

CHECKLIST FOR STATE TOBACCO TAX INCREASES

The following checklist lists the elements of a state tobacco tax proposal that should be considered. This document should be useful to tobacco prevention program staff, if asked to help with developing a tobacco tax increase proposal by the Administration, to review or critique legislative tobacco tax proposals, or to evaluate the government's current tobacco tax statutes and recommend improvements.

- 1. Does the cigarette tax increase apply to state tax stamps and tax-stamped packs held in inventory by retailers and distributors on the effective date?** Applying an inventory tax to tax stamps and cigarette packs is standard practice; but some states forget to do it, thereby delaying and reducing the new revenues from the cigarette tax increase. Without an inventory tax, any tax stamps and packs held in inventory (on which only the pre-increase tax amount has been paid) will legally evade the new tax rate despite being used and sold to consumers after the effective date of the increase. That creates an enormous financial incentive for retailers and distributors to stockpile tax stamps and stamped packs in their inventories prior to the effective date so they can evade the higher tax rate for months to come. By blocking that kind of legal tax-evasion stockpiling, an inventory tax maximizes the amount of new state revenues and makes sure the state gets the new revenues quickly, while also protecting the public health impact of the tax increase. Inventory taxes are also not just for cigarettes: any increase to the tax rates of other tobacco products also needs to apply to any such tobacco products unsold and held in inventories at the time of the increase on which only the pre-increase tax rate has been paid.

Model Text: “For each state tax stamp, including those on cigarette packages, held in business inventories at the start of the effective date of the new cigarette tax rate established by this Act, the business shall make tax payments to the state within 25 days equal to the amount that would have to be paid to acquire such a stamp after the effective date minus any payments already made to the state for the tax stamp prior to the effective date. The department of revenue shall adopt and enforce rules and procedures as necessary to carry out this section.”

- 2. If the state provides a percentage discount to the distributors that buy and apply state tax stamps to cigarette packs, has the discount percentage been adjusted to account for the tax rate increase?** States typically give the distributors a discount equal to some percentage of the tax (i.e., the price of a tax stamp) to cover their costs of applying the tax stamps to packs of cigarettes. But those costs don't increase just because the tax and tax-stamp price increases. Accordingly, if the tax or tax stamp price goes up without any change to the percentage discount, the distributors will get an undeserved windfall of new savings that reduces state cigarette tax revenues. [Similar checks should be made to make sure that any program funding or other state expenditures set as a percentage of total state cigarette tax revenues don't get any unintended increases because the tax increases raises total tax revenues.]
- 3. Does the state tax roll-your-own (RYO) tobacco for making cigarettes at the same rate as it taxes regular manufactured cigarettes?** Recently, as much as a one percent decline in taxable state cigarette sales (and related lost revenue) comes from smokers switching from regular cigarettes to under-taxed “little cigars” (see below) or under-taxed or not-taxed RYO cigarettes. The best way to tax RYO tobacco at a rate equal to cigarettes is:
 - Make sure that state law defines RYO tobacco and does so comprehensively, as in the following example: “Roll-your-own tobacco” means any tobacco which, because of its appearance, type, packaging, or labeling, is suitable for use and expected or likely to be offered to, or purchased by, consumers as tobacco for making cigarettes or any other roll of tobacco consumed through combustion. [The “any other roll” language reaches tobacco sold for making “little cigars” and the like.]
 - Make sure the state tax on RYO tobacco per ounce is at least 150% of the state tax per pack of cigarettes. Each RYO cigarette uses roughly 0.0325 ounces of tobacco. That means that 20 RYO cigarettes use about 0.65 ounces of tobacco. So the tax on RYO tobacco per ounce should be about 1.5 times the state tax rate for a pack of cigarettes ($1.54/\text{ounce} = 1.00/.65 \text{ ounces}$). For example, a

* For example, the definition of “cigarette” in the MSA at 11(m) states: *Except as provided in subsections 11(z) and 11(mm), 0.0325 ounces of “roll-your-own” tobacco shall constitute one individual “Cigarette”* – and Exhibit Q also uses 0.0325. RYO cigarette kits provide anywhere from .024 to 0.35 ounces of tobacco per cigarette.

