation in which it owns or controls more than 50 percent of the voting stock. Due to this corporate relationship between seller and buyer, the Board presumes that the sale and purchase were not at arm's-length, and the presumption is not rebutted by C. In the absence of an arm's-length transaction, the methods discussed in subdivision (c) may be used to determine the correct wholesale cost.

(3) Example 3: Distributor D acquires tobacco product free of charge and reports no wholesale cost for the product on its Tobacco Products Distributor Tax Return. However, D acquired such tobacco product at a 100 percent discount or trade allowance. In the absence of an arm's-length transaction, the methods discussed in subdivision (c) may be used to determine the correct wholesale cost.

(4) Example 4: Distributor E, with a tobacco products importers license, acquires tobacco products or finished tobacco products from a supplier outside the United States. E's tobacco product costs include, in addition to all other production or acquisition costs, the costs of all U.S. Customs fees and federal excise taxes paid or incurred by E with respect to such tobacco products.

(5) Example 5: Distributor F receives three tobacco products packaged as one unit, as a "three for the price of two" promotional package, labeled with a single UPC barcode. As the products are packaged together as one inseparable unit, tax is based on the total package price.

(6) Example 6: Distributor G receives 2 units, to sell as a "buy one, get one free" promotion. Each unit is separately packaged and each unit is labeled with a UPC barcode. Because one unit is being provided for free, tax would apply to the wholesale cost of each separate unit as calculated by a method discussed in subdivision (c).

(7) Example 7: Distributor H receives a three percent discount for paying their supplier within 10 days of receipt of their items. To calculate the wholesale cost, Distributor H must add the three percent discount to the price paid for the products.

(f) Rate Setting. The Board's annual determination of the rate of tax that applies to other tobacco products shall be made based on the wholesale cost of tobacco products as of March 1 of the current calendar year and shall be effective during the next fiscal year, beginning July 1.

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

The proposed language contained in this document may not be adopted. Any revisions that are adopted may differ from this text.



STATE BOARD OF EQUALIZATION

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State Controller

CYNTHIA BRIDGES
Executive Director

January 15, 2016

Dear Interested Party:

Enclosed are the Agenda, Issue Paper, and Revenue Estimate for proposed Regulation 4076, *Wholesale Cost of Other Tobacco Products*, and Regulation 4001, *Retail Stock*, which will be presented at the Board's January 26, 2016 Business Taxes Committee meeting. The proposed regulations will provide definitions for the cost of tobacco products and retail stock, respectively as they relate to the Cigarette and Tobacco Products Tax.

Please feel free to publish this information on your website or otherwise distribute it to your associates, members, or other persons that may be interested in this issue.

Thank you for your input on these issues and I look forward to seeing you at the Business Taxes Committee meeting at **10:00 a.m.** on **January 26, 2016** in Room 121 at the address shown above.

Sincerely,

Susanne Buehler, Chief
Tax Policy Division
Sale and Use Tax Department

SB:LS

Enclosures

cc: (all with enclosures, via email and/or hardcopy as requested)
Honorable Jerome E. Horton, Chairman, Third District
Senator George Runner (Ret.), Vice Chair, First District
Honorable Fiona Ma, CPA, Member, Second District
Honorable Diane L. Harkey, Member, Fourth District
Honorable Betty T. Yee, State Controller, c/o Ms. Yvette Stowers (MIC 73)

Ms. Kari Hammond, Board Member's Office, Third District
Ms. Shellie Hughes, Board Member's Office, Third District
Ms. Camille Dixon, Board Member's Office, Third District
Mr. Sean Wallentine, Board Member's Office, First District
Mr. Lee Williams, Board Member's Office, First District
Mr. Brian Wiggins, Board Member's Office, First District
Mr. Cary Huxsoll, Board Member's Office, First District
Mr. Alfred Buck, Board Member's Office, First District
Mr. Jim Kuhl, Board Member's Office, Second District
Ms. Kathryn Asprey, Board Member's Office, Second District
Mr. John Vigna, Board Member's Office, Second District
Mr. Tim Morland, Board Member's Office, Second District
Ms. Lizette Mata, Board Member's Office, Second District
Mr. Russell Lowery, Board Member's Office, Fourth District
Mr. Ted Matthies, Board Member's Office, Fourth District
Ms. Lisa Renati, Board Member's Office, Fourth District
Mr. Clifford Oakes, Board Member's Office, Fourth District
Mr. Ramon Salazar, State Controller's Office (MIC 73)
Ms. Cynthia Bridges (MIC 73)
Mr. Randy Ferris (MIC 83)
Mr. David Gau (MIC 101)
Ms. Lynn Bartolo (MIC 43 or 57)
Mr. Todd Gilman (MIC 70)
Mr. Wayne Mashihara (MIC 47)
Mr. Kevin Hanks (MIC 49)
Mr. Mark Durham (MIC 67)
Mr. Robert Tucker (MIC 82)
Mr. Jeff Vest (MIC 85)
Mr. Jeff Angeja (MIC 85)
Mr. David Levine (MIC 85)
Mr. Bradley Heller (MIC 82)
Mr. Lawrence Mendel (MIC 82)
Mr. John Thiella (MIC 73)
Mr. Stephen Smith (MIC 82)
Ms. Pamela Mash (MIC 82)
Mr. Richard Parrott (MIC 57)
Ms. Debra Kalfsbeek (MIC 62)
Ms. Kirsten Stark (MIC 50)
Mr. Marc Alviso (MIC 101)
Mr. Chris Lee (MIC 101)
Ms. Laureen Simpson (MIC 70)
Ms. Karina Magana (MIC 47)
Mr. Bradley Miller (MIC 92)
Mr. Bill Benson (MIC 67)
Mr. Michael Patno (MIC 50)
Ms. Laurel Smith (MIC 57)

Agenda – January 26, 2016 Business Taxes Committee Meeting
Proposed Regulations 4076, *Wholesale Cost of Tobacco Products*, and 4001, *Retail Stock*, to provide definitions for the wholesale cost of tobacco products and retail stock

<p>Action 1 – Agreed Upon Items</p> <p>Issue Paper Alternative 1 – Staff Recommendation See Agenda, pages 2-6 (Regulation 4076) page 6-8 (Regulation 4001)</p> <p>Issue Paper Alternative 2</p>	<p>Alternative 1</p> <p>Approve and authorize publication of proposed Regulations 4076, <i>Wholesale Cost of Tobacco Products</i>, and 4001, <i>Retail Stock</i>, to provide definitions for the wholesale cost of tobacco products and retail stock, respectively.</p> <p style="text-align: center;">OR</p> <p>Alternative 2</p> <p>Do not approve proposed Regulations 4076 and 4001.</p>
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**Agenda – January 26, 2016 Business Taxes Committee Meeting
Proposed Regulations 4076, Wholesale Cost of Tobacco Products, and 4001, Retail Stock, to
provide definitions for the wholesale cost of tobacco products and retail stock**

Action Item	Staff and Industry's Proposed Regulatory Language
<p>Action 1 – Staff Recommendation</p> <p>Regulation 4076</p>	<p><u>Regulation 4076. WHOLESAL COST OF TOBACCO PRODUCTS.</u></p> <p><u>(a) Definitions.</u></p> <p><u>(1) Arm’s-length transaction.</u> <u>An “arm’s-length” transaction means a sale entered into in good faith and for valuable consideration that reflects the fair market value in the open market between two informed and willing parties, neither under any compulsion to participate in the transaction.</u></p> <p><u>(2) Discounts or trade allowances.</u> <u>“Discounts or trade allowances” are price reductions, or allowances of any kind, whether stated or unstated, and include, without limitation, any price reduction applied to a supplier’s price list. The discounts may include prompt payment, payment in cash, bulk purchases, related-party transactions, or “preferred-customer” status.</u></p> <p><u>(3) Finished tobacco products; finished condition.</u> <u>“Finished tobacco products” and tobacco products in “finished condition” are tobacco products that will not be subject to any additional processing before first distribution in the state.</u></p> <p><u>(b) Wholesale cost.</u></p> <p><u>(1) If finished tobacco products are purchased by a distributor from a supplier in an arm’s-length transaction, the “wholesale cost” of the tobacco product is the amount paid for the tobacco product, including any federal excise tax, but excluding any transportation charges for shipment originating within the United States. Discounts and trade allowances must be added back when determining “wholesale cost.”</u></p> <p><u>(2) If a manufacturer or an importer is also the distributor, the wholesale cost of tobacco includes all manufacturing costs, the cost of raw materials (including waste materials not incorporated into the finished tobacco product) prior to any discounts or trade allowances, the cost of labor, any</u></p>

**Agenda – January 26, 2016 Business Taxes Committee Meeting
Proposed Regulations 4076, Wholesale Cost of Tobacco Products, and 4001, Retail Stock, to
provide definitions for the wholesale cost of tobacco products and retail stock**

Action Item	Staff and Industry's Proposed Regulatory Language
	<p><u>direct (including freight-in), and indirect overhead costs, and any federal excise and/or U.S. Customs taxes paid. Wholesale cost includes all freight or transportation charges for shipment of materials and/or unfinished product from the supplier to the manufacturer concurrently licensed as a distributor, but excludes domestic freight or transportation charges for shipment of finished tobacco products as defined in subdivision (a)(3).</u></p> <p><u>(3) If tobacco product costs include express, implicit, or unstated discounts or trade allowances, the correct wholesale costs to be reported by the distributor may be determined using any of the methods provided in subdivision (c).</u></p> <p><u>(4) If tobacco products are not purchased in an arm's-length transaction, the correct wholesale costs to be reported by the distributor may be determined using any of the methods provided in subdivision (c).</u></p> <p><u>(c) Alternative methods of estimating or calculating wholesale cost.</u></p> <p><u>To estimate or calculate a wholesale cost, the following resources or methods may be used.</u></p> <p><u>(1) 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 an estimate based on the best available information of the distributor's or a similarly situated distributor's profit.</u></p> <p><u>(2) If a publicly or commercially available price list is not available, industry data from the time period to be estimated or calculated that provides reasonable evidence of typical tobacco product costs during such time period, including, but not limited to:</u></p> <p><u>(A) Evidence reasonably indicative of the typical costs of the same or similar tobacco products for similarly situated distributors, with appropriate adjustments to such costs as indicated by all the facts and circumstances.</u></p>

**Agenda – January 26, 2016 Business Taxes Committee Meeting
Proposed Regulations 4076, Wholesale Cost of Tobacco Products, and 4001, Retail Stock, to
provide definitions for the wholesale cost of tobacco products and retail stock**

Action Item	Staff and Industry's Proposed Regulatory Language
	<p><u>(B) All the direct and indirect costs that the supplier paid or incurred with respect to acquisition, production, marketing, and sale of the tobacco products sold by the supplier to the distributor, with appropriate adjustments to such costs as indicated by all the facts and circumstances, plus a reasonable estimate of the supplier's profit.</u></p> <p><u>(C) The price of the same or similar tobacco products as reflected in a supplier's price list, with appropriate adjustments to such price as indicated by all the facts and circumstances.</u></p> <p><u>(D) The retail price of the same or similar tobacco products as reflected in a retailer's price list, with appropriate adjustments to such price as indicated by all the facts and circumstances, less reasonable estimates of the retailer's and distributor's profits.</u></p> <p><u>(E) Additional methods not mentioned above, with Board approval.</u></p> <p><u>(d) Sales not made at arm's-length.</u></p> <p><u>(1) Presumption. Sales, purchases, and transfers of tobacco products are rebuttably presumed to not be at arm's-length if they are between related parties such as: relatives (by blood or marriage, which relationships include, but are not limited to, spouses, parents, domestic partners, children and siblings); partners or a partnership and its partners; a limited liability company or association and its members; commonly controlled corporations; a corporation and its shareholders; or persons, as defined in Revenue and Taxation Code section 30010, and entities under their control or between commonly controlled entities.</u></p> <p><u>(2) Rebuttal of presumption. If the Board determines that a sale, purchase, or transfer of tobacco products was between related parties, the distributor may rebut the presumption that the sale, purchase, or transfer was not at arm's-length by showing that the price, terms, and conditions of the transaction were substantially equivalent to those that would have been negotiated between unrelated parties.</u></p>

**Agenda – January 26, 2016 Business Taxes Committee Meeting
Proposed Regulations 4076, Wholesale Cost of Tobacco Products, and 4001, Retail Stock, to
provide definitions for the wholesale cost of tobacco products and retail stock**

Action Item	Staff and Industry's Proposed Regulatory Language
	<p><u>(e) Examples of estimating or calculating the wholesale cost of tobacco:</u></p> <p><u>(1) Example 1:</u> Distributor B produces handmade cigars. B’s tobacco product costs include: all manufacturing costs, the cost of raw materials (including waste materials not incorporated into the final product), the cost of labor, any direct and indirect overhead costs, and any federal excise and/or U.S. Customs taxes paid. The cost does not include freight or transportation charges for shipment from the supplier to the distributor.</p> <p><u>(2) Example 2:</u> Distributor C purchases tobacco products from a subsidiary corporation in which it owns or controls more than 50 percent of the voting stock. Due to this corporate relationship between seller and buyer, the Board presumes that the sale and purchase were not at arm’s-length, and the presumption is not rebutted by C. In the absence of an arm’s-length transaction, the methods discussed in subdivision (c) may be used to determine the correct wholesale cost.</p> <p><u>(3) Example 3:</u> Distributor D acquires tobacco product free of charge and reports no wholesale cost for the product on its Tobacco Products Distributor Tax Return. However, D acquired such tobacco product at a 100 percent discount or trade allowance. In the absence of an arm’s-length transaction, the methods discussed in subdivision (c) may be used to determine the correct wholesale cost.</p> <p><u>(4) Example 4:</u> Distributor E, with a tobacco products importers license, acquires tobacco products or finished tobacco products from a supplier outside the United States. E’s tobacco product costs include, in addition to all other production or acquisition costs, the costs of all U.S. Customs fees and federal excise taxes paid or incurred by E with respect to such tobacco products.</p> <p><u>(5) Example 5:</u> Distributor F receives three tobacco products packaged as one unit, as a “three for the price of two” promotional package, labeled with a single UPC barcode. As the products are packaged together as one inseparable unit, tax would be based on the total package price.</p> <p><u>(6) Example 6:</u> Distributor G receives 2 units, to sell as a “buy one, get one free” promotion.</p>

Agenda – January 26, 2016 Business Taxes Committee Meeting
Proposed Regulations 4076, Wholesale Cost of Tobacco Products, and 4001, Retail Stock, to
provide definitions for the wholesale cost of tobacco products and retail stock

Action Item	Staff and Industry's Proposed Regulatory Language
Regulation 4001	<p><u>Each unit is separately packaged and each unit is labeled with a UPC barcode. As one unit is being provided for free, tax would apply to the wholesale cost of each separate unit as calculated by a method discussed in subdivision (c).</u></p> <p><u>(7) Example 7: Distributor H receives a 3% discount for paying their supplier within 10 days of receipt of their items. To calculate the wholesale cost, Distributor H must add the 3% discount to the price paid for the products.</u></p> <p><u>(f) Rate Setting. The Board’s annual determination of the rate of tax that applies to other tobacco products shall be made based on the wholesale cost of tobacco products as of March 1 of the current calendar year and shall be effective during the state’s next fiscal year.</u></p> <hr/> <p><u>Note: Authority: Section 30451, Revenue and Taxation Code. Reference: Sections 30008, 30010, 30011, 30017, 30105, 30121, 30123, 30131.2, 30201, and 30221, Revenue and Taxation Code.</u></p> <p><u>Regulation 4001. Retail Stock.</u></p> <p><u>(a) “Retail stock” means and includes:</u></p> <p><u>(1) All cigarettes and tobacco products intended and available for sale to consumers by a person who holds a retailer license; and</u></p> <p><u>(2) All cigarettes and tobacco products displayed for sale to consumers by a person who concurrently holds a distributor license and a retailer license at the same location. Cigarettes and tobacco products that are stored in the area where retail sales are made are deemed to be retail stock. Cigarettes and tobacco products that are not stored in the area where retail sales are made are not retail stock. Examples of these areas may include, but are not limited to, store</u></p>

Agenda – January 26, 2016 Business Taxes Committee Meeting
Proposed Regulations 4076, Wholesale Cost of Tobacco Products, and 4001, Retail Stock, to
provide definitions for the wholesale cost of tobacco products and retail stock

Action Item	Staff and Industry's Proposed Regulatory Language
	<p><u>rooms/closets, back offices and safes. Such cigarettes and tobacco products must be in the original manufacturer packaging, with an unbroken seal, and they must be segregated and separated from inventory accessible by consumers.</u></p> <p>(A) <u>Walk-in humidors. Tobacco products inside a walk-in humidor displayed for sale to consumers are retail stock. Tobacco products inside a walk-in humidor in the original manufacturer packaging with an unbroken seal, segregated and separated from retail stock, and not displayed for sale to consumers, are non-retail stock.</u></p> <p>(b) <u>Presumption of Distribution</u></p> <p>(1) <u>All cigarettes and tobacco products placed in retail stock have been distributed.</u></p> <p>(2) <u>Unless the contrary is established, it shall be presumed that all cigarettes and tobacco products no longer in a distributor's possession, including when they have been lost through an unexplainable disappearance, have been distributed. The presumption may be rebutted by a preponderance of the evidence demonstrating that an explainable disappearance, such as theft, has occurred.</u></p> <p><u>Examples of evidence that may overcome the presumption include, but are not limited to, the following:</u></p> <p>(A) <u>Police reports,</u> (B) <u>Insurance claims,</u> (C) <u>Insurance reimbursements,</u> (D) <u>Video surveillance,</u> (E) <u>Photographs,</u> (F) <u>Detailed tobacco inventory reports,</u> (G) <u>Cigarette and tobacco purchase invoices,</u> (H) <u>Proof of prosecution related to charges of theft of cigarettes or tobacco products.</u></p>

Agenda – January 26, 2016 Business Taxes Committee Meeting
Proposed Regulations 4076, Wholesale Cost of Tobacco Products, and 4001, Retail Stock, to
provide definitions for the wholesale cost of tobacco products and retail stock

Action Item	Staff and Industry's Proposed Regulatory Language
	<p data-bbox="570 371 1472 404"><u>Note: Authority: Sections 30008, 30109, Revenue and Taxation Code.</u></p>

Issue Paper Number 15-013



BOARD OF EQUALIZATION
KEY AGENCY ISSUE

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

Proposed Regulation 4076, *Wholesale Cost of Tobacco Products* and Proposed Regulation 4001, *Retail Stock*

I. Issue

Whether the Board should approve proposed Regulations 4076, *Wholesale Cost of Tobacco Products*, and 4001, *Retail Stock*, to provide definitions for the wholesale cost of tobacco products and retail stock, respectively, as they relate to the Cigarette and Tobacco Products Tax.

