



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

Date Amended	06/02/03	Bill No:	SB 676
Tax:	Tobacco Products Fee	Author:	Ortiz
Board Position:		Related Bills:	AB 1239 (Wiggins)

This analysis will only address the bill's provisions that impact the Board.

BILL SUMMARY

This bill would impose, on or after January 1, 2005, a tobacco products fee, as specified, on each nonparticipating manufacturer currently manufacturing tobacco products, or who has previously manufactured tobacco products, or both, that have contributed or currently contribute, or both, to tobacco-related illnesses and diseases.

A nonparticipating manufacturer would be defined to mean a tobacco product manufacturer that did not sign the Master Settlement Agreement (MSA) and related documents entered into on November 23, 1998, by the state and leading United States tobacco product manufacturers.

Summary of Amendments

The amendments to this bill since the previous analysis impose the tobacco products fee on each nonparticipating manufacturer, rather than on each person, as specified. The amendments also revise the factors upon which the Department of Health Services would establish the specific fees to be assessed, and rename the fund into which the fees are deposited from the "Tobacco Related Health Care Costs Trust Fund" to the "Tobacco Mitigation Trust Fund."

ANALYSIS

Current Law

Under current law, Section 30101 of the Cigarette and Tobacco Products Tax Law imposes an excise tax of 6 mills (or 12 cents per package of 20) on each cigarette distributed. In addition, Sections 30123 and 30131.2 impose a surtax of 12 1/2 mills (25 cents per package of 20) and 25 mills (50 cents per package of 20), respectively, on each cigarette distributed. The current total tax on cigarettes is 43 1/2 mills per cigarette (87 cents per package of 20).

Sections 30123 and 30131.2 also impose a surcharge on tobacco products at a rate to be annually determined by the Board. The tobacco products tax rate is equivalent to the combined rate of tax on cigarettes. Currently, the surcharge rate for fiscal year 2002-03 is 48.89 percent.

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 Board's formal position.

Proposed Law

This bill would add Part 5.5 (commencing with Section 105500) to Division 103 of the Health and Safety Code as the Tobacco Mitigation and Relief Act of 2003. Among its provisions, Section 105520 would impose, on or after January 1, 2005, a tobacco products fee upon each nonparticipating manufacturer currently manufacturing tobacco products, or who has previously manufactured tobacco products, or both, that have contributed or currently contribute, or both, to tobacco-related illnesses and diseases. On or before January 1, 2005, the Department of Health Services (DHS) would be required to establish, by regulation, specific fees to be assessed based on both of the following factors:

- The annual economic and health impacts cost to the state and local governments to treat individuals with tobacco-related illnesses and diseases.
- The manufacturer's share of the California tobacco products market as determined by the department.

The tobacco products fee would be annually adjusted by the DHS to reflect the following:

- Any change in the economic and health costs to the state and local governments.
- Any changes in the manufacturer's share of the California tobacco products market, as determined by the DHS.

The Board would administer the fee imposed in accordance with the Fee Collection Procedures Law, which contains "generic" administrative provisions for the administration and collection of fee programs to be administered by the Board. The Board would assess the fee imposed commencing April 1, 2005, and annually thereafter. The fees would be deposited in the Tobacco Mitigation Trust Fund, which this bill would create. The moneys the fund would, upon appropriation by the Legislature, be expended to assist individuals to access and utilize smoking cessation services.

Section 105510 would define "tobacco product" to mean cigarettes and all forms of cigars, smoking tobacco, chewing tobacco, snuff, and any other articles or products made of, or containing, at least 50 percent tobacco. "Manufacturer" or "nonparticipating manufacturer" would be defined to mean a tobacco product manufacturer that did not sign the Master Settlement Agreement and related documents entered into on November 23, 1998, by the state and leading United States tobacco product manufacturers.

In General

According to the author's office, a December 2002 report* prepared by the University of California, San Francisco (UCSF) School of Nursing Institute for Health & Aging found that smoking costs in California are nearly \$16 billion annually, or \$3,331 per smoker every year. The report states that direct health care costs of smoking account for 54

* The Cost of Smoking in California, 1999.

