

City Brewing Company
925 South 3rd Street
La Crosse, WI 54601

October 15, 2003

Chief, Regulations and Procedures Division
Attn: Notice No. 4
Alcohol & Tobacco Tax & Trade Bureau
P.O. Box 50221
Washington, DC 20091

Dear Friends:

City Brewing Company owns and operates a five million barrel capacity brewery in La Crosse, Wisconsin. The brewery was one of seven closed in 1999 as part of a massive consolidation of the US brewing industry that followed acquisition of the Stroh Brewery Company's intangible assets by Miller Brewing Company and Pabst Brewing Company. As a result of that consolidation, the three largest US brewers now brew ninety-five percent (95%) of all beer produced in the United States.

Economic Impact

City Brewing Company resumed operations in 2000 capitalized with funds contributed by employees and local investors. It adopted a contract-packing business strategy because the beer brands formerly produced at the brewery were purchased and controlled through an exclusive dealing contract between Miller and Pabst. Another equally important reason that City Brewing Company adopted a contract-packing strategy was that the massive consolidation of US breweries virtually eliminated all excess brewing capacity for beer marketers other than the largest US brewers. The contract-packing strategy has to date been successful for City Brewing Company. The brewery has been profitable since resuming operation and now employs 350 people with an annual payroll of \$10 million. In a small, midwestern town that has lost thousands of jobs after three large business closures in the last two years, City Brewing Company has added jobs to the local economy.

City Brewing Company produces and packages a variety of alcoholic and non-alcoholic products. In the alcoholic segment of its business, City Brewing Company brews a variety of malt beverages of which the largest single type is flavored malt beverages.. If reclassified as a distilled spirit under the proposed rule, City Brewing Company would no longer be permitted under Federal and state liquor control laws to produce flavored malt beverages. Loss of this business would have a significant negative impact on the business and employment at City Brewing Company. If City Brewing Company were to close as a result of these changes, it would eliminate a significant percentage of the remaining production capacity in the United States brewing industry. In the process, the big three brewers would virtually control access to production by beer marketers.

Flavored Malt Beverages

Flavored malt beverages are brewed using standard malt beverage raw materials and processes, filtered and then combined with other ingredients to create a distinctive taste and color. . They typically contain about the same amount of alcohol as beer (4%-6% by volume) and are packaged in standard brewing industry containers. In short, flavored malt beverages start out like any other beer ... the only difference occurs with the additional "flavoring" of the product.

The flavoring industry uses ethyl alcohol as an extraction medium and solvent for its flavors. Fruit essences, which are used extensively in creating natural fruit flavors, contain an appreciable

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amount (up to 25%) of naturally occurring ethyl alcohol. Flavors must be used at a higher level in malt beverages than in other foods to overcome competing alcohol and malt taste characteristics. In previous comments on this issue, the Flavor and Extract Manufacturers Association (FEMA) stated that alcohol is the "preferred medium" for use in flavorings and also warned that restriction on the amount of alcohol contributed to the finished malt beverage from flavors would make it technically impossible for flavor chemists to satisfy consumers' taste expectations.

TTB Proposed Rule

Tax and Trade Bureau Notice No. 4 proposes to reclassify flavored malt beverages from "beer" to "distilled spirits" if more than one-half of one percent (0.5%) of the product's finished alcohol content is derived from the alcohol contained in flavoring ingredients. The Notice solicits comments on other approaches, including one requiring that a majority of a product's alcohol be derived from fermentation at the brewery. The Notice also seeks comments on the amount of time necessary to comply with the proposed standards.

If all types of alcoholic beverages were taxed and regulated the same, there would be little interest in this proposed rule-making. However, malt beverages enjoy significant advantages over distilled spirits in taxation and regulation regardless of alcohol content. If flavored malt beverages are reclassified as distilled spirits, they will be taxed by the Federal government at rates almost two and one-half times greater than beer. Distilled spirits are taxed at rates dependent upon alcohol content (\$13.50 per gallon containing 50% alcohol by volume). Beer is taxed at the same rate regardless of alcohol content (\$18 per 31 gallon barrel). Thus a flavored alcoholic beverage containing 5% alcohol by volume would be taxed at the rate of \$1.35 per gallon if classified as a distilled spirit but only \$0.58 per gallon if classified as a malt beverage. The difference in Federal taxation translates to an increase of more than a \$1 per six-pack in price to the consumer after applying typical wholesale and retail percentage markups on the taxation differential. State tax differentials would only exacerbate the price increase.

Outdated Definitions

City Brewing Company acknowledges that TTB is handicapped in this rule-making by the lack of attention paid to alcoholic beverages by Congress. As noted in the proposed rule, definitions of "beer, wine" and spirits" contained in the Internal Revenue Code were written and have not been updated since enactment in 1862. The definitions themselves cross category lines. As paraphrased in the Notice of proposed rule-making, "Beer" is defined as "beer and other similar fermented beverages ... containing alcohol ... produced from malt, wholly or in part, or from any substitute therefore." "Spirits" are defined as "ethyl alcohol, ethanol or spirits of wine in any form." Therefore, by definition, beer must contain spirits.

