THE STATE of ALASKA
GOVERNOR BILL WALKER

Department of Revenue
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March 4, 2016

The Honorable Kurt Olson
Alaska State Representative
Chair, House Labor & Commerce Committee
State Capitol Room 24
Juneau, AK 99801

Dear Representative Olson:

The purpose of this letter is to provide you with responses to the questions asked of the Department of Revenue and the Department of Commerce, Community, and Economic Development during our presentations to the House Labor & Commerce Committee on February 19 and February 22, 2016. Please see questions in italics and our responses immediately below the questions.

1. *How is the School Fund used? Can it be used for all educational purposes?*

   The proceeds from the "base" cigarette tax of 38 mills per cigarette are deposited into a dedicated "School Fund" created at AS 43.50.140. The statute states that the fund "shall be used exclusively to rehabilitate, construct, and repair the state's school facilities, and for costs of insurance on buildings comprising school facilities during the rehabilitation, construction, and repair, and for the life of the buildings."

2. *How much money do we collect from pursuing those who buy untaxed cigarettes on the internet, and how much does it cost?*

   Since 2004, our compliance and enforcement efforts against internet tobacco sales resulted in a total of $1.5 million collected in tax (an average of $150,000 annually). We have another $1.6 million currently in the collections process. We have also increased our joint efforts with our criminal investigations unit to look for untaxed cigarettes sold at sea but within Alaska state waters. These efforts could bring in $6 million in the next year.

   Between 2004 and 2013, the Department of Revenue employed about 25% of an auditor's time and 5% of a criminal investigator's time on enforcement of tax on internet cigarette purchases. This amounted to an average cost to the Department of about $20,000 in 2004, rising to $35,000 by 2013.

3. *Can DOR provide a list of states that tax e-cigarettes?*

   The Department of Revenue knows of four states which currently tax e-cigarettes or will begin taxing them soon:
   - Kansas: $0.20 per milliliter of consumable material (effective July 1, 2016)
   - Minnesota: 95% of wholesale cost of any product containing or derived from tobacco. Taxes one-time-use e-cigarettes and cartridges or consumable material that contain nicotine.

- Louisiana: $0.05 per milliliter of consumable product
- North Carolina: $0.05 per milliliter of consumable product

In addition, two local jurisdictions in Alaska tax e-cigarettes: Juneau at 45% of retail value, and the Matanuska-Susitna Borough at 55% of wholesale price.

In 2015, at least 21 states considered proposals to tax e-cigarettes, but did not enact them. A list of those states and explanation from the Connecticut Office of Legislative Research is attached. (Note that Minnesota considered changing its tax from 95% of the wholesale price to 30 cents per milliliter.) Also attached is a report from the Tobacco Control Legal Consortium on frequently asked questions about e-cigarette taxation.

The Department of Revenue would note that the National Association of Attorneys General has recommended taxing e-cigarettes based on wholesale value, as is proposed in HB 304, rather than based on volume of consumable material as is done in Kansas, Louisiana, and North Carolina. The reason is because the amount of nicotine in a given volume of consumable material can vary widely.

4. *What other substances besides tobacco can be delivered through e-cigarettes?*

   The main base ingredients of the liquids delivered through e-cigarettes are propylene glycol and glycerin (though there can be other ingredients). These main ingredients generate the aerosol. Additives and flavors are then added to the base ingredients. Additives include liquid nicotine—which may be derived from tobacco—or liquid marijuana concentrate. As far as the Department of Revenue knows, all other additives are for flavor or scent, e.g. menthol or vanilla extract. However, this does not mean it is impossible for e-cigarettes to deliver other products.

5. *Is there really a trend of decreasing tobacco consumption in Alaska, or are purchases just redirecting to the black market so that we don't know about them?*

   The Department of Revenue believes there is a trend of decreasing cigarette consumption, consistent with the decline of cigarette smoking rates in nearly all parts of the United States. Between fiscal years 2005 and 2015, total cigarette purchases recorded by the Department of Revenue fell from 792 million to 527 million, a 33% drop. It is very unlikely this entire drop could be accounted for by the black market.

   In contrast, purchases of other tobacco products as measured by wholesale value are increasing, although value of the products does not correspond directly to the amount sold or number of users.

6. *Does the replacement of tobacco by e-cigarettes lead to reduced Medicaid costs?*

   There are not yet any long-term studies on the effects of e-cigarettes on tobacco use, or on the health effects of e-cigarettes vis-à-vis regular cigarettes. Therefore, it is not possible to forecast impacts of e-cigarettes on Medicaid costs.

