



**STATE BOARD OF EQUALIZATION  
STAFF LEGISLATIVE BILL ANALYSIS**

**DRAFT**

Date Amended:	<b>06/26/2006</b>	Bill No:	<b>AB 1749</b>
Tax:	<b>Cigarette and Tobacco Products Licensing Act</b>	Author:	<b>J. Horton</b>
	<b>Cigarette and Tobacco Products</b>		
Related Bills:	<b>AB 2001 (Cogdill)</b>		

**BILL SUMMARY**

Among other things, this bill would do the following:

- Require every manufacturer or importer of tobacco products to obtain and maintain a license under the Cigarette and Tobacco Products Licensing Act of 2003 (Licensing Act) to engage in the sale of tobacco products. (*BPC §§22971, 22979.21, 22979.22, 22979.23, 22979.24, and 22980.1*)
- Revise the Licensing Act to prohibit a retailer, wholesaler, or importer from purchasing cigarettes or tobacco products from any person who is not licensed or whose license has been suspended or revoked and to make manufacturers and importers prohibitions consistent. (*BPC §22980.1*)
- Delete the January 1, 2010, repeal date and indefinitely extend the Licensing Act, the Board's Investigations Division staff authority to exercise the powers of arrest of a peace officer and the power to serve warrants, as specified, and various other Cigarette and Tobacco Products Tax related provisions added pursuant to AB 71 (Ch. 890, Stats. 2003). (*BPC §22995, PC §830.11, RTC §§30216, 30359, 30435 and 30474.1*)
- Revise the definition of "importer". (*RTC §30019*)
- Allow additional deferral alternatives for a distributor that desires to defer payments for stamps or meter register settings. (*RTC §§30142 and 30168*)
- Increase the penalties for counterfeiting stamps or meter impressions with intent to evade the taxes, possessing for the purpose of sale any package of cigarettes to which there is not affixed the stamp or meter impression, and for transporting cigarettes or tobacco products upon highways, roads or streets of this state without having a permit. (*RTC 30473, 30474, and 30475*)

**Summary of Amendments**

The amendments to this bill specify that a manufacturer or importer of tobacco products would pay only one licensure fee not to exceed ten thousand dollars (\$10,000), revise the definition of "importer," and make other clarifying changes. The amendments also allow additional payment alternatives for a distributor that desires to defer payments for stamps or meter register settings.

---

*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.*

**ANALYSIS****Tobacco products manufacturer and importer licensing**

*Business and Professions Code Section 22971, 22979.21, 22979.22, 22979.23, 22979.24, and 22980.1*

**Current Law**

Under current law, Section 22979 of the Business and Professions Code requires every manufacturer and every importer of cigarettes to obtain and maintain a license to engage in the sale of cigarettes. In order to be eligible for obtaining and maintaining a license, a manufacturer or importer of cigarettes must:

- Submit to the Board a list of all brand families that they manufacture or import.
- Update the list of all brand families that they manufacture or import whenever a new or additional brand is manufactured or imported, or a listed brand is no longer manufactured or imported.
- Consent to jurisdiction of the California courts for the purpose of enforcement of this division and appoint a registered agent for service of process in this state and identify the registered agent to the Board.

Furthermore, in order for a manufacturer or importer of cigarettes to be eligible for obtaining and maintaining a license under the Licensing Act, a manufacturer or importer that is a "tobacco product manufacturer" as defined in Health and Safety Code Section 104556(i) must also certify to the Board that it is a "participating manufacturer" as defined in subsection II(jj) of the "Master Settlement Agreement," or is in full compliance with the model statute,<sup>1</sup> and submit to the Board a list of all brand families that fit under the category applicable to the manufacturer or importer, as specified.

On or before January 1, 2004, every manufacturer and every importer was required to pay an administration fee in the amount of one cent (\$0.01) per package of cigarettes (1) manufactured or imported by the manufacturer or the importer and (2) shipped into this state during the 2001 calendar year as reported to the Board. All manufacturers and all importers that began operations in the state after January 1, 2004, are charged a fee commensurate with their respective market share of cigarettes (1) manufactured or imported, and (2) sold in this state during the next calendar year as estimated by the Board.

Manufacturers and importers of cigarettes are also subject to specified prohibitions related to the sale and purchase of cigarettes as described in Section 22980.1, such as:

- No distributor, wholesaler, or importer shall sell cigarettes or tobacco products to a retailer, wholesaler, distributor, or any other person who is not licensed or whose license has been suspended or revoked.
- No retailer, distributor, wholesaler, or importer shall purchase packages of cigarettes from a manufacturer who is not licensed or whose license has been suspended or revoked.

---

<sup>1</sup> Article 3 (commencing with Section 104555) of Chapter 1 of Part 3 of Division 103 of the Health and Safety Code.

- No retailer, distributor, wholesaler, or importer shall purchase cigarettes or tobacco products from any person who is required to be licensed but who is not licensed or whose license has been suspended or revoked.

### Proposed Law

This bill would require every manufacturer or importer of tobacco products to obtain and maintain a license under the Licensing Act to engage in the sale of tobacco products. In order to be eligible for obtaining and maintaining a license, a manufacturer or importer would be required to do all of the following in the manner specified by the Board:

- Submit to the Board a list of all tobacco products they manufacture or import.
- Update the list of all tobacco products they manufacture or import whenever a new or additional product is manufactured or imported or a listed product is no longer manufactured or imported.
- Consent to jurisdiction of the California courts for the purpose of enforcement of this division and appoint a registered agent for service of process in this state and identify the registered agent to the Board.

These eligibility requirements are identical to those required under current law for manufacturers and importers of cigarettes. Furthermore, manufacturers and importers of tobacco products would be required to meet additional eligibility requirements and may petition for a redetermination of the Board's denial of a license, as provided in existing law for manufacturers and importers of cigarettes.

