STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Draft

Date Amended:	**04/30/07**	Bill No:	**SB 24**
Tax:	**Tobacco Smoke Emissions Fee**	Author:	**Torlakson**
Related Bills:			

This analysis will only address the bill's provisions that impact the Board.

BILL SUMMARY

This bill would impose a fee on consumers of cigars and cigarettes to mitigate the emission of environmental tobacco smoke by use of cigars and cigarettes.

SUMMARY OF AMENDMENTS

The amendments since the previous analysis revise the method in which the Board would be reimbursed for its administrative costs from a direct appropriation to reimbursement from the State Department of Public Health (DPH).

ANALYSIS

CURRENT LAW

Cigarette and Tobacco Products Tax Law. The current excise tax on cigarettes is 87 cents per package of 20 (43 ½ mills per cigarette). The different components of the cigarette taxes and the disposition of the revenues are as follows:

- 10 cents per pack (5 mills per cigarette) is allocated to the General Fund (Sections 30101 and 30462 of the Revenue and Taxation Code);
- 2 cents per pack (1 mil per cigarette) is allocated to the Breast Cancer Fund (Sections 30101 and 30461.6);
- 25 cents per pack (12 ½ mills per cigarette) is allocated to the Cigarette and Tobacco Products Surtax Fund (Sections 30122 and 30123); and
- 50 cents per pack (25 mills per cigarette) is allocated to the California Children and Families Trust Fund (Sections 30131.2 and 30131.3).

For other tobacco products (which are defined in Section 30121 and 30131.1 to include cigars, smoking tobacco, chewing tobacco, snuff, and other products containing at least 50 percent tobacco), Section 30123 (Proposition 99) imposes a tax on the wholesale cost of the tobacco products distributed at a rate which is equivalent to the combined rate of tax imposed on cigarettes. In addition, Section 30131.2 (Proposition 10) imposes an additional tax on tobacco products based on the wholesale cost of the tobacco products distributed at a rate which is equivalent to the 50-cent per pack tax on cigarettes also imposed by Section 30131.2. The tobacco products tax rate is determined annually by the Board and based on the March 1 wholesale cost of cigarettes. Currently, the surcharge rate for fiscal year 2006-07 is 46.76 percent.

The other tobacco products surtax imposed under Section 30123 (Proposition 99) is deposited into the Cigarette and Tobacco Products Surtax Fund (including any revenues that result from an indirect increase in the other tobacco products tax triggered by a cigarette tax increase), while the surtax imposed under Section 30131.2 (Proposition 10) is deposited into the California Children and Families Trust Fund.

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.

Sales and Use Tax Law. Under existing law, the sales tax is imposed on the gross receipts from the sale of tangible personal property, unless specifically exempted by law. "Gross receipts" and "sales price" are terms defined in the law which includes the total amount of the sale or lease or rental price, without any deduction on account of the cost of materials used, labor or service costs, interest charged, losses, or any other expenses related to the sale of the property. However, the following fees and taxes have specifically been excluded from the definition of "gross receipts" and "sales price", thereby exempting these amounts from the computation of sales tax:

- Federal taxes (except most manufacturers' or importers' excise taxes).
- Local sales and use taxes when they are a stated percentage of the sales price.
- Certain state taxes or fees imposed on vehicles, mobilehomes or commercial coaches that have been added to, or are measured by, a stated percentage of the sales price.
- State-imposed diesel fuel tax.

PROPOSED LAW

This bill would add Chapter 7.5 (commencing with Section 105435.10) to Part 5 of Division 103 of the Health and Safety Code as the Cigarette and Tobacco Products Emissions Act of 2007 (Act). Among its provisions, Section 105435.20 would impose a fee upon consumers of cigars and cigarettes who are engaged in the emission of environmental tobacco smoke by the purchase and use of cigars and cigarettes.

The DPH or its successor would be required to adopt regulations to establish specific fees per cigar and cigarette to be assessed. To the maximum extent practicable, the fees would be assessed on the basis of both of the following criteria:

- The amount of cigars and cigarettes purchased by consumers as it relates to the amount of environmental tobacco smoke created by their use.
- The estimated amount of environmental tobacco smoke to be generated by a consumer igniting and consuming the cigar or cigarette and its relation to the total environmental problem generated by cigar and cigarette smokers.

