



## STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Amended	<b>08/05/02</b>	Bill No:	<b>AB 2906</b>
Tax:	<b>Cigarette and Tobacco Products</b>	Author:	<b>Horton</b>
Board Position:	<b>Neutral</b>	Related Bills:	<b>AB 1666 (Horton)</b>

### BILL SUMMARY

Among other things, this bill would prohibit any cigarette tax stamp or meter impression to be affixed to a package of cigarettes, or tax be paid on a tobacco product defined as a cigarette, unless the tobacco manufacturer and brand family is included on the list posted by the Attorney General, as specified.

### ANALYSIS

#### Current Law

Under existing law, the State Board of Equalization (Board) administers the Cigarette and Tobacco Products Tax Law. An excise tax of \$0.87 per package of 20 cigarettes is imposed on the distribution of cigarettes in this state. Distributors pay the excise tax by purchasing cigarette stamps, which they affix to each package of cigarettes to indicate that the tax has been paid to the state. Distributors are also required to file monthly reports with the Board respecting their distribution of cigarettes and purchase of stamps during the preceding month.

#### Proposed Law

This bill would add Section 30163.1 to the Revenue and Taxation Code to require that no person affix, or cause to be affixed, any tax stamp or meter impression to a package of cigarettes, or pay the tax levied pursuant to Sections 30123 and 30131.2 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 list posted by the Attorney General.

The Attorney General's list would be annually posted on the Attorney General's web site and include both of the following:

1. All tobacco product manufacturers that have certified to the Attorney General that it is a participating manufacturer under the Master Settlement Agreement (MSA), or a non-participating manufacturer that has made all required escrow payments.
2. All brand families, and only brand families, identified by tobacco product manufacturers, as specified.

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**VIOLATIONS**

This bill would authorize the Board, upon a finding that a distributor has violated this bill's requirements, to revoke the license or licenses of a distributor in the case of a first offense. In the case of a second or subsequent offense, the Board, in addition to revoking the distributor's license or licenses, would be authorized to impose a penalty not to exceed the greater of either of the following:

- Five times the retail value of the cigarettes or tobacco products, as defined.
- Five thousand dollars (\$5,000).

A distributor would be allowed a defense for a violation of this bill's provisions provided that:

1. At the time of the violation, the cigarettes or tobacco products claimed to be the subject of the alleged violation belonged to a brand family that was included on the list, as provided.
2. At the time of the violation, the distributor possessed a copy of the Attorney General's most recent written acknowledgment of receipt of the certifications and other information required as a condition of including the brand family on the list, as provided.

However, a defense would not be available to the distributor if, at the time of the violation, the Attorney General had provided the distributor with written notice that the brand family had been excluded or removed from the list, or the distributor had failed to provide the Attorney General with a current address for the receipt of written notice through electronic mail.

Any cigarette or tobacco products that are stamped or to which a meter impression is affixed, or for which tax is paid, in violation of this bill's provisions, would be subject to seizure and forfeiture pursuant to the Cigarette and Tobacco Products Tax Law, regardless of whether the violation is subject to a defense, as provided. The cigarettes or tobacco products seized and forfeited would be destroyed.

**DISTRIBUTOR CREDIT FOR CIGARETTE AND TOBACCO TAXES PAID**

If a distributor affixes a stamp or meter impression to a package of cigarettes, or pays the tax on a tobacco product defined as a cigarette, during the period between the date on which the brand family of the cigarettes or tobacco product was excluded or removed from the list and the date on which the distributor received notice of the exclusion or removal, then both of the following would apply:

- The distributor would be entitled to a credit for the tax paid by the distributor with respect to the cigarette or tobacco product to which the stamp or meter impression was affixed or the tax paid during that period and which is forfeited by the distributor to the state. The distributor would be required to comply with regulations prescribed by the Board regarding refunds and credits, as specified. If the distributor has sold the cigarette or tobacco product to a wholesaler or retailer, and has received

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payment from the wholesaler or retailer, the distributor would be required to provide the credit to the wholesaler or retailer.

