STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	**02/19/10**	Bill No:	**AB 2496**
Tax:	**Cigarette and Tobacco Products Tax** **Cigarette and Tobacco Products Licensing Act**	Author:	**Nava**
Related Bills:			

This analysis will only address the bill's provisions which impact the State Board of Equalization (BOE).

BILL SUMMARY

Among other things, this bill would make the following BOE-related changes:

- Require every manufacturer and every importer to consent to the jurisdiction of the California courts for the purpose of enforcement of the Model Statute[1] and Tobacco Directory Law in order to be eligible to obtain and maintain a license under the Cigarette and Tobacco Products Licensing Act of 2003 (Licensing Act);
- Expand the BOE's inspection authority under the Licensing Act to any site where evidence of activities involve violations of the Tobacco Directory Law;
- Prohibit for purposes of the Licensing Act an importer, distributor, wholesaler, distributor functioning as a wholesaler, or retailer from purchasing, obtaining, or otherwise acquiring any package of cigarettes to which a stamp is affixed in violation of the Tobacco Directory Law;
- Require an appropriate stamp or meter impression to be made upon any rolls of tobacco described as a little cigar;
- Allow retailers a 60-day period to sell cigarettes removed from the Tobacco Directory before such products become subject to seizure and destruction; and
- Expand the BOE's seizure authority to include cigarettes or tobacco products of a tobacco product manufacturer or its brand families not appearing on the Tobacco Directory.

ANALYSIS

CURRENT LAW

Cigarette and Tobacco Products Tax Law (Cigarette Tax). Under existing law, the BOE administers the Cigarette Tax (Part 13 commencing with Section 30001) of Division 2 of the Revenue and Taxation Code). Revenue and Taxation Code Section 30451 specifically provides that the BOE shall enforce the provisions of the Cigarette Tax and may prescribe, adopt, and enforce rules and regulations relating to the administration and enforcement.

[1] Article 3 (commencing with Section 104555), Chapter 1, Part 3, Division 103 of the Health and Safety Code.

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 BOE's formal position.

The current excise tax on cigarettes is 87 cents per package of 20 (43 ½ mills per cigarette). The cigarette tax is paid through the use of stamps or meter impressions. An appropriate stamp is affixed to, or an appropriate meter impression is made on, each package of cigarettes prior to the distribution of the cigarettes.

The tobacco products tax rate is determined annually by the BOE and based on the March 1 wholesale cost of cigarettes. Currently, the surcharge rate for fiscal year 2009-10 is 41.11 percent. The tobacco products tax is paid through the use of a return on which the distributor reports the wholesale cost of the tobacco products distributed and calculates the tax due.

Also incorporated in the Cigarette Tax is the **Tobacco Directory Law**, which more effectively enforces and promotes the purpose of the Model Statute. The Tobacco Directory Law, which can be found in Section 30165.1, requires, in part, the Attorney General to develop and publish on its Internet web site a directory listing the following:

- All tobacco manufacturers that have provided current, timely, and accurate certifications that certify the tobacco manufacturer is either a participating manufacturer under the Master Settlement Agreement (MSA), or is a non-participating manufacturer (NPM) that has made all required escrow payments.
- All brand families that are listed in the certifications, except as specified.

No person may affix, or cause to be affixed, any tax stamp or meter impression to a package of cigarettes, or pay the tax levied on a tobacco product defined under Section 30165.1 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.

The Tobacco Directory Law also prohibits a person from:

- Selling, offering, or possessing for sale in this state, or importing for personal consumption in this state, cigarettes of a tobacco product manufacturer or brand family not included in the Attorney General's directory, and
- Selling, distributing, acquiring, holding, owning, possessing, transporting, importing, or causing to be imported cigarettes that the person knows or should know are intended to be distributed in violation of this bill's stamping prohibitions or are not included in the Attorney General's directory.

