Draft

STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	**08/06/02**	Bill No:	**SB 1849**
Tax:	**Sales and Use** **Cigarette and Tobacco Products** **Satellite**	Author:	**Committee on Budget and Fiscal Review**
Board Position:		Related Bills:	**AB 428 (Assembly Budget Committee)** **AB 433 (Assembly Budget Committee)** **SB 1890 (Ortiz)**

BILL SUMMARY

This is a budget trailer bill implementing various provisions incorporated into the 2002-03 Budget. Among other things, this bill would:

- Authorize the Board to waive any penalties and interest on unpaid sales and use taxes owed by eligible taxpayers, as defined, to the extent that the underlying tax liability is paid.
- Impose an additional excise tax on cigarettes of one hundred six and one-half mills ($0.1065) per cigarette, or $2.13 per package of 20, and impose an equivalent compensating floor stock tax, operative 10 working days following the effective date of the bill.
- Impose a 5 percent satellite television subscription tax to be collected and administered by the Board in the same manner as provided in the Fee Collection Procedures Law.

As amended on August 6, 2002. Among other things, these amendments 1) remove the provisions that would have increased the "cap" on the energy resources surcharge imposed on the consumption in this state of electrical energy purchased from an electric utility, on and after January 1, 2003, from two-tenths ($0.0002) of a mill to three-tenths ($0.0003) of a mill, and 2) increase the additional tax imposed on a package of cigarettes from $0.50 to $2.13 per package of 20 cigarettes, and 3) incorporate the waiver of interest and penalty provisions and the proposed 5 percent satellite tax.

Sponsor and purpose. This bill is sponsored by the author and is intended to address, in part, the projected 2002-03 Budget shortfall.

ANALYSIS

Penalties and interest (Section 1)

Current Law

Under existing law, when a sales or use tax liability is not paid when due, interest is imposed on the unpaid tax and one or more penalties may be added to the liability. Generally, a penalty of ten percent is imposed for failure to pay the tax timely, but the law contains other provisions for additional penalties for other reasons for noncompliance. Under the law, interest continues to accrue on any unpaid portion of the tax until the tax is paid in full. Interest is computed on a simple basis, and only accrues on the unpaid tax liability. Interest does not accrue on any unpaid penalty amounts.

If a payment is not timely received, the Board generally negotiates with the taxpayer for payments, and if the liability remains unpaid, the Board ultimately searches for any assets of the taxpayer, and takes collection actions to use the assets to satisfy the tax liability. Collection actions may include manually searching records for assets, seizing bank accounts, or seizing and selling vehicles, vessels, or stocks. In the event of a financial hardship, existing law allows installment payment arrangements, or collection may be deferred until the financial situation of the taxpayer improves. However, if taxpayers can obtain loans or can use credit lines to pay their tax liabilities, they are expected to do so.

If a debt remains unpaid for a number of years, and a lien has been filed and assets cannot be located, the Board may write off the debt pursuant to provisions in the Government Code (discharge from accountability). When a debt is written off, however, the debt is still due and owing and any liens recorded are still valid, but routine billing and collection actions are discontinued unless assets are subsequently located. There is no statute of limitations on the Board's collection of a tax debt, and interest and applicable penalties continue to accrue. The debt also remains on the taxpayer's credit record, impeding his or her ability to obtain credit.

Under existing law, under specified circumstances, the Board may reduce a delinquent tax liability, commonly called an "offer in compromise." In general, an offer in compromise is a process whereby the taxpayer offers to pay an amount that he or she believes to be the maximum amount that can be paid within a reasonable period of time. If the parties agree to the amount offered, the debt is compromised (reduced) to that amount.

Proposed Law

This bill would add Section 7093.8 to the Sales and Use Tax Law to authorize, for the period beginning October 1, 2002 and ending June 30, 2003, an eligible taxpayer's liability with respect to any unpaid taxes, to be satisfied by the payment of an amount equal to the tax liability, excluding penalties and interest. The bill would specify that this authority would be limited to an unpaid tax liability that has been determined by the Board to be a "high-risk" collection account.