Other provisions in existing law that would also apply to manufacturers and importers of tobacco products are as follows:

- A license issued to a manufacturer or an importer is only valid with respect to the manufacturer or importer designated on the license and may not be transferred or assigned to another manufacturer or importer.
- Any manufacturer or importer that is issued a license that does not commence business in the manner specified or designated in the license, ceases to do business in the manner specified or designated in the license, or is notified that the license is suspended or revoked, shall immediately surrender that license to the board.

An application for a license by a manufacturer or by an importer of tobacco products would be on a form prescribed by the Board and include information, as specified. The Board would be required to provide electronic means for applicants to download and submit applications. The Board could investigate to determine the truthfulness and completeness of the information provided in the application.

Every manufacturer or importer of chewing tobacco or snuff would be required to submit with each application a one-time license fee of ten thousand dollars (\$10,000). Every manufacturer or importer of tobacco products, excluding chewing tobacco or snuff, would be required to submit with each application a one-time license fee of two thousand dollars (\$2,000). However, the one-time license fee for a manufacturer or importer of tobacco products would be limited to ten thousand dollars (\$10,000).

This bill would also require every manufacturer or importer of tobacco products holding a license to file a monthly report to the Board, in a manner specified by the Board, which

maybe, but not be limited to, electronic media. The monthly reports would include, but not be limited to, the following:

- A list of all licensed distributors that received the manufacturer's or importer's tobacco products.
- The total wholesale cost of the products.

The Board would be authorized to suspend the license or revoke the license, pursuant to the provisions applicable to the revocation of a license set forth in Section 30148 of the Revenue and Taxation Code, of any importer or any manufacturer that has failed to comply with these reporting requirements.

Manufacturers and importers of tobacco products would be subject to the same invoicing and record-keeping requirements, and penalty provisions for violations of the Licensing Act as manufacturers and importers of cigarettes, as provided in existing law.

This bill would become effective on January 1, 2007.

### Comments

1. **Sponsor and intent.** This bill is sponsored by the author. These provisions of the bill are intended to provide an additional enforcement tool to address the unlawful distribution and sale of untaxed tobacco products.
2. **The June 26, 2006, amendments** to this bill specify that the one-time license fee for a manufacturer or importer of tobacco products is limited to ten thousand dollars (\$10,000) and make other clarifying changes, including those requested by Board staff.
3. **This provision should contain a delayed operative date.** Due to the volume of computer programming modifications required by this bill, in addition to the potential workload related to the cigarette tax increase initiative (Proposition 86), and the oil severance tax initiative (Proposition 87) that recently qualified for the November 7, 2006, ballot, and other legislative mandates, this provision should contain a delayed operative date. As such, this provision should be amended to incorporate a delayed operative date of at least six months, which would allow the Board to successfully implement the tobacco products manufacturer and importer licensing provisions.
4. **Chewing tobacco and snuff should be defined.** Segregating chewing tobacco and snuff from the definition of tobacco products for the purpose of the one-time license fee for manufacturers and importers of tobacco products could complicate the administration of the one-time fee since the terms "chewing tobacco" and "snuff" are not defined. To clarify this ambiguity, these terms should be defined.
5. **Suggested amendment.** Currently, the Licensing Act requires a manufacturer or importer that is a "tobacco product manufacturer" in subdivision (i) of Section 104556 of the Health and Safety Code to certify that it is a "participating manufacturer" or is in full compliance with the Model Statute and submit to the Board a list of all brand families, as described. In addition, existing law also provides that (1) the license issued to a manufacturer or an importer is only valid with respect to the manufacturer or importer designated on the license, (2) a license issued to a manufacturer or importer shall be surrendered to the Board if the manufacturer or importer fails to commence business, ceases to do business, or is notified that the license is suspended or revoked, and (3) any manufacturer or any importer who is

denied a license may petition for a redetermination of the Board's denial of the license.

Although each of these provisions apply to any manufacturer or importer licensed under Division 8.6 of the Business and Professions Code (the Licensing Act), it is suggested that the bill be amended to clarify that these requirements apply to manufacturers and importers of tobacco products in order to avoid any ambiguity.

6. **How many licenses would a manufacturer and importer be required to hold?** Existing law requires that manufacturers and importers be licensed to engage in the sale of **cigarettes**. This bill would establish a second license requirement for manufacturers and importers if they engage in the sale of **tobacco products**. As such, manufacturers and importers would be required to hold two licenses under the Licensing Act; one license as a manufacturer or importer of cigarettes and a second license as a manufacturer or importer of tobacco products.
7. **This bill should contain a specific appropriation to the Board.** This bill proposes a new license requirement on or after January 1, 2007, which is in the middle of the state's fiscal year. In order to begin to develop computer programs and reporting forms, an adequate appropriation is required to cover the Board's administrative start-up costs that would not be identified in the Board's 2006-07 budget.

#### **COST ESTIMATE**

The Board would incur non-absorbable administrative costs to license manufacturers and importers of tobacco products. These costs include computer programming, developing forms, and processing license fee payments. A detailed estimate of these costs is pending.

**REVENUE ESTIMATE**

**Background, Methodology, and Assumptions**

According to the 2002 Economic Census by U.S. Census Bureau, there were 70 U.S. companies manufacturing other tobacco products in 2002. Fourteen of these manufacturers had at least \$100,000 in shipments of chewing tobacco and snuff. The Census Bureau also reported that there were 1,636 U.S. wholesalers of tobacco products. These wholesalers include importers.

We do not know how many of the 1,636 U.S. wholesalers are importers, nor do we know how many import into California. The Board’s tax administration records indicate that it would be reasonable to assume that about 10 percent of these wholesalers are California importers. Board staff believes that there are relatively few importers of chewing tobacco and snuff. For revenue estimation purposes, we will assume there are no importers of chewing tobacco or snuff.

