STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

DRAFT

Date Amended:	**05/08/08**	Bill No:	**SCA 13**
Tax:	**Cigarette Tax**	Author:	**Torlakson**
Related Bills:			

BILL SUMMARY

This bill proposes an amendment to the Constitution to impose an additional excise tax on cigarettes of one hundred five mills ($0.105) per cigarette, or $2.10 per package of 20, and impose an equivalent compensating floor stock tax.[1] The revenue from the tax increase would be deposited into the Tobacco Excise Tax Account and would be used, upon appropriation, for health- and child-related purposes.

Summary of Amendments

Since the previous analysis, this bill was amended to revise the disposition of the additional cigarette tax proceeds. These amendments do not impact the State Board of Equalization (Board).

ANALYSIS

CURRENT 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

[1] A floor stock tax is a one-time tax on all tax-paid (stamped) cigarettes and unaffixed tax stamps in the possession of distributors, wholesalers and/or retailers on the effective date of a cigarette tax increase. The floor stock tax rate is the difference between the old tax rate and the new tax rate.

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.

cigarettes. Currently, the surcharge rate for fiscal year 2007-08 is 45.13 percent and will remain unchanged for fiscal year 2008-09.

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.

PROPOSED LAW

This bill would add Section 37 to Article XIII to impose an additional tax of $2.10 per package of 20 cigarettes. The additional tax would be imposed beginning on the first day of the first calendar quarter commencing more than 90 days after the effective date of this measure.

The bill would also impose a compensating floor stock tax on the cigarette inventory of a dealer (retailer) and wholesaler, and affixed and unaffixed cigarette tax stamp inventory of a licensed distributor on the first day of the first calendar quarter commencing more than 90 days after the effective date of this measure.

The proceeds from the cigarette tax increase, less refunds, would be deposited into the Tobacco Excise Tax Account created in the General Fund, which would be used, upon appropriation, for children's health care, tobacco cessation services, general health care, children's services, autism spectrum disorder programs, universal dental care, and elementary and secondary school programs.

As a constitutional amendment, this bill would require approval by a majority of the California voters to take effect. If approved by both houses of the Legislature, this bill would be put on the next statewide ballot.

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 on the November 1998 ballot, effective January 1, 1999, imposed an additional surtax of 50 cents per package of 20 cigarettes. That measure also 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.

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.

A number of cigarette tax increase proposals have been considered in recent years, but not enacted, including the following:

Bill	Year	Author	Proposed Tax Increase
SB 24	2007	Torlakson	$1.90 per package of 20, and an equivalent compensating floor stock tax.
Proposition 86	2006	Coalition for a Healthy California	$2.60 per package of 20, and an equivalent cigarette and other tobacco products floor stock tax.
SB 564	2006	Torlakson	$1.00 per package of 20, and an equivalent compensating floor stock tax.
SB 689	2003	Ortiz	$0.01 per package of 20, and an equivalent compensating floor stock tax.
AB 1416	2003	Vargas	$1.50 per package of 20, and an equivalent compensating floor stock tax.
AB 35	2003	Vargas	$1.50 per package of 20, and an equivalent compensating floor stock tax.
SB 1890	2002	Ortiz	$0.65 per package of 20, an additional excise tax on tobacco products equivalent to the additional cigarette tax, and an equivalent compensating floor stock tax.
SB 1849	2002	Committee on Budget and Fiscal Review	$2.13 per package of 20, and an equivalent compensating floor stock tax.
AB 433	2002	Committee on Budget	$0.63 per package of 20, and imposed an equivalent compensating floor stock tax.
AB 428	2002	Committee on Budget	$0.50 per package of 20, and an equivalent compensating floor stock tax.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the author and is intended to provide committed funding, in part, for health-related purposes including smoking cessation programs.

2. **Summary of amendments.** The **July 25, 2007, and May 8, 2008, amendments** revised the disposition of the additional cigarette tax proceeds. These amendments do not impact the Board.

3. **This measure would not increase the tax on other tobacco products.** Section 30123(b) (Proposition 99) generally provides that the other tobacco products tax rate, which is required to be determined annually by the Board, must be equivalent to the combined rate of all taxes imposed on cigarettes under the Cigarette and Tobacco Products Tax Law. As such, a tax increase on other tobacco products is automatically triggered whenever the tax imposed on cigarettes is increased under that law.

   However, this bill proposes an additional cigarette tax to be imposed by adding Section 37 to Article XIII to the State Constitution. Since the proposed additional tax would not be imposed under the Cigarette and Tobacco Products Tax Law, this measure would not trigger an automatic increase in the tobacco products tax rate.

