



Cover Over of Taxes Collected on Certain Distilled Spirits Transported to the United States from Puerto Rico and the U.S. Virgin Islands

Certain excise taxes collected on articles produced in Puerto Rico or the U.S. Virgin Islands (USVI) and transported to the United States are paid or “covered over” into the treasuries of Puerto Rico or the USVI, respectively. Distilled spirits originally distilled elsewhere must undergo a “substantial change in identity” in Puerto Rico or the USVI and must meet certain statutory criteria to be considered “produced” there for this purpose. Distilled spirits do not undergo a substantial change in identity when they are redistilled to make rum in Puerto Rico or the USVI and are not subjected to other manufacturing operations there. Depending on the circumstances of the individual case, distilled spirits originally distilled outside Puerto Rico or the USVI may undergo a substantial change in identity when they are subjected to additional manufacturing operations in Puerto Rico or the USVI other than redistillation alone to make rum.

TTB RULING 2014-5

Introduction

The Alcohol and Tobacco Tax and Trade Bureau (TTB) administers provisions of the Internal Revenue Code of 1986, as amended (IRC) in 26 U.S.C. 7652(a)(3) and (b)(3) that require a proportion of Federal excise taxes collected on certain distilled spirits to be paid into the treasuries of Puerto Rico and the U.S. Virgin Islands (USVI) (collectively, “the territories”), respectively. When distilled spirits described in section 7652(c) are produced in Puerto Rico or the USVI and transported to the United States, the United States government pays or “covers over” a proportion of the taxes collected on the spirits to the territory where the spirits are produced. In other words, spirits meeting these criteria are “eligible for cover over.” The spirits described in section 7652(c) include rum as defined under TTB regulations in 27 CFR part 5, subpart C.

TTB and its predecessors have long held that distilled spirits originally distilled outside Puerto Rico or the USVI must undergo a “substantial change in identity” in either territory to be considered “produced” in that territory and therefore eligible for cover over under IRC section 7652(a)(3) or (b)(3). This Ruling explains the factors TTB uses in applying the “substantial change” standard and applies the standard to certain circumstances where distilled spirits are further manufactured in Puerto Rico or the USVI after they are originally distilled elsewhere.

Statutory Authority for Excise Taxes and Cover Over

Federal Excise Taxes on Distilled Spirits

The IRC imposes a tax of \$13.50 per proof gallon on distilled spirits produced in the United States or imported into the United States from foreign countries. This tax rate is set forth in 26 U.S.C. 5001(a)(1). Separate provisions of the IRC in section 7652(a)(1) and (b)(1) also impose the same rate of tax (an “equalization tax”) on spirits coming into the United States from Puerto Rico and the USVI, except as provided in 26 U.S.C. 5314. TTB exercises authority under these provisions of the IRC pursuant to section 1111(d) of the Homeland Security Act of 2002, codified at 6 U.S.C. 531(d). The Secretary of the Treasury has delegated various authorities through Treasury Department Order 120–01 (Revised), dated December 10, 2013, to the TTB Administrator to perform certain functions and duties in the administration and enforcement of these provisions.

Cover Over of Equalization Taxes on Distilled Spirits

Sections 7652(a)(3) and (b)(3) of the IRC provide that equalization taxes collected on articles produced in Puerto Rico or the USVI and transported to the United States (less certain amounts specified in the statute) are paid or “covered over” into the treasuries of Puerto Rico or the USVI, respectively. For articles that are taxed as distilled spirits, equalization taxes collected on such articles are covered over to the territory where the article is produced at the rate specified in section 7652(f).

Section 7652(c) further provides that any article containing distilled spirits shall not be treated as produced in Puerto Rico or the USVI for the purposes of determining cover over eligibility unless at least 92 percent of the alcohol content in such article is attributable to rum. Therefore, distilled spirits produced in these territories and transported to the United States are not eligible for cover over of equalization taxes unless at least 92 percent of the alcohol content of the spirits is attributable to rum.

For purposes of section 7652(c), TTB defines the term “rum” in that provision under the standards of identity set forth in 27 CFR 5.22. Under § 5.22(f), “rum” is an alcoholic distillate from the fermented juice of sugar cane, sugar cane syrup, sugar cane molasses, or other sugar cane by-products, produced at less than 190 proof in such manner that the distillate possesses the taste, aroma, and characteristics generally attributed to rum, and bottled at not less than 80 proof; and also includes mixtures solely of such distillates.

Distilled spirits that do not meet the requirements of section 7652(c) are not eligible for cover over. For example, neutral spirits produced in Puerto Rico or the USVI and transported to the United States are not eligible for cover over. The term “neutral spirits” refers to the class of distilled spirits defined in TTB’s standards of identity in § 5.22(a). Under § 5.22(a), neutral spirits are distilled spirits that are produced from any material at or above 190 proof, and, if bottled, bottled at not less than 80 proof.