Assuming these figures, the one-time fees would be as follows:

<b>Table 1</b>	
<b>One-Time Fees:</b>	
<u>Manufacturers</u>	<u>Dollars</u>
Chewing and Smoking Tobacco Companies (14 companies)	140,000
All Other Tobacco Companies (56 companies)	<u>112,000</u>
Total	\$252,000
<u>Importers</u>	
Assume all Importers Import Tobacco Products	
Excluding Chewing Tobacco (164 companies)	\$328,000
<b>Total, Manufacturers and Importers</b>	<b>\$580,000</b>

In 2003 we estimated that revenue losses resulting from excise tax evasion by tobacco products distributors and retailers was about \$50 million. We estimate that AB 71 improved compliance by about \$16 million starting in 2004, which would reduce the evasion figure to \$34 million. With the compliance improvement measures of this bill, Board staff believes it would be reasonable to expect this proposal to result in an additional 10 percent decrease in evasion from the \$34 million estimate.

---

*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.*

**Revenue Summary**

The one-time fees are estimated to result in revenues of approximately \$0.6 million. Excise tax revenues from improved compliance are expected to increase \$3.4 million. The excise tax revenues are broken out by fund and shown with associated sales tax revenues in the table below. Associated state and local sales tax revenues increase about \$0.8 million, resulting in combined sales and excise tax revenues totaling \$4.2 million.

<b>Table 2</b>		
<b>Estimated Compliance Improvement Revenue Benefits of AB 1749</b>		
<b>Assuming a 10 Percent Decrease (\$3.4 Million) in Excise Tax Evasion</b>		
	Tax Rate or Price	Millions
<b>Tobacco Products</b>		
Wholesale Sales	n.a.	\$7.3
<b>Excise Taxes</b>	<b>46.76%</b>	<b>\$3.4</b>
Proposition 99	29.69%	2.2
Proposition 10	17.07%	1.2
<b>Sales and Use Taxes</b>		
Retail Mark-Up Over Wholesale Price	35%	n.a.
Estimated Value of Retail Sales	n.a.	\$9.8
Sales and Use Taxes, Total	7.93%	\$0.8
State		
General Fund Portion of State Rate 1/	5.00%	0.5
Local	2.00%	0.2
Special Taxing Districts	0.68%	0.1
<b>Total Excise and Sales and Use Taxes</b>	<b>n.a.</b>	<b>\$4.2</b>
Totals may not sum due to rounding.		
1/ Revenues reflecting a sales and use tax rate of 0.25% currently go into the fiscal recovery fund instead of the General Fund.		

**Qualifying Comments**

The exact number of California tobacco products importers is unknown. Therefore, one-time fees could vary from this estimate. Also, one-time fees would be reduced to the extent that some companies may decide not to sell their products in California rather than obtain licenses. The compliance improvement revenues are highly uncertain.

**Prohibit a retailer, wholesaler, or importer from purchasing cigarettes or tobacco products from any person who is not licensed or whose license has been suspended or revoked and make manufacturers and importers prohibitions consistent**

*Business and Professions Code Section 22980.1*

**Current Law**

**LICENSING ACT**

The Licensing Act requires the Board to administer a statewide cigarette and tobacco products license program to regulate the sale of cigarettes and tobacco products in the state. The Licensing Act requires every retailer, distributor and wholesaler to obtain and maintain a license to engage in the sale of cigarettes or tobacco products. Every manufacturer and every importer is required to obtain and maintain a license to engage in the sale of cigarettes.

Under the provisions of the Licensing Act, the following prohibitions are imposed:

- No manufacturer shall sell cigarettes to a distributor, wholesaler, importer, retailer, or any other person who is not licensed pursuant to this division or whose license has been suspended or revoked. Other prohibitions are as follows:
- Except as provided, no distributor, wholesaler, or importer shall sell cigarettes or tobacco products to a retailer, wholesaler, distributor, or any other person who is not licensed pursuant to this division or whose license has been suspended or revoked.
- No retailer, distributor, wholesaler, or importer shall purchase packages of cigarettes from a manufacturer who is not licensed pursuant to this division or whose license has been suspended or revoked.
- No retailer, distributor, wholesaler, or importer shall purchase cigarettes or tobacco products from any person who is required to be licensed pursuant to this division but who is not licensed or whose license has been suspended or revoked.

Any violation of the Licensing Act by any person, except as provided, is a misdemeanor. Each offense is punishable as follows:

- A fine not to exceed five thousand dollars (\$5,000),
- Imprisonment not exceeding one year in a county jail, or
- Both the fine and imprisonment.

**CIGARETTE AND TOBACCO PRODUCTS TAX LAW**

Under existing law, Revenue and Taxation Code Section 30478 makes it a misdemeanor for any retailer, as defined in Revenue and Taxation Code Section 6015, to knowingly purchase cigarettes or tobacco products for resale from any person except a distributor or wholesaler licensed pursuant to the Cigarette and Tobacco Products Tax Law.

**SALES AND USE TAX LAW**

In part, Revenue and Taxation Code Section 6015 defines a "retailer" to include:

- Every seller who makes any retail sale or sales of tangible personal property, and every person engaged in the business of making retail sales at auction of tangible personal property owned by the person or others.
- Every person engaged in the business of making sales for storage, use, or other consumption or in the business of making sales at auction of tangible personal property owned by the person or others for storage, use, or other consumption.

**Proposed Law**

This bill would amend Business and Professions Code Section 22980.1(d) to prohibit a retailer, wholesaler, or importer from purchasing cigarettes or tobacco products from any person who is not licensed or whose license has been suspended or revoked. A distributor would be prohibited from purchasing cigarettes or tobacco products from any person who is required to be licensed but who is not licensed or whose license has been suspended or revoked, which is consistent with existing law. In addition, this bill would also make the prohibitions for a manufacturer and importer consistent.

