



Senate Fiscal Agency
P. O. Box 30036
Lansing, Michigan 48909-7536

BILL



ANALYSIS

Telephone: (517) 373-5383
Fax: (517) 373-1986

Senate Bill 930 (as enacted)
Sponsor: Senator Roger Kahn, M.D.
Senate Committee: Finance
House Committee: Tax Policy

PUBLIC ACT 188 of 2012

Date Completed: 7-23-12

RATIONALE

The Tobacco Products Tax Act was enacted in 1993 to repeal a former cigarette tax law, provide for an increased tax on cigarettes, and impose a new excise tax on noncigarette tobacco products (such as loose tobacco, cigars, and chewing tobacco). The Act also requires the licensure of various people in the supply and distribution chain, including manufacturers, wholesalers, and transporters, and prescribes civil and criminal penalties for violations. Over the years, the taxes have been increased and various other amendments have been enacted. These include amendments enacted in 1997 to require that a tax stamp be affixed to all packs of cigarettes sold in Michigan, and prohibit the sale of unstamped packs to consumers. Also, after Michigan and 45 other states entered into the Master Settlement Agreement (MSA) with four major United States tobacco companies in 1998, legislation was enacted to require manufacturers that did not participate in the agreement to deposit funds into an escrow account. Under subsequent amendments, nonparticipating manufacturers (NPMs) must certify their compliance with the escrow account requirements, as well as pay equity assessments to the State.

Despite the original provisions of the Act and the subsequent changes, some people believe that a problem of tax avoidance exists. In addition, tobacco manufacturers participating in the MSA have been holding back some of the payments Michigan otherwise would receive, due to claims of "market share loss" to NPMs. Several suggestions to address these issues were made.

First, it was suggested that the State should begin to use digital stamp technology, rather than the current heat-applied stamps, in order to increase enforcement and tax collections. Evidently, the present technology is being discontinued by the manufacturer, and Michigan's existing stamp contract is scheduled to expire in 2013.

Some people also believe that the statute should treat "roll-your-own" stores as NPMs. Roll-your-own (RYO) retailers purchase loose smoking tobacco and commercial-grade cigarette-making machines. Customers then can buy tobacco and paper tubes, and pay to use the machines in order to produce their own cigarettes. Most of these establishments have not been licensed under the Act, and tax stamps have not been purchased for cigarettes made at the stores. The State also has been losing revenue from these operations because many people use pipe tobacco, which is subject to a much lower excise tax than the tax on loose cigarette tobacco. In March 2011, the Department of Treasury notified the retailers that they are required to be licensed as manufacturers.

A third suggestion involved allocating increased resources to enforcement efforts.

CONTENT**The bill amended the Tobacco Products Tax Act to do the following:**

- Include as a nonparticipating manufacturer a person who operates or permits another person to operate a commercial-grade cigarette-making machine.**

- **Require the Department of Treasury to issue a request for proposal to acquire and use digital stamps.**
- **Allow stamping agents to retain 0.5% of the tax due on cigarettes as compensation for equipment and technology upgrades necessitated by digital stamps.**
- **Allow stamping agents to retain from monthly remittances, for 18 months, 5.55% of direct costs incurred for the initial purchase of eligible equipment.**
- **Allow licensees to retain a percentage of the tax otherwise due on sales of untaxed cigarettes to Indian tribes.**
- **Require the Michigan Department of State Police (MSP) to initiate inquiries or otherwise obtain data from the Treasury Department in order to support its enforcement activities.**
- **Authorize the Department of Treasury, the Attorney General, and the MSP, before proceeds from taxes, fees, and penalties are distributed, to use the funds, upon appropriation, for enforcement and administration of the Act.**

The bill took effect on June 20, 2012.

Digital Stamps

The Act requires the Department of Treasury to procure stamps, which wholesalers and unclassified acquirers obtain from the Department and affix to packs of cigarettes. Retailers and other licensees are prohibited from acquiring cigarettes for resale or selling cigarettes unless the packs are stamped.

