

M e m o r a n d u m

To : Mr. Ramon J. Hirsig
Executive Director – MIC: 73

Date: June 29, 2005

From : Kristine Cazadd *KC K.T.*
Chief Counsel

Subject : Analysis and Possible Early Re-adoption of Emergency
Regulation 4056.1, *Expiration of Heat-Applied Decal Tax
Stamps with amendments*

Chief Counsel Matter – June 30, 2005

As of June 24, 2005, the vendor delivered 58 high-volume stamping machines that were ordered by distributors and has installed 57 machines. All the machines installed are in working order and at or near satisfactory performance levels. Occasionally, however, some machine inoperability continues to be reported, though the number of service calls has steadily declined from an average daily number of calls for the week of May 6, 2005 of 8.8 to 6.2 for the week ending on June 24, 2005. The trend of service calls illustrates that steady progress is being made toward full machinery operation. Staff recommends that a further extension of Emergency Regulation 4056.1 beyond June 30, 2005, may be advisable, if, in an abundance of caution to prevent any significant economic losses, the Board determines the few distributors who have experienced some machine downtime, may need to purchase and apply the heat-applied decal cigarette tax stamps.

Three options are available to the Board with regard to its consideration of any further extension of Emergency Regulation 4056.1 beyond June 30, 2005. First, the Board could determine that there is no need for additional regulatory action, because the evidence of continuing lengthy machine breakdowns, or production by other means, is insufficient to establish that truly significant economic losses are occurring and that commerce in the state is negatively impacted. On the other hand, the Board could determine that there is a need for additional regulatory action, because the character of the data indicates the possibility of some machine inoperability, which, even though it may occur less frequently, would likely result in economic loss. If the Board finds that conditions impeding commerce are likely to occur, the staff has drafted two alternative extensions of Emergency Regulation 4056.1, attached, which have been properly noticed, and are available for possible adoption by the Board. Both versions would extend the transition period beyond June 30, 2005, and enable distributors to utilize the current heat-applied decal tax stamps for an additional limited term, explained in detail below.

Version one (1) of proposed regulation 4056.1 allows for the continued application of heat-applied decal tax stamps for 90 days, only if specified conditions relating to the operation of the tax stamp application machinery are met. Version two (2) of proposed Regulation 4056.1 extends to all distributors the authorization to sell and apply the heat-applied decal tax stamp through July 31, 2005.

In addition to the consideration of possible regulatory action, and in furtherance of the enforcement of the ACTS Contract, Board staff will begin on or about July 15, 2005, to monitor for a 90-day period (with a report back to the Board in October 2005), the daily performance of all new cigarette tax stamp application machinery, pursuant to Section 2.2.3. of the *Invitation for Bid* (IFB), which requires but is not limited to the following:

“...machines must be capable of applying a minimum of 750 stamps per minute for each unit of stamps designated for automatic application. High-volume machines should be capable of running at a 95% operational level over a three-month period. Automated accessory components must open the flap on a standard carton of cigarettes, apply stamps to standard packages while in the open carton, validate the stamp, and glue the carton flap closed. Conveyors must move the cartons through the opener, stamper, validation, and gluer components. The feed onto the conveyor must be automated and also allow for manual feeds....”

Regulatory Background

Senate Bill (SB) 1701, enacted in 2002, added section 30162, to the Revenue and Taxation Code, which required the Board to replace the heat-applied decal cigarette tax stamps with a tax stamp that can be read by a scanning or similar device and encrypted with specific information. Although the statute became operative on January 1, 2005, without specifically providing for a transition to the use of the new tax stamp, the Legislature declared in Section 6 of Statutes 2004, Chapter 822, that the Board has the authority to implement the changes by regulation so that commerce in the state is not negatively impacted. Effective January 1, 2005, Regulation 4056.1 provided for the use of the heat-applied decal tax stamp until April 30, 2005. Effective, April 29, 2005, the re-adoption of Regulation 4056.1 enables distributors to utilize the current heat-applied decal tax stamp during their transition to the use of the new tax stamp only until June 30, 2005.

The Board is selling the new tax stamp to licensed distributors, as indicated. Although most all licensed distributors have transitioned to the new machinery and cigarette tax stamp, a few distributors have expressed concern that they may need to continue using the heat-applied decal tax stamps to meet production needs even after June 30, 2005.

