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Flavormatic Industries, Inc.

Comment on Proposed Regulations by the
Alcohol and Tobacco Tax and Trade Bureau
(TTB) 27 CFR Parts 7 and 25
[Notice No. 4]
Flavored Malt Beverages and Related
Proposals (2001R-136P)

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BACKGROUND/SUGGESTIONS:

The Alcohol and Tobacco Tax and Trade Bureau (TTB -formerly the BATF) has proposed new regulations (Notice No.4) that would change the way that companies manufacture Flavored Malt Beverages (FMB). If enacted, these proposed regulations would limit the addition of non-malt derived alcohol to less than 0.5% Alcohol By Volume (ABV). Do I favor such a drastic change that most assuredly would greatly effect the marketability and taste of such a large category - absolutely not!

As a flavor producer, we have had the privilege of working with many malt/beer producers around the world and have tried different malts from various companies. Even with additional treatment, the vast majority of the malt currently produced by some of the larger breweries is not the best tasting when fresh and the "skunky" taste/aroma, which became so popular during past advertising campaigns becomes more prevalent over time. Many flavor companies can (and have) developed acceptable Flavored Malt Beverages within the current TTB guidelines; however, the problem is that once the product gets over a few months old, that "skunky" aroma/taste starts to overpower the product.

To be fair, there is a fairly neutral malt base currently being manufactured by a company in The Netherlands. The problem with this malt base and the reason that it is not used extensively is because of cost. The technology is getting better; however it is still not economically feasible to produce such a "neutral" malt base -even in large volumes. It is possible that within a few years the technology will be affordable and it would be foolish for the TTB or anyone in favor of the proposed changes to cite the existence of this product as justification for the change. If the TTB so drastically changes the current regulations as proposed in Notice Number 4, they will surely kill the FMB market and nobody will invest monies into a technology for a category that no longer exists. The TTB must allow this category to grow and prosper so that companies and individuals will invest in new technologies that would truly revolutionize the segment and eventually allow breweries to manufacture neutral malt bases that are economical. Until such time, the changes I propose below should be seriously considered and when the technology becomes economically feasible to manufacture a truly neutral tasting malt base, the TTB should re-address these regulations and make the necessary changes; however no such change should be considered until such time as the technology is truly affordable to all breweries - large and small. Any drastic change, in my opinion, would leave only the larger breweries in business as they have the monies necessary to invest in research for a neutral malt base. Smaller breweries would be unable to compete against the larger breweries and I am sure that this is not the TTB's prerogative What I

propose is a complete re-writing of the regulations and to throw out the idea of the proposed 0.5% rule that has been openly discussed by the TTB (Notice Number 4) and industry.

I am proposing two completely different types of regulation changes. One is similar to the current distilled spirits regulations regarding the development and manufacture of cordials/liquors and the other one is similar to the current wine regulations in its simplicity. I am not advocating one over the other; however, I strongly believe that the TTB must consider alternatives to what they propose.

Before any new regulations are to be considered, the TTB and the proponents of the new regulations must understand that there is a huge difference between a malt beverage and a distilled spirit beverage. Malt is not a distilled spirit and does not taste nor have the same characteristic as distilled spirits. It is not distilled to get rid of impurities -it is a fermented product that in its pure form is not "clean" tasting and we must understand that to merely flavor a malt base and make it taste "good" is practically impossible. In addition, the justification the TTB gives for their 0.5% threshold should be reevaluated. In Notice Number 4, Section N, Sub-Section C (What is the Significance of 0.5% Alcohol by Volume), The TTB states: "In sum, 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."

This statement should have read that any product (i.e. beverage) that contains less than 0.5% Alcohol By Volume is considered to be non-alcoholic by current regulations and is therefore not subject to any alcohol tax burden. The reason I feel this is inappropriate for consideration in this matter is that the FMB is alcoholic and is being taxed under current TTB regulations. The 0.5% threshold is merely used to decide whether or not a product is alcoholic or not and if it is considered alcoholic, it will be taxed accordingly. Whether or not the FMB contains less than 0.5% ABV of distilled spirits is irrelevant; it will be taxed as an alcoholic beverage and there is precedent in the current TTB regulations to use other types of alcohol to develop a product in a different category (e.g. the use of Other-Than-Standard (OTS) Wine in the manufacture of a liquor/cordial).

