

Issue Paper Number **Regulations 4076 and 4077**CALIFORNIA DEPARTMENT OF
TAX AND FEE ADMINISTRATION
KEY AGENCY ISSUE

Regulation 4076, Wholesale Cost of Tobacco Products
Proposed Regulation 4077, Tobacco Product Manufacturer**I. Issue**

Whether the California Department of Tax and Fee Administration¹ (CDTFA), formerly known as the Board of Equalization, should approve the proposed revisions to Regulation 4076, *Wholesale Cost of Tobacco Products*, and proposed Regulation 4077, *Tobacco Product Manufacturer*, to interpret and clarify the changes made to the Cigarette and Tobacco Products Tax Law (CTPTL) due to the passage of Proposition 56, *California Healthcare, Research and Prevention Tobacco Tax Act of 2016* (Prop 56).

II. Staff Recommendation

Staff proposes revisions to Regulation 4076 and proposes a new Regulation 4077 as provided in Exhibits 2 and 3, respectively. Staff's proposed revisions and new regulation:

- Clarify terms used in the definition of Other Tobacco Products (OTP), including electronic cigarettes which were added to the definition of OTP effective April 1, 2017.
- Include examples to assist taxpayers in their understanding of the CTPTL and the effect Prop 56 had on them.

III. Other Alternative(s) Considered

Do not approve proposed amendments to Regulation 4076 or proposed Regulation 4077.

¹ Assembly Bill 102 (Stats. 2017, ch. 16) established the California Department of Tax and Fee Administration to perform the various duties, powers, and responsibilities of the State Board of Equalization relating to the administration of various taxes and fees except for those duties, powers, and responsibilities imposed or conferred upon the Board by the California Constitution. Pursuant to Government Code (GC) section 15570.24, whenever any reference to the Board appears in any statute, regulation, or contract, or in any other code, with respect to any of the functions transferred to the CDTFA pursuant to GC section 15570.22, it shall be deemed to refer to the CDTFA. For purposes of this paper, statutory references to the Board have been changed to CDTFA.

IV. Background

In November 1988, California voters passed Proposition 99, known as the “Tobacco Tax and Health Protection Act of 1988” (Prop 99). Among other things, Prop 99 imposed a surtax on every distributor (as defined in Revenue and Taxation Code (RTC) section 30011) of cigarettes at the rate of 12.5 mills (\$0.0125) per cigarette or \$0.25 per pack (\$0.0125 x 20 cigarettes) distributed. Prop 99 also imposed a tax on every distribution of tobacco products (as defined in RTC section 30121(b)) other than cigarettes (collectively referred to as “other tobacco products” or “OTP”). OTP includes, for example, cigars, smoking and chewing tobacco, and snuff, and the tax on OTP is imposed at a rate equivalent to the combined rate of the tax imposed on cigarettes, under various provisions of the CTPTL. Prop 99’s surtax on the distribution of cigarettes and the equivalent tax on the distribution of OTP are both codified in RTC section 30123, and they apply to the “distribution” (as defined in RTC section 30008) of cigarettes or OTP.

In 1998, California voters passed Proposition 10, known as “The California Children and Families First Act” (Prop 10). The purpose of Prop 10 was to create county commissions to provide early childhood medical care and education. Prop 10 imposed an additional tax on every distribution of cigarettes at the rate of 25 mills (\$0.025) per cigarette or \$0.50 per pack, as well as an equivalent tax on every distribution of OTP (as defined in RTC section 30131.1 (b), which is identical to RTC section 30121(b)). Prop 10’s tax on the distribution of cigarettes and equivalent tax on the distribution of OTP are both codified in RTC section 30131.2.

The CDTFA is responsible for enforcing the CTPTL, including the taxes imposed on distributors of OTP under RTC sections 30123 and 30131.2. Pursuant to RTC sections 30123, 30126, 30131.2, and 30131.5, the CDTFA is required to calculate the combined tax rate on OTP on an annual basis. The calculation is based on the wholesale cost of tobacco products as of March 1, and the rate determined by the CDTFA is effective during the state’s next fiscal year, which begins on July 1. This combined rate is applied by distributors to the “wholesale cost” of distributed OTP to calculate the amount of excise tax due, and the resulting tax is then required to be reported and paid to the CDTFA under chapter 4 of the CTPTL. RTC section 30017 defines “wholesale cost” as “the cost of tobacco products to the distributor prior to any discounts or trade allowances.”

In 2016, Regulation 4076 was adopted to clarify the meaning of the phrase “wholesale cost.” “Wholesale cost” means the cost of OTP to the distributor prior to any discounts or trade allowances. Regulation 4076 currently provides that if a manufacturer is also the distributor, the wholesale cost of OTP includes all manufacturing costs, the cost of raw materials (including waste materials not incorporated into the finished product), the cost of labor, any direct and indirect overhead costs, and any federal excise and/or U.S. Customs taxes paid. Wholesale cost does not include domestic freight or transportation charges for shipment of a finished product. In most cases, the wholesale cost will be the invoiced price of OTP charged to a distributor without any allowance for discounts.

Cigarettes

Cigarettes are subject to both the cigarette tax and the cigarette and tobacco products surtax, collectively referred to as taxes. The taxes are assessed on each cigarette distributed in California. Distributors are required to purchase and affix a tax stamp to each pack of cigarettes before distribution. Prior to April 1, 2017, distributors were allowed a purchase discount of 0.85% of the total tax value per purchase order to help offset the cost of affixing cigarette tax stamps. Distributors pass the cost of the excise taxes on to their customer in the form of higher prices, and the taxes become part of the retail selling price of the cigarettes.

Tobacco Products

Prior to April 1, 2017, OTP included, but was not limited to, all forms of cigars (except “little cigars”), smoking tobacco (including shisha), chewing tobacco and snuff, and any other articles or products made of or containing at least 50 percent tobacco. Tobacco products do not include cigarettes. The OTP tax, which is a component of the cigarette and tobacco products surtax, is paid by OTP distributors.

Proposition 56 (California Healthcare, Research and Prevention Tobacco Tax Act of 2016)

On November 8, 2016, California voters passed Prop 56, which went into effect on April 1, 2017. By doing so, the California electorate approved, among other things, the following:

- Amending RTC section 30121 to change the definition of tobacco products. (See Exhibit 11).
- Increasing the cigarette tax by \$2.00 per pack and raising it from \$0.87 per pack to \$2.87 per pack.
- Establishing a cap on the amount of the distributor's purchase discount of 0.85% to the first \$1.00 of the denominated value of each cigarette tax stamp.
- Establishing a floor stock tax on every cigarette dealer and wholesaler based on the inventory of cigarettes in their possession or under their control.
- Establishing a cigarette indicia adjustment tax on cigarette distributors based on their inventory of California cigarette tax stamps in their possession or under their control, whether they are affixed to any package of cigarettes or not.

The current OTP tax rate became effective July 1, 2017, and will remain in effect for the 2017-18 fiscal year. It is based on the wholesale premium brand cigarette price as of March 1, 2017, as published by the Tobacco Merchants Association, and was set at 65.08% during the April 2017 Board Meeting. This rate is significantly higher than the fiscal year 2016-17 rate of 27.30% due to the passage of Prop 56.

V. Discussion of Proposition 56 and its effects on Other Tobacco Products

The passage of Prop 56 impacted the taxes on cigarettes and OTP. Since Prop 56 did not change the CPTPL's definition of cigarettes and staff did not receive comments regarding Prop 56's impact on cigarettes, staff determined that it is not necessary to further clarify the proposition's impact on cigarettes at this time. Instead, staff determined that it was necessary to further clarify the statutory definitions of OTP and electronic cigarettes, which include liquid nicotine products, as Prop 56 changed the definition of OTP and included electronic cigarettes in the definition of OTP for the first time.

