



STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE ENROLLED BILL ANALYSIS

Date Introduced:	02/22/05	Bill No:	AB 1029
Tax:	Cigarette and Tobacco Products	Author:	J. Horton
Related Bills:			

BILL SUMMARY

This bill would revise the conditions under which a person may engage in a non-face-to-face sale of cigarettes to a person in California.

ANALYSIS

Current Law

CIGARETTE AND TOBACCO PRODUCTS TAX LAW

Under current law, Section 30101 of the Cigarette and Tobacco Products Tax Law imposes an excise tax of 6 mills (or 12 cents per package of 20) on each cigarette distributed. In addition, Section 30123 and 30131.2 impose a surtax of 12 ½ mills (25 cents per package of 20) and 25 mills (50 cents per package of 20), respectively, on each cigarette distributed. The current total tax on cigarettes is 43 ½ mills per cigarette (87 cents per package of 20).

Sections 30123 and 30131.2 also impose a surcharge on tobacco products at a rate to be annually determined by the Board. The tobacco products tax rate is equivalent to the combined rate of tax on cigarettes. The surcharge rate for fiscal year 2004-05 is 46.76 percent.

Section 30101.7 provides, in part, that no person may engage in a retail sale of cigarettes in California *unless* the sale is a vendor-assisted, face-to-face sale.

A “face-to-face sale” is defined to mean a sale in which the purchaser is in the physical presence of the seller or the seller’s employee or agent at the time of the sale. A face-to-face sale does not include any transaction conducted by mail order, the Internet, telephone, or any other anonymous transaction method in which the buyer is not in the seller’s physical presence. However, this does not prohibit any lawful sale of a tobacco product that occurs by means of a vending machine.

Persons may engage in a non-face-to-face sale of cigarettes to a person in California provided that the seller complies with both of the following conditions:

- The seller has fully complied with all of the requirements of Chapter 10A (commencing with Section 375) of Title 15 of the United States Code, otherwise known as the Jenkins Act.
- The seller has fully complied with either of the following requirements:

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- (1) All applicable California taxes on the cigarettes have been paid.
- (2) The seller includes on the outside of the shipping container for any cigarettes shipped to a resident in California from any source in the United States an externally visible and easily legible notice located on the same side of the shipping container as the address to which the package is delivered stating as follows:

"IF THESE CIGARETTES HAVE BEEN SHIPPED TO YOU FROM A SELLER LOCATED OUTSIDE OF THE STATE IN WHICH YOU RESIDE, THE SELLER HAS REPORTED PURSUANT TO FEDERAL LAW THE SALE OF THESE CIGARETTES TO YOUR STATE TAX COLLECTION AGENCY, INCLUDING YOUR NAME AND ADDRESS. YOU ARE LEGALLY RESPONSIBLE FOR ALL APPLICABLE UNPAID STATE TAXES ON THESE CIGARETTES."

The Board is required to provide information relative to a seller's failure or attempt to comply with the Jenkins Act to the Attorney General. The Attorney General is required to provide an annual report to the Legislature regarding all actions taken to comply with, and enforce, the Jenkins Act.

The Attorney General or a city attorney, county counsel, or district attorney may bring a civil action to enforce the provisions of Section 30101.7 against any person that violates that section. In addition to any other remedies provided by law, the court is required to assess a civil penalty in accordance with the following schedule:

- (1) A civil penalty of not less than one thousand dollars (\$1,000) and not more than two thousand dollars (\$2,000) for the first violation.
- (2) A civil penalty of not less than two thousand five hundred dollars (\$2,500) and not more than three thousand five hundred dollars (\$3,500) for the second violation within a five-year period.
- (3) A civil penalty of not less than four thousand dollars (\$4,000) and not more than five thousand dollars (\$5,000) for the third violation within a five-year period.
- (4) A civil penalty of not less than five thousand five hundred dollars (\$5,500) and not more than six thousand five hundred dollars (\$6,500) for a fourth violation within a five-year period.
- (5) A civil penalty of ten thousand dollars (\$10,000) for a fifth or subsequent violation within a five-year period.

SALES AND USE TAX LAW

Current law imposes a sales or use tax on the sale or purchase of tangible personal property in this state (including cigarettes and tobacco products). When a person sells cigarettes or tobacco products at retail in this state, the sales tax applies. The seller is responsible for this tax and must pay it to the state. When the sales tax does not apply, the use tax does. For example, when a person buys cigarettes from a point outside this state for the use or consumption in this state, the use tax is the applicable tax. If the out-of-state seller has nexus within the state, the seller is required to collect the use tax from the purchaser at the time of sale. If the seller does not collect the use tax, or if the

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seller does not have nexus in this state, the purchaser is required to pay the use tax directly to the Board.

