

## **FINAL STATEMENT OF REASONS NON-CONTROLLING SUMMARY**

Adopt the following regulations: 2558. *Distilled Spirits*, 2559. *Presumption – Distilled Spirits*, 2559.1. *Rebuttable Presumption – Distilled Spirits*, 2559.3. *Internet List* and 2559.5. *Correct Classification*.

### **Introduction**

In a letter dated October 25, 2006, the Board of Equalization (Board) received a petition for rulemaking requesting the Board adopt a regulation to tax flavored malt beverages (FMB) as distilled spirits and/or amend Alcoholic Beverage Regulation 2530. In December 2006, the Board voted to initiate the rulemaking process with respect to the taxation and classification of FMB. The Board's action began an Interested Parties process wherein the Board held Interested Parties meetings on February 22, 2007, and June 6, 2007, to identify and discuss issues relating to the classification and taxation of FMB. Board staff prepared several Issue Papers with draft regulatory language and received approximately 100 written submissions. The Interested Parties process concluded with the Board voting on August 14, 2007, to authorize publication of Regulations 2558, 2559, 2559.1, 2559.3 and 2559.5. A public hearing was held on November 15, 2007. Following the public hearing, the Board approved the regulations.

The adopted regulations address that the definitions of "beer" and "distilled spirits" require clarity with respect to the classification for tax purposes of certain alcoholic beverages commonly referred to as flavored malt beverages (FMB). Neither California law, nor federal law, has a specific definition of FMB. According to the federal Alcohol and Tobacco Tax and Trade Bureau:

"Flavored malt beverages are brewery products that differ from traditional malt beverages such as beer, ale, lager, porter, stout, or malt liquor in several respects. Flavored malt beverages exhibit little or no traditional beer or malt beverage character. Their flavor is derived primarily from added flavors rather than from malt and other materials used in fermentation. At the same time, flavored malt beverages are marketed in traditional beer-type bottles and cans and distributed to the alcohol beverage market through beer and malt beverage wholesalers, and their alcohol content is similar to other malt beverages - in the 4-6% alcohol by volume range.

"Although flavored malt beverages are produced at breweries, their method of production differs significantly from the production of other malt beverages and beer. In producing flavored malt beverages, brewers brew a fermented base of beer from malt and other brewing materials. Brewers then treat this base using a variety of processes in order to remove malt beverage character from the base. For example, they remove the color, bitterness, and taste generally associated with beer, ale, porter, stout, and other malt beverages. This leaves a base product to which brewers add various flavors, which typically contain distilled spirits, to achieve the desired taste profile and alcohol level.

“While the alcohol content of flavored malt beverages is similar to that of most traditional malt beverages, the alcohol in many of them is derived primarily from the distilled spirits component of the added flavors rather than from fermentation.” (See 27 C.F.R. §§ 7 & 25 (2005).)

Under California law, FMB do not neatly fit into either the statutory definition of “distilled spirits” (Bus. & Prof. Code, § 23005) or the statutory definition of “beer” (Bus. & Prof. Code, § 23006):<sup>1</sup>

23005. “Distilled spirits” means an alcoholic beverage obtained by distillation of fermented agricultural products, and includes alcohol for beverage use, spirits of wine, whiskey, rum, brandy, and gin, including all dilutions and mixtures thereof.

23006. “Beer” means any alcoholic beverage obtained by the fermentation of any infusion or decoction of barley, malt, hops, or any other similar product, or any combination thereof in water, and includes ale, porter, brown, stout, lager beer, small beer, and strong beer but does not include sake, known as Japanese rice wine.

For example, the final six words of the statutory definition of “distilled spirits” (i.e., “including all dilutions and mixtures thereof”) could be read to establish that FMB are “distilled spirits.” (See Bus. & Prof. Code, § 23005.) Under this reading of the statute whenever alcohol obtained from the distillation of fermented agricultural products is mixed, for beverage use, into an alcoholic beverage, the resulting beverage would, by definition, be a “distilled spirit” under California law. However, “beer” is defined by statute as “any alcoholic beverage obtained by fermentation of any infusion or decoction of barley, malt, hops, or any other similar product, or any combination thereof in water” (emphasis added). (See Bus. & Prof. Code, § 23006.) Accordingly, assuming that FMB retain enough alcohol from the initial fermentation process to cause them, on that basis alone, to qualify as alcoholic beverages (see Bus. & Prof. Code, § 23004), then it could also be reasonably argued that FMB fit California’s statutory definition of “beer” because they are alcoholic beverages obtained by the requisite fermentation. Therefore, because FMB could potentially meet the statutory definition of either “beer” or “distilled spirits,” interpretive action by the Board is required to resolve ambiguity for taxpayers subject to the Alcoholic Beverage Tax Law.

The ambiguity is problematic because under current law, Sections 32151, 32201, 32220 of the Alcoholic Beverage Tax Law impose the following different taxes and surcharges on the sale of “beer” and “distilled spirits”:

	Per Gallon Tax	Per Gallon Surcharge	Total
Beer	\$0.04	\$0.16	\$0.20
Distilled spirits (≤100 proof)	\$2.00	\$1.30	\$3.30
Distilled spirits (100+ proof)	\$4.00	\$2.60	\$6.60

Without clarification regarding which alcoholic beverages are “beer” and which are “distilled spirits” taxpayers may report and pay incorrect amounts.

<sup>1</sup> Revenue and Taxation Code section 32002 provides that the definitions set forth in the Alcoholic Beverage Control Act (Bus. & Prof. Code, § 23000 et seq.) govern the Alcoholic Beverage Tax Law. (Rev. & Tax. Code, § 32001 et seq.)

Prior to 1955, the Board was responsible for all aspects of the regulation, licensing and taxation of the manufacture and sale of alcoholic beverages in California. Commencing on January 1, 1955, and pursuant to a Constitutional amendment (Cal. Const., art. XX, § 22), the California Department of Alcoholic Beverage Control (ABC) was given “the exclusive power, except as herein provided and in accordance with laws enacted by the Legislature, to license the manufacture, importation and sale of alcoholic beverages in this State, and to collect license fees or occupation taxes on account thereof.” (*Id.*) In addition, Business and Professions Code section 23051 states in part:

On and after January 1, 1955, the department shall succeed to all of the powers, duties, purposes, responsibilities, and jurisdiction now conferred on the State Board of Equalization under Section 22 or Article XX of the Constitution and this division, except the power to assess and collect such excise taxes as are or may be imposed by law on account of the manufacture, importation, and sale of alcoholic beverages in this State, which shall remain the exclusive power of the State Board of Equalization. All other laws heretofore or hereafter applicable to the State Board of Equalization with respect to alcoholic beverages, except as to excise taxes, shall hereafter be construed to apply to the department.

As a result of this, while the ABC is assigned, among other things, the responsibility for the licensing of retail locations that sell alcoholic beverages in California, the Board is exclusively responsible for assessing (inclusive of the power to classify alcoholic beverages for purposes of such assessment) and collecting tax on account of the manufacture, importation, and sale of alcoholic beverages in California. Therefore, this rulemaking process pertains only to the classification of FMB for tax purposes under the Alcoholic Beverage Tax Law.

Accordingly, pursuant to its authority to promulgate regulations under the Alcoholic Beverage Tax Law (Rev. & Tax Code, § 32451), the Board has adopted the following new regulations in order to clarify for the purpose of taxation when an alcoholic beverage meets the definition of a “distilled spirit” or a “beer.”

