

[Senate Bill x2 14](#) (Hernandez)

Date: 09/09/2015

Program: Cigarette and Tobacco Products Tax

Sponsor: Author

BPC Section 22971.05, RTC Sections 30014, 30104, 30108, 30166, 30181, and Article 2.5 (commencing with Section 30130.51)

Effective January 1, 2016 but tax increase operative April 1, 2016.

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This analysis only addresses the provisions that impact the Board of Equalization (BOE).

Summary: Among other things, this bill:

- Imposes an additional \$2 per pack cigarette tax, an equivalent floor stock tax,¹ and indirectly increases the tobacco products tax;
- Imposes a new tax upon electronic cigarettes (e-cigarettes), as defined, based on the wholesale cost of these products;
- Caps the distributor discount allowed for stamp and meter register setting purchases; and
- Defines e-cigarettes as a tobacco product under the Cigarette and Tobacco Products Licensing Act of 2003 (Licensing Act).

Purpose: To decrease smoking rates, improve access to health care, and advance California's tobacco prevention and control programs.

Fiscal Impact Summary: Fiscal Year 2016-17 cigarette and tobacco tax revenues of \$1.69 billion; sales and use tax revenues of \$45.5 million; and one-time licensing fees of \$110,000.

Existing Law: Cigarette and Tobacco Products Tax Law. Existing law imposes an \$0.87 per package of 20 (43 ½ mills per cigarette) cigarette tax. The cigarette tax components and the revenue disposition are as follows:

- \$0.10 per pack (5 mills per cigarette) is allocated to the General Fund (Sections 30101 and 30462 of the Revenue and Taxation Code (RTC));
- \$0.02 per pack (1 mil per cigarette) is allocated to the Breast Cancer Fund (RTC Sections 30101 and 30461.6);
- \$0.25 per pack (12 ½ mills per cigarette) is allocated to the Cigarette and Tobacco Products Surtax Fund (RTC Sections 30122 and 30123); and
- \$0.50 per pack (25 mills per cigarette) is allocated to the California Children and Families (CCF) Trust Fund (RTC Sections 30131.2 and 30131.3).

RTC Section 30123 imposes a tax upon the distribution of tobacco products, based on the wholesale cost of these products at a tax rate that is equivalent to the combined rate of tax imposed on cigarettes. In addition, Section 30131.2 imposes an additional tobacco products tax at a rate equivalent to the \$0.50 per pack cigarette tax. The BOE determines the tobacco products tax rate annually based on the March 1 wholesale cost of cigarettes. The 2015-16 tobacco products rate is 28.13%.

The BOE deposits the tobacco products surtax imposed under Section 30123 into the Cigarette and Tobacco Products Surtax Fund (including any revenues that result from an indirect increase in the tobacco products tax triggered by a cigarette tax increase). The BOE deposits the tobacco products surtax imposed under Section 30131.2 into the CCF Trust Fund.

¹ A floor stock tax is a one-time tax on all tax-paid (stamped) cigarettes and unaffixed tax stamps in the possession of distributors, wholesalers and/or retailers on the effective date of a cigarette and tobacco products tax increase. The floor stock tax rate is the difference between the old tax rate and the new tax rate.

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Distributor Discount. RTC Section 30161 generally provides that the cigarette tax shall be paid by distributor through the use of stamps or meter impressions. Section 30163 requires that an appropriate stamp or meter impression be affixed to, or made on, each cigarette package prior to distribution of the cigarettes, unless otherwise provided.

RTC Section 30166 provides that stamps and meter register settings be sold to licensed distributors at their denominated values less 0.85 percent. The discount intends to help defray the cost (leasing equipment/labor cost) to the distributor for affixing the stamps.

Proposition 10 Backfill. Health and Safety Code (HSC) Section 130105² requires the BOE annually to determine the revenue reductions to any Proposition 99 state health-related education and research programs and the Breast Cancer Fund that result directly from Proposition 10's additional taxes. These reductions may result from reduced consumption or increased black market activity due to the increased tax. HSC Section 130105 also requires funds to be transferred from the CCF Trust Fund to affected programs to offset these revenue reductions.

Cigarette and Tobacco Products Licensing Act³ (Licensing Act). The Licensing Act requires the BOE to administer a statewide program to license cigarette and tobacco products manufacturers, importers, distributors, wholesalers, and retailers. Business and Professions Code (BPC) Section 22970.1 includes legislative findings and declarations that state "tax revenues have declined by hundreds of millions of dollars per year due, in part, to unlawful distributions and untaxed sales of cigarettes and tobacco products conducted by organized crime syndicates, street gangs, and international terrorist groups." Section 22970.1 further provides that "the licensing of manufacturers, importers, wholesalers, distributors, and retailers will help stem the tide of untaxed distributions and illegal sales of cigarette and tobacco products."