II. Alternative 1 - Staff Recommendation

Staff recommends the approval of the proposed regulations as provided in Exhibits 2 and 3. Staff's proposal defines and clarifies the terms "wholesale cost of tobacco products" and "retail stock." In addition to defining the terms, both of the proposed regulations include examples to help clarify the application of tax.

III. Other Alternative(s) Considered

Do not approve proposed Regulation 4076 and Regulation 4001.

IV. Background

The tax rate on “Other Tobacco Products” (OTP) is determined on an annual basis by the Board of Equalization (BOE). This rate is applied by distributors to their “wholesale cost” of OTP to calculate the amount of excise tax due. However, the statutory definition of “wholesale cost” is vague, causing misinterpretation and confusion. Because wholesale cost depends on a variety of factors, staff believes it is important to provide a definition with includable and excludable costs clearly stated.

Revenue and Taxation Code (RTC) section 30008 of the Cigarette and Tobacco Products Tax Law defines “distribution” in subdivision (c) as “the placing in this state of untaxed cigarettes or tobacco products in a vending machine or in retail stock for the purpose of selling the cigarettes or tobacco products to consumers.” This has led to inconsistent interpretations of what constitutes retail stock. Since retail stock must be comprised of tax paid products only, it is essential that clear guidelines are promulgated to assist sellers, in particular those businesses that are both distributors and retailers.

To provide clarity, staff proposes creating regulations to define “wholesale cost” and “retail stock.” Staff believes these regulations will provide industry with clear and specific information to simply and accurately record and report their transactions.

Wholesale Cost of Tobacco Products

Per RTC section 30017, “wholesale cost means the cost of tobacco products to the distributor prior to any discounts or trade allowances.” The definition of wholesale cost is integral to the correct calculation of tax due on OTP as described in RTC sections 30123 (b) and 30131.2 (b). However, the statutory definition of wholesale cost provides little guidance as to how the wholesale cost of OTP should be determined. For example, uncertainty as to whether manufacturing costs, shipping charges, and federal excise taxes, should be included in the calculation of wholesale cost has made it difficult for taxpayers to report the correct amount of tax. This is especially true when a distributor is also the manufacturer of OTP.

Proposed Regulation 4076 provides definitions and several examples highlighting various scenarios to illustrate how wholesale cost and the amount of tax due should be computed (see Exhibit 2).

Retail Stock

The definition of retail stock is important, as it determines whether excise tax is owed on cigarettes and tobacco products. When an item is placed in retail stock, it is deemed to be intended for sale to consumers and to have been distributed pursuant to RTC section 30008 (c). The excise tax on OTP is due when the product has been distributed, therefore, placement of tobacco products into retail stock is the event that triggers taxation.

RTC section 30008 (c) introduces the term “retail stock,” but the term is not defined in either the statute or a regulation. The lack of a detailed definition and examples of retail stock has led to disputed audits and product seizures. Proposed Regulation 4001 provides a definition for what can be considered “retail stock” (see Exhibit 3). The proposed language will be valuable to both staff and tobacco distributors who also make retail sales.

V. Discussion

Staff’s proposed Regulation 4076 and Regulation 4001 help clarify existing statutes by providing definitions and examples of the application of tax. This paper addresses suggestions that were raised in interested parties meetings and the submissions received from interested parties.

Wholesale Cost

Regulation 4076 (a) provides a definition of the “wholesale cost” of OTP and defines terms used in that definition, such as:

- Arm’s-length transaction
- Discounts or trade allowances
- Finished tobacco products and finished condition

The regulation provides guidance on how to calculate wholesale cost in several different scenarios. If the provided scenarios are not applicable, alternative methods of calculating wholesale cost are also provided in subdivision (c). Staff has inserted language allowing for the possibility of utilizing a method not currently addressed in the regulation provided the Board approves the method.

Sales Not Made at Arm’s-length

Regulation 4076 (d) clarifies when it is presumed that a sale is not at arm’s-length, such as a sale between family members or businesses with the same ownership. The regulation provides examples of what may be provided to rebut this presumption and demonstrate the transaction was in fact an arm’s length transaction.

Examples of Calculating or Estimating Wholesale Cost

Several examples are included in Regulation 4076 (e). These examples illustrate how to calculate or estimate the wholesale cost in the following situations:

- Production of handmade cigars;
- Purchasing tobacco products from a subsidiary corporation;
- Acquiring tobacco products for free;
- Tobacco importers purchasing from suppliers outside the United States;
- Promotional packaging;
- Buy one get one free; and
- Supplier discounts.

Staff believes these plain language examples for distributors will decrease confusion on how to calculate wholesale cost.

Rate Setting

Regulation 4076 (f) clarifies the BOE’s annual determination of the rate of tax that applies to OTP. This subdivision states that the determination shall be made based on the wholesale cost of tobacco products as of March 1 of the current calendar year.

Retail Stock

Regulation 4001 defines and includes examples of when cigarettes and tobacco products are considered either “retail stock” or “non-retail stock.” The examples, which illustrate how both the location and the current condition of the original manufacturer’s packaging help determine whether a product has been placed in to retail stock, will assist business owners to determine when the tax is due on their products.

Humidors

Regulation 4001, subdivision (a)(2)(A) addresses how both retail stock and non-retail stock can be stored in the same humidor, and the requirements for products in the humidor to be considered non-retail stock.

Presumption of Distribution

Staff received a submission from McClellan Davis, LLC (Exhibit 4) on November 12, 2015. They submitted additional language that they believe sets a standard of proof as well as examples of evidence to rebut the presumption that OTP has been distributed when a theft or other explainable disappearance has occurred. The suggested language has been condensed from two subdivisions to one and is now proposed as subdivision (b), *Presumption of Distribution*. This subdivision states there is a presumption for when cigarettes and OTP are considered distributed, thereby giving guidance to when tax is due. This subdivision also includes examples of what evidence is needed to overcome the presumption in instances involving theft. McClellan Davis supports the changes staff has made.

VI. Alternative 1 - Staff Recommendation

A. Description of Alternative 1

Staff recommends the approval of proposed Regulations 4076 and 4001, as provided in Exhibits 2 and 3, respectively. Staff's proposals define and clarify the terms of "wholesale cost of tobacco" and "retail stock." In addition to defining the terms, both of the proposed regulations include examples to help clarify the application of tax.

B. Pros of Alternative 1

The proposed regulations will create consistent and clear definitions of terminology frequently used in the taxation of tobacco products. The inclusion of examples of how to calculate the "wholesale cost" of tobacco products will provide guidance not previously available to distributors. The examples demonstrate when items are "retail stock" and "non-retail" stock and will allow business owners to more easily determine when their products have been placed into retail stock.

C. Cons of Alternative 1

None.

D. Statutory or Regulatory Change for Alternative 1

No statutory change is required; however, Regulation 4076 and Regulation 4001 will need to be adopted.

E. Operational Impact of Alternative 1

Taxpayers will have an additional resource to educate themselves on the taxability of tobacco products. In addition, terms will be clearly defined, which will reduce confusion. The additional examples and clarity will likely lead to more accurate reporting, possibly resulting in fewer audit findings, billings and appeal hearings.

F. Administrative Impact of Alternative 1

1. Cost Impact

The workload associated with publishing the regulation and updating forms and publications is considered routine. Any corresponding cost will be absorbed within the BOE's existing budget.

2. Revenue Impact

None. (See Exhibit 1).

G. Taxpayer/Customer Impact of Alternative 1

The proposed regulations will provide clarity for taxpayers on the application of tax to cigarette and tobacco products. The additional clarity will allow taxpayers to file more accurately and should minimize misinterpretations of statutes.

H. Critical Time Frames of Alternative 1

Staff anticipates the Office of Administrative Law will complete its review and approval of the regulation revisions by June 2016.

VII. Alternative 2

A. Description of Alternative 2

Do not adopt Regulation 4076 and Regulation 4001

B. Pros of Alternative 2

The Board will not incur the workload associated with adopting the regulations

C. Cons of Alternative 2

Taxpayers and staff will not have consistent interpretations of statutes and clear definitions of terminology used in the taxation of cigarettes and tobacco products.

D. Statutory or Regulatory Change for Alternative 2

None

E. Operational Impact of Alternative 2

With no definition provided for the terms "wholesale cost" and "retail stock" as they relate to OTP, confusion will continue resulting in a lack of compliance by taxpayers.

F. Administrative Impact of Alternative 2

1. Cost Impact

None

2. Revenue Impact

None. See Revenue Estimate (Exhibit 1)

G. Taxpayer/Customer Impact of Alternative 2

Taxpayers will not have definitions and examples to use for guidance when filing their cigarette and tobacco tax returns.

H. Critical Time Frames of Alternative 2

None.

FORMAL ISSUE PAPER 15-013

Preparer/Reviewer Information

Prepared by: Special Taxes and Fees Department and Sales and Use Tax Department

Current as of: January 6, 2016

REVENUE ESTIMATE

STATE OF CALIFORNIA
BOARD OF EQUALIZATION



Proposed Regulation 4076, Wholesale Cost of Tobacco Products and Proposed Regulation 4001, Retail Stock

I. Issue

Whether the Board should approve proposed Regulations 4076, *Wholesale Cost of Tobacco Products*, and 4001, *Retail Stock*, to provide definitions for the wholesale cost of tobacco products and retail stock, respectively, as they relate to the Cigarette and Tobacco Products Tax.

II. Alternative 1 - Staff Recommendation

Staff recommends the approval of the proposed regulations as provided in Exhibits 2 and 3. Staff's proposal defines and clarifies the terms "wholesale cost of tobacco products" and "retail stock." In addition to defining the terms, both of the proposed regulations include examples to help clarify the application of tax.

III. Other Alternative(s) Considered

Do not approve proposed Regulation 4076 and Regulation 4001.

Background, Methodology, and Assumptions

Alternative 1 – Staff Recommendation

There is nothing in the staff recommendation that would impact revenue. The proposal clarifies existing statutes by providing definitions and examples of the application of tax.

Revenue Summary

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

Other alternatives considered – alternative 2 does not have a revenue impact.

Preparation

Mr. Joe Fitz, Research and Statistics Section, Legislative and Research Division, prepared this revenue estimate. This estimate has been reviewed by Mr. Mark Durham,

Manager, Research and Statistics Section, Legislative and Research Division, and by Ms. Susanne Buehler, Chief, Tax Policy Division, Sales and Use Tax Department. For additional information, please contact Mr. Fitz at (916) 323-3802.

Current as of December 29, 2015.

Regulation 4076. WHOLESALE COST OF TOBACCO PRODUCTS.

(a) Definitions.

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

(2) Discounts or trade allowances. "Discounts or trade allowances" are price reductions, or allowances of any kind, whether stated or unstated, and include, without limitation, any price reduction applied to a supplier's price list. The discounts may be for prompt payment, payment in cash, bulk purchases, related-party transactions, or "preferred-customer" status.

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

(b) Wholesale cost.

(1) If finished tobacco products are purchased by a distributor from a supplier in an arm's-length transaction, the "wholesale cost" of the tobacco product is the amount paid for the tobacco product, including any federal excise tax, but excluding any transportation charges for shipment originating within the United States. Discounts and trade allowances must be added back when determining "wholesale cost."

(2) If a manufacturer or an importer is also the distributor, the wholesale cost of tobacco includes all manufacturing costs, the cost of raw materials (including waste materials not incorporated into the finished tobacco product) prior to any discounts or trade allowances, the cost of labor, any direct (including freight-in) and indirect overhead costs, and any federal excise and/or U.S. Customs taxes paid. Wholesale cost includes all freight or transportation charges for shipment of materials and/or unfinished product from the supplier to the manufacturer concurrently licensed as a distributor, but excludes domestic freight or transportation charges for shipment of finished tobacco products as defined in subdivision (a)(3).

(3) If tobacco product costs include express, implicit, or unstated discounts or trade allowances, the correct wholesale costs to be reported by the distributor may be determined using any of the methods provided in subdivision (c).

(4) If tobacco products are not purchased in an arm's-length transaction, the correct wholesale costs to be reported by the distributor may be determined using any of the methods provided in subdivision (c).

(c) Alternative methods of estimating or calculating wholesale cost.

The following resources or methods may be used.

(1) 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 an estimate based on the best available information of the distributor's or a similarly situated distributor's profit.

(2) If a publicly or commercially available price list is not available, industry data from the time period to be estimated or calculated that provides reasonable evidence of typical tobacco product costs during such time period, including, but not limited to:

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

(B) All the direct and indirect costs that the supplier paid or incurred with respect to acquisition, production, marketing, and sale of the tobacco products sold by the supplier to the distributor, with appropriate adjustments to such costs as indicated by all the facts and circumstances, plus a reasonable estimate of the supplier's profit.

(C) The price of the same or similar tobacco products as reflected in a supplier's price list, with appropriate adjustments to such price as indicated by all the facts and circumstances.

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

(E) Additional methods not mentioned above, with Board approval.

(d) Sales not made at arm's-length.

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

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

(e) Examples of estimating or calculating the wholesale cost of tobacco:

(1) **Example 1:** Distributor B produces handmade cigars. B's tobacco product costs include: all manufacturing costs, the cost of raw materials (including waste materials not incorporated

into the final product), the cost of labor, any direct and indirect overhead costs, and any federal excise and/or U.S. Customs taxes paid. The cost does not include freight or transportation charges for shipment from the supplier to the distributor.

(2) Example 2: Distributor C purchases tobacco products from a subsidiary corporation in which it owns or controls more than 50 percent of the voting stock. Due to this corporate relationship between seller and buyer, the Board presumes that the sale and purchase were not at arm's-length, and the presumption is not rebutted by C. In the absence of an arm's-length transaction, the methods discussed in subdivision (c) may be used to determine the correct wholesale cost.

(3) Example 3: Distributor D acquires tobacco product free of charge and reports no wholesale cost for the product on its Tobacco Products Distributor Tax Return. However, D acquired such tobacco product at a 100 percent discount or trade allowance. In the absence of an arm's-length transaction, the methods discussed in subdivision (c) may be used to determine the correct wholesale cost.

(4) Example 4: Distributor E, with a tobacco products importers license, acquires tobacco products or finished tobacco products from a supplier outside the United States. E's tobacco product costs include, in addition to all other production or acquisition costs, the costs of all U.S. Customs fees and federal excise taxes paid or incurred by E with respect to such tobacco products.

(5) Example 5: Distributor F receives three tobacco products packaged as one unit, as a "three for the price of two" promotional package, labeled with a single UPC barcode. As the products are packaged together as one inseparable unit, tax is based on the total package price.

(6) Example 6: Distributor G receives 2 units, to sell as a "buy one, get one free" promotion. Each unit is separately packaged and each unit is labeled with a UPC barcode. Because one unit is being provided for free, tax would apply to the wholesale cost of each separate unit as calculated by a method discussed in subdivision (c).

(7) Example 7: Distributor H receives a three percent discount for paying their supplier within 10 days of receipt of their items. To calculate the wholesale cost, Distributor H must add the three percent discount to the price paid for the products.

(f) Rate Setting. The Board's annual determination of the rate of tax that applies to other tobacco products shall be made based on the wholesale cost of tobacco products as of March 1 of the current calendar year and shall be effective during the next fiscal year, beginning July 1.

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

Regulation 4001. Retail Stock.

