The Florida Senate

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Budget Subcommittee on Finance and Tax

EXCISE TAX ON OTHER TOBACCO PRODUCTS

Statement of the Issue

Tobacco products, other than cigarettes and cigars, have been taxed under part II of s. 210, F.S., since 1985.[1] The tax on these products (commonly referred to as other tobacco products or OTP) is imposed at the rate of 25 percent of the wholesale sales price, and the proceeds of this tax are directed to the General Revenue Fund. Since 2009, a surcharge on other tobacco products has been imposed at the rate of 60 percent of the wholesale sales price[2] and revenue from the surcharge is credited to the Health Care Trust Fund, which is subject to the 8 percent General Revenue Service Charge.

The tax and surcharge on other tobacco products are levied on the wholesale sales price of the products. "Wholesale sales price" is defined as "the established price for which a manufacturer sells a tobacco product to a distributor, exclusive of any diminution by volume or other discounts."[3]

In 2002, McLane Suneast, Inc. ("McLane"), a distributor of other tobacco products, requested a refund of "excess" taxes it had paid from April 1, 1997, through March 31, 2002. McLane asserted that the tax had been calculated incorrectly because it was based on the sales price paid by McLane to the distributor who had first purchased the product from the manufacturer. McLane's contention was that the tax should have been calculated based on the price paid by the distributor to the manufacturer. The request was denied, and McLane challenged the denial in circuit court.[4]

In 2005, McLane and the State of Florida Department of Business and Professional Regulation ("Department") entered into a settlement agreement which provided that the appropriate tax that McLane should have paid and would pay in the future on purchases from the distributor involved in the case (UST Sales and Marketing) would be based on a formula using the property and payroll of the manufacturer (UST Manufacturing) and its wholly-owned distributor (UST Sales and Marketing). McLane received a refund of some taxes paid, and its future tax liability was reduced. Since then, other OTP distributors that purchase products from UST Sales and Marketing have applied for and received refunds and reduced their future tax liabilities. Through fiscal year 2010-11, $16 million in refunds have been granted; the recurring annual reduction in OTP tax plus the surcharge has exceeded $6 million in each of the past two years.

Discussion

Background

On January 1, 1990, United States Tobacco Company, a vertically integrated firm that manufactured and marketed moist smokeless tobacco and other tobacco products, became a holding company of two separate wholly-owned subsidiaries: United States Tobacco Manufacturing Company, Inc., which manufactured the smokeless tobacco products, and United States Tobacco Sales and Marketing Company Inc., which marketed and distributed these products. At that time, Unites States Tobacco held the number one position in the smokeless tobacco industry. (The

[1] Section 1 of ch. 85-141, L.O.F.
[2] Section 7 of ch. 2009-79, L.O.F.
[3] Section 210.25(13), F.S.
[4] *McLane Suneast, Inc. v. Florida Department of Business and Professional Regulation*, Case No. 03-CA-290 (Circuit Court of the Second Judicial Circuit, in and for Leon County, Florida.)

company, which remains the world leader in producing and marketing moist smokeless tobacco products,[5] was acquired by the Altria Group (formerly Philip Morris) in 2009.)

McLane's 2002 request for a refund of "excess" taxes it had paid from April 1, 1997, through March 31, 2002, was based on its interpretation of the statutory definition of "wholesale sales price," in light of the separation of the former United States Tobacco Company into two legally distinct entities. McLane asserted that the tax had been calculated incorrectly because it was based on the sales price paid by McLane to the distributor who had first purchased the product from the manufacturer. McLane contended that that the tax should have been calculated based on the price paid by the distributor to the manufacturer. The Department denied the request, and McLane challenged the denial in circuit court.

The tax on other tobacco products is levied at the wholesale level and based on the "wholesale sales price." Generally, the statutory scheme for determining the correct amount of tax works well when the distribution chain of the product goes from manufacturer to distributor to retailer. In this situation, the distributor pays the tax based on the price it paid the manufacturer for the products. However, when the distribution chain includes two or more distributors, the tax determination becomes unclear—is it based on the amount paid by the first distributor in the chain or on the amount paid by the second distributor? This situation is further complicated when the first distributor is a company related by ownership to the manufacturer, because in that case the "price" of the product is not determined by market forces and can be arbitrarily set by the "buyer" and "seller."

In 2005, McLane and the Department entered into a settlement agreement which provided that the appropriate tax that McLane should have paid and would pay in the future on purchases from the distributor involved in the case (UST Sales and Marketing) would be based on a formula using the property and payroll of the manufacturer (UST Manufacturing) and its wholly-owned distributor. Under the formula, the tax rate is applied to the "adjusted transfer price," which is a fraction of the price paid by McLane to the distributor. The numerator of the fraction is the sum of property and payroll of UST Manufacturing, and the denominator is the sum of property and payroll of the UST Manufacturing and UST Sales and Marketing, its wholly-owned distributor. The property and payroll factors used in the formula are determined annually by the department based on information provided in the manufacturer's and distributor's federal tax returns. By agreeing to this formula, the Department attempted to tie the price on which the tax is based to a physical measure of the production inputs provided by the manufacturer as a proportion of the total value of the product. [6]

Since the settlement agreement was reached, the adjusted transfer price has become a larger percentage of the price paid by McLane to the distributor, thereby reducing the impact of the formula.