Section 30435 authorizes an employee of the BOE, upon presentation of the appropriate identification and credentials, to enter into, and conduct an inspection of any place for which there is evidence of failure to comply with the requirements of the MSA, including, but not limited to, the Tobacco Directory Law. Any cigarette or tobacco products that are stamped or to which a meter impression is affixed, or for which tax is paid, in violation of the Tobacco Directory Law, is subject to seizure and forfeiture, pursuant to Section 30436 regardless of whether the violation is subject to a defense, as provided. The seized cigarettes or tobacco products are forfeited to the state and must be destroyed.

Cigarette and Tobacco Products Licensing Act of 2003 (Licensing Act). Division 8.6 of the Business and Professions Code established the Licensing Act, which created a statewide licensure program for the sales of cigarettes and tobacco products to address the unlawful distribution and untaxed sales of cigarettes and tobacco products.

In part, Sections 22979 and 22979.21 require every manufacturer and every importer to obtain and maintain a license to engage in the sale of cigarettes or tobacco products. In order to be eligible for a license, a manufacturer or importer is required to meet specified requirements, such as consenting to jurisdiction of the California courts for the purpose of enforcement of the Licensing Act and appoint a registered agent for service of process in this state and identify the registered agent to the BOE.

The Licensing Act also authorizes, pursuant to Section 22980, any peace officer or BOE employee granted limited peace officer status to enter any place, as described, and conduct inspections. In part, inspections may be at any place at which cigarettes or tobacco products are sold, produced, or stored or at any site where evidence of activities involving evasion of cigarette or tobacco products may be discovered.

The Licensing Act also imposes specified prohibitions and penalties in Business and Professions Code Sections 22980.1 through 22982. Among the prohibitions, subdivision (g) of Section 22980.1 provides that no importer, distributor, or wholesaler, or distributor functioning as a wholesaler, or retailer, shall purchase, obtain, or otherwise acquire any package of cigarettes to which a stamp or meter impression may not be affixed in accordance with the Cigarette and Tobacco Products Tax Law, or any cigarette obtained from a manufacturer or importer that cannot demonstrate full compliance with all requirements of the federal Cigarette Labeling and Advertising Act (15 U.S.C. Sec. 13335a et seq.) for the reporting of ingredients added to cigarettes. Any violation of the Act by any person, except as otherwise provided, is a misdemeanor. Each offense is punished by a fine not to exceed five thousand dollars ($5,000), or imprisonment not exceeding one year in a county jail, or both. Section 22981 provides that any violation of the Licensing Act by any person, except as otherwise provided, is a misdemeanor. Each offense is punishable by a fine not to exceed five thousand dollars ($5,000), or imprisonment not exceeding one year in a county jail, or both the fine and imprisonment.

PROPOSED LAW

Among other things, this bill makes changes to the Licensing Act and Cigarette Tax to enhance enforcement of the MSA and subsequent legislation (Model Statute and Tobacco Directory Law).

Licensing Act. This bill would amend Business and Professions Code Section 22979 to require a manufacturer or importer to consent to the jurisdiction of the California courts for the purpose of enforcement of the Model Statute, the Tobacco Directory Law and regulations adopted pursuant thereto.

This bill would also amend Section 22980 to allow any peace officer or BOE employee granted limited peace officer status, upon presentation of appropriate credentials, to enter any site where evidence of activities involving violations of the Tobacco Directory Law may be discovered. Such inspections must be performed in a reasonable manner and at times that are reasonable under the circumstances, taking into consideration the normal business hours of the place to be entered.

And lastly, this bill would amend Section 22980.1 to prohibit an importer, distributor, wholesaler, distributor functioning as a wholesaler, or retailer from purchasing, obtaining, or otherwise acquiring any package of cigarettes to which a stamp or meter impression may not be affixed in accordance with the Tobacco Directory Law.

Cigarette Tax. This bill would amend Section 30163 of the Revenue and Taxation Code to require and appropriate stamp to be affixed to, or an appropriate meter impression be made on any rolls of tobacco with a cellulose acetate or other integrated filter, or which has filler tobacco consisting primarily of flue-cured, burley, oriental, or unfermented tobaccos or yields smoking characteristics of those tobaccos or is wrapped in paper or any substance not containing tobacco, prior to distribution of the rolls of tobacco.