7. *Are there statistics regarding the reduced use of e-cigarettes when they are made illegal for those under age 19?*

   Similar to question 6, we are not aware of any existing research on this matter.

8. *Can DOR clarify the intent of the tax on e-cigarettes? Will it tax the batteries and smoking devices or only the substances to put in them?*

   The e-cigarette tax would not apply to batteries and smoking devices purchased separately. However, in the event that a battery or smoking device is purchased in a package along with liquid to put in them, the tax would apply to the entire package.

I hope you find this information to be useful. Please do not hesitate to contact me if you have further questions.

Sincerely,

Randall J. Hoffbeck
Commissioner

Attachments: Connecticut Office of Legislative Research report on e-cigarettes taxation; Tobacco Control Legal Consortium report on e-cigarette taxation.

Office of Legislative Research
Research Report

October 14, 2015 2015-R-0239

STATES TAXING E-CIGARETTES

By: Rute Pinho, Principal Analyst

WHAT ARE E-CIGARETTES?

E-cigarettes are battery-operated devices designed to deliver nicotine with flavorings and other chemicals to users in vapor instead of smoke. The devices come in two styles. One is a cigarette-like tube that has a self-contained battery, charger, and liquid tank. It is generally sold in convenience stores for about $10. The other is a refillable device with a large battery, around the size of a traditional cigarette pack. It is generally sold in specialty vapor shops for about $25 to $35 for a starter kit. The tubes of liquid nicotine cost about $4 for 10 milliliters, enough for hundreds of puffs.

All of the devices require a liquid solution, which generally contains propylene glycol, glycerin, water, nicotine, and flavorings (Povich, Elaine S. "States Look to Tax E-Cigarettes," The Pew Charitable Trusts, January 23, 2015).

ISSUE

Identify states that tax e-cigarettes and those that considered e-cigarette tax legislation in 2015. Provide information on how the taxes work.

Three states (Louisiana, Minnesota, and North Carolina) tax e-cigarettes. In Minnesota, the tax is 95% of the e-cigarette's wholesale cost. In Louisiana and North Carolina, the tax is $0.05 per milliliter of e-cigarette liquid solution. In addition, Kansas recently enacted a tax of $.20 per milliliter of e-cigarette solution that takes effect July 1, 2016.

At least 21 other states and the District of Columbia considered e-cigarette taxes in 2015, but did not enact them. Table 1 lists the states, the proposed tax rates, and the bill number. As the table shows, states have generally considered four different approaches to e-cigarettes taxes. These include:

1. a percentage of their wholesale price (generally the state's existing tobacco products tax rate),
2. a percentage of their retail price,
3. a flat rate per milliliter of liquid solution or milligram of nicotine in the liquid solution, and
4. the state's cigarette tax rate.

Table 1: 2015 E-Cigarette Tax Proposals

State	*Proposed E-Cigarette Tax Rate (Bill No.)*
Alabama	25 cents per ml (HB 224)
Arizona	18 cents per ml (HB 2596)
Arkansas	7.5 cents per ml (HB 1156)
District of Columbia	Tobacco products rate of 70% of wholesale price (Bill 283)
Hawaii	30% of wholesale price (SB 299) Cigarette tax rate of $3.20 (HB 349)
Indiana	0.83 cents per mg of nicotine per ml (SB 384) Tobacco products rate of 24% of wholesale price (HB 1235)
Kentucky	Tobacco products rate of 15% of wholesale price (HB 438)
Maine	Cigarette tax rate of $2.00 (HB 670)
Minnesota	30 cents per ml (HF 2218; SF 2093)
Montana	0.0173 cents per mg of nicotine per ml (HB 579)
Nevada	Tobacco products rate of 30% of wholesale price (SB 79)
New Hampshire	Tobacco products rate of 73.94% of wholesale price (HB 2)
New Jersey	75% of wholesale price (AB 4251; SB 1867)
New Mexico	4 cents per mg of nicotine (SB 65)
New York	Tobacco products rate of 75% of wholesale price (A296; S722)
North Carolina	12.8% of wholesale price (HB 939) 3 cents per ml multiplied by the nicotine concentration percentage (SB 407)
Ohio	Cigarette tax rate of $2.25 (HB 64)
Oregon	Tobacco products rate of 65% of wholesale price (HB 2074, HB 2134)
Pennsylvania	5 cents per ml (HB 1461)
Vermont	46% of wholesale price (SB 139, proposed House amendment)
Virginia	40 cents per ml (HB 1310) 18 cents per ml (SB 1004)
Washington	60% of taxable sales price (HB 2211)

Source: Compiled based on National Association of Tobacco Outlets database (http://www.natocentral.org/?page_id=2614, accessed October 2, 2015) and "E-Cigarette Tax Bill Update" (http://www.cspnet.com/category-news/tobacco/articles/e-cigarette-tax-bill-update, accessed October 2, 2015)

RP:cmg

E-Cigarette Taxation: Frequently Asked Questions

Over the past few years, the sale of e-cigarettes and related products has expanded exponentially. Since there is virtually no federal regulatory oversight of the e-cigarette market, many state and local governments have scrambled to enact a variety of restrictions on the sale and use of these products. While most states have enacted youth access restrictions and a few states, along with many local governments, have included e-cigarettes in smoke-free laws, the latest frontier in e-cigarette regulation seems to be taxation.

