

DRAFT



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

Date Amended:	<b>2/18/2000</b>	Bill No:	<b>SB 1038</b>
Tax:	<b>Cigarette</b>	Author:	<b>Burton</b>
Board Position:	<b>Support</b>	Related Bills:	

**BILL SUMMARY:**

This bill would prohibit the affixing of a California cigarette tax stamp to a package of cigarettes which bears a brand name that is a registered trademark of a participating manufacturer if the package was imported by anyone other than the participating manufacturer.

**ANALYSIS:**

Current Law:

Currently, Cigarette and Tobacco Products Tax Law Section 30163 requires that an appropriate stamp or meter impression be affixed to, or made on, each package of cigarettes prior to distribution of the cigarettes. However, this section prohibits the affixing of any cigarette tax stamp to, or meter impression made upon, any package of cigarettes if any one of the following occurs:

1. The package does not comply with all requirements of the Federal Cigarette Labeling and Advertising Act (15 U.S.C. Sections 1331-1341) for the placement of labels, warnings, or any other information upon a package of cigarettes that is to be sold within the United States.
2. The package of cigarettes is labeled "For Export Only", "U.S. Tax Exempt", "For Use Outside U.S.", or similar wording indicating that the manufacturer did not intend that the product be sold in the United States.
3. The package of cigarettes has been altered by adding or deleting the wording, labels, or warnings described in (1) or (2) above.
4. The package of cigarettes was imported into the United States after January 1, 2000, in violation of Section 5754 of Title 26 of the United States Code.

Section 30163 also requires the Board to revoke the license of any distributor who violates the stamping restrictions of that section. In addition, Section 30436 authorizes the Board to seize cigarettes that have been stamped in violation of the restrictions contained in Section 30163.

*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:

Among other things, this bill would amend Section 30163 to prohibit the affixing of a California tax stamp to a package of cigarettes which bears a cigarette brand name that is a registered trademark of a manufacturer that participated in the Master Settlement Agreement between the states and tobacco companies, if the package was imported by anyone other than the participating manufacturer.

This bill also contains Bank and Corporation Tax Law changes that do not impact the Board.

In General:

Several American cigarette manufacturers produce cigarettes domestically and overseas, and some American-brand cigarettes are produced overseas by other manufacturers pursuant to licensing agreements with the manufacturers that “own” the brands. Because the foreign-manufactured cigarettes can be purchased at a reduced price, some California distributors have been importing these cigarettes, paying federal and state taxes and duties, and selling them in California. The price differential between domestic and foreign-manufactured cigarettes averages \$6 per carton.

Background:

The current restriction on the distribution of cigarettes in California that do not meet all the requirements of the Federal Cigarette Labeling and Advertising Act was amended into Section 30163 by Senate Bill 2134 (Stats. 1998, Ch. 292) and sponsored by the California Distributors Association. The sponsor asserted that “for export only” cigarettes, which are manufactured in the United States by American cigarette manufacturers for foreign markets, were returned to the United States and have become associated with export fraud, smuggling, and organized crime. Their bill was intended to deter the increasing volume of ex-tax cigarettes sold in California.

In spite of the restriction placed into the cigarette tax law by Senate Bill 2134, “for export only” cigarettes continued to be available in California because these cigarettes *did* comply with the Federal Cigarette Labeling and Advertising Act, which basically requires health warning labels and a plan approved by the Federal Trade Commission describing how the four health warning labels will be included on the cigarette packages throughout the year. Accordingly, Section 30163 was once again amended by Senate Bill 702 (Stats. 1999, Ch. 935) to prohibit the affixing of a tax stamp on:

1. cigarette packages which are labeled “For Export Only”, “U.S. Tax Exempt”, “For Use Outside U.S.”, or similar wording indicating that the manufacturer did not intend that the product be sold in the United States,
2. cigarette packages which have been altered by adding or deleting the health warnings or “export only” language, or
3. cigarette packages that were imported into the United States after January 1, 2000, in violation of Section 5754 of Title 26 of the United States Code.

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This bill was sponsored by the California Distributors Association and was intended to clarify the definition of export tobacco products subject to the stamping restrictions in current law and give the Board the authority to seize the cigarettes found to be in violation of those restrictions.

