STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Amended	**01/26/04**	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 is eligible, but 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.

Summary of Amendments

Since the previous analysis, this bill was amended to: (1) revise the definition of "nonparticipating manufacturer" and "tobacco product;" (2) require the Department of Health Services (DHS), in consultation with the Board, to establish specific tobacco product fees to be assessed on a manufacturer; (3) require the Board to determine the manufacturer's share of payment into the nonparticipating manufacturer's escrow account for purposes of establishing and adjusting the tobacco products fees; (4) require the Board to issue a certificate to a manufacturer as proof of payment of the fee upon collection of the fee; and (5) prohibit the Board from issuing a license pursuant to the Cigarette and Tobacco Products Licensing Act of 2003 (Licensing Act) until it has paid the tobacco products fee.

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 2003-04 is 46.76 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 DHS in consultation with the Board would be required to establish, by regulation, specific fees to be assessed on a manufacturer based on all of the following factors:

- The annual economic and health impact cost to the state and local governments to treat individuals for tobacco-related illnesses and diseases.
- The manufacturer's share of the California tobacco products market, as determined by the DHS.
- The manufacturer's share of payment into the nonparticipating manufacturer escrow account, as determined by the Board

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.
- An adjustment in the manufacturer's share of payment into the nonparticipating manufacturer escrow account, as determined by the Board.

Adjustment of the fees would not be subject to the rulemaking requirements of the Administrative Procedures Act; they would instead be subject to a public comment period of at least 45 days established by the DHS in consultation with the Board.

The Board would administer and annually collect 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 roll-your-own tobacco products. "Manufacturer" or "nonparticipating manufacturer" would be defined to mean a tobacco product manufacturer that is eligible, but 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.

Other Board Responsibilities

- The Board would issue a certificate to a manufacturer as proof of payment of the tobacco products fee upon collection of the fee from the nonparticipating manufacturer.

- The Board would be prohibited from licensing a cigarette manufacturer or importer pursuant to the Licensing Act until it has paid the fee imposed by this measure.
- The Board would be authorized to adopt regulations as necessary to implement the Tobacco Mitigation and Relief Act of 2003.

This measure would become effective January 1, 2005.

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.

In 2003, Assembly Bill 71 (J. Horton, Chapter 890) enacted Complementary Legislation to make state enforcement of the Model Statute more effective and thereby promote the purpose for which the Model Statute was enacted. In general, the Complementary Legislation prohibits a person from affixing any tax stamp to a package of cigarettes, or pay 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 a compliance list posted by the Attorney General.

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 **January 26, 2004**, amendment deletes Section 105525, which would have provided that the fees imposed by this measure are not to be deductible as ordinary business expenses or as any other classification of expenses or costs under the Personal Income Tax Law or the Corporation Tax Law. This amendment does not impact the Board.

   The **January 20, 2004**, amendments revise the definition of "nonparticipating manufacturer" and "tobacco product," require the DHS in consultation with the Board to establish specific tobacco product fees to be assessed on a manufacturer, and require the Board to determine the manufacturer's share of payment into the nonparticipating manufacturer's escrow account for purposes of establishing and adjusting tobacco products fees. The amendments also require the Board to issue a certificate to a manufacturer as proof of payment of the fee upon collection of the fee and prohibit the Board from issuing a license pursuant to the Licensing Act until it has paid the tobacco products fee.

   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. **The Board could not administer a new fee program with a January 1, 2005, effective date without risk to its Revenue Database Consolidation (RDC) Project.** Beginning in April 2004 and running through the remainder of the 2004 calendar year, the Board is implementing the RDC project. The RDC project involves extensive changes to the Integrated Revenue Information System (IRIS), the Board's primary tax administration system. The RDC project implementation and stabilization efforts will occupy significant Board staff resources for the rest of 2004.

   In addition, the Board is currently in the process of developing, testing and implementing technology changes related to new legislatively mandated programs[*] enacted in 2002 and 2003. This effort has been included in the multi-year, multi-phase RDC project and will be on-going through the end of 2004.

   This bill would create a new fee program as of January 1, 2005. This would require programming to the Board's computer system at the end of 2004, which is during the final stages of the RDC Project. Making modifications at the end of the system development, which this bill would require, would put the Board's RDC project at substantial risk. Because of this risk, the Board can not add a new tax or fee program to its system until early 2005. It is therefore suggested that the bill be amended to require the department to establish the fee *no earlier* than **July 1, 2005** with an annual due date of **October 1**.

