

Statement of Reasons
for the Proposed Adoption of Section 4801, *Retailer's Records*,
in Title 18 of the California Code of Regulations

The California Department of Tax and Fee Administration (Department) proposes to adopt California Code of Regulations, title 18, section (Regulation) 4801, *Retailer's Records*, to clarify for licensed retailers of cigarettes and tobacco products the scope and duration records should be maintained. The proposed regulation will also explain the requirements for transferring cigarettes and tobacco products between retail locations operated by the same licensed retailer.

General Background

On October 12, 2003, the Cigarette and Tobacco Products Licensing Act (Act) was enacted and established a statewide licensing program under Division 8.6 (commencing with Section 22970) of the Business and Professions Code (BPC). The Act imposes licensing requirements on all retailers, wholesalers, and distributors of cigarettes and tobacco products and all manufacturers and importers of cigarettes. Assembly Bill 1749 (Chapter 501, Statutes 2006) added the same licensing requirements for manufacturers and importers of tobacco products. These licensing requirements are in addition to other permits and licenses that may be required depending on a person's business operations. The Act intended to address the problem of untaxed distributions and illegal sales of cigarettes and tobacco products in California and included provisions for new recordkeeping requirements. The Act identifies violations that may result in license suspensions or revocations including the imposition of civil and criminal penalties. It also authorizes the Department to inspect and seize any untaxed cigarettes and tobacco products. These inspections are performed by the Department's Investigations Bureau and, based upon their findings, may result in the issuance of citations and penalties for violations.

Additionally, the Act authorizes the Department to administer and enforce its remaining provisions as well as prescribe, adopt, and enforce rules and regulations relating to administration and enforcement. Since the inception of the Act, regulations have been adopted to clarify the provisions with the intent to uniformly administer and enforce the provisions of the Act, and to provide guidance and clarity of the Act's provisions to licensed and unlicensed retailers, wholesalers, distributors, manufacturers, and importers of cigarettes and tobacco products.

Recordkeeping requirements are addressed within the statutes of the Act. Records to be maintained by retailers generally are purchase invoices for their cigarettes and tobacco products inventories. Section 22974, titled *Records*, states:

A retailer shall retain purchase invoices that meet the requirements set forth in Section 2298.4 for all cigarettes or tobacco products the retailer purchased for a period of four years. The records shall be kept at the retail location for at least one year after the purchase. Invoices shall be made available upon request during normal business hours for review inspection and copying by the board or by a law enforcement agency. Any retailer found in violation of these requirements or any person who fails, refuses, or neglects to retain or make available invoices for inspection and copying in accordance with this section shall be subject to penalties pursuant to Section 22981.

When the Department's Investigations Bureau inspects a retailer, the retailer must establish that its inventory of cigarettes and tobacco products was purchased tax paid by providing a valid purchase invoice. In many instances, a retailer does not provide a purchase invoice showing the product in question was purchased by the retail location being inspected; instead, the retailer asserts the product

was purchased tax paid at another retail location and was later transferred to the retail location under inspection. Therefore, the Department deemed it necessary to develop language to clarify retailers' record keeping obligations and explain the documentation required for a transfer of cigarettes and tobacco products between licensed retail locations owned by the same person.

Overview

Publication 78, *Sales of Cigarettes and Tobacco Products in California*

In April 2011, Publication 78, *Sales of Cigarettes and Tobacco Products in California*, was updated. The publication includes guidance to licensees on the Department's view of the law with respect to the transfer of cigarettes or tobacco products from one retail location to another retail location. At the time of the update, a letter was sent to 1,790 legal entities operating retail locations of cigarette and tobacco products. The language in Publication 78, specifically relating to store-to-store transfers, has remained unchanged and still appears as follows:

Generally, the transfer of cigarettes and tobacco products are not permitted. However, if you own more than one store and licenses are held by the same legal entity, you may be allowed to transfer cigarettes and tobacco products between stores belonging to the same legal entity. When transferring cigarettes and tobacco products, legible transfer records and copies of the original purchase invoice must be kept at each location involved in the transfer. Such transfer records which must be prepared at the time of transfer, must include the address of each store, the purchase invoice date, the purchase invoice number, the supplier's name on the invoice, including type of packaging, flavor and or style, and the amounts of items transferred. Failure to provide such documentation when requested can result in the seizure of the claimed transferred product.

Publication 78 also addresses the records to be maintained by a retailer of cigarettes and tobacco products. While referred to in other sections within the publication, a summary of record requirements currently appears under the Enforcement section as follows:

You must keep and maintain legible, accurate, and complete records, including purchase invoices for your resale stock of cigarettes and tobacco products (including products under the expanded definition of a tobacco product when sold or purchased in combination with nicotine), for four years. The most recent twelve months of invoices must be kept at the retail location for at least one year after the date of purchase. Failure to maintain records and provide them upon request to CDTFA staff or a law enforcement agency may result in a misdemeanor citation punishable by a fine of up to \$5,000 and/or imprisonment for up to one year in a county jail.