### **Specific Purpose/Necessity**

Based on and inclusive of the foregoing, the specific purpose of each adoption, and the rationale for the determination that each adoption is reasonably necessary to carry out the purpose for which it is proposed, is as follows:

#### **Regulation 2558. Distilled Spirits.**

This regulation clarifies that distilled spirits include an alcoholic beverage, except wine as defined by Business and Professions Code section 23007, which contains 0.5 percent or more alcohol by volume from flavors or ingredients containing alcohol obtained from the distillation of fermented agricultural products. The purpose of this regulation is to provide a bright line for when an alcoholic beverage is a “distilled spirit” under the Alcoholic Beverage Tax Law. Clarity is necessary because alcoholic beverages can reasonably fall under both the definition of “beer” and “distilled spirits.”

The 0.5 percent threshold was selected for two reasons. First, a bright line was needed to assist taxpayers in properly reporting and paying taxes. Therefore, since California law uses a 0.5 percent threshold to establish what beverage products contain a sufficient percentage of alcohol

by volume to qualify as alcoholic beverages (See Bus. & Prof. Code, § 23004.), if an alcoholic beverage contains 0.5 percent or more alcohol by volume obtained from the distillation of fermented agricultural products (whether added via flavors or other ingredients containing such alcohol, or otherwise), then that alcoholic beverage should be classified as a distilled spirit for taxation purposes. This standard allows for a de minimis or negligible amount of alcohol from distillation to be allowed in products obtained from fermentation as a result of adding a diminutive amount of flavorings and thereby preserves the definition of “beer” since the use of small amounts of alcohol-based flavorings (e.g., hops extract) can occur even in the manufacture of traditional beer products; but, at the same time, this standard recognizes that alcoholic beverages with the requisite amounts of alcohol from distillation meet the definition of “distilled spirits.” Second, the federal Alcohol and Tobacco Tax and Trade Bureau during its rulemaking process addressing FMB considered a 0.5 percent threshold. (70 Fed. Reg. 194 et seq. (January 3, 2005).) During the federal rulemaking process traditional beer companies indicated that their products were generally under this threshold.

Wine, as defined by Business and Professions Code section 23007, was excluded from the regulation because the definition of “wine” (Bus. & Prof. Code, § 23007) specifically allows for the inclusion of certain distilled products, if the added products are “distilled from the particular agricultural product or products of which the wine is made,” together with no more than “15 percent added flavoring, coloring, and blending material,” so long as the finished product “contains not more than 24 percent of alcohol by volume . . . .”<sup>2</sup> Therefore, unlike the definition of “beer,” the statutory definition of “wine” specifically provides for certain mixtures or additions of alcohol obtained from distillation. Thus, in contrast to FMB, no similar clarification is required with respect to which products are within the definition of “wine.”

This regulation is necessary to provide clear, objective guidance to taxpayers with respect to which alcoholic beverages meet the definition of “beer” and which ones meet the definition of “distilled spirits” under the Alcoholic Beverage Tax Law. Without clarification regarding which alcoholic beverages are “beer” and which are “distilled spirits,” taxpayers may report and pay incorrect amounts.

### **Regulation 2559. Presumption – Distilled Spirits.**

This regulation establishes a rebuttable presumption that alcoholic beverages, except wine as defined by Business and Professions Code section 23007, contain 0.5 percent or more alcohol by volume from flavors or ingredients containing alcohol obtained from the distillation of fermented agricultural products. If a manufacturer does not rebut the presumption as provided in Regulation 2559.1, the alcoholic beverage will be presumed to meet the definition of “distilled spirits.”

This regulation is necessary in order to assist the Board with classifying products that meet the 0.5 threshold provided in Regulation 2558. In the interest of administrative feasibility, this regulation rebuttably presumes that alcoholic beverages contain 0.5 percent or more alcohol by volume from flavors or ingredients containing alcohol obtained from the distillation of fermented

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<sup>2</sup> “‘Wine’ means the product obtained from normal alcoholic fermentation of the juice of sound ripe grapes or other agricultural products . . . or any such alcoholic beverage to which is added grape brandy, fruit brandy, or spirits of wine, which is distilled from the particular agricultural product or products of which the wine is made . . . and which does not contain more than 15 percent added flavoring, coloring, and blending material and which contains not more than 24 percent of alcohol by volume . . . .” (Bus. & Prof. Code, § 23007 [emphasis added].)

agricultural products. The Board understands that there are potentially thousands of alcoholic beverages which may meet the clarifying standard set forth in Regulation 2558. Neither the Board nor the ABC possesses the necessary expertise to chemically analyze alcoholic beverages. Therefore, this presumption was utilized to place the burden of establishing which alcoholic beverages contain the requisite amount of alcohol from distillation on the parties with the actual knowledge of the contents of these beverages. This presumption also eliminates the undue delay and minimizes the administrative inefficiencies that would result from requiring the Board to analyze or review each and every alcoholic beverage sold in this state before tax could properly be assessed and collected.

This regulation is necessary to provide clear, objective guidance to taxpayers with respect to which alcoholic beverages meet the definition of “beer” and which ones meet the definition of “distilled spirits” under the Alcoholic Beverage Tax Law. Without clarification regarding which alcoholic beverages are “beer” and which are “distilled spirits,” taxpayers may report and pay incorrect amounts.

#### **Regulation 2559.1. Rebuttable Presumption – Distilled Spirits.**

This regulation allows the manufacturer to rebut the presumption set forth in Regulation 2559 with respect to any alcoholic beverage by filing a statement, under penalty of perjury, that specifies the sources and amount of the alcohol content of the beverage. If necessary, the regulation additionally provides that the Board may require a copy of the manufacturer’s “Statement of Process” or “Formula” filed with the federal Alcohol and Tobacco Tax and Trade Bureau, its predecessor agency or successor agency. This regulation recognizes that many products may contain less than 0.5 percent alcohol by volume from flavors or ingredients containing alcohol and a manufacturer should be allowed to provide the Board with verifying information. Additionally, the statement under penalty of perjury mechanism for rebuttal was selected to ensure that only a minimal burden is placed on manufacturers seeking to rebut the presumption.

This regulation is necessary in order to provide the mechanism for a manufacturer, with minimum burden, to rebut the presumption that its alcoholic beverage is a distilled spirit and furthers the necessity of providing clear, objective guidance to taxpayers with respect to which alcoholic beverages meet the definition of “beer” and which ones meet the definition of “distilled spirits” under the Alcoholic Beverage Tax Law. Without clarification regarding which alcoholic beverages are “beer” and which are “distilled spirits,” taxpayers may report and pay incorrect amounts.

#### **Regulation 2559.3. Internet List.**

This regulation requires the Board to establish and maintain on its Internet site a listing of alcoholic beverages that have been found, in the Board’s discretion, to have successfully rebutted the presumption. An Internet list was selected because it is the most efficient way to provide taxpayers with the most current information for reporting and paying any tax amounts due under the Alcoholic Beverage Tax Law.

This regulation is necessary to assist taxpayers in classifying products as “beer” or “distilled spirits” for purposes of reporting and paying any taxes due under the Alcoholic Beverage Tax Law. Without clarification regarding which alcoholic beverages are “beer” and which are “distilled spirits,” taxpayers may report and pay incorrect amounts.

### **Regulation 2559.5. Correct Classification.**

This regulation provides that taxpayers who rely for reporting purposes on the information provided on the Internet list required by Regulation 2559.3 will be afforded a safe harbor from potential tax liabilities. This regulation is necessary because the Board recognizes that in many instances the taxpayer is not the manufacturer of the alcoholic beverage in question, and, therefore, the taxpayer should be able to rely on the Board’s Internet list when reporting and paying taxes under the Alcoholic Beverage Tax Law. This ability to rely on the Board’s Internet list furthers the necessity of providing clear, objective guidance to taxpayers with respect to which alcoholic beverages meet the definition of “beer” and which ones meet the definition of “distilled spirits” under the Alcoholic Beverage Tax Law. Without clarification regarding which alcoholic beverages are “beer” and which are “distilled spirits,” taxpayers may report and pay incorrect amounts.

