




STATE OF WASHINGTON
DEPARTMENT OF REVENUE
OFFICE OF THE DIRECTOR

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November 21, 2014

TO: Hunter Goodman, Secretary
Washington State Senate

Barbara Baker, Chief Clerk
Washington State House of Representatives

FROM: Carol K. Nelson, Director 
Department of Revenue

SUBJECT: Report to Legislature - Verifying Payment of the Tobacco Products Tax on Moist Snuff

The Department of Revenue (Department) respectfully submits this report to the Legislature in response to RCW 82.26.260(2), which requires the Department to report on recommendations to verify payment of the tobacco products tax on moist snuff.

RCW 82.26.260(2) is the result of ESHB 2493 passed in the 2010 Legislative Session. The purpose of this legislation was to leverage an anticipated effort by the federal government to require tobacco product manufacturers to place a traceable product code on each individual unit of moist snuff for sale in order to track the product through the chain of distribution.

However, the anticipated federal action did not occur by July 1, 2011. Therefore, the statute requires the Department to report on options to verify payment of the tobacco products tax as well as present a study of compliance with the tobacco products tax, the effect of noncompliance on state revenue, and the effect of adopting a method to verify payment of the tax.

If you have any questions, please contact Drew Shirk, Assistant Director of the Legislation & Policy Division, at (360) 534-1547.

cc: The Honorable Andy Hill, Chair, Senate Ways and Means Committee
The Honorable Reuven Carlyle, Chair, House Finance Committee
The Honorable Christopher Hurst, Chair, Government Accountability & Oversight Committee
Committee Staff, Jeff Mitchell, Dean Carlson, David Rubenstein
Miguel Perez-Gibson, Executive Director, Legislative Affairs, Office of the Governor
David Schumacher, Director, Office of Financial Management



Verifying Payment of the Tobacco Products Tax on Moist Snuff

November 2014
Washington State Department of Revenue

Purpose of the Report

Pursuant to RCW 82.26.260(2), the Department of Revenue (Department) must report to the Legislature on recommendations to verify payment of the tobacco products tax on moist snuff. This is required because the federal government did not act to create a tobacco product code on moist snuff by July 1, 2011. The Department must also present a study of compliance with the tobacco products tax, the effect of noncompliance on state revenue, and the effect of adopting a method to verify payment of the tax.

Specifically, this report provides an overview of:

- Tobacco products tax
- Tobacco products tax revenue
- Purpose of RCW 82.26.260(2)
- Compliance related issues
- Tobacco products tax compliance rate
- Department Request For Information (RFI) on stamping
- Challenges with stamping moist snuff
- Options for stamping moist snuff
- Department recommendation

The Tobacco Products Tax

Chapter 82.26 RCW authorizes the taxation of tobacco products sold in Washington. A tobacco product is any kind or form of tobacco intended for human consumption except a cigarette. The tax is levied and collected from the distributors of tobacco products (generally wholesalers).

Tax Rates

All tobacco products except cigars, small cigars, and moist snuff are taxed at a rate of 95 percent of the “taxable sales price,” which is generally the wholesale cost of the product:

