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Committee on Regulated Industries

Senator Dennis L. Jones, D.C., Chair

FLORIDA TOBACCO SETTLEMENT AND NONSETTLING MANUFACTURERS

SUMMARY

This report examines whether legislative action is needed to protect the revenue from Florida's Tobacco Settlement Agreement from diminution or significant loss. The report reviews the status of Florida's Tobacco Settlement Agreement and the Master Settlement Agreement (MSA).

Because payments under Florida's tobacco settlement agreements and the MSA are based on market share, the payments may be adversely affected by the cost advantage of nonsettling cigarette manufacturers. Staff recommends that the Legislature impose a tax or fee on the cigarettes sold in Florida by nonsettling manufacturers in an amount that reflects the settling manufacturers per cigarette cost under the Florida tobacco settlements. The legislation should provide that the fee or tax is intended to recoup the state's health costs and discourage under-aged smokers.

If the Legislature chooses to enact the fee or tax, it should be collected from wholesalers or stamping agents in the same manner that the cigarette excise tax is collected. The wholesalers or stamping agents should receive compensation for collecting and administering the fee or tax. Alternatively, the Legislature could provide for collection of the fee or tax directly from the nonsettling manufacturers, provided that all cigarette manufacturers and importers should also be required to make certain reports to the state.

The report recommends additional reporting requirements and maintenance of statistics requirements related to seizures of, and arrests related to, counterfeit and contraband cigarettes in order to accurately assess the extent of any law enforcement and tax collection problems. The report also recommends additional bond requirements for excise tax stamping agents, and additional requirements for the purchase of tax stamps.

BACKGROUND

Florida's Tobacco Settlements

In February 1995, the State of Florida sued a number of tobacco manufacturers, and others, asserting various claims for monetary and injunctive relief. The defendants included: American Tobacco Company, R.J. Reynolds Tobacco Company, Brown & Williamson Tobacco Corp., Philip Morris Inc., Liggett Group, Inc., Brooke Group, Ltd., Lorillard Corporation, British American Tobacco Co., Ltd., and Dosal Tobacco Corp, Inc. On March 3, 1996, Florida, as one of five settling states,¹ entered into a settlement agreement with Liggett Group, Inc., Brooke Group, Ltd., and Liggett & Myers, Inc. (collectively herein referred to as Liggett). In August, 1997, the "Big Four" tobacco companies (Phillip Morris, Inc., R.J. Reynolds Tobacco Company, Brown & Williamson Tobacco Corp., and Lorillard Tobacco Company) entered into the landmark \$368.5 billion tobacco settlement agreement.

At the time of the settlement, the settling manufacturers held approximately 97.35 percent of the tobacco market share in the U.S.² The remaining market share was held by various, smaller producers who were not named in the state's suit as defendants. Dosal Tobacco Corp. Inc., was subsequently dismissed from the lawsuit. The annual tobacco settlement payments are based on several factors, including the total volume of U.S. cigarette sales, and national market share.

Subsequent to Florida's settlement, the "Big Four" tobacco companies settled with 46 states, the District of Columbia, and five U.S. territories in November 1998,

¹ The five states that entered into the March 3, 1996, settlement agreement are the states of West Virginia, Florida, Mississippi, Massachusetts, and Louisiana.

² "Tobacco Settlement and Declining State Revenues," *Trends Alert*, The Council of State Governments, March 2002, page 5.

by entering into the Master Settlement Agreement (MSA).³ The “Big Four” tobacco companies are known as the Original Participating Manufacturers or OPMs. Forty-five additional tobacco manufactures, including Liggett, have since joined the MSA, but have not reached a comparable settlement with Florida.⁴ These manufacturers are known as Subsequent Participating Manufacturers or SPMs. The manufacturers that have not joined the MSA or otherwise settled with a state are known as Non-Participating Manufacturers or NPMs.

Because payments under Florida’s settlement agreements and the MSA are based on national market share, the amounts received under the tobacco settlements may be adversely affected by marketing practices that can supplant domestic tobacco product sales or divert market share to nonsettling tobacco product manufacturers. There is evidence that the market share of the settling manufacturers has been decreasing relative to the market share of nonsettling manufacturers.

