

Regulatory Impact Statement: Amending how excise and excise-equivalent duty is calculated, and making flavoured tobacco a prohibited import to stop tax evasion

Coversheet

Purpose of Document	
Decision sought:	<i>Cabinet agreement to charge excise and excise-equivalent duty on flavoured tobacco by gross-weight of the total product, and to amend the Customs and Excise Act 2018 to make flavoured tobacco a prohibited import.</i>
Advising agencies:	<i>New Zealand Customs Service</i>
Proposing Ministers:	<i>Minister of Customs</i>
Date finalised:	<i>23 March 2022</i>
Problem Definition	
<p>The problem this proposal is seeking to address is the impossibility of accurately measuring the tobacco content in flavoured tobacco, which appears to be leading to significant under-declaration of tobacco content in importations of flavoured tobacco. This under-declaration is problematic for excise collection as excise is currently charged per kilo of tobacco content (KTC). As there is no facility either domestically or internationally for testing and measuring flavoured tobacco content, and a robust method of determining KTC does not exist, Customs is unable to accurately determine and verify overseas manufacturers or importers declarations to ensure correct excise-equivalent duty is collected.</p> <p>As it is impossible to verify the tobacco content of flavoured tobacco that is not manufactured in New Zealand, a standard percentage must be used to achieve health and tobacco tax objectives. The problem is in determining a standard percentage that fairly reflects likely tobacco content on average across all products impacted.</p>	
Executive Summary	
<p>Flavoured tobacco¹ is a niche product in New Zealand, smoked in water pipes and typically popular with those of a Middle Eastern connection. As well as tobacco and glycerol, it can contain a variety of other ingredients such as aromatic oils, molasses, sugar, and fruit flavouring. Smoking flavoured tobacco can have detrimental effects on health.</p> <p>New Zealand currently taxes flavoured tobacco based on KTC, using the same excise rate that applies to tobacco. Importers currently pay duty based on self-declared tobacco content.</p> <p>This is proving problematic as it is impossible for Customs to even approximately verify the tobacco content of the product (there is no domestic or international approved facility or</p>	

¹ Flavoured tobacco is a mixture of tobacco and glycerol. It may also contain aromatic oils and extracts, molasses or sugar and may be flavoured with fruit. It is also known as, water-pipe tobacco, hookah, Shisha, molasses and fruit tobacco.

recognised methodology to do this). Importers are aware of this. While technical constraints on our ability to test for tobacco content means that we cannot meet the evidentiary standards needed to prove declarations are false, we strongly believe this is resulting in widespread under-declaration of tobacco content and duty evasion.

In 2020 and 2021 combined, we collected \$5 million in total duty and Goods and Services Tax (GST) on flavoured tobacco. We estimate the loss to the Crown from evasion could be up to \$31.5 million, over the two years.

In addition, importers are exploiting the regulatory environment in New Zealand and using it to smuggle flavoured tobacco to Australia. Large shipments can be declared at a low KTC in New Zealand, and smuggled to Australia to avoid the much higher excise rates Australia applies to flavoured tobacco². For example, we are aware of cases where flavoured tobacco has been smuggled from New Zealand to Australia, by sending it as smaller parcels that were falsely declared as body scrub.

To counter these problems, we propose changing the calculation of excise and excise-equivalent duty on flavoured tobacco replacing the current method of charging per KTC, with charging based on total weight of the product and a standard percentage of tobacco content.

Using the current excise rate of \$1,565.18 per KTC, three options were considered to set an appropriate rate of excise and excise-equivalent duty based on total-weight of the flavoured tobacco, which includes anything added to the tobacco during manufacturing or processing. Each option is based on a different assumed tobacco content. As is the current situation, this excise and excise-equivalent duty rate would subsequently be adjusted annually, in line with tobacco excise indexation.

Status Quo –Duty liability based on a self-declared KTC that Customs is unable to verify.

This does not address the issues detailed above. It will continue to incentivise continued under-declaration of tobacco content on importation, and on-going duty evasion. The Crown would continue to forgo duty that it should be collecting. Allowing under-taxed flavoured tobacco to enter our domestic market would continue to be at variance with New Zealand’s strategy to reduce smoking by taxing tobacco, and criminal syndicates would continue to exploit the situation by smuggling flavoured tobacco to arbitrage the different duty treatments of New Zealand and Australia.

Option One (Customs preferred option) – calculate excise on total weight at 15 per cent assumed tobacco content

Excise equivalent duty is charged based on total weight. The applicable excise rate would be calculated using the tax rate that applies to tobacco, with an assumption that flavoured tobacco comprises around 15 per cent tobacco by weight, with the remaining 85 per cent being other constituents.

² In contrast to New Zealand’s approach of taxing it on the declared tobacco content of the product, Australia treats flavoured tobacco as if it is solely comprised of tobacco for excise purposes. This means if the product can be imported into New Zealand, and then smuggled into Australia, large amounts of Australian tax can be evaded. Doing this, rather than smuggling it directly from its country of origin, is attractive because New Zealand is seen as having a robust law-enforcement environment—which means that exports from New Zealand are seen as lower risk than exports from other countries.

Option Two – as for option one, but calculate excise on total weight at 20 per cent assumed tobacco content

This is similar to option one, but with a higher assumed tobacco content. The 20 per cent assumption is the mid-range of tobacco content that one manufacturer has advised they use in the manufacture of their flavoured tobacco that is imported here (between 15 and 25 per cent). This option may over-tax some goods relative to the tobacco content. It would result in a higher duty rate than Option One.

Option Three – calculate excise on total weight, at 30 per cent assumed tobacco content

This is similar to options one and two, but with a higher assumed tobacco content. It is based on an open-source check of tobacco content of flavoured tobacco. This option is much more likely to over-tax more goods relative to the tobacco content than options one and two.