\$1.00 per pack tax on cigarettes = a \$1.54 per ounce or \$24.64 per pound tax on RYO tobacco. Another option is to include language in the statute stating: “The Commissioner [or Department of Revenue] shall annually set the tax rate for RYO tobacco at a rate parallel to the state tax on cigarettes, based on the assumption that the average RYO cigarette or roll uses no more than 0.0325 ounces of tobacco.” That way, the RYO rate will be increased whenever the cigarette tax goes up. [See TFK Factsheet, *The Problem with Roll-Your-Own (RYO) Tobacco*, <http://www.tobaccofreekids.org/research/factsheets/pdf/0336.pdf>.]

4. **Does the cigarette tax increase legislation make parallel increases to the state tax rate(s) on other tobacco products in order to maintain tax equity, increase public health benefits, and maximize new state revenues?** To compare the cigarette tax rate to other tobacco product tax rates, the new per-pack cigarette tax rate can be roughly translated roughly into what it amounts to as a percentage of the average factory price of a pack of cigarettes (roughly \$2.50). For example, a \$2.00 per pack cigarette tax equals about an 80% percentage of manufacturer/wholesale price OTP tax rate.

To promote tax equity even better (and maximize revenues and public health benefits), state taxes on OTPs should include minimum tax rates for each major category of tobacco product that are directly linked to the state cigarette tax. For example, the minimum tax for regular smokeless tobacco that typically comes in a 1.2 ounce can could be set at “an amount equal to the total tax on a pack of 20 cigarettes for each 1.2 ounces.” Cigars could have a minimum tax of “an amount equal to the total tax on a pack of 20 cigarettes per each five cigars” (since cigarillos and blunts typically come in packs of five). [See TFK Factsheets, *State Benefits from Increasing Smokeless Tobacco Tax Rates*, <http://www.tobaccofreekids.org/research/factsheets/pdf/0180.pdf>, *The Best Way to Tax Smokeless Tobacco*, <http://www.tobaccofreekids.org/research/factsheets/pdf/0282.pdf>, *How to Make State Cigar Tax Rates Fair and Effective*, <http://www.tobaccofreekids.org/research/factsheets/pdf/0335.pdf>, and *Closing Weight-Based Tax Loopholes for the New Generation of Low Weight Moist Snuff Smokeless Tobacco Products*, <http://www.tobaccofreekids.org/research/factsheets/pdf/0355.pdf>.]

5. **Are there any caps on cigar or other tobacco product taxes that could be eliminated?** These maximum tax amounts (e.g., 50 cents per cigar) reduce taxes the most on the highest priced brands and have no impact on the taxes of the cheapest brands. It is fairer to tax all tobacco products at the same rate (the more profits and revenue the product brings in, the larger amount it pays – but the tax rate as a percentage is the same for all). And eliminating caps brings in more state revenues. If the existing caps on cigar taxes cannot be eliminated, they should at least be increased to reflect increases in inflation and cigar prices since the cap amount was originally established (or raised even higher – the higher the better) – e.g., set the cigar cap to equal and rise with the state’s tax on a pack of cigarettes. [For more information on cigar taxes, see TFK Factsheet, *How to Make State Cigar Tax Rates Fair and Effective*, <http://www.tobaccofreekids.org/research/factsheets/pdf/0335.pdf>.]
6. **Can the state law definitions of “cigarette” be improved?** To make sure the definitions are comprehensive and reach cigarettes pretending to be “small cigars,” add the following to all existing state tax and other law definitions of cigarette: “and also includes any roll of tobacco, however wrapped, that weighs no more than three pounds per thousand [except for any such roll wrapped in whole tobacco leaf that does not have a filter].” (Text in brackets should be used only if needed.) [Model definitions are available by request at factsheets@tobaccofreekids.org.]
7. **Can the state law definitions of “other tobacco products” and/or “smokeless tobacco” be improved?** To make sure these state definitions reach any and all new and odd tobacco products add: “and also includes any other product containing tobacco intended or expected to be consumed without being combusted.” [Model definitions are available by request at factsheets@tobaccofreekids.org.]
8. **Can the state’s tax on smokeless or moist snuff be fixed?** If the state taxes smokeless on a percentage-of-price basis, fixing it means establishing a minimum tax on all smokeless tobacco or on all “moist snuff” smokeless tobacco. Adding a minimum tax to a percentage-of-price tax on smokeless directly addresses Altria/UST concerns about low-cost products paying too low per-can taxes compared to high-priced premium products – but without causing all the revenue losses and public health problems that would come from switching to a weight-based tax (which Altria/UST pushes), instead. If the state already has a weight-based smokeless tax, it should be fixed by adding an automatic annual adjustment for inflation and