The Florida Legislature established the Task Force on Tobacco-Settlement Revenue Protection (Task Force) to determine the need for, and to evaluate methods for, protecting the state’s settlement revenue from diminution or significant loss.⁵ The Task Force recommended several options for protecting the tobacco settlement revenues, including the imposition of a licensing fee or equitable assessment on non-participating tobacco product manufacturers, and securitization of the payments.

2004 Regular Session

Two bills were introduced during the 2004 Regular Session to address concerns regarding the threat to Florida’s share of the tobacco settlement presented by the increasing market share of the nonsettling manufacturers, counterfeit cigarettes, and non-tax-paid cigarettes.

SB 2112 by Senator Dockery would have amended s. 210.0205, F.S., to impose a fee of 25 mills per cigarette from a nonsettling manufacturer. The legislative purpose of the fee was to recoup settlement revenue lost to cigarette sales by nonsettling manufacturers. The Revenue Estimating Conference did not establish a revenue estimate for SB 2112. However, it provided an unofficial preliminary estimate in the range of \$50 million to \$86 million. The bill prohibited the transportation of cigarette packages from Florida for sale in another state without first affixing the tax stamp or paying the excise tax required by the state into which the cigarettes are to be sold, and established reporting requirements relating to sales made out-of-state. It would have prohibited the stamping of cigarettes for, paying taxes to, or selling cigarettes in, another state if the other state prohibits either action. SB 2112 was passed by the Senate, but died in the Senate. The companion bill, HB 405 by Representative Farkas, was reported unfavorably by the House Committee on Business Regulation and died in the House.

CS/CS/CS/SB 2676 by the Committee on Regulated Industries, the Committee on Commerce, Economic Opportunities, the Committee on Appropriations, and Senator Haridopolos, would have established permit and reporting requirements on the importation and export of cigarettes to and from Florida that were intended to prevent nonsettling manufacturer from transporting cigarettes into MSA states through Florida as a means to evade MSA escrow payments. To this end, the bill required compliance with other states’ laws. It also expanded the state’s authority to seize, destroy, and forfeit unstamped cigarettes, increased criminal penalties, and enhanced civil penalties for contraband cigarette violations. The companion bill was HB 1459 by Representative Altman with a committee substitute amendment by the Committee on Business Regulation. The bill died in the House.

METHODOLOGY

Committee staff reviewed Florida’s Tobacco Settlement Agreement and the Master Settlement Agreement. Staff reviewed relevant statutory provisions and rules adopted by the Department of Business and Professional Regulation (DBPR) relating to cigarette sales and taxation. Committee staff met with the staff of the DBPR, the Florida Attorney General’s Office (AG), the Department of Financial Services (DFS) Office of the Auditor General, National Association of Attorneys General (NAAG),

³ *Master Settlement Agreement* (Nov. 1998), available at the Internet website for the National Association of Attorneys General at: <http://www.naag.org/issues/tobacco/index.php?sdpid=399> (last visited on October 25, 2004). Florida, Minnesota, Mississippi, and Texas were not parties to the Master Settlement Agreement.

⁴ A complete listing as of September 22, 2004 of the SPMs under the MSA can be found at: <http://www.naag.org/issues/tobacco/index.php?sdpid=927> (last visited on October 25, 2004).

⁵ See ch. 2000-128, s. 5, L.O.F.

representatives of the affected businesses, and other interested parties.

FINDINGS

Securitization of the Tobacco Settlement.

Some states have securitized their tobacco settlement proceeds to protect to protect these proceeds.⁶ Securitization replaces the settlement funds with negotiable instruments that are issued in capital markets. These are usually bonds sold through insurers. The state would sell the bonds and the bonds would be backed by future tobacco settlement payments. Several states have chosen to secure their tobacco settlement payments.⁷ Securitization offers potential benefits: 1) the state can sever ties with the tobacco companies, 2) it reduces the risk of declining or no payments, and 3) it provides a one time infusion of funds. Securitization also offers potential risks: 1) the state's reputation and credit rating could be tainted if the bonds cannot be repaid, and 2) costs associated with securitization, including interest, could outweigh the risks of not securing the tobacco settlement payments.