**Background**

In 2003, AB 71 (J. Horton, Ch. 890) was signed into law to establish a statewide program to license manufacturers and importers of cigarettes, and distributors, wholesalers, and retailer of cigarettes and tobacco products, known as the Cigarette and Tobacco Products Licensing Act of 2003. This measure was intended to provide an additional enforcement tool to address the unlawful distribution and sales of untaxed cigarettes and tobacco products. AB 71 also provided the Board's Investigation Division with the statutory authority to more effectively and efficiently conduct their investigative duties, including new limited peace officer status and strengthened penalties and avenues for the collection of cigarette and tobacco products excise taxes.

In addition, the Board recently implemented the provisions of SB 1701 (Peace, Ch. 881, Stats. 2002) which required the Board to replace the stamps and meter impressions, currently required to be affixed to a package of cigarettes, with stamps and meter impressions generated by a technology capable of being read by a scanning or similar device, and encrypted with specified information. The intent of SB 1701 was to address the counterfeit tax stamp issue where stamps are reproduced and appear identical to legitimate indicia.

**In General**

Prior to the enactment of AB 71, the Board estimated cigarette excise tax evasion to be \$238 million annually for retailers, associated with 274 million packs of cigarettes. This estimate did not include tobacco products excise tax evasion or related sales tax losses.

In 2004, the Licensing Act resulted in \$68.3 million in additional sales and use tax and excise tax, and \$49.5 million and \$19.9 million in additional sales and use tax and excise tax for 2005 and 2006, respectively. The revenues are through February 2006, for cigarettes and through December 2005, for tobacco products.

---

*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.*

In total, the Licensing Act and implementation of the new cigarette tax stamp has resulted in an increase of \$137.8 million in additional sales and use tax and excise tax revenues.

### Comments

1. **Purpose.** This provision is intended to make technical and clarifying amendments to the Licensing Act.
2. **This bill is necessary to clarify existing law.** Business and Professions Code Section 22980.1(d) provides that a retailer, distributor, wholesaler or importer is prohibited from purchasing cigarettes or tobacco products from any person who is *required* to be licensed. Since sellers outside California that do not have nexus with this state are not “required” to be licensed, retailers, distributors, wholesalers, and importers could legally purchase cigarettes or tobacco products from such sellers under the Licensing Act. However, this provision is not consistent with the Cigarette and Tobacco Products Tax Law, which prohibits a retailer (which includes a wholesaler) from purchasing cigarettes or tobacco products from any person except a licensed distributor or licensed wholesaler.

In addition, existing law may be confusing to a retailer, wholesaler or importer in that they believe they are in compliance with its purchasing provisions when in fact they may be in violation of other provisions of the Licensing Act. For example, a retailer, wholesaler, or importer (that is not licensed as a distributor to pay the tax) that purchases cigarettes or tobacco products from an unlicensed out-of-state seller is very likely purchasing untaxed product. The possession, storage, ownership or sale of unstamped cigarettes or untaxed tobacco products by other than a licensed distributor is a violation of the Licensing Act, which constitutes a misdemeanor punishable by specified actions and subjects such product to seizure and forfeiture by the Board or a law enforcement agency (Sections 22974.3 and, 22978.2).

3. **Would the purchase of cigarettes from an unlicensed manufacturer be permitted?** Section 22980.1(c) of the Licensing Act prohibits a retailer, distributor, wholesaler, or importer from purchasing packages of cigarettes from a manufacturer who is not licensed pursuant to the Licensing Act or whose license has been suspended or revoked. The proposed change to Business and Professions Code Section 22980.1(d) would not affect this provision. As such, a retailer, distributor, wholesaler, or importer would continue to be prohibited from purchasing cigarettes from a manufacturer unless that manufacturer is licensed if this bill were successfully signed into law.

### COST ESTIMATE

Enactment of this provision would not impact the Board’s administrative costs.

### REVENUE ESTIMATE

This provision would not affect the state’s revenues.

**Delete the repeal date for the Licensing Act, limited peace officer status, and various other sections of the Cigarette and Tobacco Products Tax Law**

*Business and Professions Code Section 22995, Penal Code Section 830.11, and Revenue and Taxation Code Sections 30216, 30359, 30435 and 30474.1.*

**Current Law**

Under current law, Section 22995 of the Business and Professions Code provides that the Licensing Act shall remain in effect until January 1, 2010, and as of that date shall be repealed. Identical sunset language is also contained in the following:

- Penal Code Section 830.11, which allows persons employed by the Board's Investigations Division, who are designated by the executive director, provided that the primary duty of these persons is the enforcement of laws administered by the Board, to exercise the powers of arrest of a peace officer as specified in Section 836 of the Penal Code, and the power to serve warrants as specified in Sections 1523 and 1530 of the Penal Code during the course and within the scope of their employment, if they receive a course in the exercise of those powers pursuant to Section 832 of the Penal Code. The authority and powers of the persons employed as investigators by the Board is extended to any place in the state.

Persons employed by the Board's Investigations Division designated with limited peace officer status are not entitled to peace officer retirement benefits.

- Revenue and Taxation Code Section 30216, which would repeal Article 2.5 (commencing with Section 30210) that provides that the tax, and applicable penalties and interest become immediately due and payable on account of all products distributed if a person becomes a distributor without first securing a license.
- Revenue and Taxation Code Section 30359, which would repeal Article 5 (commencing with Section 30355) that includes seizure and sale provisions to the Cigarette and Tobacco Products Tax Law to facilitate the administration of the sections providing for the immediate liability for the tax.
- Revenue and Taxation Code Section 30435, which provides that an employee of the Board, upon presentation of the appropriate identification and credentials, is authorized to enter into, and conduct an inspection of any building, facility, site, or place, as described. Any person that refuses to allow an inspection would be guilty of a misdemeanor and subject to a fine, not to exceed \$1,000 for each offense.
- Revenue and Taxation Code Section 30474.1, which provides that the sale or possession for sale of counterfeit tobacco products, or the sale or possession for sale of counterfeit cigarettes by a manufacturer, importer, distributor, wholesaler, or retailer would result in the seizure of the product by the Board or any law enforcement agency.

