



**STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS**

Date Amended:	03/26/07	Bill No:	SB 554
Tax:	Cigarette and Tobacco Products	Author:	Migden
Related Bills:	AB 1617 (DeSaulnier)		

BILL SUMMARY

This bill would revise the definition of “cigarette” for purposes of the Cigarette and Tobacco Products Tax Law.

ANALYSIS

CURRENT LAW

Cigarette and Tobacco Products Tax Law

Under existing law, Cigarette and Tobacco Products Tax Law Section 30003 defines “cigarette” to mean any roll for smoking, made wholly or in part of tobacco, irrespective of size or shape and irrespective of whether the tobacco is flavored, adulterated or mixed with any other ingredient, where such roll has a wrapper or cover made of paper or any other material, except where such wrapper is wholly or in the greater part made of tobacco and such roll weighs over three pounds per thousand.

For purposes of the Cigarette and Tobacco Products Surtax, which was adopted by voters as Proposition 99 in November 1988, the term “cigarette” is defined in Section 30121(a) to have the same meaning as in Section 30003, as it read on January 1988. Section 30130 provides that the provisions contained in Article 2, of Part 13, of Division 2 (Cigarette and Tobacco Products Surtax), including Section 30121, may be amended only by vote of four-fifths of the membership of both houses of the Legislature. All amendments must be consistent with its purposes.

The term “cigarette” is also defined in Section 30131.1(a) for purposes of the California Children and Families First Trust Fund Account, which was adopted by voters as Proposition 10 in December 1998, to have the same meaning as in Section 30003, as it read on January 1, 1997. The California Children and Families First Act of 1998 may be amended only by a vote of two-thirds of the membership of both houses of the Legislature. All amendments to this act must be to further the act and must be consistent with its purposes.

The current excise tax on cigarettes is 87 cents per package of 20 (43 ½ mills per cigarette). The different components of the cigarette taxes and the disposition of the revenues are as follows:

- 10 cents per pack (5 mills per cigarette) is allocated to the General Fund (Sections 30101 and 30462 of the Revenue and Taxation Code);
- 2 cents per pack (1 mil per cigarette) is allocated to the Breast Cancer Fund (Sections 30101 and 30461.6);
- 25 cents per pack (12 ½ mills per cigarette) is allocated to the Cigarette and Tobacco Products Surtax Fund (Sections 30122 and 30123); and

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- 50 cents per pack (25 mills per cigarette) is allocated to the California Children and Families Trust Fund (Sections 30131.2 and 30131.3).

For tobacco products (which are defined in Sections 30121 and 30131.1 to include cigars, smoking tobacco, chewing tobacco, snuff, and other products containing at least 50 percent tobacco), Section 30123 (Proposition 99) imposes a tax on the wholesale cost of the tobacco products distributed at a rate which is equivalent to the combined rate of tax imposed on cigarettes. In addition, Section 30131.2 (Proposition 10) imposes an additional tax on tobacco products based on the wholesale cost of the tobacco products distributed at a rate which is equivalent to the 50-cent per pack tax on cigarettes also imposed by Section 30131.2. The tobacco products tax rate is determined annually by the Board and based on the March 1 wholesale cost of cigarettes. Currently, the surcharge rate for fiscal year 2006-07 is 46.76 percent.

The other tobacco products surtax imposed under Section 30123 (Proposition 99) is deposited into the Cigarette and Tobacco Products Surtax Fund (including any revenues that result from an indirect increase in the other tobacco products tax triggered by a cigarette tax increase), while the surtax imposed under Section 30131.2 (Proposition 10) is deposited into the California Children and Families Trust Fund.

Master Settlement Agreement (MSA)

The MSA, and the two laws that implement the MSA, the Model Statute¹ and the Complementary Legislation² (Tobacco Directory Law), define "cigarette" to mean the following:

Any product that contains nicotine, is intended to be burned or heated under ordinary conditions of use, and consists of or contains (1) any roll of tobacco wrapped in paper or in any substance not containing tobacco; (2) tobacco, in any form, that is functional in the product, which because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette; or (3) any roll of tobacco wrapped in any substance containing tobacco which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette described in this section. "Cigarette" also includes "roll-your-own" tobacco, meaning any tobacco which, because of its appearance, type, packaging, or labeling is suitable for use and likely to be offered to, or purchased by, consumers as tobacco for making cigarettes. For purposes of this definition of "cigarette," 0.09 ounces of "roll-your-own" tobacco shall constitute one individual "cigarette."