The 0.5% Standard

We question TTB's contention at Page 18-19 in its Notice of Proposed Rulemaking ("What is the Significance of 0.5% Alcohol by Volume?") that "the Treasury Department and its alcohol taxation agencies have historically used the 0.5% alcohol by volume threshold as a dividing line between alcohol products subject to one type of taxation or another." Instead, we contend that the 0.5% "threshold" has heretofore only been used as a line of demarcation between alcoholic and non-alcoholic beverages and not as a line of demarcation between types of alcoholic beverages. The Adjunct Reference Manual has since 1980 allowed the addition of ethyl alcohol to beer without limitation. More recently in Ruling 96-1, ATF allowed flavoring to contribute 1.5% alcohol by volume to malt beverages having 6% or more alcohol by volume. In short, the 0.5% measure has not been used to distinguish between types of alcoholic beverage. Instead, it has only been used as a "tracing measure" to distinguish between beverages with or without alcohol. As a "tracing measure," it is not appropriate for distinguishing between beverages that normally will contain at least 10 to as much as 100 (or more) times the amount of alcohol. In sum, TTB should adjust the percentage of allowable alcohol contribution from flavoring upward to a more

reasonable level. It should do so (i.) in light of the comments of FEMA, (ii.) consistent with TTB's (or its predecessor's) previous guidance on this issue, (iii.) due to the impracticality of using a "trace measure to distinguish between beverages having considerably greater than a "trace" of alcohol, and (iv.) to allow continuing flavor development and product innovation in malt beverages.

Beyond The Source of Alcohol

We also question why TTB focuses exclusively on the source of alcohol in flavored malt beverages in apparent disregard for the amount of alcohol in the finished product. The "alcohol" contributed by flavors or "spirits" in a 5% flavored malt beverage same "alcohol" obtained through fermentation of cereal grains or corn syrup in a 5% beer. Alcohol is alcohol ... it doesn't and shouldn't matter where it comes from. What should matter is the amount of alcohol in the finished product. A leading brand of "ice beer" delivers over 50% more alcohol per comparable serving than the leading brand of flavored malt beverage. So-called "extreme beers" deliver 500% more alcohol than flavored malt beverages. Yet under TTB's proposed rule, the lower alcohol product will be taxed almost two and one-half times greater than the higher alcohol product because its alcohol is derived from "flavoring." In addition, TTB's rule will only mandate that the alcohol content of the lower alcohol product be labeled. What public policy is advanced by such a rule?

Most of the leading brands of beer produced in the United States use a significant percentage of so-called "adjunct" material. In some cases, "fermented malt beverage" is a misnomer ... the name should be changed to "fermented corn syrup beverage." Indeed, there is no Federal regulation mandating that malt comprise a "majority" of the fermentable material in beer. Malt usage can be as little as 25% and still satisfy Federal requirements. Ironically, the "beer" from which spirits are distilled is probably as true a fermented malt beverage as many brands of "beer."

Burdening Innovation and Competition

Common to most highly concentrated industries, there has been little product innovation and correspondingly no recent growth in the United States brewing industry. The leading brewers compete on the basis of promotion and advertising rather than through product innovation. Many leading beer brands are indistinguishable in taste. Not surprisingly, the only segments of the US beer market that have actually grown in recent years are flavored malt beverages and imported beers, both of which offer significant variety in taste and both of which originated from outside the concentration of the US brewing industry. Beer consumers have switched to flavored malt beverages and imported beers as an alternative to the all too common taste of light, American lager beers. Whether intentional or coincidental, the TTB should be concerned about burdening an innovative segment of the beer business, growing in consumer preference, in favor of those with a vested interest in the no-growth status quo.

Alternative Proposal

City Brewing Company suggests that a more reasonable regulation would require that in order to be classified as a fermented malt beverage, not less than 50% of the alcohol in any beverage may be derived from malt or other cereal grains fermented on a brewery premises. Other alcohol additions would be limited to less than 50% of the final alcohol content. In addition, any mandatory labeling regulation should be uniformly applied to all malt beverages regardless of flavoring.

If TTB is concerned about the absolute amount of alcohol that might be added from sources other than fermentation on a brewery premises, it might consider reducing the percentage if the alcohol content of the finished product exceeds those normally associated with beer (4-6% alcohol by volume).

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Implementation Issues

One of the challenges imposed by the proposed regulatory change is how to maintain the taste that has caused consumers to embrace flavored malt beverages. There have been and are flavored malt beverages on the market that have not enjoyed consumer acceptance. To ensure the right taste will require time and money. City Brewing Company recommends a one-year implementation period from the date any final regulation is adopted.

Very truly yours,

CITY BREWING COMPANY

Randy Smith
President