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STUDY ON THE SHIPMENT OF OTHER TOBACCO PRODUCTS IN MARYLAND

PRESENTED TO:

Maryland General Assembly

PRESENTED BY:

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Serving the People

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I. History of Legislation, Regulation, and Taxation for Other Tobacco Products

In 1999, the Maryland General Assembly passed legislation that was signed by the Governor creating a new excise tax beginning July 1, 2000, on Other Tobacco Products ("OTP") which includes items such as cigars, pipe tobacco, chewing tobacco, and snuff. Prior to the codification of the law, there was no previous excise tax on OTP. There was however, an excise tax on cigarettes which are not considered OTP.

The tax rate was established at 15% of the wholesale price of the tobacco products. The term "wholesale price" is defined under Md. Code Ann. Tax Gen. § 12-101 (j) as "the price exclusive of any discount, trade allowance, rebate, or other reduction for which a wholesaler buys OTP from a supplier or manufacturer …."

The legislation further provided the OTP tax to be paid by the wholesaler who sells the OTP to a retailer or consumer in the State, or, paid by a retailer or consumer who possesses OTP on which the tax had not been paid. However, since the inception of an OTP excise tax the State has only collected about $500 from consumers who purchased and possessed untaxed OTP, which could indicate general tax avoidance on the part of consumers. Unfortunately, the OTP legislation passed in 1999 did not provide for effective enforcement measures against the illegal smuggling and possession of "contraband" OTP. Consequently, in 2010, the Maryland General Assembly passed House Bill 88, also signed by the Governor, which set out a framework to license and regulate the OTP industry in Maryland. Although passed in 2010, House Bill 88 did not take effect until May 1, 2011.

Shortly after House Bill 88 became effective, a consequence arose that was previously not anticipated. Specifically, orders for distinctive, premium cigars placed by consumers directly to OTP wholesalers and retailers, licensed or not, via mail-order catalog, telephone, internet, etc. were prohibited. The result was that consumers lost choice, product availability, and the convenience of home delivery.

To remedy this situation, the Maryland General Assembly, in 2012, passed companion bills (House Bill 570 and Senate Bill 452) which, among other things, restored consumer choice, product availability, and convenient delivery. The bills also required this issue be further studied and reported on in an effort to provide for the fair and equitable collection of taxes, reduce access of OTP to minors, and to deter illegal smuggling and sales.

Furthermore, during the 2012 Special Session of the Maryland General Assembly, House Bill 1802 and Senate Bill 1302 were passed and signed into law by the Governor. The bills addressed a variety of tax issues including the increase of the OTP excise tax rate by product type. Generally, OTP is taxed at 30% of the wholesale price, with two exceptions, non-premium cigars are taxed at 70% of the wholesale price and premium cigars, as defined in Title 16.5 of the Business Regulation Article, are taxed at 15%.

II. Current Law Pertaining to Other Tobacco Products

Title 16.5 of the Business Regulation Article establishes the framework for the distribution of OTP in Maryland by requiring that Maryland OTP manufacturers, wholesalers who sell to OTP retailers and tobacconists, and the OTP retailers and tobacconists themselves all be licensed to sell OTP in Maryland. This structure, and the regulations that support it, work to create a level playing field amongst Maryland businesses and ensure the proper collection of excise taxes and sales and use taxes owed to the State.

Currently, as it pertains to premium cigars and pipe tobacco, and more specifically, the shipping of these products directly to consumers in the State in non face-to-face transactions, out-of-state retailers are not required to be licensed by the State or collect and remit any taxes to the State. Both out-of-state and in-state sellers of premium cigars and pipe tobacco may ship directly to consumers, however, the in-state sellers must be licensed and collect and remit taxes whenever shipping directly to consumers in Maryland.

III. Other Tobacco Products Attraction and Accessibility to Youth

According to the Maryland Youth Tobacco Survey, cigarette smoking has decreased amongst high school students by nearly 40% since the year 2000. However, as students turn away from cigarettes, they have been turning to alternative tobacco products such as cigars.