4. **Suggested amendments.** This bill provides that the proposed additional cigarette tax be administered and collected in accordance with the existing Cigarette and Tobacco Products Tax Law. The tax proposed by this bill cannot simply be collected in a manner consistent with the Cigarette and Tobacco Products Tax Law without adding conforming and necessary code section references to the existing law. For example, Sections 30104 and 30108, which both reference the cigarette and tobacco tax imposed by Sections 30101, 30123, and 30131.2 would need to be amended to also reference the proposed additional tax.

   Furthermore, this measure would impose a floor stock tax on the cigarette inventory of a dealer (retailer) and wholesaler, and affixed and unaffixed cigarette tax stamp inventory of a licensed distributor. Although the bill specifies a due date for every dealer, wholesaler and distributor to file a return, it does not specify a due date for the remittance of the floor stock tax. As such, this bill should be amended to incorporate language as follows:

   > The taxes required to be paid by subdivisions (b) and (c) are due and payable on or before the first day of the first calendar quarter commencing 180 days after the effective date of this section. Payments shall be made by remittances payable to the state board and the payments shall accompany the forms required to be filed by subdivisions (b) and (c).

   And lastly, the bill should also include language addressing the application of interest and penalties to floor stock tax payments not timely paid:

   > Any amount required to be paid by this section that is not timely paid shall bear interest at the rate and by the method established pursuant to Section 30202 of the Revenue and Taxation Code from the first day of the first calendar quarter commencing 180 days after the effective date of this section, until paid, and shall be subject to determination, and redetermination, and any penalties provided under Part 13 (commencing with Section 30001) of Division 2 of the Revenue and Taxation Code with respect to determination and redeterminations.

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

5. **Administrative start-up and on-going cost funding for the Board.** The additional excise tax on cigarettes would begin on the first day of the first calendar quarter commencing more than 90 days after the effective date of this measure. If this measure appears on the November 4, 2008, General Election ballot and approved by voters, its provisions would become operative April 1, 2009. In order to properly administer a floor stock tax, notify cigarette distributors, wholesalers and retailers of the additional tax, develop computer programs, reporting forms, and hire appropriate staff, an appropriation is required to cover the Board's administrative start-up costs that are not already identified in the Board's 2008-09 budget.

   This bill should also be amended to authorize reimbursement for the Board's ongoing costs of administration.

5. **Floor stock tax provisions.** This measure contains language to impose a floor stock tax on the cigarette inventory of a dealer (retailer) and wholesaler, and affixed and unaffixed cigarette tax stamp inventory of a licensed distributor, on the first day of the first calendar quarter commencing more than 90 days after the effective date of this measure. A floor stock tax is a one-time tax on all tax-paid (stamped) cigarettes and unaffixed tax stamps in the possession of distributors, wholesalers and/or retailers on the effective date of a tax increase. The floor stock tax rate is the difference between the old tax rate and the new tax rate. Generally, a floor stock tax is imposed to equalize the excise tax paid by cigarette dealers (retailers), wholesalers, or distributors on their inventory and those cigarettes and other tobacco products 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 purchased before the increase, but sold after, can be raised and attributed to the rate increase. These additional funds would represent a windfall profit rather than excise taxes paid to the state. A floor stock tax mitigates this windfall profit.

   While the Board would incur additional costs that would need to be reimbursed for administering the floor stock tax, these costs would be more than offset by the proceeds from the tax.

6. **Cigarette and tobacco product tax evasion.** Tax evasion is one of the major areas that can reduce state revenues generated from cigarettes and other tobacco products taxes. Board staff recently estimated cigarette tax evasion in California at approximately $182 million, and tobacco products tax evasion at approximately $94 million, annually. That estimate was only for evasion of cigarette and tobacco products taxes, and did not include associated evasion of other taxes, such as sales and use or income 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 increase the cigarette tax substantially, which would result in an increase in the retail price, to the extent that the tax increase is passed along to consumers. Based on previous experiences related to Proposition 10 and the tobacco settlement, along with research of experiences in other states, Board staff believes the proposed cigarette tax increase and resulting increase in the other tobacco products tax could result in both a decrease in actual consumption and an increase in cigarette and other tobacco products tax evasion. The exact magnitude of these responses is uncertain since the proposed excise tax increases are significantly greater than previously experienced.

7. **Increase in 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 and other tobacco products is not specifically exempted or excluded, the excise tax is included in the total amount of the sale and subject to sales or use tax.

   This measure would increase the excise tax on cigarettes and result in another tobacco products tax rate increase, which may be passed on to the ultimate consumer through an increase in the retail-selling price of cigarettes and other tobacco products. Any increase in the amount of the retail-selling price of cigarettes as a result of this measure would be included in the amount on which sales or use tax is computed.

8. **Backfill of existing cigarette tax funds.** Under existing law, Health and Safety Code Section 130105 (added by Proposition 10) requires the Board to determine the revenue reductions to any Proposition 99 state health-related education and research programs and the Breast Cancer Fund that are a direct result of the additional taxes imposed by Proposition 10's additional taxes, and annually backfill these amounts from the tax revenues received from Proposition 10.

