Tobacco and vape tax automation

Is it time to consider new technology?



Introduction

Amid all the shifts and innovations within the tobacco and vape business, one thing is certain: Tax complexity is here to stay for manufacturers, wholesalers, distributors, and retailers. Let's examine how the industry – and taxes – are changing.

Does this sound familiar? Every day, as your company's sales transactions are processed, you have to identify any tax liabilities. Catching these potential errors requires a labyrinth of spreadsheets, reporting mechanisms, and custom integrations – some sort of system that's been developed gradually over time. Add to that a maze of tax compliance filing and the latest Prevent All Cigarette Trafficking (PACT Act) reporting. With each new tax or regulatory ruling comes another change, and with every tax law change another tweak to the process.

With the growing complexity of federal, state, county, city, and other local taxes as well as regulations continuing to expand – can your business keep up? It's a tough scenario many companies are facing.

Consider the trajectory other tobacco products (OTP) have taken. Once upon a time, just a handful of states collected excise tax on electronic cigarettes and vapor. Then the FDA finalized a rule to regulate all tobacco products, and the level of excise calculation and compliance complexity began to increase tenfold. This is just one example among many that makes tobacco tax determination and compliance a highly complicated, highly involved responsibility.

Thankfully, it isn't just IT consultants and tobacco tax teams tracking and automating these liabilities. Tax industry specialists are too, and they're supporting comprehensive automation solutions that have already been shown to save tremendous resources and reduce audit risks in many industries, including tobacco.

AN INDUSTRY OF INNOVATION

In 2017, Bloomberg published an in-depth report. The headline: Big Tobacco Has Caught Startup Fever. The takeaway: Consumer demands are shifting further from cigarettes, and tobacco companies are at the helm of innovations. Bloomberg reported, "It's no longer such a stretch to imagine ... a nicotine-delivery gadget capable of doing to cigarettes what Uber did to taxicabs or Napster did to the compact disc." As of 2024, the revenue in the e-cigarettes market in the United States is projected to reach a staggering \$8.8 billion.

With the excitement of innovation around this new product type comes ever-evolving tax rules, rates, and regulations. Tobacco is no longer measured in sticks, cartons, and packs alone, but also in milliliters, cartridges, and ounces. At the same time, new distribution channels have opened the door for manufacturers and wholesalers to sell directly to consumers, and for retailers to act as wholesalers.

These trends toward new types of tobacco products, and new methods for getting them in the hands of consumers, haven't made taxation any simpler. If anything, the opposite is true. As the tobacco industry continues to innovate, tax authorities seek new ways to regulate.

TOBACCO AND VAPE TAX CHALLENGES

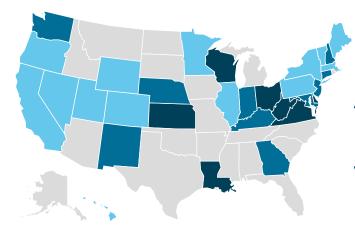
What happens when millions of people abandon one product in favor of another? Tax authorities take note. Such is the case with tax on vaping products and OTP. As the smoking population increasingly trades traditional cigarettes for these other products, tax dollars are diverted to newer forms of smoking or nicotine intake. In response, federal and state governments are determining not just how to regulate this multifaceted industry, but also how to enhance tax revenues from these products.

As of early 2024, 32 states and the District of Columbia have specific vaping tax laws in place, as well as a number of large municipalities. This number is expected to continue to grow, leading to what's arguably the most wildly disparate (and toughest to follow) range of compliance requirements compared with any other industry in the United States.

To complicate matters, vapor products, cigars, and OTP are taxed based on SKU-level attributes. For example, states tax open systems differently than closed vapor systems or nicotine, no-nicotine, or synthetic nicotine products. Cigars have even more attributes to measure and each state's combination of attributes varies.

In Minnesota, e-cigarettes are taxed at 95% of the wholesale price, while in West Virginia they're taxed volumetrically at \$0.075/ml of e-cigarette liquid. California taxes vaping products at 56.92% of the wholesale price, while New York taxes them at 20% of the retail price. In many states an entire e-cigarette starter kit package may be taxed, while in other states a starter kit (or just a pod or cartridge) may only incur sales tax while e-liquid may be taxed at the volumetric rate. In Connecticut, open system vaping products are taxed at \$0.40/ml, while closed system containers of e-liquid are taxed at 10% of the wholesale price. Regulators continue to struggle with appropriate taxing structure due to nicotine content variation among products and packaging issues. There's also concern over the true end goal of the tax – whether it's growing tax revenue or redirecting use of cigarettes to something considered less harmful.





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The U.S. Supreme Court decision in South Dakota v. Wayfair, Inc., in 2018 also added a new state tax wrinkle. While the primary impact of the decision expanded sales tax nexus for online sellers, it also resulted in a requirement for OTP sellers to collect state excise tax in addition to sales tax in the states where they have nexus. Since economic nexus thresholds vary by state, remote sellers face an additional level of complexity. Merchants need to keep close tabs on sales volumes. It's easy to exceed thresholds, triggering new registration and tax collection requirements.

PACT ACT COMPLIANCE UPDATES

In March 2021, thousands of businesses that sell and ship vaping products suddenly became subject to new compliance rules when an amendment to the PACT Act went into effect. The amendment broadened

the interpretation of the word *cigarette* to encompass all electronic nicotine delivery systems, including vape pens, refillable devices, e-cigarettes, hookah pens, and e-pipes, as well as vape liquids, system components, and accessories.

