



STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Amended	09/08/03	Bill No:	AB 1239
Tax:	Cigarette Fee	Author:	Wiggins
Board Position:		Related Bills:	SB 676 (Ortiz)

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

BILL SUMMARY

This bill would impose, on or after July 1, 2004, a cigarette fee, as specified, on each nonparticipating manufacturer currently manufacturing tobacco products, or who has previously manufactured tobacco products, or both, that have contributed or currently contribute, or both, to tobacco-related health impacts.

A nonparticipating manufacturer would be defined to mean a tobacco product manufacturer that did not sign the Master Settlement Agreement (MSA) and related documents entered into on November 23, 1998, by the state and leading United States tobacco product manufacturers.

Summary of Amendments

Previous versions of this bill did not impact the Board.

ANALYSIS

Current 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, Sections 30123 and 30131.2 impose a surtax of 12 1/2 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 1/2 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. Currently, the surcharge rate for fiscal year 2003-04 is 46.76 percent.

Proposed Law

This bill would add Part 13.5 (commencing with Section 30500) to Division 2 of the Revenue and Taxation Code to impose, on or after July 1, 2004, a tobacco products fee upon each nonparticipating manufacturer currently manufacturing tobacco products, or who has previously manufactured tobacco products, or both, that has contributed or currently contribute, or both, to tobacco-related health impacts. On or before July 1, 2004, the Department of Health Services (DHS) would be required to set the fee for each nonparticipating manufacturer at the rate of twenty-five mills (\$0.025) for each cigarette sold, based on 2002-03 fiscal years sales, by that nonparticipating manufacturer.

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.

On or before July 1, 2005, for the 2004-05 fiscal year, and every fiscal year thereafter, the DHS would be required to determine a fee rate to be assessed on a nonparticipating manufacturer that it estimates will produce sufficient revenue to fund that manufacturer's proportionate share of the current year's costs for the creation, expansion, and administration of smoking cessation programs based on the following factors:

- The total annual cost to the state and local governments to fund the creation, expansion, and administration of smoking cessation programs.
- The nonparticipating manufacturer's share of the California tobacco products market as determined by the department.
- The costs incurred by the Board in administering the fee.

The Board would administer and annually collect the fee imposed in accordance with the Fee Collection Procedures Law, which contains "generic" administrative provisions for the administration and collection of fee programs to be administered by the Board. The Board would assess the fee imposed commencing July 1, 2004, and annually thereafter. The fees would be deposited in the Nonparticipating Tobacco Manufacturer Mitigation Trust Fund, which this bill would create in the State Treasury. The moneys the fund would, upon appropriation by the Legislature, be expended to reimburse the Board for the costs incurred in administering the cigarette fee and the DHS to address the tobacco-related health impacts, including the creation, expansion, and administration of smoking cessation programs.

This bill would require the Board to issue a certificate to each nonparticipating manufacturer upon payment of the cigarette fee. The manufacturer would be required to present that certificate to the distributor to prove payment of the fee prior to that distributor receiving stamps on its packages of cigarettes. This bill would prohibit a distributor from affixing a stamp to a package of cigarettes of a nonparticipating manufacturer without a manufacturer's certificate.

This bill would define "tobacco product" to mean cigarettes. "Manufacturer" or "nonparticipating manufacturer" would be defined to mean a tobacco product manufacturer that did not sign the MSA and related documents entered into on November 23, 1998, by the state and leading United States tobacco product manufacturers.

This bill would become effective January 1, 2005.

Background

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.

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.

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. In order to safeguard themselves against unfair competition from tobacco products manufacturers who do not participate in the MSA, the MSA contains provisions which would reduce the payments made to states that do not enact a “Model Statute” to require nonparticipating manufacturers to put funds into escrow accounts. The money in the escrow accounts is intended to be available to pay judgments or settlements on any claims brought by the state against any nonparticipating tobacco manufacturers.

In 1999, California enacted a "Model Statute" pursuant to Senate Bill 822 (Escutia, Chapter 780). That bill, among other things, required any tobacco product manufacturer selling cigarettes in California to either:

- Become a participating manufacturer as defined in the MSA and meet the financial obligations of the participants, or
- Place into escrow with the state specified amounts per units sold.