The fee would be adjusted annually by the DPH based upon specified information, including the administrative costs to the DPH to implement the Act.

The fee would be collected by a retailer of cigars or cigarettes at the time of purchase. The bill specifically provides that the Act would not apply to, and no fee would be assessed upon, any retailer, manufacturer, distributor, or wholesaler of cigars or cigarettes.

The fee would be administered and collected by the Board in the same manner that taxes are administered and collected under the Sales and Use Tax Law. The fee would be deposited in the Cigarette and Tobacco Products Emission Fund (Fund), which this bill would establish in the State Treasury. Moneys in the Fund would, upon appropriation by the Legislature, be available to the DPH for health and education-related purposes, as described, and to pay or reimburse the administrative costs incurred by the Board and the DPH in administering the Act.

The Act would define the following terms:

- "Cigar" - any roll of tobacco wrapped in leaf tobacco or in any substance containing tobacco, but shall not include any roll of tobacco wrapped in any substance which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette.
- "Cigarette" - any product that contains nicotine, is intended to be burned or heated under ordinary conditions of use, and consists of or contains (1) any roll of tobacco wrapped in paper or in any substance not containing tobacco; (2) tobacco, in any form, that is functional in the product, which because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette; (3) any roll of tobacco wrapped in any substance containing tobacco which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette described in this section; or (4) "roll-your-own" tobacco, meaning any tobacco which, because of its appearance, type, packaging, or labeling is suitable for use and likely to be offered to, or purchased by, consumers as tobacco for making cigarettes or for use in a pipe. For purposes of the definition of "cigarette," 0.09 ounces of "roll-your-own" or "pipe-fill" tobacco shall constitute one individual "cigarette."
- "Consumer" - any person who purchases cigars or cigarettes.
- "Retailer" - includes a seller who makes a retail sale of cigarettes or cigars, and every person engaged in the business of making retail sales of cigarettes or cigars.

This bill would also amend Sections 6011 and 6012 of the Sales and Use Tax Law to specifically provide that the amount of any fee imposed under the Act is not included within the definition of “sales price” or “gross receipts,” respectively.

This bill also makes findings and declarations that, among other things, state the intent of the Legislature to impose regulatory fees pursuant to the Act within the limitations approved by the Supreme Court of California in *Sinclair Paint Co. v. State Bd. of Equalization* (1997) 15 Cal.4th 866.

The bill would become effective on January 1, 2008.

BACKGROUND

In 2003, SB 676 (Ortiz) and AB 1239 (Wiggins) would have imposed a tobacco products fee, as specified, on each nonparticipating manufacturer currently manufacturing tobacco products, or who has previously manufactured tobacco products, as described. AB 676 died in the Assembly Committee on Governmental Organization and AB 1239 died in the Senate Committee on Revenue and Taxation.

In 2005, SB 942 (Chesbro, et al.) and AB 1612 (Pavley) would have required each manufacturer of cigarettes to pay a cigarette pollution and litter prevention fee for each package of cigarettes sold by that manufacturer in the state, as specified. SB 942 was held under submission in the Senate Appropriations Committee and the fee provisions were amended out of AB 1612.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the author and is intended to fund programs to reduce and prevent environmental tobacco smoke and to research and cure environmental tobacco smoke-related health problems.

2. **Summary of amendments.** The **April 30, 2007, amendments** revise the method in which the Board would be reimbursed for its administrative costs from a direct appropriation to reimbursement from the DPH. The **April 7, 2007, amendments** deleted the provisions imposing an additional excise tax on cigarettes of nine and one-half cents ($0.095) per cigarette and add provisions to impose a tobacco emissions fee on consumers of cigars and cigarettes. The **January 2, 2007, amendments** were clarifications of the disposition of the funds collected.

3. **The Board could not administer a new fee program with a January 1, 2008, effective date.** This bill would create a new fee program as of January 1, 2008. This would require notifying and registering cigarette and cigar retailers, hiring and training key staff, creating returns and supporting schedules and programming to the Board's Integrated Revenue Information System (IRIS), the Board's primary tax administration system. To successfully implement this bill, these tasks should be completed before the fee imposition provisions become operative. As such, the fee imposition provisions of this bill should have a delayed operative date for the first day of the month eight months after the effective date of the bill.

