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Business and Professions

Read My Lips, No Inappropriate Beer Taxes: Chapter 96 Amends the Definition of Beer, Protecting Craft Brewers

Josh Hunsucker

Code Section Affected

Business and Professions Code § 23006 (amended).
AB 1812 (Chesbro); 2012 STAT. Ch. 96.

I. INTRODUCTION

Democrats and Republicans can at least agree on one thing: beer.¹ California is home to over 270 independent craft breweries,² and “today nearly every craft beer brewery ages some of its ales in various types of barrels.”³ In 2008, the California Board of Equalization (Board) adopted new regulations based on an interpretation of the existing law, which increased taxes on flavored malt beverages (FMB), like Mike’s Hard Lemonade and Smirnoff Ice, by taxing them as distilled spirits.⁴

1. See Michael Mishak, *Gov. Jerry Brown OKs Bill Defining Craft Beers*, L.A. TIMES (July 13, 2012 3:15 PM), <http://latimesblogs.latimes.com/california-politics/2012/07/gov-jerry-brown-california-craft-beers.html> (on file with the *McGeorge Law Review*) (describing the passing of Chapter 96).

2. CAL. CRAFT BREWERS ASS’N, <http://www.californiacraftbeer.com/who-we-are/> (last visited July 12, 2012) (on file with the *McGeorge Law Review*). There are over 145 members of the California Craft Brewers Association (CCBA) and over 20 allied trade members. *Id.*

3. See Normal Miller, *The Beer Nut: Firestone Walker Brewery Expands*, METRO W. DAILY NEWS (June 22, 2012 10:34 AM), <http://www.metrowestdailynews.com/news/x1826140632/The-Beer-Nut-Firestone-Walker-brewery-expands-to-Bay-State> (on file with the *McGeorge Law Review*) (asserting that many craft breweries in California use the Belgian brewing method of barrel-aging); see also Press Release, Cal. Craft Brewers Ass’n, Governor Signs AB 1812 Protecting Barrel-Aged Beer (July 17, 2012), available at http://www.ratebeer.com/forums/governor-jerry-brown-saves-barrel-aged-beer_208614.htm (on file with the *McGeorge Law Review*) (“California craft brewers have become literally world renown for their unique interpretation and adaptation of ageing beers in wood barrels.”); E-mail from Tom McCormick, Exec. Dir., Cal. Craft Brewers Ass’n, to author (July 17, 2012, 15:45 PST) (on file with the *McGeorge Law Review*) (estimating “[r]oughly about 100 [to] 125” member breweries of the California Craft Brewers Association use the barrel-aging technique).

4. Press Release, Cal. St. Bd. Equalization, *New Regulations Will Cause Certain Non-Wine Alcoholic Beverages To Be Taxed as Distilled Spirits* (July 2008), available at www.boe.ca.gov/sptaxprog/pdf/1195.pdf (on file with the *McGeorge Law Review*); see also Michelle Steel, *Appeals Court Overturns 1550% Tax Hike on Flavored Beers*, FOX & HOUNDS DAILY (May 2, 2012), <http://www.foxandhoundsdaily.com/2012/05/appeals-court-overturns-1550-tax-hike-on-flavored-beers/> (on file with the *McGeorge Law Review*) (explaining the intent behind the regulations). The role of the Board is to collect “California state . . . alcohol . . . taxes and fees that provide revenue for state government and essential funding for counties, cities, and special districts.” CAL. ST. BD. EQUALIZATION, <http://www.boe.ca.gov/index.htm> (last visited July 15, 2012) (on file with the *McGeorge Law Review*).

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An unintended consequence of the new regulatory scheme was that the Board started to regulate and tax beer, aged in wooden barrels previously containing wine or distilled spirits, as a distilled spirit.⁵ The heightened regulations increased the tax on barrel-aged beer 1550 percent per gallon, which cut into the profit margins of craft breweries, and raised the price of barrel-aged beer for consumers.⁶ Additionally, litigation ensued regarding the Board's power to adopt the regulations.⁷ In response to the regulations, the California Craft Brewers Association (CCBA) solicited Assembly Member Wesley Chesbro to author Chapter 96.⁸ Assembly Member Chesbro claims that the new law clarifies existing rules and protects barrel-aged beer from higher tax rates.⁹

II. LEGAL BACKGROUND

The California Constitution directs the Department of Alcohol Beverage Control (ABC) to regulate the manufacturing, distribution, sale, and taxation of alcoholic beverages "in accordance with law enacted by the Legislature."¹⁰ Additionally, the Alcohol Beverages Control Act (ABC Act) and Alcoholic Beverage Tax Law defines the Board's roll as a tax-collecting agency.¹¹ Collectively, the California Constitution, ABC Act, and Alcoholic Beverage Tax

5. See Telephone Interview with Tom McCormick, Exec. Dir., Cal. Craft Brewers Ass'n (July 6, 2012) [hereinafter McCormick Interview] (notes on file with the *McGeorge Law Review*) (describing why the regulations adopted in 2008 classified some barrel-aged beers as distilled spirits).