Adjusted Transfer Price Factor					
2006	2007	2008	2009	2010	2011
55.554%	72.829%	72.957%	73.970%	74.180%	84.240%

The settlement agreement remains in effect; the formula it provides is used to calculate McLane's tax liability and its liability for the surcharge on other tobacco products under s. 210.276, F.S. In addition, other distributors that purchase other tobacco products from the same distributor (UST Sales and Marketing) have requested and received the same treatment as McLane. According to data provided by the Division of Alcoholic Beverages and Tobacco, 20 distributors, in addition to McLane, have requested and been approved to receive refunds of taxes paid on other tobacco products pursuant to the formula in the settlement agreement. Additional requests are pending from other distributors.

[5] http://www.ussmokeless.com/en/cms/Home/default.aspx

[6] Department staff who were involved in the settlement report that the formula was a compromise between McLane's assertion that the tax should be based on the price paid by UST Sales and Marketing to UST Manufacturing, and the department's interpretation of the statute that based the tax on the price paid by McLane. The statute is not 100 percent clear about what is meant by "wholesale sales price" and the settlement prevented a potentially greater revenue loss that might have happened if the case had gone to trial.

Revenue Impact

The settlement agreement provided a refund credit in the sum of $6,211,857.31 to McLane, to be used as an offset against taxes levied under ch. 210, F.S. (excise taxes on cigarettes and other tobacco products) that are currently owed or may be owed in the future. McLane agreed to limit any claim for the credits for each calendar month to no more than 1/12 of the refund credit and to not apply the credits in such a way as to result in a cash refund. This refund resulted from taxes paid by McLane from April 1, 1997, through March 31, 2002.

McLane was granted an additional tax credit for the "Supplemental Refund Period" (April 1, 2002 through March 31, 2005) to be calculated as the difference between the other tobacco products taxes paid by McLane and the taxes that would have been paid using the "adjusted transfer price" for the supplemental refund period. In 2006 a $4,203,221 refund credit was approved to cover this period.

Beginning April 1, 2005, the settlement agreement provided that McLane would report and pay other tobacco products taxes based on the "adjusted transfer price" for products purchased from UST Sales and Marketing.

Since the McLane settlement, several distributors of other tobacco products have been granted refunds for taxes paid on products they bought from UST Sales and Marketing. In 2008, $3,837,764.68 was refunded to 9 different distributors; in 2009, $848,488.62 was refunded to 5 different distributors; and in 2010, $251,572.93 was refunded to 2 distributors. The revenue impact of the settlement is not limited to refunds, since the formula is used to compute the adjusted transfer price as the basis of each distributor's future tax liability.

Additional Impact on Other Tobacco Tax Surcharge Revenue

In 2009 the Florida Legislature enacted the Protecting Florida's Health Act, which imposed a $1 per pack surcharge on cigarettes purchased in the state and a surcharge on other tobacco products of 60 percent of the wholesale sales price of the product. The proceeds of these surcharges are directed to the Health Care Trust Fund, subject to an 8 percent General Revenue service charge. The surcharge magnifies the impact of the McLane settlement, since it applies to the same base at 2.4 times the rate of the original tax on other tobacco products.

Total Revenue Impact of Other Tobacco Product Settlement		
	Amount Refunded	Reduction from Factored Wholesale Sales Price
FY 2005-06	$11,071,596	
FY 2006-07	$0	$3,260,991
FY 2007-08	$872,537	$2,774,839
FY 2008-09	$3,196,832	$3,261,370
FY 2009-10	$616,844	$6,130,782
FY 2010-11	$251,573	$6,373,568
FY 2011-12 (estimate)	$89,475	$6,528,000
Total	$16,098,857.00	$28,329,550.00

There are pending challenges to the Department's methodology for calculating the tax and surcharge on other tobacco products, based on the definition of "wholesale sales price." If any of these challenges is successful the tax base would be further eroded.

Other Effects of the Settlement Agreement

In addition to the effect on revenue from the tax on other tobacco products and the surcharge, there are other effects of the settlement agreement:

- Other tobacco products from UST Manufacturing are taxed by a variable formula that is not found in Florida Statutes and was never approved by the Legislature, and

- Other tobacco products are subject to disparate tax treatment, depending upon their manufacturer. According to Department representatives, other OTP manufacturers have set up similar arrangements for selling their products to Florida distributors through wholly-owned subsidiaries and have sought tax refunds similar to the McLane settlement, however, since the settlement applies only to purchases from UST Sales and Marketing, the Department has not approved refunds for other manufacturers' products.

Possible Legislative Response

The Legislature may want to consider options that address the three effects of the settlement mentioned in this report: (1) a tax rate based on actions taken by third parties; (2) different OTP tax rates based on the product's manufacturer; and (3) the revenue impacts.

The language of the settlement agreement recognizes that the agreement is based on the existing legal framework and the specific circumstances of the case:

> *Unless and until there has been a material change in the governing law or facts that formed the basis for the Present Case, the parties shall use the methodology described in this paragraph 12.C. (the "Tax Base Methodology") to compute the Adjusted Transfer Price*.[7]

One option that resolves all three issues is to change the statutory definition of "wholesale sales price" to mean *the price paid by the distributor that sells the products to a Florida retailer.* This definition provides equitable treatment for diverse business models, and avoids the problems created by having multiple distributors in the distribution chain.

[7] Final Judgment, Case No. 03-CA-290 in the Circuit court of the Second Judicial Circuit, in and for Leon County, FL.