

Department of Legislative Services
Maryland General Assembly
2010 Session

FISCAL AND POLICY NOTE

House Bill 1354
Economic Matters

(Delegate Manno)

Tobacco Products - Tax Stamps - Regulations

This bill specifies that the Attorney General or Comptroller may issue regulations that require the State's cigarette tax stamps to be capable of being read by a scanner and encrypted with the following information: (1) the name and address of the distributor affixing the stamp; (2) the date the stamp was affixed; (3) the denominated value of the stamp; (4) the cigarette manufacturer; (5) the cigarette brand; (6) information that may aid the State's enforcement of the provisions of the Master Settlement Agreement (MSA); and (7) any other information required by the Attorney General or Comptroller.

Fiscal Summary

State Effect: Assuming regulations are promulgated by either the Comptroller or the Attorney General, general fund expenditures at the Comptroller's Office may increase by \$750,000 in FY 2011 due to increased tax stamp-related expenditures; this estimate reflects the October 1, 2010 effective date of the bill. Out-year expenditures increase to \$1 million due to annualization. Revenues are not likely to be affected.

Local Effect: None.

Small Business Effect: Potential meaningful.

Analysis

Current Law: Within 72 hours of receiving cigarettes in the State and before selling or attempting to sell the cigarettes, a licensed cigarette wholesaler who first possesses the cigarettes must affix, to the smallest cigarette package, tax stamps (1) in a total amount

that at least equals the tobacco tax due on the number of cigarettes in the package; and (2) in the manner that the Comptroller requires, including placing the tax stamps on the cigarette package so that the stamps are visible to a buyer. A licensed cigarette wholesaler is not required to affix tax stamps to sample cigarettes if the cigarette package is marked as required under current law; or cigarettes that are segregated or marked to indicate that the cigarettes were received in the immediately preceding 72 hours or are being held for sale or a use that is exempt.

In 1998, Maryland and 45 other states signed MSA with the four largest tobacco product manufacturers in the United States. MSA requires these manufacturers to pay the states in exchange for the states releasing them of past, present, and certain future claims. The manufacturers also must fund a national public health foundation and change their advertising and marketing practices and corporate culture to reduce underage smoking.

Background:

Tobacco Tax Evasion

State tobacco tax rate differentials provide substantial incentive to evade tobacco taxes either through organized smuggling or through individuals purchasing cigarettes over the Internet, in bordering states, or in other reduced/tax-free areas. States, including Maryland, lose substantial revenue from the consumption of cigarettes that are not taxed. In response, states have developed several initiatives to curb cigarette smuggling including increased enforcement personnel, interdiction efforts, and enforcement of authority granted to states under the federal Jenkins Act. These efforts have had mixed results.

Use of Encryption Technology

Encryption technology can improve cigarette tax stamps by making it more difficult to produce counterfeit stamps, allowing for enhanced tracking, and providing for instant verification capabilities. California currently requires encrypted cigarette tax stamps as part of a multi-pronged approach to combat cigarette tax evasion: licensing cigarette related businesses; increased enforcement activities including personally visiting storefronts; and implementing encryption technology. The combination of these activities has led to a decrease in the estimated amount of cigarette tax evasion in California. However, this does not mean that the stamps are impossible to counterfeit, only more difficult than ordinary stamps. News reports indicate that counterfeit California tax stamps were discovered soon after the introduction of encrypted technology. Several states are currently considering requiring the use of encrypted technology. Adopting encryption technology will address one specific type of

tax evasion – the use of counterfeit stamps. Encryption technology will not prevent tax evasion from any other forms of tax evasion such as individuals purchasing cigarettes over the Internet or in bordering states.

Tobacco Stamp Inspections in Maryland

The Comptroller's Field Enforcement Division has 9 inspectors and 16 agents who routinely inspect cigarette retailers and are trained to identify counterfeit stamps. Each agent and inspector has a pigment detector that verifies the authenticity of the stamp. The Comptroller expends approximately \$300,000 for the current tax stamp program. During fiscal 2009, the division conducted 4,093 cigarette retail inspections. The division also conducts criminal investigations related to illegal cigarette trading. No investigation or inspection to date has identified or seized counterfeit Maryland stamps.

State Fiscal Effect: Based on an estimate provided by a manufacturer of encrypted stamps, the Comptroller advises that transitioning to encrypted tax stamps results in increased expenditures for the State. Currently, the State purchases its stamps and distributes them to its roughly 60 wholesalers; as mentioned above, the stamps cost about \$300,000 per year. The Comptroller advises that encrypted tax stamps cost the State about \$1.3 million per year over the next five years. This price includes the cost of the stamps themselves, required software licenses, and manufacturer's expenses. Therefore, assuming that regulations are adopted requiring the use of encrypted tax stamps, general fund expenditures increase by about \$750,000 in fiscal 2011, due to the bill's October 1, 2010 effective date, and by about \$1 million annually thereafter due to tax stamp purchases at the Comptroller's Office.

This estimate pertains only to increases in State expenditures related to the purchase of encrypted stamps; Legislative Services assumes that wholesalers in the State are responsible for purchasing new stamping equipment needed as a result of the transition. The Comptroller advises that stamping equipment costs about \$110,000 per unit. Should the State be required to purchase this equipment, the Comptroller advises that it would need to procure 25 machines. Thus, general fund expenditures could increase further in the first year of implementation.

The Comptroller also advises that the use of encryption technology may result in an increase in State revenues due to additional cigarette tax compliance. However, any revenue gain in the near term is not expected due to the lack of documented tax stamp counterfeiting in the State. If the counterfeiting of State tax stamps were to become a common problem, as it has in other states, the use of encrypted stamps may result in increased tax compliance and, thus, increased revenues.

Small Business Effect: To the extent that cigarette business licensees that are small businesses are required to purchase any encryption technology, these businesses will be negatively impacted through additional expenses.

Additional Information

Prior Introductions: Similar bills, SB 491/HB 528 of 2009, received hearings in the Senate Budget and Taxation Committee and the House Ways and Means Committee, respectively. No further action was taken on either bill. HB 1259 of 2008, a similar bill, received a hearing in the House Ways and Means Committee, but no further action was taken.

Cross File: SB 346 (Senator Garagiola, *et al.*) - Finance.

Information Source(s): Office of the Attorney General, Comptroller's Office, Department of Legislative Services

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