If the Board decides to continue authorizing the sale and application of the heat-applied decal cigarette stamps after June 30, staff is submitting the attached two (2) alternative versions of amended Cigarette and Tobacco Products Tax Regulation 4056.1, *Expiration of Heat-Applied Decal Tax Stamps*, for possible early re-adoption on an emergency basis at the Board's June

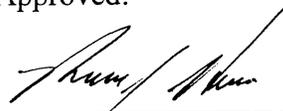
30, 2005 meeting. Both proposed alternative versions for the re-adoption of Regulation 4056.1 authorize the Board to sell, and distributors to apply, the heat-applied decal tax stamp for a limited period of time after June 30.

Version one (1) of proposed Regulation 4056.1 allows for the continued application of heat-applied decal tax stamps for a period of up to 90 days only if three specified conditions relating to the operation of the tax stamp application machinery are met: (1) The new machinery has been acquired and is not capable of operation, (2) the distributor cannot meet current customer needs with other new machines or with the new hand-applied means and (3) the Board has verified with the vendor that the machine will not be operational within one complete operational day.

Version two (2) of proposed Regulation 4056.1 extends to all distributors the authorization to sell and apply the heat-applied decal tax stamp through July 31, 2005.

Staff recommends that if, in an abundance of caution to prevent any significant economic losses, the Board decides to extend and re-adopt Emergency Regulation 4056.1 beyond June 30, 2005, version one (1), which allows for the continued application of heat-applied decal tax stamps if three specified conditions are met, is consistent with the contract performance (requiring a 95% operational level over a three-month period). The proposed early re-adoption of Regulation 4056.1 is ready for submittal to the Board, should the Board decide on the June 30, 2005, to approve and adopt one of the alternative drafts under Chief Counsel Matters.

Approved:



Ramon J. Hirsig, Executive Director

Attachment

D R A F T

Regulation 4056.1 Expiration of Heat-Applied Decal Tax Stamps version 1

(a) On and after January 1, 2005, the Board authorized the continued application of heat-applied decal tax stamps through June 30, 2005 in order to affect the orderly transition from heat-applied decal tax stamps to the new tax stamps required by Revenue and Taxation Code Section 30162 subdivision (a), effective January 1, 2005. Operative July 1, 2005, the Board will no longer sell or allow for the application of any cigarette tax stamp other than tax stamps which utilize technology meeting the requirements of Revenue and Taxation Code Section 30162, subdivision (a), effective January 1, 2005, except as provided in subdivision (b) herein:

(b) For a period of 90 days beginning July 1, 2005, the continued sale and application of heat-applied decal tax stamps is authorized if each of the following conditions are met:

1. The machinery for the application of cigarette tax stamps which utilizes technology meeting the requirements of Revenue and Taxation Code Section 30162, subdivision (a), effective January 1, 2005 has been acquired, but is temporarily not capable of operation,
2. Given the inoperability of the application machinery, the distributor cannot meet current customer needs with other machinery or by any other means at that location, and the distributor has notified the vendor of the inoperability of the machine at the vendor's designated service number.
3. The Board has verified with the vendor that the machine will not be operational within one complete operational day from the time the distributor contacted the vendor's designated service number.

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If each of the above three conditions are met, the heat-applied tax stamps may be sold and applied until the inoperable application machinery is repaired and operating; and such sale and application shall not exceed two (2) operating days without requalification.

Authority: Sections 30162 and 30451, Revenue and Taxation Code

Reference: 30161 and 30162, Revenue Taxation Code; Section 6 Of Statutes 2004, Chapter 822.

FINDING OF EMERGENCY ver 1

The State Board of Equalization (Board) finds that the adoption of Cigarette and Tobacco Products Tax Regulation 4056.2, *Emergency Sale and Application of Heat-Applied Decal Tax Stamps*, is necessary for the immediate preservation of the public peace, health and safety, and the general welfare and meets the standards set forth in Government Code Section 11349.1.

The adoption of this regulation is necessary on an emergency basis to avoid any interference with commerce related to the sale of cigarettes within this state on and after June 30, 2005. Without the proposed regulation, cigarette distributors may be unable to sell cigarettes, resulting in the loss of income to distributors. Further, if distributors cannot sell cigarettes, there will be a reduction in revenues for the General Fund, Cigarette and Tobacco Products Surtax Fund, and the California Children and Families Trust Fund.