Beer, Wine and Distilled Sprits, regardless of how they are produced (fermentation or distillation), are all alcoholic products that have a different set of regulations pertaining to their use, manufacture and effective tax rate. Many companies in the beer industry do not want their products to be classified in the same manner as distilled spirits and they are correct in stating that a flavored malt beverage or a beer is different from a distilled spirits beverage. The 0.5% threshold has absolutely no validity in regards to the taxation rate for Distilled Spirits, Wine or Beer and should not be used in the manner prescribed in Notice Number 4. It is a value at below which a product (any product) can be considered non-alcoholic and therefore subjected to no

alcohol tax. Each product -Beer, Wine and Distilled Spirits -must be treated and handled differently to take into consideration what they are, how they are manufactured and how they are consumed.

The industry manufacturing flavored malt beverages must understand that the regulations are going to change and instead of totally opposing any change; the industry should present realistic alternatives that would avoid the death of this segment. A do-or-die approach is counter-productive and we must accept the idea that the regulations will change. It is our responsibility to offer alternatives that are realistic and fair to all parties involved.

I propose regulations that create a new class of malt beverages that, in the first proposal, are treated similarly to the manner in which cordials/liquors are handled in the distilled spirits regulations and in the second proposal, they are categorized and taxed based upon their malt content (similar to current wine regulations/breakdowns). To understand the rational behind this, understand what the two parties (TTB and Industry) want.

1. The TTB wants to clearly define what is a flavored malt beverage and what is a distilled spirits beverage. In addition, they desire to get the appropriate tax revenue. It is clearly unfair when the beer/malt industry is paying only \$18.00/31- Gallon Barrel while the distilled spirits industry is paying \$13.50/Proof Gallon (PG) and in some instances, the flavored malt beverages are made using blenders which are upwards of 180 Proof. Look at the tax difference if the industry would pay distilled spirits taxes on

such a product versus what they currently pay.

Description	Tax Rate	Applicable Tax (\$ Per Gallon)
1. FMB under current regulations	\$ 18.00/Barrel	\$0.581
2. Distilled Spirits under current regulations	\$13.50/PG	\$1.485

As can be noted from this chart, the government feels that it is losing over \$28.00 in tax revenue per barrel sold. This is a great deal of money and when you take into account the current economic climate, this is money the government can easily collect with little or no repercussions from the general public. The distilled spirits industry is paying a premium in taxes and is competing against unfair, albeit legal, competition.

2. The vast majority of companies that manufacture FMB do not want any change, as they are currently able to use Blenders (upwards of 178.06) that are basically made up of Ethyl Alcohol and Citric Acid. By using very little malt, they are able to create a good tasting product that has no discernable variation in taste over time -none of the "skunkiness" of the Malt because it is used at very low levels.

The solution is not easy. The TTB does not desire to kill a segment that generates tax revenue and supports many other industries (trucking, bottles, advertising, warehouse, etc.,) and the producers of the FMB do not desire to lose millions of dollars in sales. Whatever is eventually put into law by the TTB must be fair and equitable to all parties involved. This will not be an easy task considering the forces aligning both for and against the proposed regulations.

Proposal No.1:

Firstly, as a flavor supplier, we believe that a FMB that contains at least 25% of the alcohol from Malt can still taste good in six to nine months. This is not the desired shelf life that the industries desires (it wants at least one year), but let's face facts; if the product is not moving off of a shelf in six to nine months, then the brand has problems and the least of which is the taste it will have in six to nine months. These products should sell within three months (+), not much longer. If industry is targeting a lifespan of over a year, then they better re-evaluate how much they are producing and the marketing and development of their products. A good product will sell while a poorly developed and marketed product will not!

Here are the new breakdowns/tax regulations that should be written:

1. A product cannot be considered a Flavored Malt Beverage if less than 25% of the alcohol is derived from Malt -to be considered a FMB, at least 25% of the alcohol on a Proof Gallon Basis (PG) must come from Malt.
2. Malt producers should be allowed to:
 - a. Continue using blender's manufactured predominantly from distilled spirits in the production of FMB.
 - b. Use Other-Than-Standard (OTS) Wine in the production of FMB and OTS Wines should not constitute greater than 49% (on a PG basis) of the total alcohol content.
 - c. Claim a tax credit of 2.5% on "approved for drawback" flavors and blenders.