Other Tobacco Products Redefined

RTC section 30121(b), which defines tobacco products, was amended to the following with an effective date of April 1, 2017:

“Tobacco products” includes, but is not limited to, a product containing, made, or derived from tobacco or nicotine that is intended for human consumption, whether smoked, heated, chewed, absorbed, dissolved, inhaled, snorted, sniffed, or ingested by any other means, including, but not limited to, cigars, little cigars, chewing tobacco, pipe tobacco, or snuff, but does not include cigarettes. Tobacco products shall also include electronic cigarettes. Tobacco products shall not include any product approved by the United States Food and Drug Administration for sale as a tobacco cessation product or for other therapeutic purposes where that product is marketed and sold solely for such approved use. Tobacco products does not include any food products as that term is defined pursuant to Section 6359.

Subdivision (c), which defines electronic cigarettes, was added to RTC section 30121 effective April 1, 2017, to provide the following:

“Electronic cigarettes” means any device or delivery system sold in combination with nicotine which can be used to deliver to a person nicotine in aerosolized or vaporized form, including, but not limited to, an e-cigarette, e-cigar, e-pipe, vape pen, or e-hookah. Electronic cigarettes include any component, part, or accessory of such a device that is used during the operation of the device when sold in combination with any liquid or substance containing nicotine. Electronic cigarettes also include any liquid or substance containing nicotine, whether sold separately or in

combination with any device that could be used to deliver to a person nicotine in aerosolized or vaporized form. Electronic cigarettes do not include any device not sold in combination with any liquid or substance containing nicotine, or any battery, battery charger, carrying case, or other accessory not used in the operation of the device if sold separately.

Staff’s proposed regulatory language to define “tobacco products” and “electronic cigarettes” is intended to concisely implement, interpret, and make specific the statutory definitions previously noted, so it does not duplicate the statutory definitions in every respect. (See Exhibit 2). Dr. Michael Ong, on behalf of the Tobacco Education and Research Oversight Committee, indicated that the regulatory definitions for the two terms were too abbreviated and fell “short of the original intent of Proposition 56” and Dr. Ong suggested alternative definitions for these terms. (See Exhibit 9). Therefore, in response to Mr. Ong’s suggestions, staff revised the regulatory definition of electronic cigarettes to clarify that electronic cigarettes include any liquids (“e-juice” or “e-liquid”) or substances that contain nicotine, “regardless of whether they are sold in combination with any device, delivery system, or any component, part, or accessory of such a device or delivery system,” to ensure consistency between the statutory and regulatory definitions and avoid any potential confusion. However, staff does not believe that further changes are needed to respond to Mr. Ong’s suggestions because the current regulatory definitions proposed by staff are consistent with RTC section 30121 as amended by Prop 56.

Definition of Sold in Combination With

As noted above, RTC section 30121(c) provides that a device or delivery system that can be used to deliver nicotine in aerosol or vapor form to a person and any component, part, or accessory of such a device or delivery system sold in combination with any liquid or substance containing nicotine is an electronic cigarette. Staff has determined that the phrase sold in combination with does not refer to “every” item that is merely sold “with” a liquid or substance containing nicotine in the same transaction based upon the wording of RTC section 30121(c), industry practice, and how the tobacco products tax is imposed. Staff is proposing regulatory changes to define sold in combination with in order to help taxpayers determine when items, other than a liquid or substance containing nicotine, that are sold in the same transaction as a liquid or substance containing nicotine are and are not electronic cigarettes for tobacco tax purposes.

Staff visited manufacturer websites and noted that vaping devices are commonly sold in combination with related products, including liquids and substances containing nicotine, as part of starter kits or all-in-one kits. These kits can also be customized to the individual preference of the consumer. In a typical starter kit, the manufacturers allow customers to select accessories, flavoring and nicotine content. The products selected are all together in a single box or other type of storage container and sealed by the manufacturer listing the contents as well as the manufacturer’s logos, pictures and advertisement language on the packaging. Therefore, staff determined that when a device or delivery system that can be used to deliver nicotine in aerosol or vapor form to a person and any component, part, or accessory of such a device or delivery system is sold with any liquid or substance containing nicotine in their original manufacturer packaging as one unit, then the items are sold in combination with the liquid or substance containing nicotine and the entire unit is an electronic cigarette for purposes of section 30121(c).

If a consumer orders a manufacturer’s sealed all-in-one kit with a nicotine percentage greater than zero, then those kits would fall under the definition of an electronic cigarette, as the items in those kits are sold in combination with nicotine. Conversely, if consumers purchase the same kits in the original manufacturer’s packaging but choose a zero nicotine content, then those all-in-one sealed kits would not be considered an electronic cigarette and therefore, not subject to the OTP tax. Since distributors are responsible for paying the OTP tax, distributors of starter kits and all-in-one kits sealed by manufacturers should maintain documentation to show which kits have a nicotine percentage greater than zero and are subject to the OTP tax when distributed.

Additionally, staff noted that manufacturers may also sell the same items included in starter kits and all-in-one kits individually, such as vaping devices, components, accessories, and liquids or substances containing nicotine. Staff determined that if a distributor sells all those individual items in the same transaction, and separately states the price for each item, including any liquids or substances containing nicotine, then the items

are not sold in combination with each other for purposes of RTC section 30121(c), and only the liquids or substances containing nicotine would be an electronic cigarette subject to the OTP tax. The other items would not be subject to the OTP tax because they were not packaged with the liquid or substance containing nicotine by the manufacturer for distribution as a unit and were not sold by the distributor with a liquid or substance containing nicotine for a single price. For example, items are sold for a separate price where an internet retailer's website allows the customer to place each item ordered into a customer's "cart" and a separate selling price by product is provided. Distributors that combine and sell the items included in starter kits and all-in-one kits together in the same transactions will need to maintain proper documentation to demonstrate when the items are sold for a single price or separate price.

In addition, the tobacco products tax applies to the distribution of untaxed OTP by distributors, including manufacturers and retailers that are also distributors. However, the tobacco products tax does not apply to the retail sale of tax-paid OTP by retailers. Therefore, staff determined that items are only sold in combination with a liquid or substance containing nicotine if they are packaged together as a unit by the manufacturer or sold as a unit for a single price at any time before or when the liquid or substance containing nicotine is distributed by the distributor. So, when a retailer separately purchases tax-paid liquid or substances containing nicotine and the retailer either packages the tax-paid liquid or substances containing nicotine with other items for retail sale or makes retail sales of the liquid or substance containing nicotine with other items for a single price, it does not change the distributor's tobacco products tax or make the other items into electronic cigarettes.

Staff revised the definition of sold in combination with for the second interested parties meeting held in June and further revised it after the June meeting to provide as follows:

A device or delivery system that can be used to deliver nicotine in aerosol or vapor form to a person and any component, part, or accessory of such a device or delivery system is "sold in combination with" a liquid or substance containing nicotine when any of the items are sold with any liquid or substance containing nicotine in their original manufacturer packaging as one unit or sold for a single price before or when the liquid or substance containing nicotine is distributed.

McClellan Davis, LLC on behalf of the California Smoke Free Organization (CSFO) submitted language that added a sentence to staff's prior draft of the definition indicating that if products were packaged by a retailer and sold for single price to consumers, the products will not be considered to have been sold in combination with. Staff generally agreed with the comment and has revised its definition accordingly. In addition, staff believes the current definition of sold in combination with addresses an earlier concern that interested parties had expressed that retailers who put together their own all-in-one promotional sets could be considered by the CDTFA to be "de facto" distributors. Further, examples on this issue were added to the regulation to provide added clarity to the definitions proposed. Examples 5 and 6 were proposed for subdivision (f) of Regulation 4076 to further clarify the phrase sold in combination with as it applies to retailers and distributors, respectively.

Example 5 addresses the specific concerns CSFO and Californians for Tobacco Harm Reduction (CATHR) had regarding retailers being considered a "de facto distributor" if they were audited. Staff concurred that typical retailers should not be identified as a distributor by CDTFA auditors if they packaged separately purchased products for promotional reasons. The example demonstrates that a business that is registered as a retailer only and acquiring all of its OTP tax-paid, prior to repackaging it into promotional all-in-one kits with other items, is not converting the kits into electronic cigarettes, and the retailer's retail sales of the kits is not subject to the tobacco products tax. Staff believes this also addresses CSFO's and CATHR's concerns during the interested parties process regarding records needed to prove OTP tax was paid because a retailer would only need to maintain the records they currently do in the regular course of their operations.