Proposed Law: Cigarette Tax Increase. This measure enacts **The California Health Care, Research, and Prevention Tax Act of 2015⁴** (Tobacco Act) to impose an additional cigarette tax at a rate of \$2 per package of 20. The new cigarette tax rate would be \$2.87 per pack of 20. The additional cigarette tax is imposed on and after the first day of the first calendar quarter commencing more than 90 days after the effective date.

E-Cigarette Tax. Every distributor of e-cigarettes is subject to a tax upon the distribution of e-cigarettes equivalent to the total tax imposed on cigarettes. The tax is imposed on the distribution of: (1) any liquid or substance containing nicotine, (2) any device intended to be used to deliver aerosolized or vaporized nicotine to the person inhaling from the device, and (3) any component, part, or accessory of such a device that is intended to be used to deliver aerosolized or vaporized nicotine to the person inhaling from the device.

The wholesale cost used to calculate the tax due does not include the wholesale cost of returned e-cigarettes during the same reporting period in which they were distributed when the entire amount paid is refunded, less any rehandling or restocking fees.

Floor Stock Tax. This measure also imposes a compensating floor stock tax on every dealer (retailer) and wholesaler for each cigarette in his or her possession or control at 12:01 a.m. on the first day of the first calendar quarter commencing more than 90 days after the effective date of the bill. In addition, this measure imposes upon every licensed distributor a cigarette indicia adjustment tax on affixed and unaffixed cigarette tax stamp inventory at 12:01 a.m. on the first day of the first calendar quarter commencing more than 90 days after the effective date of the bill. The floor stock tax return and tax would be due to the BOE on or before the first day of the first calendar quarter 180 days after the effective date of the bill.

² Added by Proposition 10.

³ Division 8.6 (commencing with Section 22970) of the Business and Professions Code (BPC).

⁴ Article 2.5 (commencing with Section 30130.51) of Chapter 2 of Part 13 of Division 2 of the RTC.

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Administrative Provisions. The bill authorizes the BOE to adopt regulations necessary to enforce and administer the e-cigarette tax. The regulations may address the tax imposition and description of distributor.

Backfill Provisions. The BOE would determine the effect that the additional cigarette tax and the resulting indirect tobacco products tax increase on cigarette and tobacco products consumption in this state within one year of passage and annually thereafter. If the BOE determines the additional cigarette and indirect tobacco products tax directly caused a consumption decrease, the bill requires the BOE to determine the fiscal effect of the consumption decrease on the CFF Trust Fund (Proposition 10), the Cigarette and Tobacco Products Surtax Fund (Proposition 99), and the Breast Cancer Fund, as described.

The bill requires the BOE to transfer funds from the California Health Care, Research, and Prevention Tobacco Tax Act of 2015 (Tobacco Tax Fund) to the CCF Trust Fund, the Cigarette and Tobacco Products Surtax Fund, and the Breast Cancer Fund, to offset the revenue decrease that directly results from the additional cigarette tax and indirect tobacco products tax.

Fiscal Provisions. Except for payments of refunds, the BOE would deposit all revenues in the newly created Tobacco Tax Fund, which this measure creates in the State Treasury. The Tobacco Tax Fund is established solely to carry out the purposes set forth in the new article, to fund health care and prevention programs.

The bill requires moneys in the Tobacco Tax Fund (less moneys transferred for backfill, BOE reimbursement, and moneys used to reimburse the California State Auditor and University of California, as detailed) to be transferred in specified percentages to the Health Care Treatment Fund and to various funds to fund comprehensive tobacco prevention and control programs.

Administrative Costs. Moneys from the Tobacco Tax Fund are to be used to reimburse the BOE for expenses incurred in the Tobacco Act administration, calculation and collection of taxes, as well as expenses incurred in the calculation and distribution of funds and regulation promulgation, as required. However, not more than 1% annually of the remaining Tobacco Tax Fund moneys after backfill may be used for the BOE's administrative costs.

Enhanced Funding. The bill requires \$6 million annually to be transferred to the BOE for enforcement of laws that regulate the distribution and retail sale of cigarettes and other tobacco products, as described. Not more than 1% of the amounts received may be used for administrative costs.

The bill also requires the BOE to determine the reduction in revenue resulting from a reduction in the consumption of cigarettes and tobacco products due to the additional taxes imposed on cigarettes to the Tobacco Act, and the increase in the tax on tobacco products required under the Proposition 99 provisions. The BOE must make this determination 2 years following the Tobacco Act's effective date, and annually thereafter for any revenue reduction following the first year after the effective date of the Tobacco Act. If the BOE finds a revenue reduction, the amount of moneys allocated to the BOE for enforcement of cigarette and tobacco product tax-related laws would be reduced.

