

**Text of Proposed Amendments to
California Code of Regulations, Title 18, Section 4076,
*Wholesale Cost of Tobacco Products***

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 first-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,~~ and 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~~ 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)(34).

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 ~~Board's~~ California Department of Tax and Fee Administration'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.