

Florida Tobacco Settlement and Nonsettling Manufacturers

Report Number 2005-157

November 2004

Prepared for
The Florida Senate

Prepared by
Committee on Regulated Industries

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Background

A. 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 lawsuit included as defendants the American Tobacco Company, R.J. Reynolds Tobacco Company, Brown & Williamson Tobacco Company, Philip Morris Inc., Liggett Group, Inc. Brooke Group, Ltd., Lorillard Company, British American Tobacco Co., Ltd. and Dosal Tobacco Corp, Inc., among others. On March 3, 1996, the State of Florida, as one of five settling states,¹ settled all of its claims against Liggett Group, Inc., Brooke Group, Ltd., and Liggett & Myers, Inc. (collectively herein referred to as Liggett). This settlement is known as the Attorneys General Settlement Agreement.

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 with Florida for all past, present and future claims by the state, including reimbursement of Medicaid expenses, fraud, RICO, and punitive damages.² At the time of the settlement, the settling manufacturers held approximately 97.35 percent of the tobacco market share in the U.S.³ 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 dismissed from the lawsuit. Under the settlement agreement, as subsequently amended by a Stipulation of Amendment, there are non-monetary and monetary sanctions imposed on the tobacco manufacturers. The non-monetary provisions involve restrictions on billboard and transit advertisements, merchandise promotions, product placement, and lobbying relating to all tobacco products.

From the date of the settlement, Florida was to receive \$11.3 billion over the next 25 years and an additional \$1.7 billion over the next 5 years as a result of a most favored nation clause in the settlement agreement as amended.⁴ The annual

¹ The five states that entered into the March 3, 1996, settlement agreement are the states of West Virginia, Florida, Mississippi, Massachusetts, and Louisiana. These states are known as the “initially settling states.”

² See s. 215.56005(1)(f), F.S., which defines the tobacco settlement agreement to mean *State v. American Tobacco Co. et al.*, Case no. 95-1466AH (Fla. 15th Cir. Ct. 1996).

³ The Council of State Governments, *Tobacco Settlement and Declining State Revenues*, Trends Alert (March, 2002), page 5.

⁴ Florida also negotiated a “Most Favored Nations” clause in the settlement, which provides the state with additional monies for a period of time after Minnesota settled with the defendants on terms more favorable than Florida’s.

tobacco settlement payments are based on several factors, including the total volume of U.S. cigarette sales, each company's share of the national market, net operating profits, and consumer price indices. Statutory guidelines were established to govern the expenditure of the tobacco settlement proceeds.⁵ Subsequent to Florida's settlement, the "Big Four" tobacco companies settled with the 46 remaining states, the District of Columbia, and five U.S. territories in November 1998, by entering into the Master Settlement Agreement (MSA). Several other tobacco companies have since entered into the MSA, but have not reached a comparable settlement with Florida, while continuing to sell cigarettes in this state.

B. Erosion of the Settling Manufacturers' Market Share

Because payments under both 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 the cigarette manufacturers that have not settled with Florida or the MSA states. This loss in market share may adversely affect the Florida's revenue under the tobacco settlement agreements.

C. Task Force on Tobacco-Settlement Revenue Protection

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.⁶ The task force submitted its findings and recommendations in March 2001, and expressed concern about the tobacco companies' willingness and ability to continue to make payments because declining payments have already necessitated revenue adjustments. The Task Force identified two major categories of uncertainty underlying future payments:

1. No payments due to bankruptcy or some other catastrophic financial event like an large adverse court judgment; and
2. Reduced payments with adjustments allowed under the settlement agreement.

The Task Force recommended several options for protecting the tobacco settlement revenues, including the imposition of a licensing fee or equitable

⁵ See s. 569.21, F.S.

⁶ See ch. 2000-128, s. 5, L.O.F.

assessment on non-participating tobacco product manufacturers, and securitization of the payments.

D. 2004 Regular Session

Two bills were introduced during the 2004 Regular Session to address 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 imposed a 25 mills per cigarette fee on the nonsettling manufacturers. This would have equaled a fee of \$.025 per cigarette, \$.50 per package of twenty cigarettes, or \$5.00 per carton. The bill was subsequently amended on the floor to reduce the fee to 10 mills per cigarette in Fiscal Year 2004-05 and 20 mills per cigarette for Fiscal Year 2005-06. The fee would increase each year at the rate of three percent or the consumer price index, whichever is greater. The bill stated that 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 conference's principal difficulty in establishing a revenue estimate was uncertainty regarding the extent to which the fee would affect the market and potentially divert sales from the nonsettling manufacturers to the settling manufacturers.

The bill would also have established additional reporting requirements for cigarette distributing agents and cigarette wholesale dealers. It 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. The bill 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 and was not certified to the House. The companion bill was HB 405 by Representative Farkas. It 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 restrictions on the importation and export of cigarettes to and from Florida. It prohibited the transport, or the causing to be transported, of cigarettes for sale in another state without complying with the other state's laws relating to the affixation of stamps for the payment of excise taxes on the sale of the cigarettes. It required that manufacturers and importers of

cigarettes must obtain a cigarette permit from the Division of Alcoholic Beverages and Tobacco (division), within the Department of Business and Professional Regulation (DBPR), and prohibited cigarette manufacturers and importers from selling or distributing cigarettes to anyone other than a wholesale dealer. According to industry representatives, these provisions were intended to prevent nonsettling manufacturers from transporting cigarettes into MSA states through Florida as a means of evading MSA escrow payments.⁷

CS/CS/CS/SB 2676 also would have expanded the division's authority to seize and forfeit cigarettes without tax stamps, increased criminal penalties, and enhanced civil penalties for violations of the cigarette tax laws relating to counterfeit cigarettes. The bill required that the division destroy confiscated cigarettes. The bill also provided for the seizure and forfeiture of the fixtures, equipment, and other personal property of a wholesale dealer or retail dealer violating the cigarette tax law (part I of ch. 210, F.S.). CS/CS/CS/SB 2676 passed the Senate but died in messages. 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.