In 2003, Assembly Bill 71 (J. Horton, Chapter 890) enacted Complementary Legislation to make state enforcement of the Model Statute more effective and thereby promote the purpose for which the Model Statute was enacted. In general, the Complementary Legislation prohibits a person from affixing any tax stamp to a package of cigarettes, or pay 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 a compliance list posted by the Attorney General.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the author and is intended to hold manufacturers of tobacco products financially liable for the adverse health effects of their products.
2. **The Board could not administer a new fee program prior to July 1, 2005, without risk to its Revenue Database Consolidation (RDC) Project.** Since April 2004 and running through the remainder of the 2004 calendar year, the Board is implementing the RDC project. The RDC project involves extensive changes to the Integrated Revenue Information System (IRIS), the Board’s primary tax administration system. The RDC project implementation and stabilization efforts will occupy significant Board staff resources for the rest of 2004.

In addition, the Board is currently in the process of developing, testing and implementing technology changes related to new legislatively mandated programs* enacted in 2002 and 2003. This effort has been included in the multi-year, multi-phase RDC project and will be on-going through the end of 2004.

* SB 1049 (Water Rights Fee), AB 71 (Cigarette and Tobacco Products Licensing Act), and SB 1701 (Alternative Cigarette and Tobacco Stamps)

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.

Mandating the Board to collect any new fee prior to July 1, 2005 would require programming to the Board's computer system at the end of 2004, which is during the final states of the RDC project. Making any modifications at the end of the system development would put the Board's RDC project, including the programming for the new legislatively mandated programs, at substantial risk. It is therefore suggested that the bill be amended to require the department to set the initial fee amount **on or before July 1, 2005** with an annual due date on or before **October 1**.

3. **This bill should contain a specific appropriation to the Board.** This bill proposes a fee to be assessed on or before July 1, 2004, although that date will likely be changed. If the bill is amended to impose the fee any earlier than January 1, 2006, an appropriation would be required since the Board would need to develop computer programs, reporting forms, and hire appropriate staff during the 2004-05 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 2004-05 budget.

4. **The Board would require full funding to administer the proposed cigarette fee.** In funding state agencies, the Administration and the Legislature have not provided budget dollars to support the actual agency payroll costs (for example, workers compensation costs, merit salary adjustments, and collective bargaining requirements are not fully funded in the annual budget process). The Administration and the Legislature expect state agencies to keep positions vacant or delay hiring staff in order to save dollars to meet these unfunded payroll costs.

To be able to promptly hire staff or to recruit from outside the Board's operations, the bill should be amended to provide funding to fully support the Board's actual costs of a position.

5. **Nonparticipating manufacturers.** This bill would require each nonparticipating manufacturer, as specified, to pay a fee as provided. A nonparticipating manufacturer would be defined to mean a tobacco product manufacturer that has not signed the MSA and related documents entered into on November 23, 1998, by the state and leading United States tobacco product manufacturers. As such, the fee proposed under this measure would not apply to any tobacco product manufacturer that originally or subsequently signed the MSA.

6. **Suggested technical amendments.** The following technical amendments are suggested to clarify the intent of the measure:

- It appears that it is the author's intent for the term "tobacco product" to mean a "cigarette" as defined pursuant to the Model Statute. As such, the following language is suggested:

30500. (e) "Tobacco product" means ~~cigarettes~~ a cigarette as defined in subdivision (d) of Section 104556 of the Health and Safety Code .

- Currently, Section 30507(b) provides that "The **board** shall **assess** the fee imposed pursuant to Section 30505 commencing July 1, 2004, and annually on July 1 thereafter." However, it is not clear if July 1 is the due date for the fee or a date by which the Board is to send out determinations (billings) for the fee. If it is intended that July 1 is the due date, the following language is suggested:

30507. (b) ~~The board shall assess the fee imposed pursuant to this part Section 30505 commencing~~ shall be due and payable July 1, 2004, and annually on July 1 thereafter.

- It is recommended that the bill be amended to authorize the payment of refunds on overpayments of the fee.

