LAO
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Cigarette Tax Stamp Purchases And Surety Bonds in California

LEGISLATIVE ANALYST'S OFFICE

Prepared in Accordance With Chapter 867, Statutes of 2003 (AB 1666, Cogdill)

Introduction

In October 2003, the Legislature approved and the Governor signed Chapter 867, Statutes of 2003 (AB 1666, Cogdill), which allows alternatives for the payment of cigarette tax stamps by cigarette distributors. Prior law allows cigarette distributors (which are responsible for affixing the stamps to cigarette packages prior to their sale) to defer the payment for such stamps under certain conditions, including the posting of a surety bond or other form of security. The 2003 statute reduced—on a temporary basis until January 2007—the minimum amount of the required security posted by distributors while increasing the frequency of their required tax remittances to the state from monthly to bimonthly. The measure requires the Legislative Analyst's Office (LAO) to report on the impact of the statute. Specifically, the LAO report is to include the following: (1) an evaluation of the California State Board of Equalization's (BOE) ability to collect cigarette tax revenues; (2) additional revenues, if any, generated by the twice-monthly payment program; and (3) the ability of distributors to gain access to security bonds.

Background

Cigarette Taxes

Current State Taxation. The current level of state excise taxes on cigarettes in California is 87 cents per pack. Cigarettes have been subject to excise taxation by the state since 1959. The tax was first imposed at a rate of three cents per pack, and was then raised to seven cents and then to ten cents in 1967. All the funds raised from this tax were deposited in the General Fund. Further increases in the tax occurred as follows:

- In 1989, the excise tax was increased by 25 cents per pack with the passage of Proposition 99. These revenues go to special funds that are used for tobacco research, education, and healthcare. Equivalent taxes on other tobacco products also were imposed for the first time.

- In 1994, the tax was raised by two cents per pack pursuant to statute. These special fund revenues are used for breast cancer research.

- In 1998, the tax was raised by 50 cents per pack with the passage of Proposition 10. These special fund revenues are used for developmental programs for young children.

Proposed State Taxes. The taxation of cigarettes and other tobacco products continues to be considered as a source of additional state revenue. In the recent past there have been several bills introduced in the Legislature to raise tobacco taxes in order to provide a source of funding for new programs or to help close budget shortfalls. In addition, several initiatives have been proposed, typically to provide a fund source for new programs. The most recent initiative submitted to the Attorney General would increase tax rates by $2.60 per pack for emergency health care and tobacco education.

Taxation in Other States and by the Federal Government. Other states have also increased their cigarette taxes in recent years. Currently, the highest state tax is levied in Rhode Island at a rate of $2.46 per pack. The lowest tax is levied in South Carolina at the rate of seven cents per pack. California's current rate of 87 cents per pack is slightly below the national average of 92 cents per pack. The federal government imposes an additional 39 cents per pack tax on cigarettes.

Cigarette Tax Revenues

California's cigarette excise tax results in the collection of approximately $1.1 billion in annual revenues. These revenues are distributed among the three special funds noted above and the General Fund in proportion to the fraction each tax represents of the 87 cents per pack total tax rate. Cigarette smoking prevalence has declined significantly in recent years. For example, in 1993-94, per capita consumption was over 60 packs annually; by 2003-04, it had dropped to 33 packs annually. Even with the continued growth in the state's population, the falling per capita consumption has resulted in total cigarette sales declining at the rate of 2 percent to 3 percent annually.

Cigarette Tax Administration

How Is the Tax Collected? In California, the cigarette tax is collected through the issuance of stamps or "indicia." Stamps are issued or sold to cigarette distributors at a price equal to the cigarette tax (87 cents per pack) less a slight discount of 0.85 percent. The discount is intended to compensate cigarette distributors for the administrative costs of physically attaching the cigarette stamp to the cigarette pack. Once the stamps are attached, the packs are boxed and sold to retailers.

As a result of this system, the cigarette distributor is actually the taxpaying entity and is legally responsible for remitting the tax to the state. The price that the distributor (typically a wholesaler) charges retailers and the price that retailers charge the consumer does not affect the amount of tax revenues received by the state. Currently, the Bank of America acts as the agent for the BOE for the sale of the stamps to cigarette distributors (and thus the collection of revenues for the state).