Customs' preferred option is option one and this is reflected in the Cabinet paper.

Implementing option one enables excise on flavoured tobacco products to be calculated closer to its likely tobacco content. Based on the very limited information available to it, Customs believes 15 per cent is a fair standardised percentage that is broadly in line with the actual tobacco content that most of this type of product is likely to contain.

Customs recognises that there is varying amounts of tobacco content in flavoured tobacco products, and this option essentially sets a standard excise value by deeming it to contain 15 per cent tobacco irrespective of its actual tobacco content. This will result in some products being taxed more lightly, while others are taxed more heavily, than would be the case if tobacco excise were able to be applied based on the true tobacco content of the product. However, given that this has proved impossible to do in practice, Customs considers that this option is appropriate as:

- Overall, it will improve the collection of excise by moving the effective rate closer to the likely true tobacco content of the product, compared to the status quo where Customs appear to be seeing widespread under-declaration. While this is not a perfect solution, it is better than the status quo. We consider that it will result in the duty being collected by the Crown being better aligned with the duty that should be collected were the tobacco content of the product able to be determined.
- It is capable of being implemented consistently across all legal vectors through which the product enters the market, removing incentives to falsely declare the product and creating a level playing field for importers.
- It will create certainty - where tax liability is consistent and is predictable for those seeking to import

It will support enforcement decisions. Where goods are mis-declared as Customs will be able to calculate the actual duty evaded, and meet the evidentiary standards required for a successful prosecution. Changing duty calculation methodology will not mitigate misclassifying goods as products other than tobacco, to deliberately evade duty by smuggling the product into New Zealand. Indeed, by moving the excise paid closer to the rate which should be paid, it will create stronger incentives to smuggle illicit product into New Zealand, and may increase the practice.

To help mitigate these risks, Customs also proposes to amend Schedule 3 and section 95A (1) of the Customs and Excise Act 2018 to make flavoured tobacco a prohibited import and include flavoured tobacco in the definition of tobacco products. This treats flavoured tobacco in the same way other tobacco products are treated; making it subject to

the existing tobacco products permit regime which provides that tobacco products are a prohibited import unless a permit has been issued by Customs. Including flavoured tobacco in the permit system aligns with the Smokefree 2025 Action Plan.

Option one will have minor compliance and moderate financial impacts on a small number of flavoured tobacco importers and smokers. Based on import data from 2020 and 2021, there are 15 commercial flavoured tobacco importers.

We cannot determine the material implications for Māori, children, seniors, disabled people, women, people who are gender diverse, Pacific peoples, veterans, and rural communities but we believe smoking of flavoured tobacco is not widespread.

The proposal will have an impact on some ethnic communities and those who regularly smoke this product. Flavoured tobacco appears to be particularly favoured by people with a Middle Eastern background. It is likely that paying an excise-equivalent duty based on a standardised tobacco content higher than currently being declared will increase the retail price. However, as this is a niche product, and one which is typically used socially by most users rather than daily, we do not consider that there is likely to be a large impact. Moreover, this consequential excise increase essentially represents bringing the tax included in the price of flavoured tobacco more into line with the tax included in the price of other tobacco products, by addressing a situation where we consider duty is being evaded, rather than singling out flavoured tobacco for discriminatory treatment.

Customs has not engaged with stakeholders on this proposal due to the risks of further exploitation of weaknesses. If notice was given of these proposed changes, it is likely importers will stockpile product ahead of any signalled changes in order to pay less excise, as the product has a two-year life span. Customs considers limited consultation is appropriate in these circumstances.

Customs will continue to monitor flavoured tobacco, as part of its ongoing excise enforcement. If credible information becomes available that indicates the tobacco content on which the excise and excise-equivalent rate of duty has been set is not appropriate, there is a behavioural response by exporters to exploit the new standard value, then further changes to this excise rate may be necessary in future.

Limitations and Constraints on Analysis

The following are constraints on the analysis:

Quality of data and evidence used in developing the proposal

In the absence of quality data on tobacco content of flavoured tobacco, Customs has used open-source checks and data supplied by some manufacturers who provided requested information as part of Customs investigations to determine tobacco content of imported product in this analysis.

Customs acknowledges that data limitations are significant. Most data currently comes from declarations by some manufacturers and importers, who have strong incentives to supply false data. Moreover, there is no way in which these claims about tobacco content can be robustly verified or disproved. As discussed above, it is not possible to accurately test flavoured tobacco to determine its actual tobacco content. Furthermore, different manufacturers have their own proprietary processes and additives, which are often trade secrets, and manufacture occurs in jurisdictions that Customs cannot audit.

These data limitations are the key reason why this proposal is being put forward. Were it possible to accurately determine the tobacco content of flavoured tobacco, Customs could

collect the correct excise based on KTC methodology and take action against those making false declarations. It is our inability to do this that is compromising the current excise regime and creating the need for this proposal.

Constraints on determining the true amount of tobacco content in flavoured tobacco.

Self-declaration of the tobacco content Customs strongly suspects is leading to under-reporting of tobacco content for tax purposes, and the declarations being made by some importers are not credible, but this under-declaration is not possible to prove. Customs has tried working with the importers and contacted overseas manufacturers to enable the true tobacco content to be identified. Some manufacturers have supplied what may be accurate data (tobacco content may be between 15 and 25 per cent), others have not, claiming the tobacco content is 0.4 percent. Open-source documents indicate some shisha tobacco contains 30 per cent tobacco and around 70 per cent honey/sugarcane as well as glycerol and flavours. Without reliable data it has not been possible to accurately determine an appropriate tobacco content. Customs has used a best estimate of the tobacco content based on the available information.