**Proposed Law**

This bill would delete the repeal date and indefinitely extend these provisions.

**Comments**

1. **Purpose.** This provision is intended to continue the Licensing Act, limited peace officer status, and other enforcement and collection tools that were added by AB 71 (J. Horton, Ch. 890.)
2. **Why was a sunset date added to these provisions?** In 2003, AB 71 added each of the provisions that this bill proposes to indefinitely continue by deleting the January 1, 2010, repeal date. As AB 71 developed and moved through the Legislature, it became apparent that the fees, penalties and fines imposed pursuant to the Licensing Act were not sufficient to provide long-term funding for the Licensing Act. Once the Cigarette and Tobacco Products Compliance Fund,<sup>2</sup> which AB 71 established and into which Licensing Act fees, penalties and fines are deposited, was depleted, the Board's funding would shift to the cigarette and tobacco products tax funds (General Fund, Breast Cancer Fund, Cigarette and Tobacco Products Surtax Fund, and the California Children and Families First Trust Fund).

In order to protect each of these cigarette and tobacco products tax funds and to assure that the revenue benefits exceeded the Board's costs to administer the Licensing Act, AB 71 was amended to add the January 1, 2010, sunset date.

3. **Licensing Act performance audit.** The Licensing Act includes a provision that requires the Bureau of State Audits (BSA) to conduct a performance audit of the licensing and enforcement provisions of the Licensing Act, and to report its findings to the Board and the Legislature by July 1, 2006.

The BSA released its 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" at the end of June 2006. In the cover letter, State Auditor Elaine M. Howle writes:

"This report concludes that the Board believes its implementation of the provisions of the act has increased cigarette tax compliance. Specifically, based on its analysis of cigarette tax stamps sold, Equalization estimates it received \$75 million in additional cigarette tax revenues between January 2004 and March 2006 because of the act and the new tax stamp. Although we agree that the act has increased cigarette tax compliance, we also believe that some of the factors Equalization uses to calculate the benefits of the act are overstated because they are based on the results of inspections in areas where illicit cigarette sales are more likely to occur. This resulted in Equalization estimating that annual cigarette tax evasion amounts to \$292 million, an estimate that may be at the high end of the range of potential tax evasion. Further, because a new less easily counterfeited tax stamp is now in use, increases in cigarette tax compliance since January 2005 can show only the blended effects of the act and the new tax stamp."

---

<sup>2</sup> Additional excise tax revenues resulting from Licensing Act compliance improvements are deposited into the cigarette tax funds, and are not deposited into the Cigarette and Tobacco Products Compliance 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.*

In its response to the audit report, the Board stated that it agrees with the overall conclusions of the BSA draft report and its one finding that the Board should update its calculation of cigarette tax evasion using data gathered after the implementation of the Licensing Act. The Board has already taken action to address the recommendation.

4. **The Board staff does not foresee any administrative problems with these provisions.** These provisions would simply delete the January 1, 2010, repeal date for the Licensing Act and other related provisions, which are currently administered by the Board. Accordingly, these provisions would not be problematic for the Board to continue.

**COST ESTIMATE**

The Board would continue to incur non-absorbable costs to adequately administer the Licensing Act. These costs would include enforcement, licensing manufacturers, importers, distributors, wholesalers and retailers of cigarette and/or tobacco products, processing license fee payments, conducting audits, investigating the criminal provisions/violations, developing regulations, training staff, and answering inquiries from the public.

According to the Governor’s Budget, the Board’s cost to administer the Licensing Act is as follows:

<u>Fiscal Year</u>	<u>Administrative Costs</u> <u>(in thousands)</u>
2003-04	\$2,504 (actual)
2004-05	\$7,114 (actual)
2005-06	\$8,925 (estimated)
2006-07	\$9,445 (proposed)

**REVENUE ESTIMATE**

Deleting the January 1, 2010, repeal date to indefinitely extend these provisions would allow for the Licensing Act, limited peace officer status and additional enforcement and collection tools to continue to have a positive impact on the state excise taxes collected due to decreased evasion.

**Revise “importer” definition**  
*Revenue and Taxation Code 30019*

**Current Law**

Under current law, Section 30019 of the Cigarette and Tobacco Products Tax Law defines "importer" to mean any purchaser for resale in the United States of cigarettes manufactured outside of the United States.

The Licensing Act defines “importer” in Business and Professions Code Section 22971(b) to mean an importer as defined in Section 30019 of the Revenue and Taxation Code.

**Proposed Law**

This bill would amend Section 30019 of the Revenue and Taxation Code to define “importer” to mean any purchaser for resale in the United States of cigarettes or tobacco products manufactured outside of the United States for the purpose of making a first sale or distribution in the United States.

**Comments**

1. **Purpose.** This provision is intended to clarify that an importer includes only the person that originally imports cigarettes and tobacco products into the United States, and not those persons that subsequently purchase such products from the original importer for the purpose of resale.
2. **The June 26, 2006, amendments** revise the definition for “importer” to prevent unintentionally adding or excluding additional persons to the definition of importer.
3. **The Board staff does not foresee any administrative problems with this provision.** This provision would simply clarify the definition of importer, as intended and administered by the Board. Accordingly, enactment of these provisions would not affect the Board's administration of the Cigarette and Tobacco Products Tax Law or the Licensing Act.

**COST ESTIMATE**

Enactment of this provision would not impact the Board's administrative costs.