### **Alternatives Considered**

The following two alternatives were considered:

1. The first alternative, proposed by interested parties in the Board’s Interested Parties process, proposed to amend current Regulation 2500, *Records*. The proposed alternative regulatory language, as written, appears to assume that any alcoholic beverage with any amount of alcohol derived from distillation processes would meet the definition of distilled spirits for tax purposes. The following is the language submitted (with the proposed amendment reflected by underlining):

#### *Regulation 2500 – Records.*

A taxpayer shall maintain and make available for examination on request by the board or its authorized representatives, records in the manner set forth at California Code of Regulations, Title 18, Section 4901. In addition to the records described therein, commencing July 1, 2004, a taxpayer that manufactures any alcoholic beverage shall annually submit a statement for each of the taxpayer’s alcoholic beverage products indicating whether that beverage product contains alcohol produced through distillation, and if so, stating the percentage of such product’s total alcohol content derived from distilled spirits. The taxpayer shall make this statement under penalty of perjury.

This alternative was not chosen because it appears to assume that any alcoholic beverage with any amount of alcohol derived from distillation processes would meet the definition of distilled spirits for tax purposes. Since the use of small amounts of alcohol-based flavorings (e.g., hops extract) can occur even in the manufacture of traditional beer products, this alternative would likely include many traditional beer products and could render the definition of “beer” (Bus. & Prof. Code, § 23006) obsolete. Additionally, this alternative does not provide a bright line for taxpayers to determine which alcoholic

beverages meet the definition of “beer” or which ones meet the definition of “distilled spirits.”

2. The second alternative proposed no regulatory change, which would result in continuing to tax FMB as “beer.” This alternative was not chosen because the Board determined that FMB containing substantial amounts of alcohol obtained by distillation of fermented agricultural products must be classified as “distilled spirits” under Business and Professions Code section 23005. The Board further determined that the most reasonable approach was to tax products with more than a de minimis amount of such distilled alcohol as “distilled spirits,” but those with less than a de minimis amount as “beer,” thereby preserving and clarifying the statutory definitions of both “beer” and “distilled spirits.” Therefore, the Board concluded that this second alternative would not provide the clarification needed regarding which alcoholic beverages meet the respective definitions of “beer” and “distilled spirits.” (See Bus. & Prof. Code, §§ 23005, 23006.)

### **No Economic Impact on Small Business**

The Board has determined that the regulations will not have a significant adverse economic impact on private business or persons. The regulations are proposed to interpret, implement, and make specific the authorizing statutes. These regulations will provide a bright line for determining which alcoholic beverages meet the definition of “beer” and which ones meet the definition of “distilled spirit” for purposes of the Alcoholic Beverage Tax Law.

### **No Federal Mandate or Comparable Regulations**

The regulations are not mandated by federal law or regulations and are not comparable to any federal regulations.

### **Local Mandate Determination**

The Board has determined that the adopted regulations do not impose a mandate on local agencies or school districts. Further, the Board has determined that the adopted regulations will not result in direct or indirect costs or savings to any state agency, any costs to local agencies or school districts that are required to be reimbursed under Part 7 (commencing with Section 17500) of Division 4 of Title 2 of the Government Code, or other non-discriminatory costs or savings imposed on local agencies, or cost or savings in federal funding to the State of California.

### **Responses to Public Comment**

The Board received the following written and oral comments on the proposed regulations. The written comments, except as noted below, were received during the 45-day comment period. The oral comments were received at the November 15, 2007, Board meeting where the required public hearing was held. Following the public comments, the Board adopted the proposed regulations as published.

## *Written Comments*

### Received during the 45-day comment period:

#### Comment 1: Shawn Weymouth

In an e-mail message dated November 14, 2007, Shawn Weymouth wrote “[t]hank you for your August vote and I ask you to stand your ground tomorrow.”

#### Response

The Board hereby acknowledges the written comment. The Board made no changes to the regulations as a result of this comment.

#### Comment 2: Vanessa S. Bedford, Deputy Legislative Counsel, Legislative Counsel of California

In a letter dated October 25, 2007, to the Honorable Greg Aghazarian, forwarded to the Board by the Honorable Bill Leonard, Member, Board of Equalization, Ms. Bedford responds to the following request made by the Honorable Greg Aghazarian:

“You have asked whether the State Board of Equalization has the authority to interpret the terms ‘distilled spirits,’ ‘beer,’ and ‘wine’ for purposes of the Alcoholic Beverage Tax Law (Pt. 14 (commencing with Sec. 32001), Div. 2, R.&T.C.).”

Ms. Bedford concludes the following:

“In conclusion, in light of the foregoing, the State Board of Equalization may, for purposes of the Alcoholic Beverage Tax Law (Pt. 14 (commencing with Sec. 32001), Div. 2, R.&T.C.), interpret the terms ‘distilled spirits,’ ‘beer,’ and ‘wine’ only in a manner consistent with the definition of those terms as set forth in statute, as validly interpreted by the Department of Alcoholic Beverage Control. The State Board of Equalization may not, however, interpret the terms ‘distilled spirits,’ ‘beer,’ and ‘wine’ in a manner that is inconsistent with the Department of Alcoholic Beverage Control’s valid interpretation of those statutes.”

#### Response

To the extent Ms. Bedford’s analysis and conclusions suggest that the Board does not have the exclusive power to classify alcoholic beverages for purposes of assessing and collecting tax under the Alcoholic Beverage Tax Law, the Board respectfully disagrees. (See Bus. & Prof. Code, § 23051.) However, it should be noted that, even if Ms. Bedford’s analysis and conclusions were correct, which to the extent they suggest a limitation of the Board’s exclusive assessment power they are not, the subject regulations adopted by the Board do not, as a practical matter, run afoul of Ms. Bedford’s analysis and conclusions. Thus, regardless of the validity of Ms. Bedford’s comments, the regulations adopted by the Board required no change because they interpret the terms “distilled spirits” and “beer” for purposes of the Alcoholic Beverage Tax Law in a manner consistent with the definition of those terms as set forth in the applicable statutes. Further, the regulations adopted are not inconsistent with any valid interpretation of those

statutes by ABC, as evidenced by the fact that ABC has no duly promulgated regulations that interpret the terms “distilled spirits” or “beer,” as those terms relate to the classification of FMB or otherwise. Accordingly, the proposed regulations are not inconsistent with any valid interpretation of the applicable statutes by ABC.

Comment 3: Marc E. Sorini, Esq., Mc Dermott Will & Emory, on behalf of the Flavored Malt Beverage Coalition (Coalition)

In a letter dated November 8, 2007, written on behalf of the Coalition to the Members of the State Board of Equalization, Mr. Sorini wrote in opposition to the proposed regulations. In summary, Mr. Sorini set forth the following comments:

- A. The proposed regulations are inconsistent with governing law and therefore beyond the Board’s authority. Within this comment, Mr. Sorini argues that “Flavors Are Not Distilled Spirits,” “FMBs Contain Flavors, Not Distilled Spirits,” and “FMBs Are Beer.”

Response

The regulations are consistent with the governing law in that the regulations clarify when an alcoholic beverage meets the definition of a “distilled spirit” or a “beer.” On that basis and as further discussed below, no changes were made to the regulatory language.

