SUBJECT: Prohibiting distributors from affixing tax stamps on certain cigarettes

COMMITTEE: Ways and Means — committee substitute recommended

VOTE: 8 ayes — Wilson, McCall, Pitts, Hilderbran, Luna, Paxton, Ritter, Woolley

0 nays

1 absent — J. Keffer

WITNESSES: None

BACKGROUND: In 1996, Texas filed a federal lawsuit against the tobacco industry, seeking to recover billions of tax dollars it had spent to treat tobacco-related illnesses. In settling the lawsuit, the industry agreed to pay the state $15 billion over 25 years. Florida, Minnesota, and Mississippi also reached separate settlements, while 46 other states joined the Master Settlement Agreement.

Actual payments by the industry are subject to adjustment formulas related to tobacco sales, inflation, and industry profitability. Under Texas' settlement terms, payments from the industry rise or fall in proportion to U.S. consumption of cigarettes each year as compared to consumption in 1997.

Sales by cigarette manufacturers that were not party to the Master Settlement Agreement, known as nonparticipating manufacturers (NPMs), do not result in payments to the states. However, states that were parties to the Master Settlement Agreement require NPMs to place in escrow funds that could be used to satisfy any judgments that might be entered against them in lawsuits brought by the states in the future.

Tax Code, sec. 154.152 requires a cigarette distributor that has unstamped packs of cigarettes intended for sale in another state to possess enough stamps from that state to affix to the unstamped packs in the distributor's inventory.

DIGEST: CSHB 3141 would prohibit a distributor from shipping cigarettes out of Texas for sale in another state without affixing a stamp or paying any other excise tax required by the state in which the cigarettes were to be sold. However, the distributor could ship cigarettes to the distributor's or an affiliate's location in another state without affixing stamps.

A distributor could not affix another state's tax stamp to, or pay another state's excise tax on, a pack of cigarettes if the other state prohibited those cigarettes from being stamped, having an excise tax paid on them, or being sold in the state.

Within 15 days of the end of each quarter, a interstate cigarette distributor would have to submit a report to the attorney general identifying the quantity and brand of cigarettes that had been shipped and the name and address of each recipient.

The bill would take immediate effect if finally passed by a two-thirds record vote of the membership of each house. Otherwise, it would take effect September 1, 2003.

SUPPORTERS SAY:

CSHB 3141 would close a loophole through which NPM cigarettes are sold in Master Settlement Agreement states without paying escrow. Nearly all states require cigarettes sold in the state to have a tax stamp proving that an excise tax has been paid on the cigarettes. These states allow distributors in other states to affix their tax stamp and remit the tax assessment to the state. In addition to the excise tax, Master Settlement Agreement states require a NPM to pay escrow in order to obtain a tax stamp. If an NPM does not pay escrow, the state prohibits them from affixing a stamp or selling cigarettes in the state. However, NPMs have found that by first selling their cigarettes to a Texas distributor, they can avoid paying escrow and still have their cigarettes sold in a Master Settlement Agreement state.

The following example illustrates the process. A NPM sells cigarettes intended for sale in Oklahoma to a Texas distributor. The Texas distributor affixes an Oklahoma tax stamp to each pack of cigarettes and charges the NPM the appropriate excise tax. The Texas distributor then sells the NPM cigarettes with an Oklahoma tax stamp to retailers in Oklahoma. Because Texas is not part of the Master Settlement Agreement and does not require NPMs to pay escrow, the NPM could have its cigarettes stamped and sold in Oklahoma without paying escrow, as it would have had to do if it had sold the cigarettes directly to Oklahoma.

This practice harms Texas, because increasing sales of NPM cigarettes are eroding sales of the tobacco companies that settled with the state. By avoiding escrow, NPMs can sell their cigarettes at lower prices than companies that must include the settlement costs in their prices. As more smokers switch to the lower-priced NPM cigarettes, the settling companies lose market share. However, the payments from the settling companies are based on the consumption of their cigarettes. As long as NPMs use current Texas law to create an unfair cost advantage over the settling companies, Texas stands to lose tobacco-settlement proceeds. Moreover, this practice harms other states because the money that otherwise would have been paid as escrow is not there to cover future claims.

CSHB 3141 would stop this practice by prohibiting a Texas distributor from affixing another state's tax stamp to a pack of cigarettes that will be sold in another state, if the other state would prohibit those cigarettes from receiving a tax stamp or from being sold. Thus, if a NPM did not pay escrow in Oklahoma and consequently could not receive a tax stamp, a Texas distributor could not affix an Oklahoma tax stamp to the NPM's cigarettes.

Also, requiring distributors to report to the attorney general the numbers and types of cigarettes sold out of state, as well as to whom they were sold, would allow Texas and other states to track the interstate movement of cigarettes better. The attorney general could forward the reported information to other states so that they could follow up and ensure that cigarettes sold by recipients complied with the law.

OPPONENTS SAY:

CSHB 3141 would help other states immensely but would provide little benefit to Texas. A better approach to alleviate concerns about settling companies losing market share to NPMs and its effect on the Texas tobacco settlement proceeds would be to have Texas require NPMs to pay escrow. The 46 party states to the Master Settlement Agreement already require this. The state could set up the escrow so that it was equivalent to the settlement costs paid by the settling companies. This would even out the price difference in cigarettes between settling companies and NPMs, as well as provide Texas with some assurance that NPMs could pay any future claims that the state might bring against them.

NOTES: The committee substitute would modify the bill as introduced by specifying that the bill would not prohibit a distributor from transporting stamps to its or an affiliated entity's location in another state. The substitute also would define affiliated entity.