Tax Enforcement Issues. As cigarette tax rates have risen across the country, various means of avoiding the tax—both legal and illegal—have increased in prevalence. Among several of the eastern states, where many people live within easy driving distance to another state, purchases of cigarettes in neighboring states has increased. In California, such cross-border activity (commonly known as "butt-legging") is not a significant problem; however, residents do have ready access to the Internet for purchases as well as to tribal lands. While both of these methods of purchase can be subject to taxation, such taxes are practically difficult to collect (in the case of the Internet) and inconsistantly collected (in the case of sales on tribal lands).

In addition, the increase in taxes has led to expanded counterfeiting of cigarettes and stamps and the diversion back into the state of export-bound products. In each of these cases, the cigarettes being exchanged escape California excise taxes and thus can be sold at a lower price to consumers. In response to these illegal efforts to escape the state excise tax, the Legislature passed a licensing requirement for cigarette retailers, increased investigations resources, and directed the BOE to establish a new "counterfeit proof" cigarette indicia.

Cigarette Distributors

Cigarette distributors are typically all-purpose distributors, who act as wholesalers for a wide variety of consumption items. According to industry sources, unless certain specialty items are required by a particular business, retailers prefer to use distributors that carry a broad spectrum of products. This minimizes the number of distributors each retailer must use, and reduces the work retailers need to go through to process deliveries. Since tobacco is an important consumption product in terms of revenues—especially for convenience stores—this market characteristic makes it virtually mandatory for distributors to carry tobacco products in order to keep their businesses viable.

The number of tobacco product distributors has fluctuated significantly over the last decade. In 1996, there were 144 distributors across the state. By 2001, this figure had grown to 232, before dropping in 2005 to 147. This most recent decline is likely due in large part to the additional state licensing requirement, as well as the new stamping equipment, which imposed additional capital expenditures on distributors. The cigarette distributor market in California is quite concentrated, with the three largest distributors (Coremark, Costco, and McLane) accounting for approximately three-quarters of cigarette stamp purchases.

Cigarette Tax Stamp Purchases

Cash or Credit? Every distributor of cigarettes in California must be approved and licensed by the BOE. This approval allows the distributors to purchase stamps from the BOE, apply the stamps to the cigarettes, and sell the stamped cigarettes to retailers throughout the state. Distributors may obtain the necessary cigarette stamps through one of the following means:

- Purchase the cigarette tax stamps *outright* at the beginning of the month for cash at the face value of the stamp (less the small discount for administrative costs discussed above).

- Take delivery of the stamps and elect to *defer* payment by posting a bond or other form of security.

Deferred Payment Requirements. Distributors wishing to defer payment for the cigarette stamps must be approved by the BOE. The department sets the maximum credit limit amount of such deferred payments, which, in general, cannot exceed 150 percent of the distributor's average monthly tax liability based on the distributor's previous six months experience. The department also establishes the required amount of security deposit. Before the passage of Chapter 867, distributors had only one option to delay payment for the stamps—furnish a security deposit equal to at least 70 percent of the value of the stamps offered on credit, but not more than twice their value. (All distributors using the preexisting deferred payment arrangement were and are at the 70 percent security deposit level.) Amounts owing for such stamps are required to be paid for in full by the 25th of the following month.

Distributor Security Options. The security that must be posted with BOE must be in the form of cash, insured deposits in a financial institution, or a surety bond. It is financially beneficial to the distributor to post a security deposit instead of purchasing the stamps outright in cash. (For example, the cost to a distributor of obtaining a bond would typically be less than the cost of obligating all the cash up front.) Thus, virtually all distributors of any size apply for the deferred payment option. The BOE indicates that it generally approves applications from distributors who wish to purchase stamps through the payment deferral program. Thus, those stamp tax payments made in cash are typically from small distributors who are unable to obtain a competitively priced security, or larger distributors who may temporarily exceed their credit authority.

Deferred Payment Rationale. Payment deferral allows distributors to avoid having to remit tax revenues to the state before they have actually sold or transferred the cigarettes. In this sense, the deferral program gives the distributors an opportunity to collect the tax before remitting it to the state. This treatment is similar to that for other types of state taxes. For example, under the sales and use tax, retailers submit taxes the month after they have been collected. This is particularly important for noncash purchases (for example, credit card sales), where the seller may not actually receive payment for some period of time.