⁷ See discussion below regarding escrow statutes.

Methodology

Committee staff reviewed Florida's Tobacco Settlement Agreement and the Master Settlement Agreement. Staff reviewed relevant statutory provisions and rules adopted by the DBPR relating to cigarette sales and taxation. Committee staff met with the staff of the DBPR, the Florida Attorney General's Office, the Department of Financial Services, Office of the Auditor General, National Association of Attorneys General, representatives of the affected businesses, and other interested parties.

Findings

I. Florida's Tobacco Settlement

A. Securitization of the Tobacco Settlement

In light of the uncertainty in the marketplace, the threat of bankruptcy, and pending litigation which may affect the tobacco companies' obligations under the settlement agreements, some states have securitized tobacco settlement proceeds.⁸ The Task Force recommended that the legislature consider securitizing a portion of the tobacco settlement receipts as a means to diversify the risk of non-payment. The task force recommended that the State Board of Administration (SBA), as the staff of the Task Force, should provide scenarios to the legislative appropriations staff so that the legislature can properly assess the financial implications of securitization.⁹

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.¹⁰

As recommended by the Task Force, the SBA presented securitization options for legislative review, including proposals from insurers. Securitization offers three 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

⁸ *Tobacco Settlement: States' Allocations of Fiscal Years 2002 and 2003 Master Settlement Agreement Payments*, U.S. General Accounting Office, GAO-03-407, February 2003. The GAO's legal name was changed from the Government Accounting Office to the Government Accountability Office by the GAO, Human Capitol Reform Act of 2004, Pub.L. 108-271, 118 Stat. 811 (2004).

⁹ See recommendation no. 5, *Final Report of the Task Force on Tobacco Settlement Revenue Protection to the President of the Senate and the Speaker of the House of Representatives*; Task Force on Tobacco Settlement Revenue Protection, March 28, 2001.

¹⁰ See *Tobacco Settlement, State's Allocation of Fiscal Years 2002 and 2003 Master Settlement Agreement Payments*, report no. GAO-03-407, February 2003, at page 11. The report notes that 13 of the 46 MSA states had secured with bonds all or part of their tobacco settlement payment; and also GAO, *Tobacco Settlement, State's Allocation of Fiscal Years 2003 and Expected Fiscal Year 2004 Payments*, report no. GAO-04-518, March 2004, at page 3. The report notes that half of the \$11.4 billion that the 46 MSA states expect to receive in 2004 will be from securitized proceeds.

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 recently raised on September 21, 2004, when the U.S. Justice Department and the tobacco industry¹¹ began the trial phase of the government's \$280 billion federal racketeering law suit. The government is suing the tobacco companies to recover the companies' "ill-gotten gains" under the federal Racketeer Influenced and Corrupt Organizations Act (RICO).¹² The court previously dismissed the government's counts related to tobacco-related alleged damages incurred under Medicare and the Federal Employees Health Benefits Act.¹³

B. Status of the Verification Reviews of the Tobacco Settlement Payments

Payments under the Florida tobacco settlement are made on April 30 and December 31 of each year. Through April 2004, the state has received \$4,149,676,115 under the settlement agreement. The settlement payment for 2003 was \$363,980,839.¹⁴

Based upon recommendations from the Office of the Auditor General, the Department of Financial Services (DFS) has implemented a process for assuring that the settling tobacco companies have made the appropriate annual payments.¹⁵ To assist in the process of verification, the Legislature exempted from public records requirements, proprietary confidential business information of the tobacco industry received by the state for the purpose of negotiating or verifying annual settlement payments.¹⁶ The DFS is in the process of conducting a review of the settlement payments made by the "Big Four" tobacco companies in order to

¹¹ 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.).

¹² See 18 U.S.C. 1961 *et. seq.*

¹³ *United States v. Philip Morris, Inc., et al.*, 116 F. Supp. 2d 131 (D.C. Cir. 2000).

¹⁴ These amounts are based on data provided by the Office of the Auditor General.

¹⁵ The Auditor General's recommendations regarding the administration of the tobacco settlement can be found in the following reports from the Office of the Auditor General: *An Accountability Review, Florida's Tobacco Settlement Agreement*, Report No. 13686, June 2000, and *Florida's Tobacco Settlement Agreement, An Accountability Update*, Report No. 02-052.

¹⁶ See ch. 2001-136, L.O.F., codified as s. 569.215, F.S.

determine whether the companies have satisfactorily complied with the settlement agreement and the amendments thereto, and made all required payments.

C. Status of the Verification Review for the Leggett Group Settlement

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 dated March 3, 1996, and amendments thereto, and made all required payments. Leggett's total obligation to the initial settling states under the March 15, 1996, settlement is \$5 million.¹⁷ However, this amount is subject to various adjustments, including reductions in market share. Leggett has made two payments to Florida for the state's share under the settlement agreement. Its first payment for Fiscal Year 1996-97 was in the amount of \$291,561.06. Its second payment for Fiscal Year 1997-98 was in the amount of \$92,733.66.¹⁸ The DFS 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 Office of the Attorney General (AG), which is engaged in negotiations with the company to resolve these issues. If the negotiations are unsuccessful, litigation may follow to resolve the dispute.¹⁹

D. Non-Settling Manufacturers in Florida

According to the division's records, the number of cigarettes sold by nonsettling manufacturers in Florida has doubled in recent years. For Fiscal Year 1999-2000 the division's records indicate that nonsettling manufacturers sold 101,294,526 cigarette packages, while in Fiscal Year 2003-04 the number of cigarette packages sold in Florida by the nonsettling manufacturers had increased to 203,364,458. The nonsettling manufacturers' increased sales in Florida have occurred while overall cigarette sales in Florida have decreased. The division's records of annual sales for the past ten years indicate a decline in overall cigarette sales since Fiscal Year 1995-96 of over 200 million cigarettes.