The threat of bankruptcy by one or more tobacco companies was raised on September 21, 2004, when the U.S. Justice Department and the tobacco industry⁸ began the trial phase of a \$280 billion federal racketeering law suit. The government is suing to recover the companies' "ill-gotten gains" under the federal Racketeer Influenced and Corrupt Organizations Act (RICO).⁹

⁶ See *Tobacco Settlement: States' Allocations of Fiscal Years 2002 and 2003 Master Settlement Agreement Payments*, U.S. General Accounting Office (GAO) (GAO-03-407, February 2003).

⁷ See *Tobacco Settlement, State's Allocation of Fiscal Years 2002 and 2003 Master Settlement Agreement Payments*, GAO, GAO-03-407, February 2003, at page 11; and also GAO, *Tobacco Settlement, State's Allocation of Fiscal Years 2003 and Expected Fiscal Year 2004 Payments*, GAO, GAO-04-518, March 2004, at page 3.

⁸ The defendants are Philip Morris USA, Inc., and its parent, Altria Group Inc.; R.J. Reynolds Tobacco Co.; Brown & Williamson Tobacco Co.; British American Tobacco Ltd.; Lorillard Tobacco Co.; Liggett Group, Inc.; Counsel for Tobacco Research-U.S.A.; and The Tobacco Institute. *United States v. Philip Morris, Inc.*, et al., No. Civ. A 99-2496GK (D.D.C.).

⁹ See 18 U.S.C. 1961 *et. seq.*

Status of the verification reviews of the tobacco settlement payments.

The DFS is in the process of conducting a review of the payments made by the "Big Four" tobacco companies under the Florida settlement agreement in order to determine whether the companies have made all required payments.

Leggett's total obligation to the initial settling states under the March 15, 1996, settlement is \$5 million.¹⁰ The DFS has completed a verification review process pursuant to s. 17.04, F.S., to determine whether Leggett has satisfactorily complied with the settlement agreement and has determined that there are disputed issues of fact and interpretations of the settlement agreement that preclude the DFS from concluding that Leggett has complied with the terms of the settlement agreement. The DFS has reported its findings to the AG, which is engaged in a process of negotiations with the company, which may lead to possible litigation, to resolve these issues.¹¹

Non-Settling Manufacturers in Florida.

According to records of the Division of Alcoholic Beverages and Tobacco (division), the number of cigarettes sold by nonsettling manufacturers in Florida has doubled in recent years. The division estimates that 16 percent of the Florida market share is held by non settling manufacturers. However, because there is no statutory requirement that manufacturers report their sales to the division, the division is unable to conclude that the department's listing of manufacturers distributing cigarettes in Florida is complete. According to the Office of Economic and Demographic Research (EDR), the Florida market share of the settling manufacturers has been decreasing since 1998 when it was 98.18 percent. EDR estimates that by 2007 the settling manufacturers' Florida market share will be 83.5 percent.¹²

¹⁰ See section 5.3 of the Attorneys General Settlement Agreement dated March 15, 1996.

¹¹ The AG has asserted that the DFS's work product regarding the verification review process and proprietary confidential information received by the DFS to verify settlement payments are exempted as a public record pursuant to ss. 119.07(6)(1) and 569.215, F.S.

¹² See *Revenue Estimating Conference, Tobacco Settlement Payments Forecast*, Office of Economic and Demographic Research, February 12, 2004.

Master Settlement Agreement

The OPMs' MSA payments are subject to a reduction based on their payments to the five non-MSA states. This reduction is known as the "previously settled states reduction."¹³ The SPMs are not subject to a comparable reduction in their payments under the MSA. The cigarette companies raised their prices to cover the costs of the settlement.¹⁴ Declining cigarette consumption due to rising prices may also contribute to declining domestic sales and consequently decreasing settlement payments.¹⁵ The settling states are concerned about the effect the sale of less expensive cigarettes from nonsettling manufacturers may have on settlement payments because under both Florida's settlement agreements and the MSA, the settling manufacturer's payments are based on national market share. A reduction in market share has been observed in the 46 states that are a party to the MSA.¹⁶

Escrow statutes.