The posting of a bond by the distributors protects the state's financial interest. Since cigarette stamps can be converted into cash, the bond provides the state with a form of collateral that can be used in situations where payments are not remitted by the distributor. While BOE is unable to determine a definitive explanation regarding the original rationale for the 70 percent security level, it is likely that something less than 100 percent was deemed acceptable since additional legal actions are available to the state in the event tax revenues are not remitted. (For example, the state might be able to recover some unsold tax stamps or place a lien on certain assets.)

Cigarette Tax Stamp Security Deposits

Use of Bonds by Distributors. Of a total 147 cigarette distributors in California, 27 are on the deferred payment plan, with the remainder on an upfront cash basis. Of the 27 payment-deferring distributors, 18 have posted a surety bond with the state, and the remaining nine have posted a cash equivalent (typically, a certificate of deposit). In terms of value of the stamps, over 80 percent of all stamp revenue is derived from stamps that have been purchased through deferred payments. The factors that result in this level of participation are discussed in the sections that follow.

Credit Amounts and Security Coverage. As discussed above, for distributors who wish to defer payment, the BOE establishes a credit limit amount for stamp purchases. The total amount of *monthly* credit extended by the state is currently about $155 million, resulting in an *annual* credit amount of about $1.9 billion. (The BOE indicates that the credit amount can exceed the total amount of stamp revenue of $1.1 billion because some distributors apply for more credit than they actually need.) The amount of security received by the state (in the form of bonds or cash equivalents) is about 70 percent of this amount—or $108 million monthly, on a rolling basis.

Surety Bond Cost and Availability. Surety bonds in California are typically offered through mainline insurance providers, who are likely to make the policy available to California distributors in connection with standard property and liability insurance. According to industry sources and based on discussions with insurers, the surety bond industry has limited the availability of this coverage and increased its rates in recent years as a result of:

- Increases in interest rates, which affect insurers' capital costs.
- Stricter underwriting requirements.
- Continuing health-related cigarette litigation.

As a result of these and other factors, the cost of cigarette stamp surety bonds that could be obtained at an annual rate of around 4 percent of the bond amount in 2001, has risen currently to upwards of 6.5 percent. (At the 70 percent coverage level, this higher premium rate is equivalent to an annual interest cost of about 4.6 percent.) Even at these rates, the bond may be available to only the most creditworthy firms with significant capital assets and is not likely to be extended to smaller and medium-sized distributors. Reflecting the increased thinness of the market, the number of companies actually underwriting these policies in California has dropped from between 15 and 20 about five years ago to nine currently.

One medium-sized distributor in the state, with whom we spoke, indicated that his business was unable to secure a cigarette stamp surety bond even if all of his insurance coverage was switched to that carrier. Although insurance coverage for the stamps was finally offered, it was at such a high premium as to make it a better deal financially to borrow against the business's real property and use a cash-equivalent security. For this particular distributor, this approach has led to a reduction in the business's capacity to have working capital for additional investment.

Effects of Chapter 867

The above-noted trends within the cigarette stamp bond industry were important considerations for the Legislature in the enactment of Chapter 867. The main thrust of the legislation was to reduce the minimum size of the required surety bond or other security to 50 percent from 70 percent of the value of the stamps on which payment is deferred if a bimonthly payment schedule is selected.

Policy Changes of Chapter 867

Under preexisting law, the state has allowed distributors to defer payment on stamps provided that security is posted for partial coverage and that the entire tax obligation is paid in the subsequent month. The adoption of Chapter 867 allows for a lower amount of partial security coverage in exchange for more frequent remittances of tax proceeds. Below, we provide an example of a distributor's choices under Option I (pre-Chapter 867) and Option II (post-Chapter 867):

- ***Option I:*** Distributor acquiring stamps obtains credit line of $10,000 from the state. It posts security in the form of a surety bond or cash equivalent equal to 70 percent of this stamp credit limit, or $7,000. On the 25th day of the following month, it remits to the BOE the entire $10,000 in tax it has collected in the previous month.

