

Legislative Analysis



TOBACCO PRODUCTS TAX ACT AMENDMENTS

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House Bill 5668 (Substitute H-2)
Sponsor: Rep. Larry Julian
Committee: Regulatory Reform
First Analysis (8-4-04)

BRIEF SUMMARY: The bill would amend the Tobacco Products Tax Act to do the following.

** Extend to counterfeit cigarettes the same penalties that currently exist for the illegal possession, acquisition, transportation, or offering for sale of cigarettes and tobacco products, and for the falsification of a manufacturer's label on cigarettes.

** Increase the tax penalty for a person, other than a licensee under the act, who is in control or possession of a tobacco product in violation of the act, in control or possession of an individual package of cigarettes without a stamp in violation of the act, or who offers products for sale to another for purposes of resale without a license. Currently, a person committing these violations is personally liable for the taxes imposed by the act plus a penalty of 100 percent of the amount of tax due. The bill would increase this to 500 percent of taxes due.

** Alter the penalty for a person who commits a violation of the act for which a criminal penalty is not specifically provided. Currently, such a violation is a misdemeanor punishable by imprisonment for not more than one year and/or a fine of not more than \$1,000. The bill would make the fine \$1,000 or five times the retail value of the tobacco products involved, whichever was greater.

** Add provisions (and penalties) regarding the sale of cigarettes through the Internet, by telephone, or by mail order, including provisions to prevent sales to minors.

** Provide a tax credit to wholesalers and unclassified acquirers on sales of cigarettes for specified weeks in 2004.

FISCAL IMPACT: This bill would increase the penalty for a person, other than a licensee, who is in possession of a tobacco product that is contrary to the tobacco products tax act and would impose a new penalty for transactions that violate requirements of Internet, telephone, or mail-order sales.

In addition, this bill would provide for a credit to wholesalers and unclassified acquirers equal to the product of the cigarette tax increase and a one week period, as specified in the bill, for FY 2003-04 and for FY 2004-05. This would reduce cigarette tax revenue by an estimated \$20 million to \$40 million – approximately half would affect FY 2003-04 revenue and half would affect FY 2004-05 revenue. However, the revenue loss could be greater if sales from wholesalers and unclassified acquirers during the last two week

period of June 2004 were higher than estimated. The estimated fiscal impact would affect the General Fund/General Purpose (GF/GP), School Aid Fund (SAF), Health and Safety Fund, Healthy Michigan Fund, Medicaid Trust Fund, and Wayne County revenue.

THE APPARENT PROBLEM:

Public Act 164 of 2004 (enrolled House Bill 5632) raised the tax on cigarettes from \$1.25 to \$2.00 per pack and increased the tax on other tobacco products, such as chewing tobacco and cigars, from 20 percent to 32 percent. This increase went into effect July 1. Historically, sales of tobacco products slack off somewhat following an increase in taxes. Studies show that for every ten percent increase in the cost of cigarettes, four percent of smokers will quit smoking. However, in New York City, where a large tax hike in July 2002 boosted the cost of a pack of cigarettes to \$7.50 or more, legitimate sales of cigarettes have dropped off markedly – from 30.4 million packs in January 2002 to 11.1 million in January of this year. According to media reports, some of the decrease in sales can be attributed to a combination of sales via telephone and Internet and to criminal activity by “petty criminals to organized gangs and even terrorist organizations such as Hezbollah” (“High tax fuels black market in cigarettes”, *Crainsdetroit.com*, March 11, 2004).

Now that Michigan has increased its tax on cigarettes and other tobacco products, some people are concerned that what is happening in New York City could happen here. For instance, a carton of a popular brand of cigarettes that sells for \$46 in a chain convenience store can be bought for as little as \$26.99 online. Though some of the more than 400 online outlets for tobacco products do inform purchasers that they are responsible to remit the appropriate taxes to their local governments, there currently is little that the state can do to track sales to Michigan residents so as to ensure payment of the taxes. Buying tobacco products from the states bordering Michigan is another lower-cost option for some. For example, where Public Act 164 raised the tax on a carton of cigarettes to \$20, according to information supplied by an association representing tobacco wholesalers, the tax on a carton of cigarettes is \$5.60 in Indiana, \$5.50 in Ohio, \$7.70 in Wisconsin, and only 30 cents in Kentucky. Though Michigan law only allows a person to import about two cartons of cigarettes for personal use at a time, it is nearly impossible for the state to enforce the limit or to prevent someone from filling up a car trunk or van with cigarettes and then selling them to others. Some believe, therefore, that the law should be amended to provide penalties for possessing or selling counterfeit cigarettes and to increase the penalties for some violations of the tobacco laws regarding cigarette packages that do not carry the required state tax stamp. In addition, more information gathering and reporting by Internet sellers needs to be required so that the state can collect the taxes from those who buy tobacco products online.

