House Legislative Analysis Section

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TOBACCO TAX STAMP

House Bill 4215 as enrolled
Public Act 187 of 1997
Second Analysis (8-25-98)

Sponsor: Rep. Kirk A. Profit
House Committee: Tax Policy
Senate Committee: None

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 they allege that there is widespread organized smuggling of cigarettes (particularly from North Carolina). This, they say, 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 continued to be down from 15 to 20 percent early 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; 44 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.

According to a 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have easy access to large quantities of cigarettes in North Carolina, where the tax stamp law has recently been repealed.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. Attempts to impose a tax stamp program by statute were stymied by a disagreement between the Department of Treasury and the distributors of tobacco products over how much to increase the existing 1 percent tax collection fee for wholesalers to offset the costs of a stamp program. The department opposed any increase on the grounds that wholesalers reaped a windfall benefit from the existing collection fee when the tax tripled (since collection fee revenues tripled at the same time). The industry sought an increase in the collection fee to 1.5 percent or 2 percent. The courts blocked the administration's attempt to impose a stamping program administratively through emergency rules. An agreement has been reached on this issue.

THE CONTENT OF THE BILL:

The bill would amend the Tobacco Products Tax Act to create a tax stamp program for cigarettes sold in the state. As of September 1, 1998, a pack of cigarettes could not be sold to the general public without a tax stamp. The 1 percent tax collection fee retained by wholesalers would be increased to 1.25 percent for the collection of cigarette taxes only. The bill's effective date would be April 15, 1998. Among the bill's provisions are the following.

<u>Tax Stamps on Cigarette Packs.</u> Beginning May 1, 1998, before 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 the bottom of each individual pack of cigarettes to be sold within the state a tax stamp provided by the Department of Treasury. 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.

Beginning May 1, 1998, 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 September 1, 1998, 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.

Definitions. The term "unclassified acquirer" is defined in the act as a person, except a transportation company or a purchaser at retail, who imports or acquires a tobacco product from a source other than a wholesaler or secondary wholesaler for use, sale, or distribution. The bill would add to that definition, a person who received cigars, non-cigarette smoking tobacco, or smokeless tobacco directly from a manufacturer licensed under the act or from another source outside the state who was not licensed. The term "unclassified acquirer" does not include a wholesaler. A "stamping agent" would be a wholesaler or unclassified acquirer other than a manufacturer who was licensed and authorized by the department to affix stamps to individual packages of cigarettes on behalf of themselves and other wholesalers or unclassified acquirers other than manufacturers.

Acquisition of Stamps/1.25 Percent Discount to Wholesaler. Beginning April 15, 1998, a wholesaler or unclassified acquirer would have to obtain tax stamps from the Department of Treasury and remit the unpaid balance of the tax at a 1.25 percent discount from the face amount of the stamps at the time of filing the return due on the 20th day of each calendar month. (This would replace the current 1 percent tax collection fee on cigarette taxes. The collection fee on other tobacco products would remain unchanged.) If the department determined that a wholesaler or unclassified acquirer was not financially sound, the department or sales agent could issue tax stamps only if 1) the entity filed a bond or other security with the department in an amount to be determined by the department; 2) the department required returns and payments more frequently than monthly; or 3) the department required the entity to pay for the stamps at the time of obtaining them. The department could not issue any stamps to a wholesaler or unclassified acquirer who was delinquent in paying the tax. 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 would have to advise all stamping agents of any wholesaler, secondary wholesaler, unclassified acquirer, or other person whose license had been suspended, revoked, or not renewed, or whose license had been reinstated.

Records of Stamps. The department would have to keep a record of all stamps disbursed, 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 unaffixed tax stamps 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 affixed and unaffixed tax stamps by denomination at the beginning and end of each calendar month and all tax stamps acquired during the preceding calendar month.