The bill would provide the following definitions:

- "Eligible taxpayer" means any person that receives notification from the Board that the taxpayer's unpaid tax liability may be satisfied by the payment of an eligible amount.
- "Eligible amount" means an amount equal to any unpaid tax liability, excluding penalties and interest, owed by the eligible taxpayer that is paid in one or more installments, as determined by the Board, on or before the due date established by the Board, but in no event later than June 30, 2004.
- "High-risk collection account" means any unpaid tax liability of a taxpayer where satisfaction of that liability under this bill would be in the best interest of the state, and shall include any unpaid tax liability for which the Board has made either of the following determinations:
  (1) Under the Board's collection modeling policies, practices, and procedures, efforts to collect the unpaid tax liability would not be economical.
  (2) The unpaid tax liability would not be paid in full within a reasonable period of time.
- "Unpaid tax liability" means any final liability under Part 1 (commencing with Section 6001), including tax, penalties, and interest, that are owed by an individual and, as of October 1, 2002, are unpaid.

The bill would further provide:

- No refund or credit shall be granted with respect to any penalty or interest paid or collected with respect to an unpaid tax liability prior to October 1, 2002.
- The determinations made by the Board pursuant to this bill shall be final and conclusive and shall not be subject to review by any other officer, employee, or agent of the state, or by any court.
- Nothing in Section 7056, or in any other provision of law, shall be construed to require the disclosure of standards used or to be used in connection with any determinations made by the Board for purposes of this bill, or the data used or to be used for determining those standards if the Board determines that the disclosure will seriously impair assessment, collection, or enforcement of sales or use taxes.
- Nothing in this bill shall authorize the Board to compromise any final tax liability.
- Chapter 3.5 (commencing with Section 11340) of Part 1 of Division 3 of Title 2 of the Government Code (the Administrative Procedure Act) shall not apply to any standard, criterion, procedure, determination, rule, notice, or guideline established or issued in implementing and administering the program required by this bill.
- This provision is operative with respect to unpaid tax liabilities of high-risk collection accounts that are the subject of notifications made to eligible taxpayers on or after October 1, 2002, and before July 1, 2003.
- Whenever a "high-risk collection account" is forgiven of any penalties and interest pursuant to this bill, the public record shall include all of the following information:
  (1) The name of the taxpayer.
  (2) The amount of related penalties and interest relieved.
  (3) A summary of the reason why the relief is in the best interest of the state.

COMMENTS

Related legislation. These provisions are similar to the provisions in AB 433 (Assembly Budget Committee), another trailer bill. The Board voted to support the provisions in AB 433.

Also, AB 1458 (Kelley) was signed into law this session (Chapter 152, Kelley) to provide the Board with the administrative authority to compromise tax debts. This Board-sponsored bill provides the Board with the administrative authority to compromise a tax or fee debt under the Sales and Use, Use Fuel, and Underground Storage Tank Maintenance Fee laws when the reduction amount is $10,000 or less. This authorization essentially eliminated the need to obtain a judgment through a court proceeding, which the prior law required. Elimination of the court proceeding, should result in expediting the in compromise process with a greater amount of efficiency.

COST ESTIMATE

The Board would incur administrative costs to implement this provision. These costs include staff workload associated with the identification and notification of "eligible taxpayers" and related administrative support. These costs are estimated as follows:

2002-03 (10 months)	2003-04 (2 months)
$379,000	$60,000

REVENUE ESTIMATE

It has been projected that this provision would result in additional sales or use tax payments of $20 million. As an order of magnitude, the chart below demonstrates the total existing sales and use tax accounts receivable balances as of June 30, 2001. The amounts shown do not include those liabilities in bankruptcy status.

Age of Receivable	Tax	Interest	Penalty	Total
1 to 2 years	$ 64,257,572	$ 36,714,362	$ 18,799,564	$ 119,771,498
2 to 3 years	$ 37,275,312	$ 26,306,900	$ 10,152,193	$ 73,734,405
3 to 5 years	$ 54,408,272	$ 42,789,179	$ 15,004,368	$ 112,201,819
5 to 10 years	$ 56,758,829	$ 71,546,403	$ 16,076,904	$ 144,382,136
Over 10 years	$ 14,286,586	$ 40,301,584	$ 6,016,009	$ 60,604,179
Total	$ 226,986,571	$ 217,658,428	$ 66,049,038	$ 510,694,037

ANALYSIS

Current Law

Cigarette Tax Increase (Section 16)

Pursuant to Revenue and Taxation Code Section 30101 (Cigarette and Tobacco Products Tax Law), an excise tax of 6 mills (or 12 cents per package of 20) is imposed 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 and based on the March 1 wholesale cost of cigarettes. Currently, the surcharge rate for fiscal year 2002-03 is 48.89 percent.