6. See Steel, *supra* note 4 (describing the effects of the increased tax); McCormick Interview, *supra* note 5 (explaining that some manufacturers absorbed the tax and others passed it on to the consumer).

7. See Steel, *supra* note 4 (describing the regulatory tax increase because of the 2008 regulations); *Court Overturns Higher Tax on "Hybrid" Bottled Drinks*, MCCLELLAN DAVIS, LLC (May 29, 2012), <http://www.md-salestax.com/court-overturns-higher-tax-hybrid-bottled-drinks/> [hereinafter MCCLELLAN DAVIS] (on file with the *McGeorge Law Review*) (addressing the difference in tax per gallon between distilled spirits and beer); McCormick Interview, *supra* note 5 (asserting that impacts of the regulations on craft brewers and consumers were two of the reasons that the California Craft Brewers Association sponsored Chapter 96).

8. See McCormick Interview, *supra* note 5 (explaining the process the CCBA took from 2008, when the regulations passed, until deciding to lobby for legislation); CAL. CRAFT BREWERS ASS'N, *supra* note 2 ("The primary function of the CCBA is to monitor legislative activity at the state Capitol and to provide a single and coherent political voice that represents the interests of all of California's craft breweries.").

9. Letter from Wesley Chesbro, Assembly Member, Cal. State Assembly, to Jerry Brown, Governor, Cal. (July 9, 2012) [hereinafter Chesbro Letter] (on file with the *McGeorge Law Review*) (asserting that "AB 1812 would clarify the definition of beer for purposes of the Alcohol Beverage Control Act" so that it would not include craft beers aged in barrels that previously held wine or spirits).

10. CAL. CONST. art. XX, § 22. Prior to 1955, the Board possessed complete jurisdiction to regulate alcoholic beverages in California. See CAL. BUS. & PROF. CODE § 23051 (West 1997) (detailing the succession of power from the Board and giving it to ABC). In 1955, California amended the Constitution, which transferred that authority exclusively to ABC. *Id.* (conferring all of the Board's powers, except the power to tax, on ABC). Currently, the California Constitution authorizes ABC to regulate alcoholic beverages according to state law and the Board "collect[s] license fees or occupation taxes." CAL. CONST. art. XX, § 22.

11. See BUS. & PROF. § 23051 (conferring all of the Board's powers, except the power to tax, on ABC); CAL. REV. & TAX. CODE § 32451 (West 2004) (establishing the Board as having the authority to enforce and administer the Alcoholic Beverage Tax Law); *id.* § 32002 (cross-referencing BUS. & PROF. § 23051 as providing the applicable definitions for purposes of the Alcoholic Beverage Tax Law).

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Law codify the existing and overlapping roles of the ABC and the Board, as well as define alcoholic beverages for these purposes.¹²

The Board's 2008 regulations changed the existing regulatory and tax structure and led to litigation that clarified the meaning of the ABC Act and the Alcoholic Beverage Tax Law.¹³

A. *Existing Alcohol Laws in California*

The ABC Act defines three categories of alcoholic beverages: distilled spirits, wine, and beer.¹⁴ Distilled spirits are "an alcoholic beverage obtained by the distillation of fermented agricultural products."¹⁵ The ABC Act defines beer as "any alcoholic beverage obtained by the fermentation of any infusion or decoction of barley, malt, hops, or any other similar product, or any combination thereof in water."¹⁶

The Alcoholic Beverage Tax Law taxes alcoholic beverages by type, using the definitions established by the ABC Act.¹⁷ It implements a tax on beer "at a rate of . . . \$0.20 per gallon."¹⁸ In comparison, California taxes distilled spirits at considerably higher aggregate rates of either \$3.30 or \$6.60 per gallon, depending on alcohol content.¹⁹

12. CAL. CONST. art. XX, § 22; BUS. & PROF. § 23051; REV. & TAX. §§ 3200–32557.

13. *See Diageo-Guinness USA, Inc. v. Bd. of Equalization*, 205 Cal. App. 4th 907, 910, 140 Cal. Rptr. 3d 358, 360 (3d Dist. 2012) (explaining the nature of the suit).