However, it was not apparent at the time Senate Bills 2134 and 702 were enacted that a significant number of American cigarette brands were being manufactured in foreign countries and shipped into the United States for sale in California. Although the importing and stamping of these cigarettes does not violate California's cigarette tax law, there is a potential for evasion of the cigarette tax because these cigarettes are not subject to the same reporting and tracking requirements as cigarettes manufactured and shipped within the United States.

Comments:

1. **Sponsor and intent.** This bill is sponsored by the California Distributors Association and is intended to add to the category of export cigarettes that "may not be stamped in California, those packages which are brands of a participating manufacturer to the Master Settlement Agreement brought into the state through a party other than the participating manufacturer." The emphasis is on brands, not where the product is manufactured. It ensures that such cigarette packages will be subject to state and federal reporting requirements for cigarettes shipped in the United States. Additionally, this bill is intended to ensure the capture of Master Settlement Agreement funds paid by the participating manufacturer upon retail sale of the cigarettes in the United States.
2. **This bill would better ensure that participating manufacturers make payments under the Master Settlement Agreement** for all their cigarette brands shipped in or to this country. It is Board staff's understanding that American manufacturers have licensed foreign manufacturers to produce their brand name cigarettes for sales abroad. (The brand names are registered as trademarks.) It is possible for those foreign-manufactured cigarettes to be imported into the United States for sale by someone other than the licensing participating manufacturer.

A participating manufacturer's annual payment under the Master Settlement Agreement is based on its relative market share (as a percentage) of the base amount specified in the agreement. The base amount specified in the agreement can increase or decrease, based on the number of cigarettes sold in the United States by the participating manufacturers, which is measured by the federal excise tax paid on such cigarettes. If a participating manufacturer's brand name cigarettes are manufactured off-shore pursuant to a license agreement, and imported into the United States by someone other than the participating manufacturer, the base payment amount (and, consequently, the payments to the states under the Master Settlement Agreement) may be reduced because such cigarettes will not count as cigarettes sold in the United States by the participating manufacturer. In other words, since the participating manufacturer is not involved with any part of the selling process of their cigarette brand in the United States, those cigarettes will not count for purposes of computing their base payment under the Master Settlement.

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3. **Importing of foreign-manufactured cigarettes does not automatically lead to tax evasion.** Tax evasion occurs when cigarettes are distributed without the payment of the tax. Distributors of foreign-manufactured cigarettes who properly stamp their cigarettes, and thereby pay their cigarette taxes, are not violating current state cigarette tax law. This measure, however, would prevent distributors from selling foreign-manufactured cigarettes bearing a brand name of a participating manufacturer if the cigarettes were imported by anyone other than the participating manufacturer of that brand.

Although this proposal limits the ability of distributors to sell foreign-manufactured cigarettes, even if the cigarette tax on such cigarettes is paid, it will help prevent an increase in smuggling. As smugglers become more aware that foreign-manufactured cigarettes provide potential profits and an easier method for bringing untaxed cigarettes into California (without the greater risk associated with the reporting requirements related to domestically produced and shipped cigarettes), foreign-manufactured cigarettes could potentially become a greater source of tax evasion.

It should be pointed out that this proposal would not completely prohibit the affixing of a cigarette tax stamp to a package of foreign-manufactured cigarettes. In addition to participating manufacturers importing their own cigarette brands, foreign-manufactured cigarette packages that bear a cigarette brand name which is a registered trademark of a non-participating manufacturer may be legally imported, stamped, and made available for sale by a distributor.

4. **Suggested technical amendment to accomplish intent.** The language in this bill is intended to prohibit the affixing of a California cigarette tax stamp to a package of cigarettes which bears a brand name that is a registered trademark of a participating manufacturer if the package was imported by anyone other than the participating manufacturer. Board staff has found that it is possible for two separate companies to have a registered trademark for what appears to be the same brand. For example, Philip Morris, Inc. owns the United States trademark rights to Philip Morris brands, while Philip Morris International owns the trademark rights to such brands in other countries. Because it is possible for two separate companies to have a registered trademark for the same cigarette brand, the current language could make it difficult for the Board to enforce the statute. The following language is suggested in order for this bill to accomplish its intent:

30163. (b)(5)(A) The package bears a cigarette brand name which is a registered U.S. trademark of a participating manufacturer and the package was imported by anyone other than the participating manufacturer of the cigarette brand.

