



**STATE BOARD OF EQUALIZATION**

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October 9, 2015

Dear Interested Party:

Enclosed is the Second Discussion Paper on proposed Regulation 4076, *Wholesale Cost of Tobacco Products* and proposed Regulation 4001, *Retail Stock*. Before the issue is presented at the Board's January 26, 2016, Business Taxes Committee meeting, staff would like to invite you to discuss the issue and present any additional suggestions or comments. Accordingly, a second interested parties meeting is scheduled as follows:

**October 20, 2015  
Room 122 at 1:00 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](mailto:Susanne.Buehler@boe.ca.gov) by November 13, 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)  
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Mr. Bradley Miller (MIC 92)  
Mr. Bill Benson (MIC 67)

## SECOND 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.

#### **STAFF RECOMMENDATION**

Staff proposes Regulations 4076 and 4001 as provided in Exhibits 1 and 2 to clarify the definitions of “wholesale cost” and “retail stock” with regard to tobacco products.

#### **BACKGROUND**

The tax rate on “Other Tobacco Products” (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 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.

Another area that requires clarification is the definition of “retail stock.” This term was introduced, but not defined, in Revenue and Taxation Code (RTC) section 30008(c). This has led to inconsistent interpretation of what constitutes retail stock. Because 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.”

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.

## SECOND DISCUSSION PAPER

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

Proposed Regulation 4076 (Exhibit 1) provides definitions and several examples highlighting different scenarios to illustrate how wholesale cost and the amount of tax due should be computed.

#### 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 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 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. Defining this term in proposed Regulation 4001 (Exhibit 2) will be valuable to both staff and tobacco distributors who also make retail sales.

## DISCUSSION

#### Regulation 4076

This paper addresses suggestions that were raised at the August 4, 2015 interested parties meeting and in the submissions received from interested parties. Staff received a submission on August 4, 2015, from Mr. Dennis Loper on behalf of the California Distributors Association (Exhibit 3). Mr. Loper's submission suggested wording in subdivision (c) of Regulation 4076 to allow for additional methods to be used when calculating the wholesale cost. The submission also included specific language regarding the date of the OTP rate setting.

A submission was also received on August 19, 2015, from Mr. Ron Michelson representing Briar Patch (Exhibit 4). Mr. Michelson's submission discussed Regulation 4076 and included alternative language for the definition "fair market value" in regards to "wholesale cost of tobacco."

Staff revised the proposed Regulation 4076 based on input from staff, discussions at the interested parties meeting, and from the submissions received. Proposed changes to Regulation 4076 are shown in Exhibit 1. Please note the text in underline and strikethrough show the revisions since the regulation was originally proposed in the first discussion paper.

#### *Calculation Methods, Regulation 4076(c)*

This subdivision covers various ways the wholesale cost of OTP can be calculated. After reviewing the submissions, subdivision (c)(2)(E) was added to allow additional methods to be used, provided they were approved by the BOE.

#### *Rate Setting, Regulation 4076(f)*

This subdivision was added to clarify that each year the BOE will use the price of tobacco products as of March 1<sup>st</sup> of the current year to determine the OTP tax rate for the next fiscal year. This will ensure that current year tobacco product prices are used to determine the OTP tax rates.

## SECOND DISCUSSION PAPER

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

#### *Wholesale Cost with discounts, Regulation 4076(b)(1)*

The “wholesale cost” of tobacco is the cost of the tobacco paid, including federal excise taxes, but excluding freight in charges for shipments made within the United States. Trade allowances and discounts must be added back to the actual selling price when determining “wholesale cost.”

It was suggested that the BOE allow trade discounts to be exempted from the “wholesale cost” as occasionally discounts and/or free product are provided to retailers by a manufacturer or distributor. Staff did not include this suggestion in its recommendation. It was determined that allowing free and discounted product to use a discounted tax base, OTP could be sold at retail, and not have taxes paid reflect the actual value and sales price. In a situation involving free OTP, which is a 100 percent discount, no tax would be paid. Allowing a situation where no tax is paid on OTP would possibly create a loophole inviting fraud.

