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TOBACCO TAX STAMP

House Bill 5622 (Substitute H-3)
First Analysis (5-21-96)

Sponsor: Rep. Terry London
Committee: Tax Policy

THE APPARENT PROBLEM:

Michigan's new school finance system, put in place with the passage in 1994 of Proposal A, includes a 75 cent-per-pack tax on cigarettes. Prior to that, the tax was 25 cents per pack. One result of the tax increase is a decrease in the sale of cigarettes in the state. While some of the decrease may be attributed to a decline in smoking (which is one justification for the high tax), critics of the tax increase say Michigan residents are crossing state borders to buy cigarettes, sometimes in very large quantities, and that this is having a devastating effect on the state's wholesalers and retailers, particularly the convenience stores that depend heavily on cigarette sales. A representative of the Michigan Distributors and Vendors Association has testified that sales were down 30 percent in the first year after the tax increase and continue to be down from 15 to 20 percent in 1996. The effect on sales is said to be particularly dramatic along the state's border, with one economist suggesting that there has been a 40 percent increase in sales for Indiana border merchants and a corresponding decline for Michigan businesses. Nearby states have considerably lower cigarette taxes: 15.5 cents per pack in Indiana; 24 cents in Ohio; 38 cents in Wisconsin; and 44 cents in Illinois. Kentucky's tax is said to be a mere 3 cents per pack and Tennessee's 13 cents. There are also allegations that the tobacco tax increase has led to widespread organized smuggling of cigarettes from North Carolina.

According to a recent Detroit Free Press investigation, smugglers have easy access to large quantities of cigarettes in North Carolina, where the tax stamp law has recently been repealed. Said the Free Press: "A smuggler with a truck hauling 12,000 cartons from North Carolina, where the tax is just 5 cents per pack, can net at least $84,000 reselling them in Michigan. North Carolina became a favorite source because it, like Michigan, has no stamp to distinguish its taxable cigarettes." One way to address large scale over-the-border purchases and smuggling of cigarettes is to institute a tax stamp program, whereby each package of cigarettes would bear a stamp unique to Michigan. Michigan is said to be one of only six states without such a stamp program, which allows for more effective enforcement of tobacco tax laws.

THE CONTENT OF THE BILL:

The bill would amend the Tobacco Products Tax Act (MCL 205.422 et al.) to create a tax stamp program for cigarettes sold in the state. It also would credit one percent of the taxes imposed under the act to the Department of Treasury and the Department of State Police for enforcement and administration. The bill's effective date would be June 1, 1997. Among the bill's provisions are the following.

<u>Tax Stamps on Cigarette Packs.</u> Beginning July 1, 1997, prior to delivery, sale, or transfer to any person in the state, a wholesaler or an unclassified acquirer would be required to place or cause to be placed on each individual pack of cigarettes to be sold within the state a tax stamp provided by the Department of Treasury. However, upon written notice to the revenue commissioner, a wholesaler engaged in interstate business could set aside a portion of the stock as necessary for interstate business without affixing the tax stamps. Upon written authorization of the department, a wholesaler or unclassified acquirer could appoint a tax stamping agent to affix tax stamps to individual packages of cigarettes. The bill specifies how the stamps are to be affixed.

Beginning July 1, 1997, a licensee other than a wholesaler or unclassified acquirer or a person acting as a transporter, could not acquire cigarettes for resale unless the individual package of cigarettes had a tax stamp affixed to it. Beginning November 1, 1997, a retailer or vending machine operator could not sell or offer for sale an individual pack of cigarettes to the general public that did not have the required tax stamp. If an individual package of cigarettes was found without a tax stamp affixed as required, the presumption would be that it was being kept in violation of the act.

<u>Purchase of Stamps/Two Percent Discount to Wholesaler.</u> Beginning June 1, 1997, a wholesaler or unclassified acquirer would be able to purchase tax stamps from the Department of Treasury or a tax stamp sales agent for cash or check or draft drawn on certified funds on a cash on delivery basis at a two percent discount from the face amount of the stamps. The purchase could also be made on 45 days' credit. If the department determined that a wholesaler or unclassified

acquirer was not financially sound, the department or sales agent would issue tax stamps only on the filing with the department of a bond (or other security as determined by the department) in an amount not less than the value of the tax stamps issued by the department. If a wholesaler or unclassified acquirer failed to remit the tax for the tax stamps within 45 days, the entity would have to remit the tax in a form and manner prescribed by the department. The department or tax stamp sales agent would not issue any tax stamps to that wholesaler or acquirer until it had paid for all tax stamps that it had been issued. A wholesaler or acquirer would be prohibited from giving, selling, or lending any unaffixed stamps to another person and, except as otherwise provided, a person would be prohibited from accepting, purchasing, or borrowing unaffixed stamps from another person.