14. BUS. & PROF. §§ 23004–07. Section 23004 further defines "alcoholic beverage" to include "alcohol, spirits, liquor, wine, beer, and every liquid or solid containing alcohol, spirits, wine, or beer, and which contains one-half of 1 percent or more of alcohol by volume and which is fit for beverage purposes either alone or when diluted, mixed, or combined with other substances." *Id.* § 23004.

15. *Id.* § 23005. The term distilled spirit "includes alcohol for beverage use, spirits of wine, whiskey, rum, brandy, and gin, including all dilutions and mixtures thereof." *Id.*

16. *Id.* § 23006. The term beer "includes ale, porter, brown, stout, lager beer, small beer, and strong beer but does not include sake, known as Japanese rice wine." *Id.* Although the ABC Act defines "wine" in section 2307, it is intentionally left out of this article because there are no regulations that define beer as wine. *Id.* § 23007.

17. *See* REV. & TAX. § 32002 (cross-referencing BUS. & PROF. § 23051 as providing the applicable definitions for purposes of the Alcoholic Beverage Tax Law); *id.* § 32101 (pursuant to the ABC Act, the Alcoholic Beverage Tax Law includes alcoholic beverage manufacturers as a taxpayer because they are licensed by ABC of Alcoholic Beverage Control).

18. *Diageo-Guinness USA, Inc.*, 205 Cal. App. 4th at 912, 140 Cal. Rptr. 3d at 361.

19. *See id.* (recognizing that the Board taxed barrel-aged beer at the \$3.30 rate because only distilled spirits that are over fifty percent alcohol incur the higher rate).

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B. The Board Adopts New Regulations in 2008

When FMBs entered the market, ABC mirrored federal law and decided to informally classify these beverages as beer for regulatory and tax purposes, even though they “contained flavorings that are sometimes infused in distilled spirits.”²⁰ Contrary to ABC’s definition, the Board decided to adopt regulations based on their interpretation of the ABC Act and instead classified FMBs as distilled spirits.²¹

The 2008 regulations established a rebuttable presumption, which classified a distilled spirit as any alcoholic beverage (except wine) that gained a one-half percent or more increase in its alcohol content from flavors or other ingredients used during distillation.²² Because “the residual alcohol in the wood” of wine or distilled spirit barrels increases the overall alcohol content in beer past the one-half percent threshold established in the regulations, the Board categorized some barrel-aged beer as a distilled spirit.²³ While regulations forced FMB manufacturers to reformulate their products to avoid paying higher taxes, craft brewers absorbed the costs of the tax or passed it on to the consumer, because they could not change the reality that barrel aging increased the alcohol content by more than one-half percent.²⁴

Diageo-Guinness USA, Inc. sued the Board one day after they implemented the regulations, “seeking a declaration that the FMB Regulations are void as beyond the Board’s authority and not reasonably necessary to effectuate the Board’s taxing function.”²⁵ Although the ABC Act did not define FMBs as either a beer or distilled spirit, ABC followed the federal Tax and Trade Bureau (TTB)

20. See McCLELLAN DAVIS, *supra* note 7 (explaining that ABC classified them as beer because “these drinks were low in alcohol and created by fermentation of grain”).

21. *Id.*; see also *Diageo-Guinness USA, Inc.*, 205 Cal. App. 4th at 912, 140 Cal. Rptr. 3d at 361 (discussing how the Board “received a petition requesting that it begin to tax FMBs as distilled spirits” in 2006, which led to the adoption of the 2008 regulations).

22. CAL. CODE REGS. tit. 18, § 2258 (repealed 2012). The regulations presume that any alcoholic beverage, other than wine, meets the one-half percent increase threshold unless the manufacturer files a report stating otherwise. *Id.* §§ 2259, 2259.1.

23. See McCormick Interview, *supra* note 5 (asserting that although the Board “intended the regulations to affect FMBs, some craft beers were fell under that tax category” because barrel aged beer added a one-half percent alcohol to the final product).

24. See Steel, *supra* note 4 (describing the impact of the regulations on FMB makers); McCormick Interview, *supra* note 5 (detailing the effect of the Board regulations on craft brewers who barrel-aged in wine or distilled spirit barrels). *But see* Alastair Bland, *Liquor Tax Hits Barrel-Aged Beers*, ANDERSON VALLEY ADVERTISER ONLINE (Apr. 15, 2010), <http://theava.com/archives/5765> (on file with the *McGeorge Law Review*) (asserting that some craft brewers either rinsed residual alcohol from the barrel or diluted barrel-aged beer with weaker ales to avoid the tax); E-mail from Tomme Arthur, Dir. Brewery Operations, Port Brewing & The Lost Abbey, to author (July 18, 2012 12:53 PST) (on file with the *McGeorge Law Review*) (asserting that the brewery refused to pay the elevated tax because they believed the Board’s regulations were unconstitutional).

