

The California State Auditor released the following report today:

State Board of Equalization

Its Tobacco Tax Enforcement Efforts Are Effective and Properly Funded, but Other Funding Options and Cost Savings Are Possible

BACKGROUND

Cigarettes and tobacco products are subject to various federal, state, and local taxes and fees—California currently imposes an 87-cent excise tax on each pack of 20 cigarettes and an excise tax of about 28 percent of the wholesale cost of tobacco products in addition to charging a sales tax. Last year, these excise taxes produced \$835 million, which was allocated to the State's General Fund and certain programs. The State Board of Equalization (board) administers these excise taxes, performs administrative functions such as processing tax returns for distributors, and supplies cigarette distributors with encrypted tax stamps that they must affix to every package of cigarettes. The board also enforces tax payment through its retail inspections, criminal investigations, civil audits, and other enforcement activities.

KEY FINDINGS

During our audit of the board's tax and licensing programs related to cigarette and tobacco products, we noted the following:

- Although the board believes it prevented the State from losing \$91 million in cigarette and tobacco products tax revenue, it also estimates that it did not collect \$214 million in tax revenue due to tax evasion in fiscal year 2012-13.
 - ✓ Most unpaid taxes resulted from retailers that purchased and sold cigarettes without the encrypted stamps.
 - ✓ Some consumers evaded taxes by purchasing products from distributors that did not pay the required taxes, perhaps by purchasing in another state and then transporting them back to California.
 - ✓ The board's enforcement efforts—licensing all entities involved in the sale of cigarette and tobacco products, inspecting roughly 10,000 of these entities each year, and affixing the encrypted tax stamp on every pack of cigarettes—have substantially reduced tax evasion.
- The board's licensing program does not generate enough revenue to cover all of its costs primarily because retailers only pay a one-time license fee—a rate that was established in 2005—and the fund it uses to deposit the program's licensed fees, fines, and penalties (compliance fund) has amassed a larger than necessary fund balance.
- There are options to address the licensing program's ongoing shortfall and maximize the funding for most of the funds that support the program. These options include using the excess compliance fund balance, a license fee increase or a combination of license fee increases, continued use of Cigarette Tax Fund monies, and a cigarette tax increase.
- The board's method for identifying program costs and allocating them to each program led to inaccurate time charges, which have weakened the effectiveness of cost allocations that are based on time charges.
- The board could reduce the licensing program's costs by more than \$360,000 annually, without compromising tobacco taxes enforcement outcomes, by reducing the number of inspections it conducts because the number of licensees selling cigarettes and tobacco products has declined.

KEY RECOMMENDATIONS

We recommend that the Legislature implement one of the funding options that will address the ongoing funding shortfall in the licensing program.

We also made a number of recommendations to the board including the following:

- If the Legislature does not act on one of the suggested funding options, eliminate the compliance fund's excess fund balance over the next year and limit it each year thereafter.
- More accurately allocate staff time instead of adjusting its predetermined allocation to match budgets.
- Reduce the number of annual inspections and reinspections of retailers, distributors, and wholesalers.