Treasury Procurement of Stamps. The Department of Treasury would procure tax stamps as needed in the various designs, denominations, and forms it determined necessary. The department could contract with a financial institution or other person to act as a tax stamp sales agent. The agent would have to account to the department each month for each tax stamp sold and for revenue received for the sale of tax stamps, with the accounting to be in a form and manner as prescribed by the department. The department would have to advise all tax stamp agents and all tax stamping agents (wholesalers and acquirers authorized to affix tax stamps) of any wholesaler, secondary wholesaler, unclassified acquirer, or other person whose license had been suspended or revoked or whose license had been reinstated.

Records of Stamps. The department and the tax stamp sales agent would have to keep a record of all stamps disbursed, serial numbers, name of wholesaler or unclassified acquirer, and date of disbursement. The department could release the identify of the wholesaler or acquirer to whom specific stamps were disbursed to state or local police agencies.

Monthly Reports to Treasury. The monthly report to the treasury department already required for manufacturers, wholesalers, unclassified acquirers, and transporters would have to contain the number of individual packages of cigarettes sold, the number of cigarettes in those packages, and the number and denominations of tax stamps affixed to individual packages. The return would also have to include the number and denomination of tax stamps and the serial number of each tax stamp in the licensee's possession at the end of the preceding calendar month. Wholesalers would also have to report accurate inventories of cigarettes, both stamped and unstamped at the end of the preceding calendar month. Wholesalers and unclassified acquirers would also have to report accurate inventories of tax stamps by denomination and serial number at the beginning and end of each calendar month and all tax stamps purchased during the preceding calendar month.

Redemption of Stamps. The department would have to redeem and pay a wholesaler or unclassified acquirer for any unused or spoiled stamps and stamps on unsalable packs at the value of the tax stamps less the appropriate discount paid. A wholesaler or acquirer could not resell or transfer any tax stamps purchased from the department or a tax stamp sales agent. Any stamps on hand when a license expired or was revoked or when a licensee discontinued the business of selling cigarettes would have to be returned to the department and the department would refund the value of the stamps, less the appropriate discount.

Report by Manufacturer. On or before the 20th of each month, each manufacturer would have to file a report with the treasury department listing all sales of tobacco products to wholesalers and unclassified acquirers located in the state during the preceding calendar month and any other information the department found necessary. The report would have to be in a form and manner specified by the department.

Illicit Stamps. A person who manufactured, possessed, or used a tax stamp or manufactured, possessed, or used a counterfeit tax stamp or writing or device intended to replicate a tax stamp without authorization of the department, or a licensee who purchased or obtained a tax stamp from someone other than the department or a tax stamp agent, would be guilty of a felony, with a mandatory sentence of imprisonment for not less than one year or more than 10 years. The sentence could also include a fine of not more than $10,000.

Exchange of Stamps. The department could require wholesalers and acquirers to exchange unaffixed tax stamps with the department. It could require wholesalers, acquirers, secondary wholesalers, vending machine operators, and retailers to discontinue offering for sale any unsold individual packages of cigarettes bearing a prior version of the tax stamp the department had withdrawn from circulation. The department could set a deadline after which the prior version could no longer be offered for sale. A secondary wholesaler, retailer, or vending machine operator could return cigarette packages bearing discontinued stamps to a wholesaler for credit. A wholesaler or unclassified acquirer could take credit on its tax returns for cigarettes returned.

Inspections by Treasury. The Department of Treasury or its authorized agents would be able to inspect or conduct an inventory of a wholesaler's or unclassified acquirer's stock of cigarettes, tobacco products other than cigarettes, and cigarette tax stamps during regular business hours and inspect the related statements and records. Inspections would also be authorized during business hours of the operations of a secondary wholesaler, vending machine operator, or retailer, and the contents of a specific vending machine. The inspection would have to include inspections of all statements and records required by the act, of packages of cigarettes and other tobacco products, and of the contents of cartons and shipping or storage containers to ascertain that all individual packages of cigarettes have an affixed tax stamp of proper denomination. The inspection would also have to verify that all the tax stamps were produced under the authority of the department and that the non-cigarette products have the required marking on the shipping container. A person would be prohibited from preventing or hindering the department or its authorized agents from making a full inspection of any place or vending machine where cigarettes and other tobacco products were sold or stored, or preventing or hindering the full inspection of invoices, books, records, or other papers required to be kept. A licensed wholesaler who was also a retailer would have to maintain separate secure storage for wholesale and retail inventories and separate records for the wholesale and retail operations.