Customs acknowledges there is a risk with moving to a pre-determined percentage of tobacco content, and that some products may be overtaxed relative to tobacco content, while others may be under taxed relative to tobacco content.

Constraints on consultation and stakeholder engagement

Importers of flavoured tobacco have not been consulted due to the risk of further exploitation of weaknesses. This has meant Customs has been unable to discuss with importers and those who smoke the product, what they might see as the impacts of the proposal.

These constraints have impacted on the accuracy of the financial analysis.

Responsible Manager(s) (completed by relevant manager)

Kathryn MacIver
Group Manager
Policy and Strategy
New Zealand Customs Service



[Signature]
23 March 2022

Quality Assurance (completed by QA panel)

Reviewing Agency:	New Zealand Customs Service
Panel Assessment & Comment:	The Customs Regulatory Impact Analysis Panel has reviewed the Regulatory Impact Statement and considers the information and analysis partially meet the quality assurance criteria due to the data limitations and lack of consultation. The lack of consultation and the data limitations are fully acknowledged. The promised monitoring will help alleviate data limitations.

Section 1: Diagnosing the policy problem

What is the context behind the policy problem and how is the status quo expected to develop?

What is the current state within which action is proposed?

Customs is responsible for collecting excise taxes on tobacco products, including flavoured tobacco. Excise and excise-equivalent duty on flavoured tobacco is currently calculated using the current excise rate of \$1,565.18 per KTC. KTC is self-declared by importers.

Between 1 January 2011 and 1 January 2020, excise and excise-equivalent duty on tobacco products, including flavoured tobacco, increased by 10 per cent annually, in addition to an annual inflation adjustment, as a health measure to discourage smoking as part of Smokefree 2025. The annual inflation adjustment has continued since 1 January 2020.

The cumulative effect is that New Zealand has among the highest retail prices for tobacco in the world. The high retail price of tobacco in New Zealand has made smuggling tobacco products lucrative. Organised crime groups have strong incentives to target New Zealand due to the price differential between New Zealand and other countries, which results in high profit opportunities in a low-risk environment.

Consumption of flavoured tobacco in New Zealand is not widespread. While imports have increased, they remain very small compared to cigarettes and loose (roll-your-own) tobacco. It is a niche product, popular amongst those of a Middle Eastern background, and often smoked socially in for example shisha cafes.

Imports of flavoured tobacco are generally from the United Arab Emirates, Jordan, Iran, Iraq, India, Europe, and the United States of America. Some importers are declaring KTC as low as 0.4 per cent, others between two and five per cent (one of the manufacturers has indicated the actual tobacco content is around 15 per cent). Customs does not consider that some of these declarations are plausible, but, in the absence of a robust testing methodology being available, it is difficult to contest them, including in Court.

Open-source checks have indicated flavoured tobacco can have a 30 per cent tobacco content. It is not clear how widespread this is, and whether this is an upper level. Imported packages are almost never marked with the tobacco content.

In 2020 and 2021, Customs collected \$4.082 million in excise-equivalent and tariff duty on flavoured tobacco products. This was based off self-declarations of the KTC by importers.

What are the key features of the regulatory system already in place in this area?

As part of tobacco taxation policy, excise and excise-equivalent duty is collected on the tobacco content of product. This is a reflection of the health implications tobacco products inflict on society. The duty rates (excise-equivalent duty and tariff duty) are set out in the Working Tariff Document of New Zealand and excise and excise-equivalent duty in the Excise and Excise-Equivalent Duties Table and are adjusted for inflation on 1 January each year. The goods are also subject to GST when imported.

Are there previous government decisions, legislation or regulatory impact statements in this area that are relevant to the problem?

From 1 July 2020 tobacco products became a prohibited import, requiring a permit to import

<https://www.treasury.govt.nz/publications/risa/regulatory-impact-assessment-impact-summary-imposing-import-controls-over-tobacco-products-and-tobacco-leaf-and-refuse>.

The permit regime gives Customs more oversight over tobacco imports and importers and ensures the correct excise and excise-equivalent duty is paid. At the time the import prohibition and permit regime was introduced, the need for flavoured tobacco to be included within it, had not been identified.

The import prohibition was in response to significant challenges posed by an increasing flow of illicit tobacco. Importers are required to apply to Customs in writing in advance of importation, by completing an application with the required information for a permit to import tobacco. All permits are issued subject to certain conditions or requirements specified in the permit. One of the conditions of the permit regime is that tobacco products cannot be imported through international mail.

How is the status quo expected to develop if no action is taken?

If no action is taken, Customs expects that importers will continue to self-declare flavoured tobacco at what are suspected to be unreasonably low levels and will continue under-paying excise-equivalent duty to the Crown. Customs predicts significantly increased volumes of flavoured tobacco being undeclared or mis-declared both when imported into New Zealand and re-exported to Australia will continue.

What is the policy problem or opportunity?

Customs cannot verify the actual tobacco content of flavoured tobacco for the correct levying of excise and excise-equivalent duty. This is also creating opportunities for illicit trade. Customs strongly suspects self-declaration by the importer is leading to material under-declaration of tobacco content and revenue evasion, but this is difficult to prove.

Customs currently has to rely on the import declaration and information provided by manufacturers when requested by Customs. It is not technically possible for Customs to accurately verify the tobacco content of the goods as there is neither a recognised method of doing this nor a domestic or international testing facility that can be used.

Manufacturers have provided some information which is at variance with importers declared KTC, indicating the actual KTC is approximately 15 per cent for some shipments.