Refunds and Exchanges of Stamps. If a wholesaler or acquirer had unsalable packs returned from a retailer, secondary wholesaler, vending machine operator, wholesaler, or unclassified acquirer with stamps affixed, the department would have to refund the amount of the tax less the appropriate discount paid. If the wholesaler or acquirer had unaffixed unsalable stamps, the department would have to exchange them for new stamps in the same quantity. An application for the refund of the tax would have to be filed on a department-approved form within four years from the date the stamps were originally acquired. A wholesaler or acquirer would have to make available for inspection by the department the unused or spoiled stamps and the stamps affixed to unsalable packages of cigarettes. The department could, at its discretion, witness and certify the destruction of unused or spoiled stamps and unsalable packs of cigarettes that were not returnable to the manufacturer. The wholesaler or acquirer would have to provide certification from the manufacturer for any unsalable individual packages of cigarettes returned to the manufacturer.

A wholesaler or acquirer could not resell or transfer any unaffixed tax stamps acquired from the department. 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 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.

Unstamped Cigarettes Sales Report. Each wholesaler/acquirer would have to submit to the department an unstamped cigarette sales report on or before the 20th of each month covering the sale, delivery, or distribution of unstamped cigarettes during the preceding calendar month to points outside of Michigan. A separate schedule would have to be filed for each state, country, or province into which shipments were made. For purposes of this report, the term "unstamped cigarettes" would refer to individual packages of cigarettes that do not bear a Michigan stamp. The department could provide the information in the report to a proper officer of another state, country, or province reciprocating this privilege.

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, 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 $50,000.

A person who falsely made, assisted in making, caused to be made, or purchased or received a counterfeit or altered license, vending machine disc, or marker, or who possessed a device to forge, alter, or counterfeit those documents, 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. A person who altered or falsified records or markings required under the bill would be guilty of a felony carrying the same penalty.

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 reasonable timeline 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, less the appropriate discount paid.

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. 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.

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.

Revocation of Licenses. If a manufacturer, 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. Currently, the act permits the department to suspend, revoke, or refuse to issue or renew a license for failure to comply with the act or for any other good cause. The bill would require the department, before suspending, revoking, or refusing to renew a license, to notify the person of its intent to hold a hearing before a representative of the revenue commissioner at least 14 days before the scheduled hearing date. (The act also allows an aggrieved person to apply for a hearing within 20 days after notice of the suspension, revocation, or refusal to issue or renew the license.) The bill would require that the decision on a suspension, revocation, or refusal to renew would have to be issued within 45 days of receipt of the request for hearing.

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 and would increase the maximum fine to $50,000. 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 $5,000 or imprisonment of not more than one year, or both.

Retailer Sanctions. As of September 1, 1998, if a retailer possessed or sold cigarettes on which the tax has not been paid or accrued to a wholesaler, secondary wholesaler, or unclassified acquirer licensed under the act, the retailer would be prohibited from purchasing, possessing, or selling any cigarettes or other tobacco products. For a first violation, the prohibition would be for not more than six months; for a second violation within a period of five years, for a period of at least 6 months and not more than 36 months; for a third violation within a period of five years, a period of at least 1 year and not more than 5 years. The retailer could appeal to the department and would be given a hearing that would not be a contested case hearing and would not be subject to the Administrative Procedures Act. The department would then render a decision in writing within 10 business days. (The procedure is found elsewhere in the act, in Section 9, and is the existing procedure in cases of seizures and forfeitures.)

The prohibition on sales and purchases would be effective upon service by certified mail or personal service on the retailer. Upon receipt of the notice, the retailer could return any tobacco products on which tax had been paid. The department would notify all licensed wholesalers, manufacturers, secondary wholesalers, vending machine operators, and unclassified acquirers of any retailer subject to the prohibition of selling and buying tobacco products, and they would not be permitted to sell cigarettes or other tobacco products to such a retailer after receipt of the notice. Any cigarettes or other tobacco products found on the premises of the retailer during the period of prohibition would be considered contraband and subject to seizure and would constitute an additional improper possession.