30513. There is hereby created the Nonparticipating Tobacco Manufacturer Mitigation Trust Fund in the State Treasury. Moneys in the fund shall, upon appropriation by the Legislature, be expended for the purpose of refunds of the fee imposed pursuant to this part, and for the following purposes:

(a) To reimburse the board for the costs it incurs in administering and collecting the fee created pursuant to Section 30505.

(b) To the department to address the tobacco-related health impacts described in Section 104555 of the Health and Safety Code including the creation, expansion, and administration of smoking cessation programs.

- The bill should specify a date by which the DHS is required to notify the Board of the cigarette fee rate determined each fiscal year. Further, it is recommended that such date be at least 8 weeks prior to the due date for the fee in order to provide Board staff sufficient time to notify industry.
- Section 30505(b) requires the DHS to set the cigarette fee on or before July 1, 2004. However, the rate of the fee is already specified in that same section.

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

7. **Could the state require out-of-state nonparticipating manufacturers to remit the tobacco products fee?** 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 sufficient 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 a minimum contact with the taxing state.

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.

Thus when a mail-order business purposefully directs its activities at residents of the taxing state, the Due Process Clause does not prohibit the 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 nonparticipating manufacturer of tobacco products, who has no physical presence in California, to remit the fee. However, a distributor would be prohibited from affixing a cigarette tax stamp to a package of cigarettes of a nonparticipating manufacturer that did not remit the fee.

8. **Petitions for Redetermination and claims for refund.** It is suggested that this bill be amended to authorize the DHS to handle the petitions for redetermination and approve the claims for refund based upon the grounds that the DHS improperly or erroneously established the specific fees to be assessed or identified the wrong feepayer. It would be difficult for Board staff to resolve feepayer protests and claims based on actions of another state agency, and in doing so could result in a significant number of additional appeals conferences and Board hearings. Accordingly, the following language is suggested:

30507.5. No petition for redetermination of fees determined by the department pursuant to subdivision (b) or (c) Section 30505 shall be accepted or considered by the board if the petition is founded upon the grounds that the department has improperly or erroneously established or adjusted the amount of the fee pursuant to subdivision (b) or (c) of Section 30505 or has incorrectly determined that the person is subject to the fee. Any appeal of a determination based on the grounds that the amount of the fee was improperly or erroneously established or adjusted or that the person is not responsible for the fee shall be accepted by the board and forwarded to the department for consideration and decision.

(5) No claim for refund of fees paid pursuant to Section 30505 shall be accepted or considered by the board if the claim is founded upon the grounds that the department has improperly or erroneously established or adjusted the amount of the fee pursuant to subdivision (b) or (c) of Section 30505 or has incorrectly determined that the person is subject to the fee. Any claim for refund based on the grounds that the amount of the fee was improperly or erroneously established or adjusted or that the person is not responsible for the fee shall be accepted by the board and forwarded to the department for consideration and decision.

9. **Proof of fee payment.** The bill would require the Board to issue a certificate to a manufacturer upon collection of the cigarette fee. A distributor would be prohibited from affixing a cigarette tax stamp to a package of cigarettes of a nonparticipating manufacturer without this proof. This provision, however, may be burdensome to distributors and would make it difficult for Board Investigators to know whether or not a package of cigarettes is legitimately stamped.

To address these concerns, it is suggested that the bill be amended to prohibit the Attorney General from listing on its Web site directory a nonparticipating manufacturer that has not paid the fee. Pursuant to Revenue and Taxation Code Section 30165.1, the Attorney General is required to publish on its Internet Web site a directory listing of all tobacco product manufacturers that have provided current, timely, and accurate certifications conforming to specified requirements and all brand families that are listed in the certifications. A distributor is prohibited from affixing a cigarette tax stamp, or from paying the tax on a tobacco product defined as a cigarette, unless the brand family and the tobacco product manufacturer are included on the Attorney General's Web site directory.

10. **This bill could increase state and local sales and use tax revenues.** In order to be reimbursed for the fee, tobacco product manufacturers may increase the price of cigarettes, which would be reflected in the retail sales price of cigarettes sold to the ultimate consumer.

Sales and use tax is due based on the gross receipts or sales price of tangible personal property in this state. Since the proposed tobacco products fee would not be specifically excluded from gross receipts or sales price, it would be included in the amount on which sales or use tax is computed.