The bill requires the Department, within 45 days after the bill's effective date, to issue a request for proposal (RFP) to acquire and use digital stamps that contain a unique nonrepeating code that can be read by a device that identifies the taxed product and contains other security and enforcement features as determined by the Department. The RFP must require the successful bidder to share digital stamp technology so handheld devices, including smartphones, can be readily used to further the implementation of the use of digital stamps, and so the technology and equipment used by the stamping agents can be supplied, as the Department permits, by the successful bidder or by any other providers.

The RFP also must permit the Department to manage or restrict access rights to all or part of the information contained within the stamps or accessible from them. In addition, the RFP must require the successful bidder to guarantee that the stamps will be designed and manufactured to ensure that they can be affixed to individual packs of cigarettes as required by the Act.

Under the Act, a stamp is considered affixed if more than 50% of it is affixed to the individual pack, as determined by the Department. The bill increases this to 90% or more, upon implementation of the digital stamps.

The bill also provides that stamps may be affixed to an individual pack of cigarettes only if the manufacturer of the cigarettes is on the Department's lists of participating and nonparticipating manufacturers under Section 6c (described below).

Licensee Returns & Compensation

The Act levies a tax on the sale of tobacco products sold in the State, and requires licensees (other than a retailer, an unclassified acquirer licensed as a manufacturer, or a vending machine operator) to file with the Department of Treasury a monthly return on a form prescribed by the Department. Under the bill, the Department also may require licensees to report cigarette acquisition, purchase, and sales information in other formats and frequency.

The Act requires a licensee, at the time of filing the return, to pay the tax for tobacco products sold during the month, less compensation equal to 1.0% of the total amount of the tax due on tobacco products sold other than cigarettes, and 1.5% of the total amount of the tax due on cigarettes sold.

Beginning on the bill's effective date, for sales of untaxed cigarettes to Indian tribes in the State, licensees also may retain an amount equal to 1.5% of the total amount of the tax due on those cigarettes sold as if the sales were taxable.

In addition, beginning on the first month after the use of digital stamps is implemented, a stamping agent will be allowed retain 0.5% of the total amount of

the tax due on cigarettes sold and, for sales of untaxed cigarettes to Indian tribes in the State, 0.5% of the total amount of the tax due on those cigarettes sold as if the sales were taxable, until the stamping agent is compensated in an amount equal to the direct cost actually incurred for upgrades to technology and equipment (excluding equipment reimbursed under the following provision), that are necessary to affix the digital stamps as determined by the Department.

Beginning on the first month after the use of digital stamps is implemented and continuing for the next 17 months, for the initial purchase of eligible equipment necessary to affix digital stamps, a stamping agent will be allowed to retain an amount equal to 5.55% of the total net purchase price, as reimbursement of direct costs actually incurred by the stamping agent. This reimbursement must exclude reimbursement for any costs of the installation or for ongoing maintenance related to eligible equipment. A stamping agent may receive reimbursement for the purchase of eligible equipment only to the extent that the equipment purchased does not exceed the total number of the agent's existing equipment as certified by the agent on a form prescribed by the Department.

(A stamping agent is a wholesaler or unclassified acquirer other than a manufacturer that is licensed and authorized by the Department to affix stamps to individual packs of cigarettes on behalf of itself and other wholesalers or unclassified acquirers other than manufacturers.)

The bill defines "eligible equipment" as a cigarette tax stamping machine that meets all of the following conditions:

- Was purchased by a stamping agent who was licensed as a stamping agent as of December 31, 2011.
- Enables the stamping agent to affix digital stamps to individual packs of cigarettes as required by the Act.
- Was purchased for the primary purpose of permitting the stamping agent to affix digital stamps to individual packs of cigarettes to be sold in this State after the implementation of the use of digital stamps.

The bill defines "existing equipment" as a cigarette tax stamping machine that was

owned by a person licensed as a stamping agent as of December 31, 2011, and was a cigarette tax stamping machine used before January 1, 2012, by the stamping agent to apply stamps using rolls of 30,000 stamps.

Cigarette-Making Machines

The bill amended the Act's definition of "manufacturer" to include a person who operates or who permits any other person to operate a cigarette-making machine in Michigan for the purpose of producing, filling, rolling, dispensing, or otherwise generating cigarettes. The person constitutes a nonparticipating manufacturer for purposes of Sections 6c and 6d of the Act (described below).