- The brand family would not be included on or restored to the list until the tobacco product manufacturer has reimbursed the distributor for the cost to the distributor of the cigarettes or tobacco product to which the stamp or meter impression was affixed or the tax paid during that period.

#### **MISCELLANEOUS**

This bill would authorize the Board to require those distributors that affix stamps or meter impressions to packages of cigarettes, or that pay the tax on a tobacco product defined as a cigarette, to submit all information necessary to enable the Attorney General to determine whether a tobacco product manufacturer has made all escrow payments.

The Board and the Attorney General would be authorized to exchange information as is reasonably necessary for the enforcement and administration of this bill.

#### **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.

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 judgements 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, authorized the Board to adopt any regulations necessary to ascertain, based on the amount of state excise tax paid on

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cigarettes, the number of tax paid cigarettes sold by tobacco products manufacturers who do not participate in the MSA. The Board was neutral on Senate Bill 822.

## COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by R.J. Reynolds Tobacco Company and is intended to protect California's settlement payments under the MSA, which are directly threatened by manufacturers that do not either join the MSA or make the escrow payments required by the Model Statute.

According to the author, California's MSA settlement payments have been significantly less than projected because of declining sales by the four original participating manufacturers. The decline (possibly in the millions of dollars) is partially attributable to increased sales by some non-participating manufacturers who have created an artificial price advantage over participating manufacturers by not making the escrow payments as required by law.

2. **Amendment contained in this version of the bill.** Among other things, the August 5, 2002 amendments require the distributor to provide a credit to the wholesaler or retailer where the distributor has sold the cigarette or tobacco product in violation of the bill's provisions, as provided, to a wholesaler or retailer and has received payment from the wholesaler or retailer.

In addition, the amendments 1) require any cigarette or tobacco product forfeited to the state in violation of this bill's provisions to be destroyed, and 2) clarify that cigarettes or tobacco products in violation of this bill's requirement are subject to seizure and forfeiture to the state regardless of whether the violation is subject to a distributor defense, as provided.

3. **Summary of June 17 amendments.** These amendments incorporate Board suggested changes to:

- Add cigarette and tobacco products violating this bill's provisions to the list as property that would be forfeited to the state upon seizure by the Board, which authorizes the Board to enforce the restriction on stamping cigarettes products prohibited by this bill in a manner consistent with the seizure provisions on all other illegally stamped cigarettes in California, and
- Make it clear in Section 30163.1(b) that no stamp shall be affixed to any package of cigarettes pursuant to Section 30163(a).

Additional amendments exclude a distributor from penalties if, at the time of the alleged violation, the distributor meets specified criteria. Furthermore, these amendments add a distributor credit for the tax paid with respect to the cigarette or tobacco product to which the stamp or meter impression was affixed during the period between the date on which the brand family was excluded or removed from the Attorney General's list and the date on which the distributor received notice of the exclusion or removal.

4. **The Board would not know the date a distributor affixes a stamp.** This bill would entitle a distributor to recoup excise taxes paid for a cigarette tax stamp that

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was unlawfully affixed during a specified period. In order to determine whether a distributor is entitled to recoup the excise taxes paid, the Board would need to know the exact date a stamp is affixed. However, the Board has no way of knowing the exact date a stamp or meter impression is affixed.

This concern would be addressed by SB 1701 (Peace) or AB 1666 (Horton), if chaptered, since it would require as of January 1, 2005 that the stamps and meter impressions, as specified, be encrypted with the date the stamp or meter impression was affixed.

