

California's Experience with the Cigarette and Tobacco

Products Licensing Act

Presented to the Subcommittee on Oversight of the Committee on Ways and Means

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California State Board of Equalization

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Mr. Chairman and Members of the Subcommittee:

My name is Jerome E. Horton and I am currently the Vice Chair of the California State Board of Equalization representing the 4th District and the 8.5 million people of greater Los Angeles County.

The Board of Equalization is responsible for administering the tobacco taxes in California and is comprised of four elected members and the State Controller.

As the legislative author of the California Cigarette and Tobacco Products Licensing Act (AB 71), which enhanced regulatory control over the marketing and distribution of cigarettes and tobacco products, I am particularly proud to present testimony to the subcommittee today concerning the experience of the Board of Equalization in implementing the Act.

The catalyst for the California Cigarette and Tobacco Products Licensing Act of 2003 was the devastating economic, health and safety impact that illegal counterfeiting, smuggling, distribution and consumption of cigarettes was having on our society. Of equal concern was the involvement of organized crime in the illegal cigarette trade, with consequences such as increased money-laundering and violence.

The evidence indicated that the higher the taxes were on cigarettes, then the greater the incentive for criminals to participate in this market. This resulted in increasing illegal sales of cigarettes to minors and others. Tobacco makers, distributors, and retailers, along with anti-smoking advocates, all came to view this situation as difficult and dangerous. Working together with these diverse interests, I authored the legislation that created the California Cigarette & Tobacco Products Licensing Act of 2003 (AB 71), to increase control over the marketing of cigarettes and tobacco products. Another critical part of this legislation was to set aside funding to specifically target reduction of illegal sales to minors.

The Act requires the Board of Equalization to license all entities engaged in the sale of cigarettes and tobacco products in California. The Act also gave the Board the authority to penalize violations of California's Stop Tobacco Access to Kids Enforcement Act. The authorization of additional inspectors, and their funding by the licensing requirement, have helped reduce underage access to all types of tobacco products in California.

By regulating the tobacco market in California and strategic enforcement and prosecution of criminals who evade cigarette and related tax laws, we have substantially reduced cigarette smuggling in California, taken tons of illegal cigarettes off our streets, leveled the playing field for legitimate California businesses and generated \$153 million in new tax revenue for the state.

Another result of the law, first confirmed by the California Auditor General in 2006, is that seizures of contraband untaxed tobacco products and the percentage of retailers carrying contraband products has decreased every year since the Tobacco Licensing Act was enacted, even as the number of inspections has remained relatively constant.

Importantly, taxes collected on these products are returned to California communities to support hospital services, health education, breast cancer research and prevention, and childhood development programs. Nearly \$70 million per year are allocated to vital smoking education and cessation programs.

In this regard, I want to take this opportunity to commend the Congress and the President for the enactment of the Prevent All Cigarette Trafficking Act earlier this year. The PACT Act will make it harder for vendors to circumvent federal, state, and local tax laws and will force internet retailers to comply with other regulations of tobacco products, including selling to minors. One of my primary motivations as an elected official – formerly as a legislator and now as a Member of the only elected Tax Board in the United States -- has been to do whatever I can to prevent the exposure of young people to the health and addiction risks of smoking cigarettes.

As President Obama declared when he signed the PACT Act into law, "the constant and insidious barrage of advertising...draws millions of teenagers into a lifelong struggle to quit a habit." It is a habit that kills too many Americans. So while I am pleased that California's legislation has controlled contraband tobacco and raised state revenues, I applaud the efforts of Congress and the President, which have helped California maintain its status as the number two state in the nation when it comes to the lowest percentage of population that smokes — 14 percent according to one study.

As you consider the possibility of additional federal action in this area, I urge you to reflect on two persistent problems which are highlighted by the California experience:

- First, illegal tobacco products come from interstate traffic. So long as we have a patchwork of state regulatory systems, many of which reflect less stringent regulations, California will be a target destination for smugglers.
- Second, while we have had a very high rate of success with the cigarette licensing system in California, our problem has shifted to other – non-cigarette – tobacco products – "OTP". As cigarette smuggling has decreased, we have seen a corresponding increase in enforcement problems related to OTP. Since OTP are not yet subject to an effective track and trace system, they present greater enforcement problems for both federal and state agencies.

California Cigarette and Tobacco Products Licensing

California's State Board of Equalization collects taxes and fees that provide approximately 35 percent of the annual revenue for state government and essential funding for counties, cities, and special districts. In fiscal year 2008-09, these taxes and fees produced \$48.4 billion for education, public safety, transportation, housing, health services, social services, and natural resource management essential to the economic vitality of the state.

The Board administers the state's sales and use, fuel, alcohol, tobacco, and other taxes and collects fees that fund specific state programs. More than one million businesses are registered with the agency.

