INITIAL DISCUSSION PAPER

Proposed Program to Stamp Cigars

Issue

To better ensure the collection of the excise tax on the distribution of cigars, should the Board propose a means to readily identify cigars for which tax has been paid by the placing of a stamp or other identifiable marking on cigars?

Background

Currently the tax on the distribution of tobacco products[1] is imposed upon the distributor, based on the wholesale cost of the tobacco product, paid on a monthly return. Unlike cigarettes, for which distributors pay the tax through the use of stamps on each package, tobacco products, which include cigars, have no identifiable marking to determine if the tax has been paid.

Board representatives routinely perform random retail cigarette inspections. Cigarette packages are inspected to verify that all have been stamped and unstamped cigarettes are subject to seizure under Revenue and Taxation Code Section 30436. Unlike cigarettes, an inspection of tobacco products does not readily identify that payment of tax has been made. Although field representatives conducting inspections will often ask to see purchase invoices for tobacco products to ensure they were purchased from licensed distributors, thus should be tax paid, staff is still faced with the question of whether or not the retailer is providing all the invoices for all purchases of tobacco products and assuming that the distributor paid the tax. To make certain that the tax has been paid, it may be necessary to conduct a full audit of the business and/or the distributor. Increasingly, retailers are purchasing tobacco products from out-of-state and are not reporting and paying the tax due. The problem of untaxed tobacco products is not limited to the retail level. The Board's Investigations Division has discovered gross underreporting of tax due by licensed distributors.

Evasion of the tobacco products tax has been on the rise due to the increase in the tax rate and the ease with which these products can be purchased from out-of-state vendors and subsequently distributed in California without the payment of tax. Complaints relating to the sale of tobacco products below market prices have increased dramatically over the past few years. To illustrate, in 1996, the Investigations Division received only 10 complaints related to tobacco products. This figure increased to 61, in 1998, and 53 in 1999. Recently, two of the largest fraud investigations conducted by the Investigations Division were due to the evasion of the tobacco products tax. The combined tax evaded on these two cases alone was over $3.0 million.

A requirement that the tax imposed on the distribution of cigars be paid by distributors through the use of a stamp, or other identifiable marking, similar to the requirement that presently exists for cigarettes, would require the payment of the tax in advance of distribution and discourage distributors from selling cigars for which tax has not been paid. Additionally, consumers and Board staff could readily identify if tax had been paid on cigars if stamps were required.

Currently, Revenue and Taxation Code Section 30161 prescribes that the tax on the distribution of cigarettes shall be paid by distributors through the use of stamps or meter impressions. One company, Meyercord, Inc., currently manufactures the stamps used by California. Meyercord Inc. also provides the present technology available for stamping cigarettes. This technology consists of heat-applied stamps. The stamps are affixed by stamping machines leased by Meyercord Inc. to distributors and are highly automated, although hand applied equipment (irons) is available for smaller scale distributors or cigarettes

[1] "Tobacco products", under current law, include all forms of products containing at least 50 percent tobacco, except cigarettes.

in non-standard packages. The machines currently do not have the capability of stamping anything other than standard cigarette packages.

Meyercord Inc. presently manufactures three stamp denominations, stamps for packs of 10, 20, and 25 cigarettes. By contract, tax stamps are sold by Bank of America, for the Board. Licensed cigarette distributors may purchase the stamps on a cash or deferred payment basis.

Presently, 46 states are required to affix tax stamps to cigarette packages, but no state currently requires tax stamps on cigars or any other types of tobacco products. The State of Alabama did stamp tobacco products several years ago. However, effective May 1989, they eliminated the requirement due to the complexity involved in the implementation of the program.

The Board currently has 859 licensed tobacco products distributors compared to 216 cigarette distributors; furthermore, the variety of cigars currently on the market is numerous. These two factors would make any requirement for paying the tax through the use of stamps, rather than the current return method, much more costly and difficult to implement than the requirement currently in place for cigarettes.

Discussion

On April 17, 2001, a core group of industry representatives attended a meeting to begin preliminary discussions on the topic of “stamping cigars”. The following issues were discussed with industry representatives:

The major problems identified was the vast number of cigar brands presently on the market (between 500 to 700) and the various sizes of cigars and packaging configurations. In addition, there is no standard machine for automated stamping. Until new technologies are identified, cigar stamping would have to be done manually by distributors.

Due to the enormous number of cigars in various price ranges a “no value” stamp would be the most viable alternative, because the same stamp could be used to stamp all cigars. However, this type of stamp would not readily identify if the tax on the cigar has been paid unless the invoice is examined.

Summary

Industry members agree that in order to address the problem of untaxed cigars and other tobacco products flooding the California market, it is necessary to control what is coming in from other states. Although the ideal solution would be to require manufacturers (by legislation) wishing to sell product into California to stamp the product prior to importation into the state, the lack of enforcement power over other states and/or foreign countries would not make this a viable alternative.

Legislation recently introduced in the Assembly, AB 744 (Wesson), would require California retailers selling cigarettes and tobacco products to be licensed by the Alcoholic Beverage Control Board similar to the current licensing requirements in place for the sale of alcoholic beverages. If passed, this legislation would provide the state with some of the tools needed to better control untaxed product from being sold in California.