In order to preserve their full share of the settlement payments and discourage underage tobacco use, each MSA-state is required by the MSA to enact a law to address the potential competitive advantage held by the tobacco manufacturers that are not parties to the settlement. The model escrow statute requires that every tobacco company doing business in the state must either participate in the MSA and pay its share of the settlement payments or pay into an escrow account in an amount equal to the amount the manufacturer would have paid if it had been successfully sued by the state or if it voluntarily became an SPM. Escrow payments are collected from the manufacturers who then transfer the cost to the consumers. Escrow statutes

¹³ See ss. II.(k)(k) and IX of the Master Settlement Agreement.

¹⁴ United States Department of Agriculture (USDA), *Trends in the Cigarette Industry After the Master Settlement Agreement*, report no. TBS-250-01, dated October, 2001.

¹⁵ *Id.* The USDA report notes that from 1998 to 2001 cigarettes consumption declined 7.5 percent due to rising cigarette prices.

¹⁶ According to the U.S. General Accounting Office, adjustments of settlement payments based, in part, on market share led to a \$1.6 billion reduction in the payments from projections between 1999 and 2001. See *Tobacco Settlement: States' Use of Master Settlement Agreement Payment*, GAO, GAO-01-851, June 2001. See also *Issues Affecting MSA Payment, Issue Brief Summary* from the National Conference of State Legislatures, dated October 1, 2003, at 11 (page number of the PDF file).

have the disadvantage that the funds placed in escrow cannot be used to address the health costs associated with tobacco consumption or to address other revenue needs.

The State of New York's escrow statute was challenged in the United States Court of Appeals for the Second Circuit by an NPM as a violation of the Commerce Clause of the U.S. Constitution,¹⁷ the Equal Protection Clause of the 14th Amendment of the U.S. Constitution, and the Sherman Anti-Trust Act.¹⁸ The NPMs also challenged New York's contraband statute, which required cigarette manufacturers to certify annually to the state that they were either making payments under the MSA or were in compliance with the escrow requirements. The court held that, based on the facts alleged in the complaint, the statutes may violate the Sherman Anti-trust Act because they effectively relieved the settling manufacturers from price competition. The court did not find a commerce clause or equal protection cause of action.¹⁹ In *Star Scientific, Inc., v. Beals*, the U.S. District Court of Appeals for the Fourth Circuit also upheld Virginia's escrow statute against a constitutional challenge by an NPM on due process, commerce clause, and equal protection grounds.²⁰ Anti-trust concerns were not addressed by this court.

Equitable assessment fees.

Other states have considered enacting a fee on the cigarettes of nonsettling manufacturer as a means to eliminate any cost advantage they may have in the market place and thereby avoid any downward adjustments in tobacco payments. In 2003, Minnesota, which is not an MSA state, imposed a fee of \$.35 per pack of 20 cigarettes on cigarettes produced by NPMs.²¹ In August 2004, the Court of Appeals of Minnesota held that the fee was constitutional because the settling and nonsettling manufacturer classifications create a genuine and substantial distinction tied to a legitimate state interest, i.e., to subsidize the costs of smoking to the state and to raise cigarette prices to discourage youthful smokers.²²

¹⁷ See Art. I, s. 8, cl. 3, U.S. Const.

¹⁸ See 15 U.S.C. 1

¹⁹ *Freedom Holdings, Inc. v. Spitzer*, 375 F.3d 205 (2nd Cir. 2004).

²⁰ *Star Scientific, Inc., v. Beals*, 278 F.3d 339 (4th Cir. 2002).

²¹ Section 297F.24, Minnesota Statutes (2003).