Sales to Indian Communities and U.S. Government. A wholesaler or unclassified acquirer making sales other dispositions of cigarettes or tobacco products other than cigarettes to the U.S. government or its agencies or instrumentalities (e.g., military bases) or to Indian communities would not incur tax liability and would not have to affix tax stamps to those individual packages of cigarettes. Sales to individuals, private stores, or concessionaires on federal lands would be subject to the tax and the stamp would have to be affixed before delivery.

Manufacturers' Representatives. The revenue commissioner could permit a representative of a licensed manufacturer of tobacco products whose duties require travel in the state to transport up to 138,000 cigarettes, of which not more than 36,000 cigarettes could bear the tax indicia of another state. All 138,000 cigarettes would have to bear the tax stamp approved by the treasury department or the tax indicia of another state, if any. The total value of tobacco products, excluding cigarettes, could not exceed $5,000. A manufacturer would have to notify the department of its representatives who carry cigarettes or other tobacco products while working in the state and would have to keep a record of each transaction by a representative at an office located in the state for one year and produce the records upon request of the commissioner or his or her agents. A representative could not sell, exchange, or otherwise dispose of cigarettes or other tobacco products within the state bearing the tax indicia of another state or receive tobacco products with tax indicia from retailers located in the state. A representative who sold, exchanged, or otherwise disposed of cigarettes or other tobacco products that did not bear the required tax stamp or marking, or sold, exchanged, or otherwise disposed of cigarettes or other tobacco products bearing the tax indicia of another state would be guilty of a felony, punishable by a fine of not more than $5,000 or imprisonment for not more than five years, or both.

Bad Debt Deduction. In computing the amount of tax levied for any month, a taxpayer (e.g., wholesaler or acquirer) could deduct the amount of bad debts from the tax due. The amount of bad debts deducted would be charged off as uncollectible on the books of the taxpayer. If a retailer or other licensee paid all or part of a bad debt for which a taxpayer had claimed a deduction, the taxpayer would be liable for the taxes deducted in connection with the amount of debt paid and would have to remit the taxes in the next payment. A claim for a bad debt deduction would have to be supported by that evidence required by the Department of Treasury. The term "bad debt" would mean any portion of a debt incurred after May 1, 1994, that was related to the tax on the transfer of a tobacco product that had become worthless or uncollectible "between the date when taxes accrue to the state for the taxpayer's preceding tax return and the date when taxes accrue to the state for the present return or an amount that has become worthless or uncollectible for taxes that accrue to the state after May 1, 1994, and before the first present return filed after the effective date [of the bill] and that is eligible to be claimed, or could be eligible to be claimed if the taxpayer kept accounts on an accrual basis, as a deduction pursuant to Section 166 of the Internal Revenue Code." A bad debt would not include any interest or tax on the purchase price, uncollectible amounts on tobacco products remaining in the possession of the taxpayer until the full price was paid, expenses incurred in attempting to collect any account receivable or any portion of a debt recovered, any accounts receivable that had been sold to a third party for collection, and repossessed property.

Revocation of Licenses. If a wholesaler or unclassified acquirer licensed under the act was convicted of a felony under any provision of the act, the Department of Treasury would have to revoke any license issued under the act to that person.

Revised Penalties. Currently, a person who possesses, acquires, transports, or offers for sale contrary to the act tobacco products with a wholesale price of $50 or more is guilty of a felony, punishable by a fine of not more than $5,000 or imprisonment for not more than five years, or both. The bill would make the felony penalty apply to offenses involving 3,000 or more cigarettes or tobacco products with an aggregate wholesale price of $250 or more. A person who commits a violation with 1,200 up to 3,000 cigarettes with an aggregate wholesale value of from $100 up to $250 would be guilty of a misdemeanor punishable by a fine of not more than $1,000 or imprisonment of not more than one year, or both.

Distribution of Tax. The distribution of proceeds under the act would be altered. As mentioned above, one percent of taxes imposed under the act would be credited to the treasury department and state police. Currently, the proceeds from the tax on cigars, noncigarette smoking tobacco, and smokeless tobacco go the state school aid fund. Under the bill, 94 percent of the amount remaining after the 1 percent enforcement and administration distribution would be credited to the state school aid fund and 6 percent to the Healthy Michigan Fund. The distribution percentages for the cigarette tax would remain unchanged, except that they would apply after the 1 percent for enforcement and administration had been credited. Also, the 6 percent that now is to be "dedicated to improving the health care of residents of the state" would be credited to the Healthy Michigan Fund.