STATEMENT OF SPECIFIC FACTS SHOWING THE NEED FOR IMMEDIATE ACTION

Under the Cigarette and Tobacco Products Tax Law, the Board collects the cigarette excise tax through the sale of tax stamps or meter impressions (hereafter collectively referred to as "tax stamp") to licensed distributors (Rev. & Tax. Code § 30161). All packages of cigarettes sold in this state must bear a tax stamp (Rev. & Tax. Code § 30163). Revenue and Taxation Code section 30162 provides that stamps for affixation to cigarette packages shall be of the designs, specifications, and denominations as prescribed by the Board. The Board prescribes by regulation the method and manner in which tax stamps are to be affixed to packages of cigarettes. The Board may likewise provide by regulation for the cancellation of stamps (Rev. & Tax. Code § 30162).

Senate Bill (SB) 1701, enacted in 2002, added a new Section 30162, effective January 1, 2005. This new statute requires that the Board generate tax stamps by a technology capable of being read by a scanning or similar device and that tax stamps must be encrypted with, at a minimum, the following information: (1) the name and address of the distributor affixing the stamp to the cigarette packages, (2) the date the stamp was affixed, and (3) the denominated value of the stamp. Currently, the Board sells both heat-applied decal tax stamps and tax stamps which utilize technology meeting the requirements of Rev. & Tax. Code § 30162(a), effective January 1, 2005.

The Board began selling the new tax stamps to licensed distributors in accordance with subdivision (a) of new section 30162 on January 1, 2005. However, the implementation of the new cigarette tax stamps required distributors to purchase new stamp application machinery. In response to SB 1701 (2002), the Board, in conjunction with the Department of General Services, sought bids for the new tax stamp technology. Due to the resulting time frame for the awarding of the contract and a subsequent protest by one of the bidding parties, the new stamp application machinery was not available to all distributors for conversion to the new tax stamp technology by January 1, 2005. As such, many distributors were not in a position to affix the new tax stamps by this effective date.

The provisions of Rev. & Tax. Code Section 30162(a) do not specifically provide for a transition to the use of the new tax stamp. However, in Section 6 of Statutes 2004, Chapter 822, the Legislature declared that the Board has the authority to implement the changes required by SB 1701 (2002) by regulation so that commerce in the state is not negatively impacted. Based on

this authority, the Board adopted and later readopted Emergency Regulation 4056.1, *Expiration of Heat-Applied Decal Tax Stamps* in order for distributors to continue to apply the heat-applied decal tax stamps. The readopted regulation provides for the continued application of the heat-applied decal tax stamps through June 30, 2005. While all new tax stamp application machines ordered have been installed and are being used, there continue to be distributors experiencing problems applying new tax stamps in quantities sufficient to meet the needs of their customers, and ultimately consumers in this State. As a result, distributors may continue to need the heat-applied tax stamps after June 30, 2005, until the new tax stamp application machinery is applying stamps to meet consumer needs in the State. The Board has determined that additional time is required under certain specific criteria to ensure that installed application machinery is working at required levels. Therefore, the emergency readoption text amends the current regulation by providing for additional time to sell and apply the heat-applied decal stamps if certain specified criteria are met.

Unless the proposed regulation enabling distributors to utilize the current heat-applied decal tax stamp beyond June 30, 2005, is adopted, distributors may be unable to sell cigarettes, resulting in the loss of income to those distributors. Further, if distributors cannot sell cigarettes, there will be a reduction in revenues for the General Fund (including breast cancer research), the Cigarette and Tobacco Products Surtax Fund (for hospital services, health education, physician services, research and public resources), and the California Children and Families Trust Fund (for early childhood development). In fiscal year 2002-2003 alone, for example, the Board collected approximately one billion dollars in cigarette tax revenue which was deposited directly into these funds. Accordingly, the proposed regulation allows all distributors to continue selling cigarettes, maintaining their income and maintaining state revenues.

AUTHORITY AND REFERENCE CITATIONS

Authority: Sections 30162 and 30451, Revenue and Taxation Code.

Reference: Sections 30161 and 30162, Revenue and Taxation Code; Section 6 of Statutes 2004, Chapter 822.