4. **This bill should contain a specific appropriation to the Board.** This bill proposes a fee to be imposed on or before January 1, 2008. To implement the proposed fee program, the Board would need to develop the feepayer base, reporting forms, program IRIS, and hire appropriate staff in 2007, which is in the middle of the state's 2007-08 fiscal year. To cover these administrative start-up costs, the Board would need an adequate appropriation that would not already be identified in the Board's 2007-08 budget.

   As an alternative to an appropriation, the author may want to consider amending the bill to move the operative date of the fee from January 1, 2008 to January 1, 2009. This would allow the Board to obtain funding for administrative start-up costs through the Budget Change Proposal process. It would also provide the Board sufficient time to successfully implement the bill, as discussed in comment #3.

5. **The manner in which the Board is reimbursed should be changed to a direct appropriation.** The Board's administrative costs pursuant to this bill would be reimbursed by the DPH, which is inconsistent with other tax or fees the Board is required to administer and collect.

   When the Board is required by statute to administer and collect a tax or fee, the Board is reimbursed by a direct appropriation through the annual budget development process. Most programs administered by the Board are "direct appropriation programs," such as the Sales and Use Tax Law, Motor Vehicle Fuel Tax Law, Use Fuel Tax Law, Diesel Fuel Tax Law, Alcoholic Beverage Tax Law, Cigarette and Tobacco Products Tax Law, Cigarette and Tobacco Products Licensing Act of 2003, Energy Resources Surcharge Law, Emergency Telephone Users Surcharge Law, Covered Electronic Waste Recycling Fee Law, Underground Storage Tank Maintenance Fee Law, Marine Invasive Species Fee Law, Natural Gas Surcharge Law, and Water Rights Fee Law.

This bill should be amended to change the method for reimbursing the Board for its costs to administer and collect the proposed fee to a direct appropriation from the Fund through the annual budget development process to conform to other tax and fee program the Board is required to collect and administer.

6. **Other technical concerns.** The Board has several administrative concerns, including, but not limited to, the following:

   - A date should be specified by which the DHS is required to set the tobacco products fee rate each year and notify the Board. Further, it is recommended that such date be at least 8 weeks prior to the effective date of the rate to provide Board staff sufficient time to notify retailers of a fee rate change and to provide retailers sufficient time for reprogramming.
   - A due date for the fee and return should be specified. It is also recommended that the bill be amended to authorize the payment of refunds on overpayments of the fee and to clarify that the Board shall deduct the costs of administering <u>and collecting</u> the fee before transmitting the money collected as fees to the Fund.
   - In order for the Board to administer the proposed fee under provisions consistent with other Board-administered fees, it is suggested that proposed Section 105435.20 be amended to provide the following:

     105435.20. (e) The fee imposed pursuant to this section shall be administered and collected by the board <u>pursuant to the Fee Collection Procedures Law (Part 30 (commencing with Section 55001) of Division 2 of the Revenue and Taxation Code)</u> ~~in the same manner that taxes are administered and collected under the Sale and Use Tax Law (Part 1 (commencing with Section 6001) of Division 2 of the Revenue and Taxation Code).~~ The fees shall be deposited in the Cigarette and Tobacco Products Emissions Fund.

     The Fee Collection Procedures Law contains "generic" administrative provisions for the administration and collection of fee programs to be administered by the Board. The Fee Collection Procedures Law was added to the Revenue and Taxation Code to allow bills establishing a new fee to reference this law, thereby only requiring a minimal number of sections within the bill to provide the necessary administrative provisions. Among other things, the Fee Collection Procedures Law includes collection, reporting, refund and appeals provisions, as well as providing the Board the authority to adopt regulations relating to the administration and enforcement of the Fee Collection Procedures Law.

   Board staff is willing to work with the author's office in drafting appropriate amendments.

7. **Would the proposed fee increase evasion?** Tax evasion is one of the major areas that can reduce state revenues generated from cigarettes and other tobacco products taxes.