In 2016, as many importers claimed to be unaware of the tobacco content of their imports, Customs engaged ^{s 9(2)} (a) ³ to test an importation to determine the tobacco content as there is no testing facility. **s 9(2)(a) OIA** had to clean the samples with a bleaching treatment followed by water washes as the leaf material was deeply coloured by the other materials that are added to the leaf fragments during manufacture. The samples then had to be dried to allow microscopic examination.

s 9(2)(a) OIA established the KTC as between 4 – 5 per cent in 2016. However, **s 9(2)(a) OIA** caveated this estimate and advised that results give a low figure for the tobacco content of the product, as the cell contents are substantially stripped out in the preparation process. The original weight of leaf fragments is reduced considerably, resulting in low tobacco weight per cent figures when compared to the wet sample weight.

The 2016 testing result appears to have been used by a number of importers until 2021, even though it is suspected they know this KTC is significantly lower than what is in their

³ **s 9(2)(a) OIA** recommended by ESR. ESR did not have the capability to undertake the testing.

imports. It has also been used by Customs as the base line for commercial importations by sea cargo until this year in the absence of a better measurement.

As information being supplied by importers is suspected to be false, Customs tried working with importers and contacted overseas manufacturers to enable the true tobacco content to be identified. This is a time-consuming process, with limited success. One manufacturer advised their product had a KTC of between 15 and 20 per cent while another said theirs was 0.4 per cent. There is no means of confirming whether either of these are accurate.

Customs highly suspects the 0.4 per cent KTC self-declared by the importer and backed up by the manufacturer is false, but as there is no way to have the product accurately tested, the goods had to be cleared and duty paid based on the 0.4 per cent KTC. The excise-equivalent duty paid was \$3,433.51. If the KTC was calculated at 15 per cent, excise-equivalent duty paid would have been \$128,756.74.

When the overseas manufacturers refuse to cooperate, there is little Customs can do as it falls outside New Zealand legal jurisdiction. On 30 September 2021, Customs advised all importers and stakeholder groups that Customs will require evidence of the tobacco content before imports of flavoured tobacco are released from Customs control following importation. This action resulted in manufacturers retracting information they earlier supplied to Customs and goods being held up at the border.

In 2020 and 2021, there were 15 commercial importers of flavoured tobacco. They imported 2,699 KTC of flavoured tobacco, paid a cumulative \$4.082 million in excise-equivalent and tariff duty and \$934,000 in GST. These importers will be impacted by the proposed changes.

However, some importers who may be correctly declaring the KTC of their goods are currently impacted by the under-declaration of flavoured tobacco, as an uneven playing field has been created in the market, enabling dishonest importers to undercut on price, as they are not paying the correct amount of duty.

Mis-declarations and seizures of flavoured tobacco are growing...

Most tobacco products in New Zealand are a prohibited import and require a permit to import. Flavoured tobacco is not currently a prohibited import and is not subject to the permit system.

Customs is seeing significantly increased volumes of flavoured tobacco being mis-declared both when imported into New Zealand and re-exported from New Zealand, especially to Australia, where excise on flavoured tobacco is calculated at 100 per cent tobacco content. Between 29 June 2019 and 29 June 2020, Customs seized a total of 32 grams of molasses tobacco on import. Between 29 June 2020 and 29 June 2021, Customs seized approximately 430 kilograms (kg) of molasses tobacco in import and approximately 342 kg on export.

The increase in quantity seized was accompanied by a dramatic increase in seizure numbers. Fifty-seven seizures were made between 29 June 2020 and 29 June 2021, compared with one between 29 June 2019 and 29 June 2020. It is unclear whether the significant increase in seizures was due solely to increasing illicit activity by New Zealand operators or a combination of targeting by Customs and increased illicit activity.

While there is evidence of increased seizures, this is likely to only represent the 'tip of the iceberg' of the problem. One investigation undertaken in 2020/21, identified suspected undeclared imports totalling approximately 14,000 kg, and suspected undeclared exports totalling approximately 5697 kg. At the current excise rates and structure, the suspected imports identified during this investigation represent revenue of approximately \$1,103,856.58 based on a declared tobacco content of three per cent. If the rate declared by some supplier

websites was applied (14.3 per cent) this would represent revenue of \$13,997,789.05, a revenue gap of \$12,893,932.47.

As investigations by Customs and Australian authorities have indicated, this situation has created an opportunity for criminal entities to import flavoured tobacco into New Zealand, declared at a low KTC rate or undeclared, export it to other countries, notably Australia, for significant profit. In addition, the goods are being purchased domestically for undeclared export to Australia.

What objectives are sought in relation to the policy problem?

The following objectives are sought to ensure:

- the collection of excise and excise-equivalent duty on flavoured tobacco reflects New Zealand's tobacco taxation policy and does not undermine the Government's smoke free objective
- all due revenue is collected
- consistency of approach for importers.

Section 2: Deciding upon an option to address the policy problem

What criteria will be used to compare options to the status quo?

The following criteria have been used to assess the options. Options that meet these criteria are likely to address the risks that have been identified. The criteria are:

- risk – how does the option incentivise compliance?
- certainty – does the option provide certainty to Customs and certainty to businesses?
- revenue – ensure all due revenue is collected
- proportionality – does the option enable a proportionate response?
- cost – how does the option minimise costs to implement and administer?

What scope will options be considered within?

The scope of options Customs could feasibly address has been limited by the inability to test flavoured tobacco to determine the accurate tobacco content. Our scope has therefore been determined by Border Five (B5) comparison, health policy, and how Customs calculates duty on other tobacco products. There are no non-regulatory options.

As Customs cannot verify KTC, moving to calculating duty by product weight at a standardised percentage of assumed tobacco content is a better option than the status quo to provide consistency for Customs and importers. We have provided options for what the standardised percentage could be.