Cover Over of Taxes Imposed on Certain Distilled Spirits Imported into the United States from Foreign Countries

Section 7652(e) of the IRC provides that all taxes collected under section 5001(a)(1) on rum imported into the United States (less certain amounts specified in the statute) shall be covered into the treasuries of Puerto Rico and the USVI. Like the equalization taxes described above, the taxes imposed under section 5001(a)(1) on rum imported into the United States from foreign countries are also covered over to those territories at the rate specified in section 7652(f). However, there are several key differences between rules that apply to these cover-over payments and those that apply to the cover over of equalization taxes under section 7652(a)(3) and (b)(3), as discussed above. First, for purposes of cover-over payments under section 7652(e), the term “rum” is defined as set forth in section 7652(e)(3) with reference to the Harmonized Tariff Schedule of the United States. Second, cover-over payments under section 7652(e) are split between Puerto Rico and the USVI under requirements set forth in TTB’s regulations in 27 CFR part 26, subpart Ca. The foreign country where the product is originally distilled or further manufactured is not relevant for purposes of determining the amount that is covered over to the treasury of each territory under these provisions. These two differences, while not exhaustive, are offered to illustrate that cover-over eligibility is determined in a different way for distilled spirits produced in foreign countries and transported to the United States than it is for distilled spirits produced in Puerto Rico or the USVI and transported to the United States.

The Substantial Change in Identity Standard and ATF Ruling 83–4

TTB has long held that distilled spirits originally distilled outside Puerto Rico or the USVI must undergo a “substantial change in identity” in one of the territories to be considered “produced” there under section 7652(a)(3) or (b)(3), respectively. TTB’s predecessor, the Bureau of Alcohol, Tobacco and Firearms (ATF), issued a public ruling in 1983 on this subject. See [ATF Ruling 83–4](#) (the Ruling). The Ruling described the general requirements of the “substantial change” standard as follows: “Token treatment is not sufficient. The spirits must undergo substantial changes in taste, aroma and chemical composition. In short, a new and different article must emerge.”

ATF Ruling 83–4 applied the substantial change standard to two specific factual scenarios involving products originally distilled in the United States, subsequently redistilled to make neutral spirits in Puerto Rico, and then transported back to the United States. The Ruling also applied to products transported to the United States from the USVI. First, the Ruling held that no substantial change occurred when neutral spirits at 190 proof produced in the United States were redistilled in Puerto Rico to remove congeners (but which may or may not have increased in proof), even if the spirits were also charcoal filtered. Second, the Ruling held that no substantial change occurred when spirits produced in the United States at more than 160 proof but less than 190 proof (but which were “substantially neutral in character” and conformed to no other

specific classes of spirits such as whiskey) were redistilled in Puerto Rico into neutral spirits of 190 proof or above.

The Ruling's holdings regarding neutral spirits are officially obsolete because statutory changes in 1984 (now codified in section 7652(c)) eliminated cover over of equalization taxes for neutral spirits produced in the territories and because the Ruling was revoked by [ATF Ruling 87-2](#). ATF Ruling 83-4 and ATF Ruling 87-2 are attached to this document for reference purposes. Notwithstanding the statutory changes, the Ruling's general explanation of the substantial change standard (quoted above) is still authoritative because ATF Ruling 87-2 provided that revoking ATF Ruling 83-4 and other rulings did not "reflect any change in the regulatory policies of the Bureau." The Ruling's application of the substantial change standard to the factual scenarios is therefore generally instructive for considering how the standard applies under current law.

Factors Used in Applying the Substantial Change in Identity Standard

ATF Ruling 83-4 and other TTB determinations (e.g., private letter rulings that are protected from disclosure under 26 U.S.C. 6103) point toward the following factors for determining whether distilled spirits undergo a substantial change in particular cases as a result of additional manufacturing operations in Puerto Rico or the USVI. Because TTB applies these factors under the circumstances of each individual case, determinations regarding whether a substantial change has occurred require fact-specific analysis.

- *Change in Standard of Identity:* TTB's analysis under the substantial change standard includes a review of whether the manufacturing operations in Puerto Rico or the USVI cause a change in class of the spirits for purposes of TTB's standards of identity in 27 CFR part 5. Generally, a change in class of the spirits for purposes of part 5 is a factor that weighs in favor of a finding of substantial change. However, a change in class is neither necessary nor sufficient for a finding of substantial change in every case.
- *Comparison of Products Before and After Manufacturing:* TTB's analysis also involves a comparison of the spirits before and after the manufacturing operations in Puerto Rico or the USVI to determine whether the products undergo substantial changes in taste, aroma, and chemical composition. This comparison may entail a review of descriptions of the products and a review of physical samples of the products. As part of the comparison, TTB also reviews the manufacturing operations that caused the changes. ATF Ruling 83-4 noted that "[t]oken treatment is not sufficient" to cause a substantial change. Manufacturing operations that cause more significant changes weigh in favor of a finding of substantial change for purposes of this factor. Manufacturing operations that cause less significant changes weigh against a finding of substantial change. For example, ATF Ruling 83-4 held that neither neutral spirits nor certain spirits that were "substantially neutral in character" underwent a

substantial change when they were redistilled to make neutral spirits in Puerto Rico and not subjected to other manufacturing operations.