Like many other states, California has been experiencing a downturn in its tax revenues for the last few years. Having recognized significant losses of revenue from untaxed cigarette and other tobacco products, the California Legislature enacted two measures to combat escalating cigarette and other tobacco products tax evasion. These measures, my Assembly Bill 71 (Ch. 890, CA Stats. 2003) and Senate Bill 1701 by then Senator Steve Peace from San Diego (Ch. 881, CA Stats. 2001) took a classic three-pronged approach to the problem of inadequate regulation: licensing of tobacco manufacturers and distributors, a "smart" cigarette tax stamp, and increased enforcement.

Licensing

Working with tobacco industry representatives and anti-smoking advocates, just as you did in Congress, we in the California Legislature determined that mandatory licensing was key to identifying persons engaged in the business of selling cigarettes and other tobacco products, the locations where such products were being sold, and to providing the ability to trace sales.

This enabled state enforcement officers to identify and interdict unlawful distributions and untaxed sales of cigarettes and other tobacco products.

Assembly Bill 71 (Horton), the Cigarette and Tobacco Products Licensing Act, requires persons engaged in the business of manufacturing and selling cigarettes or other tobacco products to obtain and maintain a specific license to do so.

The Licensing Act requires the licensure of all cigarette and other tobacco product manufacturers, importers, distributors, wholesalers, and retailers. The license holds these persons to specific responsibilities in the conduct of cigarette and other tobacco sales in California, including sales to, and purchases from, licensed persons, and detailed record-keeping requirements. The Licensing Act gives the Board the authority to conduct inspections at any place at which cigarettes or other tobacco products are sold, produced, or stored or at any site where evidence of activities involving evasion of cigarette or other tobacco products tax may be discovered. And by providing for monetary fines, as well as penalties ranging from a suspension to the revocation of a license for sellers found to be in violation of its provisions, and authorizing the BOE to seize cigarettes or other tobacco products purchased in violation of the Licensing Act or found to be untaxed or purchased, the Licensing Act is a significant deterrent to tax evasion.

As of July 1, 2009 there were 30 cigarette manufacturers and importers, 72 other tobacco product manufacturers and importers, 578 cigarette and other tobacco distributors, 444 wholesalers and approximately 38,000 retailers licensed in California.

"Smart" Cigarette Tax Stamp

Senate Bill 1701 (Peace) required the Board of Equalization to replace the heat-applied decal stamps and meter impressions with "bar code" stamps and meter impressions encrypted with specified information. In California, stamps are the method of tax payment for cigarettes; they are affixed to packages of cigarettes by the distributor, defined as the person making the first sale of cigarettes in California.

The data contained within the encryption of each cigarette tax stamp includes the name and address of the distributor, the date the stamp was affixed, and the denominated value of the stamp. This encrypted information provides BOE investigators "track and trace" capability by allowing verification of tax paid product using scanning devices in the field that are designed to read the encrypted information on the stamp and detect counterfeit stamps. Visual representations or images of California's tax stamp have been discovered in the marketplace; however, there has been no successful duplication of the tax stamp's encryption or security features.

The stamp does not track the sale of cigarettes through the distribution chain. This is verified through records required to be maintained by manufacturers, importers, distributors, wholesalers, and retailers. Records would also be used, if available, for unstamped cigarettes since without a stamp, the product cannot be traced back to the distributor.

Other tobacco products are not stamped in California. Verification of these tax paid tobacco products are made through inspection of purchase records.

Increased Enforcement

In conjunction with the licensing provisions, funding was included for additional enforcement. The Board increased its inspectors and investigators, who regularly visit licensed locations throughout the state and verify compliance by licensees. The investigators were also given the authority to issue civil or criminal citations, depending on the nature of the violation found. On average, the Board's inspectors and investigators have conducted 10,000 site inspections each year since implementation of the Act. This enforcement element reinforces licensing obligations

and has contributed to the reduction of tax evasion in the retail market, as shown in the attached exhibits.

The Results

The California Tobacco Licensing and Control Act is among the most successful pieces of legislation I was able to have enacted during my career as a term-limited member of the State Legislature. The effectiveness of the bar code tax stamp is reflected in the decline in the number of counterfeit stamp seizures (Exhibit A). In fiscal year 2004-05, 869 cigarettes seizures were found to have counterfeit tax stamps. In 2008-09, that number decreased to 49 cigarette seizures—a 94 percent decrease over the five-year period. Furthermore, the number of cigarette seizures overall also dropped from 14 percent to 2 percent during this period showing further Licensing Act compliance.

The state inspectors and investigators of the Board of Equalization have proven the effectiveness of technology-based tax stamps, manufacturer and distributor licensing, and vigorous enforcement. Use of these strategies has led to the retention of nearly \$153 million in annual state tax revenues: \$87.7 million in cigarette excise tax, \$16 million in other tobacco products excise tax, and \$49.2 million in state sales and use taxes. These measures have been an effective tool to reduce tax evasion and increase the retention of revenues in the cigarette and tobacco product tax program.

