

**STATE OF CALIFORNIA
CALIFORNIA STATE AUDITOR'S OFFICE
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**TITLE 2, DIVISION 10, CALIFORNIA CODE OF REGULATIONS
ADOPT SECTIONS 61200 TO 61240, INCLUSIVE, REGARDING THE
CALIFORNIA HEALTHCARE, RESEARCH AND PREVENTION TOBACCO TAX
ACT OF 2016**

INITIAL STATEMENT OF REASONS

INTRODUCTION

The California State Auditor (“State Auditor” or the “office”) proposes to amend the California Code of Regulations, title 2, division 10, to add regulations pursuant to the State Auditor’s authority to implement Revenue and Taxation Code section 30130.57, relating to defining administrative costs for purposes of the California Healthcare, Research and Prevention Tobacco Tax Act of 2016 (the “Act”). The Act was added as Article 2.5 (commencing with section 30130.50) of Chapter 2 of Part 13 of Division 2 of the Revenue and Taxation Code as a result of the approval of initiative Proposition 56 by the voters on November 8, 2016 at the statewide general election (“Proposition 56”). Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to promulgate regulations defining administrative costs for purposes of the Act. When defining administrative costs, Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to take into account the differing nature of the agencies or departments receiving funds pursuant to the Act. In developing these proposed regulations, the office has consulted with stakeholders, including the agencies or departments receiving funds pursuant to the Act, the Department of Finance, and the proponents of Proposition 56.

The State Auditor also proposes to implement, interpret, and make specific the provisions of Revenue and Taxation Code section 30130.56, subdivisions (a) and (b) and Revenue and Taxation Code section 30130.57, subdivision (b), requiring the State Auditor to conduct at least biennially an independent financial audit of the state and local agencies receiving funds pursuant to the Act; review (at a minimum) the administrative costs expended by the state agencies that receive revenues generated by the Act; provide public transparency with respect to revenues generated by the Act; ensure that revenues generated by the Act are used for healthcare, tobacco use prevention, and research; and make recommendations for improvements. Government Code section 8546.1 requires the State Auditor to conduct financial and performance audits as directed by statute and to complete any audit pursuant to the “Government Auditing Standards” published by the Comptroller General of the United States (“Audit Standards”). Under Audit Standards, a financial

audit provides an independent assessment of whether an entity’s reported financial information is presented fairly in accordance with recognized criteria. Under Audit Standards, a performance audit provides objective analysis to assist management and those charged with governance and oversight by using audit recommendations to improve program performance and operations, initiate corrective action, and contribute to public accountability. While Revenue and Taxation Code section 30130.56, subdivision (a) uses the term financial audit, the reviews, purposes, and recommendations required suggest that the State Auditor conduct a performance audit. Therefore it is necessary to clarify the type of audits that the State Auditor shall conduct as required by the Act.

Proposed Regulations

Revenue and Taxation Code section 30130.57, subdivision (f) mandates that “not more than 5 percent of the funds received pursuant to this article shall be used by any state or local agency or department receiving such funds for administrative costs.” Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to promulgate regulations defining administrative costs for purposes of the Act. These proposed regulations make specific the meaning of administrative costs for purposes of the Act. These regulations also make specific the meaning of the audit work required to be conducted at least biennially by the State Auditor with respect to the use of the revenues generated by the Act.

SPECIFIC PURPOSE OF EACH SECTION¹–GOVERNMENT CODE SECTION 11346.2, SUBDIVISION (b)(1)

This regulatory proposal would adopt the following sections in California Code of Regulations, title 2, division 10.

The specific purpose of each adoption, and the rationale for the determination that each adoption is reasonably necessary to carry out the purpose for which it is proposed, together with a description of the public problem, administrative requirement, or other condition or circumstance that each adoption or amendment is intended to address, is as follows:

Proposed Section 61200 declares the intention of the proposed regulations in California Code of Regulations, title 2, division 10, chapter 4 as being to interpret the provisions of Revenue and Taxation Code sections 30130.56 and 30130.57, requiring the State Auditor to conduct at least biennially an independent financial audit of the state and local agencies receiving funds pursuant to the Act and to promulgate the regulations required by Revenue and Taxation Code section

¹ Unless otherwise indicated, (such as by an express reference to the California Revenue and Taxation Code) any use of the term “section” in this statement is a reference to a section or proposed section of the California Code of Regulations.