The division estimates that 16 percent of the Florida market share is held by nonsettling manufacturers. However, because there is no statutory requirement

¹⁷ See section 5.3 of the Attorneys General Settlement Agreement dated March 15, 1996.

¹⁸ These amounts are based on data provided by the DFS.

¹⁹ 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 public records pursuant to ss. 119.07(6)(1) and 569.215, F.S.

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 at 83.5 percent.²⁰ Consequently, projected tobacco settlement payments are also expected to decline in the following years.

II. Master Settlement Agreement

As noted above, 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, by entering into the Master Settlement Agreement (MSA).²¹ These settling manufacturers are known as the Original Participating Manufacturers (OPMs).²² Forty five additional tobacco manufactures, including Liggett, have since joined the MSA.²³ These manufacturers are known as Subsequent Participating Manufacturers or SPMs.²⁴

²⁰ See Office of Economic and Demographic Research, *Revenue Estimating Conference, Tobacco Settlement Payments Forecast*, February 12, 2004.

²¹ *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 are not parties to the Master Settlement Agreement.

²² The OPMs are Phillip Morris, Inc., R.J. Reynolds Tobacco Company, Brown & Williamson Tobacco Corp., and Lorillard Tobacco Company. R.J. Reynolds and Brown & Williamson have since merged as Reynolds American. Some tobacco companies, such as Commonwealth Tobacco, and Liggett & Myers joined the MSA immediately.

²³ A complete listing as of September 22, 2004 of the manufacturers that have joined the MSA can be found at: <http://www.naag.org/issues/tobacco/index.php?sdpid=927> (last visited on October 25, 2004).

²⁴ The division's records identify the following SPMs as distributing cigarettes in Florida:

- Commonwealth Brands, Bowling Green, KY
- JT International USA, Englewood Cliffs, NJ
- King Maker Marketing, Paramus, NJ
- Kretek International, Moorpark, CA
- Lane Ltd (formerly TEI), Tucker, GA
- Liggett Vector Brands, Durham, NC
- Lignum-2, Inc., San Leandro, CA
- Premier MFG, Inc., Chesterfield, MO
- Santa Fe Natural Tobacco., Oxford, NC

The MSA requires that tobacco companies take down all billboard advertising and advertising in sports arenas, and stop using cartoon characters to sell cigarettes. The tobacco companies also agreed not to market or promote their products to young people. The unadjusted cost of the states' settlements ranges between \$212 billion to \$246 billion over 25 years, subject to numerous adjustments ranging from inflation to fluctuations in cigarette consumption and market share.²⁵

The payments by the OPMs under the MSA are subject to a reduction based on their payments to the four non-MSA states, including Florida. This reduction is known as the "previously settled states reduction" and it reduces the payments of the OPMs under the MSA by 12.45 percent in the case of payments due before 2007, 12.2373756 percent for payments due after 2007 but before 2018, and 11.0666667 percent for payment due after 2018.²⁶ The SPMs are not subject to a comparable reduction in their payments under the MSA. Currently, none of the SPMs have settled with Florida. SPMs make lower up-front payments to the MSA states than the OPMs.²⁷ The nonsettling manufacturers (also known as non-participating manufacturers or NPMs) make no direct payments to any state.²⁸ They are also not subject to the advertising and marketing restrictions required of the settling manufacturers. However, the NPMs are required to make payments into escrow accounts.²⁹

²⁵ According to a report prepared by WEFA, Inc., an international econometric and consulting firm, on behalf of the Westchester Tobacco Asset Securitization Corporation, dated December 15, 1999, consumption of cigarettes by adults declined 0.65 percent annually for the period 1965 to 1981, 3.31 percent for the period 1981 to 1990, and 2.47 percent for the period 1991 to 1998. If these trends hold, cigarette consumption could decline from the roughly 539 million cigarettes consumed in 1990 to less than 200 million cigarettes for the year 2040.

²⁶ See sections II.(kk) and IX of the Master Settlement Agreement.

²⁷ See *MSA: Five Years Later*, State Government News, November/December 2003, page 14.

²⁸ The division records indicate that the following nonsettling manufacturers are distributing cigarettes in Florida:

- Alternative Brands, Inc., Mocksville, NC
- American Kretek Co., Chatsworth, CA
- Bengal Tobacco Corp, Davie, FL
- CigTec Tobacco LLC, Charles City, VA
- Dosal Tobacco Corp., Miami, FL
- Farmers Tobacco Co., Cynthiana, KY
- Imperial Trading Co., Elmwood, LA
- ITL (USA) Limited, Pearl River, NY
- J & E Distributors, Hartsville, SC
- Papiotrade, Inc., Omaha, NE
- Smokin Joes, Sanborn, NY
- Southern United Netw., Crossville, TN
- Star Tobacco, Inc, Chester, VA

²⁹ See discussion below regarding escrow statutes.

The cigarette companies raised their prices to cover the costs of the settlement. Cigarette prices increased by 45 cents per pack on November 16, 1998, which is the day the MSA was signed.³⁰ Declining cigarette consumption due to rising prices may also contribute to declining domestic sales and consequently decreasing settlement payments.³¹

III. Efforts to Neutralize the Cost Advantages of the NPMs

NPMs are mostly small, domestic tobacco companies and foreign tobacco manufacturers. Many term cigarettes manufactured by these small and foreign companies as “deep discount cigarettes.” NPMs generally market their products by state or region.