- ***Option II:*** Distributor obtains credit line of $10,000 from the state. It posts security in the form of a surety bond or cash equivalent equal to 50 percent of this stamp credit limit, or $5,000. On the 5th day of the following month, it remits to BOE the greater of: (1) the tax it has collected between the 1st and the 15th of the previous month, or (2) one-half of the stamps it purchased in the previous month. On the 25th day of the following month, it remits to the BOE the remainder of the tax it collected for the month.

Effect on the State. Under Option I, the state would have financial exposure for up to 30 percent ($3,000 in this example) of the stamp credit limit for a period of 55 days (assuming a 30-day month). The remaining 70 percent would be covered by the security pledge. Thus, in the event of nonpayment during that 55-day period, the state would potentially need to collect $3,000 from the distributor through other means (as noted above).

Under Option II, the state's maximum financial exposure in this example would increase from $3,000 to $5,000, since the distributor would only be required to post a security equal to 50 percent of the stamp credit limit. However, the state's exposure would be limited to 35 days. (Since at least half of the full amount of the stamps purchased—or $5,000—would be paid by the 5th day of the following month, the state would be fully covered after that date.) In addition, as discussed below, the state would collect interest for 20 days on at least one-half of the amount of the previous month's stamp purchases.

Effect on Distributors. The effect on distributors of Chapter 867 is basically a mirror image of the impact on the state. Under Option I, distributors would have to post security equal to 70 percent of the credit extended, resulting in a higher premium than under Option II, but also receive interest on *all* tax proceeds for the period from the 5th day to the 25th day of the month following the stamp purchases. Option II would result in a lower premium payment for surety bonds because of their smaller size, but also result in reduced interest income for the distributor because of the earlier remittance requirement. Option II could also result in an increase in the availability of bonds to the extent that the lower coverage requirement reduced surety industry concerns about it being overexposed financially.

Distributors' Business Decisions. Given the above effects on distributors, their decisions regarding using cash or credit, type of security posted, and deferral option chosen, will depend on their own cost of funds, the availability and cost of credit, and the nature of alternative investment opportunities available to them. Thus, firms' decisions will vary depending on their creditworthiness and alternative investment opportunities. Nevertheless, distributors face some basic tradeoffs:

- ***Cash or Credit?*** If a distributor has the choice, utilizing the credit option will always be better than cash. This is because cash requires 100 percent payment for stamps upfront, whereas credit requires coverage of 70 percent at most, and as little as 50 percent. In other words, some of the loan is "free." Thus, most stamps are purchased through deferred payment. As noted previously, those distributors paying cash tend to be small ones unable to obtain credit coverage.

- ***Bond or Cash Equivalent?*** Using surety bonds as security under the credit option requires a small upfront payment of a bond premium, but avoids a large cash deposit. In contrast, distributors posting a cash equivalent (for example, a pledged certificate of deposit) continue to receive interest on this security, but potentially forego better investment returns. Thus, distributors must make a financial calculation whether it is better to tie up cash in a security deposit or purchase a surety bond. This decision is dependent on the availability of "idle" cash as well as the availability of surety bonds. If the surety bond market is thin (resulting in expensive premiums), distributors are likely to be better off posting cash equivalents. Thus, most large distributors currently use this option.

- ***Option I or Option II?*** Some distributors may not be in the position of choosing between Option I and Option II. For example, the lack of cash and the price of surety bonds may force some distributors into Option II—where the security amount and the bond premium are lower. Alternatively, for those distributors who *are* in the position to choose either option, the optimal choice will depend on a comparison of: (1) the interest that they can receive under each option and (2) the costs of the surety bond premium or the foregone return on alternative investments.

Impacts of Chapter 867

To date, the measure appears to have had very little impact on the state or the condition of the industry. However, the lack of a larger response may be in part due to the fact that cigarette tax increases considered at the time of the legislation were not adopted.

Number of Participating Distributors. Since the program reduced the minimum amount of the required security and requiring more frequent payments under the credit option was established, only two distributors—both of medium size—have participated. This relatively small number may be due to the fact that the legislation was adopted in the context of the potential for higher cigarette taxes being imposed. If higher taxes on cigarettes are at some point adopted, this would raise the value of the stamps as well as the surety bond requirements, and thus likely result in increased program participation.

