

D.C. Tax Revision Commission Policy Options
Policy Option #5: Unified Taxation of Tobacco Products

MEMORANDUM

Proposal: Broaden and harmonize the definition non-cigarette tobacco products (known as other tobacco products or “OTP”) and tax all tobacco products at the same rate

Tax Type: Sales

Origin: Public

Commission Goals: Simplify/modernize the D.C. tax code and broaden the tax base

Current Law

D.C. taxes different tobacco products at different rates. First, the District imposes an excise tax of \$2.50 on each package of 20 cigarettes or \$0.125 per cigarette. There also is an “in lieu of” sales tax of \$0.36 per pack—collected at the wholesale level—that brings the total D.C. tax on a package of cigarettes to \$2.86. This in lieu of tax is subject to recalculation every year and can be increased if the price of cigarettes increases, so that the tax is consistent with D.C.’s general sales tax rate. (This step is necessary so that the tax can be fully implemented at the wholesale rather than retail level.) The District switched from a retail-level tax to a wholesale-level tax in FY 2012 to simplify the administration of the tax.

Second, D.C. has an excise tax on other tobacco products (OTP)—such as chewing tobacco, smokeless tobacco, snuff and roll-your-own tobacco—of \$0.75 per ounce. In addition to the per-ounce tax, these products are subject to a sales tax of 12% of retail price.

Third, premium cigars, those costing more than \$2, and pipe tobacco are not subject to the per-ounce excise tax or the special sales tax rate. Both products are only taxed at the general sales tax rate (5.75%). Cigars that do not fall into the “premium” category, and are not considered cigarettes (e.g., “little cigars” are taxed as cigarettes), are subject to the 12% sales tax rate but not the per-ounce excise tax.

Proposed Change

Broaden the definition of OTP to any product “made or derived from tobacco,” excluding tobacco products for medicinal use (like tobacco-cessation products). E-cigarettes would also be included. The tax rate across all tobacco products would be equivalent to the rate on cigarettes.

To achieve this, a single excise tax for OTP, which would equal to 80% of wholesale price, will replace the per-ounce excise tax and special 12% sales tax. The 80% rate is equivalent to the tax on cigarettes (if that tax were just a percentage-of-price tax). Collecting OTP taxes at the wholesale level would simplify administration, but the tax rate, similar to the tax on cigarettes, would have to be calculated every year to adjust for price changes.

Reason for Change

The definitions of OTP are not consistent in the D.C. code. For example, “pipe tobacco” is included as OTP in one section but excluded in another. As a result, the current OTP excise and sales taxes fail to

apply to all current and possibly future tobacco products on the market. Moving to “made or derived from tobacco” makes all tobacco products (including cigars, pipe tobacco and e-cigarettes) subject to a tobacco excise tax.

Additionally, taxing all tobacco products at the same rate (80% of wholesale price for OTP is the percentage-of-price equivalent of the \$2.86 tax per pack for cigarettes) removes any incentive for consumers to purchase a low- or non-taxed tobacco product.

Pros

- Simplifies how D.C. taxes tobacco by replacing numerous and conflicting definitions of tobacco products with one definition and replaces multiple tax rates with one flat rate for all non-cigarette tobacco products.
- Ensures all tobacco products are taxed and taxed at the same rate—removing incentives for consumers to purchase low- or non-taxed tobacco products.
- Modernizes how D.C. taxes OTP. Only six states have a per-ounce tax for OTP and most states tax these products as a percentage of price. Rates vary, but states such as Florida (85%) and Washington (95%) have higher tax rates for OTP than the proposed 80% tax for D.C.

Cons

- Tobacco taxes are regressive. Lower-income residents will bear a disproportionate share of any tax increase.
- Higher tobacco taxes in D.C. may encourage cross-border purchasing (tax avoidance) in low-tax jurisdictions in Virginia.
- The District must annually recalculate excise taxes to ensure that the effective rate remains constant. This may prove challenging if OTP prices are difficult to obtain.

Revenue Impact

The Office of Revenue Analysis estimates that in the first year of implementation these changes in tobacco taxes will raise \$7 million in revenue.