(a) “Retail stock” means and includes:

- (1) All cigarettes and tobacco products intended and available for sale to consumers by a person who holds a retailer license; and
- (2) All cigarettes and tobacco products displayed for sale to consumers by a person who concurrently holds a distributor license and a retailer license at the same location. Cigarettes and tobacco products that are stored in the area where retail sales are made are deemed to be retail stock. Cigarettes and tobacco products that are not stored in the area where retail sales are made are not retail stock. Examples of these areas may include, but are not limited to, store rooms/closets, back offices and safes. Such cigarettes and tobacco products must be in the original manufacturer packaging, with an unbroken seal, and they must be segregated and separated from inventory accessible by consumers.
 - (A) Walk-in humidors. Tobacco products inside a walk-in humidor displayed for sale to consumers are retail stock. Tobacco products inside a walk-in humidor in the original manufacturer packaging with an unbroken seal, segregated and separated from retail stock, and not displayed for sale to consumers, are non-retail stock.

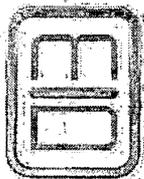
(b) Presumption of Distribution

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

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

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

Note: Authority: Sections 30008, 30109, Revenue and Taxation Code.



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November 12, 2015

Ms. Susanne Buehler, Chief
Board of Equalization
Tax Policy Division
Sales and Use Tax Department
450 N Street
Sacramento, CA 94279-0092

VIA: Email: Susanne.Beuhler@boe.ca.gov

Re: Proposed language for California Code of Regulations, title 18, section 4001, subdivision (c) - Retail Stock.¹

Dear Ms. Buehler,

This submission is being made in response to the Initial Discussion Paper issued on July 21, 2015, in addition to the interested parties meetings held on August 4, 2015 & October 9, 2015 regarding the promulgation of Regulation 4076, *Wholesale Cost of Tobacco* and Regulation 4001, *Retail Stock*. This submission only pertains to Regulation 4001.

The discussion at the second interested parties meeting was both productive and beneficial to the process in our opinion. We want to supplement and further the discussion by offering a revision to Staff's proposed language for Regulation 4001, subsection (c), so it will be in accordance with the applicable law. Portions of our prior submission have been restated in this submission because they are still applicable to the issue at hand.

¹ All references to Regulations hereafter are to California Code of Regulations, title 18, unless otherwise noted.

Submission from McClellan Davis, LLC

Ms. Susanne Buehler, Chief

Proposed Regulation 4001

November 12, 2015

Page 2 of 3

Regulation 4001, subsection (c)

Subsection (c) of proposed Regulation 4001, clarifies when cigarette or tobacco products will be considered to have been distributed in the state as follows:

(c) Tobacco products no longer in a distributor's possession or lost through theft or unexplainable disappearance are deemed to have been distributed.

We agree with Staff's interpretation that cigarettes or tobacco products should be considered to have been distributed when the products have inexplicably disappeared. We feel, however, that it is inequitable, and not consistent with the applicable law, to consider cigarettes or tobacco products to have been distributed when a theft of inventory or other *explainable* disappearance has occurred.

Revenue and Taxation Code section 30109, provides taxpayers with a rebuttable presumption by providing an opportunity to establish evidence which contradicts the presumption that products have been distributed. Code section 30109 states:²

Unless the contrary is established, it shall be presumed that all cigarettes or tobacco products acquired by a distributor...have been distributed.
(emphasis added)

The underlined portion of the statute makes it clear that the presumption of distribution is rebuttable. Based on the plain meaning of the language in the Code section, cigarette or tobacco products are not considered to be distributed if it can be demonstrated by a preponderance of the evidence that a theft or some other *explainable* disappearance has occurred, i.e., if "the contrary is established."

The proposed language for Regulation 4001, subdivision (c), does not currently afford taxpayers with the rebuttable presumption that is provided under Code section 30109. This inconsistency effectively, and impermissibly, narrows the scope of Code section 30109 and it will likely lead to confusion in the application and administration of the law.

² All references to Code sections hereafter are to the Revenue and Taxation Code unless otherwise stated.

Submission from McClellan Davis, LLC

Page 3 of 3

Ms. Susanne Buehler, Chief

Proposed Regulation 4001

November 12, 2015

Page 3 of 3

Therefore, we request that the following language replace Staff's current proposed language for subsection (c):

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

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

- (1) Police Reports,**
- (2) Insurance claims,**
- (3) Insurance reimbursements,**
- (4) Video surveillance,**
- (5) Photographs,**
- (6) Detailed tobacco inventory reports,**
- (7) Tobacco purchase invoices,**
- (8) Photos, or**
- (9) Proof that someone was prosecuted.**

We feel the addition of language which addresses the applicable standard of proof and examples of evidence which will aid in rebutting the presumption will be useful in the application and administration of the law.

We thank you for providing us with the opportunity to submit this suggestion. Please feel free to contact me with any questions or comments.

Sincerely,

James R. Dumler
Senior Tax Specialist

JD:jwm

BEFORE THE CALIFORNIA STATE BOARD OF EQUALIZATION

450 N STREET

SACRAMENTO, CALIFORNIA

REPORTER'S TRANSCRIPT

JANUARY 26, 2016

BUSINESS TAXES COMMITTEE

REPORTED BY: Carole W. Browne

CSR NO. 7351

P R E S E N T

1
2 For the Board of Diane L. Harkey.
Equalization: Chair
3
4 Jerome E. Horton
Member
5 Sen. George Runner (Ret.)
Member
6
7 Fiona Ma, CPA
Member
8 Yvette Stowers
Appearing for Betty T.
9 Yee, State Controller
(per Government Code
10 Section 7.9)
11 Joann Richmond
Chief
12 Board Proceedings
Division
13
14 For the Board of
Equalization Staff:
15 Susanne Buehler
Chief
16 Tax Policy Division
17 Scott Claremon
Tax Counsel III
18 Legal Department
19 Lawrence Mendel
Tax Counsel III
20 Legal Department
21 Robert Tucker
Assistant Chief Counsel
22 Legal Department
23 Richard Parrott
Business Taxes
24 Administrator III
Special Taxes Department
25
26 Speakers: Jim Ewert
27 General Counsel
California Newspaper
28 Publishers Association
Randy Cheek
SEIU Local 1000

1 450 N STREET

2 SACRAMENTO, CALIFORNIA

3 JANUARY 26, 2016

4 ---o0o---

5 MR. RUNNER: We're going to go ahead and begin
6 with the Business Taxes Committee, so I'll turn that
7 over to the Chair of the Business Taxes Committee.

8 MS. HARKEY: Thank you very much.

9 I -- we have several items today, and I would
10 like to first bring up -- I thought I was ready. Okay.
11 First item on the agenda is Regulation 1590, Newspaper
12 and Periodicals.

13 (Mr. Horton entered the hearing room.)

14 MR. RUNNER: Oh, here we are.

15 Mr. Chair, we just started the Business Taxes
16 Committee.

17 MR. HORTON: Thank you.

18 MR. RUNNER: If you want to go back and start
19 over, that would be fine, because we haven't actually
20 started. We just did the pledge.

21 MS. HARKEY: We haven't done anything yet, so
22 would you like to just . . .

23 MR. HORTON: Just continue.

24 MR. RUNNER: We knew you had an interest in the
25 leg., so we were waiting until you got here to do that.

26 MR. HORTON: Appreciate it. Appreciate it.

27 MS. HARKEY: Okay. Staff accompanying Susanne
28 Buehler, Charlotte -- or you want to introduce your

1 staff? Have you got any staff, Susanne?

2 MS. BUEHLER: Mr. Larry Mendel and Mr. Scott
3 Claremon are supposed to be joining me, but I'm not sure
4 that they're aware --

5 MS. HARKEY: I think they're coming up the rear
6 here.

7 MS. BUEHLER: Awesome. Thank you.

8 MR. RUNNER: Backup's on its way.

9 MS. BUEHLER: Good morning. I am Susanne
10 Buehler with the Sales and Use Tax Department. We have
11 two agenda items for your consideration today. We will
12 take each agenda item and their respective action items
13 separately before moving on to the next.

14 With me for Agenda Item 1 are Mr. Larry Mendel
15 and Mr. Scott Claremon from our Legal Department.

16 Staff requests your approval and authorization
17 to publish proposed amendments to Sales and Use Tax
18 Regulation 1590, Newspapers and Periodicals.

19 The proposed amendments clarify the application
20 of tax to newspaper subscriptions that include both
21 paper and access to digital content.

22 Staff recommends that 53 percent of the charge
23 for these subscriptions be presumed to be for the
24 nontaxable sale of the right to access digital content.
25 Taxpayers may rebut this presumption by producing
26 documentation that -- establishing that the nontaxable
27 allocation is greater than 53 percent.

28 We do have speakers on this agenda item, and

1 we'd be happy to answer any questions you may have after
2 their presentation.

3 MS. HARKEY: Thank you very much.

4 Are there any -- any questions from the Board?

5 MR. RUNNER: (Inaudible) guest speaker.

6 MS. HARKEY: Oh, okay. I'm sorry. He's not
7 part of staff. I'm sorry. Excuse me. Yes, sir.

8 MR. EWERT: Madam Chair and Members of the
9 Board, my name is Jim Ewert. I'm the general counsel
10 for the California Newspaper Publishers Association.

11 We want to thank you, Madam Chair, for
12 spearheading the effort here and for your staff's work
13 as well as the staff of the BTC. We think this is a
14 good regulation, good amendments to the regulation that
15 we've lived under since about 1991 now, and we urge an
16 aye vote.

17 MS. HARKEY: Thank you. Are there any other
18 speakers? Any member of the public? Board members?
19 Any questions or comments?

20 MR. RUNNER: Move to adopt staff
21 recommendation.

22 MS. STOWERS: Second.

23 MS. HARKEY: Second. But I'd like to just say
24 this was a very, very cooperative effort between the
25 industry and the staff. I really appreciate the staff
26 efforts of trying to move and the industry's efforts of
27 moving so that we've got something that works for
28 everyone. It's a good compromise position, and I -- I

1 want to thank you all for working collectively together.
2 Thank you. It'll -- it'll benefit the state of
3 California. Thanks so much.

4 MS. BUEHLER: Thank you.

5 MS. HARKEY: Okay. We have a motion and a
6 second. Any opposition? No? Okay. So moved.

7 MS. BUEHLER: Thank you.

8 Joining me for Agenda Item 2 will be
9 Mr. Richard Parrott from Special Taxes and Fees
10 Department, and Mr. Robert Tucker from the Legal
11 Department.

12 Staff requests your approval and authorization
13 to publish Proposed Cigarette and Tobacco Products Tax
14 Regulation 4076, Wholesale Cost of Other Tobacco
15 Products, and Regulation 4001, Retail Stock.

16 The proposed regulations define and clarify the
17 terms "wholesale cost" and "retail stock" as they relate
18 to the cigarette and tobacco products tax.

19 In addition to the definitions, both
20 regulations provide examples to assist taxpayers in the
21 application of tax.

22 Regulation 4076 also includes a rebuttable
23 presumption for showing a transaction was at arm's
24 length.

25 We do have speakers on this agenda item, and
26 we'd be happy to answer any questions you may have after
27 their presentation.

28 MS. HARKEY: Okay. Thank you.

1 Any speakers from the public? Come forward and
2 state your name and affiliation for the record, please.

3 MR. CHEEK: Thank you, Madam Harkey. Randy
4 Cheek with SEIU Local 1000.

5 We do have some concerns about the regulation
6 that deals with humidors in that you have regular retail
7 product that will be mixed in with product that is not
8 taxed yet; and therefore, that gives our inspectors,
9 whom we represent, a problem when they go into a section
10 and they don't know which one has been pretaxed and
11 which one hasn't been taxed.

12 That also provides -- if you go into some of
13 these humidors, you'll notice that they may not have
14 personnel in there, and someone can go in and take a
15 nontaxed item off the shelf and go to the clerk and pay
16 for it; and therefore, that gives the -- that will cause
17 a loss of revenue for the BOE.

18 And we feel that this particular item -- and I
19 believe it's under No. 2A that talks about the walk-in
20 humidors -- we believe that that could be a problem for
21 our members, and we also believe that that could be a
22 loss of tax revenue.

23 So therefore, we would like you to take that
24 into consideration. We -- we do have a -- oppose on
25 that particular position.

26 MS. HARKEY: I believe -- just for the record,
27 we did take that into consideration.

28 Ms. Buehler, could you define the differences

1 between the two items and when something is moved from
2 overstock, in essence, to retail stock?

3 MS. BUEHLER: I will defer to Mr. Parrott.
4 That is his area of expertise.

5 MR. PARROTT: Yes. Richard Parrott with
6 Special Taxes and Fees.

7 We have in the regulation where the product
8 must be segregated, separated, and clearly labeled.
9 The -- the wholesale -- or the nonretail stock will
10 still be sealed in the original manufacturer packaging,
11 and that's the distinction in the regulation to cause
12 the -- the difference.

13 So we felt it was very clear, even in the
14 walk-in humidors, that that product would be separately
15 set aside from the retail stock and still sealed in the
16 original manufacturer packaging.

17 MS. HARKEY: Thank you. I know we worked on
18 this for several months to try to get it right so that
19 we couldn't have a fudge factor in it or could decrease.

20 MR. PARROTT: Yes.

21 MS. HARKEY: This resulted, you know, Members,
22 as a -- a case we heard I think our first or second
23 month where there was an issue as to what was taxable,
24 what was not. So I appreciate the SEIU's concern. I
25 think we tried to address that over the several months.
26 It's been probably nine months, I think, in the works.

27 So with that, are there any other speakers?
28 Board members?

1 MR. HORTON: Madam Chair.

2 MS. HARKEY: Yes, Chairman.

3 MR. HORTON: Only because I wasn't really a
4 party to the -- to the process, I just want to make sure
5 that SEIU and the Department have reconciled their
6 differences and they're in agreement that this works for
7 the individuals who are on the front line trying to --
8 that are required to enforce the law. These are the
9 individuals that are out there in the field.

10 As much as I, you know, appreciate the
11 administrative oversight, I have a tendency to -- to --
12 to give credence to those individuals who have to --
13 actually have to enforce the law itself. So the
14 questions of both of you have -- and I'll first go to
15 SEIU. Have you had an opportunity to reconcile your
16 concerns in this regard?

17 MR. CHEEK: No, sir, we have not. I -- I last
18 spoke with one of the inspectors, and their concern was
19 that a customer can come into a walk-in humidor, see
20 that the product was on the retail side, no longer
21 available, look around the humidor, and see that, oh,
22 there's an El Presidente over there, go over to that
23 box, open it up, even though it may be sealed, and
24 purchase the product. And they felt that it wasn't
25 clearly delineated as to what was taxed and not taxed
26 inside the humidors, and that -- that gave them some
27 pause.

28 And, you know, as you know, probably don't have

1 enough inspectors out there right now, so that's
2 probably part of the issue. It causes them to have some
3 confusion, and therefore, they felt that this was an
4 issue with them.

5 MR. HORTON: Okay. Have -- have they put forth
6 a recommended solution or are they contemplating and
7 would like an opportunity to do so?

8 MR. CHEEK: They would like an opportunity to
9 do so.

10 MS. HARKEY: Thank you.

11 MS. STOWERS: Chairman -- Chairwoman, can I
12 make a comment?

13 Thank you for your comments, Mr. Cheek. I'm
14 also concerned with the -- with the definition of retail
15 stock as well.

16 First, can you clarify the reg -- the portion
17 of the regulation that deals with an individual that
18 holds the distributor's license and a retail license and
19 basically saying -- and I'll paraphrase -- that if
20 you're in that situation where you hold both licenses,
21 you can have stock on the distributor's side, store it
22 on the location but separate from the inventory that
23 you're going to sell? Is that kind of a good paraphrase
24 of that?

25 MR. PARROTT: That's correct. Yes.

26 MS. STOWERS: So at what point will this
27 distributor -- and is the distributor mainly
28 distributing the -- the product to himself on the retail

1 side?

2 MR. PARROTT: Correct.

3 MS. STOWERS: So at what point will the
4 distributor self-assess the excise tax and remit to the
5 Board and then how do we verify this?

6 MR. PARROTT: The distributor would do that
7 when they take the product from the sealed original
8 manufacturer packaging, break that seal, and put it on
9 the shelf that's intended for retail. Then at that
10 point that would trigger a taxable event that would be
11 reported on their distributor's tax return for that
12 period, and then that would be verified also through
13 audit -- our audit program.

14 MS. STOWERS: My concern is that -- that
15 process, taking it from the back room to the front room
16 and now reporting it is going to increase the cost of
17 our licensing act and that distribution when our
18 inspectors get out there and try to verify if this
19 product is taxable or not taxable. I'm also concerned
20 that it's going to raise the cost, it's going to provide
21 more administration variable to the BOE.

22 And considering that we're talking about
23 distributors, retailers that are just basically selling
24 to themselves, it seems to me a more bright-line test
25 would be that when they acquire the product from the
26 wholesaler or the -- whoever they're acquiring it from,
27 that they know that they're going to sell it to
28 themselves at some point in time, that they might as

1 well go ahead and pay the excise tax up front.

2 So I do not support 4001. I also believe that
3 it's going to encourage the underground economy and it's
4 just opening the door for noncompliance.