**REVENUE ESTIMATE**

This provision would not affect the state's revenues.

**Additional deferral alternatives for a distributor that desires to defer payments for stamps or meter register settings***Revenue and Taxation Code Sections 30142 and 30168***Current Law**

Under current Cigarette and Tobacco Products Tax Law, an excise tax of 43 1/2 mills per cigarette (87 cents per package of 20) is imposed on each cigarette distributed. The cigarette tax imposed with respect to the distribution of cigarettes is paid by distributors through the use of stamps or meter impressions. An appropriate stamp or meter impression is required to be affixed to, or made on, each package of cigarettes prior to distribution of the cigarettes, except as otherwise provided.

Current law also imposes 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 2005-06 is 46.76 percent.

**CIGARETTE TAX STAMPS PURCHASED ON A DEFERRED-PAYMENT BASIS**

Every applicant for a license as a distributor is required to file with the Board security in the amount and form as the Board prescribes. The minimum security that is required of any distributor is one thousand dollars (\$1,000). However, distributors desiring to defer payment for stamps and meter impressions are required to furnish a security in an amount as follows:

- Equal to not less than 70 percent of the amount and not more than twice the amount, as fixed by the Board, of the distributor's purchases of stamps and meter register settings for which payment may be deferred if a distributor elects to make payments on a monthly basis.
- Equal to not less than 50 percent of the amount and no more than twice the amount, as fixed by the Board, of the distributor's purchases of stamps and meter register settings for which payment may be deferred if a distributor elects to make payments on a twice-monthly basis.

A distributor may elect a monthly or twice-monthly payment basis for amounts owing for stamps and meter register settings purchased on a deferred basis. If a distributor elects a monthly basis, payment is required to be remitted on or before the 25<sup>th</sup> day of the month following the month in which the stamps and meter register settings were purchased. However, if a distributor elects a twice-monthly payment basis, the payment is due based on the following schedule:

- The first monthly remittance would be due on or before the 5<sup>th</sup> day of the month. The amount due would be equal to either one-half of the total amount of those purchases of stamps and meter register settings made during the preceding month or the total amount of those purchases stamps and meter register settings made between the first day and the 15<sup>th</sup> day of the preceding month, *whichever is greater*.
- The second monthly remittance would be made on or before the 25<sup>th</sup> day of the month for the remainder of those purchases of stamps and meter register settings that were made in the preceding month.

A distributor that elects to make deferred payments on a twice-monthly basis is also required to file a report on or before the 5<sup>th</sup> day of the month respecting his or her distributions of cigarettes and purchases of stamps and meter register settings.

The twice-monthly deferred payment option for amounts owing for stamps and meter register settings purchased on a deferred basis and corresponding reduced security will remain in effect until January 1, 2007, and as of that date is repealed.

#### **TWICE-MONTHLY ELECTION TO FILE A RETURN AND MAKE PAYMENT FOR TOBACCO PRODUCTS TAX**

A distributor is authorized to elect to file a return and make payment of the tax due on either a monthly or a twice-monthly basis respecting his or her distributions of tobacco products and their wholesale cost during the preceding month and any other information as the Board may require. If a distributor elects a monthly basis, the distributor is required to file a return and make payment of the tax on or before the 25<sup>th</sup> day of the month following the month during which the tobacco products were distributed. If a distributor elects a twice-monthly basis, the distributor is required to file two returns and make two remittances during the month following the month during which the tobacco products were distributed as follows:

- The first monthly return would be required to be filed, together with the first remittance of tax, on or before the 5<sup>th</sup> day of the month for those distributions of tobacco products that occurred between the first day and the 15<sup>th</sup> day of the preceding month.
- The second monthly return would be required to be filed, together with the second remittance of tax, on or before the 25<sup>th</sup> day of the month for those distributions of tobacco products that occurred between the 16<sup>th</sup> day and last day of the preceding month.

The twice-monthly payment and reporting basis for distributions of tobacco products will remain in effect until January 1, 2007, and as of that date is repealed.

#### **Proposed Law**

This bill would allow for two additional deferral alternatives for a distributor that desires to defer payments for stamps or meter register settings.

##### **Alternative 1**

This bill would allow, upon authorization by the Board, that no security be required for a distributor that desires to defer payments for stamps or meter register settings if the distributor's average monthly purchase of stamps or meter register settings for the previous 12 months does not exceed seventy-two thousand (72,000) stamps or meter register settings, and the distributor meets all of the following:

- The distributor has been licensed under this part for a minimum of five years;
- The distributor has not been delinquent in the filing of any reports or returns required under this part for the preceding three consecutive years;
- The distributor has not been delinquent in the payment of any tax under this part, or for any other tax or fee administered or collected by the board, for the preceding three consecutive years;

---

*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 distributor provides to the board and updates, as necessary, an electronic mail address for the purpose of receiving payment information, including, but not limited to, amounts owing for stamps and meter register settings purchased;
- Any other criteria the board may require.

This bill would require that amounts owing for stamps and meter register settings purchased on the deferred-payment basis without a security be due and payable on or before Wednesday following the week in which the stamps and meter register settings were purchased. Payment would be required to be made by a remittance payable to the Board.

### **Alternative 2**

This bill would reduce the security provided by a distributor desiring to defer payments for stamps or meter register settings to equal to not less than 25 percent of the amount and no more than twice the amount, as fixed by the Board, if that distributor elects to make payments on a weekly basis.

If a distributor elects to make payments on a weekly basis, the distributor would be required to remit the payment on or before Wednesday following the week in which the stamps and meter register settings were approved and released. Every distributor electing to make payment on a weekly basis would be required to provide to the Board and update, as necessary, an electronic mail address for the purpose of receiving payment information, including, but not limited to, amounts owing for stamps and meter register settings purchased.