²² See *Council of Independent Tobacco Manufacturers v. Minnesota*, 685 N.W.2d 467 (Minn. 2004).

Two MSA states have enacted fees, which they term “equitable assessment fees,” on NPM cigarettes. In 2003, Michigan imposed an equitable assessment of 17.5 mills (or 1.75 cent) on NPM cigarettes sold.²³ In 2004, Utah imposed a 17.5 mills (or 1.75 cent) per cigarette equitable assessment on NPM cigarettes.²⁴

Apart from constitutional concerns, *Freedom Holdings* may serve as a precedent to challenge fee legislation on anti-trust grounds.²⁵ There are also equitable concerns. The payments made by the settling manufacturers are the consequence of allegedly bad conduct by the defendant tobacco companies that prompted several states to initiate law suits to recover damages for tobacco-related health costs. The nonsettling manufacturers were never sued for these alleged wrongful acts. The nonsettling manufacturers believe that the settling manufacturers should not escape the economic consequences for their alleged wrongful acts. The nonsettling manufacturers’ position is further complicated because Florida has no mechanism or procedures for adding subsequent settlers. They further argue that, if a fee were imposed, it would not equalize the market because the settling manufacturers receive a credit on their MSA payments for their Florida settlement payments. The NPMs’ escrow payments to the MSA states would also not receive a credit for their payment of Florida’s fee or tax.

Any disproportionate advantage that the OPMs may have under the MSA by virtue of their MSA credit for Florida settlement payments may have been negated by a recent development under the MSA. In August 2004, Vibo Corporation, doing business as General Tobacco, became a participating manufacturer under the MSA. General Tobacco is a Miami-based importer. General Tobacco’s MSA settlement provides for a credit for any fees that it may be required to pay to Florida as a nonsettling manufacturer. According to representatives for NAAG, which negotiates on behalf of the MSA states, the MSA states are prepared to give the same credit to any tobacco company that has settled under the MSA or wishes to enter into the agreement.

According to representatives for the settling manufacturers, to be equitable, a fee imposed on nonsettling manufacturers’ cigarettes would have to

approximate the settling manufacturers’ per-cigarette settlement costs, i.e., approximately 20 mills (or two cents) per cigarette. Another issue is how the fee should be collected. SB 2112 provided for the monthly collection of the fee directly from the nonsettling manufacturers. According to the NAAG representatives, the MSA states’ administration of the escrow payments would have been easier if the payments were collected through the wholesalers. Representatives for the wholesalers advised staff that requiring the wholesalers to collect the fee would impose additional uncompensated regulation and administrative costs that would increase their work and expenses.

Complimentary Legislation

According to representatives for NAAG, forty-four MSA states have adopted complimentary legislation to improve the effectiveness of the escrow statutes. Complimentary legislation prohibits the tax-stamping of tobacco products that are not in compliance with a state’s escrow statute, and requires the certification that a manufacturer is either a participating manufacturer under the MSA or, if an NPM, is in full compliance with a state’s escrow statute. It requires that the state maintain a list of manufacturers who are in compliance with a settling state’s laws; and subjects violators to civil and criminal penalties and license revocation or suspension.

According to industry representatives, the shipping restrictions in CS/CS/CS/SB 2676, were designed to address escrow statute enforcement concerns.. However, it is not clear to what extent the prevalence of complimentary legislation among the MSA states may negate the need for the restrictions in the bill.

Cigarette Distribution System and the Excise Tax

Cigarettes produced by non-Florida domestic manufacturers enter the state through an unlicensed importer, or through a licensed cigarette distributing agent.²⁶ Cigarette wholesale dealers sell cigarettes to retail dealers for resale only, or operate cigarette vending machines.²⁷ An “agent” is any person authorized by the division to purchase and affix adhesive or meter stamps under part I of ch. 210, F.S.²⁸ They are commonly termed as “stamping agents.” Stamping agents are usually wholesale dealers, but not

²³ Section 205.426d, Mich. Comp. Laws (2003).

²⁴ Section 59-14-214, Utah Code Ann. (2004).