5 MR. HORTON: Okay.

6 MS. HARKEY: Other Board member comments?

7 Mr. Runner.

8 MR. RUNNER: Yeah. Just a quick question in
9 regards to my understanding of the process.

10 I assume SEIU brought this up in the IP
11 process?

12 MR. CHEEK: I'm not sure they have, no.

13 MR. RUNNER: Well, then it's -- okay. It's
14 difficult for me, when we have an IP process, which then
15 includes these kind of discussions, then to come to the
16 Board if they didn't engage during the time when this
17 was supposed to be talked about, because I think we
18 can -- it seems to me this is a solvable problem, I
19 think, I mean, unless you expect a store to have two
20 different -- two separate humidors, and in order to do
21 this, you know, move stock from one place to the other,
22 I just don't think that's reasonable for business. But
23 I guess I'm a little kind of concerned that -- at the
24 process. I assume SEIU is aware of the IP process.

25 MR. CHEEK: I am not sure that we were, no.

26 MR. RUNNER: Well, let me ask --

27 MR. CHEEK: I wasn't part of that.

28 MR. RUNNER: Okay. Let me ask, what's --

1 what's our normal process in regards to invitation to
2 the -- to the Interested Parties' meetings?

3 MS. BUEHLER: Generally we have a stock list
4 that we go from and then also pull in the industry that
5 is specific to the topic and do searches for industry
6 organizations as well as large retailers that we look
7 at.

8 MR. RUNNER: Would we normally then include
9 then representing then staff who would be enforcing of
10 that, and would -- would SEIU be notified or would -- or
11 would staff be identified -- invited and be -- be aware
12 of the IP process?

13 MS. BUEHLER: The Investigations Division was
14 represented in the meetings, yes.

15 MR. RUNNER: So they were in the meetings?

16 MS. BUEHLER: Yes.

17 MR. RUNNER: And -- okay. Again, it's hard --
18 it seems to me, again, just processwise, we have IP
19 processes so that we can kind of iron out these issues.
20 That's the whole purpose for why we do it. And so it's
21 hard then when we come to a Board meeting if all of a
22 sudden we have objections that were never even raised in
23 the IP process, and we have the investigators there that
24 are the ones that are helping to craft the -- the
25 solution.

26 You know, I -- again, what I'm hearing, I
27 think, is that there just -- that right now at least
28 what I'm hearing is that you don't believe that there is

1 a way to separate retail sale if it's all from stock --
2 from stock that isn't for retail if it's all in the same
3 big humidor, walk-in humidor.

4 MR. CHEEK: I wouldn't say that. I would say
5 that our inspectors were concerned about delineating
6 those products.

7 MR. RUNNER: Were your inspectors different
8 than the ones that were in the IP process?

9 MR. CHEEK: I do not know who was in the IP
10 process.

11 MR. RUNNER: Well, we've got -- we've got to
12 fix that. We've got to fix this so that -- so that when
13 we have an IP process that we have the right labor folks
14 that are in the IP process so we don't end up with these
15 kind of issues, you know.

16 So I guess I'm -- I'm personally satisfied the
17 IP process was there; the inspectors were there. I
18 think, you know, again, the guidelines to separate
19 retail sales from -- from stock made sense.

20 Remember, we got in this problem because of the
21 fact that there was a robbery, people couldn't keep
22 track of what was in, what was out, and so we're trying
23 to solve that problem.

24 And I would just encourage everybody who's out
25 there when we have an IP process to participate so we
26 can solve these problems in the be -- end, not when we
27 get in front of the Board.

28 MS. HARKEY: Mr. Horton.

1 MR. HORTON: Madam Chair, just from a
2 historical perspective, Members, the IP process and this
3 process is a -- is a continuous process. Individuals
4 participate at that level if they -- if they're not or
5 for whatever reason don't have an opportunity to
6 participate at that level or if the information that is
7 developed and consummated at that level, upon review of
8 that, their only alternative is to come before the Board
9 and then express their concerns if for -- for whatever
10 reason.

11 The IP process itself is not guaranteed to --
12 to dictate or delineate what the suggestions that are
13 made in the hearing. For example, staff is not required
14 to accept all suggestions and to incorporate that in
15 their ultimate recommendation. And when that doesn't
16 occur, the public's only position is to come before the
17 body and then express their concerns about the final
18 results.

19 The other inherent difference from SEIU's
20 perspective and the employees that work, that may be
21 there in an advisory capacity to provide advice to
22 staff, the investigators, they have a different
23 perspective oftentimes than from a labor perspective.

24 And so you've got two situations, often up to
25 five different situations, where individuals are --
26 ultimately will come before the Board, which is part of
27 the process and part of the duties that we have in order
28 to take that under consideration.

1 We cannot summarily dismiss concerns because
2 they didn't participate in the initial process. This is
3 a part of that process. Their participation at this
4 point is welcome.

5 And Members, I suggest we just put it over,
6 allow the parties an opportunity to work out their
7 differences and bring it back to us.

8 MS. HARKEY: Ms. Ma.

9 MS. MA: Yeah, I would second that motion just
10 because I still don't think it's going to be clear, like
11 in the case that we had, what is taxable and what's not
12 taxable. I mean, if it's in a wrapper or not in a
13 wrapper, they open the box, they don't open the box.
14 So, you know, I think we should either have it one or
15 the other instead of having someone decipher whether it
16 really was wrapped or not wrapped.

17 MS. HARKEY: Okay. There's a motion and
18 second.

19 And I would just like to comment, we went
20 through a very long process with this. I believe
21 Mr. Silva was involved, staff was involved, we had
22 members of the industry, I believe we had labor --
23 should have -- and I appreciate your concerns, because
24 this is a public hearing, but I would like to suggest,
25 if we're going to hold this over, that we bring it back
26 next month, and that we encourage everyone to get really
27 involved if we could. What -- excuse me. You have a
28 problem with doing that?

1 MS. BUEHLER: Next month, because of the
2 timeline for putting things on the Public Agenda Notice
3 I don't think would be quite feasible, so I would ask
4 that you give us a little bit more time.

5 MS. HARKEY: March?

6 MS. BUEHLER: And I would also like to suggest
7 that perhaps we bifurcate the two regulations, and
8 perhaps, since we're only having issues on the 4001,
9 Retail Stock, that we have a separate vote on 4076.

10 MS. HARKEY: Okay. That's fine. Okay. So is
11 that agreeable to everybody? Is your motion for --

12 MR. HORTON: Yes, mm-hmm.

13 MS. HARKEY: Okay. So the Retail Stock is the
14 one we have an issue with; correct? So there's a motion
15 to put that over, 4001, Retail Stock, to put that over
16 until March. And there was a second from Ms. Ma?

17 MS. MA: Mm-hmm.

18 MS. HARKEY: Okay. Any opposition? Okay. So
19 it will be.

20 MR. HORTON: Madam Chair, if you will, I do
21 believe Mr. Runner's point does have significance to
22 these, too. And this is to the general public, to the
23 extent possible, we -- it is helpful to have all of the
24 insight in each phase of the process but it's also
25 understanding and respectful to allow this process to --
26 to take its course as well.

27 And I thank you everybody for their
28 participation, particularly the Chair. She has been,

1 you know, conscious of this and working diligently
2 trying to work it out, and so . . .

3 MS. HARKEY: That has been a very --

4 MR. HORTON: Long process.

5 MS. HARKEY: -- long and difficult process
6 establishing what's what. And I would encourage the
7 members of SEIU to look at the recent case, over the
8 last year, and find out why -- how this came -- how this
9 came to be and review the tapes of the Board hearing.
10 It was -- it's quite a process for a small store that
11 has one humidor. And, you know, it's quite an expense
12 to pay the taxes on all of it up front versus as you
13 bring it into the inventory, which I think --

14 MR. HORTON: Democracy at its best.

15 MR. RUNNER: And one quick item, too. If -- if
16 we could ensure that in the IP process -- because,
17 again, I -- I get the fact that -- that investigators
18 that may have been in this process were not the same
19 folks that maybe deal with the issue in regards to the
20 SEIU, so I guess I'd like to know that when we do an IP
21 process that affects staff that we actually go the extra
22 effort to include the fact that we know that whatever
23 staff is in that discussion is also then, at least, I
24 guess, using the same eyes as -- as SEIU would be, as
25 their union would, so again, we don't end up with this
26 bifurcated issue and assume that, you know, there's
27 staff that was participating, but that staff didn't
28 necessarily hold the views or concerns of the -- of the

1 union itself. So I think -- I think that's an important
2 discussion to have at the front end so that we don't get
3 here at the back end.

4 MS. HARKEY: It's okay to bring this back. I'm
5 happy to have the discussion, and we'll go over it
6 again, but it is a -- it's a very, very difficult
7 process, and I really encourage your members to get
8 involved so that we can -- we can fine-tune this. I
9 think we did, but I respect that, you know, this is a
10 public hearing, and so more time is not a problem.
11 Thank you.

12 So then do we have a motion on Regulation 4076,
13 Wholesale Cost of Tobacco Products? Move that item?

14 MR. RUNNER: I'll move the -- okay. So the --

15 MS. HARKEY: We're bifurcating.

16 MR. RUNNER: Right. And 4001 is the one we put
17 over, and I'll move -- I'll move the -- or the
18 recommendation of adoption of Regulation 4076.

19 MS. HARKEY: Do I have a second? I will
20 second.

21 MR. RUNNER: I thought we were okay.

22 MS. HARKEY: I thought we were okay, too.

23 MS. STOWERS: Oh, I'm sorry. Second.

24 MS. HARKEY: Okay. We can't blame SEIU for not
25 showing up. Okay. Here we go.

26 Okay. We have a motion and a second to adopt
27 Regulation 4076. Any objection? Such will be the
28 order. Thank you very, very much.

1 MS. BUEHLER: Thank you.

2 MS. HARKEY: That ends the Business Taxes
3 Committee, I believe.

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REPORTER'S CERTIFICATE

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State of California)
) ss
County of Sacramento)

I, CAROLE W. BROWNE, Hearing Reporter for the California State Board of Equalization, certify that on January 26, 2016, 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 1 through 20 constitute a complete and accurate transcription of the shorthand writing.

Dated: January 31, 2016

Carole W. Browne



CAROLE W. BROWNE, CSR #7351
Hearing Reporter

**ESTIMATE OF COST OR SAVINGS RESULTING
FROM PROPOSED REGULATORY ACTION**

**Proposed Amendment of Cigarette and Tobacco Products Tax Regulation 4076,
*Wholesale Cost of Tobacco Products***

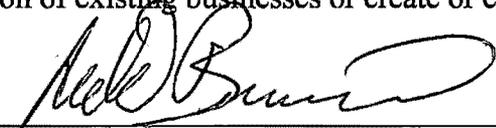
STATEMENT OF COST OR SAVINGS FOR NOTICE OF PUBLIC HEARING

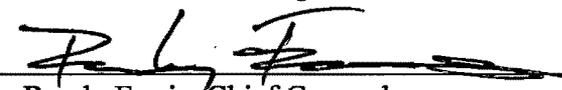
The State Board of Equalization has determined that the proposed action does not impose a mandate on local agencies or school districts. Further, the Board has determined that the action will result in no direct or indirect cost or savings to any State agency, any local agency or school district that is required to be reimbursed under Part 7 (commencing with Section 17500) of Division 4 of Title 2 of the Government Code or other non-discretionary cost or savings imposed on local agencies, or cost or savings in Federal funding to the State of California.

The cost impact on private persons or businesses will be insignificant. This proposal will not have a significant adverse economic impact on businesses.

This proposal will not be detrimental to California businesses in competing with businesses in other states.

This proposal will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses or create or expand business in the State of California.

Statement
Prepared by  Date 5-6-16
Richard Bennion, Regulations Coordinator

Approved by  Date 5/9/16
Randy Ferris, Chief Counsel

If Costs or Savings are Identified, Signatures of Chief, Fiscal Management Division, and Chief, Board Proceedings Division, are Required

Approved by _____ Date _____
Chief, Financial Management Division

Approved by _____ Date _____
Chief, Board Proceedings Division

NOTE: SAM Section 6615 requires that estimates resulting in cost or savings be submitted for Department of Finance concurrence before the notice of proposed regulatory action is released.

**ECONOMIC AND FISCAL IMPACT STATEMENT
(REGULATIONS AND ORDERS)**

STD. 399 (REV. 12/2013)

ECONOMIC IMPACT STATEMENT

DEPARTMENT NAME State Board of Equalization	CONTACT PERSON Richard E. Bennion	EMAIL ADDRESS rbennion@boe.ca.gov	TELEPHONE NUMBER 916-445-2130
DESCRIPTIVE TITLE FROM NOTICE REGISTER OR FORM 400 Title 18, Section 4076, Wholesale Cost of Tobacco Products			NOTICE FILE NUMBER Z

A. ESTIMATED PRIVATE SECTOR COST IMPACTS *Include calculations and assumptions in the rulemaking record.*

1. Check the appropriate box(es) below to indicate whether this regulation:

- a. Impacts business and/or employees
- b. Impacts small businesses
- c. Impacts jobs or occupations
- d. Impacts California competitiveness
- e. Imposes reporting requirements
- f. Imposes prescriptive instead of performance
- g. Impacts individuals
- h. None of the above (Explain below):

Please see the attached.

If any box in Items 1 a through g is checked, complete this Economic Impact Statement.

If box in Item 1.h. is checked, complete the Fiscal Impact Statement as appropriate.

2. The _____ estimates that the economic impact of this regulation (which includes the fiscal impact) is:
(Agency/Department)

- Below \$10 million
- Between \$10 and \$25 million
- Between \$25 and \$50 million
- Over \$50 million *[If the economic impact is over \$50 million, agencies are required to submit a Standardized Regulatory Impact Assessment as specified in Government Code Section 11346.3(c)]*

3. Enter the total number of businesses impacted: _____

Describe the types of businesses (Include nonprofits): _____

Enter the number or percentage of total businesses impacted that are small businesses: _____

4. Enter the number of businesses that will be created: _____ eliminated: _____

Explain: _____

5. Indicate the geographic extent of impacts: Statewide
 Local or regional (List areas): _____

6. Enter the number of jobs created: _____ and eliminated: _____

Describe the types of jobs or occupations impacted: _____

7. Will the regulation affect the ability of California businesses to compete with other states by making it more costly to produce goods or services here? YES NO

If YES, explain briefly: _____

**ECONOMIC AND FISCAL IMPACT STATEMENT
(REGULATIONS AND ORDERS)**

STD. 399 (REV. 12/2013)

ECONOMIC IMPACT STATEMENT (CONTINUED)

B. ESTIMATED COSTS *Include calculations and assumptions in the rulemaking record.*

1. What are the total statewide dollar costs that businesses and individuals may incur to comply with this regulation over its lifetime? \$ _____
 - a. Initial costs for a small business: \$ _____ Annual ongoing costs: \$ _____ Years: _____
 - b. Initial costs for a typical business: \$ _____ Annual ongoing costs: \$ _____ Years: _____
 - c. Initial costs for an individual: \$ _____ Annual ongoing costs: \$ _____ Years: _____
 - d. Describe other economic costs that may occur: _____

2. If multiple industries are impacted, enter the share of total costs for each industry: _____

3. If the regulation imposes reporting requirements, enter the annual costs a typical business may incur to comply with these requirements. *Include the dollar costs to do programming, record keeping, reporting, and other paperwork, whether or not the paperwork must be submitted.* \$ _____

4. Will this regulation directly impact housing costs? YES NO

If YES, enter the annual dollar cost per housing unit: \$ _____

Number of units: _____

5. Are there comparable Federal regulations? YES NO

Explain the need for State regulation given the existence or absence of Federal regulations: _____

Enter any additional costs to businesses and/or individuals that may be due to State - Federal differences: \$ _____

C. ESTIMATED BENEFITS *Estimation of the dollar value of benefits is not specifically required by rulemaking law, but encouraged.*

1. Briefly summarize the benefits of the regulation, which may include among others, the health and welfare of California residents, worker safety and the State's environment: _____

2. Are the benefits the result of: specific statutory requirements, or goals developed by the agency based on broad statutory authority?

Explain: _____

3. What are the total statewide benefits from this regulation over its lifetime? \$ _____

4. Briefly describe any expansion of businesses currently doing business within the State of California that would result from this regulation: _____

D. ALTERNATIVES TO THE REGULATION *Include calculations and assumptions in the rulemaking record. Estimation of the dollar value of benefits is not specifically required by rulemaking law, but encouraged.*

List alternatives considered and describe them below. If no alternatives were considered, explain why not: _____

**ECONOMIC AND FISCAL IMPACT STATEMENT
(REGULATIONS AND ORDERS)**

STD. 399 (REV. 12/2013)

ECONOMIC IMPACT STATEMENT (CONTINUED)

2. Summarize the total statewide costs and benefits from this regulation and each alternative considered:

Regulation: Benefit: \$ _____ Cost: \$ _____

Alternative 1: Benefit: \$ _____ Cost: \$ _____

Alternative 2: Benefit: \$ _____ Cost: \$ _____

3. Briefly discuss any quantification issues that are relevant to a comparison of estimated costs and benefits for this regulation or alternatives:

4. Rulemaking law requires agencies to consider performance standards as an alternative, if a regulation mandates the use of specific technologies or equipment, or prescribes specific actions or procedures. Were performance standards considered to lower compliance costs? YES NO

Explain: _____

E. MAJOR REGULATIONS *Include calculations and assumptions in the rulemaking record.*

California Environmental Protection Agency (Cal/EPA) boards, offices and departments are required to submit the following (per Health and Safety Code section 57005). Otherwise, skip to E4.