Collection of Revenues. The BOE reports that the passage of the measure has had no impact on the ability of the agency to collect cigarette excise tax revenues. Over the last ten years, there has been no case of the BOE being unable to collect revenues for any reason from sales of cigarette stamps. There was one instance in 2003 that involved a late payment for cigarette stamps as a result of a bankruptcy case. The late payment amount was $20 million, which was subsequently recovered (along with interest) in part from the distributor's surety bond.

Additional Interest Earnings and Administrative Costs. By requiring a bimonthly payment program for distributors electing a lower bond amount, the state can earn additional interest on that portion of the funds that are remitted earlier than under the standard monthly payment scheme. Over the last year, BOE estimates that additional interest of about $50,000 was received as a result of early payments. This is based on the state's Pooled Money Investment Account's recent average interest earnings rate of about 3 percent annually. Obviously, such earnings in the future would be tied to prevailing short-term interest rates.

The BOE indicates that its own administrative costs for the more frequent payments by distributors are minor and absorbable with its current budget. (When Chapter 867 was introduced, the department indicated ongoing administrative costs of $31,000 annually.) In addition, the department's contract with Bank of America was renegotiated and an additional minor amount was paid to the bank for reprogramming its computers to accept bimonthly payments.

Availability of Surety Bonds. It is difficult to determine from available data how the legislation has affected the availability of surety bonds. The industry cites several factors which have led to a reluctance on the part of the industry to continue offering such coverage, including: consolidations and mergers, caution regarding unsecured creditor status, and nonprofitability. There does not appear to be any empirical evidence that the legislative change has increased the availability of surety bonds.

There is clear evidence that the number of distributors has declined. Industry analysts believe this is due primarily to the impacts of Chapter 890, Statutes of 2003 (AB 71, Horton), which imposed a new licensing requirement on cigarette distributors. Other legislative action initiated a new counterfeit-resistant cigarette stamp, which required a substantial capital investment by distributors. It may be, however, that the more flexible payment schedule under Chapter 867 has partially counteracted the negative effect on the distributor market of additional licensing and capital requirements.

Overall, the trends in the surety bond industry appear to be negative in terms of both cost and supply. This is borne out by the decline in the number of distributors, the proportion of distributors deferring payment of stamps through the use of surety bonds, and the number of insurance companies providing credit to distributors. Chapter 867 does not appear to have affected these trends one way or the other.

LAO Recommendation

In general, the ability of cigarette distributors to defer payment for cigarette tax stamps until sometime after the tax has been collected is appropriate policy. Chapter 867 represented an attempt to improve the ability of distributors to defer payment while not worsening the state's risk in making such delayed payment possible. The program was undertaken at a time when substantially higher cigarette taxes were being discussed. That the program enrolled few participants may in part be due to the fact that the higher taxes were not, in fact, imposed. If new taxes were to be adopted in the future, however, additional program participation could occur. This is because the higher tax amounts would necessitate greater security amounts under the credit option.

To date, Chapter 867 has had a minor fiscal impact on the state. It appears that minor administrative costs have been more than offset by additional interest earnings. Furthermore, the added exposure to the state from the lower security amount has only marginally increased financial risk to the state. Therefore, we recommend that the program be continued. It may assist the distributor market to continue to be a competitive industry, and may make it more feasible for small and moderate-size wholesalers to continue to compete by expanding their ability to defer payment for cigarette tax stamps.

If the Legislature chooses to continue the program, it may also wish to consider the following refinements:

- ***Require BiMonthly Payments From All Payment Deferrers.*** Given the additional interest that the state receives by having more frequent remittances, the Legislature may want to require that all distributors that defer payment be required to remit tax proceeds on a bimonthly basis. If this is perceived as too much of an administrative burden for either the BOE or distributors, a tax revenue threshold for such a requirement could be established as an alternative.

- ***Allow Additional Forms of Collateral by Deferrers.*** The Legislature may want to explore other alternatives regarding the posting of security by distributors which defer payment. One option would be to allow for liens on property as a form of security. This would entail a more lengthy process for the state to get paid in the event of a distributor default, but it would free up some capital capacity for the businesses. Another option for posting of security would be through the deposit of negotiable assets—such as stocks or bonds.

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This report was prepared by Mark Ibele, and reviewed by Dave Vasché. The Legislative Analyst's Office (LAO) is a nonpartisan office which provides fiscal and policy information and advice to the Legislature.

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