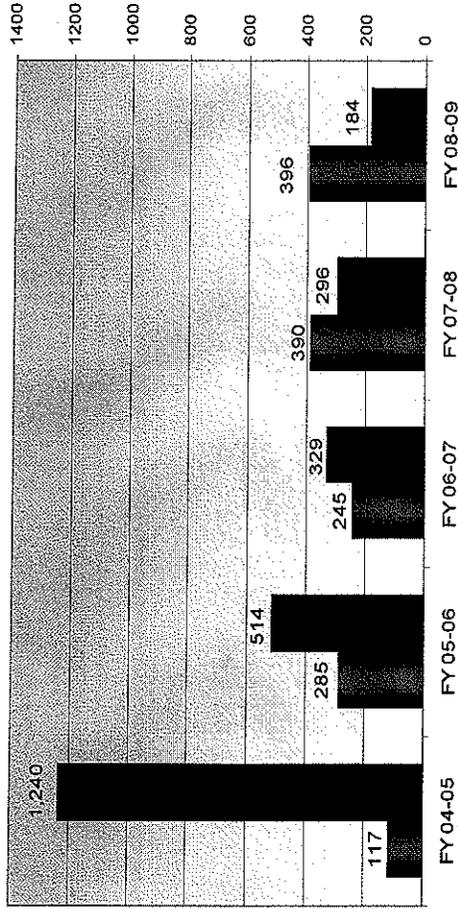
I thank the committee for the opportunity to make this information available. California is proud to be a leader in the control and interdiction of illegal untaxed tobacco products. We look forward to working with Congress and the President to further the federal-state partnership so critical to successful implementation of the federal PACT Act and other measures you may be considering to address the problems created by the underground traffic in tobacco products.

Speaking as the Vice Chair of the California Board of Equalization, I want to assure you that we are not finished and we will not rest until we have completely eradicated the distribution of illegal tobacco to all California residents and finished the job of protecting our young people from smoking addiction.

Board of Equalization – Investigations Division
AB 71 INSPECTIONS - FISCAL YEARS 2004-05 to 2008-09

Cigarette and Tobacco Product Seizures

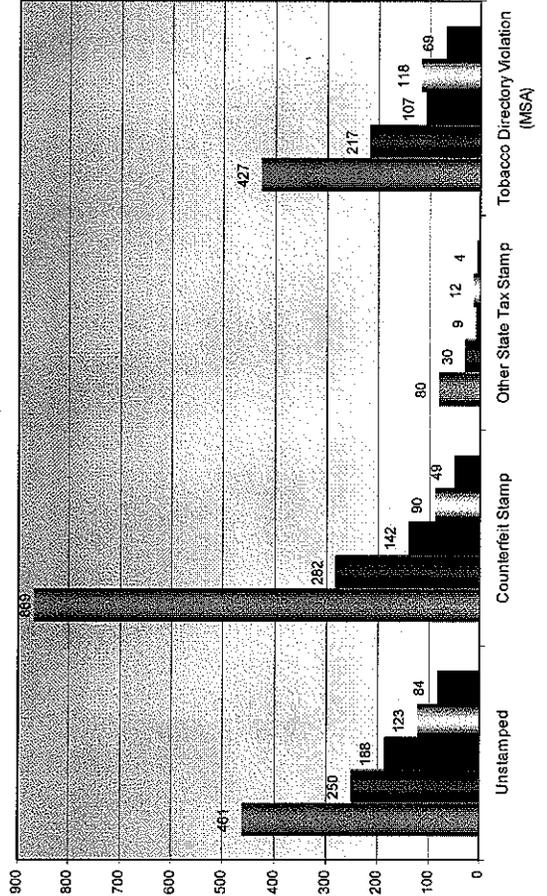
■ Cigarettes ■ Tobacco Products



	Number of Inspections	Number of Cigarette Seizures	Number of Packs Seized	Number of Tobacco Product Seizures	Wholesale Cost of Tobacco Seized
FY 04-05	9,159	1,240	326,424	117	\$ 225,084
FY 05-06	11,084	514	193,512	285	\$ 581,687
FY 06-07	10,130	329	165,014	245	\$ 286,799
FY 07-08	10,553	296	140,924	390	\$ 612,155
FY 08-09	9,495	184	87,735	396	\$1,528,550
Totals	50,421	2,563	913,609	1,433	\$3,234,275

TYPE OF CONTRABAND CIGARETTES SEIZED

■ FY 04-05 ■ FY 05-06 ■ FY 06-07 ■ FY 07-08 ■ FY 08-09



	FY 04-05	FY 05-06	FY 06-07	FY 07-08	FY 08-09
Counterfeit Stamp	869	282	142	90	49
Unstamped	461	250	188	123	84
Other State Tax Stamp	80	30	9	12	4
Tobacco Directory Violation (MSA)	427	217	107	118	69
Seizure Totals	1,837	779	446	343	206