1. Will the estimated costs of this regulation to California business enterprises exceed \$10 million? YES NO

If YES, complete E2. and E3

If NO, skip to E4

Briefly describe each alternative, or combination of alternatives, for which a cost-effectiveness analysis was performed:

Alternative 1: _____

Alternative 2: _____

(Attach additional pages for other alternatives)

3. For the regulation, and each alternative just described, enter the estimated total cost and overall cost-effectiveness ratio:

Regulation: Total Cost \$ _____ Cost-effectiveness ratio: \$ _____

Alternative 1: Total Cost \$ _____ Cost-effectiveness ratio: \$ _____

Alternative 2: Total Cost \$ _____ Cost-effectiveness ratio: \$ _____

4. Will the regulation subject to OAL review have an estimated economic impact to business enterprises and individuals located in or doing business in California exceeding \$50 million in any 12-month period between the date the major regulation is estimated to be filed with the Secretary of State through 12 months after the major regulation is estimated to be fully implemented?

YES NO

If YES, agencies are required to submit a Standardized Regulatory Impact Assessment (SRIA) as specified in Government Code Section 11346.3(c) and to include the SRIA in the Initial Statement of Reasons.

5. Briefly describe the following:

The increase or decrease of investment in the State: _____

The incentive for innovation in products, materials or processes: _____

The benefits of the regulations, including, but not limited to, benefits to the health, safety, and welfare of California residents, worker safety, and the state's environment and quality of life, among any other benefits identified by the agency: _____

**ECONOMIC AND FISCAL IMPACT STATEMENT
(REGULATIONS AND ORDERS)**

STD 399 (REV. 12/2013)

FISCAL IMPACT STATEMENT

A. FISCAL EFFECT ON LOCAL GOVERNMENT *Indicate appropriate boxes 1 through 6 and attach calculations and assumptions of fiscal impact for the current year and two subsequent Fiscal Years.*

- 1. Additional expenditures in the current State Fiscal Year which are reimbursable by the State. (Approximate)
(Pursuant to Section 6 of Article XIII B of the California Constitution and Sections 17500 et seq. of the Government Code).

\$ _____

- a. Funding provided in _____

Budget Act of _____ or Chapter _____, Statutes of _____

- b. Funding will be requested in the Governor's Budget Act of _____

Fiscal Year: _____

- 2. Additional expenditures in the current State Fiscal Year which are NOT reimbursable by the State. (Approximate)
(Pursuant to Section 6 of Article XIII B of the California Constitution and Sections 17500 et seq. of the Government Code).

\$ _____

Check reason(s) this regulation is not reimbursable and provide the appropriate information:

- a. Implements the Federal mandate contained in _____

- b. Implements the court mandate set forth by the _____ Court.

Case of: _____ vs. _____

- c. Implements a mandate of the people of this State expressed in their approval of Proposition No. _____

Date of Election: _____

- d. Issued only in response to a specific request from affected local entity(s).

Local entity(s) affected: _____

- e. Will be fully financed from the fees, revenue, etc. from: _____

Authorized by Section: _____ of the _____ Code;

- f. Provides for savings to each affected unit of local government which will, at a minimum, offset any additional costs to each;

- g. Creates, eliminates, or changes the penalty for a new crime or infraction contained in _____

- 3. Annual Savings. (approximate)

\$ _____

- 4. No additional costs or savings. This regulation makes only technical, non-substantive or clarifying changes to current law regulations.

- 5. No fiscal impact exists. This regulation does not affect any local entity or program.

- 6. Other. Explain _____

**ECONOMIC AND FISCAL IMPACT STATEMENT
(REGULATIONS AND ORDERS)**

STD. 399 (REV. 12/2013)

FISCAL IMPACT STATEMENT (CONTINUED)

B. FISCAL EFFECT ON STATE GOVERNMENT Indicate appropriate boxes 1 through 4 and attach calculations and assumptions of fiscal impact for the current year and two subsequent Fiscal Years.

1. Additional expenditures in the current State Fiscal Year. (Approximate)

\$ _____

It is anticipated that State agencies will:

a. Absorb these additional costs within their existing budgets and resources.

b. Increase the currently authorized budget level for the _____ Fiscal Year

2. Savings in the current State Fiscal Year. (Approximate)

\$ _____

3. No fiscal impact exists. This regulation does not affect any State agency or program.

4. Other. Explain _____

C. FISCAL EFFECT ON FEDERAL FUNDING OF STATE PROGRAMS Indicate appropriate boxes 1 through 4 and attach calculations and assumptions of fiscal impact for the current year and two subsequent Fiscal Years.

1. Additional expenditures in the current State Fiscal Year. (Approximate)

\$ _____

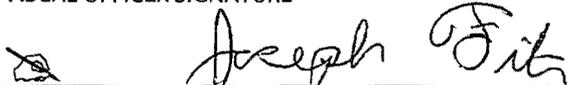
2. Savings in the current State Fiscal Year. (Approximate)

\$ _____

3. No fiscal impact exists. This regulation does not affect any federally funded State agency or program.

4. Other. Explain _____

FISCAL OFFICER SIGNATURE

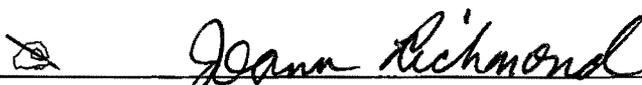


DATE

March 28, 2016

The signature attests that the agency has completed the STD. 399 according to the instructions in SAM sections 6601-6616, and understands the impacts of the proposed rulemaking. State boards, offices, or departments not under an Agency Secretary must have the form signed by the highest ranking official in the organization.

AGENCY SECRETARY



DATE

March 28, 2016

Agency approval and signature is required when SAM sections 6601-6616 require completion of Fiscal Impact Statement in the STD. 399.

DEPARTMENT OF FINANCE PROGRAM BUDGET MANAGER

Exempt under SAM section 6615

DATE

Attachment to Economic and Fiscal Impact
Statement (STD. 399 (Rev. 12/2013)) for the Proposed Adoption of
California Code of Regulations, Title 18, Section 4076,
Wholesale Cost of Tobacco Products

As explained in more detail in the initial statement of reasons, Revenue and Taxation Code (RTC) sections 30123 and 30131.2 currently impose taxes on distributors of tobacco products other than cigarettes (collectively "other tobacco products" or "OTP") 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 in the initial statement of reasons, the State Board of Equalization (Board) is proposing to adopt California Code of Regulations, title 18, section (Regulation) 4076, *Wholesale Cost of Tobacco Products*, to further define "wholesale cost," provide alternative methods for estimating or calculating wholesale cost, and provide 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 impose any costs on any persons, including businesses, or impact revenue. Therefore, the Board estimates that the 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 the 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.

Therefore, based upon the foregoing information and all of the information in the rulemaking file, the Board is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed regulatory action, and the Board has determined that the adoption of proposed Regulation 4076:

- Will not have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states;
- 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;
- Will not have a significant effect on housing costs;
- Will result in no direct or indirect cost or savings to any state agency, and will result in no cost or savings in federal funding to the State of California;
- Will result in no direct or indirect cost to any local agency or school district that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code, and will result in no other non-discretionary cost or savings imposed on local agencies; and
- Will not impose a mandate on local agencies or school districts, including a mandate that requires state reimbursement under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code.

In addition, 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, including the ability of California businesses to compete with businesses in other states.

The adoption of the proposed Regulation 4076 may affect small businesses.

NOTICE PUBLICATION/REGULATIONS SUBMISSION

(See instructions on reverse)

For use by Secretary of State only

STD. 400 (REV. 01-2013)

OAL FILE NUMBERS:	NOTICE FILE NUMBER Z-2016-0329-01	REGULATORY ACTION NUMBER	EMERGENCY NUMBER
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For use by Office of Administrative Law (OAL) only

RECEIVED DATE PUBLICATION DATE

MAR 29 '16 APR 08 '16

Office of Administrative Law

NOTICE

REGULATIONS

AGENCY WITH RULEMAKING AUTHORITY
State Board of Equalization

AGENCY FILE NUMBER (if any)

A. PUBLICATION OF NOTICE (Complete for publication in Notice Register)

1. SUBJECT OF NOTICE Wholesale Cost of Tobacco Products	TITLE(S) 18	FIRST SECTION AFFECTED 4076	2. REQUESTED PUBLICATION DATE April 8, 2016
3. NOTICE TYPE <input checked="" type="checkbox"/> Notice re Proposed Regulatory Action <input type="checkbox"/> Other	4. AGENCY CONTACT PERSON Richard E. Bennion	TELEPHONE NUMBER (916) 445-2130	FAX NUMBER (Optional) (916) 324-3984
OAL USE ONLY <input type="checkbox"/> Approved as Submitted <input type="checkbox"/> Approved as Modified <input type="checkbox"/> Disapproved/Withdrawn	ACTION ON PROPOSED NOTICE	NOTICE REGISTER NUMBER	PUBLICATION DATE

B. SUBMISSION OF REGULATIONS (Complete when submitting regulations)

1a. SUBJECT OF REGULATION(S)	1b. ALL PREVIOUS RELATED OAL REGULATORY ACTION NUMBER(S)
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2. SPECIFY CALIFORNIA CODE OF REGULATIONS TITLE(S) AND SECTION(S) (Including title 26, if toxics related)

ACTION(S) AFFECTED (List all section number(s) individually. Attach additional sheet if needed.)	ADOPT
	AMEND
	REPEAL
TITLE(S)	

3. TYPE OF FILING

- Regular Rulemaking (Gov. Code §11346)
 Resubmittal of disapproved or withdrawn nonemergency filing (Gov. Code §§11349.3, 11349.4)
 Emergency (Gov. Code, §11346.1(b))
- Certificate of Compliance: The agency officer named below certifies that this agency complied with the provisions of Gov. Code §§11346.2-11347.3 either before the emergency regulation was adopted or within the time period required by statute.
 Resubmittal of disapproved or withdrawn emergency filing (Gov. Code, §11346.1)
- Emergency Readopt (Gov. Code, §11346.1(h))
 File & Print
 Other (Specify) _____
- Changes Without Regulatory Effect (Cal. Code Regs., title 1, §100)
 Print Only

4. ALL BEGINNING AND ENDING DATES OF AVAILABILITY OF MODIFIED REGULATIONS AND/OR MATERIAL ADDED TO THE RULEMAKING FILE (Cal. Code Regs. title 1, §44 and Gov. Code §11347.1)

5. EFFECTIVE DATE OF CHANGES (Gov. Code, §§ 11343.4, 11346.1(d); Cal. Code Regs., title 1, §100)

- Effective January 1, April 1, July 1, or October 1 (Gov. Code §11343.4(a)) Effective on filing with Secretary of State \$100 Changes Without Regulatory Effect Effective other (Specify) _____

6. CHECK IF THESE REGULATIONS REQUIRE NOTICE TO, OR REVIEW, CONSULTATION, APPROVAL OR CONCURRENCE BY, ANOTHER AGENCY OR ENTITY

- Department of Finance (Form STD. 399) (SAM §6660) Fair Political Practices Commission State Fire Marshal
 Other (Specify) _____

7. CONTACT PERSON

TELEPHONE NUMBER

FAX NUMBER (Optional)

E-MAIL ADDRESS (Optional)

8. I certify that the attached copy of the regulation(s) is a true and correct copy of the regulation(s) identified on this form, that the information specified on this form is true and correct, and that I am the head of the agency taking this action, or a designee of the head of the agency, and am authorized to make this certification.

SIGNATURE OF AGENCY HEAD OR DESIGNEE

DATE

TYPED NAME AND TITLE OF SIGNATORY

For use by Office of Administrative Law (OAL) only

Notice of Proposed Regulatory Action

The State Board of Equalization Proposes to Adopt California Code of Regulations, Title 18, Section 4076, *Wholesale Cost of Tobacco Products*

NOTICE IS HEREBY GIVEN that the State Board of Equalization (Board), pursuant to the authority vested in it by Revenue and Taxation Code (RTC) section 30451, proposes to adopt California Code of Regulations, title 18, section (Regulation or Reg.) 4076, *Wholesale Cost of Tobacco Products*. Proposed Regulation 4076 further clarifies the meaning of the "wholesale cost" of tobacco products other than cigarettes (collectively referred to as "other tobacco products" or "OTP") as defined in RTC section 30017, provides alternative methods for estimating or calculating the wholesale cost of OTP, provides examples to show how the wholesale cost of OTP is determined in common situations, and clarifies that only current-year tobacco product prices may be used to determine the OTP tax rate for the next fiscal year.

PUBLIC HEARING

The Board will conduct a meeting in Room 121, at 450 N Street, Sacramento, California, on May 24-26, 2016. The Board will provide notice of the meeting to any person who requests that notice in writing and make the notice, including the specific agenda for the meeting, available on the Board's Website at www.boe.ca.gov at least 10 days in advance of the meeting.

A public hearing regarding the proposed regulatory action will be held at 9:00 a.m. or as soon thereafter as the matter may be heard on May 24, 25, or 26, 2016. At the hearing, any interested person may present or submit oral or written statements, arguments, or contentions regarding the adoption of proposed Regulation 4076.

AUTHORITY

RTC section 30451

REFERENCE

RTC sections 30008, 30010, 30011, 30017, 30105, 30121, 30123, 30126, 30131.1, 30131.2, 30131.5, 30201, and 30221

INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW

Current Law

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

NO MANDATE ON LOCAL AGENCIES AND SCHOOL DISTRICTS

The Board has determined that the adoption of proposed Regulation 4076 will not impose a mandate on local agencies or school districts, including a mandate that requires state reimbursement under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code.

NO COST OR SAVINGS TO STATE AGENCIES, LOCAL AGENCIES, AND SCHOOL DISTRICTS

The Board has determined that the adoption of proposed Regulation 4076 will result in no direct or indirect cost or savings to any state agency, no cost to any local agency or school district that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code, no other non-discretionary cost or savings imposed on local agencies, and no cost or savings in federal funding to the State of California.

NO SIGNIFICANT STATEWIDE ADVERSE ECONOMIC IMPACT DIRECTLY AFFECTING BUSINESS

The Board has made an initial determination that the adoption of proposed Regulation 4076 will not have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states.

The adoption of proposed Regulation 4076 may affect small business.

NO COST IMPACTS TO PRIVATE PERSONS OR BUSINESSES

The Board is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

RESULTS OF THE ECONOMIC IMPACT ASSESSMENT REQUIRED BY GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)

The Board has determined that proposed Regulation 4076 is not a major regulation, as defined in Government Code section 11342.548 and California Code of Regulations, title 1, section 2000. Therefore, the Board has prepared the economic impact assessment required by Government Code section 11346.3, subdivision (b)(1), and included it in the initial statement of reasons. The Board has determined that the adoption of proposed Regulation 4076 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California. Furthermore, the Board has determined that the adoption of proposed Regulation 4076 will not affect the benefits of Regulation 4076 to the health and welfare of California residents, worker safety, or the state's environment.

NO SIGNIFICANT EFFECT ON HOUSING COSTS

The adoption of proposed Regulation 4076 will not have a significant effect on housing costs.

DETERMINATION REGARDING ALTERNATIVES

The Board must determine that no reasonable alternative considered by it or that has been otherwise identified and brought to its attention would be more effective in carrying out the purpose for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

CONTACT PERSONS

Questions regarding the substance of the proposed regulation should be directed to Pamela Mash, Tax Counsel, by telephone at (916) 323-3248, by e-mail at Pamela.Mash@boe.ca.gov, or by mail at State Board of Equalization, Attn: Pamela Mash, MIC:82, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0082.

Written comments for the Board's consideration, notice of intent to present testimony or witnesses at the public hearing, and inquiries concerning the proposed administrative action should be directed to Mr. Rick Bennion, Regulations Coordinator, by telephone at (916) 445-2130, by fax at (916) 324-3984, by e-mail at Richard.Bennion@boe.ca.gov, or by mail at State Board of Equalization, Attn: Rick Bennion, MIC:80, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0080. Mr. Bennion is the designated backup contact person to Ms. Mash.

WRITTEN COMMENT PERIOD

The written comment period ends at 9:00 a.m. on May 24, 2016, or as soon thereafter as the Board begins the public hearing regarding the adoption of proposed Regulation 4076 during the May 24-26, 2016, Board meeting. Written comments received by Mr. Rick Bennion at the postal address, email address, or fax number provided above, prior to the close of the written comment period, will be presented to the Board and the Board will consider the statements, arguments, and/or contentions contained in those written comments before the Board decides whether to adopt proposed Regulation 4076. The Board will only consider written comments received by that time.

AVAILABILITY OF INITIAL STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATION

The Board has prepared a copy of the text of proposed Regulation 4076 illustrating its express terms; however, the proposed regulation is not illustrated in underline or italics format because California Code of Regulations, title 1, section 8, subdivision (b) provides that "[u]nderline or italic is not required for the adoption of a new regulation or set of regulations if the final text otherwise clearly indicates that all of the final text submitted to OAL for filing is added to the California Code of Regulations." The Board has also prepared an initial statement of reasons for the adoption of proposed Regulation 4076, which includes the economic impact assessment required by Government Code section 11346.3, subdivision (b)(1). These documents and all the information on which the proposed regulation are based are available to the public upon request. The rulemaking file is available for public inspection at 450 N Street, Sacramento, California. The express terms of the proposed regulation and the initial statement of reasons are also available on the Board's Website at www.boe.ca.gov.