[*] SB 1049 (Water Rights Fee), AB 71 (Cigarette and Tobacco Products Licensing Act), and SB 1701 (Alternative Cigarette and Tobacco Stamps)

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. To implement the proposed fee program, 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 January 1, 2006. This would allow the Board to obtain funding for administrative start-up costs through the Budget Change Proposal process. It would also provide the Board sufficient time to program its computer system, as discussed in comment #3.

5. **The Board would require the necessary funding to administer the proposed tobacco products fee.** In funding state agencies, the Administration and the Legislature have not provided budget dollars to support the actual agency payroll costs (for example, workers compensation costs, merit salary adjustments, and collective bargaining requirements are not fully funded in the annual budget process). The Administration and the Legislature expect state agencies to keep positions vacant or delay hiring staff in order to save dollars to meet these unfunded payroll costs.

   To be able to promptly hire staff or to recruit from outside the Board's operations, the bill should be amended to provide funding to fully support the Board's actual costs of a position.

6. **Bill could set precedent.** This bill would require the DHS in consultation with the Board to establish specific fees to be assessed on a nonparticipating manufacturer. Adjustment of the fees would be subject to a public comment period of at least 45 days established by the DHS in consultation with the Board.

   Having another state agency consult with the Board to set a fee or tax amount is inconsistent with the other 31 tax and fee programs administered by the Board. With the exception of the tobacco products tax, which is determined annually by the Board, the amount of the fee or tax is usually set by statute or by another state agency. The Board merely collects the tax or fee and administers the program in accordance with the statute.

   In addition, the Board has no expertise in the factors that would be used to determine the proposed tobacco products fee. That expertise appears to be with the DHS and the Attorney General. As such, it is suggested that the DHS consult with the Attorney General rather than the Board to set and adjust the tobacco products fee. It is also suggested that the term "consultation" be defined in order to make it clear what is expected of the agency that the DHS would be required to consult for purposes of establishing the proposed fee.

7. **Manufacturer's share of payment into escrow account.** This measure would require the Board to determine the manufacturer's share of payment into the nonparticipating manufacturer escrow account, which is one of the factors used to establish and adjust the proposed fee. However, it is suggested that the bill be amended to require the Attorney General to determine this factor since it is responsible for reviewing nonparticipating tobacco product manufacturer compliance with the escrow account requirements of the Model Statute.

The author may also wish to address the following staff concerns:

- The factors upon which the specific fees are established and adjusted should be more specific, such as citing a source for the information. For example, how would the DHS determine the factor of annual economic and health impacts cost to the state and local governments to treat individuals for tobacco–related illnesses and diseases?
- The factors for establishing and adjusting the fee should be consistent. As such, the following amendment is suggested:

  105520. (c)(1)(A) Any change in the economic and health costs to the state and local governments <u>to treat individuals for tobacco-related illnesses and diseases</u>.

8. **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 contact 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 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. However, to enhance the collection of the proposed fee from out-of-state manufacturers, this bill was amended to prohibit the Board from licensing a cigarette manufacturer or importer as required pursuant to

the Licensing Act until it has paid the tobacco products fee. Even with this amendment, a nonparticipating manufacturer without nexus could still avoid payment of the fee by not selling cigarettes directly into this state.

In addition, the Licensing Act does not require manufacturers of tobacco products, including roll-your-own tobacco, to be licensed. As such, prohibiting the Board from licensing such nonparticipating manufacturers until it has paid the proposed fee would not affect such manufacturers.

To address these concerns, it is suggested that the bill be amended to prohibit the Attorney General from listing on its Web site directory a nonparticipating manufacturer that has not paid the fee. Pursuant to Revenue and Taxation Code Section 30165.1, the Attorney General is required to publish on its Internet Web site a directory listing of all tobacco product manufacturers that have provided current, timely, and accurate certifications conforming to specified requirements and all brand families that are listed in the certifications. A distributor is prohibited from affixing a cigarette tax stamp, or from paying the tax on a tobacco product defined as a cigarette, unless the brand family and the tobacco product manufacturer are included on the Attorney General's Web site directory.