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 manufacturers’ payments are based on national market share, the amounts received under the tobacco settlements may be adversely affected by marketing practices that can supplant domestic cigarette sales or divert market share to the nonsettling manufacturers. A reduction in market share has been observed in the 46 states that are a party to the MSA.³²

A. Escrow Statutes

In order to preserve their full share of the settlement payments, each MSA-state is required by the MSA to enact a law to address the potential competitive advantage held by the NPMs. The Florida agreements have no comparable provision. The MSA also provides an incentive for states to prevent any settlement-related erosion of the settling manufacturers’ market share. Under the MSA, if the aggregate market share of the settling manufacturers fell by more than 2 percent below their base level in 1997, and the loss were caused in significant part by the

³⁰ United States Department of Agriculture (USDA), *Trends in the Cigarette Industry After the Master Settlement Agreement*, report no. TBS-250-01, October, 2001.

³¹ *Id.* The USDA report notes that from 1998 to 2001 cigarettes consumption declined 7.5 percent due to rising cigarette prices.

³² 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 U.S. General Accounting Office, *Tobacco Settlement: States’ Use of Master Settlement Agreement Payment* 8, report no. GAO-01-851, June 2001. See also *Issues Affecting MSA Payment, Issue Brief Summary* from the National Conference of State Legislatures, October 1, 2003, at 11 (page number of the PDF file).

terms of the MSA, the MSA payments might be reduced based on a formula that corrects for losses in market share.³³

The MSA specifies that individual states can avoid this downward adjustment to their payments, known as the “non-participating manufacturers” adjustment, by enacting and enforcing an escrow statute intended to prevent a competitive disadvantage for the participating manufacturers.³⁴ The MSA includes a model law that, if enacted and enforced by a state, would protect that state from any adjustment for market share loss, although states were permitted to enact and enforce any law that achieved the same result.³⁵ According to representatives for the National Association of Attorneys General (NAAG), which negotiates the MSA on behalf of the participating states, all MSA participating states have adopted some form of the model escrow statute.

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 or make payments into an escrow account in an amount equal to the amount the manufacturer would have paid to the state if it had been successfully sued by the state or if it voluntarily became a subsequent participating manufacturer.

Escrow payments are collected from the manufacturers who then transfer the cost to the consumers. Escrow payments are intended to limit the cost advantage of the nonsettling manufacturers and thereby potentially discourage underage tobacco use. Escrow payments are held for 25 years, after which time, if the state has not sued to recover Medicaid or other costs associated with cigarette consumption, the state must return the moneys collected. Escrow statutes 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 state 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,³⁶ the Equal Protection Clause of the 14th Amendment of the U.S. Constitution, and the Sherman Anti-Trust Act.³⁷ On these same grounds, the NPMs also challenged New York’s contraband statute, which

³³ See the “non-participating manufacturer reduction” in section IX(d) of the MSA.

³⁴ The MSA provides that a “‘Qualifying Statute’ means a settling state’s statute, regulation, law and/or rule (applicable everywhere the Settling State has authority to legislate) that effectively and fully neutralizes the cost disadvantages that the Participating Manufacturers experience vis-à-vis Non-Participating Manufacturers within such Settling State as a result of the provisions of this Agreement.” *MSA* at 60 (page number of the PDF file).

³⁵ *Exhibit T of the Master Settlement Agreement*, at 279 (page number of the PDF file).

³⁶ See Art. I, s. 8, cl. 3, U.S. Const.

³⁷ See 15 U.S.C. 1

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 contraband statute was enacted in response to the states' difficulties in enforcing the escrow statute. New York's contraband statute prohibits cigarette stamping agents from affixing a tax stamp to cigarettes from an NPM, if the NPM has not made the required certification or if the tax stamping agent has notice that the NPM is in violation of the escrow statute. The court held that the NPMs had a cause of action to challenge the statutes on the basis that the escrow and contraband statutes may, based on the facts alleged in the complaint, 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.³⁸

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.³⁹ Anti-trust concerns were not addressed by this court.

B. 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.

The Florida Legislature first considered such a fee during the 2001 Regular Session. CS/CS/SB 2214 would have imposed a 36 cent surcharge fee, which the bill termed the "Public Health Equity Surcharge," to the excise tax in s. 210.02, F.S. The bill would have imposed the fee on all cigarettes, and then provided a credit to the cigarettes from the settling manufacturers and from any manufacturer and importer who paid the fee and entered into an agreement with the state for advertising and marketing restrictions, including a prohibition on catalogue and direct mail sales. This approach differs from the approach in SB 2112 which would have imposed the fee directly on the nonsettling manufacturers' cigarettes without a credit. The principal benefit of the approach in CS/CS/SB 2214 is that it provided a mechanism for incorporating and encouraging nonsettling manufacturers to settle with the state to limit the advertising and marketing of cigarettes in a manner comparable to the restrictions imposed on the settling manufacturers under the tobacco settlements.

³⁸ *Freedom Holdings, Inc. v. Spitzer*, 357 F.3d 205 (2nd Cir. 2004).

³⁹ *Star Scientific, Inc., v. Beals*, 278 F.3d 339 (4th Cir. 2002).

