



STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

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Executive Director

January 28, 2016

Dear Interested Party:

Enclosed is the Issue Paper regarding the proposed Cigarette and Tobacco Products Tax regulations presented at the Board's January 26, 2016 Business Taxes Committee. During the meeting, an interested party expressed concerns with proposed Regulation 4001, *Retail Stock*. To allow staff additional time to work with interested parties, the Board approved and authorized publication of proposed Regulation 4076, but held over proposed Regulation 4001 until the March 29, 2016 Business Taxes Committee meeting. Accordingly, staff would like to invite you to discuss proposed Regulation 4001 and present suggestions or comments at an interested parties meeting scheduled for:

**February 11, 2016
Room 122 at 10:00 a.m.
450 N Street, Sacramento, CA**

If you would like to participate by teleconference, call 1-888-808-6929 and enter access code 7495412. You are also welcome to submit your comments to me at the address or fax number in this letterhead or via email at Susanne.Buehler@boe.ca.gov by February 19, 2016. Copies of the materials you submit may be provided to other interested parties, therefore, ensure your comments do not contain confidential information. Please feel free to publish this information on your website or distribute it to others that may be interested in attending the meeting or presenting their comments.

If you are interested in other Business Taxes Committee topics refer to our webpage at (<http://www.boe.ca.gov/meetings/btcommittee.htm>) for copies of discussion or issue papers, minutes, a procedures manual, and calendars arranged according to subject matter and by month.

Thank you for your consideration. We look forward to your comments and suggestions. Should you have any questions, please feel free to contact our Business Taxes Committee staff member, Ms. Laurel Smith, at 1-916-322-3211, who will be leading the meeting.

Sincerely,

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

SB:map
Enclosures

cc: (all with enclosures, via email and/or hardcopy as requested)

Honorable Jerome E. Horton, Chairman, Third District
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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
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Mr. Russell Lowery, Board Member's Office, Fourth District
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Mr. Todd Gilman (MIC 70)
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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)
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Mr. Chris Lee (MIC 101)
Ms. Laureen Simpson (MIC 70)
Ms. Karina Magana (MIC 47)
Mr. Bill Benson (MIC 67)

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



BOARD OF EQUALIZATION
REVENUE ESTIMATE

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.