Of the 87 cent excise tax imposed on a package of 20 cigarettes, 2 cents is deposited into the Breast Cancer Fund, 10 cents into the General Fund, 25 cents into the Cigarette and Tobacco Products Surtax Fund, and 50 cents into the California Children and Families First Trust Fund (CCFF Trust Fund). The tobacco products surtax imposed under Section 30123 is deposited into the Cigarette and Tobacco Products Surtax Fund, while the surtax imposed under Section 30131.2 is deposited into the CCFF Trust Fund.

Proposed Law

Among other things, this bill would add Article 4 (commencing with Section 30132) to Chapter 2 of Part 13 of Division 2 of the Revenue and Taxation Code to impose an additional tax of $2.13 per package of 20 cigarettes. The tax would be imposed 10 working days following the effective date of the bill. The bill would also impose a compensating floor stock tax on the cigarette inventory of a dealer, wholesaler and distributor 10 working days following the effective date of the bill.

The proceeds from the tax increase would be deposited by the Board into the General Fund.

Background

Proposition 99, passed on the November 1988 ballot, effective January 1, 1989, imposed a surtax of 25 cents per package of 20 cigarettes, and also created an equivalent tax on tobacco products. Proceeds from the taxes fund health education, disease research, hospital care, fire prevention, and environmental conservation.

Assembly Bill 478 (Ch. 660, 1993) and Assembly Bill 2055 (Ch. 661, 1993), effective January 1, 1994, added an excise tax of 2 cents per package of 20 cigarettes for breast cancer research and early detection services.

Proposition 10, passed November 3, 1998, effective January 1, 1999, imposed an additional surtax of 50 cents per package of 20 cigarettes. Additionally, the measure imposed an additional excise tax on the distribution of tobacco products equivalent to the additional cigarette tax, and imposed an equivalent compensating floor stock tax. The revenues from the additional tax are deposited into the CCFF Trust Fund and are used to: (1) fund early childhood development programs, and (2) offset any revenue losses to certain Proposition 99 Programs as a result of the additional tax imposed by Proposition 10.

COMMENTS

1. **This measure does not contain a corresponding tax increase on tobacco products.** However, the $2.13 cigarette tax increase would increase the tobacco products tax rate for fiscal year 2003-04 as a result of Proposition 99. Section 30123(b) (Proposition 99) generally provides that the tobacco products tax rate is determined annually by the Board, which is equivalent to the combined rate of tax imposed on cigarettes. As such, a tax increase on tobacco products is automatically triggered whenever the tax imposed on cigarettes is increased.

   However, an increase to the tobacco products tax rate as a result of this bill would not be effective until the 2003-04 fiscal year because current law provides that the Board determine a tobacco products rate "annually." Since the Board determined the rate for the 2002-03 fiscal year on May 7, 2002 and that rate is currently in effect, a new rate will not be determined until 2003, which would be effective for the 2003-04 fiscal year.

   It should be noted that the proceeds from the resulting tobacco products tax increase would not be deposited into the General Fund. The proceeds would be deposited into the Cigarette and Tobacco Products Surtax Fund (created by Proposition 99) to fund health education, disease research, hospital care, fire prevention, and environmental conservation.

2. **This bill would increase the incentive to evade the cigarette tax.** Tax evasion is one of the major areas that can reduce state revenues from cigarettes and tobacco products. In 1999, Board staff spent considerable time developing a variety of statistical approaches to estimate cigarette tax evasion. In addition, Board staff reviewed numerous studies of behavioral responses of smokers to price changes as well as studies that estimated tax evasion. Using a baseline statistical model, Board staff estimated that cigarette tax evasion in California was running at annual rates of approximately $130 to $270 million. The 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.