CSFO submitted additional language for Example 5 regarding the products a retailer could put together for sale. (See Exhibit 10). They believe "clarifying language regarding the exclusion from tax, notwithstanding a single price sale, is necessary for the industry and audit staff. Otherwise, a single price sale of tax-paid juice and *untaxed* accessories may be considered to be a taxable distribution of OTP, i.e., the sale of untaxed tobacco

products, with tax due on the untaxed accessories.” Staff incorporated the suggestion as it does not change the meaning of the example and staff believes the additional clarification will address CSFO’s concerns.

Example 6 explains a typical bundling scenario. In the scenario presented, if ten cartridges of e-juice containing nicotine were purchased, the buyer is given their choice of an accessory. If the accessory is not packaged together with the cartridges in the manufacturer’s original packaging and the price of the accessory is also separately stated on an invoice or buyer’s “cart” when purchased via the Internet, the free accessories will not be considered sold in combination with a nicotine product.

Proposed Regulation 4077

A question raised during the interested parties process was for clarification regarding the term “manufacturer.” With the passage of Prop 56 and the effect it had on the definition of tobacco products, questions posed involved who should be regarded as a manufacturer, specifically in regards to the electronic cigarette industry. Staff is proposing a new regulation primarily for the sector of the industry that mixes liquid nicotine with flavoring to customize e-juice for personal consumption.

Staff looked at federal law for guidance as to what constitutes manufacturing of electronic cigarettes. Specifically, staff looked at the regulation adopted by the United States Food and Drug Administration (FDA) to define tobacco product manufacturer.² Staff drafted language for proposed Regulation 4077 to define tobacco product manufacturer in accordance with the FDA’s definition. (See Exhibit 3). So, subdivision (a) of proposed Regulation 4077 now clarifies that a tobacco product manufacturer is any person, including any repacker or relabeler, who manufactures, fabricates, assembles, processes, or labels a finished tobacco product. The newly proposed regulation was discussed at the June interested parties meeting.

At our June meeting, staff was informed by the electronic cigarette industry that when the owner of a brand or formula for a type of e-juice manufactures its e-juice, the owner will sometimes contract with a third party to perform services on its behalf, such as mixing the e-juice based on the formula that the owner provides, packaging the e-juice, and labeling the packaged e-juice. In some instances, the owner will directly provide bottles for the third party to fill with e-juice. In other situations, the owner will contract with the third party to provide bottles, or packaging and labeling services, or both. Also, staff was informed that the industry refers to the owner of a brand or formula for a type of e-juice as a manufacturer regardless of whether the owner directly performs all of the services related to the manufacture of its e-juice or contracts with a third party to perform services related to the manufacture of its e-juice on the owner’s behalf. Some interested parties raised an issue about whether the general definition of tobacco product manufacturer clearly classifies the owner of a brand or formula for e-juice who contracts with a third party to perform services related to the manufacture of its e-juice as a manufacturer. And, some interested parties provided suggested language to clarify that such an owner is included in the definition of tobacco product manufacturer, consistent with the industry’s practice. (See Exhibits 4 – 7). Staff agreed with the interested parties that the owner of a brand or formula for a tobacco product who contracts with another person to physically complete the fabrication and assembly of the product to the brand or formula owner’s standard is a manufacturer and proposed adding the following additional sentence to Regulation 4077, subdivision (a), to address the issue raised by the interested parties:

The term tobacco product manufacturer includes an owner of a brand or formula for a tobacco product who contracts with another person to physically complete the fabrication and assembly of the product to the brand or formula owner’s standard.

Subdivision (b) of proposed Regulation 4077, applies more specifically to retailers of liquid nicotine. It provides that if such a retailer mixes, prepares, or combines liquid nicotine with other components of tobacco products, that retailer is also an OTP manufacturer. A person who both manufactures OTP and makes retail sales of OTP to consumers is a distributor,³ and must also register with the CDTFA as a tobacco products distributor.⁴ The distributor would report tax on the wholesale cost of the OTP it distributes as set forth in

² 21 Code of Federal Regulations part 387(20)(A).

³ RTC sections 30008 and 30011.

⁴ RTC sections 30140 and 30151.

subdivision (b)(2) of Regulation 4076, which explains what is included in wholesale cost when a person is both a manufacturer and a distributor.

Also, subdivision (b) of proposed Regulation 4077 explains that a retailer is not engaged in manufacturing solely because the retailer packages liquid nicotine with other items as one unit for retail sale or the retailer sells liquid nicotine to consumers and then allows the consumer to mix the liquid nicotine with other components of a tobacco product following the sale. And, subdivision (b) explains that a retailer who is not a licensed manufacturer or distributor, must purchase its liquid nicotine products from a licensed OTP distributor or wholesaler. This is because such a retailer would become a distributor by buying untaxed OTP, the retailer would commit a misdemeanor if the retailer engaged in business as a distributor without first obtaining a distributor's license,⁵ the excise tax, and applicable penalties and interest, on its distribution of the untaxed OTP would be immediately due and payable, and the tax, interest, and penalties would be subject to being immediately assessed and collected by seizure and sale of the OTP.⁶

Businesses that are Both a Manufacturer and Distributor

Staff provided a revised draft version of the proposed amendments for Regulation 4076 to interested parties in August. The draft had revisions proposed to subdivision (b)(2), which primarily clarified what are considered manufacturing costs. Also included was a sentence that states an importer or manufacturer of OTP that is also licensed with CDTFA as a distributor may look to subdivision (c) for alternative ways to determine the wholesale cost of OTP. In their submission, CATHR cited inconsistent information being provided by CDTFA staff regarding documentation required to support an "arm's length transaction" when determining the wholesale cost of OTP when the manufacturer and distributor are one in the same. (See Exhibit 8). Staff agreed that this issue was important. In addition, staff thought the idea of how a manufacturer should account for all movement of their OTP including sales made in a capacity other than that of a manufacturer should also be addressed. However, it was decided that this issue should be addressed after the rulemaking process was completed for the current regulations.

Refunds and Credits for OTP Shipped Out of State

In their August submission, CSFO brought up the issue of whether a distributor may obtain a refund when it purchases tax-paid OTP from another distributor and then ships the OTP out of state prior to consumption. CSFO bases its interpretation on CTPTL section 30176.1 and believes Regulation 4063.5, *Exported tax-paid tobacco products*, should be amended to clarify the circumstances under which a refund or credit may and may not be obtained. Staff believes this issue is outside the scope of this regulation process.

VI. Staff Recommendation

A. Description of Staff Recommendation

Staff proposes revisions to Regulation 4076 and proposes a new Regulation 4077 as provided in Exhibits 2 and 3, respectively. Staff's proposed revisions:

- Provide clarity for terms used in the definition of OTP, including electronic cigarettes which were added to the definition of OTP on April 1, 2017.
- Include examples to assist taxpayers in their understanding of the CTPTL and the effect Prop 56 had on them.

B. Pros of Staff Recommendation

Staff's recommendation provides clarity for an industry that was not considered part of OTP prior to April 1, 2017. The examples proposed provide a real world application as they were developed with interested parties, who provided staff their opinions and some of the language used.

⁵ RTC section 30149.

⁶ RTC sections 30210, 30211, 30212.

C. Cons of Staff Recommendation

None.

D. Statutory or Regulatory Change for Staff Recommendation

No statutory change is required. However, staff’s recommendation for Regulation 4076 will require a regulatory change and proposed Regulation 4077 will need to be adopted.

E. Operational Impact of Staff Recommendation

Taxpayers will have an additional resource to educate themselves on the taxability of other tobacco products. In addition, “electronic cigarettes” are 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 Staff Recommendation

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 CDTFA’s existing budget.

2. Revenue Impact

None. See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact of Staff Recommendation

The proposed regulation will provide clarity for taxpayers for the application of tax on OTP. The additional clarity will allow taxpayers, new to the OTP laws, to file more accurately and should minimize misinterpretations of statutes.