Other countries face the same technical limitations as Customs in dealing with flavoured tobacco. For this reason, international best practice amongst our B5 counterparts is to calculate duty on the total weight of the product without using an assumed tobacco content. However, apart from Australia, they all have significantly lower rates of duty on tobacco products than New Zealand.

This would not align with New Zealand tobacco tax policy as it would tax the product as if it were 100 per cent tobacco content which it is not. Import duties would increase very significantly as the goods would be taxed at the excise rate of \$1,565.18. It would also significantly encourage smuggling into New Zealand to evade these taxes. This has occurred in Australia. A Black Economy Taskforce report published in 2017⁴ said a change to calculate duty at 100 per cent assumed tobacco content resulted in almost the entire Shisha market to become illicit. Furthermore, the report recommended the duty rate for flavoured tobacco be lowered. For these reasons, treating flavoured tobacco as if it was 100 per cent comprised of tobacco was discarded as an option.

What options are being considered?

Changing to calculate excise-equivalent duty on flavoured tobacco by total weight and not KTC.

Status Quo – Calculate excise and excise-equivalent duty on flavoured tobacco by KTC, based on importers self-declared KTC

⁴ https://treasury.gov.au/sites/default/files/2019-03/Black-Economy-Taskforce_Final-Report.pdf page 311

Excise is charged per KTC at the current rate of \$1565.18, and charged based on the tobacco content an importer declares on their import entry. This can be as low as 0.4 per cent.

Option One (preferred option) – calculate excise and excise-equivalent duty on product weight at 15 per cent assumed tobacco content

Amend the method of calculating excise and excise-equivalent duty on flavoured tobacco from KTC to total weight of the flavoured tobacco including anything added to the tobacco during manufacturing or processing. The excise and excise-equivalent duty rate is calculated with a 15 per cent assumed tobacco content. The excise and excise-equivalent duty rate would be \$234.77 per kg of product and would be charged on all imports, regardless of tobacco content. The rate will be subject to the annual tobacco excise inflation adjustment.

How will the option deliver the objectives you have identified in relation to the policy problem/opportunity?

This option will ensure all due revenue is collected, as the importer no longer self declares the KTC to determine duty paid. The importer calculates their duty payable using \$234.77 per kg of the total weight of the product. If as part of an audit, Customs suspects the duty paid is not correct, then Customs can easily assess the correct duty by weighing the goods and calculating the excise-equivalent duty payable. This is a significant improvement against the status quo, where Customs when carrying out an audit of imports, cannot determine whether the claimed KTC is accurate or not as there is no means to test the amount of tobacco content in flavoured tobacco.

This option reflects New Zealand's tobacco tax policy, providing for tobacco content of a product to be subject to excise and excise-equivalent duty as Customs understands the percentage of tobacco content in flavoured tobacco may be between 15 and 25 per cent, based on information supplied by one manufacturer. It may also be more or less than this percentage but as indicated above, this cannot be verified. Excise-equivalent duty at 15 per cent is at the low end of this scale, but an increase on what all importers currently pay under the status quo. The highest self-declared KTC in 2021 is 14.3 per cent and the lowest 0.4 per cent. All importers will be treated consistently.

While imperfect, as the actual tobacco content of the product can vary, it will result in the duty collected on flavoured tobacco more closely corresponding with the duty that should be collected if the tobacco content of the product were able to be verified. This would better align the duty on flavoured tobacco with New Zealand's tobacco policy settings compared to the status quo.

There will be minimal cost to implement and administer this option as it can be implemented the same way Customs calculates excise-equivalent duty for other imports of tobacco products and only requires a small change to the existing import process.

What is the level of stakeholder support for this option? Who supports, and who is opposed? Has this option been affected by consultation?

Due to the sensitive nature of this proposal, there has been no stakeholder consultation undertaken. There is a very strong risk of further exploitation of weaknesses by importers. If notice was given of these proposed changes, it is likely importers will stockpile product ahead of any signalled changes in order to pay less excise-equivalent duty, as the product has a two-year lifespan. Moreover, explicitly signalling the difficulty we have in verifying claimed tobacco content would incentivise even greater under-declaration. Customs considers limited consultation is appropriate in the circumstances.

What distributional impacts could this option have, for example in relation to Māori (as individuals, iwi, hapū, and whānau), children, seniors, people with disabilities, women, people who are gender diverse, Pacific peoples, veterans, rural communities, and ethnic communities?

We cannot determine whether there will be any material implications for Māori, children, seniors, disabled people, women, people who are gender diverse, Pacific peoples, veterans, and rural communities but we are aware use of this product is not widespread, and the quantities imported are comparatively small. Therefore, as it is a niche product consumed by a relatively small group, we would not expect the impact of this change to impact large numbers of people.

This proposal will impact some ethnic communities. Flavoured tobacco is particularly favoured by people with a Middle Eastern background. It is likely the retail price will increase. Any adverse impacts on users in terms of increased price would be balanced by the positive health benefits from discouraging consumption of a harmful product.

Will the impacts of each option be direct, or will there be indirect (ie, flow on) effects? Will the impacts be one-off, recurring, or ongoing? What could the magnitude of the impacts be? Quantify if possible.

The impacts of this option will be direct and on-going. There will be a direct increase in excise-equivalent duty payable on flavoured tobacco imports for importers that declared a lower amount of tobacco in their products.

Excise-equivalent and tariff duty paid on imports from 2020 and 2021 was \$4.082 million. If the same amount was imported following this change, we expect the approximate excise and excise-equivalent and tariff duty paid to be \$31.78 million.

We anticipate there will be a flow on effect of increased retail prices as a result of this change, which will impact consumers of flavoured tobacco. The retail price of a 50-gram pack is approximately \$25, based on open-source checks. Based on the range of KTC declared on some imports, the current estimated excise and GST component on a pack could range from \$1.30 (at 4.53% KTC) to \$4.12 (at 14.3% KTC), GST inclusive.