Allowing discounts and trade allowances to be deducted from the price indicated on the price list makes it difficult to determine the actual price paid for the products. Also, by allowing trade discounts, which can be as high as 100 percent, the special funds that benefit from the taxes will potentially receive fewer tax dollars, and potentially put small businesses who may not qualify for discounts at a competitive disadvantage.

Three examples have been added to Regulation 4076, subdivision (e) to provide additional clarification in the following situations: multiple items that are packaged together as a singular promotional item, “buy one-get one free” type promotions with separately packaged products, and when an early payment discount is applied. These are listed as Example 5, 6 and 7 respectively. All three of the examples are based on current legal opinions and are in response to questions that were raised in the first interested parties meeting.

Example 5 clarifies that items which are inseparably packaged, and have a single UPC, will be taxed based on the total selling price of the package. Example 6 clarified that if one unit is purchased, a second separately packaged unit with a separate UPC is provided free of charge. In this case, the tax would be determined based on the “wholesale cost” of both products, as the product provided to the customer free of charge is discounted at 100 percent. Example 7 clarifies subdivision (a)(2) and when determining the wholesale cost, the discount for the early payment must be added to the price paid for the OTP.

#### Regulation 4001

To improve readability and clarity, staff proposes two minor changes in subdivision (a)(2), in addition to the changes discussed below. The word “subdivision” replaced “subparagraph” and the word “general” before “area” was deleted. These changes are shown in strike-through and underline in Exhibit 2.

#### *Additional clarification in description of “non-retail stock”*

Staff added language to Regulation 4001, subdivisions (a)(2) and (a)(2)(A) to clarify when OTP is considered “non-retail stock.” Staff believes to qualify as “non-retail stock,” OTP must be in the original manufacturer packaging with an unbroken seal, and must be segregated and separated from “retail stock” inventory. This language provides clear guidance and should help avoid confusion in determining if an item is “retail stock” or “non-retail stock.”

## SECOND DISCUSSION PAPER

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

Subdivision (a)(2)(B) was also added to allow a placeholder for examples of how retail stock and non-retail stock can be separated and segregated. Staff is looking for guidance from interested parties to provide examples of how they separate and segregate inventory. Examples could be defined storage areas in a warehouse; clearly labeled separate shelving in a humidor, or separate rooms. This subsection will also contain examples of when an item becomes “retail stock”; examples would include being on display for sale to retail customers, being comingled with retail stock, and when the product is no longer in the original manufacturer packaging.

#### *Tobacco products no longer in the distributor’s possession*

Staff received a submission from Mr. James Dumler on behalf of McClellan Davis, LLC (Exhibit 5). This submission was regarding Regulation 4001, and included proposed alternative language to change subdivision (c) of the regulation to be a rebuttable presumption. Staff did not include this suggestion in its recommendation.

The revised subdivision (c) was mirrored after Regulation 4066, *Stolen Indicia*, which pertains to the application of excise taxes on cigarettes that are “lost through theft or mysterious disappearance.” Regulation 4066 has successfully assisted taxpayers in interpreting RTC section 30109 for over 20 years. At the time Regulation 4066 was adopted, there were no excise taxes on OTP products. Consequently, OTP was not incorporated at that time. However, staff believes the same provisions should apply to OTP and proposes they be provided in proposed Regulation 4001.

Currently the interpretation of RTC section 30109 allows taxpayers to receive a credit in situations such as a store flooding, where the taxpayer can provide sufficient evidence to the BOE that product was destroyed and unsalable. Unfortunately due to the amount of fraud in the industry, some unscrupulous business owners claim product was stolen to avoid paying taxes on the products. This is one of the reasons why the tax is due at the moment product is distributed. If acceptable evidence cannot be provided as to why product is missing or no longer in the possession of a retailer, it is considered distributed and the tax is due.