H. Critical Time Frames of Staff Recommendation

Provided CDTFA and Government Operations approve staff’s recommendation by the end of October 2017, we anticipate the Office of Administrative Law could complete its review and approval of the regulation revisions around April of 2018.

Preparer/Reviewer Information

Prepared by: Tax Policy Bureau, Business Tax and Fee Division

Current as of: October 24, 2017

REVENUE ESTIMATE

STATE OF CALIFORNIA
Department of Tax and Fee Administration

CALIFORNIA DEPARTMENT OF
TAX AND FEE ADMINISTRATION
REVENUE ESTIMATE

**Regulation 4076, Wholesale Cost of Tobacco Products and
Proposed Regulation 4077, Tobacco Product Manufacturer**

I. Issue

Whether the California Department of Tax and Fee Administration¹ (CDTFA), formerly known as the Board of Equalization, should approve the proposed revisions to Regulation 4076, *Wholesale Cost of Tobacco Products* and proposed Regulation 4077, *Tobacco Product Manufacturer*, to interpret and clarify the changes made to the Cigarette and Tobacco Products Tax Law (CTPTL) due to the passage of Proposition 56, *California Healthcare, Research and Prevention Tobacco Tax Act of 2016* (Prop 56).

II. Alternative 1 - Staff Recommendation

Staff proposes revisions to Regulation 4076 and proposes a new Regulation 4077. Staff's proposed revisions and new regulation:

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- Include examples to assist taxpayers in their understanding of the CTPTL and the effect Prop 56 had on them.

III. Other Alternative(s) Considered

Do not approve proposed amendments to Regulation 4076 or proposed Regulation 4077.

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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.

No other alternatives are considered.

Preparation

Mr. Joe Fitz, Research and Statistics Section, Legislation and Research Bureau, prepared this revenue estimate. This estimate has been reviewed by Mr. Mark Durham, Chief, Research and Statistics Section, Legislation and Research Bureau, by Ms. Debbie Kalfsbeek, Chief, Audit and Carrier Bureau and by Ms. Trista Gonzalez, Chief, Tax Policy Bureau. For additional information, please contact Mr. Fitz at (916) 323-3802.

Current as of October 23, 2017.

§ 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) Electronic Cigarettes. “Electronic cigarettes” or “e-cigarettes” are devices or delivery systems sold in combination with nicotine that can be used to deliver the nicotine in aerosol or vapor form to a person. Electronic cigarettes include any component, part, or accessory of such a device or delivery system that is used during the operation of the device when sold in combination with any liquid or substance containing nicotine. Electronic cigarettes also include any liquids (“e-juice” or “e-liquid”) or substances that contain nicotine, regardless of whether they are sold in combination with any device, delivery system, or any component, part, or accessory of such a device or delivery system. If nicotine is not sold in combination with devices, delivery systems, components, parts, accessories, liquids, or substances, then those items are not electronic cigarettes.

(4) 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 distribution in the state.

(5) Sold in combination with. A device or delivery system that can be used to deliver nicotine in aerosol or vapor form to a person and any component, part, or accessory of such a device or delivery system is “sold in combination with” a liquid or substance containing nicotine when any of the items are sold with any liquid or substance containing nicotine in their original manufacturer packaging as one unit or sold for a single price before or when the liquid or substance containing nicotine is distributed.

(6) Tobacco Products. Effective April 1, 2017, the definition of “tobacco products” includes all products containing, made, or derived from tobacco or nicotine that are intended for human consumption, except cigarettes, any product that has been approved by the United States Food and Drug Administration for sale as a tobacco cessation product or for other therapeutic purposes where that product is marketed and sold solely for such approved use, and food products as defined in Revenue and Taxation Code section 6359. Tobacco products include, but are not limited to, cigars, little or small cigars, chewing tobacco, electronic cigarettes, pipe tobacco, and snuff.

(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 products) prior to any discounts or trade allowances, the cost of labor, ~~any direct (including freight in) and indirect overhead costs~~, any federal excise and ~~or~~ U.S. Customs taxes paid.

Manufacturing costs include all overhead expenses that are directly or indirectly attributable to the production of finished tobacco products. These costs can include, but are not limited to, production and administrative salaries, depreciation, repairs and maintenance, rent and utilities for the production facilities, and equipment. Manufacturing costs must be allocated to each product unit by a reasonable and consistent pro-rata accounting method. Manufacturing costs do not include overhead expenses that are not directly or indirectly attributable to the production of finished tobacco products. These costs can include, but are not limited to, salaries and other expenses for business activities involving selling, distribution, marketing, finance, information technology, human resources and legal activities.

Wholesale cost also includes all freight or transportation charges for shipment of materials and ~~or~~ unfinished product from ~~the a~~ supplier to ~~the a~~ 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~~4).

If a manufacturer or importer of tobacco products is also a distributor, the correct wholesale cost to be reported by the distributor may be determined using any of the methods provided in subdivision (c).

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

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

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

The following resources or methods may be used.

(1) A publicly or commercially available price list that the distributor used to determine the prices of tobacco products sold to customers in arm's-length transactions during the time period at issue, less an estimate based on best available information of the distributor's or a similarly situated distributor's profit.

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

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

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

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

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

(E) Additional methods not mentioned above, with ~~Board~~ [California Department of Tax and Fee Administration](#) 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~~ [California Department of Tax and Fee Administration](#) 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. Since B makes the cigars, B is a manufacturer in addition to a distributor. Therefore, to compute the wholesale cost of B's tobacco products, B would include the costs described in subdivision (b)(2). ~~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~~ California Department of Tax and Fee Administration 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~~two 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) In addition to the examples in subdivision (e), the following are examples of items that are and are not tobacco products effective April 1, 2017, and examples of estimating or calculating the wholesale cost of tobacco products:

(1) Example 1: Distributor K produces finished nicotine products (e.g., e-juice) intended for human consumption. Since K makes e-juice, K is considered a manufacturer in addition to a distributor. Therefore, to compute the wholesale cost of K's tobacco products, K would include the costs described in subdivision (b)(2).

(2) Example 2: Distributor L purchased two types of vaping kits. Both types of kits are sold to Distributor L as a single unit in their original manufacturer packaging and contain a personal vaping device, tank, atomizer coil, USB charger, A/C adapter and a bottle of finished flavored e-liquid. Kit #1 has 1.80 percent nicotine content in its e-liquid while Kit #2 has no nicotine in its e-liquid. Kit #1 is an electronic cigarette because Kit #1 contains a personal vaping device and related components, parts, or accessories that are sold in combination with liquid containing nicotine. When Kit #1 is distributed, Distributor L would need to report the tobacco products tax based on the wholesale cost of Kit #1 as a unit. Kit #2 is not an electronic cigarette because nicotine is not sold in combination with the items in Kit #2 and the tobacco products tax would not apply to Kit #2 because it is not a tobacco product.

(3) Example 3: Distributor M purchased 100 packages of vaping Kit #3, which the manufacturer packaging states contains the following: a personal vaping device, tank, atomizer coil, USB charger and A/C adapter. Distributor M also purchased 100 packaged bottles of finished, flavored e-liquid containing 3.20 percent nicotine. Distributor M intends to sell both packages to wholesalers and retailers and will separately charge wholesalers and retailers for packages containing Kit #3, and packages containing a bottle of the finished, flavored e-liquid containing nicotine as part of each sale of both items in the same transaction. Distributor M will need to report the tobacco products tax on the wholesale cost of the packages containing bottles of finished, flavored e-liquid containing nicotine because the nicotine is an electronic cigarette and, therefore, a tobacco product, but not on the packages of Kit #3, which are not electronic cigarettes or tobacco products, because the items in Kit #3 are not sold in combination with a liquid or substance containing nicotine.

(4) Example 4: Distributor N sells closed-system vaping devices to wholesalers and retailers. The devices are manufactured so that they contain finished, flavored nicotine product, they are immediately ready to use when purchased, and new devices cannot be sold without nicotine. The closed-system vaping devices are electronic cigarettes or e-cigarettes because they are sold in combination with a liquid or substance containing nicotine. Distributor N will need to report the tobacco products tax on the entire wholesale cost of each closed-system e-cigarette.