Other states have pursued a fee option. In 2003, Minnesota, which is not an MSA state, imposed a fee of \$.35 per pack of 20 cigarettes on cigarettes produced from manufacturers that have not entered into a settlement agreement with the state.⁴⁰ In August 2004, the Court of Appeals of Minnesota upheld a trial court decision that this fee is constitutional.⁴¹ The court held that the classifications in the statute between settling and nonsettling manufacturers 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. According to state revenue officials, Minnesota had no hard data regarding the relative market share of the cigarette manufacturers before it enacted the fee. The state assumed that the settling manufacturers had a 90.5 percent market share. Minnesota has not concluded whether the fee has had any effect on the relative market share of the settling and nonsettling manufacturers.

Two MSA states have enacted fees, which they term “equitable assessment fees,” on NPM cigarettes. In 2003, the State of Michigan imposed an equitable assessment of 17.5 mills (or 1.75 cents) per cigarette on NPM cigarettes sold in the state.⁴² In 2004, the State of Utah imposed a 17.5 mills (or 1.75 cent) per cigarette equitable assessment fee on NPM cigarettes.⁴³ Legislation to establish equitable assessment fees has failed in other states. Legislation in the State of Tennessee to establish a 25 mills (or 2.5 cent) per cigarettes fee failed in the state’s General Assembly during its 2004 regular session.⁴⁴ The Office of the Attorney General of Tennessee issued an opinion that concluded that the proposed fee was constitutionally defensible under the U.S. Constitution for various claims, including due process and claims arising out of the Commerce Clause, and the Equal Protection Clause of the 14th Amendment.⁴⁵ Also in 2004, legislation to enact an equitable assessment fee failed to pass in the states of Indiana⁴⁶ and Mississippi.⁴⁷

⁴⁰ Section 297F.24, Minnesota Statutes (2003).

⁴¹ See *Council of Independent Tobacco Manufacturers v. Minnesota*, 685 N.W.2d 467 (Minn. 2004).

⁴² Section 205.426d, Mich. Comp. Laws (2003).

⁴³ Section 59-14-214, Utah Code Ann. (2004).

⁴⁴ SB 3183 by Senator Kurita and HB 3350 by Representative Bowers, General Assembly for the State of Tennessee. Tennessee’s legislative documents may be accessed at www.legislature.state.tn.us.

⁴⁵ See Office of the Attorney General, State of Tennessee, Opinion No. 04-044, March 12, 2004. In footnote 1, the opinion notes that the fee may constitute an unauthorized amendment to the state’s escrow statute, and put all of the state’s MSA payments at substantial risk.

⁴⁶ HB 1337 by Representative Pelath, General Assembly for the State of Indiana. Indiana’s legislative documents may be accessed at: www.in.gov/legislative/session/archives.html. (Last visited on November 16, 2004).

⁴⁷ SB 2861 by Senator Gordon, Mississippi Legislature. Mississippi’s legislative documents may be accessed at:

Apart from constitutional concerns, the Second Circuit's recent decision in *Freedom Holdings* that New York's escrow statute and the other measures designed to protect the settling manufacturers' market share could violate the Sherman Anti-Trust Act may serve as a precedent to challenge fee legislation on anti-trust grounds.⁴⁸

Equitable issues that have been raised by the nonsettling manufacturers that argue against the imposition of such a fee or tax. 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, which include the denial and concealment of the deadly and addictive nature of cigarettes. The nonsettling manufacturers do not believe that they are obligated by any legal or ethical principal to voluntarily enter into state settlements for wrongful acts for which they are not responsible, i.e., the settling manufacturers should not escape the economic consequences, in the form of higher cigarette prices, for their alleged wrongful acts. They also argue that they should not be required to pay a fee or tax for their refusal to enter into such a settlement with the state.

The nonsettling manufacturers' position is further complicated because, unlike the MSA, which has a mechanism for subsequent settlers, Florida has no such mechanism for adding subsequent settlers.

The nonsettling manufacturers further argue that, if a fee were imposed, it would not equalize the market because the settling manufacturers receive a credit in their MSA payments for their Florida settlement payments. The NPM must also make escrow payments to the MSA states, but they would also receive no credit for their payment of Florida's fee or tax. The nonsettling manufacturers that have entered the MSA assert that a Florida fee or tax would disproportionately increase their price-per-carton because the prices for their products already reflect either MSA payments or escrow payments to the other states.

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

www.mississippi.gov/frameset.jsp?URL=http://www.ls.state.ms.us/ (Last visited on November, 16, 2004).

⁴⁸ See discussion below regarding escrow statutes, and the decision in *Freedom Holdings, Inc. v. Spitzer*, 357 F.3d 205 (2nd Cir. 2004).

the MSA. General Tobacco is a Miami-based importer.⁴⁹ General Tobacco's MSA settlement provides a credit for any fees that it may be required to pay to Florida as a nonsettling manufacturer. This is a dollar for dollar credit up to the company's MSA payment amount. According to representatives for NAAG, 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. There is no intent to provide a similar credit to the NPMs for their escrow payments to the MSA-states.

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. The settling manufacturers' projected adjusted tobacco settlement payment to Florida for 2004 is \$372.9 billion. This translates to a Florida settlement cost of approximately two cents (or 20 mills) per cigarette or 40 cent per cigarette package sold in this state.⁵⁰ Accordingly, if the Legislature opts to enact a fee or tax on nonsettling manufacturer cigarettes, a 20 mills (or two cent) per cigarette fee or tax would make the nonsettling manufacturer pay a per cigarette fee comparable to the settling manufacturers' costs attributable to the Florida tobacco settlements.