The bill also makes numerous amendments to Section 30165.1, the Tobacco Directory Law. Those amendments impacting the BOE's administration of the Cigarette Tax are as follows:

- For purposes of the Tobacco Directory Law, expands the term "cigarette" to include any rolls of tobacco with a cellulose acetate or other integrated filter, or which has filler tobacco consisting primarily of flue-cured, burley, oriental, or unfermented tobaccos or yields smoking characteristics of those tobaccos or is wrapped in paper or any substance not containing tobacco, or any such cigarette that is distributed, as that term is defined.
- Requires a distributor, within seven days of receiving a notice of removal of any tobacco product manufacturer or brand family from the tobacco directory, to provide a copy of the removal notice to each of their customers that have purchased product removed from the tobacco directory. The customer would be provided a 60 day sell-off period from the effective date of the removal notice to sell the affected cigarettes purchased prior to removal from the tobacco directory. On and after the 61st day, the cigarettes are contraband and become subject to seizure and destruction by the BOE.
- Expands the prohibition for any person selling, offering, or possessing for sale in this state or import for personal consumption in this state, to also include shipping or otherwise distributing into or within this state, cigarettes of a tobacco product manufacturer or brand family not included in the directory.
- Requires each manufacturer and its importers to report in the manner, including electronically, as required by the Attorney General and the BOE, all cigarettes and tobacco products, including, but not limited to, the quantity of each brand family, and make all escrow deposits and pay state taxes due before the importer or manufacturer releases the cigarettes and tobacco products for transport to or sale in California. Any manufactuer or imporeter that fails to file the report as required is liable for a civil penalty in an amount not to exceed the greater of five times the retail value of the cigarettes, as defined, that were not reported prior to release for shipment to or sale in California, or five thousand dollars ($5,000).
- Authorizes the BOE or Attorney General to require an importer to submit any additional information, including, but not limited to, samples of the packaging or labeling of each brand family, as is necessary to enable the Attorney General to determine whether a tobacco product importer has complied, is in compliance, and will continue in compliance with the Tobacco Directory Law, the Model Statute, and any regulations promulgated pursuant thereto.
- Expands from a distributor to any person the imposition of penalties for violating the Tobacco Directory Law. In the case of the first offense, the BOE would be authorized to revoke or suspend the license or licenses issued to the person by the

BOE. In addition to distributors, this amendment would now subject wholesalers and retailers to license revocation and suspension. And the licenses subject to suspension and revocation would be expanded from licenses issued to distributors and wholesalers under the Cigarette Tax to retailer, distributor and wholesaler licenses issued under the Licensing Act. In the case of a second or any subsequent offense, the BOE would be authorized to impose civil penalty in an amount not to exceed the greater of five times the retail value of the cigarettes, as defined, or five thousand dollars ($5,000).

This bill would also add Section 30165.2 to the Revenue and Taxation Code to require as a condition of selling cigarettes in the state, every tobacco product manufacturer, as defined in the Tobacco Directory Law, whose cigarettes are to be sold in the state whether directly or through a distributor, importer, retailer, or similar intermediary or intermediaries to, at the election of the tobacco product manufacturer, either:

- Submit to the Attorney General a true and correct copy of each and every applicable return of tobacco product manufacturer.
- Submit to the United States Treasury a request or consent under Internal Revenue Code Section 6103(c) authorizing the Alcohol and Tobacco Tax and Trade Bureau to disclose the applicable returns of manufacturer to the Attorney General. A foreign tobacco product manufacturer whose cigarettes are imported into the United States by an importer or importers would be required to submit, or case each of its importers to submit, to the Attorney General each and every applicable return that includes any information about cigarettes of that foreign tobacco product manufacturer imported into the United States. The Attorney General would be prohibited from disclosing any applicable returns or any information contained therein, except as necessary to carry out the functions and duties of the Department of Justice or BOE, or as otherwise provided.