(5) Example 5: Retailer P purchases e-juice containing nicotine tax-paid from a licensed tobacco products distributor. Retailer P, as a promotion, will package and sell the tax-paid e-juice containing nicotine with a battery, power adapter and carrying case all for a single price. The retailer's packaged product is not an electronic cigarette for purposes of the tobacco products tax and the retailer's wholesale cost of the packaged product is not subject to the tobacco products tax because the distribution of the e-juice containing nicotine occurred prior to Retailer P's promotional sale.

(6) Example 6: Distributor Q advertises that if customers purchase ten (10) e-cigarette cartridges with a nicotine content of 1.8 percent they will receive their choice of two accessories for free that were not packaged with the cartridges in the cartridges' original manufacturer packaging as one unit. The billing invoices show the price charged for the cartridges and a separate charge of \$0 for the accessories. The tobacco products tax would apply to the wholesale cost of the cartridges only since the accessories are not packaged with the cartridges by the manufacturer as one unit and the accessories are not sold with the cartridges for a single price.

(7) Example 7: Distributor R, who also manufactures finished tobacco products, rents a facility where it manufactures and stores finished tobacco products. The facility also houses the offices for Distributor R's entire operation, including the sales and general administration offices. Distributor R pays the sum of \$10,000.00 per month in rent for the facility. Distributor R utilizes five percent of the total volume of space for manufacturing finished tobacco products. Because a portion of the rented facility is used for manufacturing purposes, Distributor R must allocate a proportionate share of its rent expense to its calculation of its manufacturing costs. In this example, Distributor R must allocate five percent of the monthly rent ($\$10,000 \times 5\% = \500) to the wholesale cost of the finished tobacco products Distributor R manufactures at the facility.

(8) Example 8: Distributor S purchases un-taxed 60 ml. containers of finished e-liquid nicotine from an out-of-state company. Distributor S places each 60 ml. container of finished e-liquid nicotine into a single package along with a vaping kit put together by Distributor S which contains a personal vaping device, tank, atomizer coil, USB charger and an AC adapter. Distributor S will distribute the e-liquid containing nicotine by selling these combined packages to other distributors, wholesalers, retailers and consumers in California for a single price. When Distributor S sells each combined package containing un-taxed e-liquid nicotine for a single price, the entire package will be an electronic cigarette, and tax will apply to the wholesale cost of the entire package.

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

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

§ 4077. Tobacco Product Manufacturer.

(a) A tobacco product manufacturer is any person, including any repacker or relabeler, who manufactures, fabricates, assembles, processes, or labels a finished tobacco product.

The term tobacco product manufacturer includes an owner of a brand or formula for a tobacco product who contracts with another person to complete the fabrication and assembly of the product to the brand or formula owner’s standard.

(b) A retailer who mixes, prepares, or combines liquid nicotine and other components of a tobacco product is a tobacco product manufacturer. A retailer is not a manufacturer solely because the retailer packages liquid nicotine with other items as one unit or allows its customers to mix, prepare, or combine liquid nicotine and other components after a sale has been made, or both. A retailer, who is not a licensed manufacturer or distributor, must purchase its nicotine products from a licensed tobacco products distributor or wholesaler.

Reference: Authority cited: Section 30451, Revenue and Taxation Code. Reference: Sections 30008, 30010, 30011, 30016, 30103, 30121, 30131.1, 30131.2, 30149, 30210, 30211 and 30212, Revenue and Taxation Code.

SV Packaging

To Whom It May Concern:

We would like to submit the following revised language [in blue] for the definition of a Manufacturer to the BOE for consideration.

§ 4077. Tobacco Product Manufacturer.

(a) A tobacco product manufacturer is any person, including any repacker and/or relabeler, who **owns the brand and formula, and/or** manufactures, fabricates, assembles, processes, or labels a finished tobacco product.

Lonnie Bozeman
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To whom it may concern at the Board of Equalization ("BOE") and State of California,

Charlie's Chalk Dust ("Charlie's") is a company based in Costa Mesa, California. Charlie's owns the Trademarks ("Brands") and formulas of each of the many products which they sell. Within the Vapor Industry, Charlie's is known as a manufacturer and the company considers itself as such. However, according to the current language of Regulation 4077, Charlie's and many companies like Charlie's are not adequately represented.

The current definition under consideration as of The Meeting of Interested Parties — Prop 56 Regulation 4076, Wholesale Cost of Tobacco Products & Regulation 4077, Tobacco Product Manufacturer, held in Sacramento, California on June 6, 2017 is as follows:

§ 4077. Tobacco Product Manufacturer.

(a) A tobacco product manufacturer is any person, including any repacker and/or relabeler, who manufactures, fabricates, assembles, processes, or labels a finished tobacco product.

Charlie's urges the Board of Equalization, acting on behalf of the State of California, to expand this definition to include companies that cause said "finished tobacco products" to be manufactured according to a Brand-specific proprietary formula. Charlie's owns all Trademarks and formulas of its products and contracts various third-party service providers based around the world, including in California, to physically complete packaging, according to its own Brand standards. Therefore, we propose the following language be adopted:

§ 4077. Tobacco Product Manufacturer.

(a) A tobacco product manufacturer is any person, including any repacker, and/or relabeler, **product owner and/or product licensee**, who **causes tobacco products to be** **manufacturesd**, **fabricatesd**, **assemblesd**, **processesd**, or **labeleds** a finished tobacco product.

Respectfully submitted,

Patrick Taylor
VP Marketing - Charlie's Chalk Dust, LLC



MCCLELLAN DAVIS, LLC
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June 22, 2017

Ms. Trista Gonzalez, Chief
State Board of Equalization
Tax Policy Division (MIC 92)
450 N Street
Sacramento, CA 94279-0092

VIA: Email: Trista.gonzalez@boe.ca.gov

Re: Proposition 56 – Regulatory Rule Making

Dear Ms. Gonzalez,

Thank you for providing us with the opportunity to make this submission on behalf of the California Smoke Free Organization (CSFO). This submission is being made in response to the second discussion paper and the second interested parties meeting held on June 6, 2017.

The members of CSFO want to express their gratitude for Staff's willingness to listen to their concerns. As an organization that represents the interests of a large segment of the e-cigarette industry, the proposed regulations are vitally important to their ability to operate in compliance with the new law. The topics of discussion at the second interested parties meeting once again included the definition of "sold in combination with," whether the examples provided in the proposed regulation are consistent with the definition of "sold in combination with," and whether a distributor can obtain a refund or credit for selling tax paid products outside the state. New topics that were discussed include the definition of a Tobacco Products Manufacturer under proposed Regulation 4077, and questioned related to how a manufacturer should compute its wholesale cost if it also acts as a distributor. Each of those topics are addressed separately below.

Sold in combination with

The second discussion paper proposed the following definition for sold in combination with (SICW).

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The term “sold in combination with” refers to kits, systems, or sets that usually include atomizers, cartomizers or similar type device, component pieces, accessories, and liquids containing nicotine that are in their original manufacturing packaging as one unit or sold for a single price.

One of the primary concerns expressed with the SICW definition is that a retailer that combines tax-paid nicotine with an untaxed device, may be considered to be a distributor of the device when the two products are packaged and sold for single price. A proposal was made to modify example five (5) under Regulation 4076, subdivision (e), to clarify that the retailer sold the items in the example for “a single price,” and that notwithstanding the sale for a single price, tax did not apply. We agree that will help clarify the intent of the SICW definition. However, we believe additional clarity would be gained if the proposed definition of SICW was amended to explain that a retailer who packages devices or other items with e-juice and sells them for a single price, will not be considered a distributor. We propose the following definition for SICW which we believe will help make that clarification:

The term “sold in combination with” refers to kits, systems, or sets that usually include atomizers, cartomizers or similar type device, component pieces, accessories, and liquids containing nicotine that are in their original manufacturing packaging as one unit or sold for a single price. Products packaged by a retailer and sold for single price to consumers will not be considered to be “sold in combination with.”