In its study, the Maryland Department of Health and Mental Hygiene found that flavored cigars mask the taste of harsh toxins in tobaccos, thus making them appealing and addictive.[1] Many of these flavored cigars (such as grape, vanilla, apple, and chocolate – all possessing a unique and obvious appeal to younger consumers) are sold individually and are usually priced under $1.00, less than the price of a candy bar and less than the price of a premium cigar. Frequently, these flavored cigars slip through loopholes in state law definitions in order to qualify as cigars, therefore allowing them to be taxed at a lower rate than cigarettes and be more affordable and accessible to youth.

As to the use of the internet by youth wishing to purchase tobacco, approximately 65% of domestic tobacco sales websites have an age verification protocol that consists of either typing in a date of birth or selecting an age verification button. However, only 9% request the consumer to fax in a photocopy of their identification, and only 6% require identification when the tobacco is delivered to the consumer. [2]

According to the Journal of Law, Medicine & Ethics, many compliance checks have been performed on the sale of tobacco products over the internet. In these checks, under age consumers using money orders were able to successfully obtain tobacco from online vendors 89% of the time. These under age consumers were successful 94% of the time when using a credit card.

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[1] Maryland Department of Health and Mental Hygiene, *The Cigar Trap – Cigar Use among Maryland Youth, available at* http://dhmh.maryland.gov/thecigartrap/new/FactSheet_Cigar_Use_Among%20MD_Youth.pdf.

[2] Christopher Banthin, Douglas Blanke, and John Archard (Moderator), *Legal Approaches to Regulating Internet Tobacco Sales*, 32 J.L. Med. & Ethics 64 (2004).

IV. Other Tobacco Products Regulation in Other States

Most states do not have strict guidelines on regulating OTP or any specific methods in recapturing lost revenue from online sales of OTP. California, does however, have provisions in their code that are similar to the Maryland laws currently governing tobacco products.

Currently, the California law states that no person may sell, distribute, or engage in the non-sale distribution of tobacco products to minors via public or private postal services. Distributors must either match the name, address and date of birth provided by the customer to information contained in a database of individuals verified to be eighteen (18) years or older, or they must require the customer to submit verification of their age through a valid government identification card. [3]

Furthermore, the law elaborates saying that a district attorney, city attorney, or other state attorney general may assess civil penalties against any person or entity that violates the aforementioned provisions of the law. Penalties can be as high as $10,000 for those facing subsequent violations in a five (5) year period. (CA STAKE Act. Business and Professions Code Section 22963).

Every state except Pennsylvania has at least some tax on OTP. The highest rates, as a percentage of wholesale/manufacturer's price, are in Wisconsin (100%), Washington (95%), Vermont (92%), Massachusetts (90%), Rhode Island (80%), and Maine (78%). [4]

The chart below simply represents a cross section of the various and wide range of state taxes for OTP. [5]

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[3] Christopher Banthin, Douglas Blanke, and John Archard (Moderator), *Legal Approaches to Regulating Internet Tobacco Sales*, 32 J.L. Med. & Ethics 64 (2004).

[4] Tobacco Free Kids, *State Benefits from Increasing Smokeless Tobacco Tax Rates, available at* http://www.tobaccofreekids.org/research/factsheets/pdf/0180.pdf

[5] Tobacco Free Kids, *State Benefits from Increasing Smokeless Tobacco Tax Rates, available at* http://www.tobaccofreekids.org/research/factsheets/pdf/0180.pdf