INFORMATIVE DIGEST

Under the Cigarette and Tobacco Products Tax Law, the Board collects the cigarette excise tax through the sale of tax stamps to licensed distributors. All packages of cigarettes sold in this state must bear a tax stamp. Rev. & Tax. Code § 30162 provides that stamps for affixation to cigarette packages shall be of the designs, specifications, and denominations as prescribed by the Board. The Board prescribes by regulation the method and manner in which tax stamps are to be affixed to packages of cigarettes. The Board may likewise provide by regulation for the cancellation of stamps.

Senate Bill (SB) 1701, enacted in 2002, added a new Section 30162, effective January 1, 2005. This new statute requires that the Board generate tax stamps by a technology capable of being read by a scanning or similar device and that tax stamps must be encrypted with, at a minimum, the following information: (1) the name and address of the distributor affixing the stamp to cigarette packages, (2) the date the stamp was affixed, and (3) the denominated value of the stamp. Currently, the Board sells heat-applied decal tax stamps and tax stamps which utilize technology meeting the requirements of Rev. & Tax. Code § 30162(a), effective January 1, 2005.

Regulation 4056.2, *Emergency Sale and Application of Heat-Applied Decal Tax Stamps*, is proposed to implement a transition period from the heat-applied decal stamp to the new tax stamp required by Rev. & Tax. Code § 30162, enacted by SB 1701 (Stats. 2002, Ch. 881). Specifically, the regulation will provide for the sale and use of both the heat-applied decal stamp and the stamp specified in Rev. & Tax. Code § 30162(a), effective January 1, 2005, if certain specified criteria are met, as the criteria for an emergency is set forth in the regulation.

The regulation provides a transition to the sole use of the new tax stamp, thereby avoiding any disruption to the stream of commerce affecting cigarette distributorship operations and state revenues.

COST TO LOCAL AGENCIES AND SCHOOL DISTRICTS

The State Board of Equalization has determined that the proposed rule does not impose a mandate on local agencies or school districts.

ESTIMATE OF COST OR SAVINGS

The State Board of Equalization has determined that the proposed regulation will not result in any direct or indirect costs or savings to any state agency; any cost to any local agency or school district that is required to be reimbursed under Part 7 (commencing with Section 17500) of Division 4 of Title 2 of the Government Code; any other nondiscretionary costs or savings imposed on local agencies or school districts; or, any cost or savings in federal funding to the state.

Regulation 4056.1 Expiration of Heat-Applied Decal Tax Stamps version 2

(a) On and after January 1, 2005, the Board authorizes the continued application of heat-applied decal tax stamps through ~~June 30, 2005~~ July 31, 2005 in order to affect the orderly transition from heat-applied decal tax stamps to the new tax stamps required by Revenue and Taxation Code Section 30162 subdivision (a), effective January 1, 2005. Operative ~~July 1, 2005~~ August 1, 2005, the board will no longer sell or allow for the application of any cigarette tax stamp other than tax stamps which utilize technology meeting the requirements of Revenue and Taxation Code Section 30162, subdivision (a), effective January 1, 2005.

Authority: Sections 30162 and 30451, Revenue and Taxation Code

Reference: 30161 and 30162, Revenue Taxation Code; Section 6 Of Statutes 2004, Chapter 822.

FINDING OF EMERGENCY ver2

The State Board of Equalization (Board) finds that the adoption of Cigarette and Tobacco Products Tax Regulation 4056.2, *Emergency Sale and Application of Heat-Applied Decal Tax Stamps*, is necessary for the immediate preservation of the public peace, health and safety, and the general welfare and meets the standards set forth in Government Code Section 11349.1.

The adoption of this regulation is necessary on an emergency basis to avoid any interference with commerce related to the sale of cigarettes within this state on and after June 30, 2005. Without the proposed regulation, cigarette distributors may be unable to sell cigarettes, resulting in the loss of income to distributors. Further, if distributors cannot sell cigarettes, there will be a reduction in revenues for the General Fund, Cigarette and Tobacco Products Surtax Fund, and the California Children and Families Trust Fund.