Examples of sold in combination with

There was also discussion regarding the example provided under Regulation 4076, subdivision (e)(6) which describes a scenario in which products are provided for free for promotional purposes. It was explained that a distributor should make a separate charge of zero (\$0) to make it clear the items are not being SICW for a single price. We believe it would help to clarify the separate price requirement under Example 6 in the following manner:

(6) Example 6: Distributor Q advertises that if a customer purchases 10 e-cigarette cartridges with a nicotine content of 1.8 percent they will receive their choice of two accessories for free. The billing invoice shows the price charged for the cartridges and a separate charge of \$0 for the accessories. The tax applies only to the price of the cartridges as the accessories are not packaged by the manufacturer as one unit and are not invoiced as one selling

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price. It is necessary to have a separate charge of \$0 for the items to be considered sold for a separate price. If items are provided for free without a separate charge of \$0, they may be considered to be sold for a single price.

Refunds or credits for tax paid tobacco products sold outside the state

This issue continues to be a topic of significant concern for CSFO members since it is common practice in the industry to sell OTP to other distributors who ship the products outside the state for subsequent use or sale out of the state. In our first submission, we presented the following example to illustrate a common scenario in the e-cigarette industry:

Distributor A sells OTP to Distributor B inside California, and tax is applied to that transaction. Distributor B then ships the products outside the state for subsequent use or sale out of the state.

Staff expressed its opinion that Code section 30176.1 would not permit a credit or refund for the taxes collected or paid under the presented example because it states that 30176.1 only applies when tax has been “paid on the *distribution* of tobacco products which are shipped to a point outside the state.” Staff explained that Distributor A does not ship the product outside the state, so Distributor A is not entitled to a refund. It goes on to explain that Distributor B does not make a distribution [because it does not make a sale in this state], so it also is not entitled to a refund. Further, Staff stated that Code section 30361 only permits credits or refunds to the person who paid the tax.

At the second interested parties meeting, Staff was asked to describe a scenario under which a refund or credit would be provided pursuant to Code section 30176.1. Staff explained that a refund or credit would be provided under the following example:

Distributor A purchases products without tax from a manufacturer. Prior to shipping the products outside the state for use or sale out of the state, Distributor A self-accrues tax on the products in its inventory and pays the tax with its return.

Following the second meeting we again examined the language of Code section 30176.1 and the example under which Staff explained it would apply. As explained below, our examination supports that a refund or credit is due under the example we provided.

Code section 30006 defines “Sale” as “any **transfer of title or possession for a consideration**, exchange or barter, in any manner or by any means whatever.” (Emphasis added)

Code section 30008, subdivision (a), defines “Distribution” as “[t]he sale of **untaxed** cigarettes or tobacco products **in this state**.” (Emphasis added)

Together, Code sections 30006 and 30008 provide that a distribution is a transfer of title or possession for a consideration of untaxed tobacco products in this state.

Code section 30176.1, *Refunds; exported tax-paid tobacco products*, provides:

“(a) The board shall, pursuant to regulations prescribed by it, refund or credit to a distributor the tax imposed on tobacco products pursuant to Article 2 (commencing with Section 30121) and Article 3 (commencing with Section 30131) of Chapter 2 **which is paid on the distribution** of tobacco products which are shipped to a point outside the state for subsequent use or sale out of the state. (Emphasis added)

(b) This section does not apply to tobacco products delivered to the consumer in this state and subsequently taken outside the state.”

Code section 30176.1 clearly applies to scenarios where tax “is paid on the distribution.” Based on the legal definitions of “Sale” and “Distribution” quoted above, that means Code section 30176.1 applies where **tax is paid on the transfer of title or possession for a consideration of untaxed tobacco products in this state** which are shipped to a point outside the state for subsequent use or sale out of the state.

Turning back to Staff’s explanation of when a credit or refund would be due under Code section 30176.1, Staff explains that it would apply to a scenario where tax is self-accrued on inventory purchased without tax from a manufacturer. In that case, however, tax is not being paid on “the transfer of title or possession for a consideration” in this state. In other words, tax is *not* “paid on the distribution,” which is a clear requirement under Code section 30176.1. Thus, Code section 30176.1 cannot apply to the example presented by Staff.¹

In order for tax to be “paid on the distribution,” there must be a distribution, i.e., a transfer of title or possession for a consideration in this state. We agree with Staff that a “distribution” does not occur when a sale is made at a point outside this state, i.e., title and possession transfer out of the state. Therefore, the only conceivable scenario under which Code section 30176.1 could apply, is in the scenario we presented. It appears that Staff is reading

¹ We do agree that a credit or refund would be due under the example presented by Staff, because tax is imposed on a “distribution.” In the example provided, tax is not being paid on a distribution and therefore a credit or refund would be due. But, in our opinion, it would not be due pursuant to Code section 30176.1.

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Code section 30176.1 as if it cannot apply where a distribution occurs in this state, but that does not appear to be correct because a “distribution” can *only* occur “*in this state*,” pursuant to Code section 30008, subdivision (a).

Staff’s interpretation of Code section 30361, also does not appear to be consistent with the language of the statute. Staff explains in the second discussion paper that Code section 30361 *only* permits credits or refunds for the person that paid the tax. Code section 30361 provides:

“If the board determines that any amount not required to be paid under this part has been paid by any person, the board shall set forth that fact in its records and certify the amount collected in excess of the amount legally due and **the person from whom it was collected or by whom it was paid. The excess amount collected or paid shall be credited** by the board on any amounts then due and payable from **the person from whom the excess amount was collected or by whom it was paid** under this part, **and the balance shall be refunded to the person**, or his or her successors, administrators, or executors. Any proposed determination by the board pursuant to this section with respect to an amount in excess of fifty thousand dollars (\$50,000) shall be available as a public record for at least 10 days prior to the effective date of that determination.”

Code section 30161 refers to two different people, the “person from whom [the tax] was collected,” OR “by whom it was paid.” In other words, it permits a credit or refund to be provided to a purchaser from whom the tax is collected, or to a distributor that pays the tax; one *or* the other.

We believe Code section 30176.1 *must* apply to the scenario we presented. Aside from the legal analysis provided above which supports that conclusion, it also makes logical sense that the legislature would provide an avenue for a California distributor to recoup tax it pays on its purchases of products that are shipped outside the state for subsequent use or sale out of the state. Doing so places California distributors on a level playing field with distributors outside the state and it promotes commerce between California distributors. Precluding a credit or refund under that scenario has the opposite effect, and also effectively seeks to impose tax on products shipped outside the state for sale or use out of the state; which is not consistent with the expressed intent of the law.

Staff expressed concerns about amending a current regulation or creating a new regulation to address this issue, because it feels this issue may fall outside the intended scope of

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the directive made by the legislature to draft regulations in response to Proposition 56. Code section 30130.50, subdivision (b), states that the Board “shall adopt regulations providing for the implementation of an equivalent tax on electronic cigarettes...” And that “[s]uch regulation may include, *but are not limited to*, defining who is a distributor of electronic cigarettes...” (Emphasis added) Pursuant to the legislature’s directive, the Board is “not limited to,” only amending Regulation 4076 and adding Regulation 4077.

Because this issue addresses a common scenario for the e-cigarette industry, it is virtually certain to arise. We request that Staff provide specific guidance on this issue through an amendment to Regulation 4063.5, to help clarify when Code section 30176.1 does, and does not, apply.

Regulation 4077, Definition of Tobacco Product Manufacturer

Staff proposed the following definition for Tobacco Product Manufacturer under Proposed Regulation 4077. The members of CSFO greatly appreciate Staff’s efforts to clarify the definition of a manufacturer, which is another important issue for the e-cigarette industry. During the second meeting individuals from the industry that are generally considered to be manufacturers within the industry, expressed concerns about being excluded from the proposed definition.

In some instances, the owner of a proprietary e-juice recipe and brand outsources its mixing, bottling and labeling processes to third-parties. Although such a business considers itself to be a manufacturer based on its business model, the definition proposed under Regulation 4077 does not make it clear that it will be treated as a manufacturer for tax purposes. We propose the following definition to address this concern:

(a) A tobacco product manufacturer is any person, including any repacker, ~~and/or~~ relabeler, product owner and/or product licensee, who causes tobacco products to be manufacturesd, fabricatesd, assemble~~s~~d, processesd, or label~~ed~~s ~~a finished tobacco product~~.