Taxation is unique because it is an area in which the U.S. Food and Drug Administration has no regulatory authority so, unless Congress were to act, the taxation of e-cigarettes is solely in the domain of states and, where allowed by state law, local governments. Because every state's tax code is different, it is essential to work with an attorney who is familiar with your jurisdiction's tax code to ensure that any tax is appropriately tailored to meet your policy needs. In other words, there is no one-size-fits-all approach in this complicated policy area. This fact sheet answers a few of the most frequently asked questions about taxing e-cigarettes and related products.[1]

Q: Why tax e-cigarettes?

A: Most e-cigarettes contain nicotine, an addictive drug. Nicotine itself is harmful to health. In addition to acute poisoning risks, exposure to nicotine has been shown to harm both maternal and fetal health during pregnancy, and may have a lasting negative impact on adolescent brain development. Therefore, decreasing the prevalence of nicotine use, especially among children, can significantly benefit public health. Increasing price is one way to accomplish this goal. Studies have shown that increasing the price of tobacco products results in a decrease in initiation by new users and a decrease in the amount of tobacco use by current users.[2] This is especially true among youth, who are the most price-sensitive consumers. Therefore, increasing the tax on e-cigarettes would help accomplish important public health goals.

Most e-cigarettes contain nicotine that is derived from tobacco and are tobacco products.[3] Therefore, they should be taxed as tobacco products to maintain an equitable tax burden. Excluding them from tobacco taxes serves as a de facto discount, which could lead to higher initiation rates and increased use. Also, it is clear that quitting all tobacco products, including e-cigarettes, is better for one's health than using e-cigarettes. Studies have not shown e-cigarettes to be effective tobacco cessation products. In addition, preliminary research has shown that aerosol from e-cigarettes may pose health risks to bystanders.[4] For these reasons there is a strong policy rationale for treating e-cigarettes as tobacco products in all facets of a jurisdiction's regulatory structure, including taxation.

Q: Which products should be subject to the tax?

A: When determining which products to tax as e-cigarettes, be sure to consider the breadth of products on the market. This includes disposable products that resemble cigarettes, refillable devices in countless shapes and sizes, cartridges, flavored e-juice, batteries, carrying cases . . . the list goes on and on. In addition to deciding which products should be subject to the tax, clearly identify the jurisdiction's policy intentions and carefully draft definitions that will accomplish those goals. This can be tricky, so working with a tobacco control attorney early in the process to identify the risks and benefits of different approaches and to assist in drafting definitions is of paramount importance.

Looking at the different e-cigarette parts and products on a continuum can be a helpful way to identify which ones should be subject to the tax. A good starting point is with the consumable material, or e-juice. Presumably, any tax on e-cigarettes would include a tax on e-juice that contains nicotine.

The next question is whether the tax should also include e-juice that does not contain nicotine. While some argue for excluding non-nicotine e-juice since it does not technically contain tobacco, there are also strong policy arguments for including all e-juice in the tax. Regardless of the ingredients, the substance will be inhaled into the user's lungs. While there may be some disagreement regarding the severity of the health effects of such action, there can be little debate that inhaling propylene glycol and flavoring components into one's lungs is not healthy.

In addition to the health argument, practically speaking, it is very difficult to determine which products contain nicotine, making enforcement difficult. To date, there are no ingredient disclosure requirements for e-cigarettes at the federal level and tests have shown significant discrepancies between the amount of nicotine claimed to be in a product and the actual amount. In fact, some products that claim to be nicotine-free, or that claim to use nicotine derived from a source other than tobacco, have been shown to contain nicotine derived from tobacco.[5]

Combining this uncertainty regarding health effects with a unique market in which products are essentially "manufactured" at the retail level based on individual customer preferences, it becomes very difficult for enforcement officials to determine which products should be subject to the tax. Since testing all products at the retail level is simply not feasible, jurisdictions that decide to tax only products containing nicotine should presume that all products contain nicotine unless proven otherwise. Ultimately, however, whether or not a jurisdiction taxes all e-juice is a policy decision, but the ramifications of that decision should be carefully considered and planned for at the policy development stage.