This option would increase the estimated excise component of a 50-gram pack to \$4.31, GST inclusive.

Customs anticipates that there may also be an increase in smuggling of flavoured tobacco products into New Zealand as a result of the change, but the extent is likely to be small. This occurred in Australia, when they began to calculate excise-equivalent duty on flavoured tobacco at 100 per cent tobacco content.

Will there be an increase or decrease in the benefit to society compared with the status quo or counterfactual option?

There will be a marginal increased benefit to society by ensuring flavoured tobacco is taxed according to its health risk and New Zealand's tobacco tax policy, all due revenue is collected, and the product is taxed fairly and consistently for all importers.

There is a countervailing risk that product with higher tobacco content may be imported instead of lower tobacco product to take advantage of the rate, Customs will monitor this to the extent technically possible to do, and should it become apparent that a behavioural response is occurring, further measures may be warranted. These might include an increase to the excise rate, to reflect a higher assumed percentage of tobacco, at a future date.

There is a possibility that this type of product may become more popular following the broader product changes indicated in the Smokefree 2025 Action Plan. This is, however, very uncertain, given the way this product is used – consumers may or may not see this as a replacement for other forms of tobacco that may be more restricted.

Option Two – calculate excise and excise-equivalent duty on product weight at 20 per cent assumed tobacco content

Amend the method of calculating excise and excise-equivalent duty on flavoured tobacco from KTC to total weight of the flavoured tobacco including anything added to the tobacco during manufacturing or processing. Tobacco content is measured at 20 per cent of the product. The excise and excise-equivalent duty rate would be \$313.04 per kg of product and would be charged on all imports, regardless of tobacco content. The rate will be subject to the annual tobacco excise adjustment.

How will the option deliver the objectives you have identified in relation to the policy problem/opportunity?

This option is largely the same as option one with the same ability to deliver on the objectives except for objective one. Calculating assumed tobacco content at 20 per cent is less consistent with tobacco policy, compared with option one and would likely lead to most product being relatively overtaxed.

What is the level of stakeholder support for this option? Who supports, and who is opposed? Has this option been affected by consultation?

This is the same as option one.

What distributional impacts could this option have, for example in relation to Māori (as individuals, iwi, hapū, and whānau), children, seniors, people with disabilities, women, people who are gender diverse, Pacific peoples, veterans, rural communities, and ethnic communities?

This is the same as option one.

Will the impacts of each option be direct, or will there be indirect (ie, flow on) effects? Will the impacts be one-off, recurring, or ongoing? What could the magnitude of the impacts be? Quantify if possible.

The impacts of this option will be direct and on-going. There will be a direct increase in excise-equivalent duty payable on flavoured tobacco imports for importers that declared a lower amount of tobacco in their products.

Excise-equivalent and tariff duty paid on imports from 2020 and 2021 was \$4.082 million. If the same amount was imported following this change, Customs expects the approximate excise-equivalent and tariff duty paid to be \$42.38 million.

We anticipate there will be a flow on effect of increased retail prices as a result of this change, which will impact consumers of flavoured tobacco, the same as option one.

This option would increase the estimated excise component of a 50-gram pack to \$5.75, GST inclusive.

Customs anticipate that there is more likely to be an increase in smuggling of flavoured tobacco products as a result of a higher increase in excise-equivalent duty payable. This occurred in Australia, when they began to calculate excise-equivalent duty on flavoured tobacco at 100 per cent tobacco content.

Will there be an increase or decrease in the benefit to society compared with the status quo or counterfactual option?

This is the same as option one.

Option Three – calculate excise and excise-equivalent duty on product weight at 30 per cent assumed tobacco content

Amend the method of calculating excise and excise-equivalent duty on flavoured tobacco from KTC to total weight of the flavoured tobacco including anything added to the tobacco during manufacturing or processing. Tobacco content is measured at 30 per cent of the product. The excise and excise-equivalent duty rate would be \$469.55 per kg of product and would be charged on all imports, regardless of tobacco content. This would be subject to the annual tobacco excise adjustment.

How will the option deliver the objectives you have identified in relation to the policy problem/opportunity?

This option is largely the same as option one with the same ability to deliver on the objectives except for objective one. Calculating assumed tobacco content at 30 per cent is the least consistent with tobacco policy based on information Customs has been able to identify on likely tobacco content of products. Compared with options one and two, it would lead to most product being relatively overtaxed as the assumed tobacco content is likely higher than the actual tobacco content.

What is the level of stakeholder support for this option? Who supports, and who is opposed? Has this option been affected by consultation?

Same as options one and two.

What distributional impacts could this option have, for example in relation to Māori (as individuals, iwi, hapū, and whānau), children, seniors, people with disabilities, women, people who are gender diverse, Pacific peoples, veterans, rural communities, and ethnic communities?

We anticipate this option would have an impact on ethnic communities who consume the product. This excise rate is likely to result in significantly increased retail prices and many who currently smoke it, may not be able to afford to continue.

Will the impacts be one-off, recurring, or ongoing? What could the magnitude of the impacts be? Quantify if possible.

The impacts of this option will be direct and on-going. There will be a direct increase in excise-equivalent duty payable on flavoured tobacco imports for importers that declared a lower amount of tobacco in their products.

Excise-equivalent and tariff duty paid on imports from 2020 and 2021 was \$4.082 million. If the same amount was imported following this change, Customs expects the approximate excise-equivalent and tariff duty paid to be \$63.56 million.

We anticipate there will be a flow on effect of increased retail prices as a result of this change, which will impact consumers of flavoured tobacco, the same as options one and two.