A person operating or otherwise using a machine or other mechanical device, other than a cigarette-making machine, to produce, fill, roll, dispense, or otherwise generate cigarettes will not be considered a manufacturer as long as the cigarettes are produced or otherwise generated in that person's dwelling and for his or her self-consumption (i.e., production for personal consumption or use and not for sale, resale, or any other profit-making endeavor).

The bill defines "cigarette making machine" as any machine or other mechanical device that meets all of the following criteria:

- Is capable of being loaded with loose tobacco, cigarette tubes or papers, and any other components related to the production of cigarettes, including filters.
- Is designed to automatically or mechanically produce, roll, fill, dispense, or otherwise generate cigarettes.
- Is commercial-grade or otherwise designed or suitable for commercial use.
- Is designed to be powered or otherwise operated by a main or primary power source other than human power.

(Section 6c of the Act requires a nonparticipating manufacturer to certify its compliance with Public Act 244 of 1999 (which requires tobacco product manufacturers to establish escrow accounts); requires wholesalers and unclassified acquirers to report all cigarettes they acquire from nonparticipating manufacturers; and requires the Department to maintain a list of participating and nonparticipating

manufacturers that have provided a certification of compliance.

Section 6d imposes an equity assessment of 17.5 mills per cigarette sold by nonparticipating manufacturers, and requires NPMs, before selling cigarettes, to give the Department specified information and prepay the assessment.)

State Police

The bill requires the MSP to initiate inquiries to, or otherwise gain access to data from, the Department of Treasury to support or in furtherance of State Police enforcement activities under the Act.

Appropriation of Tobacco Tax Revenue

The Act allocates proceeds from the payment of taxes, fees, and penalties, as well as licensee fees. Under the bill, before funds are distributed as required, the funds may be used by the Department of Treasury, the Attorney General, and the MSP, subject to appropriations, for enforcement and administration of the Act.

Vetoed Appropriation

The version of the bill that was passed by the Senate and the House included an appropriation of \$6.0 million of tobacco products revenue from the funds directed to the General Fund, for fiscal year 2011-12 only, for enforcement and administration of the Act. The bill proposed to distribute the appropriation as follows: \$4.0 to the Department of State Police; \$1.5 million to the Department of Treasury; and \$500,000 to the Department of Attorney General.

The Governor vetoed this appropriation.

MCL 205.422 et al.

BACKGROUND

Master Settlement Agreement & NPMs

The Master Settlement Agreement is an agreement between 46 states, including Michigan, as well as several territories and the District of Columbia, and participating tobacco product manufacturers, entered into in November 1998. The states settled their lawsuits against the tobacco industry to recover smoking-related health care costs, and the tobacco companies agreed to make

annual payments to the states, as well as curtail or cease certain marketing practices. Originally, the MSA applied to four manufacturers but the agreement permits additional companies to participate.

Because nonparticipating manufacturers are not bound by the MSA, the agreement contains provisions designed to protect participating manufacturers from a loss of market share, as well as give NPMs an incentive to join the settlement. Specifically, the MSA provides for payments to states to be reduced by an "NPM adjustment percentage" based on market share loss (as determined annually by a nationally recognized firm of economic consultants). A state's payment will not be reduced, however, if the state has enacted and "diligently enforced" a statute that requires tobacco product manufacturers selling cigarettes (including roll-your-own tobacco) in the state either to become a participating manufacturer or to deposit certain amounts into a qualified escrow fund. An appendix to the MSA contains a model statute for states to enact.

Michigan Law

Michigan enacted the provisions of the MSA's model statute in Public Act 244 of 1999. In addition to requiring manufacturers to participate in the MSA or to deposit amounts into an escrow account, the Act requires NPMs to certify their compliance annually to the Department of Treasury, and prescribes penalties for manufacturers that fail to comply. The amounts that must be deposited in escrow are based on "units sold", which refers to individual cigarettes sold as measured by excise taxes collected by the State on packs bearing the tax stamp. The Act states that the term "cigarette" includes roll-your-own tobacco, and 0.09 ounce of such tobacco constitutes one cigarette.