State	Snuff Tax	Chewing & Smoking Tobacco Tax	Cigar Tax
Alabama	1.0-12.0¢/oz.	1.5¢/oz. and 4-6¢/oz.	4.0-40.5¢/10 cigars
Delaware	54¢/oz.	15% wholesale price	15% wholesale price
Idaho	40% wholesale price	40% wholesale price	40% wholesale price
Indiana	24% wholesale price	24% wholesale price	24% wholesale price
New Jersey	75¢/oz.	30% wholesale price	30% wholesale price
North Carolina	12.8% wholesale price	12.8% wholesale price	12.8% wholesale price
South Carolina	5% mfr. price	5% mfr. price	5% mfr. price
Texas	119¢/oz. (w/ min. tax)	119¢/oz. (with min. tax)	1-15¢/10 cigars
Tennessee	6.6% wholesale price	6.6% wholesale price	6.6% of wholesale price
West Virginia	7% wholesale price	7% wholesale price	7% wholesale price

V. <u>Federal Regulation Regarding Cigarettes and Other Tobacco Products</u>

The Jenkins Act and the PACT Act are the two statutes enacted by the federal government to help combat illegal sales of tobacco products. Although, both statutes provide for a laundry list of requirements in order to make non face-to-face transactions, the government has faced many complications in enforcing many of these provisions. Many online tobacco retailers are based outside of the country, thus, making it difficult to enforce the law and penalize the sellers for their actions. Furthermore, many online sites are only available for a few days and then shut down when they are faced with prosecution.

A. The Jenkins Act

The Jenkins Act, 15 U.S.C §§ 375 – 378, applies to persons who sell cigarettes or advertise the sale of cigarettes in interstate commerce, including mail order sales and advertisements. The law requires any person who advertises cigarettes for sale, including advertisements on the internet, or who ships cigarettes into a State or to any distributor licensed by the State, to file a statement with the tobacco tax administrator of that specific State. The Statement must list the seller's name, trade name, and address of all business locations.

Additionally, if the seller ships cigarettes into a State to any private individual, the seller is required to report these sales to the tobacco tax administrator of that State. This report must be filed no later than the 10th day of the following month and must contain the name and address of the buyer, the brand of cigarettes shipped, and the quantity shipped.

B. The PACT Act

On June 29, 2010, the Prevent All Cigarette Trafficking Act ("PACT Act"), signed by President Obama, went into effect. Although this law only governs the tax and trafficking issue of cigarettes and smokeless tobacco – not cigars – it may be useful to have an overview as the PACT Act has certain requirements that may be useful in any discussion concerning premium cigars and pipe tobacco.

The PACT Act addresses several issues. Those issues most related to any discussion of OTP shipment in Maryland are paraphrased and identified below. [6] The PACT Act requires internet and mail-order sellers to:

- Pay all applicable state tobacco taxes and affix related tax stamps before delivering any cigarettes or smokeless tobacco products to any customer in a state (Maryland does not have any stamping requirements for OTP);
- Comply with various state and local laws as if the internet seller were tobacco product retailers located in the same state as their customers;
- Register with the state and make periodic reports to state tax collection officials;

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[6] Bureau of Alcohol, Tobacco and Firearms, *Frequently Asked Questions – The Pact Act, available at* http://www.atf.gov/alcohol-tobacco/pact-act-faqs.pdf.

- Check the age and ID of customers both at purchase and at delivery to stop internet cigarette and smokeless sales to minors;
- Include on the bill of lading a clear and conspicuous statement "CIGARETTES/SMOKELESS TOBACCO: FEDERAL LAW REQUIRES THE PAYMENT OF ALL APPLICABLE EXCISE TAXES, AND COMPLIANCE WITH APPLICABLE LICENSING AND TAX-STAMPING OBLIGATIONS"; and
- Maintain records for 4 full years and make those records available to requesting tobacco tax state administrators and State Attorneys General.

It is important to note, that the PACT Act does **NOT** apply to sales and use taxes and is not intended to create precedent relating to the collection of state or local sales and uses taxes on out-of-state entities.