   Two major events that occurred since November 1998 have 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 additional excise tax on cigarettes of one hundred six and one-half mills ($0.1065) per cigarette, for a total excise tax of $3 per package of 20 cigarettes or $30 per carton. It is highly probable that this 245 percent increase in the cigarette tax rate would cause a correlated increase in tax evasion based on the Board's findings when developing the impacts of Proposition 10 and the tobacco settlement. It should also be pointed out that at $3 per package of cigarettes, California would have the highest cigarette tax rate followed by Massachusetts at $1.51 tax per package, New Jersey and New York at $1.50 tax per pack, and Washington at $1.425 tax per pack.

Methods of evading the tax[1] include, among other things, purchasing cigarettes from outside of this state without the payment of California tax[2] via the Internet or by telephone. Such sales of cigarettes are heavily advertised throughout the Internet, newspapers, various publications and roadside signs. Currently, the Board utilizes information required to be provided by the Federal Jenkins Act (Chapter 10A of Title 15 of the United States Code), which generally requires the sellers to provide the name and address of the purchasers to the Board, to track down purchasers of cigarettes from out-of-state sellers. However, many cigarette retailers do not comply with the provisions of the Jenkins Act due to the lack of enforcement by federal law enforcement agencies.

It is also probable that persons could purchase cigarettes without paying the California tax from bordering states that would have significantly lower cigarette tax rates, such as Oregon ($0.68 tax per pack), Nevada ($0.35 tax per pack), or Arizona ($0.58 tax per pack). Current law does, however, provide individuals an exemption from the cigarette tax for cigarettes (not more than 400 cigarettes) brought into this state in a single lot for that individuals own use or consumption. Although current law provides an exemption from the cigarette tax under the specified circumstances, such product is still subject to the use tax.

The Revenue Estimate discusses the impact this bill would have on excise tax revenues associated with tax evasion. The dollar impact is discussed in the qualifying remarks of the revenue estimate.

It should also be noted that AB 1666 (Horton) would make available funds, as provided, from the Cigarette and Tobacco Products Control Fund to the Board for criminal investigative activities related to criminal activity in the sale of cigarette or tobacco products or counterfeit cigarette or tobacco products conducted in association with the Bureau of Investigation of the Department of Justice. Assembly Bill 1666 is currently in the Assembly for concurrence in the Senate amendments.

3. **This measure would increase state and local sales and use tax revenues.** Under current Sales and Use Tax Law, the total amount of the retail sale is subject to sales or use tax unless specifically exempted or excluded by law. Because the excise tax on cigarettes is not specifically exempted or excluded, it is included in the total amount of the sale and subject to sales or use tax. Since this measure would increase the excise tax on cigarettes, which presumably would be passed on to the ultimate consumer through an increase in the retail selling price of cigarettes, the amount of the sale of these products to which the sales or use tax applies would

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[1] Examples do not include criminal evasion.
[2] California excise tax (cigarette tax) and use tax.

correspondingly increase. The impact this bill would have on state and local sales and use tax revenues is discussed in the Revenue Estimate.

4. **This bill contains floor stock tax provisions.** Proposed Section 30135 contains language to impose a floor stock tax on a dealer's, wholesaler's and distributor's inventory. A floor stock tax is important because it equalizes the excise tax paid by cigarette dealers, wholesalers, or distributors on their inventory and those cigarettes purchased after the effective date of a tax increase. Having a large cigarette inventory before a tax rate increase takes effect can result in a windfall profit to a cigarette seller. The selling price of cigarettes can be raised and attributed to the rate increase, but the additional funds collected are profit and not an excise tax paid to the state. A floor stock tax mitigates this windfall.

   As an example of the impact of not having a floor stock tax, in apparent anticipation of the tax increase of 2 cents per package of 20 cigarettes for funding breast cancer research projects beginning in January 1, 1994, sales of cigarette stamps jumped by $34.8 million in December 1993, or enough stamps for 99 million packs of cigarettes. There was a corresponding decrease in the number of stamps purchased in January and February 1994. Because distributors had an adequate inventory of 35-cent cigarette stamps on hand to affix to their cigarette packages, they could delay for months having to buy the 37-cent stamps which were sold beginning January 1, 1994. This huge inventory stockpiling translated into $2 million in lost revenue for the Breast Cancer Fund, money which had been anticipated as part of the original revenue estimate.