In addition to e-juice, component parts can be subject to the tax based either on how they are sold or their functionality. In Minnesota, for example, e-juice is taxed as a tobacco product if it contains nicotine derived from tobacco.[6] However, the devices are only subject to the tax if they are sold with e-juice containing nicotine in cartridges that cannot be removed. In other words, in Minnesota, disposable devices are considered tobacco products under the definition of tobacco products and, therefore, the entire unit is subject to the tax. If the device is sold separately from the cartridge, it is not taxed as a tobacco product. In addition to the Minnesota tax, other approaches have spanned the continuum. Several jurisdictions have attempted to tax only the consumable material by volume or active ingredient. Others have proposed, but not yet enacted, a tax on the e-juice and all component parts.

Perhaps the best practice is to broaden the tax base to include all e-juice and parts of the device necessary for its operation. This approach would tax all essential components, but not other accessories, such as carrying cases or lanyards. The key advantage of this approach is that it would include the refillable devices sold at convenience stores, as well as the mix and match component parts that are often sold separately at vape shops. One issue to consider, however, is how to tax products that might have a universal application, such as certain batteries or universal charging cords. A possible option is to exempt those items from the tax if they are sold separately. This might prevent the possibility of legal challenges that could arise if identical products, such as AAA batteries, are taxed at different rates at different stores.

As mentioned above, after deciding which products are to be taxed, governments need to develop workable definitions to achieve those policy goals. One possible definition to tax all e-juice and the operating components is the following:

> "Electronic smoking device means any device that can be used to deliver aerosolized or vaporized nicotine to the person inhaling from the device, including, but not limited to an e-cigarette, e-cigar, e-pipe, vape pen or e-hookah. Electronic smoking device includes any component, part, or accessory of such a device, whether or not sold separately, that is used during the operation of the device. Electronic smoking device does not include any battery or battery charger that is sold separately. In addition, electronic smoking device does not include drugs, devices, or combination products approved for sale by the U.S. Food and Drug Administration, as those terms are defined in the Federal Food, Drug and Cosmetic Act."

Q: Where should the tax be levied?

A: Again, the unique nature of e-cigarettes makes this a more complicated question than it seems to be on the surface. For most tobacco products, the product is sold to the customer in a form that is identical to that which is passed through the wholesaler or distributor. Because of the popularity of vape shops, e-juice is often mixed at the retail level to accommodate a customer's specific flavor and nicotine concentration preferences. This means that a new, more valuable product is essentially being manufactured at the retail level. Determining how to capture this added-value in the tax base is jurisdiction-specific and can be complicated absent a comprehensive, statewide retail licensing system. If the current tobacco tax is collected through a licensing system, one possible approach is to require retail stores to obtain a state tobacco license if these products are mixed onsite, or are not purchased through licensed distributors or wholesalers. Also, defining mix-your-own vape shops as "manufacturers" can be a way to levy the tax on the final cost of the product. Since every jurisdiction uses a different approach to collect the tax on tobacco products, it is important to review the current structure to determine whether an e-cigarette tax can be integrated into it or if the existing system should be updated.

Q: What should the tax rate be for e-cigarettes?

A: There is some disagreement within the public health community as to the appropriate tax rate for e-cigarettes, and whether it should mirror the tax rate for cigarettes or other tobacco products. Cigarettes are often taxed at fixed rate per pack, while other tobacco products are often taxed as a percentage of price.[7] Because of the tremendous product diversity and different concentration levels of e-juice, determining what amount of e-juice is equivalent to a pack of cigarettes can be difficult, if not impossible.[8] Also, given the uncertainty of the health effects of these products and the likelihood that they can serve as a gateway to other tobacco products, taxing them at the same rate as other tobacco products would seem to be the preferred approach.

Q: How should the tax be structured?

A: While some jurisdictions have enacted, or are considering, a tax based either on the volume of the e-juice or the amount of nicotine, both of these approaches have some inherent problems. In each case, accurately calculating the tax would be extremely difficult since each retail transaction could include a different calculation. In addition to the practical problems, both of these approaches could have negative unintended consequences. For example, assessing a tax on the volume of e-juice, especially if it is limited to nicotine-containing e-juice, could result in more sales of highly concentrated e-juice, or the sale of pure nicotine separately from the flavor, which could then be mixed at home. Nicotine exposure can be fatal, so mixing these products at home without adequate safety precautions is likely to result in more exposure incidents.[9]

Ideally, an e-cigarette tax would be in the form of an ad valorem tax (based on the value of the product), that is assessed on the final product at a rate that is on parity with other tobacco products. If the breadth of the tax is wide, as discussed above, this would decrease the incentive to sell products separately. Also, by defining e-cigarettes as tobacco products and taxing them as such, the enforcement agency can include them in the existing tax structure rather than creating an entirely new system. Finally, an ad valorem tax contains an automatic inflation adjustment, since it rises as the cost of the product increases.