STATEMENT OF SPECIFIC FACTS SHOWING THE NEED FOR IMMEDIATE ACTION

Under the Cigarette and Tobacco Products Tax Law, the Board collects the cigarette excise tax through the sale of tax stamps or meter impressions (hereafter collectively referred to as "tax stamp") to licensed distributors (Rev. & Tax. Code § 30161). All packages of cigarettes sold in this state must bear a tax stamp (Rev. & Tax. Code § 30163). Revenue and Taxation Code section 30162 provides that stamps for affixation to cigarette packages shall be of the designs, specifications, and denominations as prescribed by the Board. The Board prescribes by regulation the method and manner in which tax stamps are to be affixed to packages of cigarettes. The Board may likewise provide by regulation for the cancellation of stamps (Rev. & Tax. Code § 30162).

Senate Bill (SB) 1701, enacted in 2002, added a new Section 30162, effective January 1, 2005. This new statute requires that the Board generate tax stamps by a technology capable of being read by a scanning or similar device and that tax stamps must be encrypted with, at a minimum, the following information: (1) the name and address of the distributor affixing the stamp to the cigarette packages, (2) the date the stamp was affixed, and (3) the denominated value of the stamp. Currently, the Board sells both heat-applied decal tax stamps and tax stamps which utilize technology meeting the requirements of Rev. & Tax. Code § 30162(a), effective January 1, 2005.

The Board began selling the new tax stamps to licensed distributors in accordance with subdivision (a) of new section 30162 on January 1, 2005. However, the implementation of the new cigarette tax stamps required distributors to purchase new stamp application machinery. In response to SB 1701 (2002), the Board, in conjunction with the Department of General Services, sought bids for the new tax stamp technology. Due to the resulting time frame for the awarding of the contract and a subsequent protest by one of the bidding parties, the new stamp application machinery was not available to all distributors for conversion to the new tax stamp technology by January 1, 2005. As such, many distributors were not in a position to affix the new tax stamps by this effective date.

The provisions of Rev. & Tax. Code Section 30162(a) do not specifically provide for a transition to the use of the new tax stamp. However, in Section 6 of Statutes 2004, Chapter 822, the Legislature declared that the Board has the authority to implement the changes required by SB 1701 (2002) by regulation so that commerce in the state is not negatively impacted. Based on

this authority, the Board adopted and later readopted Emergency Regulation 4056.1, *Expiration of Heat-Applied Decal Tax Stamps* in order for distributors to continue to apply the heat-applied decal tax stamps. The readopted regulation provides for the continued application of the heat-applied decal tax stamps through June 30, 2005. While all new tax stamp application machines ordered have been installed and are being used, there continue to be distributors experiencing problems applying new tax stamps in quantities sufficient to meet the needs of their customers, and ultimately consumers in this State. As a result, distributors may continue to need the heat-applied tax stamps after June 30, 2005, until the new tax stamp application machinery is applying stamps to meet consumer needs in the State. The Board has determined that an additional 31 days is required to ensure that installed application machinery is working at required levels. Therefore, the emergency readoption text amends the date through which the heat-applied decal tax stamp may continued to be applied from June 30, 2005 to July 31, 2005.

Unless the proposed regulation enabling distributors to utilize the current heat-applied decal tax stamp beyond June 30, 2005, is adopted, distributors may be unable to sell cigarettes, resulting in the loss of income to those distributors. Further, if distributors cannot sell cigarettes, there will be a reduction in revenues for the General Fund (including breast cancer research), the Cigarette and Tobacco Products Surtax Fund (for hospital services, health education, physician services, research and public resources), and the California Children and Families Trust Fund (for early childhood development). In fiscal year 2002-2003 alone, for example, the Board collected approximately one billion dollars in cigarette tax revenue which was deposited directly into these funds. Accordingly, the proposed regulation allows all distributors to continue selling cigarettes, maintaining their income and maintaining state revenues.

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tax stamp required by Rev. & Tax. Code § 30162, enacted by SB 1701 (Stats. 2002, Ch. 881). Specifically, the regulation will provide for the sale and use of both the heat-applied decal stamp and the stamp specified in Rev. & Tax. Code § 30162(a), effective January 1, 2005, through July 31, 2005.

The regulation provides a transition to the sole use of the new tax stamp, thereby avoiding any disruption to the stream of commerce affecting cigarette distributorship operations and state revenues.

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The State Board of Equalization has determined that the proposed rule does not impose a mandate on local agencies or school districts.

ESTIMATE OF COST OR SAVINGS

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