As set forth previously and contrary to the Coalition’s assertions in its comments that FMB are not “distilled spirits,” but “beer,” because they contain flavors, not “distilled spirits,” the Board has determined that FMB do not neatly fit into either the statutory definition of “distilled spirits” (Bus. & Prof. Code, § 23005) or the statutory definition of “beer” (Bus. & Prof. Code, § 23006). This determination is supported most pointedly by ABC’s comments dated November 14, 2007, (set forth and discussed in Comment 7, below) which support the fact that the definitions are out of date, ambiguous and potentially subject to multiple and contradictory interpretations. Therefore, the Board has determined, contrary to Mr. Sorini’s comment, that FMB do not neatly fit into either category and that interpretive action by the Board is required to resolve the ambiguity so that tax will be properly assessed and collected under the Alcoholic Beverage Tax Law.

Therefore, the Board has adopted the subject regulations to clarify that “distilled spirits” include an alcoholic beverage, except “wine” as defined by Business and Professions Code section 23007, which contains 0.5 percent or more alcohol by volume from flavors or ingredients containing alcohol obtained from the distillation of fermented agricultural products.

- B. The Board’s presumption that all non-wine alcohol beverages are distilled spirits is inconsistent with governing law and beyond the Board’s authority.

Response

Regulation 2559, *Presumption – Distilled Spirits*, is consistent with the governing law. The regulation is necessary to assist the Board with classifying products that meet the 0.5 threshold provided in Regulation 2558 and was chosen in the interest of administrative feasibility, providing a rebuttable presumption so that products that are not within the

definition of “distilled spirits” can be readily removed from the operation of the presumption. (See Regulation 2559.1.). Accordingly, no change was made to the regulatory language adopted by the Board.

- C. The Board, a tax collection body, lacks the authority to adopt the proposed regulations because they are not consistent with the policies of the Department of Alcoholic Beverage Control.

Response

The regulatory action was adopted based on the Board’s authority pursuant to Revenue and Taxation Code section 32451 to adopt regulations for purposes of the Alcoholic Beverage Tax Law. These regulations are required to clarify when an alcoholic beverage meets the definition of a “distilled spirit” or a “beer” for tax purposes and are not inconsistent with any regulation promulgated by ABC.

Additionally, the Legislative Counsel of California has opined (see Written Comment 2, above) that the State Board of Equalization may, for purposes of the Alcoholic Beverage Tax Law, interpret the terms “distilled spirits,” “beer,” and “wine” as long as it is consistent with those terms as set forth in statute and as validly interpreted by ABC. The Board’s adoption of Regulations 2558, 2559, 2559.1, 2559.3 and 2559.5 are consistent with the statutory language and are not contrary to any regulation promulgated by ABC.

Finally, notwithstanding the Legislative Counsel opinion, the Board has the exclusive power to promulgate rules related to classification for purposes of tax assessment and collection. (Bus. & Prof. Code, § 23051.) Accordingly, no change was made to the regulatory language adopted by the Board.

- D. The proposed regulations are inconsistent with California law that compels the Board to follow federal law concerning the “system of beer and wine taxation” imposed by the federal government.

Response

Revenue and Taxation Code section 32152 provides that “the board [Board of Equalization] shall adopt such rules and regulations as may be necessary to coordinate so far as permitted by the provisions of this part [the California Alcoholic Beverage Tax Law] the system of beer and wine taxation imposed by this part with the system of beer and wine taxation imposed by the internal revenue laws of the United States.” Relevant to this issue, this section only applies to products that have been classified for purposes of tax assessment as either beer or wine. However, the regulations adopted by the Board create a regulatory system to clarify what is classified as a “beer” and what is classified as “distilled spirits.” To the extent FMB would be classified as “distilled spirits” under these regulations, Revenue and Taxation Code section 32152 would not apply to the taxation of FMB. Accordingly, no change was made to the regulatory language adopted by the Board.

- E. The proposed regulations are inconsistent with federal and state law because the exemption of wine with flavors would violate the federal Constitution's Commerce Clause and the Equal Protection guarantees of the federal and state constitutions.

Response

With respect to the Commerce Clause, the law currently taxes beer, wine and distilled spirits differently and there is no burden on interstate commerce that in any way gives rise to a Commerce Clause violation. Therefore, the addition of regulations to clarify existing statutory classifications of "beer" and "distilled spirits" for tax purposes under the current definitions would not now cause a violation of the Commerce Clause. (See *Complete Auto Transit, Inc. v. Brady* (1977) 430 U.S. 274). Interstate and intrastate transactions involving beer, wine and distilled spirits would all be treated the same under the regulations, within the parameters of each product's statutory definition. If an alcoholic beverage does not meet the definition of "wine" because, for example, distilled alcohol is added in a manner inconsistent with the requirements of Business and Professions Code section 23007, then the alcoholic beverage would be subject to the same presumption as FMB.

With respect to the Equal Protection argument, the classification distinction would survive the required rational relationship test. (See, e.g., *Fitzgerald v. Racing Association of Iowa* (2003) 539 U.S. 103). The Legislature has differentiated between beer, wine and distilled spirits in statutory definitions and provided different tax rates for each. There are certainly rational reasons for the differing definitions and tax rates. Further clarification of the definitions of "beer" and "distilled spirits" for effective tax classification under existing statutes for purposes of addressing a product that does not fit neatly into either category would not fail the rational relationship test.

Accordingly, no change was made to the regulatory language adopted by the Board.

- F. The proposed regulations are inconsistent with beverage labeling law.

Response

How a product is labeled is not impacted by the adopted regulations. The regulations are adopted *solely* for purposes of taxation under the Alcoholic Beverage Tax Law. Accordingly, no change was made to the regulatory language adopted by the Board.

- G. The proposed regulations expose beer manufacturers and wholesalers to significant risks of disclosure of trade secrets concerning product formulation.

Response

The Board recognizes and fully appreciates the seriousness of confidentiality as it relates to any proprietary information the Board may receive as authorized by the regulations. Contrary to Mr. Sorini's comment, and based on the following, the Board does not agree that the regulations expose beer manufacturers and wholesalers to significant risks of disclosure of trade secrets concerning product formulation. Accordingly, no change was made to the regulatory language adopted by the Board.

The Public Records Act (PRA) (Gov. Code, § 6250 et seq.) requires the Board to provide public access to any records the Board maintains, unless the records are legally exempt from disclosure. Any person can file a PRA request. The Board is nonetheless prohibited from disclosing any information it obtains concerning the business affairs of a company under Government Code section 15619.

Government Code section 15619 provides, in pertinent part, that:

“Any member or ex-member of the State Board of Equalization, or any agent employed by it, or the Controller, or ex-Controller, or any person employed by him or her, or any person who has at any time obtained such knowledge from any of the foregoing officers or person shall not divulge or make known in any manner not provided by law, any of the following items of information concerning the business affairs of companies reporting to the board:

“(a) ... (b)

“(b) Any information, other than the assessment and the amount of taxes levied, obtained by the State Board of Equalization in accordance with law from any company other than one concerning which that information is required by law to be made public.”

Pursuant to this section, in response to a PRA request or otherwise, Board staff would not, absent a final court order, disclose any confidential information obtained pursuant to requirements of the adopted regulations.

Trade secrets are protected by Evidence Code section 1060, which has been incorporated as an exception from disclosure of records in the PRA. (Gov. Code, § 6254, subd. (k).) However, before withholding documents from a PRA request on the basis of “trade secrets,” the Board has the obligation to initially determine if the records are “trade secrets.” The term “trade secrets” is defined in the Uniform Trade Secrets Act. (Civ. Code, § 3426 et seq.)