   While there are additional costs associated with administering the floor stock tax, the revenue substantially compensates for that cost.

5. **This bill would substantially increase the distributor's discount.** Section 30166 provides that stamps and meter impression settings shall be sold at their denominated values less 0.85 percent to licensed distributors. As such, distributor's currently receive a discount of $4.44 per case of cigarettes[3] (600 stamps * $0.87 tax per package of cigarettes * 0.85 percent discount = $4.44 discount). By increasing the excise tax on a package of 20 cigarettes to $3.00, this bill would increase the distributor's discount to $15.30 per case (600 stamps x $3 tax per package of cigarettes x 0.85 percent discount = $15.30 discount); almost a 350 percent increase.

   Based on information received from industry, the average cost to affix stamps or meter impressions in 2001 was $4.86 per case. Assuming the industry data are correct, distributors would be overcompensated by $10.44 per case. As such, it is recommended that Section 30166 be amended to limit the discount provided to distributors to prevent overcompensation.

   It is should be noted that SB 1700 (Peace) and AB 1666 (Horton) would eliminate the 0.85 percent distributor's discount and reimburse distributors based on their actual cost to affix stamps and meter impressions.

6. **Related Legislation.** This bill contains similar cigarette tax increase language as AB 428 (Assembly Budget Committee) and AB 433 (Assembly Budget Committee),

[3] There are 600 packs of cigarettes per case

which would increase the cigarette tax by 50 cents and 63 cents per package of 20 cigarettes, respectively. The Board voted to support these budget bills.

In addition, Senate Bill 1890 (Ortiz) would impose, among other things, an additional excise tax on cigarettes of 65 cents per package of 20 and an additional excise tax on the distribution of tobacco products equivalent to the additional cigarette tax. The revenue from the tax increase would be deposited into the Tobacco Use Reduction and Compensation Fund, as created by SB 1890. That bill was held in the Senate Revenue and Taxation Committee. The Board's position on SB 1890 is neutral.

COST ESTIMATE

A detailed cost estimate is pending. However, the Board would incur costs related to this measure for notifying potential feepayers, developing returns, computer programming, developing and carrying out compliance and audit efforts to ensure proper reporting, administering a floor stock tax, and investigative efforts. With respect to Assembly Bill 433 (Assembly Budget Committee), which would impose an additional excise tax on cigarettes of 63 cents per package of 20, the costs were estimated to be as follows:

2002-03	2003-04	2004-05	2005-06 and Ongoing
$1,073,000	$990,000	$533,000	$507,000

However, the Board would incur additional costs to administer a cigarette tax increase as large as the one proposed by this bill. Such costs would be related to audit efforts to ensure that the floor stock tax is properly reported and collected, compliance efforts for additional billings and delinquencies, and an increased investigative staff presence due to increased tax evasion.

REVENUE ESTIMATE

Fiscal Year 2002-03

Cigarette Tax. Tax-paid cigarette distributions were 1,288 million packs in fiscal year 2000-01, down about 5 percent from 1999-00. According to the 2002-03 *Governor's Budget Summary,* total cigarette consumption is estimated to decline in the range of 3 percent annually in the next few years. Consumption is estimated to be 1,212 million packs in fiscal year 2002-03, (1,288 million packs x 0.97 x 0.97 = 1,212 million packs). However, an increase in the tax rate as large as the one proposed by this bill would surely cause both a dramatic decrease in actual consumption and an increase in tax evasion. Although the exact magnitude of the effects is uncertain, we have assumed that this bill would cause an additional decrease of 26.7 percent in tax paid distributions. (This estimate assumes a price elasticity of demand of -0.50, applied to estimated average 2001 prices of approximately $4.00 per pack.) Sales for July and August (prior to the effective date) are estimated to be 202 million packs (1212 million packs / 12) x 2 = 202). Without a tax increase, tax-paid distributions would be 1,010 million packs for September through June 2003. Assuming a September 1, 2002 effective date, the estimated taxable distributions subject to this proposal for the period September 1, 2002 through June 30, 2003 would be 740 million packs (1,010 million packs x 0.733 = 740 million packs). The estimated taxable distributions subject to this proposal for the period July 1, 2002 through June 30, 2003 would be 942 million packs. (740 million packs plus 202 million packs).