<http://www.dhs.ca.gov/tobacco/documents/CostOfSmoking1999.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 Board's formal position.

percent of the total cost of smoking in California - \$8.6 billion. Expenditures for hospital care of current and former smokers amount to \$4.0 billion, or 47 percent of total direct medical costs; ambulatory care services amount to \$2.1 billion or 24 percent; nursing home care amounts to \$1.3 billion or 15 percent; prescription drugs amount to \$1.1 billion; and home health care amounts to \$87 million. The intent of this measure is to hold manufacturers of cigarette and tobacco products financially liable for the adverse health effects of their products.

Background

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. In order to safeguard themselves against unfair competition from tobacco products manufacturers who do not participate in the MSA, the MSA contains provisions which would reduce the payments made to states that do not enact a "Model Statute" to require nonparticipating manufacturers to put funds into escrow accounts. The money in the escrow accounts is intended to be available to pay judgments or settlements on any claims brought by the state against any nonparticipating tobacco manufacturers.

In 1999, California enacted a "Model Statute" pursuant to Senate Bill 822 (Escutia, Chapter 780). That bill, among other things, required any tobacco product manufacturer selling cigarettes in California to either:

- Become a participating manufacturer as defined in the Master Settlement Agreement and meet the financial obligations of the participants, or
- Place into escrow with the state specified amounts per units sold.

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 Board's formal position.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the author and is intended to hold manufacturers of tobacco products financially liable for the adverse health effects of their products.
2. **Summary of amendments.** The **June 2, 2003**, amendments would impose the tobacco products fee on each nonparticipating manufacturer, as specified. The previous version of the bill would have imposed the tobacco products fee on each person currently manufacturing tobacco products, or who has previously manufactured tobacco products, or both, as specified. The amendments also revise the factors upon which the DHS would establish the specific fees to be assessed, and rename the fund into which the fees are deposited from the "Tobacco Related Health Care Costs Trust Fund" to the "Tobacco Mitigation Trust Fund."
3. **Due to budgetary constraints, it would be very difficult for the Board to start-up and administer the proposed tobacco products fee.** Executive Order S-3-03 by the Governor of the State of California provides that all State agencies and departments are prohibited from filling vacancies that would constitute a new hire to state government, except as provided. In addition, all State agencies and departments are prohibited from filling vacancies through promotion, or otherwise promoting personnel except for a position presently designated by the State Personnel Board as a Career Executive Assignment (CEA).

Currently, Board staff availability is extremely limited, which is impacting staff's ability to address regular workloads. Unless the Board is able to obtain an exemption from the hiring freeze, implementation of this legislation would require the reassignment of existing staff within divisions that are already understaffed.

4. **This bill should contain a specific appropriation to the Board.** This bill proposes a fee to be imposed on or before January 1, 2005. However, the Board would need to develop the feepayer base, reporting forms, and hire appropriate staff in 2004, which is in the middle of the state's 2004-05 fiscal year. To cover these administrative start-up costs, the Board would need an adequate appropriation that would not already be identified in the Board's 2004-05 budget.

As an alternative to an appropriation, the author may want to consider amending the bill to move the operative date of the fee from January 1, 2005 to July 1, 2005 and the annual due date for the fee and return from April 1, 2005 to October 1, 2005. This would allow the Board to obtain funding for the administrative costs related to this measure through the Budget Change Proposal process.

5. **Nonparticipating manufacturers.** This bill would require each nonparticipating manufacturer, as specified, to pay a fee as provided. A nonparticipating manufacturer would be defined to mean a tobacco product manufacturer that has not signed the Master Settlement Agreement and related documents entered into on November 23, 1998, by the state and leading United States tobacco product manufacturers. As such, the fee proposed by this measure would apply to any tobacco product manufacturer that has not signed the Master Settlement Agreement.

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 Board's formal position.

6. **Tobacco product manufacturers.** This bill would require that each nonparticipating manufacturer pay a tobacco products fee, as specified. A nonparticipating manufacturer would be defined to mean a cigarette or tobacco products manufacturer that did not sign the Master Settlement Agreement, as defined in subdivision (e) of Section 104556 of the Health and Safety Code.

The Master Settlement Agreement applies only to manufacturers of cigarettes, as cigarettes are defined pursuant to the Master Settlement Agreement. Generally speaking, the Master Settlement Agreement defines a cigarette to mean any roll of tobacco wrapped in paper or other substance containing tobacco, tobacco to be offered to consumers as a cigarette, or tobacco suitable for use for making cigarettes. Excluded from the definition of cigarette are smokeless tobacco products.