SUBSTANTIALLY RELATED CHANGES PURSUANT TO GOVERNMENT CODE SECTION 11346.8

The Board may adopt proposed Regulation 4076 with changes that are non-substantial or solely grammatical in nature, or sufficiently related to the original proposed text that the

public was adequately placed on notice that the changes could result from the originally proposed regulatory action. If a sufficiently related change is made, the Board will make the full text of the proposed regulation, with the change clearly indicated, available to the public for at least 15 days before adoption. The text of the resulting regulation will be mailed to those interested parties who commented on the original proposed regulation orally or in writing or who asked to be informed of such changes. The text of the resulting regulation will also be available to the public from Mr. Bennion. The Board will consider written comments on the resulting regulation that are received prior to adoption.

AVAILABILITY OF FINAL STATEMENT OF REASONS

If the Board adopts proposed Regulation 4076, the Board will prepare a final statement of reasons, which will be made available for inspection at 450 N Street, Sacramento, California, and available on the Board's Website at www.boe.ca.gov.

Bennion, Richard

From: BOE-Board Meeting Material
Sent: Friday, April 08, 2016 8:50 AM
To: Anderson, Eboney; Angeja, Jeff (Legal); Armenta, Christopher; Asprey, Kathryn E; Bennion, Richard; Benson, Bill; Bisauta, Christine (Legal); Blake, Sue; Block, Susan; BOE-Board Meeting Material; Bridges, Cynthia; Brown, Michele C; Buck, Alfred; Cho, Daniel (Legal); Chung, Sophia (Legal); Davis, Toya P.; Duran, David; Durham, Mark; Epolite, Anthony (Legal); Ferris, Randy (Legal); Folchi, Gino; Ford, Ladeena L; Garcia, Laura; Gau, David; Gilman, Todd; Grant, Micah; Hamilton, Tabitha; Harrison, Michelle; Harvill, Mai; Heller, Bradley (Legal); Hellmuth, Leila; Herrera, Cristina; Hite, Jay; Holmes, Dana; Hughes, Shellie L; Huxsoll, Cary; Jacobson, Andrew; Jopanda, Genevieve; Kinkle, Sherrie L; Kinst, Lynne; Lambert, Gary; Lambert, Robert (Legal); Lee, Chris; Levine, David H. (Legal); Lopez, Claudia; Lowery, Russell; Manuel, Charlene; Matsumoto, Sid; Matthies, Ted; McElhinney, Andrew; Miller, Brad; Moon, Richard (Legal); Nienow, Trecia (Legal); Oakes, Clifford; Pielsticker, Michele; Ralston Ratcliff, Natasha; Renati, Lisa; Richmond, Joann; Riley, Denise (Legal); Romano, Dario; Salazar, Ramon; Sarcos, Eric; Schultz, Glenna; Silva, Monica (Legal); Singh, Sam; Smith, Kevin (Legal); Smith, Rose; Stowers, Yvette; Tran, Mai (Legal); Treichelt, Tim; Tucker, Robert (Legal); Vandrick, Tanya; Vena, Emily (Legal); Wallentine, Sean; Whitaker, Lynn; Wiggins, Brian; Williams, Lee; Wilson, David; Zivkovich, Robert; Zumaeta, Jaclyn
Subject: State Board of Equalization - Announcement of Regulatory Change 4076

The State Board of Equalization proposes to adopt new Cigarette and Tobacco Products Tax Regulation 4076, *Wholesale Cost of Tobacco Products*, to further clarify the meaning of the "wholesale cost" of tobacco products other than cigarettes as defined in Revenue and Taxation Code section 30017. A public hearing regarding the proposed amendments will be held in Room 121, 450 N Street, Sacramento, at 9:00 a.m., or as soon thereafter as the matter may be heard, on May 24-26, 2016.

To view the notice of hearing, initial statement of reasons, proposed text, and history click on the following link:
http://www.boe.ca.gov/regs/reg_4076_2016.htm.

Questions regarding the substance of the proposed amendments should be directed to Ms. Pamela Mash, Tax Counsel III, at 450 N Street, MIC:82, Sacramento, CA 94279-0082, email Pamela.Mash@boe.ca.gov, telephone (916) 323-3248, or FAX (916) 323-3387.

Written comments for the Board's consideration, notices of intent to present testimony or witnesses at the public hearing, and inquiries concerning the proposed regulatory action should be directed to Mr. Rick Bennion, Regulations Coordinator, telephone (916) 445-2130, fax (916) 324-3984, e-mail Richard.Bennion@boe.ca.gov or by mail to: State Board of Equalization, Attn: Rick Bennion, MIC: 80, P.O. Box 942879-0080, Sacramento, CA 94279-0080.

Please do not reply to this message.

Board Proceedings Division, MIC:80
Rick Bennion
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Bennion, Richard

From: State Board of Equalization - Announcement of Regulatory Change
<Legal.Regulations@BOE.CA.GOV>
Sent: Friday, April 08, 2016 10:24 AM
To: BOE_REGULATIONS@LISTSERV.STATE.CA.GOV
Subject: State Board of Equalization - Announcement of Regulatory Change 4076

The State Board of Equalization proposes to adopt new Cigarette and Tobacco Products Tax Regulation 4076, *Wholesale Cost of Tobacco Products*, to further clarify the meaning of the "wholesale cost" of tobacco products other than cigarettes as defined in Revenue and Taxation Code section 30017. A public hearing regarding the proposed amendments will be held in Room 121, 450 N Street, Sacramento, at 9:00 a.m., or as soon thereafter as the matter may be heard, on May 24-26, 2016.

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Written comments for the Board's consideration, notices of intent to present testimony or witnesses at the public hearing, and inquiries concerning the proposed regulatory action should be directed to Mr. Rick Bennion, Regulations Coordinator, telephone (916) 445-2130, fax (916) 324-3984, e-mail Richard.Bennion@boe.ca.gov or by mail to: State Board of Equalization, Attn: Rick Bennion, MIC: 80, P.O. Box 942879-0080, Sacramento, CA 94279-0080.

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fare of California residents, worker safety, and state's environment:

The clarification of BSIS firearms training terminology and methods will increase training standards for BSIS Firearm Permit holders thus resulting in increased personal and public safety.

CONSIDERATION OF ALTERNATIVES

The Bureau must determine that no reasonable alternative considered to the regulation or that has otherwise been identified and brought to its attention would be more effective in carrying out the purpose for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposal described in this Notice, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law.

Any interested person may present statements or arguments orally or in writing relevant to the above determinations at the above-mentioned hearing.

INITIAL STATEMENT OF REASONS AND INFORMATION

The Bureau has prepared an initial statement of the reasons for the proposed action and has available all the information upon which the proposal is based.

TEXT OF PROPOSAL

Copies of the exact language of the proposed regulations, and any document incorporated by reference, and of the initial statement of reasons, and all of the information upon which the proposal is based, may be obtained at the hearing or prior to the hearing upon request from the Bureau of Security and Investigative Services at 2420 Del Paso Road, Suite 270, Sacramento, CA 95834.

AVAILABILITY AND LOCATION OF THE FINAL STATEMENT OF REASONS AND RULEMAKING FILE

All the information upon which the proposed regulations are based is contained in the rulemaking file which is available for public inspection by contacting the person named below.

You may obtain a copy of the final statement of reasons once it has been prepared, by making a written request to the contact person named below or by accessing the website listed below.

CONTACT PERSON

Inquiries or comments concerning the proposed rule-making action may be addressed to:

Name: Sam Stodolski
Address: 2420 Del Paso Road, Suite 270
Sacramento, CA 95834

Telephone No.: (916) 575-7024
Fax No.: (916) 575-7287

E-Mail Address: Samuel.Stodolski@DCA.ca.gov

The backup contact person is:

Name: Jennifer Munoz
Address: 2420 Del Paso Road, Suite 270
Sacramento, CA 95834

Telephone No.: (916) 575-7005
Fax No.: (916) 575-7287

E-Mail Address: Jennifer.Munoz@DCA.ca.gov

Website Access: Materials regarding this proposal can be found at www.bsis.ca.gov.

TITLE 18. BOARD OF EQUALIZATION

The State Board of Equalization Proposes to Adopt California Code of Regulations, Title 18, Section 4076, *Wholesale Cost of Tobacco Products*

NOTICE IS HEREBY GIVEN that the State Board of Equalization (Board), pursuant to the authority vested in it by Revenue and Taxation Code (RTC) section 30451, proposes to adopt California Code of Regulations, title 18, section (Regulation or Reg.) 4076, *Wholesale Cost of Tobacco Products*. Proposed Regulation 4076 further clarifies the meaning of the "wholesale cost" of tobacco products other than cigarettes (collectively referred to as "other tobacco products" or "OTP") as defined in RTC section 30017, provides alternative methods for estimating or calculating the wholesale cost of OTP, provides examples to show how the wholesale cost of OTP is determined in common situations, and clarifies that only current-year tobacco product prices may be used to determine the OTP tax rate for the next fiscal year.

PUBLIC HEARING

The Board will conduct a meeting in Room 121, at 450 N Street, Sacramento, California, on May 24-26,

2016. The Board will provide notice of the meeting to any person who requests that notice in writing and make the notice, including the specific agenda for the meeting, available on the Board's Website at www.boe.ca.gov at least 10 days in advance of the meeting.

A public hearing regarding the proposed regulatory action will be held at 9:00 a.m. or as soon thereafter as the matter may be heard on May 24, 25, or 26, 2016. At the hearing, any interested person may present or submit oral or written statements, arguments, or contentions regarding the adoption of proposed Regulation 4076.

AUTHORITY

RTC section 30451

REFERENCE

RTC sections 30008, 30010, 30011, 30017, 30105, 30121, 30123, 30126, 30131.1, 30131.2, 30131.5, 30201, and 30221

INFORMATIVE DIGEST/POLICY STATEMENT
OVERVIEW

Current Law

In November 1988, California voters passed Proposition 99, known as the "Tobacco and Health Protection Act of 1988" (Prop. 99). Among other things, Prop. 99 imposed a surtax on every distributor (as defined in RTC, § 30011) of cigarettes at the rate of 12.5 mills (\$0.0125) per cigarette or \$0.25 per pack (\$0.0125 x 20 cigarettes) distributed. Prop. 99 also imposed a tax on every distributor of 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 ne-

gotiated 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 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 wholesale cost of tobacco products 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.

NO MANDATE ON LOCAL AGENCIES AND SCHOOL DISTRICTS

The Board has determined that the adoption of proposed Regulation 4076 will not impose a mandate on local agencies or school districts, including a mandate that requires state reimbursement under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code.

NO COST OR SAVINGS TO STATE AGENCIES, LOCAL AGENCIES, AND SCHOOL DISTRICTS

The Board has determined that the adoption of proposed Regulation 4076 will result in no direct or indirect cost or savings to any state agency, no cost to any local agency or school district that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code, no other non-discretionary cost or savings imposed on local agencies, and no cost or savings in federal funding to the State of California.

NO SIGNIFICANT STATEWIDE ADVERSE ECONOMIC IMPACT DIRECTLY AFFECTING BUSINESS

The Board has made an initial determination that the adoption of proposed Regulation 4076 will not have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states.

The adoption of proposed Regulation 4076 may affect small business.

NO COST IMPACTS TO PRIVATE PERSONS
OR BUSINESSES

The Board is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

RESULTS OF THE ECONOMIC IMPACT
ASSESSMENT REQUIRED BY GOVERNMENT
CODE SECTION 11346.3, SUBDIVISION (b)

The Board has determined that proposed Regulation 4076 is not a major regulation, as defined in Government Code section 11342.548 and California Code of Regulations, title 1, section 2000. Therefore, the Board has prepared the economic impact assessment required by Government Code section 11346.3, subdivision (b)(1), and included it in the initial statement of reasons. The Board has determined that the adoption of proposed Regulation 4076 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California. Furthermore, the Board has determined that the adoption of proposed Regulation 4076 will not affect the benefits of Regulation 4076 to the health and welfare of California residents, worker safety, or the state's environment.

NO SIGNIFICANT EFFECT ON
HOUSING COSTS

The adoption of proposed Regulation 4076 will not have a significant effect on housing costs.

DETERMINATION REGARDING
ALTERNATIVES

The Board must determine that no reasonable alternative considered by it or that has been otherwise identified and brought to its attention would be more effective in carrying out the purpose for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

CONTACT PERSONS

Questions regarding the substance of the proposed regulation should be directed to Pamela Mash, Tax Counsel, by telephone at (916) 323-3248, by e-mail at Pamela.Mash@boe.ca.gov, or by mail at State Board of

Equalization, Attn: Pamela Mash, MIC:82, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0082.

Written comments for the Board's consideration, notice of intent to present testimony or witnesses at the public hearing, and inquiries concerning the proposed administrative action should be directed to Mr. Rick Bennion, Regulations Coordinator, by telephone at (916) 445-2130, by fax at (916) 324-3984, by e-mail at Richard.Bennion@boe.ca.gov, or by mail at State Board of Equalization, Attn: Rick Bennion, MIC:80, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0080. Mr. Bennion is the designated backup contact person to Ms. Mash.

WRITTEN COMMENT PERIOD

The written comment period ends at 9:00 a.m. on May 24, 2016, or as soon thereafter as the Board begins the public hearing regarding the adoption of proposed Regulation 4076 during the May 24-26, 2016, Board meeting. Written comments received by Mr. Rick Bennion at the postal address, email address, or fax number provided above, prior to the close of the written comment period, will be presented to the Board and the Board will consider the statements, arguments, and/or contentions contained in those written comments before the Board decides whether to adopt proposed Regulation 4076. The Board will only consider written comments received by that time.

AVAILABILITY OF INITIAL STATEMENT OF
REASONS AND TEXT OF
PROPOSED REGULATION

The Board has prepared a copy of the text of proposed Regulation 4076 illustrating its express terms; however, the proposed regulation is not illustrated in underline or italics format because California Code of Regulations, title 1, section 8, subdivision (b) provides that "[u]nderline or italic is not required for the adoption of a new regulation or set of regulations if the final text otherwise clearly indicates that all of the final text submitted to OAL for filing is added to the California Code of Regulations." The Board has also prepared an initial statement of reasons for the adoption of proposed Regulation 4076, which includes the economic impact assessment required by Government Code section 11346.3, subdivision (b)(1). These documents and all the information on which the proposed regulation is based are available to the public upon request. The rulemaking file is available for public inspection at 450 N Street, Sacramento, California. The express terms of the proposed regulation and the initial statement of reasons are also available on the Board's Website at www.boe.ca.gov.

**SUBSTANTIALLY RELATED CHANGES
PURSUANT TO GOVERNMENT CODE
SECTION 11346.8**

The Board may adopt proposed Regulation 4076 with changes that are non-substantial or solely grammatical in nature, or sufficiently related to the original proposed text that the public was adequately placed on notice that the changes could result from the originally proposed regulatory action. If a sufficiently related change is made, the Board will make the full text of the proposed regulation, with the change clearly indicated, available to the public for at least 15 days before adoption. The text of the resulting regulation will be mailed to those interested parties who commented on the original proposed regulation orally or in writing or who asked to be informed of such changes. The text of the resulting regulation will also be available to the public from Mr. Bennion. The Board will consider written comments on the resulting regulation that are received prior to adoption.

**AVAILABILITY OF FINAL STATEMENT
OF REASONS**

If the Board adopts proposed Regulation 4076, the Board will prepare a final statement of reasons, which will be made available for inspection at 450 N Street, Sacramento, California, and available on the Board's Website at www.boe.ca.gov.

**TITLE 22. DEPARTMENT OF PUBLIC
HEALTH**

**Title 17, California Code of Regulations
DPH-07-005, WIC Participant Sanctions**

PUBLIC PROCEEDINGS

The California Department of Public Health (Department) is conducting a 45-day written public proceeding during which time any interested person or such person's duly authorized representative may present statements, arguments or contentions (all of which are hereinafter referred to as comments) relevant to the action described in the Informative Digest/Policy Statement overview section of this notice.

PUBLIC HEARING

The Department has not scheduled a public hearing on this proposed action. However, the Department will hold a hearing if it receives a written request for a public hearing from any interested person, or his or her duly

authorized representative, no later than 15 days prior to the close of the written comment period.

WRITTEN COMMENT PERIOD

Any written comments pertaining to these regulations, regardless of the method of transmittal, must be received by the Office of Regulations by 5:00 p.m. on May 23, 2016 which is hereby designated as the close of the written comment period. Comments received after this date will not be considered timely. Persons wishing to use the California Relay Service may do so at no cost by dialing 711.

Written comments may be submitted as follows:

1. By email to: regulations@cdph.ca.gov. It is requested that email transmission of comments, particularly those with attachments, contain the regulation package identifier "DPH-07-005" in the subject line to facilitate timely identification and review of the comment;
2. By fax transmission: (916) 440-5747;
3. By Postal Service to: California Department of Public Health, Office of Regulations, 1415 L Street, Suite 500, Sacramento, CA 95814;
4. Hand-delivered to Office of Regulations, 1415 L Street, Suite 500, Sacramento, CA 95814.