Accountability. To provide full public accountability concerning the uses to which moneys from the Tobacco Tax Fund are put, and to ensure full compliance with the Tobacco Act, all of the following must occur:

- The California State Auditor shall conduct at least biennially an independent financial audit of the state and local agencies receiving moneys pursuant to the Tobacco Act. An audit conducted shall include, but not be limited to, a review of the administrative costs expended by the state agencies that administer the fund.
- Based on the independent audit, the California State Auditor shall prepare a report detailing its review and include any recommendations for improvements. The report shall be made available to the public.

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- Each state agency and department, including the BOE, receiving funds pursuant to the Tobacco Act, on an annual basis, publish on its respective Internet Web site an accounting of how much money was received from the Tobacco Tax Fund and how that money was spent. The annual accounting shall also be posted on any social media outlets the state agency or department deems appropriate.

Distributor Discount. The bill amends RTC Section 30166 to calculate the 0.85 percent distributor discount upon the first one dollar (\$1.00) in stamp or meter register setting denomination value.

Definitions. The Tobacco Act includes the following definitions:

- “Cigarette” has the same meaning as in Section 30003 as it read on January 1, 2015.
- “Electronic cigarettes” means any device that is intended to be used to deliver aerosolized or vaporized nicotine to the person inhaling from the device, including, but not limited to, an e-cigarette, e-cigar, e-pipe, vape pen, or e-hookah. E-cigarettes include any component, part, or accessory of a device that is used during the operation of the device, whether sold separately or as a package with that device, if it is intended to be used to deliver aerosolized or vaporized nicotine to the person using the device. E-cigarettes also include any liquid or substance containing nicotine intended to be inhaled during the use of the device. E-cigarettes do not include any battery, battery charger, carrying case, or other accessory not used in the operation of the device if sold separately. E-cigarettes shall not include any product that has been approved by the United States Food and Drug Administration for sale as a tobacco cessation product or for other therapeutic purposes where that product is marketed and sold solely for such an approved purpose.

The Tobacco Act provides that the references to “tobacco products” throughout the Cigarette and Tobacco Products Tax Law, except in Article 2 (commencing with Section 30121) and Article 3 (commencing with Section 30131) of Chapter 2 (commencing with Section 30101), and Chapter 9 (commencing with Section 30461), includes e-cigarettes, unless the context otherwise requires.

Cigarette and Tobacco Products Tax. This bill amends several sections within the Cigarette and Tobacco Products Tax Law to add conforming and necessary code section references that allow the BOE to properly administer the surtax in a manner consistent with the existing cigarette and tobacco products tax.

The bill also amends RTC Section 30014 to include within the “transporter” definition any person transporting into or within this state e-cigarettes upon which the e-cigarette tax has not been paid.

Licensing Act. This bill adds BPC Section 22971.05 to include e-cigarettes within the term “tobacco products.” The revised definition becomes operative on and after the first day of the first calendar quarter commencing more than 90 days after the bill’s effective date.

Operative Date. The bill becomes effective January 1, 2016; however, the additional cigarette tax and new e-cigarette tax become operative on the first day of the first calendar quarter commencing more than 90 days from bill’s effective date.

Background: Proposition 99, approved by voters in November 1988 and effective January 1, 1989, imposed a surtax of \$0.25 per package of cigarettes, and also created an equivalent tax on other tobacco products. Tax proceeds provide funding for health education, disease research, hospital care, fire prevention, and environmental conservation.

Assembly Bill 478 (Ch. 660, 1993) and Assembly Bill 2055 (Ch. 661, 1993), effective January 1, 1994, added an excise tax of \$0.02 per package of cigarettes for breast cancer research and early detection services.

Proposition 10, approved by voters in November 1998 and effective January 1, 1999, imposed an additional surtax of \$0.50 per package of cigarettes. Additionally, the measure imposed an additional excise tax on the distribution of tobacco products equivalent to the additional cigarette tax and imposed

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an equivalent compensating floor stock tax. The additional tax revenues are deposited into the CCF Trust Fund and used to fund early childhood development programs, and to offset any revenue losses to certain Proposition 99 programs resulting from the Proposition 10 tax increase.

Commentary:

1. **Indirect tobacco products rate increase.** This measure does not directly increase the tobacco products tax; however, existing law triggers an automatic tobacco products tax increase whenever the cigarette tax is increased.⁵ Specifically, Section 30123(b), as added by Proposition 99, generally requires the BOE to annually determine the tobacco products tax rate at a rate *equivalent to the combined rate of all taxes imposed on cigarettes*.

Additionally, existing law directs the BOE to deposit these indirect tobacco products tax proceeds into the Cigarette and Tobacco Products Surtax Fund (Proposition 99) to fund health education, disease research, hospital care, fire prevention, and environmental conservation.

2. **Indirect tobacco products increase effective date.** Existing law requires the BOE to annually determine the tobacco products tax rate.