### **Background**

A cigarette tax increase of thirteen cents (\$0.13) per cigarette, or two dollars and sixty cents (\$2.60) per package of 20, recently qualified for the November 7, 2006, ballot (Proposition 86). If approved by voters, the cigarette tax would increase from eighty seven cents (\$0.87) to three dollars and forty seven cents (\$3.47) per package of 20 cigarettes. Such an increase in the cigarette tax would impose an ongoing hardship on cash and deferred payment distributors.

Cash basis distributors pay the cigarette tax at the time the tax stamps are issued although the incidence of tax (distribution) has not occurred. A distribution occurs, in general, upon the sale of untaxed cigarettes in this state, the use or consumption of untaxed cigarettes in this state, or the placing in this state of untaxed cigarettes in a vending machine or in retail stock for the purpose of selling the cigarettes to consumers. With an increase in the cigarette tax as large as the one proposed by the initiative, smaller cash basis distributors may not have the resources to pay for the tax stamps upfront and may not be able to obtain a competitively priced security. Therefore, such distributors may simply go out of business.

Those distributors paying cash tend to be small ones unable to obtain credit coverage. For example, surety bonds may be available only to the most creditworthy firms with significant capital assets and is not likely to be extended to smaller and medium-sized distributors.<sup>3</sup>

---

<sup>3</sup> According to the Legislative Analyst's Office report titled "Cigarette Tax Stamp Purchases and Surety Bonds in California"

Deferred payment distributors are required to furnish a security in an amount as specified in the Cigarette and Tobacco Products Tax Law. The applicant is allowed to select the type of security he or she prefers. Subject to specific conditions, four types of security are acceptable for purposes of fully complying with the security requirement for deferred payment of cigarette tax stamps or meter register settings. These are:

1. Cash Deposits
2. Deposit accounts in banks, savings banks, and savings and loans including Insured Accounts, Fully Paid Investment, Bonus Investment Certificates and Accumulative Investment Certificates
3. State and Federal Credit Union Shares
4. Surety bonds

Any security in the form of cash, insured deposits in banks or savings and loan institutions, or a bond or bonds duly executed by an admitted surety insurer, payable to the state, conditioned upon faithful performance of all the requirements of the Cigarette and Tobacco Products Tax Law and expressly providing for the payment of all taxes, penalties, and other obligations of the person that arise under the Cigarette and Tobacco Products Tax Law are to be held by the Board in trust to be used solely in the manner provided.

The proposed cigarette tax increase initiative would also impact larger distributors purchasing on a deferred payment basis as the amount of security required to be furnished would substantially increase relative to the proposed tax increase and the amount of credit authorized. With respect to distributors posting security in the form of a surety bond, recent increases in bond rates combined with the proposed cigarette tax increase would likely result in expensive premiums. Distributors electing to post security in the form of a cash equivalent would have to tie up additional cash in order to meet the increased security requirement.

### Comments

1. **Purpose.** This provision is intended to improve the ability of distributors to defer payment for stamps or meter register settings.
2. **The June 26, 2006, amendments** add this provision, which would allow additional deferral alternatives for a distributor that desires to defer payments for stamps or meter register settings.
3. **This provision should contain a delayed operative date.** Due to the volume of computer programming modifications required by this bill, in addition to the potential workload related to the cigarette tax increase initiative (Proposition 86), and the oil severance tax initiative (Proposition 87) that recently qualified for the November 7, 2006, ballot, and other legislative mandates, this provision should contain a delayed operative date. As such, this provision should be amended to incorporate a delayed operative date of at least six months, which would allow the Board to successfully implement the deferral payment alternatives.

4. **Would these provisions become operative if Proposition 86 is not approved by voters?** These provisions would become operative whether or not Proposition 86 is approved by voters on November 7, 2006. If it is the author's intent that these provisions only become operative if Proposition 86 is successful, this bill should be amended to clarify that intent.

5. **Distributors purchasing tax stamps on a deferred basis.** Currently, 24 of the 126 distributors licensed with the Board purchase cigarette tax stamps on a deferred basis. In terms of value of the stamps, over 70 percent of all stamp revenue is derived from stamps that have been purchased through deferred payments.

The combined credit limit for distributors purchasing cigarette tax stamps on a deferred basis is approximately \$155 million, with a corresponding security of \$107 million. The credit limit and corresponding security for distributors electing the monthly or twice-monthly payment basis is as follows:

- Distributors electing the **monthly payment basis** have an approximate total credit limit of \$146 million, with a corresponding security of \$102 million.
- Distributors electing the **twice-monthly payment basis** have an approximate total credit limit of \$9 million, with a corresponding security of \$4.5 million.

The Board is authorized to suspend a distributor's privilege to purchase tax stamps on the deferred basis if a distributor fails to promptly pay for stamps when payment is due. If collection of these amounts remains unpaid, the Board could pursue the distributor's security deposit.

6. **This provision should contain a specific appropriation to the Board.** This provision would allow two additional deferral alternatives for a distributor that desires to defer payments for stamps or meter register settings, both including a weekly payment requirement. If enacted, these provisions would require that implementation begin during the 2006-07 fiscal year. In order to begin to notify distributors and develop computer programming, an adequate appropriation is required to cover the Board's administrative start-up costs that would not already be identified in the Board's 2006-07 budget.

7. **Suggested technical amendments.** This bill proposes to amend Revenue and Taxation Code Section 30168 to specify the due date for amounts owing for stamps and meter register settings purchased on the deferred payment basis without security or where a distributor elects to make payments weekly.

Subdivision (a) of Section 30168 provides that except for stamps and meter register settings purchased without a security, amounts owing for stamps and meter register settings are due and payable on or before the 25th day of the following calendar month. Subdivision (b) of that same section further provides that a distributor is required to elect a payment basis and specifies a due date for amounts owing based the monthly or weekly payment election. Monthly payments would be due and payable on or before the 25th day of the following calendar month and weekly payments would be due and payable on or before Wednesday following the week in which the stamps and meter register settings were approved and released.