Q: How will this be enforced?

A: The enforcement component of any regulation is extremely important and yet frequently overlooked at the policy development stage. Since every jurisdiction is unique in how it collects its tobacco taxes, it is important to seek input from the start from those who will be in charge of enforcement. Ideally, an e-cigarette tax will be treated as a tobacco tax, so the existing framework can be used. Moreover, the lessons learned from collecting taxes on other tobacco products can inform how the e-cigarette tax can be structured and implemented.

Contact Us

Please feel free to contact the Tobacco Control Legal Consortium at publichealthlaw@wmitchell.edu with any questions about the information included in this guide or to discuss any concerns you may have about implementing such a policy.

Last updated: March 2015

Notes

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[1] The information contained in this document is not intended to constitute or replace legal advice. Before attempting to implement any of these measures, we encourage you to consult with local legal counsel.

[2] Campaign for Tobacco-Free Kids, *Raising Cigarette Taxes Reduces Smoking, Especially Among Kids (And the Cigarette Companies Know It)* (last accessed March 25, 2015), http://www.tobaccofreekids.org/research/factsheets/pdf/0146.pdf; Frank Chaloupka et al., *Tax, Price and Cigarette Smoking: Evidence from the Tobacco Documents and Implications for Tobacco Company Marketing Strategies*, 11 TOBACCO CONTROL 1 (2002), http://tobaccocontrol.bmj.com/content/11/suppl_1/i62.full. *See also* Center for Public Health Systems Science & Tobacco Control Legal Consortium, *Pricing Policy: A Tobacco Control Guide* (2014), *available at* http://publichealthlawcenter.org/sites/default/files/resources/tclc-guide-pricing-policy-WashU-2014.pdf.

[3] U.S. DEP'T OF HEALTH AND HUMAN SERVICES, *Deeming – Extending Authorities to Additional Tobacco Products*, http://www.fda.gov/TobaccoProducts/Labeling/ucm388395.htm.

[4] Americans for Nonsmokers' Rights, *Electronic Smoking Devices and Secondhand Aerosol*, http://no-smoke.org/pdf/ecigarette-secondhand-aerosol.pdf*;* Arian Saffari et al., 10 J ENVTL. SCI., PROCESS & IMPACTS 2259-67 (2014), *available at* http://pubs.rsc.org/en/content/articlelanding/2014/em/c4em00415a/unauth#!divAbstract

[5] LEGACY, *Tobacco Fact Sheet: Electronic Cigarettes (E-Cigarettes)* (2014), http://www.legacyforhealth.org/content/download/582/6926/file/LEG-FactSheet-eCigarettes-JUNE2013.pdf; Tyler McCanus, *Alert! False E-Liquid Nicotine Levels at Vape Shops*, ELECTRONIC CIGARETTE CONSUMER REVIEWS (Feb. 2, 2015), http://www.electroniccigaretteconsumerreviews.com/alert-false-e-liquid-nicotine-levels-at-vape-shops.

[6] MINNESOTA DEP'T OF REVENUE, *E-Cigarettes*, http://www.revenue.state.mn.us/businesses/tobacco/Pages/e-Cig.aspx.

[7] *See* the Public Health Law Center webpage, Tobacco and Product Pricing, http://publichealthlawcenter.org/topics/tobacco-control/taxation-and-product-pricing (containing several publications about the taxation of cigarettes and other tobacco products).

[8] CONFERENCE OF THE PARTIES TO THE WHO FRAMEWORK CONVENTION ON TOBACCO CONTROL, *Electronic Nicotine Delivery Systems* (2014), http://apps.who.int/gb/fctc/PDF/cop6/FCTC_COP6_10-en.pdf?ua=1; U.S. DEP'T OF HEALTH AND HUMAN SERVICES, *E-Cigarettes: Questions and Answers*, http://www.fda.gov/forconsumers/consumerupdates/ucm225210.htm.

[9] Trisha Korioth, *Liquid Nicotine Used in E-cigarettes Can Kill Children*, PARENT PLUS: THE AMERICAN ACADEMY OF PEDIATRICS (2014), http://aapnews.aappublications.org/content/early/2014/12/17/aapnews.20141217-1.full.