With respect to the tobacco products rate determination, existing law requires:

- The BOE to annually determine the tobacco products rate;
- The BOE to base the rate on the wholesale cost of tobacco products as of March 1; and
- The determined tobacco products rate to be effective during the state's next fiscal year.

Consequently, the BOE's rate determination must occur no earlier than March 1, but no later than June 30, each year to be effective for the next fiscal year. Accordingly, the 2016-17 tobacco products rate determination would include the proposed tax, effective July 1, 2016.

3. **E-cigarette tax is also imposed on devices.** This bill imposes a new tax upon the distribution of e-cigarettes at a rate equivalent to the total cigarette tax rate. This bill not only applies the e-cigarette tax to liquid nicotine, but also to components, parts, and accessories such as an aluminum shell, sensor, smart chip microprocessor, atomizer, coils, tips, o-rings, and vaporized mesh. The tax applies whether such products are sold in a bundle with liquid nicotine or as an individual part. However, the tax does not apply to the battery, chargers, adapters, cases, and any other part not necessary during the device's operation, if sold separately.

Imposing the tax on individual components, parts, and accessories sold without liquid nicotine complicates tax administration since all components, parts, and accessories would need to be identified by the BOE to determine whether or not those parts are necessary during the device's operation. Furthermore, taxing the individual components, parts, and accessories complicates and burdens a distributor's tax reporting, likely resulting in reporting errors.

In contrast, current law does not impose the tobacco products tax on a pipe or similar implement used to deliver the traditional pipe tobacco to the user. As such, BOE staff recommends imposing the tax upon liquid nicotine and any components, parts, and accessories when packaged with liquid nicotine.

4. **Administrative start-up cost funding is essential.** The additional cigarette tax and new e-cigarette tax would likely be imposed either January 1, 2016, or April 1, 2016, based on the bill's delayed operative date. As a result, the BOE must begin to implement the bill in fiscal year 2015-16. However, the BOE's 2015-16 budget does not include funding to implement the bill. Consequently, the BOE requires an adequate appropriation to cover administrative implementation costs.

⁵ Imposed under the Cigarette and Tobacco Products Tax Law.

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Typically, the BOE seeks administrative cost reimbursement from the account or fund into which tax proceeds are deposited. However, this bill creates the Tobacco Tax Fund, which lacks funding to reimburse the BOE prior to collection of the tax. Upfront BOE implementation cost reimbursement is essential. Thus, BOE staff suggests the bill authorize a loan from the General Fund (GF) or other eligible fund to the Fund. The loan would be repaid from taxes collected.

Constitutional and statutory provisions prohibit the BOE from using special fund appropriations to support the administration of the proposed cigarette tax increase. Without an appropriation, it may be necessary for the BOE to divert GF dollars to implement the proposed tax program. A GF diversion typically results in a negative impact on GF-supported programs and related State and local government revenues.

5. **Delayed operative date necessary.** To effectively implement this bill, the BOE must: notify and register taxpayers; develop computer programs; hire and train key staff; change the cigarette tax stamp design and denomination; create and revise necessary forms and schedules; determine all components, parts, and accessories that are intended to be used to deliver aerosolized or vaporized nicotine; and answer taxpayer inquiries. These functions must take place before the tax becomes operative. While the current effective date of either January 1, 2016, or April 1, 2016, is typically sufficient, the BOE requires an additional delay due to the implementation of [AB 1717](#)⁶ (Perea) and [SB 84](#)⁷ (Budget and Fiscal Review), which leaves the BOE's computer system without the capacity to handle other concurrent programming changes, regardless of whether additional staff resources are provided. It is suggested that the additional cigarette tax and new e-cigarette tax be imposed beginning January 1, 2017.
6. **Floor stock tax provisions.** The bill contains language to impose a floor stock tax on the cigarette inventory of every dealer (retailer) and wholesaler, and affixed and unaffixed cigarette tax stamp inventory of a distributor. A floor stock tax imposes a one-time tax on all tax-paid (fixed stamp) cigarettes and unaffixed tax stamps in the possession of distributors, wholesalers and/or retailers on the effective date of a cigarette tax increase. The floor stock tax rate is the difference between the old tax rate and the new tax rate. Generally, a measure imposes a floor stock tax to equalize the excise tax paid by cigarette retailers, wholesalers, or distributors on their inventory and those cigarettes purchased after the effective date of a tax increase.

Without a floor stock tax, a cigarette seller could purchase a large amount of cigarettes before the tax rate increase takes effect. That seller could then sell those cigarettes at a higher price and attribute the higher selling price to the tax increase. The higher selling price in this case represents a windfall profit to the seller rather than excise taxes paid to the state since the cigarettes were purchased at the prior (and lower) tax rate. A floor stock tax mitigates this windfall profit. This measure contains a floor stock tax on cigarettes only, and not tobacco products.