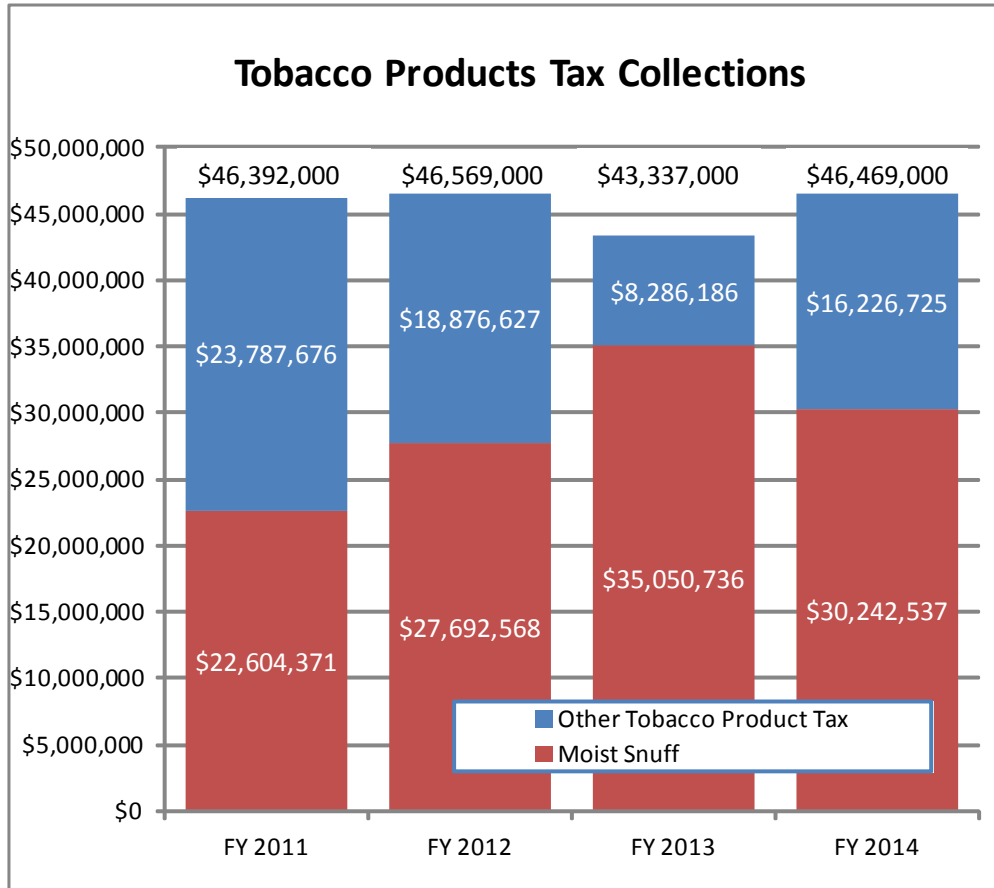
- The tax on cigars is capped at a maximum of \$0.65 a cigar.
- Small cigars (cigars with a cellulose acetate filter) are taxed at the equivalent rate of cigarettes.
- Moist snuff consumer-sized containers of 1.2 ounces or less are taxed at the greater of \$2.526 per container or 83.5 percent of the cigarette tax. Containers of moist snuff greater than 1.2 ounces are taxed at the proportionate rate of the 1.2 ounce container.

Administration and Enforcement Responsibilities:

The Department collects the tobacco products tax from taxpayers and also conducts routine tax audits of licensed tobacco product distributors and retailers. The Liquor Control Board (LCB) is responsible for industry compliance and enforcement. LCB officers ensure that tobacco retailers and distributors are properly licensed, investigate and halt illegal acquisitions of tobacco products, and verify that tobacco retailers do not sell to minors.

Tobacco Products Tax Revenue

All tobacco products tax revenue are deposited in the general fund. In October 2010, the reporting of the tobacco products tax on moist snuff changed from the general tobacco products tax rate to the unique \$2.526 per container rate. Below are the tax revenues as reported on excise tax returns to the Department for the periods subsequent to the change:



Purpose of RCW 82.26.260(2)

RCW 82.26.260(2) is the result of ESHB 2493, passed in the 2010 legislative session. The purpose of this legislation was to leverage an anticipated effort by the federal government to require tobacco product manufacturers to place a traceable product code on each individual unit of moist snuff for sale in order to track the product through the chain of distribution.

The readable product code could be used for tax purposes by electronically capturing the unique code at the time of tax reporting and, by use of a database, subsequently allowing the state to identify if tax was paid on a per unit basis.

This legislation was focused on moist snuff because:

- Moist snuff represents the largest segment (approximately 70 to 75 percent) of the other tobacco products market in Washington.
- Moist snuff is the most uniformly packaged tobacco product and would be the easiest product to design equipment for capturing label data.

However, the federal actions anticipated by ESHB 2493 did not occur by July 1, 2011, and are unlikely to occur in the near future. In the event such federal action was not taken, the Legislature directed the Department to prepare this report.

Compliance Related Issues

High tax rate

Washington's high tax rate is an incentive for tax avoidance and evasion. As of July 1, 2014, Washington and Minnesota share the highest tobacco products tax rate in the nation at 95 percent of the wholesale price. Minnesota's tax on moist snuff is higher: \$2.83 per container as opposed to Washington's rate of \$2.526 per container.

Below are the tax rates of neighboring states:

- Oregon: 65 percent of wholesale cost; \$2.14 per container of moist snuff.
- Idaho: 40 percent of wholesale cost for all tobacco products.
- Montana: 50 percent of wholesale cost; \$0.85 per ounce of moist snuff (approximately \$1.02 per container).
- California: 29.82 percent of wholesale cost for all products (as of July 2014).