   During the mid-1990's, the Board's cigarette tax evasion estimates changed little since there was little change to cigarette prices and excise taxes during that time. However, two major events that occurred since November 1998 dramatically increased California excise taxes as well as cigarette prices (excluding taxes): Proposition 10 and the Tobacco Master Settlement Agreement between states and tobacco manufacturers (tobacco settlement). Together, these two developments, when coupled with typical wholesaler and retailer distribution margins, coincided with an increase in the average prices of cigarettes to California consumers by about 50 percent in relation to early November 1998 prices. It is estimated that the impacts of Proposition 10 and the tobacco settlement more than doubled the dollar amount of cigarette tax evasion in California.

   Since the 1998 experience, many new measures have been implemented to reduce cigarette and other tobacco products tax evasion. These include the Cigarette and Tobacco Products Licensing Act, an encrypted cigarette tax stamp, and various Internet restrictions (such as agreements with UPS, DHL, and FedEx under which those companies have agreed to stop transporting cigarettes directly to individual consumers nationwide and credit card companies adopting policies to prohibit the use of credit cards for the illegal sale of cigarettes over the Internet).

   This measure would result in an increase in the amount paid by consumers for cigarettes and cigars. Based on previous experience related to Proposition 10 and the tobacco settlement, along with research of experiences in other states, Board staff believes the proposed fee could result in both a decrease in actual consumption and an increase in cigarette and other tobacco products tax evasion.

   The Board staff is currently in the process of updating the cigarette and other tobacco products tax evasion estimate using data gathered after implementation of the Cigarette and Tobacco Products Licensing Act, as recommended in the Bureau of State Audits report titled "Board of Equalization: Its Implementation of the Cigarette and Tobacco Products Licensing Act of 2003 Has Helped Stem the Decline in Cigarette Tax Revenues, but It Should Update Its Estimate of Cigarette Tax Evasion." It is anticipated that the updated evasion estimate will be completed by June 29, 2007.

8. **This bill could complicate a retailer's records and reporting.** Retailers already must collect and remit sales and use tax on the retail sale of cigarettes and cigars in California. Cigarette and cigar retailers most likely sell other tangible personal property subject to sales and use tax. Adding an additional fee that would be due on the sale of cigarettes and cigars would require retailers to keep track of such sales separately from other sales of tangible personal property.

   Additionally, smaller retailers may find collecting the fee burdensome. Larger retailers would have the ability to program the amount of the fee for each product into its computer system. Therefore, the fee would be automatically added to the purchase price once the product code or UPC is entered at the register. Cashiers at smaller retail stores, which are typically not computerized, would have to manually charge the fee. As such, the fee would be collected based on cashier judgment,

which would likely lead to reporting errors. Furthermore, retailers would be required to determine the number of cigarettes contained in roll-your-own or pipe fill tobacco based on the bill's definition of cigarette, which provides, in part, that 0.09 ounces of "roll-your-own" or "pipe-fill" tobacco constitutes one individual cigarette.

9. **The proposed fee would not be subject to sales and use tax.** The proposed tobacco smoke emissions fee is imposed on the consumer, rather than the retailer. Since the fee is imposed on the consumer, it is not considered part of gross receipts received by the retailer, and therefore, is not subject to the sales and use tax. Any amounts the retailer may charge above the proposed fee amount would be considered part of the retailer's gross receipts, and would be subject to sales and use tax.

   As such, it is not necessary to amend the Sales and Use Tax Law to specifically exclude the proposed fee from the definition of gross receipts or sales price. Therefore, the bill should be amended to remove the proposed changes to the Sales and Use Tax Law and to require the retailer to separately state the fee on the invoices or other form of billing.

COST ESTIMATE

The Board would incur non-absorbable costs to adequately develop and administer a new fee program. These costs would include registering fee payers, developing computer programs (IRIS), mailing and processing returns and payments, carrying out compliance and audit efforts to ensure proper reporting, developing regulations, training staff, answering inquiries from the public and investigative efforts. A cost estimate of this workload is pending; however, it is estimated these costs would be major (over $1 million).

REVENUE ESTIMATE

This measure does not specify the amount of the tobacco products fee. Accordingly, a revenue estimate could not be prepared.

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