(b) A retailer who mixes, prepares, or combines liquid nicotine and other components of a tobacco product is a tobacco product manufacturer. If the retailer does not mix, prepare or combine any liquid nicotine products but allows its customers to do so after a sale has been made then that retailer is not a manufacturer. A retailer that is not also a manufacturer or distributor must purchase their nicotine products from a licensed tobacco products distributor.

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The change to subdivision (b) was made to clarify that a retailer that is also a manufacturer and/or a distributor, *may* purchase tobacco products from an unlicensed distributor, i.e., from a distributor located outside the state.

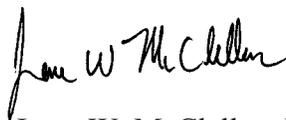
Computing Wholesale Cost by a Manufacturer

Finally, questions arose about how an e-cigarette manufacturer should compute its wholesale cost when it is also a distributor. Pursuant to Regulation 4076, subdivision (b)(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).” (Emphasis added)

The emphasized language above is a source of confusion. The questions posed surround what labor costs to include. For example, should labor costs for customer service, accounting, administration and product promotion and sales be included in the computation? Another way to answer the question, may be to clarify what costs, if any, may be excluded? Based on discussions with Staff, it appears that the foregoing labor costs should *not* be included in the computation of wholesale costs. One option discussed was to have an additional example added to Regulation 4076 to help clarify how these costs should be treated. We agree that would provide some very useful guidance to the industry and audit staff.

We thank you again for your consideration to the many issues we have raised in our submission(s). We understand that it is a difficult task to draft regulations for a new industry and applaud your efforts and fine work thus far. We remain available to address any questions you may have. Please do not hesitate to contact me.

Very truly yours,



Jesse W. McClellan, Esq.

On behalf of CSFO

Cc: California Smoke Free Organization

From: Ting Fan
To: [Gonzalez, Trista](#); [Patno, Michael](#)
Subject: CSFO Prop 56
Date: Tuesday, June 20, 2017 9:43:41 PM

Hi,

We would like to submit the following revised language [in blue] for the definition of a Manufacturer to the BOE for consideration.

§ 4077. Tobacco Product Manufacturer.

(a) A tobacco product manufacturer is any person, including any repacker and/or relabeler, who owns the brand and formula, and/or manufactures, fabricates, assembles, processes, or labels a finished tobacco product.

Best Regards,

Ting Fan



August 10, 2017

Trista Gonzalez, Chief
Tax Policy Bureau
Business Tax and Fee Division
California Department of Tax and Fee Administration
450 N Street, Sacramento, CA

Subject: Proposed Regulation 4076 – Clarification of Arm’s Length Transaction; Wholesale Cost

Dear Ms. Gonzalez,

We are writing on behalf of Californians for Tobacco Harm Reduction (CATHR) to comment on the proposed regulation 4076 for the implementation of Proposition 56 taxation on the wholesale cost of tobacco products. CATHR is an organization that represents small business owners from across the state that aims to educate and advocate for the sale and use of e-cigarettes as safer alternative to traditional cigarettes.

In proposed Regulation 4076 subdivision (b)(2), the revised language reads: *“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 finished tobacco product) prior to any discounts or trade allowances, the cost of labor, and any federal excise and/or U.S. Customs taxes paid.”*

Confusion regarding this regulation resides in when an “arm’s length transaction” applies, and how that relates to determining the wholesale cost of tobacco products when an entity holds both a manufacturing and distribution license. When we contacted CDTFA staff, we received the following response to the question “Is a manufacturer who holds a distributors license required to conduct an arms-length transaction between departments (i.e. manufacturing and distribution) or just pay the tax based on how to calculate the wholesale cost published in the guidelines, when the product is distributed in California?”:

“There is no requirement that a certain transaction be performed to document the movement of tobacco product from a licensed manufacturer that is also a licensed distributor when they are the same entity. We will require that documentation be provided to support the calculation of wholesale cost in accordance with Regulation 4076(b)(2).”

Despite this clarification from staff, members of our association continue to receive inconsistent answers from both the CDTFA and inspectors on the ground. For example, a manufacturer who is also a distributor received a visit from three inspectors at one time. The inspectors asked to see where the arm’s length transaction took place for one specific date between the manufacturer and distributor, and finally to the retailer and the consumer. Because this manufacturer separates the books from the distribution side of the same business, and sells it to themselves for 25% above the cost to manufacture the product (including the cost of employees, products, rent, utilities, etc), they were told that they have been doing things the “right

way". However, because of the way the current law is written, that company has been overpaying their taxes. Other members of the association have reported similar experiences, so it is apparent more clarity is needed for staff and businesses.

It is important for the CDTFA to include language in the regulation that makes it clear to both businesses and department staff how wholesale cost should be calculated and documented when an entity holds both manufacturing and distribution licenses. We propose that the language explicitly spell out that there is no requirement that a certain transaction be performed to document the movement of tobacco products from a licensed manufacturer that is also a licensed distributor when they are the same entity, as staff clarified. We would also like explicit clarification that an arm's length transaction would not be required in this circumstance.

In addition to addressing our concerns regarding Regulation 4076, we also ask that as the CDTFA considers the new equivalency tax, along with new regulations, that they continue to engage in a transparent and inclusive process. CATHR is concerned that the new equivalency tax will disproportionately affect small business owners and cause more companies to move out of state. We hope that you will work with our organization and others to ensure that any new taxes or regulations are fair and equitable for all.

Sincerely,



Pamela Cube,
Californians for Tobacco Harm Reduction (CATHR)



Kari Hess,
Californians for Tobacco Harm Reduction (CATHR)



Laura McCollum,
Californians for Tobacco Harm Reduction (CATHR)

From: Ong, Michael M.D.
To: [BTFD-BTC Information Requests](#); [Patno, Michael](#); [Lavezzo, Merrill \(CDPH-CDIC\)](#); [Kwong, Richard T. \(CDPH-CDIC\)](#)
Subject: Re: BOE - Business Taxes Committee Material - Second Discussion Paper (Prop. 56) - Regulations 4076 & 4077
Date: Friday, August 11, 2017 2:58:53 PM

On behalf of the Tobacco Education and Research Oversight Committee, I did want to point out two areas where abbreviation of the original initiative falls short of the original intent of Proposition 56.

Notably, this comes up on Page 1 of 6 of Exhibit 1, in:

(3) where it states Electronic cigarettes also include any liquids ("e-juice" or "e-liquid") or substances that contain nicotine.

(6) derived from tobacco or nicotine that are intended for human consumption.

We would suggest using this instead for (3)

Electronic cigarettes also include any liquid or substance containing nicotine, whether sold separately or sold in combination with any device that could be used to deliver to a person nicotine in aerosolized or vaporized form.

and for (6)

“Tobacco products” includes, but is not limited to, a product containing, made, or derived from tobacco or nicotine that is intended for human consumption, whether smoked, heated, chewed, absorbed, dissolved, inhaled, snorted, sniffed, or ingested by any other means

Best,

m

Michael Ong, M.D. Ph.D.
Chair, State of California Tobacco Education and Research Oversight Committee
Associate Professor in Residence
UCLA and VA Greater Los Angeles Healthcare System

From: BTFD-BTC Information Requests <BTFD-BTC.InformationRequests@boe.ca.gov>
Sent: Friday, May 26, 2017 5:18:47 PM
Subject: BOE - Business Taxes Committee Material - Second Discussion Paper (Prop. 56) -

Regulations 4076 & 4077

Per your request for electronic copies of California State Board of Equalization Business Taxes Committee material, here is a link to our website for staff's Second Discussion Paper regarding proposed amendments to Regulation 4076, *Wholesale Cost of Tobacco Products* and proposed Regulation 4077, *Tobacco Product Manufacturer*:

<http://www.boe.ca.gov/meetings/pdf/4076IDPweb032717.pdf>.