Consumers can avoid the tax

Consumers may legally avoid paying the tobacco products tax because the tax is imposed on the first person that "handles *for sale* any tobacco products ... upon which tax has not been imposed." Consumers may legally purchase tobacco products from exempt sources (i.e., out of state retailers or tribal businesses on reservations) without incurring Washington's tobacco products tax (they do incur a use tax liability).

Convenient tax exempt sources also provide easy access to Washington retailers for obtaining exempt product they can then resell and evade payment of the tax. The absence of tax indicia (a stamp) on the product makes identifying taxed and untaxed product difficult. Currently, an audit reconciling inventory purchases to product sales is necessary to determine whether tobacco products sold by a retailer were purchased from a licensed distributor.

Washington's method of taxing tobacco products (applying the tax at the distributor level) is generally the same as the other 48 states (Pennsylvania has no tobacco products tax). Due to the lack of a tax stamp, most states also do not pass the liability for the tax on to the consumer.

Tobacco Products Tax Compliance Rate

Estimated evasion is 30 percent

An analysis of the most recent data indicates that non-cigarette tobacco products evasion may have declined from around 50 percent to closer to 30 percent, which is in the range of cigarette noncompliance. Because the tobacco products tax is not an obligation of the buyer, and the product carries no indicia indicating that the tax was paid, the tax has historically been difficult to enforce. As a consequence, evasion was long thought to be relatively high.

Fiscal Year 2014 data indicate that the noncompliance rate is 30.5 percent, where noncompliance is defined as the tax evasion amount as a percent of total Washington consumption. It's estimated that out of 20 million "pucks" of moist snuff consumed, about six million "pucks" were illegally sold without the tax. Noncompliance for all categories of other tobacco products is thought to be similar.

PACT Act

The improved compliance, if it holds up over time, may be the result of the 2010 Federal *Prevent All Cigarette Trafficking Act* (PACT Act). The PACT Act requires sellers who ship tobacco products in interstate commerce to register and file monthly shipping reports with state tobacco administrators that include information on the brand and quantity of tobacco products sold. The sellers must also comply with applicable state and local laws.

It appears that manufacturers and other sellers may be inducing Washington taxpayers to comply with state tobacco taxes. There should be less competitive pressure for noncompliance as the number of compliant market participants increases.

Estimated revenue loss of \$21 million in FY 2014

Noncompliance for tobacco products, other than cigarettes, cost the state an estimated \$21 million in lost tobacco product tax revenues in Fiscal Year 2014. Because untaxed tobacco products are indistinguishable from taxed product on store shelves, it's believed that retail sales tax and B&O tax are more likely to be collected than for cigarettes where illegally untaxed product is more likely to be purchased from informal sellers or from out of state. Therefore, lost retail sales taxes and B&O taxes are believed to be small.

Department Request for Information (RFI)

In March 2013, the Department issued a *Request For Information* (RFI) asking respondents to provide information on methods to verify the payment of the tobacco products tax (See Appendix A). Four companies responded to the Department's RFI: Xerox, Meyercord/Sicpa, Red Stamp, and Holographic Security Concepts.

While no market-ready product to automate the application of stamps to moist snuff is currently available, features common to all RFI responses included:

- All recommended a pressure-sensitive physical stamp.

- All required that the individual containers be removed from the original packaging for the stamp to be applied and the products repackaged.
- All offered different options regarding security features in their stamp.
- All proposals had options of hand application for low volume distributors and automated application for high volume distributors.
- None of the responding companies currently have a machine in production that will open manufacturer packaging, apply digitally readable stamps and repackage the product after stamping. Three of the four proposals cited the use of a machine made by one of the responding companies that is currently in prototype.

The responses offered varying levels of stamp security, from simple labels to readable microchip products. The options included overt security features (detectable by the human eye) and covert security features (authentication by a device). Some responses also offered options including banking, delivery, and tracking solutions; priced at different levels based on services chosen.

Costs

Only two of the four proposals contained cost estimates. These estimates were heavily qualified and dependent on the features and services purchased. A formal Request for Proposals (RFP) would be needed to obtain any confirmed pricing.

The cost for stamps per year ranged from \$31,250 to \$301,125, with the initial stamp production set-up costing approximately \$11,000. The initial track and trace/data management set-up would cost from \$25,000 to \$70,000, with an ongoing maintenance fee of \$500 a month.