If you sell or advertise vaping products, you must now register with both the Bureau of Alcohol, Tobacco, Firearms and Explosives (ATF) and with the tobacco tax administrator in each state where products are shipped. This applies to direct-to-consumer sales and to wholesale distribution. Moreover, if your website can be seen by a consumer in a state, that's considered advertising. Failure to register correctly can lead to a \$5,000 fine for the first violation and \$10,000 for subsequent violations, or 2% of the gross sales of cigarettes or smokeless tobacco of the delivery seller during the one-year period ending on the date of the violation.

Companies also need to file detailed shipping reports on a monthly basis in each state, and some sellers may require new business licenses. Of course, businesses are also liable for tax collecting and remitting. Changes to the PACT Act mean vaping businesses are on the hook for both sales tax and excise tax at the federal, state, and local levels.

It's critical for online sellers, and any tobacco seller who must collect both tax types, to have a streamlined solution for compliance. This is a heavy lift for many small or mediumsized businesses that aren't prepared for this level of documentation. Most larger tobacco and vape companies understand that automation is key to handling any of these complexities, but few are maintaining automation solutions as efficiently as they could.



THE HIDDEN COSTS AND RISKS OF LIMITED AUTOMATION

How much time is devoted weekly to tax activities and related IT tasks? Many companies with DIY or inadequate tobacco tax automation systems spend too many hours on the following tasks:

- Monitoring changes every day to regulatory rules, rates, and forms
- Tweaking, testing, and deploying new spreadsheet and automation processes
- Responding to pressing tax demands that delay strategic projects
- Keeping up with the rapidly mounting costs of PACT Act noncompliance
- Handling an unreasonable level of reconciliations

Bottom line: The ongoing efforts required to maintain inadequate automated compliance systems can require extensive IT costs and tax analyst resources over the long haul. Due to the manual nature of custom updates and integrations, using these systems also increases both the risk of reporting errors and the potential for noncompliance penalties. Trying to handle compliance manually can be particularly cumbersome and prone to errors.

Most businesses would rather focus on more strategic initiatives to keep them competitive, which means the time is right for tobacco and vape companies to discover the automation solutions currently embraced by other industries.

TAX COMPLIANCE TODAY

Many manufacturers, wholesalers, distributors, and retailers have compliance automation processes in place – ones that have been built over time to address the ever-mounting array of regulatory complexity, including Master Settlement Agreement (MSA) reporting, PACT Act reporting, and thousands of different state, local, city, and county excise taxes.

These systems are often implemented as add-ons to legacy ERP applications or as custom spreadsheets with manual entries, and they must be updated each time an additional tax law goes into effect or reporting regulation is put in place. They require significant IT and tax resources to modify and test every time there's a change to taxing or reporting regulations.

To make matters even more complex, state tax authorities often modify required forms and legislative mandates and introduce new reporting requirements. All the while, local, city, and county tax regulations continue to emerge. Many companies also find it challenging to secure all required business licenses, as authorities have different regulations. Tack on the burden of managing resale certificates and it's no wonder a lot of businesses feel overwhelmed. Every one of these changes, no matter how seemingly small, takes extra effort by tobacco and vape company tax analysts to comply with additional requirements. And if a system is designed to handle only one unit of measure, it can require major changes to accommodate new ones.

BEST PRACTICES FROM OTHER INDUSTRIES

Many industries with similar tax complexity, such as motor fuel supply and distribution, have learned to successfully outsource automation for tax determination, exemption certificate management, reconciliation, and return preparation and filing. By offloading the effort required to track tax rules, rates, and reporting requirements, these companies are able to spend a fraction of the time previously required to build and maintain custom automation systems. This, in turn, allows staff to focus on more strategic work.

Tobacco manufacturers, wholesalers, distributors, and retailers should consider a similar approach to excise tax compliance automation. By trusting a third party to handle automation, especially when it's delivered as SaaS, IT and tax teams benefit from shared resources: Tax law research, adjustments, and tests are all handled by dedicated specialists whose full-time work is devoted to fine-tuning automation solutions and ensuring the latest tax laws are reflected. The result? Greater reliability and scalability as well as savings on IT operations and hardware.



Embracing tax automation as a real option

Before embarking on the next round of system upgrades required to maintain tobacco tax compliance, consider automating your sales tax and excise tax functions with the experts at Avalara.

Avalara AvaTax for Tobacco is an excise tax calculation engine, regularly updated to reflect accurate rates and rules for a wide variety of transactions in thousands of jurisdictions for tobacco and vape businesses. Avalara AvaTax, created specifically for sales and use tax, can also be useful for those businesses that require non-tobacco point-of-sale tax calculations, like grocery and convenience stores.

With so many additional businesses now required to maintain a business license in shipping states to comply with the PACT Act, it's crucial not to miss this step. **Avalara Business Licenses** makes obtaining business licenses and registering in new states easy.

When it's time to remit, **Avalara Returns for Tobacco** automates the preparation and filing of state and local tobacco returns, including electronic filing as required. Under the PACT Act, returns must be filed in all jurisdictions where you're registered, even if no sales were made (a zero return). **Avalara Returns for Tobacco** also offers PACT Act compliance reporting services to help make sure you maintain your requirements in every state – on time, every month.

Avalara Exemption Certificate Management streamlines the collection, storage, and management of resale or exemption certificates that are often mandatory.

These cloud-based tax automation solutions save enormous amounts of time while reducing compliance risks created by shifting regulations like PACT Act changes, allowing tax and financial leaders more time to focus on revenue-generating projects.

Avalara

How much extra time and effort are you spending on tobacco and vape tax compliance at your company?

Contact Avalara today to discover how we can streamline your business and reduce your risk. You can learn more at Avalara for Tobacco or call 877-803-9818.