9. **Proof of payment certificate.** This bill would require the Board to issue a certificate to manufacturers as proof of payment of the fee. However, it is not clear what the purpose is for the certificate. For example, would a distributor purchasing from a nonparticipating manufacturer be required to maintain a copy of the certificate? Would a distributor be prohibited from stamping cigarettes, or paying the tax on tobacco products defined as a cigarette, purchased from a nonparticipating manufacturer, unless they have a copy of that manufacturer's certificate?

10. **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 redeterminiation 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.

11. **Administrative Procedures Act provisions.** Initially, this bill would require the DHS in consultation with the Board to establish, by regulation, specific fees to be assessed on a nonparticipating manufacturer. This regulation for establishing the fee would be subject to the rulemaking requirements of the Administrative Procedures Act. The annual adjustment of the fees by the DHS, however, would not be subject to the Administrative Procedures Act rulemaking requirements. Instead, the adjustment of fees would be subject to a public comment period of at least 45 days established by the DHS in consultation with the Board.

12. **Other technical concerns.** In order to avoid any ambiguity with administration of the proposed Tobacco Mitigation and Relief Act of 2003, the author may wish to amend the bill to address the following concerns:

- It appears to be the author's intent that the term "tobacco products" have the same meaning as the term "cigarettes" as defined under the Model Statute (Article 3 (commencing with Section 104555) of Chapter 1 of Division 103 of the Health and Safety Code). This appears to be the intent because it is the Model Statute that requires manufacturers to either become a participating manufacturer or place into escrow with the state specified amounts per units sold. As such, the following amendment is suggested for the purpose of clarity and for consistency with the Model Statute:

  105510. (e) "Tobacco products" means cigarette as defined in subdivision (d) of Section 104556 of the Health and Safety Code ~~cigarettes and roll-your-own tobacco~~.

- Currently, Section 105523(b) provides that "the **board** shall **assess** the fee imposed pursuant to this part commencing April 1, 2005, and annually thereafter." However, it is not clear if April 1 is the due date for the fee or a date by which the Board is to send out determinations (billings) for the fee.

  105523. (b) The ~~board shall assess the~~ fee imposed pursuant to this part shall be due and payable ~~commencing~~ April 1, 2005, and annually on April 1 thereafter.

  In addition, Section 105523(b) refers to "board", however, that term is not defined to mean State Board of Equalization. However, reference to the Board in subdivision (b) of Section 105523 is not necessary since subdivision (a) of that same section would require the Board to administer and annually collect the proposed fee.

- 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.

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

  105530. There is hereby established the Tobacco Mitigation Trust Fund in the State Treasury. Moneys in the fund shall, upon appropriation by the Legislature, be expended for the purpose of refunds of the fee imposed pursuant to this part, and for the following purposes:

  (a) To reimburse the State Board of Equalization for its costs of administration and collection of the fee imposed pursuant to this part.

  (b) To ~~to~~ assist individuals to access and utilize smoking cessation services.

13. **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.

14. **Sinclair Paint Company Court decision.** In July 1997, the California Supreme Court held that the Childhood Lead Poisoning Prevention Act of 1991 imposed bona fide regulatory fees and not taxes requiring a two-thirds vote of the Legislature under Proposition 13. In summary, the Court found that while the Act did not directly regulate by conferring a specific benefit on, or granting a privilege to, those who pay the fee, it nevertheless imposed regulatory fees under the police power by requiring manufacturers and others whose products have exposed children to lead contamination to bear a fair share of the cost of mitigating those products' adverse health effects.

    This measure would impose a tobacco products fee that would be used to fund a program to assist individuals to access and utilize smoking cessation services. However, the tobacco products fee would not be imposed on all tobacco product manufacturers, only on nonparticipating manufacturers. Tobacco product manufacturers that signed the tobacco Master Settlement Agreement would not be required to pay the fee.

    As such, it could be argued that not all tobacco product manufacturers would be bearing a fair share of the cost of tobacco cessation services since the fee is only imposed on nonparticipating manufacturers. Therefore, it is questionable whether the fee imposed by this measure is a fee consistent with the California Supreme Court decision in Sinclair Paint Company v. State Board of Equalization (1997) 15 Cal.4th 866.

15. **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: 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.

16. **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.

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