These ideas are similar to the regulations currently in place by the TTB in regards to the development of liquors/cordials except that TTB approved for drawback blenders/flavors would be taxed at distilled spirits rates when used in flavored malt beverages. In addition, it should be noted that there is precedent by the TTB to allow the use of other classes of alcohols in the development of another class. For example: OTS Wines can be used in the development of a liquor/cordial and the use of blenders and the "flavor" credit are also in the distilled spirits regulations. A creative product development person could technically create a liquor/cordial where over 50% of the

alcohol would come from an OTS Wine, Flavor or Blender. To be successful in the alcohol industry, one must understand the regulations and know how to use them to their advantage.

1. The following categories of malt products should be taxed at the current rate of \$18.00 per Barrel (31 Gallons):

- a. Beer
- b. Flavored Beer
- c. Flavored Malt Beverage where at least 51% of the alcohol is derived from Malt (51% on a Proof Gallon basis).

2. All other Flavored Malt Beverages would be taxed in the same manner as liquors/cordials and must have at least 25% of their alcohol derived from Malt. In other words, we are creating a new category in the malt regulations for beverages where 25% -<51% (on a PG Basis) of the alcohol is derived from Malt.

3. Regardless of what method is used, the minimum tax levy will be \$18.00/barrel (31 gallons) when manufacturing a FMB up to 6% ABV. If a brewmaster is creative and the tax levy per barrel is less than \$18.00/barrel, the barrel would be taxed at \$18.00/barrel; not the lower rate. The minimum tax levy would remain at \$18.00/barrel.

4. For FMB where 25%-<51% (on a PG basis) of the alcohol is derived from Malt:

- a. OTS Wine will be taxed according to TTB regulations. (See below); however no more than 49% of the alcohol (on a PG basis) may come from an OTS Wine.
- b. TTB Approved Blenders (manufactured using distilled spirits) will be taxed accordingly at a TTB rate of \$13.50/PG. This is new!! No longer will TTB approved for drawback blenders be used without any tax consequence in the development of a FMB. This tax will only be imposed if the TTB Approved Blender is used at greater than 2.5% (on a PG basis). Under 2.5%, the tax credit would negate any tax due.
- c. Malt will be taxed at a rate of \$2.64/PG. This amount is being used because some malt producers ferment a malt up to 11% ABV (+). If we were to sell a barrel of such a product, this would work out to approximately \$2.64/PG. This assigns a \$/PG tax to malt that I believe is fair and in many instances, it is close to the tax rate of \$18.00/Barrel (\$0.58/WG).

The effective tax rates would be as follows:

Malt	: \$2.64/PG
Wine (14% and under ABV)	: \$1.07/WG
Wine (14 to 21% ABV)	: \$1.57/WG
Wine (Over 21 to 24% ABV)	: \$3.15/WG
Distilled Spirits/Blenders (flavors)	: \$13.50/PG(*)

This tax structure would only be used on FMB that have 25 to 51% of their alcohol (on a PG basis) derived from Malt and the only addition to Current TTB regulations is the Malt Tax Rate of \$2.64/PG and the tax imposed on TTB approved blenders/flavors when used in the manufacture of a FMB.

(*) Distilled Spirits Blenders\Flavors would only be taxed at this rate if they are used at greater than 2.5% (on a PG Basis) in the FMB. Up to 2.5%, the tax credit would negate

any tax consequence.

Yes, the tax levy will be more than \$18.00/barrel in some instances; however if they desire a cleaner tasting product, they will have to pay for that privilege and the additional tax cost is not insurmountable. For example, if a beverage were developed where 25% of the alcohol (PG basis) came from Malt and the remainder came from a blender, the tax liability would be almost double what it currently is (\$35.63/barrel vs. \$18.00/barrel); however the additional cost per 12-ounce bottle would be an extra \$0.054 (\$1.30/case). I cannot imagine that the consumer would not pay an additional \$0.06/bottle for a better tasting product that has a longer shelf life. If the brewery considers this to be too large an additional tax burden, they have the flexibility to re-formulate the FMB to their liking.