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**COST ESTIMATE:**

The Board would incur non-absorbable costs to implement this bill. These one-time costs would include staff overtime and equipment to seize and destroy the contraband products. A detailed cost estimate is pending.

**REVENUE ESTIMATE:****Background, Methodology, and Assumptions**

The bill affects certain imported cigarettes only. For purposes of this estimate, we assume that the proportion of imported to total taxed cigarettes is the same in both the United States and California. We also assume that all imports remain in the country and are tax-paid.<sup>1</sup>

The exact number of packages affected by this bill cannot be determined by available reports. However, data provided by the United States Department of Agriculture (USDA) allow us to estimate the percentage of taxed cigarettes that are imported.<sup>2</sup> An estimated 8 billion cigarettes were imported into the United States in 1999. Estimated total consumption in the United States was 435 billion cigarettes, including imports. Thus, about 1.8 percent of taxed cigarettes sold in this country last year was imported. (8 billion imports / 435 billion taxed cigarettes).

This bill does not affect some imports. It would not affect foreign-made cigarettes produced by a non-participating manufacturer regardless of who imports them. It also would not affect cigarettes produced and imported by a participating manufacturer. Although the number of potentially affected packages is less than 1.8 percent of taxable distributions in California, the proportion of affected to unaffected imports cannot be determined with available data.

In fiscal year 1998-99, California distributors stamped and distributed 1,523 million packages of cigarettes. Based on revenue forecasts in the 2000-01 Governor's Budget, distributors will stamp and distribute 1,464 million packages in fiscal year 2000-01 (\$1,273.5 million / \$0.87/package). Based on our assumptions, the total number of cigarette packages affected by this bill in fiscal year 2000-01 is less than 26.4 million (1,464 million packages x .018). Cigarette tax revenue on 26.4 million packages is \$23.0 million (26.4 million packages x \$0.87/package).

Domestic participating manufacturers' cigarette brands are made outside the United States by foreign subsidiaries and manufacturers with licensing agreements to produce them. Phillip Morris, with a domestic market share approaching 50 percent, has numerous

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<sup>1</sup> From about 1991 to 1993, many Canadian imports were re-exported to Canada. Since Canada lowered its extremely high excise taxes on cigarettes, re-exportation has not been the problem it was.

<sup>2</sup> USDA Tobacco Situation and Outlook Report, Table 1—Cigarettes: US output, removals, and consumption, 1989-99, updated on 12-14-99, <http://www.econ.ag.gov/briefing/tobaco/Table1.htm>.

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subsidiaries in foreign countries.<sup>3</sup> The brand and packaging appear to be identical to the brands produced domestically. Since carton costs in California increased by \$9.50 in less than two months, foreign-made brands, such as Marlboros, have become more prevalent.<sup>4</sup> They sell for about \$6.00 less per carton. This bill would impact the availability of foreign-made Marlboros and other popular brands made outside the United States.

If this bill passes, distributors of affected imports will be forced to buy domestic versions of popular brands, buy directly from manufacturer-importers, switch to equivalent brands, or lose business. Popular brands made outside the United States will not be available unless the participating manufacturers choose to import and sell them to distributors.

To the extent that consumers and distributors remain loyal to popular brands, this bill would effectively constitute a price increase on foreign-made cigarettes replaced by domestic counterparts. Brand loyalty is most likely for popular brands made outside the United States, such as Marlboros. Distributors and consumers of other brands will likely switch to equivalent brands that are about the same price they currently pay.

The overall impact on cigarette tax revenues is believed to be negligible. Consumers will likely remain loyal to popular brands and pay higher prices for them or switch to equivalent brands if the popular brands are too expensive. Consumers will likely switch to equivalent brands if affected brands become unavailable.

### Revenue Summary

This bill would have an unknown, but negligible impact on cigarette tax revenues.

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<sup>3</sup> Phillip Morris has subsidiaries in Australia, Brazil, Germany, the Netherlands, Hong Kong, Mexico, Spain, Switzerland, and Turkey.

<sup>4</sup> In November 1998, domestic manufacturers raised wholesale prices by \$4.50 per carton to recover costs related to the Master Settlement Agreement. On January 1, 1999, California excise taxes on cigarettes increased carton costs by \$5.00.

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