Additionally, the PACT Act generally prohibits the mailing of tobacco products via the United States Postal Service (USPS) as the USPS cannot adequately perform the age and ID identification at delivery that the PACT Act requires. Moreover, USPS cannot effectively ensure that the persons submitting the tobacco products for delivery are legally authorized to do so. The Act also requires sellers to make records of all delivery sales accessible to the U.S. Attorney General.

VI. Constitutional Issues to Other Tobacco Products Regulation and the Commerce Clause

The cases below deal with both cigarettes and various tobacco products and the statues/regulations that both New York and Maine developed to control who received deliveries of tobacco products and to ensure tax collection. Both cases highlight the limits placed on states regarding provisions of the Constitution, such as the Commerce Clause.

A. ***Brown & Williamson Tobacco Corp. v. Pataki*, 320 F.3d 300 (2nd Cir. 2003)**

In this case, the Court battled the issue of whether a New York law which dealt with the unlawful shipment of cigarettes was unconstitutional and whether it violated the Commerce Clause of the U.S. Constitution. The law in New York stated that it was unlawful for any person engaged in the business of selling cigarettes to ship or cause to be shipped any cigarettes to any person who is not a licensed wholesaler or tax agent. Furthermore, the law made it unlawful for any common contract carrier to knowingly transport cigarettes to any person in the State.

The backlash from New York's law came from out-of-state sellers who filed suit against the State for discriminating against them and violating the Commerce Clause of the Constitution. However, the Court ruled in favor of the State of New York. Their opinion stated that the law was not discriminatory because it did not make a distinction between out-of-state sellers and in-state direct shippers of cigarettes. Both of these sellers would have to go through the process of building brick and mortar operations in order to have face-to- face transactions as required by the law. The Court further opined that no alleged hardship would be borne disproportionately by out-of-state cigarette shippers compared to their in-state counterparts. The Court stated that the law did not impede or obstruct the flow of cigarettes in interstate commerce; rather the law merely requires a seller to verify the buyer's age and to collect the proper amount of excise taxes. Additionally, the court used a balancing test which stated that where the statute regulates even-handedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such is clearly excessive in relation to the putative local benefits.

B. *Rowe v. New Hampshire Motor Transport Associations, et. al.*, 552 U.S. 364 (2008)

The issue the Court reviewed in this case dealt with whether a federal statute, the Federal Aviation Administration Authorization Act, that prohibits states from enacting any law related to motor carrier price, or route of service, pre-empts two provisions of a Maine tobacco law, which regulates delivery of tobacco to customers within the State.

The Maine law forbade anyone other than a Maine licensed tobacco retailer to accept an order for delivery of tobacco. When a licensed retailer accepts a delivery it must have a special verification service which states (i) the person who bought the tobacco is to whom the package is addressed; (ii) the person to whom the package is addressed is of legal age to purchase tobacco; (iii) the person to whom the package is addressed actually signs for the package; and (iv) if a person is under the age of 27, they have a valid government issued identification on hand.

The Supreme Court struck down Maine's statute which forbade licensed tobacco retailers to employ a delivery service unless that service follows particular delivery procedures, thereby creating a direct connection with motor carrier services. The effect of Maine's regulation is that carriers will have to offer tobacco delivery services that differ significantly from those that in absence of the regulation, the market might dictate. Although identification requirements may have been plausible, the fact that Maine's statute required retailers to choose certain carriers over others was far overreaching.

Maine, through their law wants to prohibit sales of tobacco products made to minors. Maine, like other states can prohibit sales to minors by banning all non-face-to-face sales of tobacco if necessary and it can seek federal regulation. To allow the provisions in Maine's law, similar state requirements could easily lead to a patchwork of state service determining laws, rules and regulations. The state regulatory patchwork is inconsistent with Congress' major legislative effort to leave such decisions, where federally unregulated to the competitive market.