   This measure would not backfill the Cigarette and Tobacco Products Surtax Fund (Proposition 99), California Children and Families Trust Fund (Proposition 10), General Fund, or Breast Cancer Fund.

9. **Distributor discount.** Under existing law, Section 30166 of the Revenue and Taxation Code provides that stamps and meter impression settings shall be sold at their denominated values less 0.85 percent to licensed distributors. The discount is intended to help defray the cost (leasing of equipment/labor cost) to the distributor for affixing the stamps.

   Currently, distributors receive a discount of $221.85 per roll of 30,000 cigarette tax stamps [(30,000 stamps x $0.87 tax per package of cigarettes) x 0.85 percent discount = $221.85 discount]. By increasing the excise tax on a package of 20

cigarettes to $2.10, this measure would increase the distributor's discount to $757.35 per roll [(30,000 stamps x $2.97 tax per package of cigarettes) x 0.85 percent discount = $757.35 discount].

COST ESTIMATE

A detailed cost estimate is pending. However, the Board would likely incur substantial costs related to the administration and collection of the additional cigarette and tobacco products tax proposed by this measure. These costs would be related to notifying taxpayers, developing returns, programming computers, developing and carrying out compliance and audit efforts to ensure proper reporting, and administering a floor stock tax.

The proposed tax increase would require enhanced efforts to ensure that the floor stock tax is properly reported and collected, greater compliance efforts for additional billings and delinquencies, and increased investigative staff presence due to increased tax evasion.

REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

Tax-paid cigarette distributions were about 1,158 million packs in fiscal year 2006-07. Over the past twenty years tax paid distributions have averaged a decline of about 3 percent per year. We believe this is a reasonable estimate of the underlying trend for future years, so we project a 3 percent decline for 2007-08 and future years. If this measure is placed on the November 2008 ballot, the new rate would take effect April 1, 2009.

Based on previous tax increases and research of experiences in other states, we believe an increase in the tax rate as large as the one proposed by this bill is likely to cause both a decrease in actual consumption and an increase in tax evasion. Although the exact magnitude of the split between evasion and consumption is uncertain, we estimate that this bill would cause a decrease of 22 percent in tax paid distributions. This estimate uses a price elasticity of demand of -0.60 calculated by the arc price elasticity formula, applied to an average 2006 price of approximately $4.05 per pack.[2]

There is a corresponding floor stock tax, imposed on inventories on April 1, 2009. We assume a three weeks supply of cigarettes would be subject to the floor stock tax, based on a combination of expected sales rates before and after the tax takes effect.

Sales and Use Tax Impacts

We expect that all of the cigarette tax increase is passed on to consumers. We added sales taxes on the excise tax increases and subtracted sales taxes resulting from projected declines in sales to determine net sales tax gains. Sales taxes are calculated assuming the average 2006 retail price.

[2] The general price elasticity of demand formula is: $e_p = (Q_1 - Q_2) / ((Q_1 + Q_2)/2) / (P_1 - P_2) / ((P_1 + P_2)/2)$, where P = price, and Q = sales.

REVENUE SUMMARY

The revenue impacts of this bill are shown in the table below. The first entire year the provisions of the bill are in effect would be fiscal year 2009-10. For fiscal year 2009-10 the Tobacco Excise Tax Account would receive $1,760.8 million from cigarette sales. However, the other cigarette excise funds would lose a combined total of $184.4 million, resulting in a net gain of $1,576.4 million in all cigarette excise taxes. These revenues are likely to decline about 3 percent per year in fiscal years following 2009-10 as the long term decline in cigarette smoking continues. Floor stock revenues are $121.1 million, but these are not received in future fiscal years. State and local sales and use taxes revenues are $64.7 million per year, and would decline in future years as tax paid distributions decline.

SCA 13 Revenue Impacts Summary	
	Fiscal Year 2009-10 ($ Millions)
Cigarette Excise Tax Revenues by Fund	
General Fund	$1,760.8
Breast Cancer	-$4.8
Proposition 99	-$59.8
Proposition 10	-$119.8
Total Cigarette Excise Tax Revenues	$1,576.4
Floor Stocks Tax	$121.1
State Sales and Use Tax (at 5.25%)	$42.8
General Fund (5.00%)	$40.8
Fiscal Recovery Fund (0.25%)	$2.0
Local Sales & Use Tax (at 2.0%)	$16.3
Transit Tax (at 0.70%)	$5.7
Total	*$1,762.3*
Total (Excluding Floor Stock Revenues)	*$1,641.2*

Analysis prepared by:	Cindy Wilson	(916) 445-6036	05/21/08
Revenue estimate by:	Joe Fitz	(916) 323-3802	
Contact:	Margaret S. Shedd	(916) 322-2376	

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.