CIGARETTE AND TOBACCO PRODUCTS LICENSING ACT OF 2003

Division 8.6 of the Business and Professions Code established the Cigarette and Tobacco Products Licensing Act of 2003 (Act). The Act established 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, the Act requires a retailer to have in place and maintain a license to engage in the sale of cigarettes or tobacco products (B&PC §§22972 – 22974.8). Among other responsibilities, a retailer must: conspicuously display their license at each retail location, keep complete and legible purchase invoices for cigarettes and tobacco products for four years, maintain cigarette and tobacco products invoices at each licensed location for at least one year after the date of purchase, and allow Board staff or law enforcement officers to review cigarette and tobacco products purchase invoices upon request.

The Act also imposes specified prohibitions and penalties in Sections 22980.1 through 22982. Among other prohibitions, the Act provides that a person engaging in the business of selling cigarettes or tobacco products in this state without a license or after a license is suspended or revoked is guilty of a misdemeanor punishable by a fine not to exceed five thousand dollars (\$5,000), or imprisonment not exceeding one year in a county jail, or both. 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.

FEDERAL JENKINS ACT

Chapter 10A of Title 15 of the United States Code (also known as the Jenkins Act) provides that any person that sells or transfers cigarettes for profit in interstate commerce, whereby such cigarettes are shipped into a State taxing the sale or use of cigarettes, to other than a distributor licensed by or located in such State, to file by the 10th of each calendar month a memorandum or a copy of the invoice for each and every shipment of cigarettes made during the previous calendar month in that state. This information is required to show the name and address of the person to whom the shipment was made, the brand, and quantity of the shipment. Any person who violates these provisions shall be guilty of a misdemeanor and shall be subject to a fine of not more than \$1,000, imprisoned not more than 6 months, or both.

Proposed Law

This bill would amend Section 30101.7 of the Revenue and Taxation Code to provide that a person may engage in a non-face-to-face sale of cigarettes to a person in California provided that **all** of the following conditions are met:

- The seller has fully complied with all of the requirements of the Jenkins Act.

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- The seller has fully complied with all of the requirements imposed by Sections 22972 to 22974.8, inclusive, of the Business and Professions Code and imposed by Sections 22980.1 to 22982, inclusive of the Business and Professions Code.
- The seller has collected and remitted to the Board all applicable California taxes imposed on cigarettes, or, if applicable, has provided verification and evidence that the applicable taxes have already been paid.
- The seller has verified that the manufacturer of the cigarettes is in full compliance with paragraph (2) of subdivision (a) of Section 104557 of the Health and Safety Code.
- The seller includes on the outside of the shipping container for any cigarettes shipped to a resident in California from any source in the United States an externally visible and easily legible notice located on the same side of the shipping container as the address to which the package is delivered stating as follows:

"IF THESE CIGARETTES HAVE BEEN SHIPPED TO YOU FROM A SELLER LOCATED OUTSIDE OF THE STATE IN WHICH YOU RESIDE, THE SELLER HAS REPORTED PURSUANT TO FEDERAL LAW THE SALE OF THESE CIGARETTES TO YOUR STATE TAX COLLECTION AGENCY, INCLUDING YOUR NAME AND ADDRESS. YOU ARE LEGALLY RESPONSIBLE FOR ALL APPLICABLE UNPAID STATE TAXES ON THESE CIGARETTES."

This bill would also require the Board to provide information to the Attorney General relative to a seller's failure or attempt to comply with all of the conditions required to be met to engage in a non-face-to-face sale of cigarettes. The Attorney General would be required to provide an annual report to the Legislature regarding all actions taken to comply with, and enforce, non-face-to-face sales of cigarettes.

In addition to the civil actions and penalties authorized under existing law, the Attorney General or a city attorney, county counsel, or district attorney would be authorized to bring a civil action against any person that fails to pay any tax that applies to a face-to-face sale of cigarettes in this state and, in addition to any other remedies provided by law, the court would be required to assess a civil penalty in an amount equal to 500 percent of the unpaid taxes that are owed by that person.

The bill would become operative January 1, 2006.

