

Overview of the Tax and Licensing Programs – Excise Taxes Division

Cigarette and Tobacco Products Taxes

Cigarettes first became subject to tax, also known as an excise tax, in July 1959 at the rate of \$0.03 per package. Since that time there have been four increases to the tax rate including a cigarette and tobacco products surtax to bring the combined tax rate per package to its current rate of \$0.87. Distributors pay the tax and surtax by purchasing cigarette tax stamps from BOE. Each package of cigarettes must have a stamp affixed to it to demonstrate that the taxes have been paid before it can be distributed. The use of stamps for the payment of taxes is required in statute. Taxes are also imposed on the distribution of tobacco products. Tobacco products—such as all forms of cigars, smoking tobacco, chewing tobacco, and snuff—are subject only to the cigarette and tobacco products surtax, which is reported and paid directly to the BOE by the distributors on their monthly tax returns. Tobacco products are not required to display a tax stamp. The imposition to tax on tobacco products differs since it is not determined on a “per cigarette” or per package basis, instead the statute provides that the tax is to be set at a rate equivalent to that which is imposed on cigarettes. Additionally, the tax on tobacco products is calculated based on a percentage of the distributors wholesale cost. The tobacco products tax rate, currently at 41.11%, is set annually by the elected Board.

In response to complaints received from licensed California distributors, retailers, and manufacturers and the potential loss of tax revenues, the BOE established the Cigarette Internet (CI) program. This program informs consumers of their tax obligations on their purchases of untaxed cigarettes and tobacco products. Consumers that purchase untaxed cigarettes or untaxed tobacco products must file with the Board a return reporting the amount of cigarettes and tobacco products received. Staff register accounts for consumers to allow them to file tax returns. Staff also notifies out-of-state sellers of their requirement to provide BOE with information regarding their sales to California consumers. A federal law, known as the Jenkins Act, requires the out-of-state seller to provide specific information regarding their sales of cigarettes. Staff continually identify out-of-state sellers and notify them of their responsibility to comply with the Federal Jenkins Act.

The Excise Taxes Division is responsible for registering accounts, selling cigarette tax stamps, mailing and processing tax returns, working delinquencies, issuing billings and refunds, providing advisory services; collecting account receivables, handling petitions and appeals, and conducting tax audits of cigarette and tobacco product distributors.

Cigarette and Tobacco Products Licensing Program

The Cigarette and Tobacco Products Licensing Act of 2003, which took effect in January 2004, seeks to lessen cigarette tax evasion by requiring the Board of Equalization (Equalization) to license all entities engaged in the sale of cigarettes and tobacco products in California. This program requires statewide licensing of all manufacturers, importers, distributors, wholesalers, and retailers of cigarette and tobacco products. Manufacturers, retailers, and tobacco product importers are subject to a one-time licensing fee. Distributors and wholesalers are subject to an annual fee of \$1,000.

The Excise Taxes Division is responsible for reviewing and screening new applications, performing background checks, batching and processing approximately 39,000 annual renewal applications, issuing new licenses, performing account maintenance, closing out accounts, processing refunds, processing citations and violations, issuing notice of violations, handling appeals, conducting first level and second level hearings, preparing Decision and Recommendation notices, issuing suspensions and revocations, issuing billings for fines and penalties, performing collection functions on complex fraud and audit billings, providing phone advisory services, scanning and imaging licensing documents, and ensuring proper oversight of the provisions of the Licensing Act.

The Investigations Division (ID) is responsible for enforcement of the Cigarette and Tobacco Products Licensing Act of 2003. Enforcement includes, but is not limited to: conducting taxpayer education, licensee compliance inspections, seizing contraband product, issuing civil and misdemeanor citations for violations of the Licensing Act, responding to consumer and industry tax evasion complaints, and following investigative leads which may develop into a felony criminal investigation. Felony investigations involve surveillance, coordinating with other state, local and federal enforcement agencies, issuing search warrants, preparing audit reports, prosecution packages, and ultimately working with the prosecuting authority to adjudicate cases.

California has taken in approximately \$139.6 million in new tobacco tax revenues between the period January 2004 – June 2006. This increase is attributed to the “three prong” approach of the new counter-proof stamp, a cigarette and tobacco product licensing program and field enforcement.

The Bureau of State Audits concluded that the BOE’s implementation of the Cigarette and Tobacco Licensing Act of 2003 and the encrypted cigarette tax stamp has significantly increased cigarette and tobacco products tax compliance. Furthermore, BOE’s Research and Statistics Section similarly concluded that the Licensing Act and new stamp efforts resulted in \$139.1 million annually in additional revenue. Since BOE implemented these legislative bills within the same general timeframe, revenue benefits from the licensing program cannot be distinguished from revenue benefits of the new cigarette tax stamp. Regardless, this \$139.1 million in additional revenue is substantially higher than originally estimated.