Proposed Regulation 4001, subdivision (c) allows taxpayers the ability to receive a refund of tax paid on product that has an explainable and documented disappearance such as a fire or flood; however, it does not allow for a refund for reasons that cannot be explained or supported with sufficient documentation. The Investigations Division has frequently dealt with business owners who claim that their untaxed product was stolen but later discovered the product was actually hidden from the investigators or had been distributed.

#### **SUMMARY**

As stated above, the purpose of developing 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 proposed Regulations 4076 and 4001 are sufficient and clear.

## **SECOND DISCUSSION PAPER**

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

Staff welcomes any comments, suggestions, and input from interested parties on this issue. Staff invites interested parties to participate in the October 20, 2015, interested parties meeting. The deadline for interested parties to provide written responses regarding this discussion paper is November 13, 2015.

Prepared by Special Taxes Policy and Compliance Division

Current as of October 9, 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 [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](#)~~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 [subdivision](#)~~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 an ~~an reasonable~~-estimate based on best available information of the distributor's or a similarly situated distributor's profit.

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

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

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

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

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

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

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

(1) **Presumption.** Sales, purchases, and transfers of tobacco products are rebuttably presumed to not be ~~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, 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 ~~BOE~~-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 ~~BOE-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~~~~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, 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 would be 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. As one unit is being provided for free, tax would apply to the wholesale cost of each separate unit as calculated by a method discussed in subdivision (c).

(7) Example 7: Distributor H receives a 3% discount for paying their supplier within 10 days of receipt of their items. To calculate the wholesale cost, Distributor H must add the 3% discount to the price paid for the products.

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

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 subdivision 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 are not deemed to be in retail stock only if they are segregated and separated from retail inventory, in the original manufacturer’s container with an unbroken seal, and 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; in the original manufacturer’s packaging with an unbroken seal, 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~~ non-retail stock.

(B) Examples of retail and non-retail 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.



Suggested change to drafted regulations 4001 and 4076 dated July 21, 2015:

First, the alternative methods for determining wholesale cost in Regulation 4076(c) should not be exclusive. It is conceivable that in a given case, these methods would not work and a different method would better fit the facts and circumstances. This could be achieved by adding the word “non-exclusive” in subdivision (c) as follows: “To estimate or calculate a wholesale cost, the following non-exclusive resources or methods may be used.” Or a subsection (2)(E) could be added to Regulation 4076(c), stating “Any other reasonable method.”

Second, the pending proposal makes this an appropriate time to confirm the meaning of “the wholesale cost of tobacco products as of March 1” that is referred to in Rev. & Tax. Code § 30131.5. In particular, the annual determination required of the State Board of Equalization pursuant to subdivision (b) of Section 30131.2 shall be made based on the wholesale cost of cigarettes or other tobacco products (as appropriate) as of March 1 of *the current calendar year*. This clarification could be included as subsection (f) of Regulation 4076, or it could be established as a new regulation.

**Second Discussion Paper**  
**Submission from R.Michelson**

**Exhibit 4**

**From:** Ron Michelson [<mailto:ron@briarpatch.biz>]  
**Sent:** Wednesday, August 19, 2015 12:48 PM  
**To:** Buehler, Susanne  
**Cc:** 'Paula Treat'  
**Subject:** Response to Meeting of Interested Parties on Regulation 4076  
**Importance:** High

Ms Buehler

I am responding to the Meeting of Interested Parties on Regulation 4076, Cost of Tobacco Products that took place August 4, 2015. I have an issue with your definition of Wholesale Cost in Section (b) (1) of Exhibit 1.

A somewhat more detailed definition of **fair market value** than printed in the discussion paper, from [businessdictionary.com](http://businessdictionary.com) is as follows:

Probable [price](#) at which a willing [buyer](#) will [buy](#) from a willing [seller](#) when (1) both are unrelated, (2) know the [relevant facts](#), (3) neither is under any compulsion to buy or [sell](#), and (4) all [rights](#) and [benefit inherent](#) in (or attributable to) the item must have been included in the [transfer](#).