License Fees. The bill would make some changes in fees. Currently, the fee for an unclassified acquirer is to be determined by the department, but not to exceed $150. The bill would require the following fees for the various kinds of unclassified acquirer: for the State of Michigan, no fee; for a retail importer of tobacco products other than cigarettes, $10; for a retail importer of cigarettes, $100; for a vending machine operator buying direct from a cigarette manufacturer, $100; for a manufacturer, $100; and for any other importer, $100. Currently, there are four levels of fees for vending machine operators, from $5 per machine for those with three or fewer machines up to a $100 fee for those with 50 or more machines. The bill would provide for one $25 fee for vending machine operators.

License Applications. In addition to current licensing requirements, the bill would require that applications for persons applying for an initial license under the act be accompanied by satisfactory proof of all of the following:

-- The applicant's financial responsibility, including but not limited to satisfactory proof of a minimum net worth of $25,000.

-- That the applicant owned, or had an executed lease for, a secure non-residential facility for the purpose of receiving and distributing cigarettes and conducting its business (if the applicant did own or had executed a lease on such a facility). If the applicant carries on another business in conjunction with the secure non-residential facility, the other business also would have to be identified.

-- United States citizenship or eligibility to obtain employment within the U.S. if not a citizen. If the applicant was not an individual, the controlling shareholders, partners, directors, and principal officers would have to be U.S. citizens or eligible to obtain employment within the U.S. if not citizens.

If there was a change of ownership or control or a change in the general partnership of a licensee, the department could require that licensee to file a new application for a license or an updated financial statement.

Distribution of Tax. The distribution of proceeds under the act would be altered. Currently, the proceeds from the tax on cigars, non-cigarette 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 essentially unchanged.

MCL 205.422 et al.

FISCAL IMPLICATIONS:

The House Fiscal Agency estimates that net tobacco tax revenues could be expected to increase by $10 million to $30 million on a full-year basis as a result of tobacco tax stamps. (Fiscal Note dated 2-4-97) The Senate Fiscal Agency has estimated a net increase in cigarette tax revenue of $12.2 million. (SFA analysis dated 2-12-97) Both fiscal agencies report that it is "very difficult"or "impossible" to estimate precisely the additional revenue from a stamping program. The Senate Fiscal Agency says the number of packs of cigarettes taxed declined 15.2 percent from fiscal year 1992-93 to fiscal year 1994-95, representing a loss in tax revenue of $117 million (compared to what would have been collected if sales had remained stable). The Department of Treasury has estimated the reduction in sales of taxed cigarettes at 22 percent from 1993 to 1996. The SFA cites as contributing factors the long-term downward trend in smoking due to health hazards; an increase in tax-exempt sales at military bases; the higher price of cigarettes; and smuggling, both organized and casual smuggling by individuals. The SFA attributes $20 million of the loss in cigarette revenue to organized smuggling. (It should be noted that the estimated total tobacco products tax revenue for fiscal year 1996-97 was $575.1 million, according to a recent report from the House Fiscal Agency. In 1993, before the tax increase, revenues totaled $243.5 million.)

ARGUMENTS:

For:

Although Michigan has one of the highest cigarette taxes in the country, it is said to be one of six states 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 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, and particularly to the school aid fund, 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 as written contains an additional one-quarter-of-a-percent collection fee to help cover the additional costs associated with organizing and maintaining stamping operations. This represents a compromise between the Department of Treasury and tobacco wholesalers. 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. 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. Distributors say it is unrealistic to introduce a dramatic new regulatory scheme and expect the industry to pay for it out of existing revenues. The Department of Treasury has argued that the industry gets sufficient revenues from the current collection fee, since revenues from the fee tripled along with the tax. An agreement has been reached on this matter to allow tobacco tax stamping to go forward.

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 additional 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.

Analyst: C. Couch