

Budget Change Proposal - Cover Sheet

Fiscal Year: 2020-21

Business Unit: 7600

Department: California Department of Tax and Fee Administration

Priority Number:

Budget Request Name: 7600-073-BCP-2020-GB

Program: Cigarette and Tobacco Products Tax Program

Subprogram:

Budget Request Description: Electronic Cigarette Products Taxes

Budget Request Summary:

The Electronic Cigarette Products Tax is a new nicotine content-based tax imposed upon the distribution of electronic cigarette products. The new tax is in addition to the existing tobacco products tax based on the wholesale cost. The new tax imposes an equivalent floor stock tax. Upon the procurement of a new stamp contract, the new tax will be paid with tax stamps or meter impressions purchased by tobacco products distributors, who will be required to affix the appropriate tax stamp on each package of electronic cigarette products.

The California Department of Tax and Fee Administration (CDTFA) requests \$9.9 million and 10.5 positions in fiscal year (FY) 2020-21, \$10.2 million and 17.0 positions in FY 2021-22, and \$10.4 million and 16.4 positions in FY 2022-23.

These resources will allow the CDTFA to address the workload associated with implementing and administering the Electronic Cigarette Products Tax and procuring a new stamp contract.

Requires Legislation: Yes No

Code Section(s) to be Added/Amended/Repealed:

Does this BCP contain information technology (IT) components? Yes No

If yes, departmental Chief Information Officer must sign.

Department CIO Name:

Department CIO Signature:

Signed On Date:

For IT requests, specify the project number, the most recent project approval document (FSR, SPR, S1BA, S2AA, S3SD, S4PRA), and the approval date.

Project Number:

Project Approval Document:

Approval Date:

If proposal affects another department, does other department concur with proposal?

Yes No

Attach comments of affected department, signed and dated by the department director or designee.

Chief Financial Officer:

Date:

Chief Deputy Director:

Date:

Department Director:

Date:

Agency Secretary:

Date:

Department of Finance Use Only

Additional Reviews: Capital Outlay: ITCU: FSCU: OSAE:

Department of Technology:

PPBA:

Date submitted to the Legislature:

A. Budget Request Summary

The Electronic Cigarette Products Tax is a new nicotine content-based tax imposed upon the distribution of electronic cigarette products. The new tax is in addition to the existing tobacco products tax based on the wholesale cost. The new tax imposes an equivalent floor stock tax. Upon the procurement of a new stamp contract, the new tax will be paid with tax stamps or meter impressions purchased by tobacco products distributors who will be required to affix the appropriate tax stamp on each package of electronic cigarette products.

The CDTFA requests \$9.9 million and 10.5 positions in fiscal year (FY) 2020-21, \$10.2 million and 17.0 positions in FY 2021-22, and \$10.4 million and 16.4 positions for FY 2022-23.

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B. Background/History

The Taxpayer Transparency and Fairness Act of 2017, established the CDTFA under the Government Operations Agency and shifted most of the tax and fee programs previously administered by the Board of Equalization (BOE) to the CDTFA, including cigarette and tobacco products tax and licensing programs. The CDTFA administers 37 tax and fee programs, that generated \$74.4 billion in revenue in FY 2018-19. The programs include California's sales and use tax, fuel, cigarette, tobacco products, environmental, as well as other special taxes and fees. Over one million discrete businesses currently interact annually with the CDTFA, many involved with multiple tax and fee programs.

Since 1998, many measures have improved cigarette and tobacco products' tax compliance and reduced evasion. These improvements include the Cigarette and Tobacco Products Licensing Act of 2003 mandated by Chapter 890 of the Statutes of 2003 (Assembly Bill (AB) 71) and Chapter 501 of the Statutes of 2006 (AB 1749), a counterfeit-resistant encrypted cigarette tax stamp in 2005, and the Prevent All Cigarette Trafficking (PACT) Act of 2009. The PACT Act requires Internet and other remote sellers to comply with the California laws. AB 71 established a statewide licensing program administered by the CDTFA to reduce untaxed distributions and illegal sales of cigarettes and tobacco products.

In 1989, California began to tax tobacco products. The excise tax on tobacco products is imposed upon every distributor, upon the distribution of tobacco products, based on the wholesale cost of tobacco products, at a rate equivalent to the combined rate of tax

imposed on cigarettes. The wholesale cost of tobacco products is the cost of tobacco products to the distributor prior to any discounts or trade allowances. The CDTFA is required to annually determine the tobacco products tax rate based on the wholesale cost of cigarettes as of March 1 each year and the rate is effective during the next fiscal year. Effective July 1, 2019, the tobacco products tax rate is 59.27 percent of the wholesale cost.