Overview of the drivers that affect costs/revenues

1. Senate Bill (SB) 1701 (Chapter 881, Statutes of 2002)

- SB 1701 was enacted to combat the increasing use of counterfeit cigarette tax stamps. California was losing an estimated \$280 million in cigarette taxes annually.
- SB 1701 required the Board of Equalization (BOE) to replace the heat-applied decal tax stamps with a technology based counterfeit resistant stamp capable of being read by a scanning or similar device, and encrypted with specific information.
- The cost for the stamp contract is approximately \$6.0 million per year.

2. Assembly Bill (AB) 71 (Chapter 890, Statutes of 2003) Cigarette and Tobacco Products Licensing Act of 2003 (BCP # 3, FY 2004-05)

- This act required statewide licensing of all manufacturers, importers, distributors, wholesalers, and retailers of cigarette and tobacco products.
- Manufacturers, importers, and retailers are subject to a one-time licensing fee. Distributors and wholesalers are subject to an annual fee of \$1,000.
- The Excise Taxes Division is responsible for issuing licenses to cigarette & tobacco products manufacturers, importers, distributors, wholesalers, and retailers; processing citations and violations; issuing billings for fines and penalties; providing advisory services; collecting bills and fines; and conducting appeal hearings.

3. AB 71 Cigarette and Tobacco Products Compliance Fund Funding Shift (BCP # 5, FY 2006-07)

- In foreseeing that expenditures to administer and enforce the act would exceed license fee revenue in the outlying years. The Legislature added Section 22 which states “all revenues and expenses generated by this act with respect to the taxes imposed under the Cigarette and Tobacco Products Tax Law (Part 13 (commencing with Section 30001) of Division 2 of the Revenue and Taxation Code) shall be allocated under the Cigarette and Tobacco Products Tax Law as that law read on the effective date of this act.”
- To address this funding shortfall in the Cigarette and Tobacco Products Compliance Fund and ensure the enforcement and administration of AB 71, the BOE requested resources of approximately \$2.141 million in FY 2006-2007, \$7.214 million in FY 2007-08, \$7.4 million in FY 2008-09, and \$3.695 million in FY 2009-10 from the Cigarette Tax Fund to supplement the Cigarette and Tobacco Products Compliance Fund. The funding shift was permanently established in BCP # 7, FY 2009-10.

4. Enforcement of Consumer Purchases of Tobacco Products from Out-of-State Sellers (BCP # 2d, FY 2006-07)

- This BCP provided resources for the Cigarette and Tobacco Products Internet Program as part of an ongoing effort to help California consumers report and pay excise and use taxes on purchases of untaxed cigarettes, tobacco products and other items such as cigarette papers, pipes, and humidors purchased from out-of-state, and subsequently brought into California for use, storage or consumption.
- The BCP also provided resources for audit workload related to common carrier and shipment records.
- The resources were provided for a 2 year limited term, but were permanently established in BCP # 4, FY 2008-09.

5. Assembly Bill (AB) 1749 Tobacco Products Manufacturer and Importer Licensing (BCP # 14, FY 2007-08)

- AB 1749 expanded the California Cigarette and Tobacco Products Licensing Act of 2003 in order to license manufacturers and importers of tobacco products that are engaged in selling tobacco products in California.
- AB 1749 also provided new deferral options for a distributor to defer payments for stamps. Cigarette distributors may defer payments for stamps if they hold a line of credit and post the required security deposit.
- The bill required tobacco products manufacturers and importers to file monthly returns and schedules.
- Resources were established for a 2 year limited term but were made permanent in BCP # 7, FY 2009-10.

6. BCP # 4, FY 2008-09 “Cigarette and Tobacco Products Taxes Revenue Recovery”

- This BCP permanently established BCP # 2d resources and provided additional resources to increase revenue recovery and enhance overall voluntary compliance in the cigarette and tobacco products tax programs.
- The areas of revenue recovery included out-of state tax avoidance, accounts receivable collections, tax audit activities, and enforcement efforts.

7. Cigarette and Tobacco Products Licensing and Enforcement (BCP # 7, FY 2009-10)

- This BCP permanently established resources to administer and enforce the Cigarette and Tobacco Products Licensing Act (AB 71- BCP # 3, FY 2004-05 and AB 1749- BCP # 14, FY 2007-08); accommodate a funding shortfall in the Cigarette and Tobacco Products Compliance Fund; and provide additional funding for use of the encrypted cigarette tax stamp as mandated by SB 1701.
- This BCP also added two permanent audit positions to perform field reviews, process cigarette tax stamp refunds, tobacco product refunds, and other related activities associated with claims for refunds.