In a closely related matter, a recent study conducted by researchers at the University of North Carolina and published in the *Journal of the American Medical Association* (JAMA) in September of 2003 revealed that children, some as young as 11 years old, were successful more than 90 percent of the time in purchasing cigarettes over the Internet. More than 86 percent of these purchases were either left at the door by delivery

employees or allowed to be accepted by the youthful purchasers with no age verification. Though legislation has been introduced at the federal level to tighten age verification requirements, some feel that the state should take more of an initiative in protecting youth by creating more stringent age verification requirements for Internet, telephone, and mail-order sellers at the time of a sale and when delivering the product.

THE CONTENT OF THE BILL:

The bill would amend the Tobacco Products Act. A description of the bill follows.

Counterfeit Cigarettes. The following are the existing penalties for violations of the act that would be specifically extended to counterfeit cigarettes. The bill would define a “counterfeit cigarette” as a cigarette in an individual package of cigarettes or other container with a false manufacturing label or a cigarette in an individual package of cigarettes or other container with a counterfeit stamp.

A violation involving 3,000 or more cigarettes is a felony punishable by a fine of not more than \$50,000 and/or imprisonment for not more than five years. A violation involving 1,200 to 2,999 cigarettes is a misdemeanor punishable by a fine of not more than \$5,000 and/or imprisonment for not more than one year.

The falsification of a manufacturer’s label on cigarettes is a felony punishable by imprisonment for not less than one year or more than ten years. A fine of not more than \$50,000 could also be imposed.

Tax Credit on Cigarette sales. Wholesalers and unclassified acquirers are required under the act to make monthly reports on inventory, the number of unfixed tobacco stamps, the quantity of cigarettes purchased, and so forth and pay the required tax for tobacco products sold during the calendar month covered by the return.

The bill would allow every wholesaler and unclassified acquirer who paid the tax in July 2004 to claim a credit against their current tax liability on their August 2004 return equal to 37.5 mills per cigarette for each cigarette sold in the last seven-day period of June 2004 and another tax credit for the same amount could be claimed on the October 2004 return for each cigarette sold in the second-to-last seven-day period of June 2004.

Internet, Phone, and Mail-Order Sales. Such sales could not be completed unless the seller had obtained from the purchaser a certification that included a valid government-issued document confirming that the purchaser was at least the legal minimum age to purchase cigarettes; that the cigarettes were not intended for consumption by an underage person; and a written statement signed by the purchaser that certified the purchaser’s address and that the purchaser is at least the minimum legal age. The statement would also have to confirm that the purchaser understood that signing another’s name was illegal; that the sale of cigarettes to underage persons was illegal; and that the purchase of cigarettes by underage persons was illegal in Michigan. The seller would have to verify the information contained in the certification against a commercially available database

of government records or obtain a photocopy or other image of the valid, government-issued identification.

All invoices, bills of lading, sales receipts, and other documents related to the sale of cigarettes through the Internet, by telephone, or by mail order would have to contain the current seller's valid Michigan sales tax registration number, business name and address, and a statement whether all sales taxes and tobacco taxes had been paid. All packages of cigarettes shipped from a seller to purchasers residing in Michigan would have to clearly print the package with the word "Cigarettes" on the outside of all sides of the package clearly visible to the shipper. In addition, the package would have to contain an externally visible and clearly legible notice located on the same side of the package as the delivery address, stating (in capital letters): "If these cigarettes have been shipped to you from a seller located outside of the state in which you reside, the seller has reported under federal law the sale of these cigarettes to our state tax collection agency, including your name and address. You are legally responsible for all applicable unpaid state taxes on these cigarettes."

If an order was made as a result of an advertisement over the Internet, the tobacco retailer would have to request the electronic mail address of the purchaser and receive payment by credit card or check before shipping.

A person who violated the bill's provisions regarding Internet, phone, or mail order sales would be guilty of a misdemeanor, punishable by a fine of not more than \$10,000 and/or imprisonment for not more than one year. Each violation would be a separate offense. (The Internet, phone, and mail order provisions would not apply to sales made by wholesalers and unclassified acquirers.)

MCL 205.422 et al.

ARGUMENTS:

For:

Due to tough economic times, lawmakers recently increased the per pack tax on cigarettes by \$1.25. Though meant to increase revenue to the state to support governmental services, some are concerned that the increase will spur criminal activity such as smuggling cigarettes from border or nearby states where taxes are much lower. For example, the City of New York has seen a rise in black market sales since their tax increase went into effect in the summer of 2002. In fact, in 2002, ten members of Hezbollah were arrested in North Carolina and convicted of using the proceeds from cigarette smuggling to aid the organization in its activities. Reportedly, the federal Bureau of Alcohol, Tobacco, Firearms and Explosives has been increasing its enforcement efforts since then. But, with federal agencies also feeling the pinch from reduced funding, some feel that Michigan needs to do more to discourage illegal sales and increase the state's ability to collect taxes on legal sales of tobacco products by Internet, telephone, and mail order companies. The increased penalties for smuggling cigarettes from other jurisdictions into the state should add an effective deterrent. The

increased accountability and record-keeping requirements the bill would provide will go far in enabling the state to track sales to Michigan residents and then to verify whether or not those purchasers remitted the appropriate taxes to the state.