In General

Because of the state excise tax imposed on cigarettes and the sales tax due on such sales, many consumers have turned to the Internet as a way of obtaining cigarettes from out-of-state sellers who do not charge the California taxes. In May 1999, the Board began a program to promote Jenkins Act compliance by out-of-state cigarette distributors. At the inception of the program, out-of-state sellers were reporting as many as 80,000 cartons in a single quarter. However, the number of cartons of cigarettes reported pursuant to the federal Jenkins Act significantly decreased beginning in 2001 due to the lack of enforcement at the federal level.

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With respect to the number of cartons of cigarettes that are not being reported, the Board recently estimated cigarette excise tax revenues for out-of-state cigarette purchases to be \$53.9 million per year. However, that figure includes out-of-state purchases from all untaxed out-of-state sources, including the Internet, mail order, and cross border sales. The Jenkins Act only applies to Internet and mail order sales, which staff estimates to be 40 percent of the total amount of out-of-state sales. Therefore, it is estimated that approximately \$21,560,000 ($\$53,900,000 \times .40 = \$21,560,000$) in excise tax or 2,478,161 ($\$21,560,000 / \$8.70 \text{ excise tax per carton} = 2,478,161$) cartons of cigarettes, are not being reported to the Board on an annual basis.

Background

Senate Bill 1766 (Ch. 686, Stats. 2002, Ortiz) added Section 30101.7 to the Cigarette and Tobacco Products Tax Law to require, in part, that every retail sale of cigarettes in California be a vendor-assisted, face-to-face sale, unless all applicable taxes due on the sale are paid or the seller includes a prominent notice on the package indicating that the purchaser is responsible for any applicable California taxes on the cigarettes.

On April 1, 2003, Attorney General Bill Lockyer filed lawsuits to enforce, in part, the provisions of SB 1766. Specifically, the lawsuits were filed against five out-of-state tobacco retailers for selling cigarettes to minors via the Internet, failing to report tobacco sales to California tax authorities, and depriving the state of excise taxes. The complaints allege that the defendants have violated California laws that govern payment of excise taxes on Internet cigarette sales, and federal statutes that require out-of-state sellers to report such sales to California tax agencies. Additionally, the lawsuits allege the defendants have wrongfully denied the state revenue. The defendants' failure to notify consumers of their obligation to pay taxes constitutes deceptive advertising, according to the complaints.

In 2002, Senate Bill 2082 (Bowen) would have required any person who advertises on the Internet to sell cigarettes in California, and who is subject to the provisions of the Jenkins Act, to conspicuously disclose that a purchaser who buys cigarettes shipped into California is responsible for paying the state excise tax and the state use tax and to show in the advertisement the amount of these taxes that would be due. This bill would have also required the person selling or transferring the cigarettes to provide to the Board a copy of the invoice for each shipment made into California. That bill failed to pass out of the Assembly Revenue and Taxation Committee.

In 2003, Senate Bill 1016 (Ch. 603, Bowen) added compliance with the Jenkins Act as a condition to allow a person to engage in a non-face-to-face sale of cigarettes to a person in California. That bill also requires the Board to provide information relative to a seller's failure or attempt to comply with the Jenkins Act to the Attorney General.

* The number was not adjusted for cartons of cigarettes reported to the Board since that volume is deemed to be relatively insignificant to the estimated \$53.9 million per year in out-of-state purchases of cigarettes.

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COMMENTS

1. **Sponsor and Purpose.** This bill is sponsored by the author to facilitate the collection of taxes on cigarettes sold to residents of California over the Internet or by mail order.
2. **Is this measure enforceable?** Various Supreme Court cases have focused on states' ability to impose the use tax on out-of-state firms making sales to in-state customers. In 1967 the Supreme Court ruled in *National Bellas Hess, Inc. v. Illinois Department of Revenue*, 386 U.S. 753 (1967), that a firm that has no link to a state except mailing catalogs to state residents and filling their orders by mail cannot be subject to that state's sales or use tax. The Court ruled that these mail order firms lacked substantial physical presence, or nexus, required by the Due Process Clause and the Commerce Clause of the United States Constitution.

In the 1977 case of *Complete Auto Transit, Inc. v. Brady* (1977) 430 U.S. 274 {51 L.Ed.2d 326, 97 S.Ct. 1076} the Court articulated that, in order to survive a Commerce Clause challenge, a tax must satisfy a four part test: 1) it must be applied to an activity with a substantial nexus with the taxing State, 2) it must be fairly apportioned, 3) it does not discriminate against interstate commerce, and 4) it must be fairly related to the services provided by the State.