²⁵ See discussion supra, regarding escrow statutes, and the decision in *Freedom Holdings, Inc. v. Spitzer*, 357 F.3d 205 (2nd Cir. 2004).

²⁶ Section 210.01(14), F.S.

²⁷ Section 210.01(6), F.S.

²⁸ Section 210.01(9), F.S.

all wholesale dealers are stamping agents. An “exporter” is a person who transports non-stamped cigarettes into Florida under bond for delivery beyond state borders.²⁹ Section 210.15, F.S., requires that every person, firm or corporation desiring to deal in cigarettes in Florida as a distributing agent, wholesale dealer, or exporter must apply for a cigarette permit.

Section 210.02, F.S., imposes an excise tax on cigarettes sold in Florida that ranges from 16.9 cents per package to 67.8 cents per package, depending on the number of cigarettes per package.³⁰ The current excise tax is 33.9 cents per standard 20-cigarette pack.³¹ Section 210.06, F.S., requires that every stamping agent affix a tax stamp as evidence that the excise tax has been paid before the cigarettes can be offered for sale in this state. Sections 210.02 and 210.04, F.S., provide that excise taxes must be paid by the wholesale dealer upon the first sale or transaction within this state whether or not such sale or transfer is to the ultimate purchaser or consumer. Because wholesaler dealers may purchase cigarettes from other wholesaler dealers, only the first sale is taxed. Distributing agents, acting as agents of the manufacturers, are not required to pay taxes for the distribution of cigarettes to wholesaler dealers.

Cigarettes Reporting Requirements

Pursuant to s. 210.09(2), F.S., the division requires all manufacturers and importers to report to the division the amount of cigarettes shipped to Florida cigarette stamping agents. The extent of the division authority under s. 210.09(2), F.S., to require out-of-state manufacturers to report shipments to Florida is unclear. According to the division, not all manufacturers or importers submit monthly reports. A reporting requirement permits the division to know what unlicensed or non-reporting entities are selling cigarettes to the retailers in Florida. Florida law does not provide for the licensure of cigarette importers. According to the division, all importers may not be reporting to the division. When the division becomes aware of a non-reporting importer, it gives the importer notice of the reporting requirement. There are no reporting requirements for retailers.

Jenkins Act and Internet Cigarette Sales.

The Jenkins Act³² requires that anyone who sells or transfers cigarettes for profit into any state that taxes cigarettes must register with the tax administrator for that state and file with the state’s tax administrator each calendar month, a memorandum or copy of the invoice of every shipment made during the previous month. The Jenkins Act applies to cigarettes that are shipped directly to consumers. The division requires direct-to-consumer solicitors to submit a monthly report to show compliance with the Jenkins Act.³³ Persons receiving cigarettes from outside the state are responsible for the payment of the applicable excise tax.³⁴

Increasing Internet cigarette sales from low-tax states to consumers in high-tax states, and from non-taxed American Indian dealers to consumers have raised concerns that these sales are adversely affecting the states’ collection of excise taxes.³⁵ A recent study estimated that two percent of the 20 billion packs of cigarettes sold in 2002 were purchased over the Internet, and that the estimate may be as high as three percent today.³⁶ Increasing Internet sales to consumers of cigarettes manufactured by small manufacturers may continue the erosion of market share that the settling manufacturers are experiencing, and thereby further contribute to declining the projected settlement payments to Florida.

State enforcement is hindered by the states’ difficulty in determining which companies are shipping into the state and which consumers are receiving the shipments. Pending Federal legislation, S. 1177, by Senator Hatch (R-Utah), would prohibit the mailing of any tobacco product, including cigarettes. The bill is known by the short title “Prevent All Cigarette Trafficking Act” or “PACT Act.” The PACT Act has passed the U.S. Senate and is pending in the U.S. House of Representatives.³⁷

³² Title 15, U.S.C., ss. 375 et. seq.

³³ Section 210.18(5), F.S.

³⁴ See s. 210.02(6), F.S. However, s. 210.18, F.S., provides that persons may bring into this state up to three cartons of cigarettes from outside the state without the excise tax indicia affixed or having to pay excise taxes on the cigarettes.