11. **Would the proposed tobacco products fee increase evasion?** Tax evasion is one of the major areas that can reduce state revenues from cigarettes and tobacco products. Board staff recently estimated that cigarette tax evasion in California was running at a rate of approximately \$292 million annually. That estimate was only for evasion of cigarette taxes, and did not include associated evasion of other taxes, such as sales and use, tobacco products or income taxes. A key premise in the Board's research is that both cigarette consumption and cigarette tax evasion are highly correlated to product prices and excise tax rates.

Two major events since November 1998 have dramatically increased California cigarette prices: the Proposition 10 tax increase and the Tobacco Master Settlement Agreement made between states and tobacco manufacturers (tobacco settlement). Together, these two developments, when coupled with typical wholesaler and retailer distribution margins, have increased average prices of cigarettes to California consumers by about 50 percent in relation to early November 1998 prices. It was estimated that the impacts of Proposition 10 and the tobacco settlement more than doubled cigarette tax evasion in California.

This bill would impose a fee on each person currently manufacturing tobacco products, or who has previously manufactured tobacco products, as specified. This fee could result in an increase in the selling price of tobacco products, which based on the Board's findings when developing the impacts of Proposition 10 and the tobacco settlement, would cause a correlated increase in tax evasion.

12. **Sinclair Paint Company Court decision.** In July 1997, the California Supreme Court held that the Childhood Lead Poisoning Prevention Act of 1991 imposed bona fide regulatory fees and not taxes requiring a two-thirds vote of the Legislature under Proposition 13. In summary, the Court found that while the Act did not directly regulate by conferring a specific benefit on, or granting a privilege to, those who pay the fee, it nevertheless imposed regulatory fees under the police power by requiring manufacturers and others whose products have exposed children to lead contamination to bear a fair share of the cost of mitigating those products' adverse health effects.

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.

This measure would impose a cigarette fee that would be used to address tobacco-related health impacts, as described, including the creation, expansion, and administration of smoking cessation programs. However, the cigarette fee would not be imposed on all tobacco product manufacturers, only on nonparticipating manufacturers. Tobacco product manufacturers that signed the tobacco Master Settlement Agreement would not be required to pay the fee.

As such, it could be argued that not all tobacco product manufacturers would be bearing a fair share of the cost to address tobacco-related health impacts since the fee is only imposed on nonparticipating manufacturers. Therefore, it is questionable whether the fee imposed by this measure is a fee consistent with the California Supreme Court decision in *Sinclair Paint Company v. State Board of Equalization* (1997) 15 Cal.4th 866.

13. **Related legislation.** This bill contains similar fee language as SB 676 (Ortiz). However, Senate Bill 676 would impose, on or after January 1, 2005, a tobacco products fee, as specified, on each nonparticipating manufacturer currently manufacturing tobacco products, or who has previously manufactured tobacco products, or both, that have contributed or currently contribute, or both, to tobacco-related illnesses and diseases. For purposes of SB 676, "tobacco product" would be defined to mean cigarettes and roll-your-own tobacco products.

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, 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.

REVENUE ESTIMATE

Background, Methodology, and Assumptions

The fee for fiscal year 2004-05 is specified to be \$0.025 per cigarette (\$0.50 per pack of 20 cigarettes) for all cigarettes and roll-your-own tobacco sold by nonparticipating manufacturers in fiscal year 2002-03. The fee for following fiscal years is to be determined by the DHS.

Data from the Excise Taxes Section indicate that nonparticipating manufacturers sold about 32.9 million packs of cigarettes in fiscal year 2002-03. In addition, Excise Taxes Section data show tobacco sales equivalent to 1.9 million packs of roll-your-own cigarettes, converted at a rate of 0.09 cigarettes per ounce of tobacco, as specified in the MSA. Cigarette and equivalent roll-your-own tobacco sold in fiscal year 2002-03 total 34.8 million packs.

Revenue Summary

Based on sales of 34.8 million packs, we estimate that fees would generate about \$17.4 million in fiscal year 2004-05.

Analysis prepared by:	Cindy Wilson	916-445-6036	06/03/04
Revenue estimate by:	Joe Fitz	323-3802	
Contact:	Margaret S. Shedd	916-322-2376	

Is

1239-1revisedCW.DOC

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.