

spirits prior to bottling or releasing bottled distilled spirits from customs custody. Regulations implementing these FAA Act provisions appear in 27 CFR Part 5, Labeling and Advertising of Distilled Spirits.

E. Why Are We Concerned With the Production, Labeling, and Taxation of Flavored Malt Beverages?

This proposed rulemaking addresses the question: "Should certain products currently marketed as flavored malt beverages be classified as malt beverages or distilled spirits under the FAA Act and the Internal Revenue Code?" The answer to this question affects the rate of tax applicable to them, the premises where they may be produced, the way they are labeled, advertised, marketed, and the distribution system by which they are sold to retailers and consumers. Further, their classification as malt beverages or as distilled spirits may affect State oversight and control of these alcohol beverages.

State regulatory and taxation agencies have expressed concern about flavored malt beverages and have requested that we take action to clarify their status as either malt beverages or distilled spirits. Moreover, through our own examination of these products, we believe that, because of their present formulations, many beverages currently marketed as flavored malt beverages should not be so classified.

This notice proposes significant changes in our regulations issued under both the IRC and the FAA Act.

II. Alcohol Beverage Production

A. Fermentation

Fermentation is the process by which yeast converts sugar into alcohol and carbon dioxide. Both the definition of "beer" under IRC section 5052 and "malt beverage" under § 211 of the FAA Act focus on fermentation as the source of the alcohol in these products.

B. IRC Definition of Beer

Under the Internal Revenue Code, "fermentation" is the determining criteria for defining beer. In 1869, the Commissioner of Internal Revenue ruled that the term "substitute for malt" within this definition includes other fermentable substances such as rice, grain of any kind other than malt, sugar, bran, and glucose. In re-enacting the Internal Revenue Code in 1954, Congress specifically included saké, a fermented rice-based beverage, and products similar to saké within the definition of beer for production and taxation purposes. This specific inclusion shows that, while saké and

similar products do not resemble beer, ale, porter or stout, Congress intended that such products are to be considered fermented products and taxed at the beer rate. In all cases, the IRC definition of beer hinges "fermentation."

C. What Are Nonbeverage Distilled Spirits?

Distilled spirits have thousands of nonbeverage and industrial uses. Distilled spirits are used in solvents, medicines, flavor manufacture, pharmaceutical products, cleaning products, food products, fuels, ink, and many other ordinary items. Generally, the IRC does not require payment of the excise tax, or it permits rebate of most of the excise tax, when distilled spirits are used for nonbeverage or industrial purposes.

Under IRC § 5131, a person may use taxpaid distilled spirits in the manufacture of medicines, medicinal preparations, food products, flavors, flavoring extracts, or perfume.

The excise tax treatment of distilled spirits used in "nonbeverage" products is different because these products are "unfit for beverage use;" i.e., an ordinary person would not consume these products for beverage purposes. This criterion does not, however, require that nonbeverage products be poisonous or harmful if consumed, and, indeed, nonbeverage products deemed "unfit for beverage use" are often used to produce food and beverage products intended for human consumption.

D. How Are Flavored Malt Beverages Different Than Other Malt Beverages?

Flavored malt beverages are produced at breweries and taxpaid as beer. However, as previously stated, most flavored malt beverages differ from traditional brewery products:

- The beer base is treated to remove taste, aroma, bitterness, and extracts, leaving a base;
- Their taste is derived from added flavors rather than from fermentation of malt and other fermentable materials;
- They have low carbonation;
- They are clear in color, or their color is derived from added flavoring or coloring materials;
- Their alcohol content is derived in large part from the distilled spirits contained in the added flavoring materials, rather than from the fermentation of malt and other materials.

The last characteristic not only sets flavored malt beverages apart from other malt beverages, but also raises the question of whether they should be classified as beer or as distilled spirits.

III. Flavored Malt Beverages Study

A. What Was the Study's Intent?

In order to address the question of the classification of flavored malt beverages, we examined the formulation of 114 alcohol beverage products labeled and marketed as flavored malt beverages. The intent of this study was to find out how these products are produced, what ingredients are used, and where the alcohol in them is derived. This study did not examine malt beverages that are labeled and marketed as flavored beers, flavored ales, and so forth since these types of malt beverages typically have the character of malt beverages and their alcohol is derived primarily from fermentation.

Please note: Since this study examined individual formulas and production batch records furnished by brewers, it contains confidential, proprietary information that is protected from unauthorized disclosure under IRC sections 6103 and 7213, and under the Trade Secrets Act, 18 U.S.C. 1905. Thus, by law, we cannot furnish this study to the public, either on request or under the Freedom of Information Act, without pervasive redactions.

B. What Were the Study's Findings?

For each flavored malt beverage, we examined batch records to determine: (1) The amount of alcohol derived from alcohol flavors added during production, (2) the amount of alcohol derived from fermented material produced at the brewery, and (3) the volume of beer base present in the flavored malt beverage. For the 114 different flavored malt beverages studied, we found the following:

TABLE 1.—ALCOHOL DERIVED FROM ADDED ALCOHOL FLAVORING MATERIALS

Alcohol percentage derived from added alcohol flavors	Number of Flavored Malt Beverages
0–25	4
26–50	0
51–75	5
76–100	105
Maximum Alcohol Derived From Added Alcohol Flavors: 99.98%	Total: 114