This option would increase the estimated excise component of a 50-gram pack to \$8.63, GST inclusive.

Customs anticipates an assumed tobacco content of this level is most likely to incentivise smuggling of flavoured tobacco products as it likely assumes a tobacco content higher than any product imported into New Zealand.

Will there be an increase or decrease in the benefit to society compared with the status quo or counterfactual option?

There will be a decreased benefit to society as flavoured tobacco will likely be overtaxed at this level compared to New Zealand's tobacco tax policy settings despite its health risk. This may result in less revenue collected (if illicit imports increase).

There is a greater countervailing risk that tobacco product with a higher tobacco content will be imported than is the situation now, if it doesn't become completely illicit. This goes against New Zealand's Smokefree 2025 policy. Customs will monitor this to the extent it is technically possible to do, and should it become apparent that a behavioural response is occurring, further measures may be warranted.

There is a possibility that this type of product may become more popular following the broader product changes indicated in the Smokefree 2025 Action Plan. This is, however, very uncertain, given the way this product is used – consumers may or may not see this as a replacement for other forms of tobacco that may be more restricted.

Making flavoured tobacco a prohibited import

Status Quo – No import controls

Flavoured tobacco can be imported through all import streams. Customs has low visibility of importers of flavoured tobacco prior to importation.

Tobacco products are a prohibited import requiring a permit issued prior to importation under section 95A (1) of the Customs and Excise Act 2018. Flavoured tobacco is excluded from the definition of tobacco products.

Option One (preferred option) – flavoured tobacco becomes a prohibited import and requires a permit to import.

Under this option, flavoured tobacco will be a prohibited import, included within the definition of tobacco products under section 95A (1) of the Customs and Excise Act 2018. Importers will be required to apply to Customs by completing a permit application form in advance of importation.

As with other tobacco products, all permits will be issued subject to certain conditions or requirements specified in the permit, to be complied with by the holder of the permit. One of the conditions issued will be that flavoured tobacco products can no longer be imported through international mail.

Increasing the amount of excise paid on flavoured tobacco will increase the incentives to smuggle it into New Zealand. This will help Customs have increased visibility of importers prior to import.

Any importation of flavoured tobacco without a permit may be seized by Customs without the need to consider whether the goods were packaged or described in way to avoid the payment of excise.

How will the option deliver the objectives you have identified in relation to the policy problem/opportunity?

Prohibiting the importation of flavoured tobacco without a permit is aimed at tightening border controls to reduce revenue evasion by increasing Customs' visibility on imports. Including

flavoured tobacco in the permit regime ensures Customs is aware of the identity of importers of tobacco products before importation can take place and can perform due diligence to manage the risk of non-payment of excise prior to granting a permit.

This option reflects New Zealand's tobacco tax policy by ensuring that the excise-equivalent duty flavoured tobacco is subject too, is paid. Making flavoured tobacco a prohibited import in line with most other tobacco products and subject to the permit regime, is the best option to provide assurance over the trade of flavoured tobacco in and through New Zealand.

All importers of flavoured tobacco will be subject to the permit system.

What is the level of stakeholder support for this option? Who supports, and who is opposed? Has this option been affected by consultation?

Due to the sensitive nature of this proposal, there has been no stakeholder consultation undertaken. There is a very strong risk of further exploitation of weaknesses by importers. If notice was given of these proposed changes, it is likely importers will stockpile product ahead of any signalled changes in order to pay less excise-equivalent duty, as the product has a two-year lifespan. Moreover, explicitly signalling the difficulty we have in verifying claimed tobacco content would incentivise even greater under-declaration. Customs considers limited consultation is appropriate in the circumstances.

What distributional impacts could this option have, for example in relation to Māori (as individuals, iwi, hapū, and whānau), children, seniors, people with disabilities, women, people who are gender diverse, Pacific peoples, veterans, rural communities, and ethnic communities?

We cannot determine the material implications for Māori, children, seniors, disabled people, women, people who are gender diverse, Pacific peoples, veterans, and rural communities but we are aware its use isn't widespread. It is a niche product consumed by a relatively small group, mainly of a Middle Eastern background.

Making flavoured tobacco a prohibited import will impact on all importers, including those importing for their own use who want to import using the international mail system. Once the goods are a prohibited import, they will not be able to be imported through the international mail system. The reason for this restriction is Customs would continue to have no advance information on the importer. All importers will be able to import using fast freight, a freight forwarder, the fast-freight courier system or as bulk sea or air cargo. This includes New Zealand Post's international courier service. This may be a slightly more expensive option for those currently using international mail. There is a small number of imports through the mail centre. The impact on commercial importers will be very low.

Will the impacts of each option be direct, or will there be indirect (ie, flow on) effects? Will the impacts be one-off, recurring, or ongoing? What could the magnitude of the impacts be? Quantify if possible.

The impacts of this option will be direct and ongoing. Legitimate importers would not be unduly inconvenienced. They will be required to apply to Customs in writing in advance of importation by completing an application for a permit to import tobacco. This is a simple form containing applicant contact details, type of tobacco product(s) for import and the purpose for importing, for example personal or commercial. There is no fee for a permit. Of the 15 commercial importers, five are familiar with the permit regime as they hold a permit to import tobacco products.

Currently, Customs is obliged to consider the range of compliance and enforcement options when identifying mis-declared flavoured tobacco. Once the goods are a prohibited import,

some importers may decide not to mis-declare their goods and risk losing them, choosing instead to apply for a permit and pay the duty.

Will there be an increase or decrease in the benefit to society compared with the status quo or counterfactual option?

There will be a marginal increased benefit to society by ensuring flavoured tobacco becomes a prohibited import. This will help to reduce mis-declaration of flavoured tobacco and ensure all due revenue is collected. In addition, it removes loopholes and supports data collection and identification of importers across the broader tobacco class of products.