VII. <u>Conclusion</u>

The information provided above attempts to answer the inquiries of House Bill 570 and Senate Bill 452. First, the previously mentioned study by the Department of Mental Health and Hygiene did highlight an increase in the use of cigars by minors. However, this study did not differentiate between premium cigars and all other types of cigars.

In order to ensure that the direct shipment of certain OTP complies with all necessary legal requirements, and given the lack of governing statutes and regulations nationally, it may be wise to consider the direct wine shipment statutes in the Maryland Annotated Code as a model. So far, this model has not experienced any significant, reported issues and seems practical for use since the direct shipment of wine and certain OTP share related issues such as employing uniform methods to verify the age of the product recipient and provide for the collection and remission of appropriate taxes.

By following such provisions of the direct wine shipment law, premium cigars and pipe tobacco too can be regulated for shipment, allowing for non-face-to-face transactions, and creating shipment laws that are fair and equitable to both in-state and out-of-state retailers. As evidenced by *Brown v. Pataki*, the State can place equal burdens on all common carriers in protecting a legitimate public interest and such law will be upheld unless the burden is clearly excessive in relation to the local benefits.

VIII. <u>Determinations</u>

It is not the intent of this report to dictate that the Maryland General Assembly promulgates legislation concerning the direct shipment of premium cigars and pipe tobacco to Maryland consumers. However, pursuant to House Bill 570 and Senate Bill 452, the fundamental assumption underlying the following determinations is that the Maryland

General Assembly would debate some type of legislation concerning premium cigars and pipe tobacco.

Therefore, using the direct wine shipper statute as a model, this report sets out to determine:

1. The best practices for preventing access by minors to premium cigars and pipe tobacco that is shipped directly to consumers;

The law should set certain requirements for recipients, first to be eighteen (18) years of age and secondly to not resell the OTP shipment they have received. Moreover, packages of OTP should be conspicuously labeled as containing tobacco products with the name and address of the consumer who is the intended recipient and that a signature of a person at least eighteen (18) years old is required for delivery. [7]

2. Any significant increase or decrease in access to or demand for premium cigars and pipe tobacco by minors that has been documented as the result of direct shipment of premium cigars and pipe tobacco;

No specific documentation was found indicating any significant increase or decrease in access to or demand for premium cigars and pipe tobacco by minors. While there has been a general increase of cigar usage by minors, as mentioned above, no differentiation was made between premium cigars and all other types of cigars.

3. The best means for collecting relevant tax revenues;

Establish a State-issued permit authorizing the sale and shipping of premium cigars and pipe tobacco to consumers in the State for their personal consumption. Make as a requirement of the permit, the payment of the appropriate OTP excise tax. Consider requiring a bond to secure the tax remission if the permitee and/or licensee do not already have a bond with the State.

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[7] Md. Ann. Code Art 2B § 7.5-107

4. The benefits and costs to consumers;

The benefits to consumers include the continuation of consumer choice in locating and purchasing premium cigars and pipe tobacco as well as the convenience of conducting the transaction remotely. Analogous to wine, there are many producers of these premium products and for a variety of reasons not all products are routinely available to consumers without access to on-line retailers.

With regards to costs, consumers making on-line purchases of premium cigars and pipe tobacco are, generally, not remitting the excise or sales and use taxes to the State. If the online retailers become permitted and are required to collect and remit appropriate taxes, consumers can expect to see increases in cost relative to the taxes collected and any additional administrative costs the online retailer incurs.

5. The effect of direct premium cigar and pipe tobacco shipment laws on in–State licensed other tobacco products retailers and tobacconists and other local businesses.

The creation of a State-issued permitting structure should serve to level the playing field for all sellers of premium cigars and pipe tobacco by uniformly requiring a permitting or licensing fee and the collection and remission of appropriate taxes. Furthermore, this permitting structure will minimize or maybe eliminate the disadvantaged position in-State other tobacco products retailers and tobacconists currently experience. At this time, with limited tangible information, it is difficult to determine the effect of direct shipment laws on other local businesses.