Proposition 99, approved by voters in November 1988, effective January 1, 1989, imposed a surtax of \$0.25 per package of cigarettes and created an equivalent tax on other tobacco products. AB 478 and AB 2055, effective January 1, 1994, added an excise tax of \$0.02 per package of cigarettes.

Proposition 10, approved by voters in November 1998, effective January 1, 1999, imposed an additional surtax of \$0.50 per package of cigarettes and an equivalent compensating floor stock tax. Additionally, the measure imposed an additional excise tax on the distribution of tobacco products equivalent to the additional cigarette tax.

Proposition 56, approved by voters in November 2016, effective April 1, 2017, imposed an additional \$2.00 per pack of 20 cigarettes and an equivalent compensating floor stock tax. The measure also expanded the definition of “tobacco products” to include products containing any amount of tobacco or nicotine, including electronic cigarette products containing nicotine or sold in combination with nicotine, that is intended for human consumption. Since the cigarette tax increased, the tobacco products tax rate indirectly increased to the equivalent of a \$3.37 cigarette tax (\$2.87 combined cigarette tax [Proposition 99] plus \$0.50 [Proposition 10]). Existing law triggers an automatic tobacco products tax increase whenever the cigarette tax is increased.

As California consumers and retailers seek less expensive sources to avoid the payment of excise taxes, the CDTFA staff expect both a decrease in actual consumption and an increase in cigarette and tobacco products tax evasion.

Based on licensing registration data as of June 28, 2019, there are 31,171 licensed retailers and 1,121 licensed distributors and licensed wholesalers that engage in the sale of cigarettes and tobacco products in California.

Resource History

Dollars in thousands

Program Budget	2014-15	2015-16	2016-17	2017-18	2018-19
Authorized Expenditures	25,753	25,670	23,439	30,472	31,440
Actual Expenditures	22,455	23,596	19,346	21,496	20,517
Revenues	835,636	843,756	1,239,192	2,148,479	2,057,392
Authorized Positions	112.7	95.9	98.1	134.1	128.0
Filled Positions	100.8	83.7	85.4	88.5	83.0
Vacancies	11.9	12.2	12.7	45.6	45.0

Workload History

Workload Measure	2014-15	2015-16	2016-17	2017-18	2018-19
Retailer Accounts	35,020	34,154	33,814	31,657	31,171
Tobacco Manufacturer Accounts	84	87	236	260	260
Tobacco Distributer Accounts	513	517	802	870	810
Tobacco Wholesaler Accounts	247	259	303	334	340
Consumers	46	109	39	31	46
Tobacco Distributor Audits*	52	68	82	77	73
Inspections	10,770	11,304	10,933	11,819	12,287

*Does not include refund audits.

C. State Level Considerations

The CDTFA collects taxes, fees, and surcharges that provide over 26.4 percent of the annual revenue for the state government and essential funding for counties, cities, and special taxing districts. In FY 2017-18, the CDTFA administered tax and fees that produced \$70.4 billion for education, public safety, transportation, housing, health services, social services, and natural resources management. The CDTFA administers the state's sales and use, fuel, alcohol, tobacco, and other taxes, and collects fees that fund specific programs. More than one million businesses are registered with the Department.

This proposal is consistent with the CDTFA's mission to make life better for Californians by fairly and efficiently collecting the revenue that supports essential public services.

D. Justification

The CDTFA is mandated to implement the legislative changes, administer and collect the new tax and floor stock tax, effective January 1, 2021, and procure a stamp contract. Upon the procurement of a stamp contract, the CDTFA will be required to provide appropriate stamps for distributors to pay the tax and distributors will be required to affix the stamp to each package of electronic cigarette products. However, prior to the procurement of a stamp contract and stamps being made available for purchase, distributors will be required to file a return and pay the tax. Once a stamp contract is in place and a stamp is released, distributors will pay the tax by purchasing stamps, from the CDTFA, and will file a report reconciling inventories of both electronic cigarette products and stamps.

The CDTFA must begin to implement the legislative changes in FY 2020-21, before January 1, 2021, the effective date of the new tax and floor stock tax. Effective implementation requires the CDTFA to perform several functions prior to January 1, 2021: notify taxpayers, develop and implement system programming changes, hire and train key staff, prepare and draft a stamp contract. The stamp contract will include providing input on the tax stamp design, provide the option to purchase or lease stamping machinery, and finance, install, and train distributors on the proper usage of stamping machines. The CDTFA will also create and/or revise forms and schedules and answer taxpayer inquiries.

The mandated legislative changes generate new workloads that impact all functions of tax administration including greater efforts for return processing, delinquencies, collections, audits, appeals, refunds, online services, and various other support functions.

The requested resources are essential to effectively implement and administer the

legislative changes. The following outlines the areas that will be impacted and includes explanations of the efforts needed. Without the requested resources, the CDTFA will be unable to comply with the legislative changes, resulting in delays and loss of substantial revenue.