PROPOSED LAW

This bill would repeal and add Section 30003 to the Cigarette and Tobacco Products Tax Law to revise the definition of "cigarette" for purposes of the imposition of the cigarette tax. The term "cigarette" would be defined to mean:

"Any product that contains nicotine, is intended to be burned or heated under ordinary conditions of use, and consists of or contains (a) any roll of tobacco wrapped in paper or in any substance not containing tobacco; (b) tobacco, in any form, that is functional in the product, which because of its appearance, the type

¹ Article 3 (commencing with Section 104555) of Chapter 1 of Part 3 of Division 103 of the Health and Safety Code.

² Section 30165.1 of the Revenue and Taxation Code.

of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette; or (c) any roll of tobacco wrapped in any substance containing tobacco which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette described in this section.”

This bill would also amend Sections 30121 and 30131.1 to provide for purposes of the tax imposed pursuant to the Cigarette and Tobacco Products Surtax (Proposition 99) and California Children and Families First Trust Fund Account (Proposition 10), respectively, the term “cigarette” has the same meaning as in Section 30003, as that section read on January 1, 2008.

The bill would become effective on January 1, 2008.

Under the November 1998 MSA between the State of California, other states, and tobacco product manufacturers, each tobacco company must make annual payments to the participating states in perpetuity, totaling an estimated \$206 billion through 2025. California’s share of the revenue is projected to be \$25 billion over the next 25 years, based on receiving approximately 12.8% of the total payments. The payments will be split 50/50 between state and local governments under a Memorandum of Understanding negotiated by the Attorney General and various local jurisdictions (cities and counties) which had also sued the tobacco companies.

The payment provisions of the MSA apply to “participating manufacturers” which include both original signatories to the MSA, as well as other companies which subsequently agree to be bound by the MSA. In return for these payments, the states have agreed to release the cigarette manufacturers from all claims for damages, penalties, and fines. In addition, the participating manufacturers have agreed to certain non-economic terms that restrict their advertising and marketing practices and control their corporate behavior. The primary purpose of these restrictions is to prevent marketing of cigarettes to minors and thereby reduce smoking by minors.

The MSA prompted States to enact the Model Statute by creating a significant financial incentive: Settling States that enact and “diligently enforce” the Model Statute would not be subject to severe reductions to their MSA payments. All settling states have enacted Model Statutes requiring non-participating (NPM) reserve (escrow) funds, including California. California’s “Model Statute” was enacted in 1999 pursuant to Senate Bill 822 (Escutia, Chapter 780). That bill, among other things, authorized the Board to adopt any regulations necessary to ascertain, based on the amount of state excise tax paid on cigarettes, the number of tax paid cigarettes sold by tobacco products manufacturers who do not participate in the MSA.

While the Settling States, such as California, have been aggressively enforcing the provisions of the Model Statutes, enforcement has proved costly and cumbersome. Accordingly, almost every state has enacted Complementary Legislation to make state enforcement of the Model Statutes more effective and thereby promote the purposes for which the Model Statutes were enacted.

In 2003, California enacted Complementary Legislation (Tobacco Directory Law) pursuant to Assembly Bill 71 (Horton, Chapter 890). Generally, these statutes:

- Require the Attorney General to develop and publish on its Internet web site a directory of all tobacco manufacturers that have provided current, timely, and accurate certifications that certify the tobacco manufacturer is either a participating

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manufacturer under the MSA, or is a NPM that has made all required escrow payments, and all brand families that are listed in the certifications, except as specified.

- Prohibit a person from affixing, or cause to be affixed, any tax stamp or meter impression to a package of cigarettes, or pay the tax levied on a tobacco product defined as a cigarette, unless the brand family of cigarettes or tobacco product, and the tobacco product manufacturer that makes or sells the cigarettes or tobacco product, are included on a compliance list posted by the Attorney General.
- Subject violators, principally manufacturers and distributors, to civil and criminal penalties and license suspension or revocation.

COMMENTS

3. **Sponsor and purpose.** This bill is sponsored by the Attorney General (AG) and is intended to:

- Reduce confusion in the industry and market place created by multiple, inconsistent definitions of cigarette;
- Prevent excise and sales tax evasion; the current, weight-based definition of cigarette for California excise taxes (Section 30003) is easily avoided and the taxes evaded by simply increasing the weight of a product (e.g., a "brown" cigarette, which is intentionally mislabeled as a "little cigar") to weigh more than 3lbs per 1,000;
- Bring fairness to the marketplace by classifying, treating, and taxing as a cigarette any product that functions like a cigarette; and
- Strengthen the AG's and Board's ability to diligently enforce the Model Statute, which protects the state's \$800 million annual income stream from the MSA. The annual income stream from the MSA may be at risk if a court or arbitration panel were to determine that California had failed to diligently enforce the Model Statute as required by the MSA.