In the tobacco industry it has long been standard practice of manufacturers/distributors to offer discounts, and/or free product (which results in a discount) generally to its customer base. In fact, most of the product purchased from these manufacturers/distributors are purchased at these 'discounted' prices. It is a **relevant fact** that these manufacturers/distributors will generally provide these discounts to their customers. Because of this the fair market value becomes the price paid by the customers, and not the price on the manufacturers'/distributors' published price lists.

For the same reason, if a manufacturer/distributor will sell their product only under a specific set of terms and provides a discount to its customers based on those terms the net price after the discount becomes the fair market value.

Because of the above the net price paid for tobacco products by licensed California Distributors should be the basis for computing the excise tax due the State. This includes 'terms discounts' if the only terms available to the buyers come with an associated discount.

Please let me know if you must have this response via regular mail.

Regards,

*Ron Michelson*

**Briar Patch**

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August 25, 2015

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

VIA: Email: [Susanne.Beuhler@boe.ca.gov](mailto:Susanne.Beuhler@boe.ca.gov)

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

Dear Ms. Buehler,

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

Because our firm has represented, and currently represents, numerous distributors of cigarette and tobacco products, and because nearly all of our consultants were previously Board of Equalization auditors, we feel we can provide a useful perspective on the proposed language of Regulation 4001. We have seen first-hand through our interactions with taxpayers and the audit staff that there is a need for the clarifying language being proposed and discussed through this process and we want to thank Staff for their efforts in this regard.

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

Ms. Susanne Buehler, Chief  
Proposed Regulation 4001  
August 25, 2015  
Page 2 of 3

Regulation 4001, subsection (c)

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

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

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

We feel, at a minimum, that a rebuttable presumption should be established within the proposed regulation to allow taxpayers the opportunity to provide evidence to demonstrate that a theft of inventory or other explainable disappearance has occurred. Examples of evidence rebutting the presumption could include, but may not be limited to, the following: police reports, insurance claims, and/or surveillance video. Under circumstances in which a taxpayer can support a reduction in inventory for theft or other *explainable* disappearance, the inventory should not be treated as having been distributed, because it hasn't actually been distributed.

Revenue and Taxation Code section 30109, currently affords taxpayers the opportunity to establish evidence to the contrary to overcome the presumption of distribution<sup>2</sup>:

*Code section 30109- Unless the contrary is established, it shall be presumed that all cigarettes or tobacco products acquired by a distributor...have been distributed. (emphasis added)*

The underlined portion of the forgoing statute establishes that the presumption is rebuttable, and based on a plain reading of this Code section, tobacco products would not be considered to have been distributed if it could be demonstrated by a preponderance of the evidence that a theft or some other explainable disappearance had occurred.

The proposed language of Regulation 4001, subdivision (c), does not currently afford taxpayers with the same rebuttable presumption as provided under Code section 30109. This

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

Ms. Susanne Buehler, Chief  
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inconsistency effectively, and impermissibly, narrows the scope of Code section 30109 and could lead to confusion in the application and administration of the law.

Therefore, we request that the phrase “Unless the contrary is established...” be added to the beginning of subdivision (c), so taxpayers will be provided with the opportunity to establish, if appropriate under the circumstances, that the subject tobacco products were not actually distributed. We also request that “...or lost through theft or unexplainable disappearance...” be deleted from the proposed language. The addition of the rebuttable presumption and the deletion of the forgoing language will provide for a more uniform, consistent description of the law.

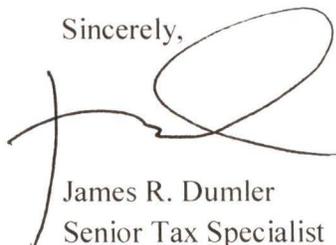
Subdivision (c), as suggested herein, would then read as follows:

*(c) Unless the contrary is established, tobacco products no longer in a distributor’s possession are deemed to have been distributed.*

The addition of language addressing theft of inventory and examples of evidence rebutting the presumption may be useful as well and we offer that option up for further discussion.

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

Sincerely,



James R. Dumler  
Senior Tax Specialist

JD: jwm