Accordingly, since smokeless tobacco manufacturers are not subject to the provisions of the Master Settlement Agreement, as defined, they would be subject to the tobacco products fee *unless* they also manufacture cigarettes and are a signatory to the Master Settlement Agreement.

7. **Could the state require out-of-state nonparticipating manufacturers to remit the tobacco products fee?** Various Supreme Court cases have focused on states' ability to impose the use tax on out-of-state firms making sales to in-state customers. In 1967 the Supreme Court ruled in *National Bellas Hess, Inc. v. Illinois Department of Revenue*, 386 U.S. 753 (1967), that a firm that has no link to a state except mailing catalogs to state residents and filling their orders by mail cannot be subject to that state's sales or use tax. The Court ruled that these mail order firms lacked sufficient nexus required by the Due Process Clause and the Commerce Clause of the United States Constitution.

In the 1977 case of *Complete Auto Transit, Inc. v. Brady* (1977) 430 U.S. 274 {51 L.Ed.2d 326, 97 S.Ct. 1076} the Court articulated that, in order to survive a Commerce Clause challenge, a tax must satisfy a four part test: 1) it must be applied to an activity with a substantial nexus with the taxing State, 2) it must be fairly apportioned, 3) it does not discriminate against interstate commerce, and 4) it must be fairly related to the services provided by the State.

North Dakota enacted anti-*National Bellas Hess* legislation with the expressed purpose of creating nexus with mail order firms selling to consumers in the state, in an attempt to compel out-of-state retailers to collect the use tax on mail order sales and test the continuing validity of the *National Bellas Hess* decision. The statute was challenged, and in 1992 the Supreme Court issued a ruling in *Quill Corporation v. North Dakota* (1992) 504 U.S. 298. The Court in *Quill* applied the *Complete Auto Transit* analysis and held that satisfying due process concerns does not require a physical presence, but rather requires only a minimum contacts with the taxing state. Thus when a mail-order business purposefully directs its activities at residents of the taxing state, the Due Process Clause does not prohibit the state's requiring the retailer to collect the state's use tax. However, the Court held further that physical presence in the state was required for a business to have a "substantial nexus" with the taxing state for purposes of the Commerce Clause. The Court therefore affirmed

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 Board's formal position.

that in order to survive a Commerce Clause challenge, a retailer must have a physical presence in the taxing state before that state can require the retailer to collect its use tax.

Based on the above cases, it is questionable whether the state could require an out-of-state nonparticipating manufacturer of tobacco products, who has no physical presence in California, to remit the fee.

8. **Petitions for Redetermination and claims for refund.** It is suggested that this bill be amended to authorize that the DHS handle the petitions for redetermination and approve the claims for refund based upon the grounds that the DHS improperly or erroneously established the specific fees to be assessed or identified the wrong feepayer. It would be difficult for Board staff to resolve feepayer protests and claims based on actions of another state agency, and in doing so could result in a significant number of additional appeals conferences and Board hearings. Accordingly, the following language is suggested:

105520. (d)(4) No petition for redetermination of fees determined by the department pursuant to subdivision (b) and (c) shall be accepted or considered by the State Board of Equalization if the petition is founded upon the grounds that the department has improperly or erroneously established or adjusted the amount of the fee pursuant to subdivision (b) or (c) or has incorrectly determined that the person is subject to the fee. Any appeal of a determination based on the grounds that the amount of the fee was improperly or erroneously established or adjusted or that the person is not responsible for the fee shall be accepted by the State Board of Equalization and forwarded to the department for consideration and decision.

(5) No claim for refund of fees paid pursuant to Section 105520 shall be accepted or considered by the State Board of Equalization if the claim is founded upon the grounds that the department has improperly or erroneously established or adjusted the amount of the fee pursuant to subdivision (b) or (c) or has incorrectly determined that the person is subject to the fee. Any claim for refund based on the grounds that the amount of the fee was improperly or erroneously established or adjusted or that the person is not responsible for the fee shall be accepted by the State Board of Equalization and forwarded to the department for consideration and decision.

It is also suggested that the bill be amended to reimburse the Board for its costs of collection and making refunds associated with the Tobacco Mitigation Trust Fund.

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 Board's formal position.