³⁵ See Porter, “Indian Sales of Tobacco Face New Pressure,” *The New York Times*, September 26, 2004.

³⁶ See Campagnino, Robert T., *Buying Cigarettes Over the Internet*, Prudential Financial Research, September 24, 2002.

³⁷ S. 1177 amends Title 18, U.S.C., s. 1716, pertaining to the postal service and the mailing of injurious articles.

²⁹ Section 210.01(17), F.S.

³⁰ See ss. 210.02(3) and (4), F.S.

³¹ Section 210.02(3)(b), F.S.

The division is unable to accurately determine or estimate the number of cigarettes shipments made each year directly to consumers from out-of-state. Direct-to-consumer cigarette sales, when not reported to the division, may undermine the state's collection of cigarette excise tax revenue and may adversely affect the market share of the settling manufacturers, and consequently the state's share of the tobacco settlement. However, no studies have been conducted and it is not clear to what extent, if any, Internet sales or mail order sales may affect the relative market share of the settling and nonsettling manufacturers.

Contraband Cigarettes

The sale of contraband cigarettes, which includes untaxed and counterfeit cigarettes, deprives the state of excise and sales tax revenue, and it may supplant legal sales and thereby reduce the state's tobacco settlement payments. A recent U.S. Government Accountability Office (GAO) report found a link between international terrorist groups and the illicit trafficking in contraband cigarettes and counterfeit cigarette tax stamps.³⁸ The extent of the contraband cigarette problem is unknown principally because of the illegal nature of the conduct.³⁹

The scope of counterfeit or untaxed cigarettes sales in Florida is also unknown. The Florida Department of Law Enforcement (FDLE) and the division do not maintain records of counterfeit cigarette seizures or related arrests. Section 210.18(7), F.S., requires sheriffs, deputy sheriffs, and police officers report to the division the seizure of any unstamped cigarettes in order that the state may be kept informed as to the size and magnitude of the illicit cigarette business. According to the DBPR, the department is not aware of any local enforcement cigarette seizures without DABT agents in attendance. The division advises that although the total amount of counterfeit cigarettes entering the state is unknown, it believes that the number is growing. In addition to local law enforcement and the DABT, the Department of Transportation (DOT) highway inspectors are a

potential source of information regarding cigarette seizures.

Permit and Bond Requirements.

According to the division and industry representatives, there is a growing problem in Florida with persons who apply for a wholesale dealer license and avoid paying taxes. These persons evade the excise taxes by purchasing the tax stamps with a check for insufficient funds and then close their business before reporting and paying the taxes to the division.

Stamping agents may purchase cigarette tax stamps by check or credit. If a payment is made by check, and there are insufficient funds to cover the amount of the check, the bad check may not be identified for several weeks or months. During this time the stamping agent could amass a high bill for unpaid taxes. A credit payment could either not be paid or also paid with a bad check. Therefore, when tax stamps are purchased with a bad check, the taxes may not be collected before the stamping agent goes out of business. Stamping agents must obtain a surety bond to cover the taxes, but the bond required may not cover the cost of a typical roll of tax stamps. A typical roll of tax stamps costs over \$10,000. Section 210.08, F.S., requires a \$10,000 bond as surety for payment of all taxes, authorizes the division to accept a bond that is not less than \$1,000, and prohibits the division to require a bond greater than \$10,000. The \$10,000 bond limit and \$1,000 bond minimum, have been in effect since 1945, when the excise tax on cigarettes was two cents.⁴⁰

Section 210.021, F.S., permits the division to require a wholesaler to pay the tax by electronic funds transfer (EFT) if the stamping agent has paid \$50,000 or more in taxes during the previous year. According to the division, requiring all stamping agents to pay by EFT may lessen the problem because EFT payments made with insufficient funds are less common than with check payment. The division also believes that requiring all new stamping agents to pay by cashiers checks for the first year of operation would establish the stamping agent as a permanent business with a reduced risk of going out of business and disappearing with a large outstanding tax bill.