2. **Would the definition be consistent with the MSA?** This bill would revise the definition of "cigarette" for purposes of the excise tax to be consistent with that term as defined in the MSA and its two implementing statutes, except that it would not include RYO.

The definition of "cigarette" in the MSA and related statutes is based upon function; specifically whether the product's appearance, the type of tobacco used in the filler, and its packaging and labeling make it likely to be purchased as a cigarette. The excise tax-related definition is based on weight and the tobacco content of the paper.

As a result of the inconsistent definitions, a product that weighs slightly more than three pounds per thousand and has more than 50 percent tobacco in the wrapper would be taxed as a "tobacco product." Yet because of its appearance, the type of tobacco used in the filler and its packaging and labeling it may be considered a "cigarette" under the MSA, Model Statute and Tobacco Directory Law.

3. **Would a consistent definition for "cigarette" help distributors?** Under existing law, distributors are authorized to affix a tax stamp to packages of cigarettes if the

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cigarette brand is in compliance with the MSA or the Model Statute and listed on the [Attorney General's Tobacco Directory](#). However, the cigarettes listed on the Tobacco Directory do not include all brands that are currently defined as a cigarette for purposes of the Cigarette and Tobacco Products Tax Law. It is currently estimated that there are 16 products labeled as little cigars by the manufacturer that are classified as a "cigarette" for tax purposes because of their weight and wrapper, but are not listed on the Tobacco Directory. As a result of the inconsistent definitions, it could be confusing for a distributor to determine if a product that is classified by the Board as a cigarette for tax purposes is in compliance or is required to be in compliance with the MSA or the Model Statute since these products are not listed on the Tobacco Directory by the AG.

In addition, the AG may add cigarette brands required to appear on the Tobacco Directory after further lab analysis of such products. This could result in products being classified as a "cigarette" for purposes of the Tobacco Directory but not for tax purposes, which could result in a distributor affixing tax stamps to product not required to be stamped because it weighs more than three pounds per thousand.

This measure would create essentially a uniform definition of cigarette under California law, which could simplify a distributor's determination as to:

- Products that are required to have a stamp affixed for tax purposes, and
- Products are in compliance with the MSA or the Model Statute by simply referring to the Tobacco Directory.

However, it should be noted that any additional products considered to be a cigarette may, after further analysis, be contained in packaging not conducive to a distributor's high volume stamping equipment. Such product would have to be hand stamped by the distributor if this bill were signed into law.

4. What is the Board's enforcement role for the Model Statute? The Board has several responsibilities with respect to "diligent enforcement" of the Model Statute, which protects the state's approximately \$800 million annual revenue payment stream from the MSA. When a product is treated as a cigarette by the Board, but not the AG, or vice versa, the Board's enforcement of the excise tax and Model Statute is challenging and time consuming. The Board's enforcement role is as follows:

- The Model Statute requires NPMs to place into a qualified escrow fund by April 15 an amount, as specified, based on units sold during the previous year. "Units sold" is generally defined to mean the number of individual cigarettes sold in the state by the applicable tobacco product manufacturer as measured by excise taxes collected by the state on packs bearing the excise tax stamp of the state. The Board is authorized to adopt any regulations necessary to ascertain, based on the amount of state excise tax paid on cigarettes, the number of tax paid cigarettes sold by NPMs.

As a result of this provision, the Board provides the AG with annual statistics of cigarettes sold in California by NPMs. The Board compiles this information measured by the excise tax reported to the Board, which is adjusted by Board staff to remove brands that are considered a "cigarette" for tax purposes, but not for purposes of the Model Statute.

- The Tobacco Directory Law prohibits a distributor from affixing a tax stamp to a package of cigarettes, or paying the tax on a tobacco product defined as a cigarette, unless the brand family of cigarettes or tobacco product, and the tobacco product manufacturer that makes or sells the cigarettes or tobacco product, are included on Tobacco Directory. A violation of this prohibition could result in the revocation or suspension of the license or licenses of the distributor and/or a civil penalty and subject such products to seizure and forfeiture by the Board.
- The Cigarette and Tobacco Products Licensing Act, which was enacted by AB 71 (Stats. 2003, Chapter 890), requires every manufacturer or importer required to obtain and maintain a license to engage in the sale of cigarettes. In order to be eligible to obtain and maintain a license, a manufacturer or importer that is a “tobacco products manufacturer” pursuant to the Model Statute must 1) certify to the Board that it is a “participating manufacturer” or is in compliance with the Model Statute, and 2) submit to the Board a list of all its brand families. AB 71 also gave the authority to the Board to revoke or suspend the license of a distributor for selling product not listed on the California Tobacco Directory.