In addition, Section 6c of the Tobacco Products Tax Act was enacted in 2002 to require each NPM annually to certify that it has met its obligations under Public Act 244 of 1999. The certification must include a list of all brand names of cigarettes sold by the NPM for consumption in Michigan during the preceding year. An NPM that has not provided the certification of compliance is prohibited from selling cigarettes in this State or selling cigarettes in or outside of the State for sale, distribution, or

consumption in Michigan. The Act also prohibits a person from purchasing cigarettes from, or selling cigarettes acquired from, an NPM that has not provided the certification of compliance.

In 2003, Section 6d of the Tobacco Products Tax Act was enacted to require NPMs to prepay an annual equity assessment to the State based on all cigarettes anticipated to be sold in the year. The amount of the assessment is either 17.5 mills multiplied by the number of cigarettes the Department expects the NMP to sell, or \$10,000, whichever is greater.

Sections 6c and 6d both prescribe a maximum civil fine of \$1,000 for each violation, in addition to other fines and penalties that may be imposed, and allow the seizure and forfeiture of cigarettes acquired from or manufactured by a noncompliant NPM.

Treasury Notice

On March 1, 2011, the Michigan Department of Treasury issued a "Notice Regarding Cigarette Rolling Machines", which stated the following: "The operation of a machine that is loaded with loose tobacco and rolling tubes for the purpose of producing cigarettes constitutes 'cigarette manufacturing' in Michigan. Anyone possessing, operating, or permitting others to operate such a machine is considered a 'manufacturer' of tobacco products in Michigan and therefore must obtain a 'manufacturer' license under the Michigan Tobacco Products Act... Exempt from this requirement would be those who meet the exception for self-consumption under federal law."

The Notice also indicated that a person considered a manufacturer as described above would be a nonparticipating manufacturer and required to establish and fund a qualified escrow account, prepay an equity assessment, submit to the Department a certification of compliance, and provide copies of the certification to the Attorney General. In addition, the Notice stated that failure to comply can lead to criminal and civil penalties, and retailers that sell cigarettes without a tax stamp will be subject to penalty and seizure provisions of the Tobacco Products Tax Act. In April 2011, the Department mailed a follow-up letter to RYO retailers.

Although a lawsuit seeking to enjoin enforcement of the Notice was brought in May 2011, the suit was recently dismissed.

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

With a cigarette excise tax of \$2 per pack, Michigan is a high-tax state compared with the national average and all of the surrounding states except Wisconsin. Michigan's tax ranks 11th in the nation, while the cigarette excise taxes in Illinois, Indiana, and Ohio rank 32nd, 31st, and 27th, respectively (according to Campaign for Tobacco-Free Kids). This differential creates an incentive for criminals to engage in cross-border smuggling and other tax evasion schemes, making lower-cost cigarettes available to consumers while depriving the State of tax revenue that otherwise would be collected. The illegal trade in tobacco products also takes business away from law-abiding manufacturers, wholesalers, and retailers. Often, illicit tobacco trade is connected to other crimes, and violators may use the proceeds to fund other criminal activity. In addition, illegal tobacco schemes undermine governmental efforts to discourage tobacco use, especially among minors, and to reduce public health costs.

Many of the same concerns were raised in the 1990s, after Michigan's cigarette tax was increased from 25 cents to 75 cents per pack. The tax stamp requirements were enacted in 1997 to address the problem. With the tax now at \$2 per pack, the incentive to avoid taxation in Michigan also has increased. Due to the clandestine nature of the activity, the exact extent of the problem cannot be measured, but it can be presumed to exist, especially because of the ease and convenience of transporting cigarettes across state borders, and the high potential for illicit gains at relatively low risk, compared with the penalties for other offenses.

One way to combat illegal activity involving cigarettes is to institute digital stamp technology. With the current tax stamp contract expiring, the Department of Treasury already issued a Request for Information (RIF) from stamp

manufacturers, and the next step is a Request for Proposal. The RIF, however, was not limited to digital stamps, and the Department would not necessarily enter into a contract with a manufacturer that uses digital technology unless directed to do so.

By requiring the Department to move toward digital stamp technology, the bill will enhance Michigan's efforts to fight cigarette tax evasion. Digital tax indicia have the ability to authenticate in a number of ways, verifying that cigarettes have followed the proper distribution channels, and that taxes have been paid. With this information, enforcement agents can locate and identify products that have circumvented the legal distribution channel, and obtain evidence to prosecute violators. Greater investigation and enforcement also should help deter illegal schemes.