A tobacco product manufacturer who does not comply with the above requirements would, after 30 days notice by the state to the tobacco product manufacturer of the failure to comply, be removed, along with its brand families, from the tobacco directory unless the tobacco product manufacturer has brought itself into compliance by the end of the 30-day period.

Any tobacco manufacturer or importer that intentionally provides any applicable return containing materially false information shall be liable for a civil penalty in an amount not to exceed the greater of either of the following:

- Five times the retail value of the cigarettes or tobacco products defined as cigarettes under this section and about which false information was provided.
- Five thousand dollars ($5,000).

The Attorney General would be authorized to promulgate regulations to implement and carry out proposed Section 30165.2.

And lastly, this bill would amend Section 30436 to provide that cigarettes or tobacco products of a tobacco product manufacturer or its brand families that do not appear on the tobacco directory maintained by the Attorney General are forfeited to the state upon seizure by the BOE.

This bill would become effective January 1, 2011.

IN GENERAL

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.

The MSA prompted States to enact the Model Statute by creating a significant financial incentive: Settling States that enact and "diligently enforce" the Model Statute would not be subject to severe reductions to their MSA payments. All settling states have enacted Model Statutes requiring NPM reserve (escrow) funds, including California. California's "Model Statute" was enacted in 1999 pursuant to Senate Bill 822 (Escutia, Chapter 780). That bill, among other things, authorized the BOE to adopt any regulations necessary to ascertain, based on the amount of state excise tax paid on cigarettes, the number of tax paid cigarettes sold by tobacco products manufacturers who do not participate in the MSA.

While the Settling States, such as California, have been aggressively enforcing the provisions of the Model Statutes, enforcement has proved costly and cumbersome. Accordingly, almost every state has enacted Complementary Legislation to make state enforcement of the Model Statutes more effective and thereby promote the purposes for which the Model Statutes were enacted.

In 2003, California enacted Complementary Legislation (Tobacco Directory Law) pursuant to Assembly Bill 71 (Horton, Chapter 890). Generally, these statutes:

- Require the Attorney General to develop and publish on its Internet web site a directory of all tobacco manufacturers that have provided current, timely, and accurate certifications that certify the tobacco manufacturer is either a participating manufacturer under the MSA, or is a NPM that has made all required escrow payments, and all brand families that are listed in the certifications, except as specified.
- Prohibit a person from affixing, or cause to be affixed, any tax stamp or meter impression to a package of cigarettes, or pay the tax levied 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.
- Subject violators, principally manufacturers and distributors, to civil and criminal penalties and license suspension or revocation.

COMMENTS

1. **Sponsor and purpose.** The bill is sponsored by the Attorney General and is intended to allow for better enforcement of internet and other delivery sales of cigarettes and tobacco products in this state, strengthen the Attorney General's and BOE's ability to diligently enforce the Model Statute and Tobacco Directory Law, and to provide retailers relief of any financial hardship resulting from cigarettes and tobacco product inventory that immediately becomes illegal to sell upon removal from the Tobacco Directory.

2. **What is the BOE's enforcement role for the Model Statute?** The BOE has several responsibilities with respect to "diligent enforcement" of the Model Statute, which protects the state's approximately $900 million annual revenue payment stream from the MSA. The BOE's enforcement role is as follows:

   - The Model Statute requires NPMs to place into a qualified escrow fund by every April 15 an amount, as specified, based on units sold during the previous year. "Units sold" is generally defined to mean the number of individual cigarettes sold in the state by the applicable tobacco product manufacturer as measured by excise taxes collected by the state on packs bearing the excise tax stamp of the state. The BOE is authorized to adopt any regulations necessary to ascertain, based on the amount of state excise tax paid on cigarettes, the number of tax paid cigarettes sold by NPMs.

     As a result of this provision, the BOE provides the Attorney General with annual statistics of cigarettes sold in California by NPMs. The BOE compiles this information measured by the excise tax reported to the BOE, which is adjusted by BOE staff to remove brands that are considered a "cigarette" for tax purposes, but not for purposes of the Model Statute.