All submitted comments should include the regulation package identifier, DPH-07-005, author's name and mailing address.

Authority and Reference

The Department is proposing to repeal the regulation section identified under the authority provided in sections 131000, 131050, 131051, 131052, and 131200 of the Health and Safety Code. The aforementioned sections provide the Department with the authority to repeal 22 CCR section 40679(a)(2)(G).

**INFORMATIVE DIGEST/POLICY STATEMENT
OVERVIEW**

Summary of Proposal

The California Department of Public Health (Department) proposes to repeal Title 22 California Code of Regulations (22 CCR) section 40679(a)(2)(G) pursuant to a settlement agreement so ordered by the court entered in 2002 that limits the grounds on which participants in the Women, Infants and Children (WIC) program can be sanctioned.

Pursuant to a settlement agreement entered on July 29, 2002, in *Nicholas v. Bonta et al.*, Superior Court of California, County of Sacramento, case number 01CS00678, the WIC program is no longer allowed to use a participant's "rude or abusive behavior" that does



STATE BOARD OF EQUALIZATION

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State Controller

DAVID J. GAU
Executive Director

April 8, 2016

To Interested Parties:

Notice of Proposed Regulatory Action

**The State Board of Equalization Proposes to Adopt
Amendments to California Code of Regulations,
Title 18,
Section 4076, *Wholesale Cost of Tobacco Products***

NOTICE IS HEREBY GIVEN that the State Board of Equalization (Board), pursuant to the authority vested in it by Revenue and Taxation Code (RTC) section 30451, proposes to adopt California Code of Regulations, title 18, section (Regulation or Reg.) 4076, *Wholesale Cost of Tobacco Products*. Proposed Regulation 4076 further clarifies the meaning of the "wholesale cost" of tobacco products other than cigarettes (collectively referred to as "other tobacco products" or "OTP") as defined in RTC section 30017, provides alternative methods for estimating or calculating the wholesale cost of OTP, provides examples to show how the wholesale cost of OTP is determined in common situations, and clarifies that only current-year tobacco product prices may be used to determine the OTP tax rate for the next fiscal year.

PUBLIC HEARING

The Board will conduct a meeting in Room 121, at 450 N Street, Sacramento, California, on May 24-26, 2016. The Board will provide notice of the meeting to any person who requests that notice in writing and make the notice, including the specific agenda for the meeting, available on the Board's Website at www.boe.ca.gov at least 10 days in advance of the meeting.

A public hearing regarding the proposed regulatory action will be held at 9:00 a.m. or as soon thereafter as the matter may be heard on May 24, 25, or 26, 2016. At the hearing, any interested person may present or submit oral or written statements, arguments, or contentions regarding the adoption of proposed Regulation 4076.

AUTHORITY

RTC section 30451

REFERENCE

RTC sections 30008, 30010, 30011, 30017, 30105, 30121, 30123, 30126, 30131.1, 30131.2, 30131.5, 30201, and 30221

INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW

Current Law

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

NO MANDATE ON LOCAL AGENCIES AND SCHOOL DISTRICTS

The Board has determined that the adoption of proposed Regulation 4076 will not impose a mandate on local agencies or school districts, including a mandate that requires state reimbursement under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code.

NO COST OR SAVINGS TO STATE AGENCIES, LOCAL AGENCIES, AND SCHOOL DISTRICTS

The Board has determined that the adoption of proposed Regulation 4076 will result in no direct or indirect cost or savings to any state agency, no cost to any local agency or school district that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code, no other non-discretionary cost or savings imposed on local agencies, and no cost or savings in federal funding to the State of California.

NO SIGNIFICANT STATEWIDE ADVERSE ECONOMIC IMPACT DIRECTLY AFFECTING BUSINESS

The Board has made an initial determination that the adoption of proposed Regulation 4076 will not have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states.

The adoption of proposed Regulation 4076 may affect small business.

NO COST IMPACTS TO PRIVATE PERSONS OR BUSINESSES

The Board is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

RESULTS OF THE ECONOMIC IMPACT ASSESSMENT REQUIRED BY GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)

The Board has determined that proposed Regulation 4076 is not a major regulation, as defined in Government Code section 11342.548 and California Code of Regulations, title 1, section 2000. Therefore, the Board has prepared the economic impact assessment required by Government Code section 11346.3, subdivision (b)(1), and included it in the initial statement of reasons. The Board has determined that the adoption of proposed Regulation 4076 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California. Furthermore, the Board has determined that the adoption of proposed Regulation 4076 will not affect the benefits of Regulation 4076 to the health and welfare of California residents, worker safety, or the state's environment.

NO SIGNIFICANT EFFECT ON HOUSING COSTS

The adoption of proposed Regulation 4076 will not have a significant effect on housing costs.

DETERMINATION REGARDING ALTERNATIVES

The Board must determine that no reasonable alternative considered by it or that has been otherwise identified and brought to its attention would be more effective in carrying out the

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

CONTACT PERSONS

Questions regarding the substance of the proposed regulation should be directed to Pamela Mash, Tax Counsel, by telephone at (916) 323-3248, by e-mail at Pamela.Mash@boe.ca.gov, or by mail at State Board of Equalization, Attn: Pamela Mash, MIC:82, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0082.

Written comments for the Board's consideration, notice of intent to present testimony or witnesses at the public hearing, and inquiries concerning the proposed administrative action should be directed to Mr. Rick Bennion, Regulations Coordinator, by telephone at (916) 445-2130, by fax at (916) 324-3984, by e-mail at Richard.Bennion@boe.ca.gov, or by mail at State Board of Equalization, Attn: Rick Bennion, MIC:80, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0080. Mr. Bennion is the designated backup contact person to Ms. Mash.

WRITTEN COMMENT PERIOD

The written comment period ends at 9:00 a.m. on May 24, 2016, or as soon thereafter as the Board begins the public hearing regarding the adoption of proposed Regulation 4076 during the May 24-26, 2016, Board meeting. Written comments received by Mr. Rick Bennion at the postal address, email address, or fax number provided above, prior to the close of the written comment period, will be presented to the Board and the Board will consider the statements, arguments, and/or contentions contained in those written comments before the Board decides whether to adopt proposed Regulation 4076. The Board will only consider written comments received by that time.

AVAILABILITY OF INITIAL STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATION

The Board has prepared a copy of the text of proposed Regulation 4076 illustrating its express terms; however, the proposed regulation is not illustrated in underline or italics format because California Code of Regulations, title 1, section 8, subdivision (b) provides that "[u]nderline or italic is not required for the adoption of a new regulation or set of regulations if the final text otherwise clearly indicates that all of the final text submitted to OAL for filing is added to the California Code of Regulations." The Board has also prepared an initial statement of reasons for the adoption of proposed Regulation 4076, which includes the economic impact assessment required by Government Code section 11346.3, subdivision (b)(1). These documents and all the information on which the proposed regulation are based are available to the public upon request. The rulemaking file is available for public inspection at 450 N Street, Sacramento, California.

April 8, 2016

The express terms of the proposed regulation and the initial statement of reasons are also available on the Board's Website at www.boe.ca.gov.

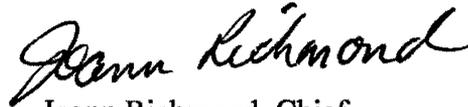
SUBSTANTIALLY RELATED CHANGES PURSUANT TO GOVERNMENT CODE SECTION 11346.8

The Board may adopt proposed Regulation 4076 with changes that are non-substantial or solely grammatical in nature, or sufficiently related to the original proposed text that the public was adequately placed on notice that the changes could result from the originally proposed regulatory action. If a sufficiently related change is made, the Board will make the full text of the proposed regulation, with the change clearly indicated, available to the public for at least 15 days before adoption. The text of the resulting regulation will be mailed to those interested parties who commented on the original proposed regulation orally or in writing or who asked to be informed of such changes. The text of the resulting regulation will also be available to the public from Mr. Bennion. The Board will consider written comments on the resulting regulation that are received prior to adoption.

AVAILABILITY OF FINAL STATEMENT OF REASONS

If the Board adopts proposed Regulation 4076, the Board will prepare a final statement of reasons, which will be made available for inspection at 450 N Street, Sacramento, California, and available on the Board's Website at www.boe.ca.gov.

Sincerely,



Joann Richmond, Chief
Board Proceedings Division

JR:reb

STATE BOARD OF EQUALIZATION		
BOARD APPROVED		
At the	<u>May 24, 2016</u>	Board Meeting
	<u>Joann Richmond</u>	
Joann Richmond, Chief Board Proceedings Division		

**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.

**Proposed Text of
California Code of Regulations, Title 18, Section 4076,
*Wholesale Cost of Tobacco Products***

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

4076. Wholesale Cost of Tobacco Products.

(a) Definitions.

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

(2) Discounts or trade allowances. "Discounts or trade allowances" are price reductions, or allowances of any kind, whether stated or unstated, and include, without limitation, any price reduction applied to a supplier's price list. The discounts may be for prompt payment, payment in cash, bulk purchases, related-party transactions, or "preferred-customer" status.

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

(b) Wholesale cost.

(1) If finished tobacco products are purchased by a distributor from a supplier in an arm's-length transaction, the "wholesale cost" of the tobacco product is the amount paid for the tobacco product, including any federal excise tax, but excluding any transportation charges for shipment originating within the United States. Discounts and trade allowances must be added back when determining "wholesale cost."

(2) If a manufacturer or an importer is also the distributor, the wholesale cost of tobacco includes all manufacturing costs, the cost of raw materials (including waste materials not incorporated into the finished tobacco product) prior to any discounts or trade allowances, the cost of labor, any direct (including freight-in) and indirect overhead costs, and any federal excise and/or U.S. Customs taxes paid. Wholesale cost includes all freight or transportation charges for shipment of materials and/or unfinished product from the supplier to the manufacturer concurrently licensed as a distributor, but excludes domestic freight or transportation charges for shipment of finished tobacco products as defined in subdivision (a)(3).

(3) If tobacco product costs include express, implicit, or unstated discounts or trade allowances, the correct wholesale costs to be reported by the distributor may be determined using any of the methods provided in subdivision (c).

(4) If tobacco products are not purchased in an arm's-length transaction, the correct wholesale costs to be reported by the distributor may be determined using any of the methods provided in subdivision (c).

(c) Alternative methods of estimating or calculating wholesale cost.

The following resources or methods may be used.

(1) 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 an estimate based on best available information of the distributor's or a similarly situated distributor's profit.

(2) If a publicly or commercially available price list is not available, industry data from the time period to be estimated or calculated that provides reasonable evidence of typical tobacco product costs during such time period, including, but not limited to:

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

(B) All the direct and indirect costs that the supplier paid or incurred with respect to acquisition, production, marketing, and sale of the tobacco products sold by the supplier to the distributor, with appropriate adjustments to such costs as indicated by all the facts and circumstances, plus a reasonable estimate of the supplier's profit.

(C) The price of the same or similar tobacco products as reflected in a supplier's price list, with appropriate adjustments to such price as indicated by all the facts and circumstances.

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

(E) Additional methods not mentioned above, with Board approval.

(d) Sales not made at arm's-length.

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

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

(e) Examples of estimating or calculating the wholesale cost of tobacco:

(1) Example 1: Distributor B produces handmade cigars. B's tobacco product costs include: all manufacturing costs, the cost of raw materials (including waste materials not incorporated into the final product), the cost of labor, any direct and indirect overhead costs, and any federal excise and/or U.S. Customs taxes paid. The cost does not include freight or transportation charges for shipment from the supplier to the distributor.

(2) Example 2: Distributor C purchases tobacco products from a subsidiary corporation in which it owns or controls more than 50 percent of the voting stock. Due to this corporate relationship between seller and buyer, the Board presumes that the sale and purchase were not at arm's-length, and the presumption is not rebutted by C. In the absence of an arm's-length transaction, the methods discussed in subdivision (c) may be used to determine the correct wholesale cost.

(3) Example 3: Distributor D acquires tobacco product free of charge and reports no wholesale cost for the product on its Tobacco Products Distributor Tax Return. However, D acquired such tobacco product at a 100 percent discount or trade allowance. In the absence of an arm's-length transaction, the methods discussed in subdivision (c) may be used to determine the correct wholesale cost.

(4) Example 4: Distributor E, with a tobacco products importers license, acquires tobacco products or finished tobacco products from a supplier outside the United States. E's tobacco product costs include, in addition to all other production or acquisition costs, the costs of all U.S. Customs fees and federal excise taxes paid or incurred by E with respect to such tobacco products.

(5) Example 5: Distributor F receives three tobacco products packaged as one unit, as a "three for the price of two" promotional package, labeled with a single UPC barcode. As the products are packaged together as one inseparable unit, tax is based on the total package price.

(6) Example 6: Distributor G receives 2 units, to sell as a "buy one, get one free" promotion. Each unit is separately packaged and each unit is labeled with a UPC barcode. Because one unit is being provided for free, tax would apply to the wholesale cost of each separate unit as calculated by a method discussed in subdivision (c).

(7) Example 7: Distributor H receives a three percent discount for paying their supplier within 10 days of receipt of their items. To calculate the wholesale cost, Distributor H must add the three percent discount to the price paid for the products.

(f) Rate Setting. The Board's annual determination of the rate of tax that applies to other tobacco products shall be made based on the wholesale cost of tobacco products as of March 1 of the current calendar year and shall be effective during the next fiscal year, beginning July 1.

Note: Authority cited: Section 30451, Revenue and Taxation Code. Reference: Sections 30008, 30010, 30011, 30017, 30105, 30121, 30123, 30126, 30131.1, 30131.2, 30131.5, 30201, and 30221, Revenue and Taxation Code.

Regulation History

Type of Regulation: Cigarette and Tobacco Products Tax Regulation

Regulation: 4076

Title: *Wholesale Cost of Tobacco Products*

Preparation: Pamela Mash

Legal Contact: Pamela Mash

The State Board of Equalization proposes to adopt Regulation 4076 to further clarify the meaning of the "wholesale cost" of tobacco products other than cigarettes as defined in Revenue and Taxation Code section 30017.

History of Proposed Regulation:

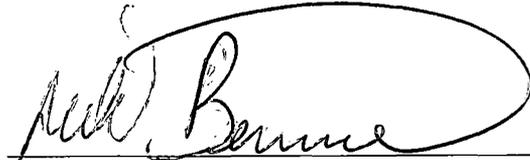
May 24-26, 2016	Public Hearing
April 8, 2016	OAL publication date; 45-day public comment period begins; Interested Parties mailing
March 29, 2016	Notice to OAL
January 26, 2016	Business Tax Committee, Board Authorized Publication (Vote 5-0)

Sponsor:	NA
Support:	NA
Oppose:	NA

Statement of Compliance

The State Board of Equalization, in process of adopting Sales and Use Taxes Regulation 4076, *Wholesale Cost of Tobacco Products*, did comply with the provision of Government Code section 11346.4(a)(1) through (4). A notice to interested parties was mailed on April 8, 2016, 46 days prior to the public hearing.

June 1, 2016

A handwritten signature in cursive script, appearing to read "Richard Bennion", is written over a horizontal line. The signature is enclosed within a large, hand-drawn oval.

Richard Bennion
Regulations Coordinator
State Board of Equalization

BEFORE THE CALIFORNIA STATE BOARD OF EQUALIZATION

450 N STREET
SACRAMENTO, CALIFORNIA

REPORTER'S TRANSCRIPT

MAY 24, 2016

ITEM F

PUBLIC HEARINGS

ITEM F1

PROPOSED ADOPTION OF CIGARETTE AND TOBACCO PRODUCTS

TAX REGULATION 4076,

WHOLESALE COST OF TOBACCO PRODUCTS

REPORTED BY: Kathleen Skidgel

CSR NO. 9039

P R E S E N T

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For the Board
of Equalization:

Fiona Ma, CPA
Chairwoman

Diane L. Harkey
Vice Chair

Jerome E. Horton
Member

Sen. George Runner (Ret.)
Member

Yvette Stowers
Appearing for Betty T.
Yee, State Controller
(per Government Code
Section 7.9)

Joann Richmond
Chief
Board Proceedings
Division

For Board of
Equalization Staff:

Pamela Mash
Tax Counsel
Legal Department

Bradley Heller
Tax Counsel IV
Legal Department

---oOo---

Speaker:

Dennis Loper
California Distributors
Association

---oOo---

1 450 N STREET
2 SACRAMENTO, CALIFORNIA
3 MAY 24, 2016

4 ----oOo----

5 MS. MA: Okay. The Board meeting is
6 reconvening.

7 Ms. Richmond, please call the first item.

8 MS. RICHMOND: Good afternoon, Members.
9 Our first item on the afternoon agenda is the Item F
10 Public Hearings. Item F1 Proposed Adoption of
11 Cigarette and Tobacco Products Tax Regulation 4076,
12 Wholesale Cost of Tobacco Products.

13 MS. MA: Thank you.

14 And to the Department, if you would please
15 introduce yourself for the record, and then commence
16 your presentation.

17 MS. MASH: Thank you, Chairman --
18 Chairwoman Ma and Members of the Board. I'm Pamela
19 Mash from the Board's Legal Department, along with
20 Bradley Heller, also from the Legal Department.