The language contained in subdivision (a) does not take into account a distributor's election to make payments on a weekly basis and therefore conflicts with the

language provided in subdivision (b). To correct this unintentional drafting error, the following language is suggested:

30168. (a) Except as provided for in subdivision (c), amounts owing for stamps and meter register settings purchased on the deferred-payment basis ~~in any calendar month~~ shall be due and payable based on a distributor's election to make the payment pursuant to subdivision (b) on or before the 25th day of the following calendar month. Payment shall be made by a remittance payable to the board.

7. **Related legislation.** AB 2001 (Cogdill) would also amend Sections 30142 and 30168 to delete the January 1, 2007, repeal date to indefinitely reduce a distributor's security to equal to not less than 50 percent of the amount and no more than twice the amount, as fixed by the Board, of the distributor's purchases of stamps and meter register settings for which payment may be deferred if a distributor elects to make payments on a twice-monthly basis. Since this bill and AB 2001 would both amend Sections 30142 and 30168, both bills should incorporate double-joining language.

## **COST ESTIMATE**

The Board would incur costs related to this measure for notifying licensed distributors, revising forms and publications, and programming computers. A detailed estimate of these costs is pending.

There would also be an additional cost related to the Board's contract with Bank of America (BoFA) to accept and process weekly payments. The current contract, which will expire on June 30, 2008, is based on the amount of activity for the services provided. As such, any additional distributors desiring to make payments weekly for amounts owing for stamps and meter register settings would increase activity with BoFA and the related cost for services. However, the current contract contains a maximum agreement amount of \$114,696 for the July 1, 2005 through June 30, 2008 contract period.

## **REVENUE ESTIMATE**

Enactment of this measure would have no impact on cigarette tax revenues.

**Increase Penalties for Possession of Counterfeit Stamps, Sale of Untaxed Cigarettes, and Transporting Untaxed Cigarettes or Tobacco Products**  
*Revenue and Taxation Code Sections 30473, 30474 and 30475*

**Current Law**

Section 30473 of the Revenue and Taxation Code provides that any person who falsely or fraudulently makes, forges, alters, reuses or counterfeits any stamp or meter impression, or tampers with any metering machine, or causes or procures to be falsely or fraudulently made, forged, altered, reused or counterfeited, any such stamp or meter impression or knowingly and willfully utters, publishes, passes, or tenders as genuine any such false, forged, altered, reused or counterfeited stamp or meter impression, for the purpose of evading the tax imposed by this part, is guilty of a felony and subject to imprisonment for two, three or four years, or to a fine of not less than one thousand dollars (\$1,000) and not more than ten thousand dollars (\$10,000), or to both fine and imprisonment.

Section 30474 of the Revenue and Taxation Code provides that any person who knowingly possesses, keeps, stores, or retains for the purpose of sale, or sells or offers to sell, any unstamped package of cigarettes is guilty of a misdemeanor punishable by a fine of not more than one-thousand dollars (\$1,000), imprisonment for not more than one year in a county jail, or both. The guilty person must also pay one hundred dollars (\$100) for each carton of 200 cigarettes possessed, sold or offered for sale, as determined by the court. The court must direct that 50 percent of the penalty assessed be transmitted to the local prosecuting jurisdiction, to be allocated for costs of prosecution, and 50 percent of the penalty assessed be transmitted to the Board.

The penalty for possessing, selling or offering to sell unstamped cigarettes does not apply to a licensed distributor.

Subdivision (b) of Section 30475 provides that any transporter who, with intent to defeat or evade or with intent to aid another to defeat or evade cigarette and tobacco products taxes, at any given time transports 40,000 or more cigarettes or tobacco products with a value of five thousand dollars (\$5,000) or more upon the highways, roads or streets of this state without having obtained a permit or without having a permit in the transporting vehicle, as prescribed, or without having in the transporting vehicle the invoices, bills of lading or delivery tickets for the cigarettes or tobacco products, as prescribed, shall be punished by imprisonment in the county jail for not more than one year, or in the state prison, or by fine of not more than five thousand dollars (\$5,000), or be subject to both fine and imprisonment in the discretion of the court.

**Proposed Law**

This bill would amend Section 30473 of the Revenue and Taxation Code to increase the maximum fine from ten thousand dollars (\$10,000) to twenty-five thousand dollars (\$25,000).

This bill would also amend Section 30474 of the Revenue and Taxation Code to increase the maximum fine from one thousand dollars (\$1,000) to twenty-five thousand dollars (\$25,000).

And lastly, this bill would amend Section 30475 Revenue and Taxation Code to increase the maximum fine from five thousand dollars (\$5,000) to twenty-five thousand dollars (\$25,000).

**Comments**

1. **Purpose.** This provision is intended to provide an effective deterrent against flagrant offenders.
2. **The Board staff does not foresee any administrative problems with these provisions.** These provisions would simply increase the maximum fines under the Cigarette and Tobacco Products Tax Law, which are imposed by the courts. Accordingly, enactment of these provisions would not affect the Board's administration of the Cigarette and Tobacco Products Tax Law.

**COST ESTIMATE**

The administrative costs associated with these provisions would be insignificant (under \$10,000). These costs would include developing and mailing a special notice to notify distributors, wholesalers and retailers of the increase in the maximum fine amount.

**REVENUE ESTIMATE**

These provisions would not affect the state's revenues.

Analysis prepared by:	Cindy Wilson	916-445-6036	07/07/06
Revenue prepared by:	Joe Fitz	916-445-0840	
Contact:	Margaret S. Shedd	916-322-2376	
mcc			1749-4cw.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.*