North Dakota enacted anti-National Bellas Hess legislation with the expressed purpose of creating nexus with mail order firms selling to consumers in the state, in an attempt to compel out-of-state retailers to collect the use tax on mail order sales and test the continuing validity of the National Bellas Hess decision. The statute was challenged, and in 1992 the Supreme Court issued a ruling in *Quill Corporation v. North Dakota* (1992) 504 U.S. 298. The Court in *Quill* applied the Complete Auto Transit analysis and held that satisfying due process concerns does not require a physical presence, but rather requires only minimum contact with the taxing state. Thus when a mail-order business purposefully directs its activities at residents of the taxing state, the Due Process Clause does not prohibit a state from requiring the retailer to collect the state's use tax. However, the Court held further that physical presence in the state was required for a business to have a "substantial nexus" with the taxing state for purposes of the Commerce Clause. The Court therefore affirmed that in order to survive a Commerce Clause challenge, a retailer must have a physical presence in the taxing state before that state can require the retailer to collect its use tax.

Based on the above cases, it is questionable whether the state could require an out-of-state seller of cigarettes, who has no physical presence in California, to be licensed pursuant to the Act, and to remit the applicable California cigarette tax and use tax in order to engage in a non-face-to-face sale of cigarettes to a person in California.

3. **The Jenkins Act.** The Jenkins Act requires any person that sells or transfers cigarettes for profit in interstate commerce and ships the cigarettes into a state that imposes a tax on cigarettes to file by the 10th of each calendar month a copy of the invoice for each and every shipment of cigarettes made during the previous calendar month in that state. Many consumers who shop on the Internet may not be aware of

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these provisions and think they are successfully avoiding the tax by purchasing cigarettes from out-of-state sellers over the Internet. The Board utilizes the information required to be provided by the Jenkins Act to bill consumers for the taxes due. Unfortunately, some cigarette retailers do not comply with the provisions of the Jenkins Act. Since the Jenkins Act is a federal statute, the Board requires the assistance of federal law enforcement agencies to enforce the provisions of the Jenkins Act. Also, the provisions of the Jenkins Act apply only to the sale of cigarettes, not tobacco products.

4. **Internet purchases.** As efforts increase in this state to stop the illegal sale of cigarettes to minors, they may find it more difficult to purchase cigarettes from traditional locations such as liquor stores and gas station mini-marts. This may lead to minors turning to the Internet as a means of acquiring cigarettes since the retailer is not likely to verify the age of the purchaser. This can lead to additional tax avoidance since the Internet retailer is unlikely to collect the California taxes due and the minor purchasing cigarettes is unlikely to self-report the California taxes due.
5. **This measure would not apply to tobacco products.** Under existing law and as proposed by this measure, sales of tobacco products are not required to be a vendor-assisted, fact-to-face sale. As such, the conditions that must be met by sellers of cigarettes to engage in non-face-to-face sales of cigarettes do not apply to sellers of tobacco products. Tobacco products are defined to include, but not be limited to, all forms of cigars, smoking tobacco, chewing tobacco, snuff, and any other articles or products made of, or containing at least 50 percent, tobacco, but does not include cigarettes.

Board staff has recently estimated evasion for tobacco products. Board staff believes that tobacco products excise tax evasion is equal to annual tobacco products revenues of approximately \$50 million per year. This figure does not include associated evasion of the use tax. Although the Legislative intent in enacting Section 30101.7 was to facilitate the collection of all applicable state taxes on cigarettes sold to residents in the state, consideration should be given to expanding Section 30101.7 to also facilitate the collection of the tobacco products tax and related use tax.

COST ESTIMATE

Any costs associated with the provisions of this bill are dependent upon whether the Attorney General or a city attorney, county counsel, or district attorney brings a civil action to enforce this measure. As a result of such action, records of the person in violation may be provided to the Board. The Board in turn would audit those records and bill the appropriate in-state consumer for the applicable cigarette tax and related use tax.

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Accordingly, the Board would incur non-absorbable costs for each action brought upon a person in violation of this measure. These costs would include conducting audits, mailing and processing returns and payments, carrying out compliance efforts to ensure proper reporting, and answering inquiries from the public. A detailed cost estimate is pending.

REVENUE ESTIMATE

The provisions of this bill may have a positive impact on the state excise tax collected on sales of cigarettes and also on use tax collected on cigarettes purchased from out-of-state retailers. However, the Board has no way of measuring the potential impact these provisions may have, and therefore, cannot provide an estimate at this time.

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