   - The Tobacco Directory Law prohibits a distributor from affixing a tax stamp to a package of cigarettes, or paying 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 Tobacco Directory[2]. A violation of this prohibition could result in the revocation or suspension of the license or licenses of the distributor and/or a civil penalty and subject such products to seizure and forfeiture by the BOE.

   - The Licensing Act requires every manufacturer or importer required to obtain and maintain a license to engage in the sale of cigarettes. In order to be eligible to obtain and maintain a license, a manufacturer or importer that is a "tobacco products manufacturer" pursuant to the Model Statute must 1) certify to the BOE that it is a "participating manufacturer" or is in compliance with the Model Statute, and 2) submit to the BOE a list of all its brand families. AB 71 also gave the authority to the BOE to revoke or suspend the license of a distributor for selling product not listed on the California Tobacco Directory.

[2] Tobacco products commonly known as "'little cigars" currently do not have to be listed in the tobacco directory in order to be lawfully sold in California. The AG may decide in the future to require that certain brands of little cigars be listed in this Directory.

Finally, Licensing Act allows an employee of the BOE, upon presentation of the appropriate identification and credentials, is authorized to enter into, and conduct an inspection of, any building, facility, site, or place, for which there is evidence of the failure to comply with the requirements of the Model Statute or the Tobacco Directory Law.

3. **Should the Tobacco Directory Law and related enforcement provisions be in the Cigarette Tax?** Revenue and Taxation Code Section 30451 requires the BOE to enforce the provisions of the Cigarette Tax. The Tobacco Directory Law was added to the Cigarette Tax in 2003 pursuant to AB 71 (Ch. 890, J. Horton). Although the Tobacco Directory Law mostly contains non-tax provisions enforced by the Attorney General, it also includes provisions that appropriately tie-in with the tax law enforced by the BOE.

   However, this bill proposes to expand the Tobacco Directory Law, much of it unrelated to the BOE's enforcement and administration of the Cigarette and Tobacco Products Tax Law. The bill also proposes to add Section 30165.2 to the Cigarette and Tobacco Products Tax Law, which has no direct relationship to the cigarette or tobacco products tax. Since the Tobacco Directory Law and proposed Section 30165.2 are primarily related to enforcement of the Model Statute, it is suggested that the bill be amended to place the Tobacco Directory Law and proposed Section 30165.2 in the Health and Safety Code along with the Model Statute, which is located in Article 3 (commencing with Section 104555), Chapter 1, Part 3, Division 103 of the Health and Safety Code. It is further suggested that the current BOE Tobacco Directory Law responsibilities, which are tax-related, remain in the Cigarette Tax or, if appropriate, placed in the Licensing Act.

   In addition to maintaining only tax-related provisions within the tax law, these suggested amendments would more clearly define the BOE's and Attorney General's role for enforcement of the Model Statute and funding for those costs. The BOE staff is currently working with staff from the Attorney General's office on drafting these amendments.

4. **Notification of brand family or manufacturer removal from the Tobacco Directory.** Under current law, cigarettes or tobacco products to which a tax stamp is affixed, or for which tax is paid, is subject to seizure and forfeiture by the BOE at the time the manufacturer or any of its brand families are removed from the tobacco directory. When a manufacturer or brand family is removed from the Tobacco Directory, only distributors are notified of the removal by e-mail. Wholesalers and retailers must check the Tobacco Directory, which is located on the Attorney General's website, for recent changes to the directory, such as removals. As such, wholesalers and retailers are typically not aware that a manufacturer or a brand family has been removed from the directory when found by BOE inspectors to be selling, offering, or possessing for sale removed product. If the removed products are being sold, offered or possessed for sale, which is a violation of the Tobacco Directory Law, they are subject to seizure by the BOE.