The effect on revenue for fiscal year 2002-03 is shown in the table below.

	Packs (millions)	Rate (per pack)	Revenue (millions)
July and August, 2002	202	$0.87	$176
Proposed Rate (September – June, 2003)	740	$3.00	$2,220
Total Revenues, Proposed Rate	942	N/A	2,396
Current Rate	1,212	$0.87	$1,054
Difference			$1,342

A corresponding floor stock tax, assuming a three weeks supply of cigarettes, approximately 51 million packs (((1,212 million packs x 0.733) / 52 weeks) x 3 = 51.3), would produce approximately $109 million in additional revenue (51 million packs x $2.13 = $108.6 million).

Tobacco Products Tax. The proposed $2.13 per pack increase in the cigarette excise tax rate will not affect the tobacco products tax rate until fiscal year 2003-04.

Fiscal Year 2003-04

Cigarette Tax. As mentioned earlier, under current law cigarette consumption is estimated to be 1,212 million packs in fiscal year 2002-03. Under current law, tax-paid cigarette sales in 2003-04 would be 3 percent below sales in 2002-03, or 1,176 million packs (1,212 x 0.97 = 1,175.6). The $2.13 tax increase would result in an annual decline of 324 million packs, (1,212 million packs x .733 = 888 million packs; 1,212 - 888 = 324 million packs). This implies fiscal year 2003-04 sales of 852 million packs (1,176 million packs minus 324 milion packs = 852 million packs).

A $2.13 per pack increase would result in increased cigarette tax revenues for fiscal year 2003-04 as follows:

	Packs (millions)	Rate (per pack)	Revenue (millions)
Proposed Rate	852	$3.00	$2,556
Current Rate	1,176	$0.87	$1,023
Difference			$1,533

Tobacco Products Tax. Pursuant to Proposition 99, this measure would result in an additional tax on tobacco products at a rate equivalent to the new $2.13 per pack rate this measure would impose on cigarettes. This tax increase would be effective on July 1, 2003.

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.

The effective tobacco products tax is currently based on the wholesale cost of these products at a tax rate that is equivalent to the rate of tax imposed on cigarettes. The rate is determined by dividing the tax rate per cigarette by the average wholesale cost per cigarette. For rate setting purposes, the average cost per cigarette for the 2002-03 fiscal year is $0.1401. The current tax rate on cigarettes is $0.0685 per cigarette. The tobacco tax rate for 2002-03 is 48.89 percent ($0.0685 / $0.1401 = 0.48894).

For revenue estimation purposes, we assume no further increase in the wholesale cost of cigarettes in fiscal year 2003-04. The proposed tax rate on cigarettes would increase to $0.175 per cigarette for purposes of calculating the tobacco products tax rate ($3.50 per pack, comprised of the current rate of $1.37 per pack plus the rate increase of $2.13 per pack; 3.50 / 20 = 0.175).[4] This would increase the 2002-03 tobacco products tax rate to 124.91 percent ($0.175 / $0.1401 = 1.2491).

The wholesale cost of tobacco products was $90.6 million during the 2000-01 fiscal year, down about 5 percent from 1999-00. It would be reasonable to expect continued declines of 3 percent per year, similar to the long term trend for cigarette consumption. Using this assumption, estimated wholesale costs of tobacco products will be about $82.7 million in fiscal year 2003-04 ($90.6 x 0.97 x 0.97 x 0.97 = $82.7).

However, an increase in the tax rate as large as the one proposed by this bill would surely cause both a decrease in actual consumption and an increase in tax evasion. Tax evasion is a larger problem with tobacco products than with cigarettes. Tax indicia, which are one disincentive to evaders, are not required for tobacco products. As mentioned earlier, at $0.1401 per cigarette, the estimated wholesale cost of cigarettes was $2.80 per pack, and the estimated retail cost prior to the tax increase was $4.00 per pack. Assuming a price elasticity of demand of –0.50, we would expect an additional decline of about 27 percent in tobacco products sales in 2003-04 resulting from the consumer behavior response to the tax increase (($2.13 / $4.00) x -0.50) = -0.27). Although the exact magnitude of the effects is uncertain, we have assumed that this bill would cause a decrease of 27 percent. Therefore, the estimated wholesale cost of tobacco products subject to this proposal for fiscal year 2003-04 would be (($82.7) x 0.73 = $60.4 million).