25. See *Diageo-Guinness USA, Inc.*, 205 Cal. App. 4th at 913–14, 140 Cal. Rptr. 3d at 362 (Diageo-Guinness argued that the Board enacted regulations without the express or “implied delegation of power” from the State Constitution or the ABC Act, and exceeded their delegated powers.).

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definition of FMBs because “the volume of [the] added ingredients [were] sufficiently low.”²⁶ The court held that “the Board must look to the definitions in the ABC Act” and cannot adopt independent classifications of alcoholic beverages.²⁷ The ruling in *Diageo-Guinness* did address some of the taxation concerns of the CCBA because it repealed the Board’s regulation and forced the Board to use the ABC Act’s definitions of alcoholic beverages.²⁸ However, the ABC Act still did not explicitly classify barrel-aged beer as a “beer” for regulatory purposes.²⁹

III. CHAPTER 96

Chapter 96 amends the definition of beer in the ABC Act to include “[b]eer aged in an empty wooden barrel previously used to contain wine or distilled spirits shall be defined exclusively as ‘beer.’”³⁰ It also specifically excludes this type of beer from being “considered a dilution or mixture of any other alcoholic beverage.”³¹

IV. ANALYSIS

The purpose of Chapter 96 is to confirm that California law defines barrel-aged beer as “beer” under the ABC Act in order to clarify California’s current regulatory status quo.³² Chapter 96 clarifies the ABC Act’s classification of beer through two complementary statutory amendments.³³ It is likely that these amendments will be sufficient to protect craft brewers from a future reclassification by ABC and will properly regulate beer.³⁴

26. *See id.* at 917, 140 Cal. Rptr. 3d at 365 (although the court applied the TTB definition to FMBs, the resulting increase in alcohol content from barrel aging beer mirrors that of FMBs).

27. *See id.* at 919–20, 140 Cal. Rptr. 3d at 367 (noting that “[r]egulation 2558 essentially redefines beer and distilled spirits” when compared to the ABC Act, which amounts to a “wholesale rewrite” of the statute for taxation purposes).

28. *See* McCormick Interview, *supra* note 5 (describing the positive impact that the ruling in *Diageo-Guinness* had on getting Chapter 96 to pass into law and the remaining concerns the CCBA has regarding the definition of beer for regulatory purposes).

29. *Id.*

30. CAL. BUS. & PROF. CODE § 23006 (amended by Chapter 96).

31. *Id.*

32. SENATE FLOOR, COMMITTEE ANALYSIS OF AB 1812, at 2 (June 27, 2012).

33. BUS. & PROF. § 23006 (amended by Chapter 96).

34. *See* McCormick Interview, *supra* note 5 (asserting that the *Diageo-Guinness* ruling solved the barrel-aged beer tax issue and that Chapter 96 ensures craft brewers will be properly taxed).

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A. Clearly Defining Barrel-Aged Beer

Chapter 96 uses an inclusive and exclusive means to define barrel-aged beer.³⁵ Assembly Member Chesbro, the CCBA, and ABC worked together to draft the language of Chapter 96 specifically to eliminate all ambiguity in the definition of beer pursuant to the ABC Act.³⁶ Chapter 96 effectively uses two parts to clarify the definition of barrel-aged beer: it expands the definition of beer and explicitly excludes barrel-aged beer from the definition of a distilled spirit.³⁷

The first part of Chapter 96 expands the definition of beer in the ABC Act to state clearly what constitutes a barrel-aged beer.³⁸ The words “previously used to contain wine or distilled spirits” are an important inclusion, not only because they encompass a popular brewing technique used by the California craft beer industry, but also because they directly address the ambiguity in the law that exposed barrel-aged beer to the 2008 regulations.³⁹

The second way Chapter 96 clarifies the definition of barrel-aged beer is by purposely matching the existing language in the ABC Act and explicitly excluding barrel-aged beer from the definition of a distilled spirit.⁴⁰ Both Chapter 96 and section 23005 of the ABC Act, which defines distilled spirits, use the words “dilutions” and “mixtures.”⁴¹ While the definition of a distilled spirit uses these words inclusively, Chapter 96 clearly states that barrel-aged beer “*shall not be considered* a dilution or mixture of any other alcoholic beverage,” which directly excludes it from the definition of any other alcoholic beverage but beer.⁴²

B. Chapter 96 Logically Extends the Diageo-Guinness Ruling

While *Diageo-Guinness* did not explicitly address barrel-aged beer, it did clarify that the ABC Act provides California’s exclusive definitions of alcoholic beverages for tax purposes.⁴³ Because, in combination, the *Diageo-Guinness*

35. BUS. & PROF. § 23006 (amended by Chapter 96).

36. *Id.*

37. *See id.* (discussing the wording used in Chapter 96).