Specifically, Civil Code section 3426.1, subdivision (d), provides that:

“Trade secrets means information, including a formula, pattern, compilation, program, device, method, technique, or process, that:

1. Derives independent economic value, actual or potential, from not being generally known to the public or to other persons who can obtain economic value from its disclosure or use; and
2. Is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.”

The information involving the formulas of the alcoholic beverages in question would meet this definition. Therefore, in the event the Board were to receive such information for purposes of establishing the proper tax classification of these beverages, the Board would not disclose this information and would vigorously defend against any attempt to compel disclosure through litigation or otherwise. Additionally, the Board

would give notice to the person whose information was being sought by any PRA request asking for the disclosure of confidential information.

Further, to ensure that confidential taxpayer information would not need to be disclosed during the course of the administrative appeals process, Regulation 2559.5, *Correct Classification*, was adopted to protect taxpayers who are not the manufacturers of the products subject to the presumption set forth in Regulation 2559. Regulation 2559.5 provides that a taxpayer be deemed to have correctly classified an alcoholic beverage for purposes of reporting if, at the time taxes were incurred, the alcoholic beverage was included in the Board's list published on its Internet site pursuant to Regulation 2559.3. This "safe harbor" would be an absolute defense for the taxpayer and would mean that information about product formulas or manufacturing processes would not be required at a public Board meeting.

If, however, it became necessary for the Board to review documentation in order to determine whether or not an alcoholic beverage successfully rebutted the presumption in Regulation 2559, something the Board believes would be unlikely since the presumption sets for an objective bright line, the Board has the ability under current law and under its new Rules for Tax Appeals<sup>3</sup> to conduct hearings, or portions of hearings involving confidential information, in a closed session (See Gov. Code, § 11126, subd. (f)(7)(B) & (f)(8); see also Rules for Tax Appeals 5574.)

- H. The proposed regulations are invalid because the Board fails to demonstrate that they will not have an adverse impact on California businesses.

#### Response

The Board has determined that the regulations will not have a significant adverse economic impact on private business or persons. The regulations interpret, implement, and make specific the authorizing statutes. In other words, the regulations clarify existing statutes. These regulations provide a bright line for determining which alcoholic beverages meet the definition of "beer" and which ones meet the definition of "distilled spirit" for purposes of the Alcoholic Beverage Tax Law.

The Board does not agree with Mr. Sorini that there will be an adverse impact on California businesses. Board staff prepared a Revenue Estimate that provides an excise tax revenue increase of \$38.3 million per year. This estimate contains qualifying remarks acknowledging that there are several assumptions that were made given uncertainties in the market that cannot be determined with certainty. In any case, affected California businesses will be able to recoup the economic cost of correctly classifying FMB that were previously erroneously assessed as "beer" by passing this cost on to their customers. While the passing on of this cost may have some effect on which products retail customers of legal age may purchase, Mr. Sorini has provided no persuasive evidence that the subject regulations will have a significant adverse impact on California businesses. For example, customers may purchase other alcoholic beverage products or manufacturers may provide incentives for purchasing FMB that offset any costs associated with correctly classifying FMB as distilled spirits. Moreover, many

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<sup>3</sup> The Rules for Tax Appeals were recently adopted by the Board and are awaiting approval by the Office of Administrative Law.

consumers may continue to buy FMB, even at a higher price, if any. Further, as Mr. Sorini's report suggests, manufacturers may reformulate FMB so that their products will clearly fall under the "beer" classification. In short, the Board does not agree that any significant adverse impact on California businesses would be caused by the clarification of existing statutory definitions. As explained above, the Board, with these regulations, is not changing the tax law, but instead providing needed clarification for what products meet the existing statutory definitions.

Additionally, ABC is not required to follow these regulations for purposes of licensing, so a licensee will not be required to obtain any different license to sell FMB. Also, as previously explained, the burdens on industry associated with the procedures for rebutting the presumption that any non-wine alcoholic beverage should be taxed as a distilled spirit are minimal. Finally, according to a report prepared by the Economic Consulting Services submitted and referenced by Mr. Sorini, the FMB portion of California's so-called "beer market" by volume was 2.4 percent in 2004 and 2.1 percent in 2006. Given the small size of this market segment, and in light of all the mitigating factors discussed above, correctly classifying FMB for tax purposes would not appear to have a significant impact on California businesses.

Accordingly, in the absence of any persuasive evidence of significant adverse impact on California businesses, no changes were made to the regulations adopted by the Board.

- I. Mr. Sorini enclosed the following documents and requested that they be included in the rulemaking file:
  - a. A copy of the petition for rulemaking that began these proceedings.
  - b. Transcripts of the Board's proceedings on December 12 and 13, 2006, February 22, 2007, and June 6, 2007.
  - c. The Initial Discussion Paper, dated February 9, 2007, and Second Discussion Paper, dated May 18, 2007, prepared by the Board staff for meetings with Interested Parties.
  - d. Copies of the Coalition's prior submissions to the Board, with exhibits, dated December 7, 2006, February 19, 2007, March 15, 2007, May 10, 2007, and June 20, 2007.
  - e. Copies of the submissions made by other interested parties that the Board made available to the public during the course of the informal proceedings prior to the initiation of the 45-day comment period associated with formal rulemaking.

#### Response

The documents are included as part of the rulemaking record.

#### Comment 4: Paul Kronenberg, President, Family Winemakers of California

In a letter dated November 14, 2007, written on behalf of the Family Wine Makers of California, Mr. Kronenberg wrote in opposition to the proposed regulations. In summary, Mr. Kronenberg set forth the following comments:

- A. By allowing BOE to act in clear excess of its authority, the proposed regulations introduce uncertainty and confusion into the regulatory scheme governing California's regulation of alcoholic beverages.

Response

The Board has the authority to promulgate regulations for purposes of administering the Alcoholic Beverage Tax Law. See Response to Written Comment 3.C., above. The adopted regulations clarify when an alcoholic beverage meets the definition of a "distilled spirit" or a "beer." Further, the adopted regulations, taken as a whole, and in particular the safe harbor provision of Regulation 2559.5, *Correct Classification*, provide a bright line to assist taxpayers in properly reporting and paying taxes required to be administered by the Board. The compliance burdens associated with the adopted regulations are minimal and these regulations do not impact in any manner ABC's licensing responsibilities. Accordingly, no changes were made to the regulations adopted by the Board.

- B. The proposed regulations would unduly and unnecessarily burden California's wine producers by forcing those producers to overcome, on an annual basis, the presumption that both flavored and unflavored wines are "distilled spirits."

Response

There is no annual requirement set forth in the adopted regulations. In the absence of a reformulation or evidence that the alcoholic beverage in question has not been properly classified, the sworn statement required to rebut the presumption of taxation as a distilled spirit need only be proffered one time.

The Board has excluded "wine," as defined under the Alcoholic Beverage Tax Law, from the adopted regulations because the Board recognizes that it cannot exceed its regulatory authority by seeking to clarify a statutory classification that does not appear to require any clarification. "Wine," as defined by Business and Professions Code section 23007, specifically allows for the inclusion of certain distilled components. Therefore, unlike the definition of "beer," the statutory definition of "wine" specifically provides for certain mixtures or additions of alcohol obtained from distillation. No similar clarification is required with respect to which products are within the definition of "wine."