While the BOE incurs additional costs to administer the floor stock tax, these costs would be offset by the tax proceeds.

7. **Cost reimbursement cap is problematic.** This bill limits funding for any department's administrative costs to 1% of the Tobacco Tax Fund revenues. Although the 1% cap appears currently to provide adequate funding, it is unknown if the cost cap would allow for full reimbursement to the BOE in future years since cigarette tax is a declining revenue source. Tax-paid cigarette distributions are expected to decrease by about 3% per year, as discussed in the Revenue Estimate.

Furthermore, it is unclear whether the 1% cost cap applies to the BOE's total costs to administer the additional tax and additional enforcement moneys allocated to the BOE from the Tobacco Tax Fund, or only the costs to administer the additional tax.

⁶ AB 1717 imposes upon each prepaid consumer a prepaid mobile telephone services surcharge to be collected by a seller on each retail transaction involving prepaid mobile telephone services.

⁷ SB 84 imposes a BOE-collected fee on owners of hazardous materials transported by rail in this state.

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8. **Proposition 99 backfill.** This measure requires the BOE to determine the effect of the additional cigarette tax and indirect tobacco products tax on cigarette and tobacco products consumption. To the extent that a consumption decrease directly results from the additional cigarette tax and indirect tobacco products tax increase, the bill requires the BOE to determine the fiscal effect of the consumption decrease on the existing cigarette tax funds: Cigarette and Tobacco Products Surtax Fund, the Breast Cancer Fund, the CCF Trust Fund, and General Fund. The bill directs an amount transferred from the Tobacco Tax Fund to each of the existing cigarette and tobacco products tax funds to offset the revenue decrease resulting from this measure's additional cigarette and indirect tobacco products tax increase. The BOE estimates that total backfill to all funds would be \$120.8 million in 2016-17.

In addition to the backfill, the bill indirectly increases the tobacco products tax. Existing law requires the BOE to deposit those new revenues into the Proposition 99-enacted Cigarette and Tobacco Products Surtax Fund.

9. **Enhanced enforcement funding.** The bill requires a \$6 million annual appropriation, to be used in part "to enforce laws that regulate the distribution and retail sale of cigarettes and other tobacco products, such as laws that prohibit cigarette and tobacco product smuggling, counterfeiting, selling untaxed cigarettes and other tobacco products, and selling cigarettes and other tobacco products without a proper license."
10. **Tax evasion.** Tax evasion reduces state revenues that cigarettes and other tobacco products taxes generate. BOE staff estimates that cigarette tax evasion in California was about \$126 million in fiscal year 2012-13, along with \$88 million in tax on other tobacco products.⁸

During the mid-1990s, the BOE's cigarette tax evasion estimates remained stable since cigarette prices and excise taxes were fairly constant during that time. However, since November 1998, two major events dramatically increased California excise taxes and cigarette prices (excluding taxes): Proposition 10 and the Tobacco Master Settlement Agreement between states and tobacco manufacturers (tobacco settlement). These two developments, coupled with typical wholesaler and retailer distribution margins, coincided with approximately a 50% increase in the average price of cigarettes to California consumers compared to early November 1998. According to BOE estimates, the impacts of Proposition 10 and the tobacco settlement more than doubled the dollar amount of cigarette tax evasion in California.

Since 1998, many new measures have reduced cigarette and other tobacco products tax evasion. These include the Licensing Act, an encrypted cigarette tax stamp, and the Prevent All Cigarette Trafficking Act (PACT Act).

The substantial cigarette tax imposed by this bill will result in an increase in the retail price of cigarette and tobacco products to the extent that the tax increase is passed along to consumers. Based on historical data related to Proposition 10 and the tobacco settlement, as well as research of similar experiences in other states, BOE staff believes the proposed cigarette tax increase and resulting increase in the tobacco products tax could result in both a decrease in actual consumption and an increase in tax evasion. The exact magnitude of these variables is uncertain since the proposed excise tax increase is significantly greater than prior tax increases.

And lastly, the new tax this measure imposes on e-cigarettes, components, parts, and accessories that may drive consumers to purchase such products ex-tax online from out-of-state retailers. The PACT Act provisions that require a retailer to report to each state detailed cigarette and smokeless tobacco shipments into that state do not apply to e-cigarettes.

⁸ <http://www.boe.ca.gov/legdiv/pdf/CigaretteEvasion.pdf>.

11. **Defined distribution chain.** This bill includes e-cigarettes as a tobacco product for tax and licensing purposes, as described. As a result, the bill requires e-cigarette, liquid nicotine, and device components, parts, and accessories to follow the same distribution chain as cigarettes and tobacco products: Distributor (taxpayer) to wholesaler to retailer, or distributor to retailer.
12. **Effect on the Compliance Fund.** Currently, the BOE's Licensing Act enforcement costs exceed licensing fee revenues. The Licensing Act authorizes the various cigarette and tobacco products tax funds⁹ to make up the difference.