The only true concern I have is how the individual states tax flavored malt beverages. An additional \$0.12/bottle tax. levy would be a burden upon industry and this issue must also be addressed. How will any changes in TTB regulations effect tax levies by states?

A brew master (so long as they pay for the appropriate license), may use OTS Wine (in the same manner as developers of liquors/cordials) and also continue to use blenders. The same regulations that exist in creating a liquor/cordial would apply to flavored malt beverages that have 25%-<51% (on a PG basis) of their alcohol from Malt. A flavored malt beverage that has 51% (on a PG basis) of their alcohol from malt may continue to use blenders/flavors to make up the other 49%.

The rationale here is that to avoid paying additional tax. Most brew masters would create beverages where 51% of the alcohol comes from the Malt. For others who desire to have a cleaner tasting product, especially six months down the road, they have the freedom to develop such a product and pay the appropriate taxes.

The reason I chose the 25% limit is because I believe that a good tasting product could be created containing this much Malt and if taxed in the same manner as a liquor/cordial, the tax liability would be acceptable to both industry and the TTB.

To help you understand the tax consequences better, I have put together charts showing the various tax levies at various percentages. Please feel free to look at this and send me your comments. (see attachments). In the example, I look at the creation of a flavored malt beverage that is 5.5% alcohol by volume (11 Proof). I have attached a spreadsheet showing various tax levies depending on the raw materials (Malt, Alcohol Blender and OTS Wine) used to manufacture a FMB. Please review the attached spreadsheet and note that I will be attaching this file to the TTB (as an Excel Spreadsheet) via e-mail so that they can adjust the numbers and see how the calculations work.

The Charts (4) May Be Viewed in the ATF Reference Library

Proposal No.2:

This proposal simplifies the tax structure and is similar to Proposal #1 in that it does not allow the manufacturer of a FMB to have a Malt content of less than 25% ABV. The reason this is offered as an option is because of its simplicity. Current procedures would remain in place with the only differences being the tax paid per barrel (this would vary as per Malt content) and the 25% Malt threshold that would now be enforced. The proposal is as follows:

1. Where Malt Content is 1-25% Alcohol by Volume (ABV), the product would not be permissible and could not be produced and/or marketed.
2. Where the Malt Content is 25-<51 % ABV, the tax would be \$26.00/barrel.
3. Where the Malt Content is Greater than 51 %, the tax would be \$18.00/barrel.
4. FMB producers could continue use Blenders to make up the remainder of the alcohol content of the FMB. (OTS Wines use could not be used.)

Proposal No.2 is offered as an alternative to Proposal No.1 and is offered due to its

simplicity. For producers who still desire to develop a product with as little Malt as possible, they could develop a product where 25% of the alcohol comes from Malt and merely pay a higher tax rate. The option is theirs and they must make the decision as to whether or not they could market and sell a FMB with a higher tax levy. The option to do so is still available to them and that is the purpose of my proposals - flexibility.

CONCLUSION:

As I read the Notice No.4 from the TTB, I was concerned that the TTB and industry were headed down a dangerous path that could eventually lead to the death of this category. For years, industry got away with murder and it was now pay-back time. It was not my desire to please everyone involved in this decision making process and most assuredly, I will not please everyone in the industry. The fact is the regulations will change and we must except this; however we must do our best to create fair and workable regulations that do not overly burden industry and create a fair and equitable tax revenue that is acceptable to both industry and the TTB. Does that mean my comments should be used as a basis for generating new regulations? Possibly; however, they should be used to have open and truthful discussion that will eventually lead to the fair and equitable regulations that we all desire. To accept what the TTB proposes would most assuredly result in the death of the FMB category. I ask the TTB to take into consideration their actions and to work with the FMB industry in developing fair and equitable regulations.

Any change will be frowned upon; however the changes I have outlined above are fair and give industry a little flexibility and creativity that never existed before.

If you have any questions or comments, please address them to me at the address below.
Sincerely Yours,

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The Flavored Malt Beverage Calculation Sheet May Be

Viewed in the ATF Reference Library