Another issue is how the fee should be collected. SB 2112 provided for the monthly collection of the fee directly from the nonsettling manufacturers. The representatives for NAAG recommended that Florida should consider collecting the fee at the wholesale level in the same manner that the state collects excise taxes. The NAAG representatives based this recommendation on the MSA states' experience in collecting escrow payments from 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 regulation and administrative costs for the wholesalers that would increase their work and expenses. Of special concern to the wholesalers is the amount of compensation that the stamping agent and wholesaler can collect for affixing and accounting for the excise tax. Section

⁴⁹ General Tobacco is the importer for several South American cigarette manufacturers. Although General Tobacco is an importer, the MSA was amended to permit an importer to act as a manufacturer for settlement purposes.

⁵⁰ For the purpose of this analysis, shipments by Liggett are excluded because the company made no settlement payments during the period in question. These calculations are based on the estimates of the *Revenue Estimating Conference, Tobacco Settlement Payments Forecast*, February 12, 2004. Under section 7 of the *Stipulation of Amendment to Settlement Agreement and For Entry of Consent Decree* dated September 11, 1998, Florida's *pro rata* share of the companies' national market share, e.g., volume, is 5.5 percent. The settling manufacturers' estimated applicable domestic volume (market share) for 2004 is 340.6 billion cigarettes with an estimated 18.73 billion Florida volume.

210.05(3)(a), F.S., authorizes stamping agents and wholesalers to collect two percent of the par value of the amount of stamps purchased during the fiscal year. However, the discount is calculated on the basis of 24 cents per pack of cigarettes, which is less than the 33.9 cent excise tax rate for a standard 20-cigarette pack.⁵¹ The representatives for the wholesalers assert that this compensation is an insufficient amount for their collection of the tax, and that a additional requirement for collection and administration of a fee on nonsettling manufacturers' cigarettes would impose an additional uncompensated expense on the industry.

C. Complimentary Legislation

Tobacco industry and NAAG representatives assert that, since the MSA was signed in 1998, there has been an increase in the interstate transportation of cigarettes by NPMs from the four non-MSA states (Florida, Minnesota, Mississippi, and Texas) into the MSA states. They assert that this increase in the interstate transportation of cigarettes is intended to avoid compliance with state escrow statutes. Because MSA escrow payments are made by the NPMs for the cigarettes that manufacturers ship directly into the MSA states, cigarettes shipped to Florida and then transported to the MSA states would effectively evade the escrow requirements. These shipments through Florida and other non-MSA states are known by the term "transshipment." According to industry representatives, NPMs that are able to evade escrow payments through transshipment have a cost advantage over the settling manufacturers' cigarettes, which leads to a reduced market share for the settling manufacturers and consequently a reduction in tobacco settlement payments. However, no studies have been conducted and it is not clear to what extent, if any, the transshipment of cigarettes through Florida, or through any other non-MSA state, has reduced the market share of the settling manufacturers.

The MSA states have adopted legislation designed to improve the effectiveness of the escrow statutes. These laws are termed "complimentary legislation." According to representatives for NAAG, forty-four MSA states have adopted complimentary legislation. The MSA's complimentary legislation prohibits the tax-stamping of tobacco products that are not in compliance with a settling state's escrow statute. Complimentary legislation requires that a manufacturer to certify that it 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 that are in compliance with a settling state's laws and subjects violators to civil and criminal penalties and license revocation or suspension.

⁵¹ See s. 210.02(3)(b), F.S.

According to industry representatives, the shipping restrictions in CS/CS/CS/SB 2676, which prohibited the transport of cigarettes into another state in violation of that state's laws, were designed to address transshipping concerns. However, it is not clear to what extent the prevalence of complimentary legislation among the MSA states may negate the need for transshipping restrictions in Florida.

IV. Cigarette Distribution System

Florida law establishes a tier system for the distribution of cigarettes composed of manufacturers, manufacturer agents, distributors, wholesalers, and retail dealers. Florida does not license cigarette manufacturers. Cigarettes produced by non-Florida domestic manufacturers enter the state through an unlicensed importer, or through a licensed cigarette distributing agent, which is defined in Florida law as any person, firm, or corporation who receives cigarettes and distributes them to wholesalers or other distributing agents inside or outside the state.⁵² According to the department, distributing agents may have their own warehouses or may share warehouse space with cigarette wholesale dealers.

Cigarette wholesale dealers sell cigarettes to retail dealers for resale only, or operate cigarette vending machines in more than one place of business.⁵³ According to the division, the number of permitted wholesale dealers increased significantly after the tobacco settlements. For example, based on the division's records, before 1998, there were fewer than 20 wholesale dealer permit holders in Dade County, but in 2000 that number had increased to over 100 permit holding wholesale dealers.⁵⁴

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.⁵⁵ They are commonly termed as "stamping agents." Stamping agents are usually wholesale dealers, but not 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.⁵⁶

⁵² Section 210.01(14), F.S.

⁵³ Section 210.01(6), F.S.

⁵⁴ This estimate is based on information from the division's Miami field office. Before 2001, the division did not capture information regarding the number of wholesale dealers. According to the division, the number of wholesale dealers has remained relatively constant since 2001 with 459 wholesale dealers in June 2001 and 433 wholesale dealers in February 2004.

⁵⁵ Section 210.01(9), F.S.

⁵⁶ Section 210.01(17), F.S.

V. Cigarette Excise Tax

The division oversees the collection of excise taxes from the sale of cigarettes and other tobacco products. 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. The current excise tax in Florida ranges from 16.9 cents per package to 67.8 cents per package, depending on the number of cigarettes per package.⁵⁷ The current excise tax is 33.9 cents per standard 20-cigarette pack.⁵⁸

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 inside the 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.

Collected excise taxes are paid to the division. Stamps representing various denominations of tax are purchased in bulk by the stamping agents and are affixed to packages as proof of payment. Cigarettes that are not properly stamped may not be sold in Florida. The amount of the tax then becomes a part of the price of the cigarettes to be paid by the purchaser or consumer. According to the division, it collected \$416 million in cigarette excise taxes from stamping distributors for the Fiscal Year 2003-04.