For:

When the tax increase took effect on July 1, one tobacco wholesaler reported a 70 percent drop in sales over a few days time. A representative of an association representing distributors and vendors who supply products to grocery and convenience stores testified that each tobacco tax increases a wholesaler's costs of doing business; for example, inventory carrying costs, insurance costs, security costs, and accounts receivables carrying costs. A roll of 30,000 state cigarette tax stamps increased from \$37,500 to \$60,000 overnight. In addition, though members of the association supply every type of product sold by grocery and convenient stores, tobacco product sales represent about 70 percent of sales. The increased business costs associated with the tax hike coupled with a decrease in sales of their major product puts some small wholesalers in danger of going out of business. The bill would help by giving wholesalers a two week floor stocks tax exemption. The exemption would be taken as a deduction on the required monthly tax filing, with one week's exemption taken in the 2003-2004 fiscal year and the other week's exemption taken in the 2004-2005 fiscal year. This two-week exemption will mitigate the initial losses experienced by wholesalers and provide a needed cushion for some small business owners who otherwise may face the loss of their businesses.

Response:

The tax increase was necessitated by the severe budget problems facing the state and this provision of the bill would reduce cigarette tax revenue by an estimated \$20 million to \$40 million, with half of that affecting the current fiscal year budget and the other half affecting next year's budget. This would impact revenue earmarked for education and several health programs, in addition to the general fund and Wayne County revenue. These programs provide needed services to the young and low-income individuals needing health care. Besides, a collection commission is paid to cigarette and other tobacco products wholesalers to collect the tobacco products tax. Currently, the commission tax is 1.5 percent of the tax collected for cigarette wholesalers and 1 percent for other tobacco products wholesalers. The increased taxes generated by Public Act 164 of 2004 are expected to increase the commission paid to the cigarette wholesalers by an estimated \$0.9 million in the 2003-2004 fiscal year and \$4.3 million in the next fiscal year. Hopefully, this increase in the tax commission will provide sufficient financial help to the wholesalers to absorb the additional costs associated with being tobacco wholesalers.

Against:

Youth trying to buy cigarettes online already face more hurdles than at the neighborhood store. For instance, few minors have a credit card in their own name, and online retailers partner with credit card companies to determine the age of the credit card user. Moreover, the policy of most, if not all, parcel delivery companies is to have a person sign for the package and show proof of age to accept packages containing tobacco products. Therefore, the bill's requirements that online, telephone, or mail order companies receive a certification that includes a government-issued document to verify

the person's age is not really needed, nor are the additional notices that these sellers would have to provide to purchasers.

Response:

The facts as reported in the University of North Carolina study regarding online sales of cigarettes to minors do not support the above argument. Even children as young as 11 years of age were able to purchase cigarettes in over 90 percent of their attempts and were able to receive delivery of those purchases 86 percent of the time! Obviously, employees of the U.S. Postal Service and private delivery companies need to adhere more closely to company policies. However, children should not be able to buy cigarettes online in the first place. The bill's requirements would put an additional burden on retailers selling over the Internet, through the mail, or by telephone (i.e., requiring a faxed copy of a driver's license or state I.D.) to verify the name and age of the purchaser. In addition, requiring every box to be clearly marked regarding its contents may make it tougher for minors to receive delivery. Though it may not prevent every underage sale, the bill should significantly reduce the number of incidents. With statistics showing that 4,000 children every year try smoking for the first time, and that one-half of those will become regular smokers (and one-third of those dying prematurely from smoking-related diseases), it is imperative that every effort be made to reduce underage smoking.

As to the notification requirements, many people remain unaware that taxes must be remitted for untaxed goods purchased from out-of-state Internet or mail order companies for use or consumption within Michigan. Therefore, the notification requirements should further educate the public that Internet and mail order purchases of tobacco products may be legal, but that tax avoidance is not.

POSITIONS:

The following organizations indicated support for the bill to the House Committee on Regulatory Reform on 7-6-04: the Michigan Distributors and Vendors Association, Inc.; the Michigan Grocers Association; Altria (parent company of Philip Morris and Kraft Foods); and Lorillard Tobacco.

The Department of Treasury is opposed to the bill. (7-6-04)

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■ 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.