The increase in tobacco products tax revenue for fiscal year 2003-04 would be as follows:

	Wholesale Cost (millions)	Rate	Revenue (millions)
Proposed Rate	$60.4	124.91%	$75.4
Current Rate	$82.7	48.89%	$40.4
Difference			$35.0

[4] The current effective rate of $1.37 per pack for tobacco products consists of $0.87 per pack related to Proposition 99 and $0.50 related to Proposition 10.

Sales and Use Tax Impacts

The total increase in excise tax revenues would be $1,451 million for fiscal year 2002-03 and $1,568 million for fiscal year 2003-04. If all of these taxes are passed on to the ultimate consumer, there would be an increase in state and local sales and use tax revenue as follows:

	Increased Revenue	
	2002-03	2003-04
State (5%)	73 million	78 million
Local (2.25%)	33 million	35 million
Transit (0.67%)	10 million	11 million
Total	$116 million	$124 million

Revenue Summary

Increasing the cigarette tax by $2.13 per pack and the resulting increase under Proposition 99 and Proposition 10 on tobacco products would result in the following revenue increase for the 2002-03 fiscal year and the 2003-04 fiscal year:

	2002-03	2003-04
Cigarette Tax Revenue Increase	$1,342 million	$1,533 million
Floor Stock Tax	$ 109 million	0
Tobacco Tax Revenue Increase	0	$ 35 million
State Sales & Use Tax (at 5%)	$ 73 million	$ 78 million
Total State	$1,524 million	$1,646 million
Local Sales & Use Tax (at 2.25%)	$ 33 million	$ 35 million
Transit Tax (at 0.67%)	$ 10 million	$ 11 million
TOTAL	$1,567 million	$1,692 million

Qualifying Remarks

With existing tax law cigarette tax evasion estimates range from approximately $130 million to $260 million. However, if excise taxes increases by $2.13 per pack, the value of each pack of contraband cigarettes sold would increase by that amount. In addition, the tax increase provides additional incentives that would likely result in even more evasion, absent any changes in compliance or enforcement. The table below shows the estimated increases in evasion that would occur *without* any changes in compliance or enforcement for both of these reasons.

Cigarette Tax Evasion High and Low Range Estimates at an Excise Tax Rate of $3.00 Per Pack						
	Current Law Evasion		Additional Evasion		Total Evasion	
Evasion Range	Low End	High End	Low End	High End	Low End	High End
Portion of Decline in Tax-Paid Distributions Attributable to Evasion	12.5%	25.0%	12.5%	25.0%	12.5%	25.0%
Evasion Estimate (Millions of Packs)	149	299	41	81	190	380
Evasion Estimate (Excise Taxes of $3.00 Per Pack, Millions of Dollars)	$447	$897	$123	$243	$570	$1,140
Current-Law Evasion (Excise Taxes of $0.87 Per Pack, Millions of Dollars)	$130	$260	--	--	$130	$260
Estimated Increase in Evasion (Millions of Dollars)					$440	$880

As shown in the table, the high-end estimate of evasion under the current law tax rate of $0.87 per pack is 299 million packs, a value of $260 million (299 x 0.87 = 260.1). At a tax rate of $3.00 per pack, these cigarettes would be worth $897 million (299 x 3.00 = 897). In addition, we would expect 81 million more packs of contraband cigarettes to be sold at an excise tax rate of $3.00 per pack, with a value of $243 million (81 x 3.00 = 243). The total high-end evasion estimate at an excise tax rate of $3.00 per pack would be $1,140 million. The low-end evasion estimate at an excise tax rate of $3.00 per pack would be $570 million.

ANALYSIS

Current Law

Satellite Television Subscription Tax (Section 17)

Under existing law, there is no state-imposed tax or fee on home satellite subscriptions.

Under existing law, cable service in California is subject to direct local taxation based on the rationale of the use of public rights-of-way and being granted a local monopoly. Cable service is regulated by the federal government and the State of California, and is subject to a regulatory fee levied by the FCC. In California, two principal fees and charges are levied on cable television connections.