re-defining the smokeless or moist snuff subject to the weight-based tax in a way that excludes the new super-low-weight moist snuff products (e.g., snus, Ariva). [See TFK Factsheets, *The Best Way to Tax Smokeless Tobacco*, <http://www.tobaccofreekids.org/research/factsheets/pdf/0282.pdf>, and *Closing Weight-Based Tax Loopholes for the New Generation of Low Weight Moist Snuff Smokeless Tobacco Products*, <http://www.tobaccofreekids.org/research/factsheets/pdf/0355.pdf>.]

Model Text (to equalize the smokeless tobacco tax to the cigarette tax rate): “(a) The tax on all smokeless tobacco products consisting of loose tobacco or is not sold in discrete single-use lozenges, pouches, pills, capsules or other units, or in packages of such single-dose units, shall be the higher of the percentage-of-price tax rate for tobacco products established in this chapter or the same amount as the total tax on a pack of 20 cigarettes established by this chapter, for the first 1.2 ounces, with a proportionate tax on any weights of fewer or more than 1.2 ounces, based on the net weight as listed in good faith by the manufacturer on the product package. All tobacco products subject to this paragraph shall be sold in packages containing at least one ounce. (b) The tax on any tobacco product other than cigarettes or cigars that is offered in packages of discrete single-dose lozenges, pouches, pills, capsules or other units shall be taxed at the higher of the percentage-of-price tax rate for tobacco products established in this chapter or at a rate equal to the per-cigarette amount of the total tax placed on cigarettes in this chapter per each single dose unit. All such tobacco products shall be sold in packages containing at least ten individual single-use dose units.” [This language sets a minimum tax for smokeless tobacco, whether it is a percentage-of-price or weight-based tax, and whether it is sold in traditional cans or in discrete doses (like snus). More importantly, it ties the smokeless tobacco tax rate to the cigarette tax rate, so whenever the cigarette tax rate increases, the OTP tax rate automatically increases as well.]

Model Text (to establish a minimum tax in a percentage-of-price system): “Any smokeless tobacco product subject to the percentage-of-price-tax in this section with a price of less than \$2.00 per ounce shall be taxed as if its price were \$2.00 per ounce. The Department of Revenue shall annually increase this \$2.00 amount, effective July 1, to account for increases to the price of smokeless tobacco products over the past calendar year, based on the Consumer Price Index for tobacco products other than cigarettes or on other reliable smokeless tobacco price trend data available to the Department.” [\$2.00 per ounce is substantially lower than the wholesale price for first-tier premium brands (which control most of the smokeless market), somewhat higher than the price of second-tier value brands, and quite a bit higher than the price of the very-low-cost third-tier or fourth-tier discount brands. This price amount could be set higher or lower, the higher the amount, the more new state revenue and the bigger impact on reducing smokeless tobacco use and its harms and costs.]

Model Text (to fix a weight-based moist snuff tax): “(a) The ‘moist snuff’ subject to the weight-based tax is defined as finely cut, ground or powdered tobacco that has a moisture content of no less than 45 percent and is not offered in individual single-dose tablets or other discrete single-use units. (b) The Department of Revenue shall annually increase all monetary amounts in this section, effective July 1, to account for increases to the price of such tobacco products over the past calendar year, based on the Consumer Price Index for tobacco products other than cigarettes or on other reliable smokeless tobacco price trend data available to the Department.” [Note: Adjusting just for regular inflation is not enough because smokeless and OTP prices typically go up faster than regular inflation.]