According to the division, multiple permits for the same location can lead to auditing and tax collection enforcement problems. Multiple cigarette wholesale dealer and/or cigarette distributing agent permits for the

The bill was referred on January 20, 2004 to the House Committee on Energy and Commerce.

³⁸ *Terrorist Financing: U.S. Agencies Should Systematically Access Terrorists' Use of Alternative Financing Mechanisms*, GAO, GAO-04-163, November 2003.

³⁹ *Cigarette Smuggling; Federal Law Enforcement Efforts and Seizure Increasing*, GAO, GAO-04-641, May 2004.

⁴⁰ See ss. 2 and 6, ch 22645, L.O.F. (1945).

same location increases the possibility of hidden inventory, and makes it easier for cigarette distributing agents to sell unstamped cigarettes to other cigarette distributing agents and to cigarette wholesale dealers. According to industry representatives, wholesalers have observed numerous instances of excise tax evasion due to the confusion that may arise when a location or person has multiple permits. However, there have been no studies conducted on this issue and it is unclear to what extent, if any, this circumstance has resulted in uncollected excise taxes.

According to the division, one person holding both a cigarette distributing agent permit and a cigarette wholesale dealer permit blurs the distinction between the permits, and the absence of arms length transactions can hinder the division's ability to audit either permit.

RECOMMENDATIONS

Staff recommends that the Legislature take the following actions:

The Legislature should impose a tax or fee on the cigarettes sold in Florida that are manufactured by cigarette manufacturer that are not making tobacco settlement payments to Florida, if the Legislature believes that the nonsettling-manufacturers are not paying their equitable share of the costs associated with tobacco use and are causing an erosion of the market share for Florida's settling manufacturers to the detriment of Florida's tobacco settlement payments. In order to offset any cost advantage by cigarette manufacturers that are not making tobacco settlement payments to Florida, the fee or tax would have to reflect the settling manufacturers per cigarette cost under the Florida tobacco settlement. The MSA-states' willingness to provide the SPMs with a credit for any fee or tax paid in Florida on nonsettling manufacturers' cigarettes may negate concerns regarding inequitable treatment of the SPMs.

If the Legislature chooses to enact the fee or tax, it should also provide that the purpose of the fee or tax is to recoup the state's health costs associated with the use of nonsettling manufacturer cigarettes and to discourage under-aged smokers by reducing the cost advantage of lower-priced cigarettes.

If the Legislature chooses to enact the fee or tax, it should provide for collection of the fee or tax from wholesalers or stamping agents in the same manner that

the cigarette excise tax is collected. The Legislature should also permit the wholesalers or stamping agents to reserve from the amount collected an amount sufficient to compensate the wholesalers or stamping agents for their expenses in collecting and administering the fee or tax.

In order to effectuate the enforcement of the fee or tax, the manufactures and importers should be required to identify the quantity of cigarettes shipped or sold, or cause to be shipped or sold, and to whom the cigarettes were shipped or sold, or cause to be shipped or sold.

If the Legislature chooses to enact the fee or tax and require that the fee or tax must be collected directly from the nonsettling manufacturers, the Legislature should require that all manufacturers and importers must file a monthly report to the division if they ship or sell, or cause to be shipped or sold, cigarettes into Florida for sale to consumers in this state.

The Legislature should amend s. 210.08, F.S., to increase the maximum bond requirement for stamping agents. The maximum bond amount should be sufficient to cover the actual amount of tax stamps purchased. The Legislature should also authorize the division to require all new stamping agents to pay for tax stamps with a certified cashier's check or by EFT for the first year of operation in order establish that the stamping agent is a permanent business. These measures would reduce the risk of tax stamps being purchased with checks for insufficient funds.

The Legislature should require that the division maintain statistics regarding seizures of counterfeit and contraband cigarettes, and related arrests in order to accurately assess the extent of any law enforcement and tax collection problems.

The Legislature should amend s. 210.18(7), F.S., to require the Department of Transportation to report to the division the seizure of any unstamped and contraband cigarettes.