The Licensing Act makes available Compliance Fund moneys to implement, enforce, and administer the Licensing Act, including any provisions this bill adds to the Licensing Act. Thus, the Licensing Act administrative costs related to this bill by revising the "tobacco products" definition to include e-cigarettes increases the Compliance Fund shortfall and increases the amount needed from the cigarette and tobacco products tax funds, including the General Fund.

13. **Increase in state and local sales and use tax revenues.** The total retail sales price of tangible personal property is subject to the sales or use tax, unless specifically exempted or excluded by law. Since the proposed cigarette tax increase and indirect tobacco products tax is not specifically exempted or excluded, it would be included in the total sales price and, therefore, subject to sales or use tax.

To be reimbursed for the proposed new taxes, a distributor, wholesaler, or retailer would likely incorporate the additional taxes into the sales price of the cigarettes and tobacco products sold to other licensees or consumers. The Revenue Estimate discusses the impact on state and local sales and use tax revenues.

14. **Distributor discount is limited.** RTC Section 30166 requires stamps and meter impression settings to be sold to licensed distributors at their denominated values less 0.85%. The discount helps defray the distributor's cost (leasing of equipment/labor cost) for affixing the stamps to cigarette packages.

Currently, distributors receive a discount of \$221.85 [(30,000 stamps x \$0.87 tax per package of cigarettes) x 0.85% discount = \$221.85 discount] per roll of 30,000 cigarette tax stamps. A \$2.87 excise tax on a package of cigarettes increases the distributors' discount to \$731.85 [(30,000 stamps x \$2.87 tax per package of cigarettes) x 0.85% discount = \$731.85 discount] per roll of 30,000 stamps; however, the Tobacco Tax Act limits the discount to the first one dollar (\$1.00) in denomination value. Accordingly, this bill limits the distributors' discount to \$255 [(30,000 stamps x \$1.00 capped tax per package of cigarettes) x 0.85% discount = \$255 discount] per roll of 30,000 stamps.

15. **Licensing Act funding.** In 2003, Assembly Bill 71 (J. Horton, Ch. 890) enacted the Licensing Act, which established a statewide licensure program administered by the BOE to help stem the tide of untaxed distributions and illegal sales of cigarettes and tobacco products. Currently, the BOE licenses 35,000 retailers and 900 distributors and wholesalers to engage in the sale of cigarettes and tobacco products in California.

As Assembly Bill 71 made its way through the Legislature, revenue projections indicated that revenue beyond the licensure fees would be needed to sustain the Licensing Act program. Since the Licensing Act enforces the CTPTL and directly benefits the funds established pursuant to that program, the bill was amended to require that the cigarette and tobacco products tax funds¹⁰ cover the difference between the amount received in licensure fees and the funds needed for the program. Specifically, the uncodified language provides:

All revenues and expenses generated by this act with respect to the taxes imposed under the

⁹ Comprised of payments made to the state for the excise taxes on the distribution of cigarettes and tobacco products.

¹⁰ General Fund, Breast Cancer Fund, Cigarette and Tobacco Products Surtax Fund (Prop. 99) and California Children and Families Trust Fund (Prop. 10).

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Cigarette and Tobacco Products Tax Law (Part 13 (commencing with Section 30001) of Division 2 of the Revenue and Taxation Code), shall be allocated in the same manner as those revenues and expenses are allocated under the Cigarette and Tobacco Products Tax Law **as that law read on the effective date of this act.**

It does not appear that the tax revenues generated by this bill could be used to reimburse the BOE's Licensing Act administrative costs because the tax proposed in this bill was not effective on the date of the Licensing Act.

16. **Suggested amendment.** BOE staff suggests the following amendment:

- **Section 30130.52(b)(2)**, which authorizes the BOE to adopt regulations, duplicates existing law. In addition, this bill already specifies the tax imposition and existing law defines what constitutes a distributor, which Section (b)(2)(B) allows the BOE to describe by regulation. BOE suggests removing this language. If the language remains, the reference in subdivision (b)(2)(B) should be revised from Section 30111 to Section 30011.

17. **Related legislation.** ABx2 16 (Bonta) and SBx2 13 (Pan) contain similar tax-related provisions as this bill.

SB 591 (Pan) imposes a new \$2 per pack cigarette tax, an equivalent floor stock tax,¹¹ and indirectly increases the tobacco products tax. SB 591 becomes operative only if AB 1396 (Bonta) is enacted and takes effect on or before January 1, 2016. SB 591 is currently on the Senate inactive file.