Proposed Regulation 4801 is consistent with the above guidance.

Pertinent Statutes

Purchases of cigarettes or tobacco products by a retailer from anyone except a properly licensed distributor or wholesaler of cigarettes or tobacco products are expressly prohibited by Revenue and Taxation Code (RTC) section 30478. However, the Act does not specifically state whether transfers of cigarettes and tobacco products between retail locations owned by the same person are allowed. The Act requires a retailer of cigarettes and tobacco products to do the following:

- obtain a separate retailer's license for each retail location at which cigarettes and tobacco products are sold,
- maintain purchase invoices that meet the requirements set forth in section 22978.4 of the BPC for all cigarettes and tobacco products the retailer purchased for a period of four years, and

- maintain records at their retail location for at least one year after purchase.

Section 22978.4 also prescribes form and content requirements for invoices issued by distributors and wholesalers. In addition to requiring distributor and wholesaler information, each invoice must contain the name, address and license number of the customer, an itemized listing of cigarettes and tobacco products sold, date of sale, and the amount of excise taxes due to the state by the distributor or a statement that reads: “All California cigarette and tobacco product taxes are included.”

Although the Act does not directly state all inventory transfers are allowable, the language contained within it could be interpreted to imply that specific transfers are not necessarily prohibited. Section 22971(q) defines a retail location as any building from which cigarettes and tobacco products are sold at retail or a vending machine. “Sale” is defined in section 30006 of the RTC as any transfer of title or possession for consideration, exchange, or barter, in any manner or by any means whatever. As a result, the Act does not require a retailer to maintain a license at a warehouse or storage location from which retail sales are not made. The Act also does not require that a distributor or wholesaler deliver only to the address of the licensed retail location. Section 22978.4(a)(4) requires that a distributor or wholesaler include on any invoice the name, address, and license number of the retailer, distributor, or wholesaler to whom cigarettes and tobacco products are sold, but it does not require that the product be delivered to the address where the retail license is held. There are good reasons for not requiring such a limitation, such as traditional cash and carry purchases would be prohibited, and vending machine operators would only be able to take delivery at the location of a licensed vending machine, which is generally located at another person’s business. Thus, it appears that without such delivery limitations, the Act contemplates transfers of cigarettes and tobacco products between retail or storage locations owned by the same legal entity when the invoice retention requirements are satisfied at each retail location.

While the Department has determined that the Act does allow a person to transfer inventories of cigarettes or tobacco products from one retail location to another, the Department also has determined that such a transfer requires certain documentation to verify that a retailer’s inventory is tax-paid. When a retail location is under inspection by the Department’s Investigations Bureau, the retailer is required to provide invoices showing it purchased its inventory of cigarette and tobacco products tax-paid from a licensed distributor or wholesaler. Invoices from a distributor or wholesaler to a retailer must contain the retailer’s address and license number, and a retailer owning more than one retail location must obtain a separate license for each retail location. When a retail location under inspection provides a purchase invoice showing the type of product in its inventory was purchased tax-paid by a different retail location, the inspector cannot know that the item in the inventory being inspected is the same item described on the invoice unless there is also an inventory transfer log showing that the item described on the invoice was transferred from the retail location that purchased the product to the retail location being inspected. The Department has determined that it is essential that inventory transfer logs be prepared contemporaneously at the time of transfer and that the transfer log be provided upon request from the inspector. If these conditions are not requirements, a retailer owning multiple locations could prepare a transfer log after-the-fact to use purchase invoices from one retail location to conceal untaxed purchases at another retail location.

Proposed Regulation 4801

As discussed below, proposed Regulation 4801 offers taxpayers a clear and concise explanation of what records should be maintained by retailers. The regulation also addresses the record keeping required by retailers to support their claims of store-to-store transfers of cigarettes and tobacco products.

Subdivision (a), In General

Subdivision (a) provides the general rules regarding retailers' purchase invoices. It states that a retailer must maintain their purchase invoices for a period of four years. Subdivision (a) further specifies that purchase invoices must be kept at the retail location to which the cigarettes and tobacco products were sold for at least one year after the retailer's purchase date. The subdivision also states that these purchase invoices must be made available upon request by the Department.

Subdivision (b), Transfers

Subdivision (b) addresses transfers of cigarettes and tobacco products from one retail location to another retail location. The retail locations involved must be registered to the same person. A transfer log must be prepared at the time a transfer occurs and be kept for four years from the date the retailer purchased the transferred inventory. The transferring and receiving locations must keep copies of the transfer log and the purchase invoices for the transferred inventory for at least one year from the date of transfer.

