



STATE BOARD OF EQUALIZATION

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Executive Director

July 21, 2015

Dear Interested Party:

Enclosed is the Initial Discussion Paper on Regulation 4076, *Wholesale Cost of Tobacco Products*, and Regulation 4001, *Retail Stock*. Before the issue is presented at a 2016 Business Taxes Committee meeting (date to be determined), staff would like to invite you to discuss the issue and present any additional suggestions or comments. Accordingly, an interested parties meeting is scheduled as follows:

**August 4, 2015
Room 122 at 12:30 p.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 August 25, 2015. 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:LS

Enclosures

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

Honorable Jerome E. Horton, Chairman, Third District
Senator George Runner (Ret.), Vice Chair, First District
Honorable Fiona Ma, CPA, Member, Second District
Honorable Diane L. Harkey, Member, Fourth District
Honorable Betty T. Yee, State Controller, c/o Ms. Yvette Stowers (MIC 73)
Ms. Kari Hammond, Board Member's Office, Third District
Mr. David Hunter, Board Member's Office, Third District
Ms. Shellie Hughes, 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. Alan Giorgi, Board Member's Office, First District
Mr. Brian Wiggins, Board Member's Office, First District
Mr. Jim Kuhl, Board Member's Office, Second District
Ms. Kathryn Asprey, Board Member's Office, Second District
Mr. John Vigna, Board Member's Office, Second District
Mr. Tim Morland, Board Member's Office, Second District
Ms. Lizette Mata, Board Member's Office, Second District
Mr. Russell Lowery, Board Member's Office, Fourth District
Mr. Ted Matthies, Board Member's Office, Fourth District
Mr. Clifford Oakes, Board Member's Office, Fourth District
Ms. Lynne Kinst, Board Member's Office, Fourth District
Mr. Ramon Salazar, State Controller's Office
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Mr. David Gau (MIC 101)
Ms. Lynn Bartolo (MIC 57)
Mr. Todd Gilman (MIC 70)
Mr. Wayne Mashihara (MIC 46)
Mr. Kevin Hanks (MIC 49)
Mr. Mark Durham (MIC 67)
Mr. Robert Tucker (MIC 82)
Mr. Robert Lambert (MIC 82)
Mr. Jeff Vest (MIC 85)
Mr. Jeff Angeja (MIC 85)
Mr. David Levine (MIC 85)
Mr. Bradley Heller (MIC 82)
Mr. Lawrence Mendel (MIC 82)
Mr. John Thiella (MIC 73)
Mr. Stephen Smith (MIC 82)
Ms. Pamela Mash
Ms. Kirsten Stark (MIC 50)
Mr. Richard Parrott (MIC 57)
Ms. Debra Kalfsbeek (MIC 62)
Mr. Marc Alviso (MIC 101)

Mr. Chris Lee (MIC 101)
Ms. Laureen Simpson (MIC 70)
Ms. Karina Magana (MIC 46)
Mr. Bradley Miller (MIC 92)
Mr. Bill Benson (MIC 67)
Mr. Michael Patno (MIC 50)
Ms. Laurel Smith (MIC 57)

INITIAL DISCUSSION PAPER

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

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.

BACKGROUND

Voters of California passed Proposition 99, known as the Tobacco and Health Protection Act of 1988 (Prop. 99). Among other things, Prop. 99 imposed a surtax on the distribution of cigarettes of 12.5 mills per cigarette (\$0.25 per pack). In addition, Prop. 99 imposed a tax on the distribution of tobacco products other than cigarettes, including, for example, cigars, smoking and chewing tobacco, and snuff, (collectively referred to as “other tobacco products” or OTP) at a rate equivalent to the combined rate of tax imposed, under various provisions of the law, on cigarettes.

In 1998, California voters passed Proposition 10, known as “The Children and Families First Act” (Prop. 10). The purpose of this proposition was to create county commissions to provide early childhood medical care and education. Prop. 10 created an additional \$0.50 per pack tax on cigarettes, as well as an equivalent tax on OTP.

The tax rate on OTP is calculated on an annual basis by the Board of Equalization (BOE). This rate is applied by distributors to the “wholesale cost” of OTP to calculate the amount of excise tax due. However, the term “wholesale cost” is not defined in a regulation, causing misinterpretation and confusion. Because wholesale cost can vary based on a variety of factors, staff believes it is important to provide a definition with includable and excludable costs clearly stated.

Another area of confusion to taxpayers has been the definition of “retail stock.” This term was introduced, but not defined, in Revenue and Taxation Code (RTC) 30008(c). This has led to inconsistent interpretation of what comprises retail stock. Since retail stock must be comprised of tax paid products only, it is essential that clear guidelines are promulgated to assist sellers, specifically 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

The definition of wholesale cost is integral to the correct calculation of the amount of tax due on tobacco products under RTC section 30123(b). However, the definition provided for in RTC section 30017 of the Cigarette and Tobacco Products Tax Law, merely defines wholesale cost as:

“...the cost of tobacco products to the distributor prior to any discounts or trade allowances.”