FISCAL IMPLICATIONS:

The House Fiscal Agency estimates that net revenues collected by the state (after increased collection fees and before additional appropriations to the Departments of Treasury and State Police) could be expected to increase $10 million to $30 million on a full-year basis. The HFA says "precise estimates of the impact of this legislation are impossible to make due the nature of the problem. However, the presence of a tax stamp and enhanced enforcement would clearly make it more difficult to bring 'bootleg' cigarettes into Michigan. To the extent that legal sales increase . . . there would be an increase in gross tobacco tax revenues and a small increase in gross sales tax revenue. Hence, there is both a state and local impact." The HFA also points out that the commission paid to wholesalers for collecting the tobacco tax would increase from one to two percent, meaning they would receive an additional $6 million per year ($12 million total) in commissions. (Fiscal Note dated 5-15-96)

ARGUMENTS:

For:

Although Michigan has one of the highest cigarette taxes in the country, it is one of six without a tax stamp law that allows law enforcement officials to trace the source of cigarettes being sold in the state. The use of tax stamps, coupled with more resources devoted to enforcement, will work to counteract smuggling. Stemming the flow of illegal cigarettes into the state will mean more business for Michigan retailers and wholesalers of tobacco and more revenue to the state from the tobacco tax. The recent tripling of the tobacco tax has created an enormous incentive for Michigan residents to go out of state to purchase cigarettes and for organized smuggling operations to bring vast quantities of cheap, tax-free cigarettes into the state by the truckload. The current situation is said to be having a devastating effect on wholesalers and retailers who sell cigarettes, especially convenience stores, and particularly on the state borders. Cigarette sales are up in nearby states and down in Michigan, say critics, suggesting that people are not quitting smoking in large numbers but buying out-of-state or from retailers who have obtained their cigarettes at lower prices out of state. The bill would designate one percent of tobacco taxes to administration and enforcement of the law, which will allow for increased law enforcement emphasis on cigarette smuggling.

While a tax stamp program will help Michigan businesses that sell cigarettes, it will also be a burden, especially for wholesalers, who collect the tax on behalf of the state. The bill as written contains an additional one percent collection fee to help cover the additional costs associated with organizing and maintaining stamping operations. Wholesalers will have to buy stamps and affix them to each pack of cigarettes (or have it done for them). There will be a need for additional space, equipment, and personnel, and there will be an increase in paperwork. It is unrealistic to introduce a dramatic new regulatory scheme and expect the industry to pay for it out of existing revenues. Not to provide an increase in the wholesaler's commission would be punitive. The bill also contains a bad debt deduction, which the House has already approved once -- in House Bill 4855.

Response:

It should be noted that the decrease in cigarette sales is at about the level anticipated by treasury department officials when the tobacco tax increase was proposed and that revenues from tobacco sales remain strong, at about $600 million per year, compared to about $240 million before the tax increase.

Against:

Department of Treasury officials have pointed out that when the tax on cigarettes increased from 25 cents per pack to 75 cents per pack, the commission paid wholesalers for their tax collection functions remained at one percent. This means they received a large increase in revenue, even though the effort involved in collecting taxes remained the same. The revenue to wholesalers increased from $2.4 million to $6 million with the tax increase. It does not cost more to collect a higher tax rate. (Wholesalers also received what some would describe as an unanticipated and unjustified revenue windfall from the timing of the tax increase) It is simply not justifiable to increase the commission to wholesalers by one percent, as this bill would do. Further, the bill provides to wholesalers a bad debt deduction, which permits businesses to deduct from the taxes due to the state amounts that cannot be collected from retailers. This, in essence, says the treasury department, asks the state to underwrite the credit decisions of wholesalers. It will make the state bear the burden of bad debts between wholesalers and retailers. (It could lead, moreover, to a parade of requests for similar exceptions for taxes on other products.) Taken together, the increased commission and the bad debt deduction will significantly reduce state revenue from the tax stamp proposal.

Against:

The best way to stop consumers from buying cigarettes out of state and to stop widespread smuggling of cigarettes is to lower the tax. It is possible that adoption of a tax stamp system will not halt smuggling for long, given Michigan's high cigarette tax, but will lead to the counterfeiting of tax stamps and more sophisticated operations. Why add an additional layer of regulation and bureaucracy, when lowering the tax would remove the incentives for smuggling?

Response:

Efforts to reduce the cigarette tax should be resisted. To the extent that the high tax reduces consumption, the tax achieves beneficial public health objectives. (It is also successfully producing revenue for the state schools and for public health programs) There needs to be further study to determine what is causing the decline in cigarette sales, to determine the effect that smuggling and cross-border sales are having and the effect that decreased consumption of tobacco is having. A tax stamp program should not be used to create an atmosphere in which it will seem more palatable to simply reduce tobacco taxes.

POSITIONS:

The Michigan Distributors and Vendors Association, Inc. supports the bill in its current form. (5-20-96)

Representatives of Spartan Stores, of Kroger, and of Farmer Jack have all indicated support for the bill as written. (5-20-96)

The Department of Treasury is strongly opposed to the bill as written. (5-17-96)

■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.