When Michigan makes the transition to digital tax stamps, it will follow the lead taken by California. In 2005, that state implemented digital stamping as one component of efforts to institute a comprehensive enforcement program. Before California enacted these measures several years earlier, it was estimated that the state was losing up to \$238.0 million annually in uncollected tobacco tax revenue. As a result of its enforcement strategies, California reportedly has increased its annual tax revenue by nearly \$153.0 million, including \$87.7 million in cigarette excise tax collections, \$16.0 million in other tobacco products excise taxes, and \$49.2 million in sales and use taxes.

The bill also will combat tobacco tax avoidance by making it clear in statute that RYO establishments are nonparticipating manufacturers. This is consistent with the Department of Treasury's efforts to bring these retailers into compliance with the law. Like other NPMs, an outfit that operates or allows its customers to operate a cigarette-making machine will have to become licensed as a manufacturer, pay excise taxes, pay for cigarette stamps, deposit funds into an escrow account, and prepay an equity assessment of at least \$10,000 a year.

These combined measures will improve the State's ability to collect tobacco products taxes and crack down on offenders. The legislation also will help show that Michigan is "diligently enforcing" its statute, as

required by the Master Settlement Agreement. To date, manufacturers have held back over \$300.0 million in tobacco settlement payments to Michigan, based on the contention that the State is not diligently enforcing its law. These payments are arbitrated on a year-by-year basis, and payments from 2003 are currently being arbitrated. The new amendments should strengthen Michigan's claim to its future payments.

In addition, to support administration and enforcement of the Act, the bill provides ongoing authority for revenue under the Act to be appropriated for this purpose.

Opposing Argument

By treating RYO retailers as manufacturers, the bill will cause many, if not most of them to go out of business. Becoming licensed as a manufacturer and fulfilling applicable State and Federal requirements will be not only unaffordable but also impossible for these retailers. For example, Federal regulations governing manufacturers require retail operations to be completely segregated from manufacturing operations, and require the principal business activity of a manufacturer to be the manufacture of tobacco products. Federal regulations also impose packaging and labeling requirements that RYO retailers cannot meet, and State law requires NPMs to certify the brand names of cigarettes sold for consumption. In addition, it is not clear how the State's stamping requirements will be implemented, since RYO cigarettes are made individually and are not sold in packages or containers. Moreover, if a retailer has a commercial agreement with RYO Machine Rental (an Ohio-based company that sells self-service cigarette tube filling machines to distributors and retailers), the retailer is strictly prohibited from producing cigarettes for its customers, which means that the retailer cannot be a manufacturer without breaching its agreement.

Roll-your-own retailers are small businesses that contribute to the economy in some of the State's most depressed areas. These stores are job-providers. They give their owners a livelihood and pay wages that workers need for household or educational expenses. Many of the owners and employees are raising children or helping to support elderly or ailing parents. In addition to paying salaries, payroll taxes, sales and use taxes, and rent, these establishments

provide work for carpenters, painters, electricians, delivery people, and others. They deal with many local vendors and typically sell a variety of products besides cigarette-making supplies. Causing these businesses to fail will have the same negative consequences that shutting down any other retailer has.

Putting RYO establishments out of business will not generate any appreciable cigarette tax revenue for the State. Rather than purchasing commercial cigarettes, it is likely that most of their customers simply will roll their own at home, as they did before commercial machines became available.

Response: Treating RYO retailers as manufacturers is consistent with a recently enacted Federal law, PL 112-141. This law reauthorized Federal transportation programs and contains many additional provisions, including an amendment to the definition of "manufacturer of tobacco products". The term now includes "any person who for commercial purposes makes available for consumer use (including such consumer's personal consumption or use...) a machine capable of making cigarettes, cigars, or other tobacco products", with an exception for the retail sale of a machine to a consumer for his or her personal home use, if the machine is not used at retail premises and is designed to produce tobacco products only in personal use quantities. Therefore, because RYO retailers are now considered manufacturers under Federal law, the arguments against this aspect of Senate Bill 930 are largely moot.