A retailer must provide copies of the transfer log and the purchase invoices for the transferred inventory upon request and at the time the inspection has commenced. If a retailer fails to do so, then they are unable to establish the receiving location's inventory as being tax paid. Even if a purchase invoice is presented showing that the same type of tax-paid product was sold to a different retail location, and the transferring location is owned by the same licensee as the receiving location, it will not establish the cigarettes and tobacco products as being tax paid.

Subdivision (c), Prohibited Transfers

Transfers of tax-paid inventory are only allowed between properly licensed locations held by the same person. If the two licensed retailer locations have a different ownership type, then the transfer is prohibited. Subdivision (c) provides examples when a retailer is not the same person and the transfer is prohibited.

Subdivision (d), Transfer Log

Subdivision (d) addresses the type of records retailers should prepare and maintain for every store-to-store transfer they conduct. The subdivision states that the transfer log must contain the transfer date, the business name, address and license number of the transferring and receiving locations, a detailed itemized list by supplier with specific descriptions of the cigarettes and tobacco products transferred, quantity transferred, purchase invoice number, and the names and license numbers of each supplier. An example of a transfer log is found in Appendix A.

Subdivision (e), Alternative Storage Media

A retailer may convert documents, including transfer logs and original purchase invoices into "storage-only imaging media." Subdivision (e) explains that a document conversion must comply with the requirements of the California Code of Regulations, title 18, section 4901, subdivision (h). Storage-only imaging media includes PDF files and other media used in electronic imaging. Once converted, the retailer may discard the original hardcopy documents.

Subdivision (f), Inspections, Citations and Seizures

Purchase invoices and transfer logs must be provided upon request at the time of inspection. If a retailer is unable to comply with such a request, it may result in the issuance of a citation and the seizure of their cigarettes and tobacco products. Transfer logs or similar documents that were not prepared at the time a transfer occurred or were not provided upon request at the time of inspection will not be accepted. A transfer log provided after the fact will not establish that cigarettes and

tobacco products were erroneously or illegally seized, provide grounds for the dismissal of a citation for any violation of the Act, or reduce penalties imposed under the Act.

Interested Parties Meeting and Comments

The Department distributed a discussion paper which explained proposed Regulation 4801 on October 13, 2020, and held an interested parties meeting on October 28, 2020, to obtain public input. During the interested parties meeting, attendees did not comment on the proposed regulation. Additionally, the Department did not receive any written submissions after the interested parties meeting was held.

Economic and Fiscal Impact

Proposed Regulation 4801 impacts 21,729 licensed retailers of cigarettes and other tobacco products. Of that amount, 2,004 are retailers with multiple locations, with many of those licensees being small businesses. There are no comparable Federal regulations. In the absence of Federal regulation, state regulation is needed, and the Department is the state agency responsible for administering taxes on cigarettes and other tobacco products. The benefits of the regulatory change are the result of goals developed by the agency based on broad statutory authority. The Department considered whether to begin the formal rulemaking process to adopt the proposed regulation at this time or, alternatively, whether to take no action at this time. No additional alternatives were considered.

Although the statewide dollar costs and benefits from this regulation are unknown, the proposed regulation provides guidance on general recordkeeping requirements as well as the recordkeeping needed to support certain transfers of cigarettes and tobacco products. The proposed regulation is needed to prevent situations where a retailer is unable to verify that their retail inventory which was transferred store-to-store is tax-paid. Proposed Regulation 4801 is consistent with previous Department outreach on the topic. As such, the Department anticipates the proposed regulation to have little to no economic impact on businesses as they are already maintaining records according to the Department's current guidance. The Department anticipates:

- The estimated economic impact of the regulation is below \$10 million.
- No businesses or jobs will be created or eliminated because of the regulatory change.
- The regulation will not affect the ability of California businesses to compete with other states by making it more costly to produce goods and services here.
- The regulation does not directly impact housing costs.
- There are no other benefits of the regulation, including, but not limited to, benefits to the health, safety, and welfare of California residents, worker safety, and the state's environment and quality of life, identified by the Department.

Additionally, there is no estimated change of investment in the state; no incentive for innovation in products, materials, or processes; and no fiscal impact. The proposed regulation does not mandate specific technologies or equipment. This regulatory change does not affect any local entity or program and does not affect any federally funded state agency or program. The Department will post the proposed Regulation 4801, after it is approved, on its website and incorporate the regulation into industry guidance. The workload associated with incorporating these changes is considered routine. Any corresponding cost would be absorbed within the Department's existing budget.