

BRIEFINGS



April 2006

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This report was initially released electronically before being printed in hardcopy format

Legislature Should Consider a Unit-Based Tobacco Products Tax

Florida taxes “other tobacco products,” such as smokeless tobacco, on a price-based system. The tax rate is applied to the wholesale sales price of the product. Other excise taxes collected by Florida’s Department of Business and Professional Regulation, Division of Alcoholic Beverages and Tobacco, such as cigarette and alcoholic beverage taxes, are unit based. Cigarettes are taxed per pack, alcoholic beverages are taxed by the gallon.

Florida TaxWatch was asked by a member of the Florida Legislature to examine the issue of the “other tobacco products” tax base. Our analysis finds that the Legislature should revisit the decision to use an ad valorem tax for moist smokeless tobacco (MST), and that there are merits associated with a unit/weight based tax.

Under the current tax system, as consumers increasingly switch to lower-priced MST brands, the state’s tax base erodes, resulting in loss of revenue. Further, a recent lawsuit points to some existing confusion and needed clarity in the administration of the tax. These issues would be mitigated by a unit-based tax.

Tax on Wholesale Price Creates Some Administrative Challenges

There has been some confusion and disagreement about the determination of the proper tax base under the other tobacco products tax. When a product is transferred from the manufacturer to an affiliated wholesaler/distributor and then to an unaffiliated wholesaler/ distributor, a corporate structure commonly used across all industries, at what price should the tax be levied? A weight/unit based tax eliminates the confusion over the appropriate tax base and is the reason this confusion does not exist in industries whose products are taxed on the basis of weight or volume.

A company that distributes smokeless tobacco products to retailers in Florida filed a lawsuit against the Department of Business & Professional Regulation (DBPR), claiming a refund of more than \$14 million dollars in Other Tobacco Products Taxes over a five-year period. The core of the argument was what constitutes the “wholesale sales price.”

The distributor contended the taxable wholesale sales price was the lower price a smokeless tobacco company’s sales and marketing subsidiary paid to its manufacturing subsidiary for the

product the distributor later purchased. The distributor had been taxed on the price it paid to the sales and marketing subsidiary.

In March 2005, the Court approved a settlement under which DBPR gave the distributor a \$6.2 million credit against future taxes. The Court retained jurisdiction for one year. The potential for other such claims exists.

A uniform unit-based tax would be easier to administer for both the state and tobacco product distributors. In addition to the determination of the proper tax base, the industry reports that there is confusion and disagreement over the taxation of pre-packaged promotional units, such as “buy one get one free” offers.

The Division of Alcoholic Beverages and Tobacco, which administers the tax, reports that the wholesale price tax requires more time for compliance for both the division and wholesalers than would a uniform unit-based tax. While not constituting an undue burden, there are a few more opportunities for error. For example, care must be taken to separate non-taxable items, such as rolling papers and matches, from invoices, or the taxpayer may pay more than the tax due.

History of Cigarette and Smokeless Tobacco Tax

Florida began taxing cigarettes in 1943. That tax has always been levied on a unit basis, and the rate now stands at 33.9 cents per pack. In 1985, Florida began to tax “other tobacco products,” such as loose tobacco, chewing tobacco, and snuff. The rate was 25% of the wholesale price and that rate remains today. Cigars are currently not taxed by either the cigarette or other tobacco products tax.

Cigarette smoking in the United States has been declining for the last twenty years. This is true in Florida as well, and that decline is evident in the state’s cigarette tax collections. Total tax collections are less than they were in 1990-91, when the last tax rate hike occurred, dropping from a high of \$442.9 million to \$424.3 million in 2005-06.

Nationally, moist smokeless tobacco consumption has been increasing by 4%-5% annually. In Florida, collections of the other tobacco products tax have approximately doubled since 1990-91.

One argument for an ad valorem tax is that as prices inflate, tax revenues will rise. However, increasing competition in the industry may be holding prices down as the industry has seen some wholesale price reductions. Also, a major cigarette company has recently announced its entry into the MST market. In addition to competition, a price consideration with a larger impact on tax revenues is the phenomenon known as “trading down.”

“Trading Down” Erodes a Price-Based Tax Base

Although consumption of MST and the attendant tax revenues are increasing, a trend within the industry is having a negative impact on state revenue collections. There is a wide variance in the price of different brands of MST. The industry has three classifications, or tiers, of products. Tier 1 (premium) has the highest wholesale prices, followed by Tier 2 (price/value), and then

Tier 3 (sub-price/value) with the lowest wholesale price. The difference in wholesale price between Tier 1 and Tier 3 can exceed \$2 per can. The average Tier 1 price is currently \$3.01 per can, and Tier 3 prices are as low as \$0.81 per can.

This wide variance in price contributes to what is termed “trading down.” Although 90% of first-time MST consumers purchase Tier 1 products, the price difference provides an incentive for those who continue to use MST to switch to lower-priced brands.

Data from Citigroup shows that sales of MST grew 6.4% nationwide in 2005 and that while Tier 3 grew by 28.8%, sales of Tier 1 products fell by 2.8%. In Florida, data from a smokeless tobacco manufacturer shows that since Tier 3 products came into play in 2001, that share of the state’s market has grown to 16% while Tier 1’s share has dropped from 83% to 69%. Tier 2’s share has decreased from 17% to 14%.

In Florida, with an ad valorem-based tax, the decision of a consumer to “trade down” from a Tier 1 product to a lower-priced brand has negative revenue consequences for the state. Although the tax is actually collected at the wholesale level, trading down has the effect of reducing the tax paid on that purchase by as much as 55 cents (75 cents vs. 20 cents).

Summary and Conclusion

The current system of taxing smokeless tobacco on the wholesale price presents some problems that would be addressed by a unit-based tax. This is the way other similar excise taxes (alcoholic beverages, cigarettes, motor fuel) are levied in Florida. The federal excise tax on smokeless tobacco is unit-based (weight).

A unit-based tax would remove the litigation exposure to the state associated with the determination of the proper tax base, similar to the one that cost the state \$6.2 million in tax credits in 2005.

A unit-based tax could mitigate the revenue loss that occurs through the increasing incidence of “trading down.” When a consumer makes the choice to switch from a premium brand to a lower-priced one, there are negative tax revenue consequences. This differential can be as much as 55 cents on a single can. A uniform tax for all brands avoids this erosion of the tax base.

This is especially important when the overall collections from state tobacco taxes have decreased in the last 15 years.

Compliance and enforcement of the tax would be simpler for both taxpayers and the state.

The current tax is a tax advantage for lower-priced brands, particularly when considered in context of other state excise taxes. For example, the excise tax on a premium bottle of wine is the same as the tax on the lowest price brand. It should be remembered that tobacco products are also subject to the state’s sales and use tax, which capture price differentials and fluctuations.

The Legislature should revisit the other tobacco products and consider changing to a unit-based tax.

This Briefings was written by Kurt R. Wenner, Senior Research Analyst, under the direction of John Turcotte, Senior VP for Research.

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