VI. Cigarettes Reporting Requirements

A. Manufacturers

Under current law, the cigarette manufacturers do not report to the division any information pertaining to the tobacco settlement agreement. All such information is reported to Attorney General's office.

Section 210.09(2), F.S., provides a monthly reporting requirement for "any distributing agent, wholesale dealer, retail dealer, common carrier, or any other person handling, transporting or possessing cigarettes for sale or distribution within the state." Although this reporting requirement applies to all persons,

⁵⁷ See ss. 210.02(3) and (4), F.S.

⁵⁸ Section 210.02(3)(b), F.S.

including manufacturers, handling, possessing, transporting, or distributing cigarettes in-state, the division requires all manufacturers, including out-of-state manufacturers to report to the division the amount of cigarettes, by invoice total, shipped to Florida cigarette stamping agents. However, according to the division, not all manufactures submit these reports.

Although most out-of-state manufacturers report their deliveries in Florida voluntarily, Florida law does not require that manufacturers report their in-state sales to the division. According to the division, a requirement that manufacturers must report monthly to the division all cigarettes sold in Florida, would permit the division to know what unlicensed or non-reporting entities are selling cigarettes to the retailers in Florida and not reporting to the division. According to the division, this information would allow the division to cross-reference and identify distributors who are not licensed or who do not report and pay taxes to the state. These untaxed cigarettes sales, i.e., less expensive cigarettes, may adversely affect the market share of the settling manufactures and thereby adversely affects Florida share of the tobacco settlement.

B. Importers

Florida law does not provide for the licensure of cigarette importers. Florida law also does not define the term “importer” in the context of cigarettes or other tobacco products importers. To define the term, the division relies on the definition for importers in s. 561.14(4), F.S., which establishes a license classification for importers of alcoholic beverages.⁵⁹

Section 210.185, F.S., regulates the importation of cigarettes into this state. This provision makes unlawful the importation of “gray market” or diverted tobacco products. Gray market cigarettes are typically domestically manufactured cigarettes that are obtained at reduced prices from international markets and imported for domestic sale. Section 210.185, F.S., prohibits the acquiring, holding, owning, possessing, or transporting or importation, for sale or distribution in this state of cigarettes that the manufacturer did not intend to sell or distribute in the United States.

As with cigarette manufactures, the division relies on s. 201.09(2), F.S., to require that cigarette importers report to the division the amount of cigarettes shipped to Florida cigarette stamping agents. According to the division, all importers may not

⁵⁹ Under s. 561.14(4), F.S., an importer of alcoholic beverages, whether resident or nonresident, is “licensed to sell, or to cause to be sold, shipped, and invoiced, alcoholic beverages to licensed manufacturers or licensed distributors, and to no one else.”

be reporting to the division. When the division becomes aware of a non-reporting importer, it gives the importer notice of the reporting requirement.

C. Wholesalers and Distributing Agents

Cigarette distributing agents file a monthly report with the division detailing the number of cigarettes shipped through their warehouse for the preceding month, including all cigarettes received from manufacturers and delivered to each stamping agent. Stamping agents file a monthly report listing all stamp purchases and usage for the preceding month, including ending and beginning inventories. Wholesale distributors that are not stamping agents file a similar report of all purchases and sales inside and outside the state for the preceding month, including ending and beginning inventories.⁶⁰ Sales of cigarettes out-of-state are reported on a wholesale dealer's monthly report as exempt from the excise tax because the tax applies only to sales in Florida. The monthly report details the number of cigarette packages, but does not include any information about the quantity of each brand.⁶¹ There are no reporting requirements for retailers.

VII. Jenkins Act and Internet Cigarette Sales

The Jenkins Act⁶² 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 memorandum or copy of the invoice must include the name and address of the person to whom the shipment was made and the brand and quantity of such shipment. 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.⁶³ Persons receiving cigarettes from outside the state are responsible for the payment of the applicable excise tax to the division for the received cigarettes.⁶⁴

⁶⁰ See s. 210.09(2), F.S., and rule 61A-10.011, F.A.C.

⁶¹ See DBPR's *Taxable Cigarette Wholesale Dealer's Monthly Report, Form AB&T 4000A-205-1* (Dec. 2003), available at http://www.state.fl.us/dbpr/abt/forms/index_auditing.shtml (last visited Mar. 1, 2004).

⁶² Title 15, U.S.C., ss. 375 et. seq.

⁶³ Section 210.18(5), F.S.

⁶⁴ 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.

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.⁶⁵ A recent study estimated that 2 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.⁶⁶ Major manufacturer cigarettes may be found and purchased on the internet, but the study found that the major manufacturers are hesitant to conduct Internet sales because of age verification issues. However, it is not clear to what extent these manufacturers limit the sale of their products over the Internet or by mail order.

The study also found that Internet retailers offer a wide variety of cigarettes manufactured by the small manufacturers and that the Internet market offers these smaller manufacturers a significant national distribution market for their products.⁶⁷ These 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 manufacturers and nonsettling manufacturers.

The Jenkins Act provides a mechanism for collecting the excise tax for cigarettes sold over the Internet directly from consumers, but 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.⁶⁸

The division is unable to accurately determine or estimate the number of cigarettes sales made each year directly to consumers from out-of-state by the Internet, or through other means like mail order. When the division learns of any direct to consumers sales activity, which can include mail order sales and Internet sales, it notifies the manufacturer of the reporting requirements under the Jenkins Act. The

⁶⁵ See Porter, *Indian Sales of Tobacco Face New Pressure*, The New York Times, September 26, 2004.