The adopted regulations do not subject the wine industry to any undue or unnecessary burdens. If the alcoholic beverage meets the statutory definition of "wine," then the product will be taxed as a "wine." Absent any evidence to the contrary, including corroboration from ABC that a particular product does not fit neatly within the statutory definitions of "wine" or "distilled spirits," ABC's determination of a "wine" for licensing purposes will be followed for purposes of taxation.<sup>4</sup> As discussed above, the statutory definition of "wine" provides in specified instances for the inclusion of distilled alcohol. If a product does not meet the statutory definition of "wine," then the product will be subject to the adopted regulations. This is the case for any alcoholic beverage.

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<sup>4</sup> As discussed in response to Comment 7 below, with respect to FMB, ABC has corroborated the Board's understanding that FMB do not fit neatly within the definition of either "beer" or "distilled spirits."

Accordingly, no changes were made to the regulations adopted by the Board.

- C. Proving that a particular wine product (1) is a “wine” within the meaning of Business and Professions Code section 23007; or (2) is not a “distilled spirit” within the meaning of Regulation 2558 of the proposed regulations, will require California wine producers to disclose valuable trade secrets that will erode the competitive advantage California’s ultra-premium wine makers share over the competition.

Response

See Response to Written Comment 3.G., above. Accordingly, no changes were made to the regulations adopted by the Board.

- D. The proposed regulations could expose California’s smallest wine producers to retaliatory action from other states. Such action could adversely affect California’s tax base.

Response

How another state may react to the Board’s regulatory action, while important, cannot prevent the Board from exercising its exclusive power promulgate regulations to clarify the classification of alcoholic beverages for purposes of tax assessment and collection. The Legislature has already treated alcoholic products differently by providing different definitions for alcoholic beverages. The Board is within its authority (Rev. & Tax. Code, § 32451; Bus. & Prof. Code, § 23051), for tax purposes, to clarify statutory definitions, where, as discussed above, clarity is required.

Accordingly, no changes were made to the regulations adopted by the Board.

Comment 5: Mike Falasco, Director, California State Relations, Wine Institute

In a letter dated November 14, 2007, written on behalf of the Wine Institute, Mr. Falasco wrote in opposition to the proposed regulations. In summary, Mr. Falasco set forth the following comments:

- A. The Department of Alcoholic Beverage Control has the exclusive right to classify alcoholic beverages for all purposes, including purposes under the Alcoholic Beverage Tax Law.

Response

See Response to Written Comment 3.C., above. Accordingly, no changes were made to the regulations adopted by the Board.

- B. The proposed regulations conflict with the statute defining “distilled spirits.”

Response

See Response to Written Comment 3.A. and 3.B., above. Accordingly, no changes were made to the regulations adopted by the Board.

- C. The proposed regulations would cause confusion, especially among retailers, and related significant economic dislocation and harm.

Response

See Response to Written Comment 3.H., above.

With respect to retailers, there should be no confusion. Contrary to Mr. Falasco's comment that a retailer "would be confused as to whether FMBs should be merchandized as distilled spirits or beer," retailers should not be confused. The adopted regulations do not impact ABC's licensing or federal labeling laws. Retailers would retain their current licenses, which would include "beer" licenses for FMB and federal labeling would continue to be mandated under federal law. Accordingly, no changes were made to the regulations adopted by the Board.

- D. The proposed regulations are an improper response to the problem of underage drinking.

Response

The Board agrees that consumption of alcohol by underage youth is a serious problem. However, this rulemaking pertains to the correct classification of FMB for the purpose of taxation under the Alcoholic Beverage Tax Law. Accordingly, no changes were made to the regulations adopted by the Board.

Comment 6: Lara Diaz Dunbar, Vice President, Government Affairs & Public Policy, California Restaurant Association (CRA)

In a letter dated November 14, 2007, written on behalf of the CRA, Ms. Dunbar wrote in opposition to the proposed regulations. In summary, Ms. Dunbar set forth the following comments:

- A. The CRA believes that reclassification is fatally flawed and fails to present feasible, cost-effective solutions to implement the reclassification and, given California's current budget deficit, is a costly financial burden.

Response

See Response to Written Comment 3.A. and 3.H., above. Accordingly, no changes were made to the regulations adopted by the Board.

- B. Reclassifying FMBs will not reduce underage drinking.

Response

See Response to Written Comment 5.D., above. Accordingly, no changes were made to the regulations adopted by the Board.

- C. Reclassifying will give the wine industry a competitive advantage and economically hinder law-abiding foodservice businesses, especially smaller independently owned restaurants.

Response

The Board has excluded “wine,” as defined by statute, from the adopted regulations because the definition of “wine” (Bus. & Prof. Code, § 23007) specifically allows for the inclusion of certain distilled components. To the extent this provides any advantage to the wine industry, it is an advantage conferred by the California Legislature, not the Board. Ultimately, however, the wine industry is not in a different position. If a particular product does not meet the statutory definition of “wine,” then the product will be subject to the adopted regulations. This is the case for any alcoholic beverage. There is no greater or lesser burden. Accordingly, no changes were made to the regulations adopted by the Board.

With respect to the impact of the adopted regulations to retailers/restaurants, see Response to Written Comment 3.H., above. Further, no persuasive evidence exists of “smaller independently owned restaurants” being jeopardized. The adopted regulations do not impact ABC’s licensing. Retailers, regardless of their size, would retain their current licenses. Any smaller restaurant that is currently permitted to sell FMB as a “beer” for licensing purposes would not lose the ability to do so.

Accordingly, no changes were made to the regulations adopted by the Board.

- D. Reclassifying FMB would not properly classify this new segment of the beer industry.

Response

See Response to Written Comment 3.A., above. Accordingly, no changes were made to the regulations adopted by the Board.

Comment 7: Comments of the California Department of Alcoholic Beverage Control (ABC)

In a document dated November 14, 2007, ABC submitted comments. The following summarizes the comments:

- A. ABC comments that “[w]here products are clearly defined, it is appropriate for BOE to exercise their regulatory power, but not when clarification is needed from the Legislature.”

Response

The regulatory action was adopted based on the Board’s authority pursuant to Revenue and Taxation Code section 32451 to adopt regulations for purposes of the Alcoholic Beverage Tax Law. Moreover, as ABC has previously admitted to the California Court of Appeal, First Appellate District, the Board, not ABC, has the exclusive power to classify alcoholic beverage for purposes of taxation. (See Bus. & Prof. Code, § 23051; see also Exhibit 1 to ABC’s written comments, at p. 14.) Although ABC believes that legislative intervention is preferable to Board regulatory action, ABC is well aware that its preference is not mandated by law. As page 14 of Exhibit 1 to ABC’s written comments

makes clear, in a Memorandum of Points and Authorities filed in support of its Answer to Petition for Writ of Mandate (dated January 26, 2006), ABC correctly stated that: “Moreover, while the definitions of beer, wine and distilled spirits are found in the ABC Act (Bus. & Prof. Code §§ 23000 *et seq.*), and are incorporated by reference into the Revenue and Taxation Code (Rev. & Tax. Code § 32002), neither statute empowers or authorizes the ABC to direct BOE how to classify any product for taxation purposes. [footnote]” In the accompanying footnote, ABC stated: “Indeed, BOE has, in the past, simply deferred to ABC’s classification of products [citation omitted]. Such deference is not required by law, and BOE is free to tax products as it deems appropriate.”

While the Legislature, to the extent it believes the adopted regulations fail to adequately clarify the distinctions between “beer” and “distilled spirits” for tax purposes, is certainly empowered to abrogate the adopted regulations, the Legislature’s current inactivity does not prevent the Board from exercising its exclusive regulatory power in this area.