Administration

The Electronic Cigarette Products Tax establishes a new fund, the Electronic Cigarette Products Tax Fund. The new fund will require numerous analyses for maintenance, reconciliation, and reporting for, interim statements, preparation of special reports, and monitoring critical cash flow by the Accounting Branch. Administration of this fund will also require special reporting to all stakeholders. Additional administrative functions include the processing of all paper returns by key data operators.

Implementation/Administrative Support

Implementing the Electronic Cigarette Products Tax will require system programming changes and modifications to capture the new reporting requirements. Staff must develop new online and paper returns (for posting on the public website) and floor stock tax returns and instructions. Staff will also: (1) update forms, publications, letters, and webpages; (2) develop, distribute, and publish numerous outreach materials, special notices, news releases, newsletter and tax information bulletin articles, policy memorandums; and (3) train and provide technical advice to CDTFA staff and the public.

The new tax also imposes new reporting and filing requirements for distributors, manufacturers, and wholesalers. Tobacco Products manufacturers and distributors first returns will be due February 25, 2021, and Tobacco Products wholesalers are required to submit their first report of nicotine-content inventory by February 25, 2021. In addition, distributors, wholesalers, and retailers will be required to report the floor stock tax as of January 1, 2021, with the return and tax due by April 1, 2021. As a result, staff will be required to process the increased remittances received for the new tax and floor stock tax via electronic funds transfer, checks, credit cards, and wire transfers.

Staff will track revenues associated with the new tax and prepare additional reports and/or modify existing reports as necessary.

Compliance

To ensure compliance of the new electronic cigarette tax legislation, the CDTFA will be required to perform registration and licensing functions, including stamp sales, return processing functions, and collection functions. Every distributor of electronic smoking or vaping devices, or any tobacco or nicotine product that is intended for human

consumption, must register with the CDTFA and report and pay the tax on these products. CDTFA staff will also process returns, reports, schedules, payments, interest and penalty relief requests, review overpayments, issue refunds, and provide customer service for this new program. In order for a wholesaler of electronic cigarettes, vaping devices, or any tobacco or nicotine product intended for human consumption to engage in sales of these products, they must register with the CDTFA for a wholesaler license.

Tax Stamp Contract

The cigarette tax is generally paid by cigarette distributors through their purchases of tax stamps from the CDTFA. The CDTFA has a cigarette stamping program where distributors apply the cigarette tax stamp to each package of cigarettes with a stamping machine. Stamping machines auto apply the tax stamp to each cigarette package contained in a carton. The cigarette tax stamp is a high-tech, counterfeit-resistant, encrypted tax stamp capable of being read by a hand-held scanning device. The encrypted tax stamps are embedded with specified information, such as the name and address of the distributor that applied the stamp, the date the stamp was affixed, and the stamp's denomination value.

The CDTFA will need to work with a vendor for a similar contract to develop different denominations of tax stamps and equipment for distributors to affix tax stamps to electronic cigarette products. The CDTFA will need to work with stamping machine manufacturers to review options for automating stamp application and activation using either existing machine options or the potential for new machine development. The CDTFA will need to seek a contract with a vendor to establish a tax stamp contract for electronic cigarette products. For FY 2020-21 and subsequent years, the CDTFA is estimating \$8 million in contract costs for a stamping contract, which is based on the cigarette contract currently in place.

Return Processing

Every retailer, wholesaler, and distributor will need to report and pay the one-time floor stock tax. Staff will need to design and develop new floor stock tax returns for each filer and provide returns to all licensed retailers, wholesalers, and distributors to report their inventories and pay the floor stock tax. System programming changes will be required to allow for the one-time floor stock tax return and payment and for proper allocation to the new fund.

Staff will be responsible for critical tax return/payment processing, reports, account maintenance, account billings and adjustments, and desk review activities. It is anticipated that taxpayers will need assistance when filing the new return and floor stock tax returns and making payments.

Collections

The new tax and floor stock tax represents additional liabilities and new delinquencies. Additionally, taxpayers may file non-remittance, partial remittance or late returns, resulting in staff initiating a billing, subject to collection actions. Therefore, staff must develop new delinquency and billing notices, lien, withhold, and levy capabilities for the new tax and floor stock tax.

Audit

The audit component is vital to the effective administration of any tax program. Staff will verify and audit registered tobacco products distributors that sell electronic cigarette products to ensure the correct amount of tax was imposed, collected, and paid on the electronic cigarette products distributed. Audit staff resources will ensure compliance with the new tax and floor stock tax imposed on electronic cigarette products. Each audit is independently reviewed to ensure it is complete and accurate.

Appeals

Audit assessments of the one-time floor stock tax and new tax will result in petitions for redetermination. Staff will handle all aspects of the appeals process resulting in additional workload to process.