How do the options compare to the status quo/counterfactual?

Example key for qualitative judgements:

- ++ much better than doing nothing/the status quo/counterfactual
- + better than doing nothing/the status quo/counterfactual
- 0 about the same as doing nothing/the status quo/counterfactual
- worse than doing nothing/the status quo/counterfactual
- much worse than doing nothing/the status quo/counterfactual

Calculating excise-equivalent duty on weight of product and not KTC

	Status Quo	Option One – 15 per cent assumed tobacco content (preferred option)	Option Two – 20 per cent assumed tobacco content	Option Three – 30 per cent assumed tobacco content
Risk	0	++	+	-
Certainty	0	++	++	++
Revenue	0	++	+	-
Proportionality	0	+	-	--
Cost	0	+	+	+
Overall assessment	0	++	+	-

Making flavoured tobacco a prohibited import and subject to the permit system

	Status Quo	Option One – flavoured tobacco becomes a prohibited import, subject to permit system
Risk	0	++
Certainty	0	++
Revenue	0	++
Proportionality	0	++
Cost	0	+
Overall assessment	0	++

What option is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?

Option one for both problems. This approach best reflects the policy objectives and delivers the highest net benefits.

What are the marginal costs and benefits of the options?

Affected groups <i>importers, consumers of product</i>	Comment <i>nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks.</i>	Impact <i>\$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts.</i>	Evidence Certainty <i>high, medium, or low, and explain reasoning in comment column.</i>
Additional costs of the preferred option compared to taking no action			
Regulated groups	One off cost of understanding the new requirements and applying for a tobacco permit. Importers will need to renew their permit		High. Based on experience with the tobacco products permit regime
Regulators	Ongoing cost to collect excise Small cost of producing information for importers on the new regime Small ongoing cost to include flavoured tobacco in the permit regime	Costs will be met from within existing baselines	High
Others (eg, wider govt, consumers, etc.)	Potential Increased retail price for consumer	The retail price of a 50-gram pack is approx. \$25, based on open-source checks. Based on the range of KTC declared on some imports, the estimated excise and GST component on a pack could range from \$1.30 (at 4.53% KTC) to \$4.12 (at 14.3% KTC), GST inclusive. The preferred option would increase the estimated excise component to \$4.31, GST inclusive	Medium to high
Total monetised costs	Potential consumer increase per 50 gram		Medium

	pack of up to \$3.01, GST inclusive.		
Non-monetised costs	Up to \$3.01 per 50 gram pack		
Additional benefits of the preferred option compared to taking no action			
Regulated groups	Fair collection of excise from all importers, all will pay at the same rate	No financial benefits for importers as excise payable will increase for them, but it will be consistent for all importers compared with the status quo where some pay more and some pay less	Medium
Regulators	<p>Customs is easily able to determine whether the correct duty has been paid</p> <p>Reduced ongoing cost to monitor non-compliance and determine what might be the correct KTC</p> <p>Easier for Customs to prove duty evasion when prosecuting</p>		High
Others (eg, wider govt, consumers, etc.)		Estimated increase to crown revenue of \$31.5 million	Medium/low
Total monetised benefits		\$31.5 million in Crown revenue	
Non-monetised benefits			

Section 3: Delivering an option

How will the new arrangements be implemented?

Customs will be responsible for the ongoing operation and enforcement of the new arrangements. The preferred option will make flavoured tobacco a prohibited import and included in the definition of tobacco products in section 95A (1) of the Customs and Excise Act 2018. This will require importers of flavoured tobacco to apply for and be issued with a permit to import by Customs prior to importing. No imports even with a permit, will be permitted using international mail.

The proposed commencement date is 1 July 2022 if the proposal is enacted as part of Budget 2022. This will allow sufficient timing to include flavoured tobacco in the online permit

regime material and for importers to apply for and be issued with a permit, assuming they make their application at least two weeks prior to 1 July 2022 and with the required information. The current fifteen commercial importers will be advised in writing of the new requirements, including being provided with a permit application form.

The proposal to make flavoured tobacco a prohibited import requires consideration of New Zealand's international trade obligations. The trade agreements to which New Zealand is a Party permit us to take measures necessary for the protection of human health.

Implementation will be supported by an education and information programme aimed at raising awareness of the proposed new requirements to obtain a permit to import flavoured tobacco and of the new excise and excise-equivalent duty rate.

The legislation will likely include a transitional arrangement to allow the importation of some tobacco products without a permit if ordered and shipped in advance of the legislation being introduced and passed.

An implementation risk is that some importers may claim an excise rate based on 15 per cent tobacco content is considerably higher than the actual tobacco content of their product and may choose to mis-declare their goods in order to evade paying the new excise rate. Customs will put in place mechanisms to identify this.

How will the new arrangements be monitored, evaluated, and reviewed?

This proposal is part of a programme of measures to reduce the risk of revenue loss to the Crown from tobacco smuggling. The programme is subject to regular review and update as the market and its suppliers react and adapt to the various controls that are put in place. This proposal has arisen as part of that programme.

Data is already collected on system level impacts and on enforcement. Customs has a system that monitors seizure rates and the permitting regime.

Customs will continue to work with the B5 and other countries to reduce the risk of under-declared and mis-declared flavoured tobacco. Customs will continue to work with Australia to reduce smuggling from New Zealand, including on joint investigations.

Customs will reassess the regime if credible information becomes available that indicates the tobacco content on which the excise and excise-equivalent rate of duty has been set is not appropriate or if any other changes may become necessary should importers' behaviours change.

Stakeholders can also raise with Customs any issues outside of the review process.