In evaluating whether distilled spirits originally distilled outside Puerto Rico or the USVI undergo a substantial change in identity as a result of further manufacturing in one of the territories, TTB applies the factors described above and considers any other relevant circumstances.

TTB Determination on Certain Redistillation Operations

TTB has received inquiries asking whether distilled spirits originally distilled outside Puerto Rico or the USVI may be redistilled in one of these territories to make rum that is eligible for cover over under section 7652(a)(3) or (b)(3), respectively. Under these scenarios, the distilled spirits are originally distilled outside Puerto Rico or the USVI from fermented sugar cane products at less than 190 proof. The distilled spirits are then shipped to Puerto Rico or the USVI for redistillation. In Puerto Rico or the USVI, the spirits are redistilled at less than 190 proof. The redistillation increases the proof of the spirits and decreases the proportion of congeners in the spirits. Under the scenarios described, no additional manufacturing operations occur in Puerto Rico or the USVI, and the spirits conform to TTB's standard of identity for rum in § 5.22(f) after redistillation. The spirits are then transported to the United States.

Held: The distilled spirits in these scenarios do not undergo a substantial change in identity as a result of the redistillation in Puerto Rico or the USVI. This determination is based on application of the substantial change factors described herein. First, the redistillation does not cause a change in class for purposes of TTB's standards of identity because the spirits before redistillation substantially conform to the standard for rum in § 5.22(f). Second, although a comparison of the spirits before and after redistillation shows changes in proof and congener content of the spirits, changes caused by redistillation alone are not enough to cause a substantial change when the redistillation does not cause a change in class of the spirits. In light of these factors, TTB has determined that the spirits in these scenarios do not undergo a substantial change in identity in Puerto Rico or the USVI and are therefore not eligible for cover over under section 7652(a)(3) or (b)(3).

TTB Determination on Certain Operations Other Than Redistillation Alone

TTB has also received inquiries asking whether distilled spirits originally distilled outside Puerto Rico or the USVI may be subjected to additional manufacturing operations other than redistillation alone in one of these territories to make rum that is eligible for cover over under section 7652(a)(3) or (b)(3), respectively. Under these scenarios, the distilled spirits are originally distilled outside Puerto Rico or the USVI from fermented sugar cane products at less than 190 proof and then shipped to one of the territories for further manufacturing. In one scenario, the spirits are not redistilled in the territory but are subjected to additional operations that include mixing with other spirits that have been originally distilled in the territory. In a second scenario, the spirits are redistilled in

the territory and then subjected to additional operations that include mixing with spirits that are not originally distilled in the territory. Additional operations in the territories under these two scenarios include a combination of at least two of the following: aging in oak barrels, treatment with oak chips, filtration, and other operations. In both scenarios, the spirits conform to TTB's standard of identity for rum in § 5.22(f) after the manufacturing operations in Puerto Rico or the USVI. The spirits are then transported to the United States.

Held: In determining whether the spirits undergo a substantial change in identity as a result of the manufacturing operations described in the scenarios, TTB applies the substantial change factors to the circumstances of each individual case. First, the manufacturing operations in the two scenarios do not cause a change in class for purposes of TTB's standards of identity because the spirits originally distilled outside Puerto Rico or the USVI substantially conform to the standard for rum in § 5.22(f) before the manufacturing operations. Second, however, TTB has found in some cases that the spirits in these scenarios undergo a substantial change in identity because the manufacturing operations in Puerto Rico or the USVI cause substantial changes in taste, aroma, and chemical composition. In the first scenario, TTB has found in some cases that the spirits undergo a substantial change when they are mixed with other spirits that have been originally distilled in the territory and the mixture is subjected to a combination of at least two of the additional operations described above. In the second scenario, TTB has found in some cases that the spirits undergo a substantial change when they are redistilled in the territory and mixed with spirits that are not originally distilled in the territory, and the mixture is subjected to a combination of at least two of the additional operations described above. In the cases where the spirits undergo a substantial change in these scenarios, TTB has determined that the spirits are eligible for cover over under section 7652(a)(3) or (b)(3).

Date signed: September 4, 2014

/s/

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