⁶⁶ See Campagnino, Robert T., *Buying Cigarettes Over the Internet*, Prudential Financial Research, September 24, 2002.

⁶⁷ *Id.*

⁶⁸ S. 1177 amends Title 18, U.S.C., s. 1716, pertaining to the postal service and the mailing of injurious articles. The bill was referred on January 20, 2004 to the House Committee on Energy and Commerce.

division has received only three reports from companies selling cigarettes directly to consumers since September 2002. Two of these companies have only reported once, and the third company made several reports but hasn't reported any sales since January 2004. The division has issued 289 letters to consumers for the purpose of collecting excise taxes. Of the \$7,471.61 in taxes that the division has billed to consumers, only \$3,905.33 has been collected.

VIII. 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 GAO report found a link between international terrorist groups and the illicit trafficking in contraband cigarettes and counterfeit cigarette tax stamps.⁶⁹ According to the GAO report, law enforcement officials have determined that international terrorist groups use cigarette trafficking to raise funds. The extent of the contraband cigarette problem is unknown principally because of the illegal nature of the conduct, however, federal seizures of contraband cigarettes have increased dramatically in recent years from 12 seizure in 1998 to 191 seizures in 2003.⁷⁰

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 department asserts that its district offices maintain contact with the local law enforcement officials and work in unison in any activities involving either alcoholic beverages or tobacco products. Accordingly, no reports of any seizures without DABT involvement have been reported to the division pursuant to s. 210.18(7), F.S. The division has not kept records of seizures.

In addition to local law enforcement and the DABT, Department of Transportation (DOT) highway inspectors are a potential source of information regarding cigarette seizures. To date the DOT has had no contraband cigarette

⁶⁹ *Terrorist Financing: U.S. Agencies Should Systematically Access Terrorists' Use of Alternative Financing Mechanisms*, U.S. General Accounting Office, GAO-04-163, November 2003.

⁷⁰ *Cigarette Smuggling; Federal Law Enforcement Efforts and Seizure Increasing*, U.S. General Accounting Office GAO-04-641, May 2004.

seizures because its motor carrier compliance officers, who are certified law enforcement officers, were not trained in the identification of contraband and unstamped cigarettes. However, in October 2004, the DOT began to train its officers regarding counterfeit and unstamped cigarettes.

The division's enforcement staff perceives that this is a prevalent problem in the state. The division states that, through their work with the Federal government, several million packs of cigarettes have been seized in the past five years. The division advises that although the total amount of counterfeit cigarettes entering the state is unknown, it believes that the number is growing.

IX. Permit Requirements

A. Bonding Requirements

Persons must obtain a stamping agent permit in order to obtain cigarette tax stamps. When tax stamps are purchased, the division anticipates a tax report the next month, and actively pursues any permitted cigarette wholesale dealer who does not file a report. 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 bank drafts that are subsequently returned for insufficient funds. These licensees then close their business before reporting and paying the taxes to the division.

According to the division, many of these operations involve not commonly recognized cigarette brands that are either purchased from unlicensed entities through customs or from small manufacturers, e.g., nonsettling manufacturers, who do not report to the state on a monthly basis. These cigarette brands are commonly referred to as private brands and as fourth-tier cigarettes. Florida law does not require manufacturers or importers to report to the division information regarding cigarettes sold from out-of-state to stamping agents, but most report this information voluntarily. However, as noted above, many do not report.

Stamping agents may purchase cigarette tax stamps by check of credit. For example, a typical roll of tax stamps costs over \$10,000. 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, 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 required bond does not cover the cost of a typical purchase of tax stamps. Section 210.08,

F.S., requires a \$10,000 bond as surety for payment of all taxes. Section 210.08, F.S., 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.⁷¹

Because of the \$10,000 bond limitation, a stamping agent may purchase tax stamps in excess of \$10,000. According to the division, individual tax stamp purchases in excess of \$10,000 are common, and the typical roll of stamps costs more than \$10,000. According to the division, since the year 2000, it has received approximately 14 bad checks from 10 stamping agents. After collecting on the bonds, two of the checks remain partially unpaid for a total outstanding amount of \$30,724. This does not include staff time to collect the checks and on the bond.

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.

B. Multiple Permits and Warehousing Concerns

The division has identified at least 20 locations that have both a cigarette wholesale dealer and a cigarette distributing agent permit. It has also identified several warehouses with multiple cigarette wholesale dealer and cigarette distributing agent permits for the same warehouse, e.g., the division identified a warehouse with four different cigarette wholesale dealer permit holders and three different cigarette distributing agent permit holders.

According to the division, multiple permits for the same location can lead to auditing and tax collection enforcement problems. Cigarette distributing agents are agents for the manufacturers and serve as a means for transporting the unstamped (untaxed) cigarettes from the manufacturer to the distributors. Monthly reports from cigarette distributing agents help the division to verify the records of the stamping (tax paying) distributors. According to the division, multiple cigarette wholesale dealer and/or cigarette distributing agent permits for the same location increases the possibility of the cigarette wholesale dealer hiding

⁷¹ See ss. 2 and 6, ch 22645, L.O.F. (1945).

unstamped inventory in the cigarette distributing agent's inventory, bonded warehouses, or in Foreign Trade Zones. It also 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 and a cigarette wholesale dealer permit blurs the distinction between the permits. For example, a stamping agent is prohibited by law from shipping unstamped cigarettes. If a stamping agent obtains a cigarette distributing agent permit, it can bypass this restriction by acting under the cigarette distributing agent permit. According to the division, the absence of arms length transactions can hinder the division's ability to audit either permit because, in most cases, two permits in the same location results in no real separation of products and no real audit trail.

Conclusions and 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.