   To provide better notification of manufacturers or brand families removed from the tobacco directory, this bill would require each distributor, within seven days of receiving a removal notice from the Attorney General, to provide each customer with a copy of the removal notice. To clarify any ambiguity of the sponsor's intent, BOE staff suggests amending the bill to substitute the term "retailer" for "customer,"

require wholesalers to provide their email address to the Attorney General for direct notification of removals, and require both a distributor and a wholesaler to provide a copy of the removal notice to every customer who is a retailer, distributor or wholesaler who has purchased the removed product within the previous two years.

In addition, a distributor should be given more than seven days, which is the same amount of time they are required to provide a copy of the removal notice to customers, to provide the BOE a list of the customers to whom the removal notices were sent. It is unclear, however, to BOE staff what the purpose is for the BOE to receive a list of the customers to whom the removal notices were sent. The amendments don't provide a defense for those retailers not receiving a copy of the notice who are found selling, offering or possession for sale product after the 61st day from the effective date of the removal notice. Should the list of customers be send to the Attorney General to document compliance with the requirements of customer notification? In addition, there is no specific penalty for failing to provide the BOE the list of customers to whom removal notices were sent.

5. **Retailer sell-off period for product removed from the Tobacco Directory.** Currently, cigarettes or tobacco products of a manufacturer or its brand families become illegal to sell, offer, or possess for sale upon removal from the Tobacco Directory. Even with proper notice of such removal, it is a financial hardship on retailers who have an inventory of the removed products that they can no longer sell. To address this hardship, this bill would provide a distributor's customer (retailer) 60 days from the effective date of the removal notice to sell the affected product <u>only</u> if it was purchased prior to being removed prior to being removed from the Tobacco Directory. This provision would provide a retailer an opportunity to sell their existing inventory of removed product thereby limiting or eliminating any financial hardship imposed under current law.

   BOE staff is continuing to work with staff from the Attorney General's office to develop appropriate amendments intended to properly notify wholesalers and retailers of product removal and to provide clear and concise sell-off period language.

6. **Additional cigarette and tobacco products subject to seizure by the BOE.** With respect to Tobacco Directory Law violations, only cigarettes or tobacco products not appearing on the Tobacco Directory to which are affixed a cigarette stamp, or for which the tax is paid, are currently forfeited to the state upon the BOE's seizure. This bill would expand the BOE's seizure authority for Tobacco Directory violations to include <u>untaxed</u> cigarettes and tobacco products. These additional seizures could be from manufacturers, importers and distributors of cigarettes or tobacco products that have not been distributed, which is the incidence of tax. Such seizures would be strictly related to Tobacco Directory violations with no relationship to cigarette and tobacco products tax enforcement.

   As background, cigarettes and tobacco products currently seized for Tobacco Directory Law violations typically involve other violations of the Cigarette Tax or Licensing Act, which the BOE is required to administer and enforce. By requiring the BOE to seize untaxed cigarettes and tobacco products, this bill would likely involve Tobacco Directory seizures funded by the cigarette and tobacco products tax funds (General Fund, Breast Cancer Fund, Cigarette and Tobacco Products Surtax Fund, and California Children and Families Trust Fund).

On the other hand, the additional seizure authority would allow the BOE to seize cigarettes or tobacco products that are in violation of the Tobacco Directory where a taxable distribution has occurred, but the tax has not been remitted to the BOE. These seizures would also involve a violation of the tax law and Licensing Act.

BOE staff will continue to work with the sponsor to clarify the intent of the additional seizure authority, role of the BOE, and appropriate funding for administrative costs related to Tobacco Directory Law seizures.

COST ESTIMATE

The BOE would incur administrative costs related to revising Licensing Act application forms for manufacturers and importers, issuing citations to licensees for purchasing, obtaining or otherwise acquiring cigarettes stamped in violation of the Tobacco Directory law, and for additional cigarette and tobacco products seizures. These costs are estimated to be minor (over $10,000 and under $50,000); however a detailed cost estimate is pending.

REVENUE ESTIMATE

This bill would not affect the state's revenues.

Analysis prepared by:	Cindy Wilson	916-445-6036	03/31/10
Contact:	Margaret S. Shedd	916-322-2376	

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