AB 1396 (Bonta) contains provisions applicable to SB 591. These provisions include the BOE requirement to determine the effect of the additional cigarette tax and indirect tobacco products tax on cigarette and tobacco products consumption and to backfill the existing cigarette tax funds to offset the revenue decrease resulting from this measure's additional cigarette and indirect tobacco products tax increase. The bill also includes revenue allocation provisions that require an unspecified percentage of Tobacco Tax Fund revenues to be appropriated, in part, to the Tobacco Law Enforcement Account for enhanced cigarette tax enforcement. AB 1396 is currently on the Assembly inactive file.

In addition, SBx2 5 (Leno) and ABx2 6 (Cooper) revise the Licensing Act's "tobacco products" definition for retail licensure purposes to conform to the Stop Tobacco Access to Kids Enforcement (STAKE) Act¹² "tobacco product" definition, which conflicts with the definition proposed in this measure (BPC Section 22971.05). Those bills add a "tobacco product" definition to the STAKE Act that includes an electronic nicotine delivery device, such as an e-cigarette.

Administrative Costs: BOE administrative costs related to this bill are substantial. These costs include taxpayer notification, tax return design, computer programming, cigarette tax stamp design and denomination changes, compliance and audit efforts to ensure proper reporting, and floor stock tax administration.

Furthermore, the bill requires enhanced efforts to ensure proper floor stock tax reporting and collection, greater compliance efforts for additional billings and delinquencies, and an increase in BOE program and investigative staff presence due to increased tax evasion.

A detailed cost estimate is pending, which will also incorporate administrative costs for revising the "tobacco products" definition within the Licensing Act.

A **preliminary cost estimate** limited to the additional cigarette tax and new e-cigarette tax is as follows: \$11.92 million in fiscal year (FY) 2015-16, \$13.45 million in FY 2016-17, \$12.58 million in FY 2017-18 and on-going.

¹¹ A floor stock tax is a one-time tax on all tax-paid (stamped) cigarettes and unaffixed tax stamps in the possession of distributors, wholesalers and/or retailers on the effective date of a cigarette and tobacco products tax increase. The floor stock tax rate is the difference between the old tax rate and the new tax rate.

¹² Division 8.5 (commencing with Section 22950) of the BPC.

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Revenue Impact:

Background, Methodology, and Assumptions. Staff made the following major assumptions:

- An implementation date of April 1, 2016.
- Consistent with long-term trends, tax-paid cigarette distributions will likely decline by about 3% annually for FY 2015-16 and future years absent federal or state law changes.
- Based on previous tax increases, academic studies, and research of experience in other states, staff believes a sizeable tax rate increase likely would cause both a decrease in actual consumption and an increase in tax evasion. Although the exact magnitude of the split between evasion and consumption is uncertain, staff estimates tax-paid distributions to decrease by 20%. This estimate uses a price elasticity of demand of -0.70 calculated by the arc price elasticity formula, applied to an average estimated November 1, 2015 price of approximately \$5.74 per pack.¹³
- Tobacco products sales in FY 2016-17 will decrease by 18% because of the increase in the tax rate for other tobacco products associated with the \$2 per pack increase. This estimate uses a price elasticity of demand of -0.70, the same as cigarettes.
- Wholesale sales of tobacco products have increased an average of about 8.7% per year over the past three years; therefore, the assumption is that sales will grow 8.7% per year without the proposed tax increase.
- All of the cigarette and tobacco products excise tax increases will be passed on to consumers.
- Industry data indicate that U.S. e-cigarette sales were about \$2.5 billion in 2014 and are likely to grow about 40% in 2015, then 24% per year over the next several years.¹⁴
- Staff believes that the 12% California share of U.S. population provides an accurate estimate of sales of e-cigarettes in this state.
- Based on an industry survey, there are about 1,100 retailers that sell electronic nicotine delivery devices, but do not sell cigarettes or tobacco products.
- Changes in ownership of e-cigarette retailers will be about 20% per year.

Cigarette Tax. In FY 2014-15, 867 million tax-paid cigarette packs were distributed. With the stated assumptions, the bill will result in a decline to 677 million tax-paid cigarette packs in FY 2016-17 (677 million x \$2 = \$1,354 million).

Tobacco Products Tax. This measure would result in an additional tobacco products tax equivalent to the new \$2 per pack imposed on cigarettes. The BOE sets the tobacco tax rate prior to the start of each fiscal year using wholesale cost data available as of March 1. In recent years, the BOE has set the rate for the upcoming fiscal year in April or May. FY 2016-17 would be the first year the tobacco tax rate calculations would include the proposed tax rate increase.

The tobacco products tax is based on the wholesale cost of these products at a tax rate equivalent to the tax rate imposed on cigarettes. The rate is determined by dividing the tax rate per cigarette by the average wholesale cost per cigarette. In recent years, wholesale costs of cigarettes have risen, which results in rate declines since the total California excise tax on cigarettes has been constant since 1999. The BOE set the rate for FY 2015-16 at 28.13%.¹⁵ FY 2016-17 would be the first fiscal year affected by this measure. Staff estimates that, with the additional \$2 per pack tax, the tobacco products tax rate in FY 2016-17 would be 65.97%.