Finally, AB 71 also clarified that an employee of the Board, upon presentation of the appropriate identification and credentials, is authorized to enter into, and conduct an inspection of, any building, facility, site, or place, for which there is evidence of the failure to comply with the requirements of the Model Statute or the Tobacco Directory Law.

5. **How does this measure affect the Board?** This measure would allow the Board to more effectively and efficiently enforce the Model Statute. Among other things, the Board would no longer be required to adjust the Annual Statistics of Cigarettes Sold report provided to the AG for products considered a “cigarette” for tax purposes, but not for purposes of the Model Statute. This bill would also simplify the inspection process since the Board’s inspectors would be working with one definition of “cigarette” for enforcement of both the California excise tax and Tobacco Directory Laws.

Finally, it would help the Board’s enforcement of the excise and sales taxes because the current weight-based definition of cigarette for purposes of the excise tax is easily avoided by simply increasing the weight of a product (e.g., a “brown” cigarette, which is intentionally mislabeled as a “little cigar”) to weigh more than three pounds per thousand.

6. **Related legislation.** AB 1617 (DeSaulnier) would, among other things, prohibit shipping or transporting cigarettes to persons in California, with certain exceptions.

COST ESTIMATE

Enactment of this provision would not materially impact the Board’s administrative costs.

REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

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As a result of the definition change, certain tobacco products under current law would be considered to be cigarettes under the proposed legislation. True little cigars are already defined as cigarettes under California tax law, and distributors pay a cigarette excise tax of \$0.87 per pack of 20 sold. However, certain manufactures sell “cigarette-like cigars” (CLCS) in California that are defined as tobacco products, not as cigarettes. These products are similar to little cigars, in some cases nearly indistinguishable. Distributors of CLCS pay the tobacco products tax rate of 46.76 percent of wholesale costs instead of \$0.87 per pack.

We have no data on numbers of little cigars or CLCS sold in California. U.S. data indicate that the market for little cigars and CLCS, while growing rapidly, is small in relation to cigarettes. Data from the USDA and the Cigar Association of America indicate that unit sales of all little cigars and CLCS were about 1.1 percent of tax-paid distributions of cigarettes for the U.S. in 2005. California tax-paid cigarette distributions were about 1,190 million packs in fiscal year 2005-06. If we assume national proportions, we estimate that about 13 million packs of little cigars and CLCS were sold in California (20 little cigars or CLCS per pack).

Board staff estimates that about 40 percent of the little cigar and CLC market are little cigars. These are already taxed as cigarettes. The remaining 60 percent of the 13 million packs of little cigars and CLCS sold in California are CLCS and would be affected by the proposal. These are about 7.8 million packs per year.

While some participating manufacturers (PMs) to the MSA market little cigars, based on U.S. market shares data we believe that relatively few PMs market CLCs. This revenue estimate assumes that all manufacturers of CLCS are NPMs to the MSA. We also assume that these NPMs would make MSA escrow payments if SB 554 becomes law.

Board staff estimates that a typical cost of CLCS is about \$1.10 per pack at the wholesale level. At the current tobacco tax rate of 46.76 percent of wholesale costs, the excise tax would be about \$0.51 per pack under current law. Under SB 554 the tax rate would increase by \$0.36 to \$0.87 per pack. In addition, for revenue estimation purposes, we assume that each pack sold would trigger MSA escrow payments of \$0.416. We expect both the tax increase and the MSA escrow payments to be passed on to consumers. Table 1 shows our estimates of retail prices assuming a 20 percent markup of wholesale costs. Under SB 554 the average retail price of CLCS increases about 42 percent.

Table 1 Retail Price Estimates of "Cigarette-Like Cigars" (CLCS) (Dollars Per Pack)		
	Current Law	SB 554
Wholesale Price	\$1.100	\$1.100
Calculations:		
Add 20% Retail Margin	1.320	1.320
California Excise Tax	0.514	0.870
MSA Escrow Payment	<u>0.000</u>	<u>0.416</u>
<i>Estimated Retail Price per Pack</i>	\$1.834	\$2.606

Table 2 Price Changes and Behavioral Impacts of Consumers	
Current Retail Price	\$1.83
Retail Price Under SB 554	\$2.61
Percent Change	42.1%
Assumed Price Elasticity of Demand	-0.25
Percent Change in Quantity	-10.5%

Based on previous tax increases for cigarettes and tobacco products and research of experiences in other states, we believe a price increase this large is likely to cause a decrease in consumption. Although the exact magnitude is uncertain, we estimate that this bill would cause a decrease of 10.5 percent in tax paid distributions of CLCS. This estimate uses a price elasticity of demand of -0.25, applied to the average retail price of \$2.61 per pack shown in Table 1. The calculations are shown in Table 2.