Hand held stamp readers/data capture devices would cost between \$320 and \$3,700 each, depending on the features. The equipment for automatic stamp application and data capture for large distributors was estimated at \$150,000 each (although the technology is still in prototype).

Conclusions

While automated stamping of moist snuff may become available in the near future, the market does not currently have a machine that can perform this task. Hand stamping of moist snuff, a highly labor-intensive and costly process, would be required until the automated technology moves out of prototype and into production.

Challenges with Stamping Moist Snuff

Manufacturer packaging

Moist snuff manufacturers oppose disturbing product packaging because moist snuff is generally considered a time sensitive and perishable product. They argue disturbing packaging would reduce product freshness. Moist snuff is distributed to retailers in shrink wrapped rolls of 5 or 10 container packages. An automated stamping process would require machinery that could unwrap and rewrap rolls of containers. One RFI proposal suggested slicing rolls to allow hand stamping and then recovering with tape.

If established, federal track and trace technology requirements on moist snuff containers would likely require the manufacturer to place the unique identifiers on the product, which would likely avoid the need to disturb the package for tax purposes (assuming transparent packaging). However, there is currently no federal track and trace requirement for moist snuff.

High overhead costs for distributors relative to product sales

Any fully automated stamping machine would likely cost distributors \$150,000 or more to purchase (when out of prototype). The stamping machine would incur additional labor costs to operate and would require regular maintenance. Tax stamps would also be purchased from the state in advance of any stamp application; requiring distributors to make upfront pre-payment of the tax.

Some costs could be mitigated by a stamping allowance similar to the cigarette tax. A high cost of complying with tax requirements could push some distributors out of the moist snuff market. Fewer legal sources for obtaining the product could move more retailers and consumers to untaxed sources, thereby exasperating tax avoidance and reducing tax revenues.

Unique tax scheme

If adopted, stamping moist snuff would be unique to Washington State. National manufacturers and distributors would make cost-benefit decisions related to marketing moist snuff in Washington.

Options for Stamping Moist Snuff

Below are four potential options to ensure that the tobacco products tax is collected on moist snuff in Washington.

1. Require hand stamping of moist snuff (no automated stamping method available)

Advantages

- Provides visual proof to the consumer and enforcement personnel that tax has been paid, minimizing the need for audit verification.
- Would reduce the ability of retailers to disguise the sale of untaxed product.
- Would limit the distributor's overhead costs to the labor needed for applying stamps and repackaging product.
- Provides the state with more options in stamp selection.
- Allows for the collection of the tax via stamp purchases and eliminates the need for the monthly reporting of the tax.

Disadvantages

- Increases distributor costs in labor and product packaging.
- Would require the advance purchase of stamps (tax payment) by distributors.

- The volume of moist snuff sales may not be sufficient to warrant the added operating overhead and distributors may cease carrying the product. This could drive more business to untaxed venues.

2. Require distributors to use either automated or hand stamping of moist snuff

Advantages

- Provides visual proof to the consumer and enforcement personnel that tax has been paid, minimizing the need for audit verification.
- Would reduce the ability of retailers to disguise the sale of untaxed product.
- Provides distributors with choices concerning the method of stamping.
- Large volume distributors could automate their stamping process.

Disadvantages

- Increases distributor costs in labor, stamping machinery, and product stamping.
- Would require the advance purchase of stamps (tax payment) by distributors.
- Only a prototype machine currently exists that could provide for fully automated stamping and additional time for development and testing is needed before automated stamping could occur.
- The volume of moist snuff sales may not be sufficient to warrant the added operating overhead and distributors may cease carrying the product. This could drive more retailers and consumers to untaxed venues.

3. Collect the tax on all tobacco products at the cash register (liquor tax model)

Advantages

- The tobacco products tax would be collected at the retail level at the time the consumer purchases the product.
- No stamp would be necessary since the receipt carries proof of tax paid and any retail sale would require tax collection.
- Eliminates retailer smuggling or substitution since tax is accounted for at the time of sale.
- Cash registers would record the amount of tax to be reported to the Department.

Disadvantages

- Moves the responsibility for reporting the tax from 100 licensed distributors to 6,000 licensed retailers, increasing administrative complexity and the potential for non-compliance.
- Retailers would be required to program cash registers to assess the tobacco products tax at the time of retail sale. Many convenience store owners lack cash registers sophisticated enough to separately account for and collect the tax.
- Significant statutory changes would be required to implement.