38. *Id.* (amended by Chapter 96); SENATE FLOOR, COMMITTEE ANALYSIS OF AB 1812, at 2 (June 27, 2012).

39. BUS. & PROF. § 23006 (amended by Chapter 96); *see also* McCormick Interview, *supra* note 5 (discussing the construction and wording of Chapter 96).

40. McCormick Interview, *supra* note 5. *Compare* BUS. & PROF. § 23005 (West 1997) (defining distilled spirit), *with id.* § 23006 (amended by Chapter 96) (using identical language to specifically exclude barrel-aged beers).

41. BUS. & PROF. § 23005 (West 1997); *id.* § 23006 (amended by Chapter 96); *see also* Chesbro Letter, *supra* note 9 (illustrating that the Board adopted the 2008 regulations based on the definition in section 23005).

42. *See* BUS. & PROF. § 23006 (amended by Chapter 96) (emphasis added); McCormick Interview, *supra* note 5.

43. *See Diageo-Guinness USA, Inc. v. Bd. of Equalization*, 205 Cal. App. 4th 907, 921, 140 Cal. Rptr. 3d 358, 386 (3d Dist. 2012) (asserting that the ABC Act represents California’s “uniform system of classifications for alcoholic beverages”).

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ruling and Chapter 96 are clear, it is unlikely the Board will make any future legal or regulatory challenges to Chapter 96.⁴⁴ The *Diageo-Guinness* case also created awareness and support from the legislature and the alcohol industry that led to Governor Brown signing Chapter 96 into law.⁴⁵ The support from powerful segments of the alcohol industry, such as Anheuser-Busch, also suggests that no lobby will try to put forth future legislation to challenge the validity of Chapter 96.⁴⁶

V. CONCLUSION

Chapter 96 remedies an ambiguous definition of beer that led to improper regulation and taxation of barrel-aged beer.⁴⁷ It protects the existing regulatory and tax structures from improper regulation.⁴⁸ Consequently, Chapter 96 shields craft brewers from increased regulation and higher taxes on barrel-aged beer.⁴⁹ Chapter 96 benefits the California craft brewing industry by increasing profit margins and preventing craft brewers from passing on the additional tax costs to consumers.⁵⁰ The unanimous support from the legislature and broad support from the alcohol industry also indicates that Chapter 96 will prove effective in properly regulating beer.⁵¹

44. BUS. & PROF. § 23006 (amended by Chapter 96); *Diageo-Guinness USA, Inc.*, 205 Cal. App. 4th at 910, 140 Cal. Rptr. 3d at 360; *see also* Press Release, Cal. St. Bd. Equalization, California Court of Appeal Invalidates Distilled Spirits Regulations (June 2012), *available at* www.boe.ca.gov/sptaxprog/pdf/1317.pdf (on file with the *McGeorge Law Review*) (“According to the . . . ruling in *Diageo-Guinness*, . . . California’s Alcoholic Beverage Tax Regulations 2558, 2558.1, 2559, 2559.1, 2559.3, and 2559.5, defining ‘distilled spirits’ . . . for taxation purposes have been invalidated.”).

45. *See* Chesbro Letter, *supra* note 9 (noting that Chapter 96 “passed out of both houses unanimously . . . [with] no opposition”); *see also* McCormick Interview, *supra* note 5 (asserting that the ruling in *Diageo-Guinness* helped Chapter 96 pass into law). “We reached out to beer distributors, big breweries like Anheuser-Busch and MillerCoors, and the wine industry to let them know what we wanted to do and get their feedback. There was no concern or opposition from them [about Chapter 96].” *Id.*

46. *See* McCormick Interview, *supra* note 5 (discussing the wide ranging support for Chapter 96).

47. *See* BUS. & PROF. § 23006 (amended by Chapter 96); McCormick Interview, *supra* note 5 (asserting that the Board over stepped their role in collecting taxes).

48. SENATE FLOOR, COMMITTEE ANALYSIS OF AB 1812, at 2 (June 27, 2012).

49. *Id.*

50. McCormick Interview, *supra* note 5.

51. *Id.*; Chesbro Letter, *supra* note 9.