5. **Would this bill authorize the Board to request additional information from distributors?** This bill would authorize the Board to require those distributors that affix stamps to packages of cigarettes to submit all information necessary to enable the Attorney General to determine whether a tobacco product manufacturer has made all escrow payments, as required. The Board currently requires those distributors to provide information allowing staff to calculate the number of tax paid units sold in California by each participating manufacturer pursuant to Section 30454. Section 30454 provides, in general, that in addition to any other reports required, the Board may require additional, other, or supplemental reports from licensed distributors. As such, it appears this provision would not create a new responsibility for the Board.
6. **Suggested technical amendment.** Section 30163.1(g)(1) generally provides that a distributor entitled to recoup taxes paid would be required to comply with regulations prescribed by the Board regarding refunds and credits that are adopted pursuant to Section 30176. In this case, the taxes would have been paid on cigarettes through the application of the tax stamps, which prior to distribution, would be destroyed by the Board. As such, it is recommended that Section 30177, rather than Section 30176, be referenced since it pertains to a refund or tax credit for destroyed cigarettes.

In addition, it is also recommended that the distributor's ability to recoup taxes paid only apply to cigarettes. Section 30177 was written to specifically provide for a refund of the excise tax on cigarettes, which is paid through the application of a cigarette tax stamp to each package of cigarettes prior to distribution. The tax imposed on tobacco products is not paid through the application of a stamp. The excise tax on tobacco products is paid through the use of a return on which the distributor reports the wholesale cost of the tobacco products distributed and remits the tax due – after distribution. Accordingly, since the tobacco products in a distributor's inventory are not tax paid the refund or credit of the tobacco tax is unnecessary. As such, the following amendment is suggested:

30163.1. (g)(1) The distributor shall be entitled to a credit for the tax paid by the distributor with respect to the cigarettes ~~or tobacco product~~ to which the stamp or meter impression was affixed, ~~or the tax paid during that period~~. The distributor shall comply with regulations prescribed by the board regarding refunds and credits that are adopted pursuant to Section 301767.

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7. **Related legislation.** Assembly Bill 1666 (Horton) contains, among other things, provisions substantially similar to this bill. The Board took a neutral position on these provisions as contained in AB 1666.

### **COST ESTIMATE**

The Board would incur additional costs to 1) revoke or suspend the license or licenses of the distributor for stamping or paying taxes on brands that are in violation of this bill's requirements, 2) impose additional penalties for violations, 3) provide credit for taxes paid, as specified, 4) prepare reports and answer the requests from the Office of the Attorney General, 5) seize cigarettes, and 6) warehouse and destroy product seized. Beginning January 1, 2003, it is estimated that the Board would incur start-up costs of approximately \$150,000 and annual on-going costs of \$243,000.

### **REVENUE ESTIMATE**

The following chart shows the estimated annual tobacco settlement payments to California as compiled by the Legislative Analyst's Office, the actual payments for 1998, 2000 and 2001, and projected payments as of July 31, 2001, compiled by the Attorney General's Office. As previously indicated, California's MSA settlement payments have been significantly less than projected because of declining sales by the four original participating manufacturers.

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Estimated Annual Tobacco Settlement Payments to California 1998 through 2025 (in millions)						
Year	State		Local*		Total	
	Projected In 1998	Actual	Projected In 1998	Actual	Projected In 1998	Actual
1998 & 2000 Initial Payment 2000 Annual Payment	\$562	\$515	\$562	\$515	\$1,124	\$1,030
2001	\$442	\$383	\$442	\$383	\$884	\$766
	Projected in 1998	Projected in 2001	Projected in 1998	Projected in 2001	Projected in 1998	Projected in 2001
2002	\$531	\$445	\$531	\$445	\$1,062	\$891
2003	\$536	\$445	\$536	\$445	\$1,072	\$891
2004 thru 2007 (each year)	\$447	\$386	\$447	\$386	\$894	\$771
2008 thru 2017 (each year)	\$456	\$367**	\$456	\$367**	\$912	\$773
2018 thru 2025 (each year)	\$511	\$441	\$511	\$441	\$1,022	\$881
<b>Totals</b>	<b>\$12,503</b>	<b>\$10,531</b>	<b>\$12,503</b>	<b>\$10,531</b>	<b>\$25,007</b>	<b>\$21,445</b>

\*Includes payments to all 58 counties and the cities of Los Angeles, San Diego, San Francisco, and San Jose.

\*\* Less \$38,232 Strategic Contribution Fund Allocation

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