• Franchise fees--these are paid to local governments by privately-owned cable companies for the privilege of using local government property and rights-of-way. Federal law prohibits franchise fees from exceeding 5 percent of gross receipts, while state law also limits franchise fees to a percentage of gross receipts. State and federal law also prevents companies from providing cable services without acquiring a franchise. California has delegated to cities and counties the franchising authority over cable companies, whose fee payments represent a general fund revenue source.

• Utility-user tax--this is a gross proceeds tax levied by some local governments on cable television services, and other utilities such as telephone, gas, and electric services. Tax rates generally range from 5 percent to 7 percent and represent a general fund revenue source for local governments.

Proposed Law

This bill would add Part 14.5 (commencing with Section 33001) to Division 2 of the Revenue and Taxation Code to impose a 5 percent tax on the total gross charges that are incurred by a subscriber of direct broadcast satellite television service in this state. The revenues from the proposed tax would be transferred to the State's General Fund.

The bill would provide the following definitions:

- "Direct broadcast satellite television service" would mean television programming transmitted or broadcast by satellite directly to the subscriber's premises without the use of ground receiving or distribution equipment, except at the subscriber's premises or in the uplink process to the satellite, regulated by the Federal Communications Commission.
- "Subscriber" would mean any person, firm, partnership, corporation, limited liability company, or other entity paying to receive direct broadcast satellite television service in this state.
- "Total gross charges" would mean all charges imposed on the subscriber related to transmissions, including "pay-per-view" charges, but would not include any equipment costs, as described.

The bill would specify that the tax would be collected and administered in accordance with the Fee Collections Procedure Law.

The proposed tax would apply to any charges incurred by a subscriber on or after the earlier of either:

1) The date upon which the Board determines by resolution that the necessary procedures and criteria for the administration and enforcement of the law have been authorized and established, or

2) 90 days after the bill becomes effective.

COMMENTS

Provisions should not be problematic to administer. There are relatively few direct broadcast satellite television service providers in California. And, as currently drafted, the bill would not incorporate any exemptions from the proposed tax. Therefore, we do not anticipate any significant problems to administer the proposed tax.

COST ESTIMATE

The Board would incur nonabsorbable costs to adequately develop a new tax program. These costs would include identifying and registering taxpayers, developing computer programs, and designing new tax returns. We expect that any ongoing costs in administering such a program would be absorbable. A cost estimate is pending, but as an order of magnitude, estimated start-up costs of $77,000 were associated with a bill that would have provided for a proposed surcharge for 4 public utility gas providers and approximately 10 interstate pipeline consumers.

REVENUE ESTIMATE

Background, Methodology, and Assumptions

According to the most recent report (4th quarter 2001) from the *Satellite Broadcasting and Communication Association* there are an estimated 2.3 million subscribers of direct broadcast satellite television service in California. Nationwide, subscriptions for direct broadcast television service are expected to increase by 17 percent each year through 2005. According to the *US Industry and Trade Outlook 2000*, the average cost of direct satellite television service in 2002 is estimated at $60 per month. In determining gross service receipts for fiscal years 2003-04 and 2004-05, we assumed that the average cost for direct broadcast television service will remain at $60 per month. Since the proposal will take effect immediately, we have assumed a start date of September 1, 2002. The estimate for gross revenue for the 10 month period ending June 30, 2002 is $1,380 million (2,300,000 subscribers x $60 x 10 months). Total state revenue, for the period of September 1, 2002 through June 30, 2003, at the rate of 5% is estimated to be $69.0 million ($1,380 million x .05).

Revenue Summary

Direct satellite television service subscriptions are estimated to increase annually by 17 percent through 2005. In determining gross service receipts for fiscal years 2003-04 and 2004-05, we assumed that the average cost for direct broadcast television service will remain at $60 per month. Imposing a 5% tax on the gross charges for direct satellite television service, with an implementation date of September 1, 2002, will provide state revenue as shown below:

	2002-03 (10 months)	2003-04	2004-05
Number of Subscribers	2.3 million	2.7 million	3.2 million
Gross Service Receipts	$1,380 million	$1,944 million	$2,304 million
State Revenue (at 5%)	$69 million	$97 million	$115 million

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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.