9. **Suggested technical amendments.** The following technical amendments are suggested to clarify the intent of the measure:

- The term "tobacco products" should be clarified to further define the term "cigarettes." If the author intends for tobacco products to mean cigarettes and tobacco products as defined in the Cigarette and Tobacco Products Tax Law, the following language is suggested:

105510. (d) "Tobacco product" means ~~cigarettes and all forms of cigars, smoking tobacco, chewing tobacco, snuff, and any other articles or products made of, or containing, at least 50 percent tobacco~~ cigarettes as defined in Section 30003 of the Revenue and Taxation Code and tobacco products as defined in subdivision (b) of Section 30121 and subdivision (b) of Section 30131.1 of the Revenue and Taxation Code.

- A date by which the DHS is required to set the tobacco products fee rate each year and notify the Board should be specified. Further, it is recommended that such date be at least 8 weeks prior to the effective date of the rate to provide Board staff sufficient time to notify industry before a fee rate change and to provide industry sufficient time for reprogramming.
- The operative date of the fee should be clarified. Section 105520(a) indicates that the fee would be paid on and after January 1, 2005. However, subdivision (e) (2) provides that the Board would assess the fee imposed commencing April 1, 2005.
- A due date for the fee and return should be specified. It is also recommended that the bill be amended to authorize the payment of refunds on overpayments of the fee and authorize reimbursement for the Board's costs of administration.

Board staff is working with the author's office in drafting appropriate amendments.

10. **This bill could increase state and local sales and use tax revenues.** In order to be reimbursed for the fee, tobacco product manufacturers may increase the price of tobacco products, which would be reflected in the retail sales price of tobacco products sold to the ultimate consumer.

Sales and use tax is due based on the gross receipts or sales price of tangible personal property in this state. Since the proposed tobacco products fee would not be specifically excluded from gross receipts or sales price, it would be included in the amount on which sales or use tax is computed.

11. **Would the proposed tobacco products fee increase evasion?** Tax evasion is one of the major areas that can reduce state revenues from cigarettes and tobacco products. Board staff recently estimated that cigarette tax evasion in California was running at a rate of approximately \$292 million annually. That estimate was only for evasion of cigarette taxes, and did not include associated evasion of other taxes, such as sales and use, tobacco products or income taxes.

A key premise in the Board's research is that both cigarette consumption and cigarette tax evasion are highly correlated to product prices and excise tax rates. For example, two major events that occurred since November 1998 dramatically increased California excise taxes as well as cigarette prices excluding taxes:

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 Board's formal position.

Proposition 10 and the Tobacco Master Settlement Agreement made between states and tobacco manufacturers (tobacco settlement). Together, these two developments, when coupled with typical wholesaler and retailer distribution margins, have increased average prices of cigarettes to California consumers by about 50 percent in relation to early November 1998 prices. It was estimated that the impacts of Proposition 10 and the tobacco settlement more than doubled cigarette tax evasion in California.

This bill would impose an unspecified fee on each person currently manufacturing tobacco products, or who has previously manufactured tobacco products, as specified. This fee could result in an increase in the selling price of tobacco products, which based on the Board's findings when developing the impacts of Proposition 10 and the tobacco settlement, would cause a correlated increase in tax evasion.

12. **Related legislation.** This bill contains similar fee language as AB 1239 (Wiggins). However, Assembly Bill 1239 would impose, on or after July 1, 2004, a tobacco products fee, as specified, on each nonparticipating manufacturer currently manufacturing tobacco products, or who has previously manufactured tobacco products, or both, that has contributed or currently contribute, or both, to tobacco-related health impacts. For purposes of AB 1239, "tobacco product" is defined to mean cigarettes.

COST ESTIMATE

The Board would incur non-absorbable costs to adequately develop and administer a new fee program. These costs would include registering fee payers, developing computer programs, mailing and processing returns and payments, carrying out compliance and audit efforts to ensure proper reporting, developing regulations, training staff, answering inquiries from the public and investigative efforts. A cost estimate of this workload is pending.

REVENUE ESTIMATE

This measure does not specify the amount of the tobacco products fee. Accordingly, a revenue estimate could not be prepared.

Analysis prepared by:	Cindy Wilson	916-445-6036	01/13/04
Contact:	Margaret S. Shedd	916-322-2376	
Is			0676-2CW.DOC

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 Board's formal position.