9. **Can any of the new cigarette tax revenues be allocated to tobacco prevention?** If a direct allocation is not politically possible, another possibility is to get language added that allocates to tobacco prevention all (or half) or any additional tobacco tax revenues each year above the total amount projected to come in after the tax increase is implemented. That way, if the cigarette tax increase brings in more money than is expected or needed, tobacco control will at least get all or at least a share of any surplus. Chances for a surplus increase if the state's revenue projections are conservative and if steps are taken to reduce tax evasion and smuggling (such as some of the measures listed below). Other possibilities: Increase OTP rates and allocate all or some of the new OTP tax revenues to tobacco control; or allocate any unexpected excess or surplus funds above projected total state tobacco revenues (all tobacco tax revenues plus tobacco settlement revenues) to tobacco control.

Sample Model Text: “In any fiscal year after 200X when total tobacco product excise tax receipts and/or total tobacco settlement payment receipts are in excess of \$_____, an amount equal to [one-half of] the excess shall be appropriated and directed to the Department of Health in the next fiscal

year solely for the purpose of increasing state efforts to prevent and reduce tobacco use and its harms. These funds shall not be used to replace existing funding but solely to increase the total amount of expenditures to prevent and reduce tobacco use and its harms in the state.”

10. **Could high-tech tax stamps be implemented to reduce tax evasion and increase revenues?** The tax stamps in every state except California use an out-of-date 1950's technology that does very little to block counterfeiting or otherwise impede contraband trafficking and tax evasion. [SC, NC, and ND have no tax stamps at all.] California implemented new, high-tech tax stamps and, with related enforcement, increased its cigarette tax revenues by about \$40 million per year (with no tax rate increase). In some states, high-tech tax stamps could be implemented to raise revenues and combat contraband trafficking and tax evasion administratively (e.g., through new regulations issued by the Treasurer, Comptroller or Finance or Revenue Director); but in other states, statutory authorization is needed to implement the high-tech tax stamps (or to get it to happen quickly). [See TFK Factsheet, *The Case for High-Tech Cigarette Tax Stamps*, <http://www.tobaccofreekids.org/research/factsheets/pdf/0310.pdf>. Model legislative text is available by request at factsheets@tobaccofreekids.org.]
11. **Could other low-cost and no-cost measures be implemented to reduce tax evasion and increase revenues?** For additional measures that could be implemented to combat smuggling and tax evasion, see TFK Factsheet, *State Options to Prevent and Reduce Cigarette Smuggling and to Block Other Illegal State Tobacco Tax Evasion*, <http://tobaccofreekids.org/research/factsheets/pdf/0274.pdf>.
12. **Can state tobacco tax and/or tobacco settlement revenues be stabilized by providing for periodic automatic tobacco tax rate increases?** To counter any arguments that cigarette tax revenues will decline over time as smoking drops, something like the following language could be added into the tax code. Such language could also protect against any possible unexpected significant drops in state tobacco settlement revenues and promote tax equity and fairness between different types of tobacco products.

Model Text: “In any calendar year after 200X when the state’s total revenues from all its tobacco excise taxes and tobacco settlement payment receipts is less than the total amount of such revenues received by the state during the preceding calendar year, an additional excise tax on the sale of cigarettes shall be implemented, effective the following July 1, in the amount the Director of the Department of Revenue determines will bring in annual additional net new state revenue in an amount approximately equal to, but not lower than, the amount of the decline in total state tobacco tax and tobacco settlement revenues from the one calendar year to the next. The amount determined by the Director shall also be large enough to bring in any additional annual net new state revenues required to compensate for any prior cigarette tax rate increases failing to bring in annual net new revenues in an amount equal or greater to the amounts projected by the state prior to implementation. When any cigarette tax rate adjustments are made pursuant to this section, the Director shall also adjust the tax rates on all other tobacco products to amounts the Director determines shall promote tax equity by establishing, to the extent possible, parallel tax rates, on a per-dose basis, for all different types of tobacco products consumed in the state.”

For more information on many of these topics, see the Campaign for Tobacco-Free Kids website at http://www.tobaccofreekids.org/facts_issues/fact_sheets/policies/tax/us_state_local/. For questions or assistance requests, please contact the Campaign at: factsheets@tobaccofreekids.org.