Refunds

Taxpayers who believe they overpaid the floor stock tax and/or new tax are permitted to file a claim for refund. Additionally, staff will handle the additional claims for refund for the new nicotine tax stamps and or returned stamps. Staff will handle all aspects of the refunds process and process requests for relief from interest and penalty.

E. Outcomes and Accountability

Based on CDTFA's retailer data, the estimated number of retailer accounts will continue to decline at a rate of 1.67 percent each year. This trend might continue as more cities ban flavored tobacco products and more retailers restrict sales of such products. Excluding FY 2017-18 sales (first year under Proposition 56), the number of retailers has declined about 1.67 percent per year on average (See Workload History table on page 3 for number of cigarette/tobacco retailers. The average decline in retailers from FYs 2014-15 to 2015-16, FYs 2015-16 to 2016-17, and FYs 2017-18 to 2018-19 is an average of 1.67 percent), which might be a reasonable assumption for the near future. The CDTFA estimates the number of wholesalers and distributors to stay near the

current levels, as the market is unlikely to be impacted by new technological innovations, tax increases, or new products.

Projected Outcomes

Workload Measure	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25
Retailer Accounts	30,650	30,139	29,635	29,140	28,654	28,175
Tobacco Distributor Accounts	810	810	810	810	810	810
Tobacco Wholesaler Accounts	340	340	340	340	340	340
Consumers ¹	46	46	46	46	46	46
Tobacco Distributor Audits ²	128	128	128	128	128	128
Inspections	12,000	11,250	11,250	11,250	11,250	11,250

¹Some consumers pay the CDTFA directly for taxes due on untaxed product.

²This item does not include refund audits.

F. Analysis of All Feasible Alternatives

Alternative 1 - Authorize funding of \$9.9 million and funding for 10.5 positions in FY 2020-21, \$10.2 million and 17.0 positions in FY 2021-22, and \$10.4 million and 16.4 positions in FY 2022-23.

Pros:

- Provides resources to successfully implement and administer the Electronic Cigarette Products Tax and procure a tax stamp contract on a limited-term basis.
- Ensures Electronic Cigarette Products Tax revenue is recognized, determined, collected, and allocated.

Cons:

- Requires expenditure of Special Funds.
- Will require additional budget augmentation after limited-term positions expire.

Alternative 2 - Authorize funding of \$9.9 million and permanent ongoing funding for 10.5 positions in FY 2020-21, \$10.2 million and permanent ongoing funding for

17.0 positions in FY 2021-22, and \$10.4 million and permanent funding for 16.4 positions in FY 2022-23.

Pros:

- Provides flexibility to adjust to unexpected changes.

Cons:

- Requires expenditure of Special Funds.

Alternative 3 - Do not provide the requested resources.

Pros:

- This alternative does not require a budget augmentation.

Cons:

- Does not provide the CDTFA with necessary resources to meet Legislative mandates.
- The CDTFA cannot absorb the workload with its current baseline budget. Furthermore, statutes, constitutional provisions, and court decisions prevent the CDTFA from diverting controlled special funds to pay for other programs.
- The CDTFA may not be able to fully identify and collect all revenue due from the Electronic Cigarette Products Tax.

G. Implementation Plan

Hire and train new staff on implementation and administration - July 2020 and ongoing

Design, program, and test registration system - July 2020 and ongoing

Design, program, and test new return - July 2020 and ongoing

Design, program, and test online services - July 2020 and ongoing

Design, program, and test collection, audit and appeal capabilities - July 2020 and ongoing

Update form, publications, webpages, etc. - July and August 2020

Train staff on how to handle public inquiries - July 2020 and ongoing

Register taxpayers for the new program and perform account maintenance - December 2020 and ongoing

Contract for new indicia for e-cigarette products - July 2020 and ongoing

Outreach to taxpayers and public - July 2020 and ongoing

Respond to technical tax questions - Ongoing

Prepare reports as necessary - April 2021 and ongoing

Establish new accounting fund - July 2020

Create new tax returns and schedules for tobacco products manufacturer, distributor, wholesaler, consumer, and create new floor stock tax return - July 2020 and ongoing

Process returns and payments as necessary - February 2021 and ongoing

Perform collection activities - April 2021 and ongoing

Perform refund activities - April 2021 and ongoing
Hire staff to develop and implement audit program - April 2021 and ongoing
Hire and train staff to conduct audits - April 2021 and ongoing
Hire and train staff to process petitions - April 2021 and ongoing
Report on the program effectiveness and outcomes - August 2021

H. Supplemental Information

None.

I. Recommendation

The CDTFA recommends Alternative 1. These resources will ensure uninterrupted administration of the Cigarette and Tobacco Products tax program and provide the resources necessary to implement the new taxes and mandates of the Electronic Cigarette Products Tax, and procurement of a viable stamp contract.

Additional Workload Details Upon Request