¹³ The general price elasticity of demand formula is: $e_p = (Q_1 - Q_2) / ((Q_1 + Q_2) / 2) / (P_1 - P_2) / ((P_1 + P_2) / 2)$, where P = price and Q = sales.

¹⁴ "FDA Cloud Hangs Over Vape Shops," July 7, 2015, *Wall Street Journal*, <http://www.wsj.com/articles/SB10130211234592774869404581088451777513530>; U.S. e-cigarette sales seen rising 24.2% per year through 2018, 6/10/14, Fortune.com.

¹⁵ The methodology and data used for the fiscal year 2015-16 rate was approved at the April 29, 2015 Board meeting, http://www.boe.ca.gov/meetings/pdf/2015/042815_P4_1_Tobacco_Products_Tax_Rate.pdf
This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the BOE's formal position.

The wholesale cost (or wholesale sales) of tobacco products was about \$272 million in FY 2013-14.

E-Cigarettes. The previously stated assumptions imply California e-cigarette revenues of about \$344 million in FY 2016-17.

Sales and Use Tax Impact. For both cigarettes and tobacco products, we added sales tax to the excise tax increase and subtracted from the excise tax increase the sales tax that would decline due to a decline in projected sales to determine net sales tax gains.

Revenue Summary

FY 2015-16. Quarter-year revenues for the California Healthcare, Research and Prevention Tobacco Tax Act of 2015 Fund are estimated to be \$348.9 million. Associated state and local sales and use tax revenues would be an additional \$11.7 million.

FY 2016-17. FY 2016-17 will be the first complete year of the measure's impact. The revenue impact is shown in the table. For fiscal year 2016-17 the fund created by this initiative would receive \$1,698 million from cigarette sales at the new tax rate and from taxing e-cigarettes at an equivalent rate (\$1,354 million + \$344 million = \$1,698 million). State and local sales and use tax revenue from both cigarettes and tobacco products combined would increase by \$45.5 million. In FY 2016-17, this measure would generate \$1,743.5 million (\$1,698.0 million + \$45.5 million) in total revenue.

Revenue Impacts Summary

	FY 2016-17 (Millions of Dollars)
California Healthcare, Research and Prevention Tobacco Tax Act of 2016 Fund (Includes Revenues From E-Cigarettes)	\$1,698.0
<u>Sales and Use Tax:</u>	
State General Fund	\$23.3
Local Sales and Use Tax	\$17.0
Special Districts Tax	\$5.1
Total Sales and Use Taxes	\$45.5
Total Excise and Sales Taxes	\$ 1,743.5

Backfill Impacts. Cigarette revenue backfill impacts associated with this initiative for each fund for FY 2016-17 are shown in Table 2. These figures include the effects of illegal sales of cigarettes. (While there is no backfill provided in the legislation for the General Fund, the impacts are shown in Table 2 for illustrative purposes.) Since the sales and use impacts shown in Table 1 are positive, there are no backfills for the sales and use tax.

Table 2	
Excise Tax Backfill Amounts	
Fund	2016-17 (\$ Millions)
General Fund	-13.9
Breast Cancer	-2.8
Proposition 99	-34.7
Proposition 10	-69.4
Total, All Funds	-120.8

Distributor Impacts. Under current law, cigarette distributors are reimbursed for costs of stamping cigarettes at a rate of 0.85% of the value of the stamp. The bill amends RTC Section 30166 to calculate the 0.85 percent distributor discount upon the first \$1 in stamp or meter register setting denomination value. The impact on distributors is estimated to be a \$10.8 million loss in FY 2016-17. Consequently cigarette tax revenues net of the discount are \$10.8 million higher than they would be under the current distributor discount.

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Licensing Fees. Staff are not aware of any estimates regarding the number of e-cigarette manufacturers and distributors who do not also manufacture or distribute cigarettes or other tobacco products. As for retailers, as mentioned earlier, an industry survey estimates there are about 1,100 retailers that sell electronic nicotine delivery devices, but do not sell cigarettes or tobacco products. At current fee rates, this implies additional one-time revenues of \$110,000, and ongoing annual revenues of about \$22,000. This assumes 20% of owners change every year.

Future Years. Staff expects cigarette and related taxable sales revenues to decline in FY 2018-19 and future years. This is because tax-paid cigarette distributions would continue to decrease by about 3% per year. Without any other factors affecting revenue, related revenue also would weaken by about 3% per year.

With the exception of forecasting greater declines in tax-paid cigarette and tobacco distributions, this revenue estimate does not account for any further changes in economic activity that may or may not result from enactment of the proposed law. Totals may not add up due to rounding.