Legislative Analyst: Suzanne Lowe

FISCAL IMPACT

The digital cigarette tax stamps that the bill requires are estimated to cost more than the current heat-applied stamps. The current stamp contract (which expires during FY 2012-13) provides for the State to purchase stamps at 87 cents per 1,000 stamps. Digital stamps, depending on the features of the stamps and the details of the contract, cost between \$5 and \$8 per 1,000 stamps, according to the Department of Treasury. Currently, the State's cost of cigarette tax stamps is about \$450,000 per year. With digital stamps, the cost will be in the range of \$2.6 million to \$4.1 million per year, assuming the number of stamps purchased remains the same. The Department will incur additional costs to issue the request for

proposal to acquire and use digital stamps and for information technology improvements to gain access to and use the increased data on the movement and sale of cigarettes, which will be useful in enforcing the cigarette tax. The amount of additional revenue from the improved tax enforcement is unknown.

Under the bill, the State will reimburse stamping agents for the approved costs of digital stamping equipment and related technology upgrades. The total reimbursement costs are estimated to be between \$3.0 million and \$6.0 million depending on the technology adopted and the final costs involved. Stamping agents will be authorized to increase their allowable deductions from the cigarette tax revenue remitted to the State. Machine purchases will be reimbursed over 18 months, and the cost of other technology and equipment upgrades will be reimbursed through deductions of 0.5% of tax revenue collected, which the stamping agents will retain until those costs have been fully reimbursed. Licensees also will be able to retain an administrative fee on untaxed cigarettes sold to Indian reservations. The Department estimates that this change will reduce State revenue by approximately \$60,000 per year.

The bill will reduce potential losses in State cigarette tax revenue by specifying that operators of cigarette-making machines are considered manufacturers, making them subject to the licensing requirements and regulations that apply to other cigarette manufacturers. This is expected to reduce the sale of untaxed cigarettes and increase cigarette tax revenue by an unknown amount.

Overall, these changes will have an indeterminate effect on State cigarette tax revenue. The change to digital stamps will increase the State's costs and also the State's tax enforcement capabilities, which will increase revenue over the current estimates. The amount of this effect is unknown, however, and will likely only partially offset the long-term trend of declining tobacco tax revenue. Table 1 shows tobacco tax revenue for both cigarette and other tobacco products taxes.

Table 1

Tobacco Tax Revenue		
Fiscal Year	Tobacco Tax Revenue¹⁾ (in millions)	Percent Change from Prior Year
FY 2006-07	\$1,129.2	(3.4)%
FY 2007-08	1,073.7	(3.9)
FY 2008-09	1,041.5	(3.0)
FY 2009-10	1,006.5	(3.4)
FY 2010-11 Preliminary	968.2	(3.8)
FY 2011-12 Estimated	961.7	(0.7)
FY 2012-13 Estimated	941.6	(2.1)

¹⁾ Cigarette and other tobacco products tax.

Source: January 2012 Consensus Revenue Estimates

The State revenue from tobacco taxes is distributed among several funds including the General Fund and the School Aid Fund according to allocations specified in the Tobacco Products Tax Act (MCL 205.432). The funds receiving revenue from the cigarette tax and the other tobacco products tax are shown in Table 2. Revenue changes will affect all of these funds. The bill provides ongoing authority for appropriation of tobacco tax revenue to the Departments of Treasury, State Police, and Attorney General for tobacco tax enforcement and administration. These appropriations will be funded before calculation of the revenue available for distribution to the funds shown in Table 2.

Table 2

Statutory Allocation of Tobacco Tax Revenue Pursuant to MCL 205.432		
	Allocation of Cigarette Tax Revenue¹⁾	Allocation of Other Tobacco Products Tax Revenue
General Fund	19.8%	25%
School Aid Fund.....	41.6	--
Health and Safety Fund.....	2.4	--
Healthy Michigan Fund.....	3.8	--
Medicaid Benefits Trust Fund	31.9	75
Wayne County Indigent Health Care	0.6	--

¹⁾ Rounded to the nearest one-tenth of one percent.

Source: Senate Fiscal Agency

Fiscal Analyst: Elizabeth Pratt

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.