An interested parties meeting to discuss this issue will be held on Tuesday, June 6, 2017. Information regarding the meeting, including teleconferencing information, is included in the cover letter to the paper. The issue will be presented at the Board's August 29 - 31, 2017 meeting of the Business Taxes Committee.

If you have difficulty opening the attached link, please contact me to make alternative arrangements to receive a copy.

Mac OS users, if your file is appearing distorted, please download the file first and then open it in Acrobat reader

Michael A. Patno
Program Policy Specialist
Business Taxes Committee and Training Section
(916) 323-9676

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August 18, 2017

Ms. Trista Gonzalez, Chief
California Department of Tax and Fee Administration
Tax Policy Division (MIC 92)
450 N Street
Sacramento, CA 94279-0092

VIA: Email: Trista.gonzalez@cdtfa.ca.gov

Re: Proposition 56 – Regulatory Rule Making

Dear Ms. Gonzalez,

Thank you, again, for providing us with the opportunity to make a submission on behalf of the California Smoke Free Organization (CSFO). This submission is being made in response to the most recent versions of Regulations 4076 and 4077 that were circulated by the Business Tax and Fee Department (Department).

We would like to express our utmost appreciation for you and your staff's efforts to establish regulatory guidelines that will help enable the e-cigarette industry to comply with the law. CSFO is in general agreement with the proposed regulations, with the exception of two points.

First, as provided in the submissions dated April 26, 2017 and June 22, 2017, which we incorporate here by reference, we believe that Code section 30176.1, *Refunds; exported tax-paid tobacco products*, establishes a distributor's right to obtain a refund or credit on tax-paid products that are shipped to a point outside the state for subsequent use or sale out of the state. We were informed that staff does not agree with our interpretation of Code section 30176.1. Nonetheless, to provide clarity for the industry, we believe Regulation 4063.5, *Exported tax-paid tobacco products*, should be amended to clearly set forth the circumstances under which a refund or credit *may and may not* be obtained. Currently, it is not clear. Proposition 56 expressly provides the CDTFA with authority to issue regulations that *are not limited* to establishing a definition for an e-cigarette distributor. Because this is a new tax for a relatively new industry, we believe now is the best time to provide clarity for the e-cigarette industry in this regard.

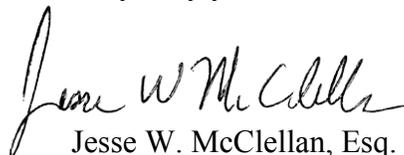
The other issue involves the example provide under proposed Regulation 4076, subdivision (f)(5). The issue was discussed in detail at the second interested parties meeting, but was not addressed in our prior submissions because we understood an agreement was reached. The example currently reads as follows:

“(5) Example 5: Retailer P purchases e-juice tax-paid from a licensed tobacco products distributor. Retailer P, as a promotion, will package the e-juice with a battery, power adapter and carrying case. The retailer’s packaged product is not subject to tax as the distribution occurred prior to Retailer P’s promotional sale.”

At the interested parties meeting, it was discussed that language would be added to the example to clarify that tax would not apply to the transaction even if the retailer sold the promotional package for a single price. We believe clarifying language regarding the exclusion from tax, notwithstanding a single price sale, is necessary for the industry and audit staff. Otherwise, a single price sale of tax-paid juice and *untaxed* accessories may be considered to be a taxable distribution of OTP, i.e., the sale of untaxed tobacco products, with tax due on the untaxed accessories. (See Rev. & Tax. Code §§ 30011, 30008, 30121; Proposed Reg. 4076, subs. (a)(3), (a)(5), (a)(6).)

Thank you for the consideration given to our suggestions and concerns and please do not hesitate to contact me should you have any questions.

Very truly yours,



Jesse W. McClellan, Esq.
On behalf of CSFO

Cc: California Smoke Free Organization
Mr. Michael Patno, Program Policy Specialist, Business Taxes Committee

Cigarette and Tobacco Products Tax Law

CHAPTER 2. IMPOSITION OF TAX.

ARTICLE 2.5. THE CALIFORNIA HEALTHCARE, RESEARCH AND PREVENTION TOBACCO TAX ACT OF 2016¹

SECTION 30130.50

30130.50. **Definitions.** For the purposes of this article:

(a) "Cigarette" has the same meaning as that in Section 30003 as it read on January 1, 2015.

(b) "Tobacco products" has the same meaning as that in subdivision (b) of Section 30121, as amended by this act.

¹Article 2.5 Article 2.5 added by Proposition 56, Section 4.1, approved by voters at the November 8, 2016 election, in effect November 9, 2016.

Cigarette and Tobacco Products Tax Law

CHAPTER 2. IMPOSITION OF TAX.

ARTICLE 2. CIGARETTE AND TOBACCO PRODUCTS SURTAX¹

SECTION 30121

30121. **Definitions.** For purposes of this article:

(a) "Cigarettes" has the same meaning as in Section 30003, as it read on January 1, 1988.

(b) "Tobacco products" includes, but is not limited to, ~~a~~ a product containing, made, or derived from tobacco or nicotine that is intended for human consumption, whether smoked, heated, chewed, absorbed, dissolved, inhaled, snorted, sniffed, or ingested by any other means, including, but not limited to, cigars, little cigars, chewing tobacco, pipe tobacco, or snuff, but does not include cigarettes. Tobacco products shall also include electronic cigarettes. Tobacco products shall not include any product that has been approved by the United States Food and Drug Administration for sale as a tobacco cessation product or for other therapeutic purposes where that product is marketed and sold solely for such approved use. Tobacco products does not include any food products as that term is defined pursuant to Section 6359.

(c) "Electronic cigarettes" means any device or delivery system sold in combination with nicotine which can be used to deliver to a person nicotine in aerosolized or vaporized form, including, but not limited to, an e-cigarette, e-cigar, e-pipe, vape pen, or e-hookah. Electronic cigarettes include any component, part, or accessory of such a device that is used during the operation of the device when sold in combination with any liquid or substance containing nicotine. Electronic cigarettes also include any liquid or substance containing nicotine, whether sold separately or sold in combination with any device that could be used to deliver to a person nicotine in aerosolized or vaporized form. Electronic cigarettes do not include any device not sold in combination with any liquid or substance containing nicotine, or any battery, battery charger, carrying case, or other accessory not used in the operation of the device if sold separately. Electronic cigarettes shall not include any product that has been approved by the United States Food and Drug Administration for sale as a tobacco cessation product or for other therapeutic purposes where that product is marketed and sold solely for such approved use. As used in this subdivision, nicotine does not include any food products as that term is defined pursuant to Section 6359.

(▲d) "Fund" means the Cigarette and Tobacco Products Surtax Fund created by Section 30122.

History.—Proposition 56, Section 3.1, approved by voters at the November 8, 2016 election, operative April 1, 2017, substituted "a product containing, made, or derived from tobacco or nicotine . . . pipe tobacco, or snuff" for "all forms of cigars, smoking tobacco, chewing tobacco, snuff, and any other articles or products made of, or containing at least 50 percent, tobacco" after "'Tobacco Products' includes, but is not limited to" and added the second, third, and fourth sentences, to subdivision (b); added subdivision (c); and relettered former subdivision (c) as (d).

Note.—Proposition 56, Section 10, approved by voters at the November 8, 2016 election, in effect November 9, 2016, states "This act shall become effective as provided in subdivision (a) of Section 10 of Article II of the California Constitution; provided, however, the amendment to Section 30121 of the Revenue and Taxation Code shall become effective April 1, 2017."

Tobacco Tax and Health Protection Act of 1988 (Proposition 99) is Constitutional.—A statutory initiative, approved by a majority of the electorate, that increases taxes on cigarettes and other tobacco related products and allocates the revenue raised to address tobacco related problems does not violate the provisions of the California State Constitution related to changes in State taxes for the purpose of increasing revenue (ART. XIII A §§3 & 4) or the single subject rule. (ART. II §8(d)) *Kennedy Wholesale, Inc. v. State Board of Equalization*, (1991) 53 Cal.3d 245.

¹Article 2 adopted by voters, Prop 99 Sec. 4, in effect January 1, 1989.