21 I'm here to request that the Board vote to
22 adopt proposed special regulation -- special taxes
23 Regulation 4076, Wholesale Costs of Tobacco
24 Products.

25 The proposed regulation clarifies the
26 meaning of the term wholesale cost of tobacco
27 products as defined in Revenue and Taxation Code
28 section 30017.

1 And I understand there's someone here to
2 speak on this.

3 MS. MA: Yes. We have one public speaker,
4 Mr. Dennis Loper. If you would, please, come to the
5 front. You will have three minutes for your
6 presentation. And please introduce yourself for the
7 record.

8 ---oOo---

9 DENNIS LOPER

10 ---oOo---

11 MR. LOPER: Chairwoman Ma, Members, Dennis
12 Loper for the California Distributors Association.

13 We've reviewed the regulation. And, unless
14 I hear something different from what Legal has to
15 say, we're in support.

16 MS. MA: Okay. Members, any questions,
17 comments?

18 Seeing none, do I have a motion to accept
19 staff recommendation?

20 MR. HORTON: So moved, Madam Chair.

21 MS. MA: Okay. Motion by Mr. Horton.

22 Seconded by --

23 MS. STOWERS: Second.

24 MS. MA: -- Ms. Stowers.

25 Without objection, item carries.

26 ---oOo---

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REPORTER'S CERTIFICATE

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State of California)
) ss
County of Sacramento)

I, Kathleen Skidgel, Hearing Reporter for the California State Board of Equalization certify that on May 24, 2016 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 1 through 4 constitute a complete and accurate transcription of the shorthand writing.

Dated: May 31, 2016

Kathleen Skidgel

KATHLEEN SKIDGEL, CSR #9039

Hearing Reporter



2016 MINUTES OF THE STATE BOARD OF EQUALIZATION

Tuesday, May 24, 2016

PUBLIC HEARINGS**F1 Proposed Adoption of Cigarette and Tobacco Products Tax Regulation 4076, Wholesale Cost of Tobacco Products**

Pamela Mash, Tax Counsel, Tax and Fee Programs Division, Legal Department, made introductory remarks regarding a new regulation to further clarify the meaning of the "wholesale cost" of tobacco products other than cigarettes as defined in Revenue and Taxation Code section 30017 (Exhibit 5.4).

Speakers: Dennis Loper, California District Association

Action: Upon motion of Mr. Horton, seconded by Ms. Stowers and unanimously carried, Ms. Ma, Ms. Harkey, Mr. Runner, Mr. Horton and Ms. Stowers voting yes, the Board adopted the amendments to Regulation 4076 as published.

F2 Business Taxpayers' Bill of Rights Hearings

Todd Gilman, Taxpayer's Rights Advocate, Taxpayer's Rights Advocates Office, made introductory remarks regarding the Business Taxpayers' Bill of Rights hearings. Individuals have the opportunity to present ideas, concerns, and recommendations regarding legislation, the quality of agency services, and other issues related to the Board's administration of its tax programs, including sales and use taxes, environmental fees, fuel taxes, and excise taxes, and any problems identified in the Taxpayers' Rights Advocate's Annual Report (Exhibit 5.5).

Speakers: Jesse W. McClellan, Esq, McClellan Davis, LLC
Rex Halverson, Tax Attorney, Rex Halverson & Associates
Gene Christopher, Taxpayer

Mr. Gilman entered into the record written comments from an anonymous business owner (Exhibit 5.6).

F3 Property Taxpayers' Bill of Rights Hearings

Todd Gilman, Taxpayer's Rights Advocate, Taxpayer's Rights Advocates Office, made introductory remarks regarding the Property Taxpayers' Bill of Rights hearings. Individuals have the opportunity to present their ideas, concerns, and recommendations regarding legislation, the quality of agency services, and other issues related to the Board's administration of its tax programs, including state and county property tax programs, and any problems identified in the Taxpayers' Rights Advocate's Annual Report (Exhibit 5.7).

Speakers: Tim Phillis, Taxpayer (Exhibit 5.8)
Denise Friedman, Taxpayer (Exhibit 5.9)
John Gamper, CA Farm Bureau Federation

Note: These minutes are not final until Board approved.



STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

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Third District, Los Angeles County

DIANE L. HARKEY
Fourth District, Orange County

BETTY T. YEE
State Controller

DAVID GAU
Executive Director

April 8, 2016

To Interested Parties:

Notice of Proposed Regulatory Action
The State Board of Equalization Proposes to Adopt
Amendments to California Code of Regulations,
Title 18,
Section 4076, *Wholesale Cost of Tobacco Products*

NOTICE IS HEREBY GIVEN that the State Board of Equalization (Board), pursuant to the authority vested in it by Revenue and Taxation Code (RTC) section 30451, proposes to adopt California Code of Regulations, title 18, section (Regulation or Reg.) 4076, *Wholesale Cost of Tobacco Products*. Proposed Regulation 4076 further clarifies the meaning of the "wholesale cost" of tobacco products other than cigarettes (collectively referred to as "other tobacco products" or "OTP") as defined in RTC section 30017, provides alternative methods for estimating or calculating the wholesale cost of OTP, provides examples to show how the wholesale cost of OTP is determined in common situations, and clarifies that only current-year tobacco product prices may be used to determine the OTP tax rate for the next fiscal year.

PUBLIC HEARING

The Board will conduct a meeting in Room 121, at 450 N Street, Sacramento, California, on May 24-26, 2016. The Board will provide notice of the meeting to any person who requests that notice in writing and make the notice, including the specific agenda for the meeting, available on the Board's Website at www.boe.ca.gov at least 10 days in advance of the meeting.

A public hearing regarding the proposed regulatory action will be held at 9:00 a.m. or as soon thereafter as the matter may be heard on May 24, 25, or 26, 2016. At the hearing, any interested person may present or submit oral or written statements, arguments, or contentions regarding the adoption of proposed Regulation 4076.

AUTHORITY

RTC section 30451

REFERENCE

RTC sections 30008, 30010, 30011, 30017, 30105, 30121, 30123, 30126, 30131.1, 30131.2, 30131.5, 30201, and 30221

INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW

Current Law

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

NO MANDATE ON LOCAL AGENCIES AND SCHOOL DISTRICTS

The Board has determined that the adoption of proposed Regulation 4076 will not impose a mandate on local agencies or school districts, including a mandate that requires state reimbursement under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code.

NO COST OR SAVINGS TO STATE AGENCIES, LOCAL AGENCIES, AND SCHOOL DISTRICTS

The Board has determined that the adoption of proposed Regulation 4076 will result in no direct or indirect cost or savings to any state agency, no cost to any local agency or school district that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code, no other non-discretionary cost or savings imposed on local agencies, and no cost or savings in federal funding to the State of California.

NO SIGNIFICANT STATEWIDE ADVERSE ECONOMIC IMPACT DIRECTLY AFFECTING BUSINESS

The Board has made an initial determination that the adoption of proposed Regulation 4076 will not have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states.

The adoption of proposed Regulation 4076 may affect small business.

NO COST IMPACTS TO PRIVATE PERSONS OR BUSINESSES

The Board is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

RESULTS OF THE ECONOMIC IMPACT ASSESSMENT REQUIRED BY GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)

The Board has determined that proposed Regulation 4076 is not a major regulation, as defined in Government Code section 11342.548 and California Code of Regulations, title 1, section 2000. Therefore, the Board has prepared the economic impact assessment required by Government Code section 11346.3, subdivision (b)(1), and included it in the initial statement of reasons. The Board has determined that the adoption of proposed Regulation 4076 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California. Furthermore, the Board has determined that the adoption of proposed Regulation 4076 will not affect the benefits of Regulation 4076 to the health and welfare of California residents, worker safety, or the state's environment.

NO SIGNIFICANT EFFECT ON HOUSING COSTS

The adoption of proposed Regulation 4076 will not have a significant effect on housing costs.

DETERMINATION REGARDING ALTERNATIVES

The Board must determine that no reasonable alternative considered by it or that has been otherwise identified and brought to its attention would be more effective in carrying out the

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

CONTACT PERSONS

Questions regarding the substance of the proposed regulation should be directed to Pamela Mash, Tax Counsel, by telephone at (916) 323-3248, by e-mail at Pamela.Mash@boe.ca.gov, or by mail at State Board of Equalization, Attn: Pamela Mash, MIC:82, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0082.

Written comments for the Board's consideration, notice of intent to present testimony or witnesses at the public hearing, and inquiries concerning the proposed administrative action should be directed to Mr. Rick Bennion, Regulations Coordinator, by telephone at (916) 445-2130, by fax at (916) 324-3984, by e-mail at Richard.Bennion@boe.ca.gov, or by mail at State Board of Equalization, Attn: Rick Bennion, MIC:80, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0080. Mr. Bennion is the designated backup contact person to Ms. Mash.

WRITTEN COMMENT PERIOD

The written comment period ends at 9:00 a.m. on May 24, 2016, or as soon thereafter as the Board begins the public hearing regarding the adoption of proposed Regulation 4076 during the May 24-26, 2016, Board meeting. Written comments received by Mr. Rick Bennion at the postal address, email address, or fax number provided above, prior to the close of the written comment period, will be presented to the Board and the Board will consider the statements, arguments, and/or contentions contained in those written comments before the Board decides whether to adopt proposed Regulation 4076. The Board will only consider written comments received by that time.

AVAILABILITY OF INITIAL STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATION

The Board has prepared a copy of the text of proposed Regulation 4076 illustrating its express terms; however, the proposed regulation is not illustrated in underline or italics format because California Code of Regulations, title 1, section 8, subdivision (b) provides that "[u]nderline or italic is not required for the adoption of a new regulation or set of regulations if the final text otherwise clearly indicates that all of the final text submitted to OAL for filing is added to the California Code of Regulations." The Board has also prepared an initial statement of reasons for the adoption of proposed Regulation 4076, which includes the economic impact assessment required by Government Code section 11346.3, subdivision (b)(1). These documents and all the information on which the proposed regulation are based are available to the public upon request. The rulemaking file is available for public inspection at 450 N Street, Sacramento, California.

April 8, 2016

The express terms of the proposed regulation and the initial statement of reasons are also available on the Board's Website at www.boe.ca.gov.

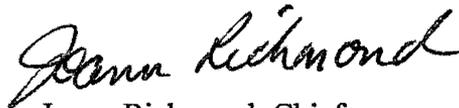
SUBSTANTIALLY RELATED CHANGES PURSUANT TO GOVERNMENT CODE SECTION 11346.8

The Board may adopt proposed Regulation 4076 with changes that are non-substantial or solely grammatical in nature, or sufficiently related to the original proposed text that the public was adequately placed on notice that the changes could result from the originally proposed regulatory action. If a sufficiently related change is made, the Board will make the full text of the proposed regulation, with the change clearly indicated, available to the public for at least 15 days before adoption. The text of the resulting regulation will be mailed to those interested parties who commented on the original proposed regulation orally or in writing or who asked to be informed of such changes. The text of the resulting regulation will also be available to the public from Mr. Bennion. The Board will consider written comments on the resulting regulation that are received prior to adoption.

AVAILABILITY OF FINAL STATEMENT OF REASONS

If the Board adopts proposed Regulation 4076, the Board will prepare a final statement of reasons, which will be made available for inspection at 450 N Street, Sacramento, California, and available on the Board's Website at www.boe.ca.gov.

Sincerely,



Joann Richmond, Chief
Board Proceedings Division

JR:reb

**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," "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).

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.

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 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.

**Proposed Text of
California Code of Regulations, Title 18, Section 4076,
Wholesale Cost of Tobacco Products**

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

4076. Wholesale Cost of Tobacco Products.

(a) Definitions.

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

(2) Discounts or trade allowances. "Discounts or trade allowances" are price reductions, or allowances of any kind, whether stated or unstated, and include, without limitation, any price reduction applied to a supplier's price list. The discounts may be for prompt payment, payment in cash, bulk purchases, related-party transactions, or "preferred-customer" status.

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

(b) Wholesale cost.

(1) If finished tobacco products are purchased by a distributor from a supplier in an arm's-length transaction, the "wholesale cost" of the tobacco product is the amount paid for the tobacco product, including any federal excise tax, but excluding any transportation charges for shipment originating within the United States. Discounts and trade allowances must be added back when determining "wholesale cost."

(2) If a manufacturer or an importer is also the distributor, the wholesale cost of tobacco includes all manufacturing costs, the cost of raw materials (including waste materials not incorporated into the finished tobacco product) prior to any discounts or trade allowances, the cost of labor, any direct (including freight-in) and indirect overhead costs, and any federal excise and/or U.S. Customs taxes paid. Wholesale cost includes all freight or transportation charges for shipment of materials and/or unfinished product from the supplier to the manufacturer concurrently licensed as a distributor, but excludes domestic freight or transportation charges for shipment of finished tobacco products as defined in subdivision (a)(3).

(3) If tobacco product costs include express, implicit, or unstated discounts or trade allowances, the correct wholesale costs to be reported by the distributor may be determined using any of the methods provided in subdivision (c).

(4) If tobacco products are not purchased in an arm's-length transaction, the correct wholesale costs to be reported by the distributor may be determined using any of the methods provided in subdivision (c).

(c) Alternative methods of estimating or calculating wholesale cost.

The following resources or methods may be used.

(1) 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 an estimate based on best available information of the distributor's or a similarly situated distributor's profit.

(2) If a publicly or commercially available price list is not available, industry data from the time period to be estimated or calculated that provides reasonable evidence of typical tobacco product costs during such time period, including, but not limited to:

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

(B) All the direct and indirect costs that the supplier paid or incurred with respect to acquisition, production, marketing, and sale of the tobacco products sold by the supplier to the distributor, with appropriate adjustments to such costs as indicated by all the facts and circumstances, plus a reasonable estimate of the supplier's profit.

(C) The price of the same or similar tobacco products as reflected in a supplier's price list, with appropriate adjustments to such price as indicated by all the facts and circumstances.

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

(E) Additional methods not mentioned above, with Board approval.

(d) Sales not made at arm's-length.

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

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

(e) Examples of estimating or calculating the wholesale cost of tobacco:

(1) Example 1: Distributor B produces handmade cigars. B's tobacco product costs include: all manufacturing costs, the cost of raw materials (including waste materials not incorporated into the final product), the cost of labor, any direct and indirect overhead costs, and any federal excise and/or U.S. Customs taxes paid. The cost does not include freight or transportation charges for shipment from the supplier to the distributor.

(2) Example 2: Distributor C purchases tobacco products from a subsidiary corporation in which it owns or controls more than 50 percent of the voting stock. Due to this corporate relationship between seller and buyer, the Board presumes that the sale and purchase were not at arm's-length, and the presumption is not rebutted by C. In the absence of an arm's-length transaction, the methods discussed in subdivision (c) may be used to determine the correct wholesale cost.

(3) Example 3: Distributor D acquires tobacco product free of charge and reports no wholesale cost for the product on its Tobacco Products Distributor Tax Return. However, D acquired such tobacco product at a 100 percent discount or trade allowance. In the absence of an arm's-length transaction, the methods discussed in subdivision (c) may be used to determine the correct wholesale cost.

(4) Example 4: Distributor E, with a tobacco products importers license, acquires tobacco products or finished tobacco products from a supplier outside the United States. E's tobacco product costs include, in addition to all other production or acquisition costs, the costs of all U.S. Customs fees and federal excise taxes paid or incurred by E with respect to such tobacco products.

(5) Example 5: Distributor F receives three tobacco products packaged as one unit, as a "three for the price of two" promotional package, labeled with a single UPC barcode. As the products are packaged together as one inseparable unit, tax is based on the total package price.

(6) Example 6: Distributor G receives 2 units, to sell as a "buy one, get one free" promotion. Each unit is separately packaged and each unit is labeled with a UPC barcode. Because one unit is being provided for free, tax would apply to the wholesale cost of each separate unit as calculated by a method discussed in subdivision (c).

(7) Example 7: Distributor H receives a three percent discount for paying their supplier within 10 days of receipt of their items. To calculate the wholesale cost, Distributor H must add the three percent discount to the price paid for the products.

(f) Rate Setting. The Board's annual determination of the rate of tax that applies to other tobacco products shall be made based on the wholesale cost of tobacco products as of March 1 of the current calendar year and shall be effective during the next fiscal year, beginning July 1.

Note: Authority cited: Section 30451, Revenue and Taxation Code. Reference: Sections 30008, 30010, 30011, 30017, 30105, 30121, 30123, 30126, 30131.1, 30131.2, 30131.5, 30201, and 30221, Revenue and Taxation Code.

Regulation History

Type of Regulation: Cigarette and Tobacco Products Tax Regulation

Regulation: 4076

Title: *Wholesale Cost of Tobacco Products*

Preparation: Pamela Mash

Legal Contact: Pamela Mash

The State Board of Equalization proposes to adopt Regulation 4076 to further clarify the meaning of the "wholesale cost" of tobacco products other than cigarettes as defined in Revenue and Taxation Code section 30017.

History of Proposed Regulation:

May 24-26, 2016	Public Hearing
April 8, 2016	OAL publication date; 45-day public comment period begins; Interested Parties mailing
March 29, 2016	Notice to OAL
January 26, 2016	Business Tax Committee, Board Authorized Publication (Vote 5-0)

Sponsor: NA
Support: NA
Oppose: NA