Additionally, although the Board respectfully disagrees with certain aspects of the above-discussed opinion of the Legislative Counsel of California (see Written Comment 2 and Response to Written Comment 2, above), the Legislative Counsel has opined that the State Board of Equalization may, for purposes of the Alcoholic Beverage Tax Law, interpret the terms “distilled spirits,” “beer,” and “wine” as long as it is consistent with those terms as set forth in the relevant statutes and as validly interpreted by ABC. The Board’s adoption of Regulations 2558, 2559, 2559.1, 2559.3 and 2559.5 are consistent with the relevant statutory language and are not contrary to any regulation promulgated by ABC.

Accordingly, no change was made to the regulatory language adopted by the Board.

- B. ABC comments that “[b]ecause the statutes and definitions **are** ambiguous and potentially subject to multiple and contradictory interpretations, the Department believes that the policy debate and final resolution **should be made by the Legislature**.... A clarification or contrary determination is appropriate for a Legislative resolution so as to ensure that conflicting treatments by two state agencies for a single product not happen....” (Emphasis in original.)

Response

See Response to Written Comment 7.A., above. Accordingly, no change was made to the regulatory language adopted by the Board.

- C. Contradictory and conflicting treatment and statutory interpretation such as would be caused by the Board’s regulatory action would disrupt the orderly marketing of these controlled and regulated products. Such conflicting treatment would also create confusion in the market place and confusion of the law.

Response

See Response to Written Comments 3.H., 4.A., and 6.C., above. There should be no substantial or persistent confusion on the part of taxpayers or retailers. The adopted regulations provide clear guidance for tax classification purposes. Moreover, the adopted regulations do not impact ABC’s licensing or federal labeling laws. No disruption of the

market would occur because licensees would retain their current licenses, which allow FMB to be sold as “beer,” and federal labeling would continue to be mandated under federal law.

Accordingly, no changes were made to the regulations adopted by the Board.

Comment 8: Judy Walsh-Jackson, Chair, on behalf of the California Coalition on Alcopops and Youth (Youth Coalition)

In a letter dated November 8, 2007, written on behalf of the Youth Coalition, Ms. Walsh-Jackson submitted comments in support of the Board’s regulatory action. The following summarizes the comments:

- A. The regulations are consistent with, and authorized by, state law.

Response

The Board generally agrees with the Youth Coalition’s comment. Accordingly, no changes were made to the regulations adopted by the Board.

- B. The proposed regulations provide much-needed clarity to both the Board and to taxpayers on the issue of what constitutes a distilled spirit.

Response

The Board generally agrees with the Youth Coalition’s comment. Accordingly, no changes were made to the regulations adopted by the Board.

- C. The proposed regulations are the best available alternative.

Response

The Board generally agrees with the Youth Coalition’s comment. Accordingly, no changes were made to the regulations adopted by the Board.

- D. The proposed regulations will have only minimal impact on manufacturers.

Response

The Board generally agrees with the Youth Coalition’s comment. Accordingly, no changes were made to the regulations adopted by the Board.

- E. The proposed regulations will impose only a minimal financial burden on businesses.

Response

The Board generally agrees with the Youth Coalition’s comment. Accordingly, no changes were made to the regulations adopted by the Board.

Comment 9: California Flavored Beer Coalition (CFB Coalition)

In a letter dated November 14, 2007, the CFB Coalition submitted written comments in opposition to the regulatory actions. The following summarizes the comments:

- A. The Board does not have the resources nor the expertise to effectively administer the proposed change and the change is ill timed as the state considers budget reductions.

Response

The Board is mandated to administer the Alcoholic Beverage Tax Law. The current regulatory action is therefore required to clarify which alcoholic beverages meet the definition of “beer” and which ones meet the definition of “distilled spirits.” In clarifying the taxation of FMB, the adopted regulations were drafted to promote effective and efficient tax administration with the least amount of burden on taxpayers. Moreover, budgetary constraints, to the extent they exist, do not excuse the Board from its responsibility to exercise, when needed, its exclusive authority over the classification of alcoholic beverages for tax purposes. (Bus. & Prof. Code, § 23051.) In any case, the Board has no authority with respect to California’s budget.

Accordingly, no changes were made to the regulations adopted by the Board.

- B. There will be a negative impact on the Board and 35,000 small businesses.

Response

See Response to Written Comments 3.H., 4.A., 6.C, and 7.C., above. Further, the Board is not aware of any evidence that the adopted regulations will have a negative impact on the Board. Accordingly, no changes were made to the regulations adopted by the Board.

Comment 10: Peggy Buckles

In an e-mail message dated September 28, 2007, Ms. Buckles, member of the 12<sup>th</sup> District PTA, wrote that she was “writing to ask that the Flavored Malt Beverages be taxed at the same rate as distilled spirits. These drinks are marketed to teens and this additional tax will, hopefully, make them too expensive for teens to purchase. In addition, the alcohol content is more in line with that of distilled spirits than of beer.”

Response

The Board hereby acknowledges the written comment. The Board made no changes to the regulations as a result of this comment.

Comment 11: Sep Whaley

In an e-mail message dated September 28, 2007, Sep Whaley, member of the 12<sup>th</sup> District PTA, wrote that he or she was “writing to ask that the Flavored Malt Beverages be taxed at the same rate as distilled spirits. These drinks are marketed to teens and this additional tax will, hopefully,

make them too expensive for teens to purchase. In addition, the alcohol content is more in line with that of distilled spirits than of beer.”

Response

The Board hereby acknowledges the written comment. The Board made no changes to the regulations as a result of this comment.

Comment 12: Lou Langkusch

In an e-mail message dated September 28, 2007, Mr. Langkusch, member of the 12<sup>th</sup> District PTA, wrote that he was “writing to ask that the Flavored Malt Beverages be taxed at the same rate as distilled spirits. These drinks are marketed to teens and this additional tax will, hopefully, make them too expensive for teens to purchase. In addition, the alcohol content is more in line with that of distilled spirits than of beer.”

Response

The Board hereby acknowledges the written comment. The Board made no changes to the regulations as a result of this comment.

Comment 13: Wendy Laufer

In an e-mail message dated September 28, 2007, Ms. Laufer, member of the 12<sup>th</sup> District PTA, wrote that she was “writing to ask that the Flavored Malt Beverages be taxed at the same rate as distilled spirits. These drinks are marketed to teens and this additional tax will, hopefully, make them too expensive for teens to purchase. In addition, the alcohol content is more in line with that of distilled spirits than of beer.”

Response

The Board hereby acknowledges the written comment. The Board made no changes to the regulations as a result of this comment.

Comment 14: Written Appendices to Oral Comments of Miller Brewing Company

On behalf of Miller Brewing Company, Mr. Gene Livingston submitted written appendices to the oral comments of Miller Brewing Company (Appendices). The Appendices are comprised of the following:

- (1) Full Text of Proposition 3 – Alcoholic Beverage Control (6 pages); and
- (2) 38 pages of various newspaper articles.

Response

See Response to Oral Comments, Oral Comment 2, below. As explained below, no changes were made to the regulations adopted by the Board.

Received after the 45-day comment periodComment 15: Honorable Bill Leonard, Member, Board of Equalization, Second District

After the close of the 45-day comment period, in a letter dated November 16, 2007, Board Member Bill Leonard objected to the adoption of the proposed rules. For the sake of completeness and because comments preceding the 45-day comment period are included as part of the rulemaking record, as requested by Mr. Marc E. Sorini (see Written Comment 3.I. and Response to Written Comment 3.I., above), Mr. Leonard's letter is also included in the rulemaking record at tab 24.