INITIAL DISCUSSION PAPER

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

The statutory definition of wholesale cost provides little guidance as to how the wholesale cost of a tobacco product should be determined. The lack of guidance regarding whether discounts, trade allowances, certain manufacturing costs, shipping charges, and federal excise taxes should be included in the calculation of wholesale cost makes it difficult for taxpayers to accurately report amounts subject to the excise tax. This is especially true when a distributor is also the manufacturer of the product.

The calculation of wholesale cost has been the subject of litigation, exemplifying the need for regulatory clarification. Providing definitions and several examples highlighting different scenarios to illustrate how wholesale cost should be computed will help bring clarity on how to calculate the amount of tax due.

Retail Stock

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

RTC section 30008(c) refers to 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. The term retail stock was the main topic of an appeal presented to the Board during the February 2015 Board Meeting. The case presented to the Board involved cigars located in a retail store that were kept in a humidor accessible by customers. Because they were located in a retail store and accessible by customers, BOE staff presumed the cigars were part of the retail stock. Excise taxes had not been paid on the products, which led to an audit liability. At the Board hearing, the taxpayer stated that the cigars were part of his wholesale stock and had not yet been placed into retail stock; therefore, they had not been distributed as defined by RTC section 30008(c). Because there was no available statutory or regulatory definition of retail stock, the Board voted to decrease the liability owed by the taxpayer, and recommended that a regulation be created to provide specific guidance regarding what characterizes retail stock. Defining this term will be beneficial to both staff and tobacco distributors who also make retail sales.

DISCUSSION

Proposed Regulation 4076 (Exhibit 1) clarifies how tobacco product distributors will determine the wholesale cost of the tobacco products they distribute and how to determine the wholesale cost of tobacco products, including, but not limited to, situations where the reported wholesale cost is incorrect. In this situation, proposed Regulation 4076 addresses the potential need for alternate methods of calculating wholesale cost, and the methods that may be used to make these computations. Proposed Regulation 4076 also provides the factors that should be considered when determining the wholesale cost of tobacco products under various circumstances and specifies how those factors shall be incorporated.

INITIAL DISCUSSION PAPER

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

To help understand the terminology used, proposed Regulation 4076 defines four commonly used terms in the tobacco industry: “arm’s-length transaction,” “discounts or trade allowances,” “finished tobacco products,” and “finished condition.” Historically, these are the areas that have caused the most confusion in reporting. To help taxpayers compute an accurate figure for wholesale cost, the regulation provides explanations and examples of calculation methods to address various circumstances. The examples include situations where transactions were made by a manufacturer-distributor, not at arm’s-length, or when the tobacco products were acquired from a supplier outside the United States.

Regulation 4001 (Exhibit 2), clarifies what constitutes retail stock for the purpose of establishing when product has been distributed pursuant to RTC section 30008(c). Specifically, unless a distributor who makes wholesale sales as well as retail sales from the same location separately stores tobacco products not intended to be sold at retail in a clearly defined area, the product will be considered retail stock and therefore distributed. If the tobacco products are in retail stock (and therefore distributed) without evidence that excise taxes have been paid, the tobacco products may be subject to seizure and/or an audit liability.

SUMMARY

As stated above, the purpose of creating these regulations is to provide guidance to industry, staff, and other interested parties. The BOE is looking for input from interested parties to help determine if the definitions and examples provided in Regulations 4076 and 4001 are sufficient and clear.

Staff welcomes any comments, suggestions, and input from interested parties on this issue. Staff invites interested parties to participate in the August 4, 2015, interested parties meeting. The deadline for interested parties to provide written responses regarding this discussion paper is August 25, 2015.

Prepared by Special Taxes Policy and Compliance Division

Current as of July 21, 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 include 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 within the United States. Discounts and trade allowances must be added back when determining "wholesale cost."

(2) If a manufacturer 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 section (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 section (c).

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

To estimate or calculate a 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 a reasonable estimate 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.

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

(1) **Presumption.** Sales, purchases, and transfers of tobacco products are rebuttably presumed to be not 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, 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 BOE 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 BOE 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 section (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 section (c) may be used to determine the correct wholesale cost.

(4) **Example 4:** Distributor E 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.

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 by a person who holds a retailer’s license to customers; and
- (2)** All cigarettes and tobacco products intended and available for sale by a person who concurrently holds a distributor’s and a retailer’s license at the same location to customers other than licensed distributors, wholesalers, or retailers, whether or not the cigarettes and tobacco products are displayed. Except as provided in subparagraph (A), cigarettes and tobacco products that are stored in the general area where retail sales are made are deemed to be in retail stock. Cigarettes and tobacco products that are not stored in the general area where retail sales are made (e.g., in separate storage rooms or offices) are not deemed to be in retail stock.

(A) Walk-in humidors. Tobacco products inside a walk-in humidor displayed for sale to consumers are retail stock. Tobacco products, segregated and separated from retail stock, stored in a walk-in humidor for sale to licensed distributors, wholesalers, or retailers, but not displayed for sale to consumers, are wholesale stock.

(b) All cigarettes and tobacco products placed into retail stock are deemed to have been distributed.

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