- Doesn't prevent the consumer from seeking out exempt sources.

4. Maintain the current tax scheme for all tobacco products

Advantages

- Would not raise administrative costs to distributors or the state.
- Provides uniformity with the tobacco tax programs of other states.
- Allows for implementation of an automated system in the event the federal government acts concerning track and trace requirements for moist snuff.

Disadvantages

- Does not address the current compliance related issues.
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Department Recommendation

The Department recommends Option 4 (above). This option would maintain the current tobacco products tax scheme until such time as either the federal government or the marketplace adopt a uniform track and trace technology for moist snuff products. A cost effective track and trace technology could provide market and inventory benefits to industry as well as tax administration advantages. While the technology exists in prototype, a product that stamps moist snuff with a digitally readable product identifier is not currently available in the marketplace.

The FDA is still reviewing the benefits of requiring the tracking of moist snuff through the product distribution process. The Department believes leveraging an existing track and trace product would be most cost effective for tax purposes. The Department also believes developing a tax administration scheme that increases overhead costs for moist snuff tax reporting may be a disincentive to voluntary compliance and could possibly raise product prices. Higher retail prices from legal sources would likely increase tax avoidance by consumers.

Request for Information (RFI)

RFI # 2013-03-002

For a

Moist Snuff Tax Tracking and Verification Solution

Released by

Washington State Department of Revenue

March 29, 2013

Response Due Date: May 30, 2013

Statement of Need

The Washington State Department of Revenue (Department) is soliciting information from vendors concerning legislated requirements for proposals to stamp or otherwise verify and track moist snuff tax payments.

The Department is required to determine and recommend to the legislature a method to verify the payment of, or exemption from, the tax imposed by Revised Code of Washington (RCW) **82.26.260**. Recommended verification methods may employ stamping, manufacturer's digitally readable product identifiers, or other methods. The Department must make its recommendation to the legislature by November 1, 2014.

Information Gathering

We are exploring our options and therefore requesting industry input into the establishment of a new process for taxing 800,000 units of moist snuff a month, involving some 100 distributors and 6,000 retailers. We invite your ideas and innovative thinking.

More specifically, we are soliciting:

- User friendly options that consider process and cost impacts upon the Department, distributors and retailers.
- Suggestions for a stamp or other identifiable tax indicia for moist snuff that distinguishes each individual consumer unit or package.
- Options to track and trace moist snuff through the distribution system.
- Information on your proposed solution, costs and overall expertise, which will help with our final recommendation to the legislature.

Information Requested

We are looking for information on the following:

Tax Indicia

- Do you currently supply tax indicia? If so, please provide a detailed explanation.
- If you are proposing a new type of indicia for this process? Please describe:
 - How will the indicia be tracked?
 - How is it applied to the containers?
 - Your proposed solution to apply or collect the varied tax values (tax due is \$2.526 on 1.2 oz or less, \$2.105 per oz on packages over 1.2 oz).

Scenarios

- What would be a basic service process flow (e.g. indicia only)?
- What would be a mid-range service process flow (e.g. indicia and banking)?
- What would be a high-range service process flow (e.g. indicia, banking, and tracking database)?

Costs/Options

- What is the estimated cost per 1,000 indicia?
- What is the estimated cost for each portion of service (indicia, banking, database, etc)?
- Provide a process flow of each proposed process (tracking sales to the distributor, and a second option of tracking from the distributor to the retailers).

For estimated costs, provide a percentage of accuracy or range.

Company Information

- Company name
- Contact person
- General Description of your company

Contact Information

By Mail:

State of Washington Department of Revenue
Special Programs Division
Regarding Moist Snuff RFI
PO Box 47477
Olympia WA 98504-7477

Via Email, phone:

Barney Veenstra: barneyv@dor.wa.gov, (360) 570-3200

RFI Schedule

- Release RFI March 29, 2013
- Vendor questions submitted by May 1, 2013
- Response to vendor questions (all questions and answers to be shared, unless questions submitted as "proprietary") by May 16, 2013
- Submission of final RFI by May 30, 2013

Request for Information Process

Participation in the Request for Information process is not a requirement for any subsequent competitive procurement, although the results of this RFI may be used to build and refine an RFP. The Department of Revenue reserves the right to refrain from issuing an RFP or any other formal solicitation document. This RFI is not a formal solicitation and no contract will be awarded as a result.