Comment 16: North Coastal Prevention Youth Coalition (NCP Youth Coalition)

After the close of the 45-day comment period, on November 16, 2007, the Board received 18 postcards from the NCP Youth Coalition. The postcards provide the following:

“Dear Board of Equalization: THANK YOU for your vote to correctly tax alcopops as distilled spirits. This effort by the BOE will bring \$53 million dollars more to the state, and even more importantly, it will help reduce underage drinking.”

For the sake of completeness and because comments preceding the 45-day comment period are included as part of the rulemaking record, as requested by Mr. Marc E. Sorini (see Written Comment 3.I. and Response to Written Comment 3.I., above), NCP Youth Coalition's submissions are also included in the rulemaking record.

***Oral Comments***

The following oral comments were made at the November 15, 2007, Board meeting in Sacramento, California.

*Speaking In Opposition:*Comment 1: Mr. Marc E. Sorini, representing the Flavored Malt Beverage Coalition (Coalition)

Mr. Sorini first stated that the Coalition would stand on their written submission but would like to emphasize three points. The following is a summary of the three points:

- A. First, the proposed regulations are inconsistent with the governing statutes and law.
- A flavor is a nonbeverage product under Business and Professions Code section 23112, yet the regulations say that by adding a flavor containing sufficient alcohol obtained from distillation to a beer causes the beer to transform into a distilled spirit.
  - The proposed regulations rewrite the operative language of the distilled spirits statute that speaks to a beverage product, as the regulations change the language “alcoholic beverage” to “product containing distilled alcohol.”
  - The presumption created by the regulations that all beer are distilled spirits until such time as affirmative action is taken to rebut the presumption is inconsistent with the statute.

- B. Second, the Board lacks the authority to regulate in the manner proposed.
- The sole authority to regulate rests per the California Constitution with the Department of Alcoholic Beverage Control (ABC), and the ABC agrees with that position.
  - The Board's authority is quite constrained and consists of assessing and collecting tax on account of those activities that have been regulated and defined by the ABC.
  - The Board's reason for acting is a temperance concern related to underage drinking that is within the exclusive jurisdiction of the ABC.
- C. Third, the adopted regulations create ambiguity with respect to the status of wine.
- The exemption of wine from the regulations is discriminatory treatment towards beer.
  - If the wine industry is affected, then the wine industry must be given adequate notice and opportunity to respond; if the wine industry is unaffected, this disparate treatment is arbitrary and in violation of the Commerce Clause.

### Response

See Response to Mr. Sorini's written comments, Written Comment 3, and Response to ABC's written comments, Written Comment 7, above. Additionally, the wine industry was given proper notice of this regulatory process. This is evidenced by the written submissions by several wine groups. Accordingly, the Board made no changes to the regulations as a result of these oral comments.

### Comment 2: Mr. Gene Livingston, representing the Miller Brewing Company

Mr. Livingston introduced himself as the former Director of the Office of Administrative Law (OAL), appearing on behalf of the Miller Brewing Company. The following is a summary of Mr. Livingston's comments:

- A. Mr. Livingston stated that, if he was still Director of OAL and these regulations came to him today, he would reject them for the following grounds, which were also mentioned by Mr. Sorini:
- First, the Board does not have authority to adopt the regulations in question because ABC has the exclusive authority to classify alcoholic beverages for both licensing and taxation purposes; and
  - Second, the regulations are inconsistent with the statutes they purport to implement, interpret, or make specific.

### Response

See Responses to Written Comments 3 and 7, above. Accordingly, no changes were made to the regulations adopted by the Board.

- B. Mr. Livingston concluded by urging the Board on behalf of Miller Brewing Company, and in harmony with the written comments of ABC (see Written Comment 7, above), to "drop" this

regulation and to work with the Legislature to make a change rather than to adopt a regulation for which the Board has no authority.

### Response

See Response to Written Comment 7, above. Accordingly, no changes were made to the regulations adopted by the Board.

### Speaking In Favor:

#### Comment 3: Mr. Fred Jones, on behalf of the California Council on Alcohol Problems and the Alcopops and Youth Coalition

Mr. Jones stated that the Board followed a proper rulemaking process that he described as being long, deliberative and inclusive. He further opined that the regulations meet the six criteria of proper regulatory language. Mr. Jones discussed the definition of “wine,” per Business and Professions Code section 23007, and stated that the definition allows distilled spirits to be added to wine. Mr. Jones also commented that the definition of “beer” is limited, whereas the definition of “distilled spirits,” pursuant to Business and Professions Code section 23005, is very broad in that it includes “all dilutions and mixtures thereof.”

Mr. Jones explained that Assembly Bill 417 (Aghazarian) was passed by the Legislature two years ago and vetoed by the Governor. Mr. Jones views this action by the Legislature as an admission that FMB do not fit the definition of “beer.”

Mr. Jones stated that it was unfortunate that the ABC has not acted upon the classification of FMB with respect to point-of-sale licensing issues, but that he views the Board as having the constitutional prerogative for purposes of taxation. He also observed that the Legislative Counsel opinion discussed above (see Written Comment 2 and Response to Written Comment 2) is contradicted by the Attorney General’s opinion, previously expressed to the Board, that an alcoholic beverage that contains any amount of distilled spirits is a distilled spirit under California law. He further reminded the Board that, by adopting the regulations in question, they would merely be exercising their constitutional prerogative to clarify the correct taxation of FMB.

Mr. Jones also discussed the 0.5-percent threshold of Regulation 2558 and stated his belief that this bright-line threshold will meet the Office of Administrative Law’s concerns relating to establishing clear industry standards.

### Response

The Board generally agrees with Mr. Jones’s comments. However, the Board reiterates that it does not agree with certain aspects of the referenced Legislative Counsel’s opinion (see Response to Written Comment 2, above). Accordingly, no changes were made to the regulations adopted by the Board.

Comment 4: Mr. Michael Scippa, Advocacy Director, Marin Institute

Mr. Scippa thanked the Board for their majority decision in August to tax FMB correctly. He explained that industry was currently attempting to describe the Board action as a tax increase when the action is actually correcting a taxation error. He explained that the United States is the only country where certain manufacturers utilize a tax loophole of manufacturing these products from a flavored malt base rather than using vodka as is done in other countries. Mr. Jones also commented that efforts to correctly reclassify FMB as distilled spirits are ongoing in other states, as well.

Response

The Board hereby acknowledges the oral comment. The Board made no changes to the regulations as a result of this comment.

Comment 5: Mr. Jimmy Jordan, California Friday Night Live Partnership, one of the original petitioners

Mr. Jordan stated it is the Board's responsibility to correctly tax alcopops [FMB]. He explained that he only has a high school education and he can clearly understand the language used in these regulations. He further stated that alcopops contain distilled spirits and should be taxed accordingly and expressed his belief that alcopops are a "gateway" drink for youth to other alcoholic beverage products. Lastly, Mr. Jordan acknowledged that the adopted regulations would not end the problem of underage drinking, but that these regulations would serve as an important step in addressing this problem.

Response

The Board hereby acknowledges the oral comment. The Board made no changes to the regulations as a result of this comment.

Comment 6: Ms. Katie E. Lucas, Government Relations Director, Girl Scout Councils of California

On behalf of the Girl Scout Councils of California and its approximately 300,000 members, Ms. Lucas commended the Board for doing its constitutional duty to correctly tax FMB as distilled spirits under California law and urged the Board to formally adopt the regulations.

Response

The Board hereby acknowledges the oral comment. The Board made no changes to the regulations as a result of this comment.

Comment 7: Ms. Janessa Madrid, Student

Ms. Madrid identified herself as a senior at Galt High School and commended and thanked the Board for moving forward with the regulations.

Response

The Board hereby acknowledges the oral comment. The Board made no changes to the regulations as a result of this comment.