Revenue impacts occur on these sales because of the difference resulting from the tax rate applied to wholesale costs under current law and the tax rate per cigarette under this bill. Since the mix of funds and their respective proportions of excise taxes differ whether CLCS are taxed as cigarettes or tobacco products, there are changes in revenues for each fund. Revenue gains, losses and net impacts by fund are shown in Table 3. In addition to the excise tax differences, there are also sales tax impacts resulting from the next change in the total retail value of sales. Details of sales tax calculations are shown in Table 4. Since the new rate would take effect January 1, 2008, the impacts for fiscal year 2007-08 are about half of the full-year impacts.

REVENUE SUMMARY

The revenue impacts of this bill for each fund are shown in the Table 3. The first complete year that all the provisions of the proposal are in effect will be fiscal year 2008-09. For fiscal year 2008-09 excise taxes increase by about \$2.1 million. Sales and use tax revenues increase by an additional \$0.3 million, for a total revenue increase of \$2.4 million.

Table 3				
Revenue Impacts of SB 554				
	Rates	Proportions	Fiscal Year 2007-08	Fiscal Year 2008-09
Estimated Tax Paid Distributions of "Cigarette-Like Cigars" (CLCS) Taxed as Tobacco Products Under Current Law (Packs of 20)			3,902,691	7,805,382
Tax Paid Distributions Under SB 554 (Consumer Behavioral Impacts Decline of 10.5 Percent, See Table 2 for Details)			3,492,266	6,984,531
<u>Revenue Gains</u>				
General Fund	0.10	11.5%	\$349,227	\$698,453
Breast Cancer	0.02	2.3%	69,845	139,691
Proposition 99	0.25	28.7%	873,066	1,746,133
Proposition 10	0.50	57.5%	1,746,133	3,492,266
Total Tax Rate and Revenues	\$0.87	100.0%	\$3,038,271	\$6,076,542
<u>Wholesale Sales @ \$1.10/Pack</u>			\$4,292,960	\$8,585,921
<u>Revenue Losses</u>				
Proposition 99	29.69%	63.5%	1,274,702	2,549,403
Proposition 10	17.06%	36.5%	732,587	1,465,174
Total Tax Rate and Revenues	46.76%	100.0%	\$2,007,289	\$4,014,577
<u>Net Excise Tax Revenue Impacts</u>				
Proposition 99	n.a.	n.a.	-\$401,635	-\$803,270
Proposition 10	n.a.	n.a.	1,013,546	2,027,091
General Fund	n.a.	n.a.	349,227	698,453
Breast Cancer	n.a.	n.a.	69,845	139,691
Total Excise Tax Revenues	n.a.	n.a.	\$1,030,983	\$2,061,965
<u>Taxable Sales Revenues</u> (See Table 4 for Details)				
State	5.25%		\$101,950	\$203,900
Local	2.00%		\$38,838	\$77,676
Transit	0.69%		\$13,399	\$26,798
Total Sales Tax Revenues	7.94%		\$154,187	\$308,374
<u>Change in Excise Tax and Sales Tax Revenues</u>			\$1,185,170	\$2,370,339

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Table 4 Sales Tax Calculations - SB 554			
	Fiscal Year 2007-08	Fiscal Year 2008-09	Rates
<u>Taxable Sales (Retail)</u>			
<i>Cigarettes - SB 554</i>			
Tax Paid Distributions	3,492,266	6,984,531	
Retail Cost (Includes \$.087 tax + MSA)	\$2.61	\$2.61	
Total Value at Retail Prices	\$9,100,844	\$18,201,688	
<i>Tobacco Products - Current Law</i>			
Wholesale Costs	\$4,292,960	\$8,585,921	
Total Value at Retail Prices	\$7,158,941	\$14,317,881	
Change in Value From CA Excise Tax (SB 554 - Current Law Total Values)	\$1,941,904	\$3,883,807	
<u>Taxable Sales Revenues</u>			
State	\$101,950	\$203,900	5.25%
General Fund (5.00%)	97,095	194,190	5.00%
Fiscal Recovery Fund (0.25%)	4,855	9,710	0.25%
Local	38,838	77,676	2.00%
Transit	13,399	26,798	0.69%
Total	\$154,187	\$308,374	7.94%

QUALIFYING REMARKS

These revenue figures are based on information we currently have available. We are in the process of working with another researcher who has access to some alternative data sources. If we use these data, the estimates could change.

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