30130.57 defining administrative costs for purposes of the Act. This proposed regulation is necessary to inform the Legislature, state and local government agencies, and the general public of the purpose of the proposed regulations, and furthers the purposes of Revenue and Taxation Code sections 30130.56 and 30130.57.

Proposed Section 61201 defines a variety of terms, each of which is described in more detail below. This proposed regulation is necessary to establish terms and give each term a particular meaning so as to provide clarity and allow for easy reference to a state agency or local agency subject to the proposed regulations. Further, establishing definitions helps to avoid ambiguity in the proposed regulations.

Proposed Section 61201, subdivision (a) defines the term “Act” to mean that portion of Proposition 56 adopted by the voters on November 8, 2016 at the statewide general election that was added as Article 2.5 (commencing with section 30130.50) of Chapter 2 of Part 13 of Division 2 of the Revenue and Taxation Code and is consistent with the terms of Proposition 56. By establishing this term and giving it a particular meaning, the proposed subdivision allows easy reference to a state agency or local agency receiving revenues pursuant to the Act and helps to avoid ambiguity in the proposed regulations.

Proposed Section 61201, subdivision (b) defines the term “administrative cost” as used in the proposed regulations. By establishing this term and giving it a particular meaning, the proposed subdivision allows easy reference to a state agency or local agency receiving revenues pursuant to the Act and helps to avoid ambiguity in the proposed regulations. In the way the term is defined by the proposed regulation, the proposed regulation makes clear that what constitutes an administrative cost with respect to the Act for each state or local agency will be based on particular criteria set forth with respect to that particular agency. It also makes clear that the definition of administrative costs is only applicable to funds received by any state agency or local agency pursuant to Revenue and Taxation Code sections 30130.55, 30130.56, or 30130.57.

Proposed Section 61201, subdivision (c) defines the term “applicable funds” as moneys received by any state agency or local agency pursuant to Revenue and Taxation Code sections 30130.55, 30130.56, or 30130.57. This is necessary as, in accordance with Revenue and Taxation Code section 30130.54, a portion of the revenues generated by Proposition 56 will be used to backfill the Cigarette and Tobacco Products Surtax Fund created by Revenue and Taxation Code section 30122 (Proposition 99 as approved by the voters at the November 8, 1988 statewide general election), the Breast Cancer Fund created by Revenue and Taxation Code section 30461.16, the California Children and Families Trust Fund created by Revenue and Taxation Code section 30131 (Proposition 10 as approved by the voters at the November 3, 1998 statewide general election), and the revenues derived from Revenue and Taxation Code section 30101, to address revenue declines that result from the additional tax authorized by Proposition 56. Each of the backfilled

programs set forth in Revenue and Taxation Code section 30130.54 was established prior to the approval of Proposition 56 and each state or local agency participating in a backfilled program has a pre-established method for charging administrative costs with respect to those backfilled programs. Limiting the scope of these regulations to the funds received by any state agency or local agency pursuant to Revenue and Taxation Code sections 30130.55, 30130.56, or 30130.57 eliminates the ambiguity of the possible impact of these proposed regulations on the backfilled programs.

Proposed Section 61201, subdivision (d) defines the term “audit” and interprets and makes specific the provisions of Revenue and Taxation Code section 30130.56, subdivisions (a) and (b) and Revenue and Taxation Code section 30130.57, subdivision (b), requiring the State Auditor to conduct at least biennially an independent financial audit of the state and local agencies receiving funds pursuant to the Act; review (at a minimum) the administrative costs expended by the state agencies that receive revenues generated by the Act; provide public transparency with respect to revenues generated by the Act; ensure that revenues generated by the Act are used for healthcare, tobacco use prevention, and research; and make recommendations for improvements. Government Code section 8546.1 requires the State Auditor to conduct financial and performance audits as directed by statute and to complete any audit pursuant to the “Government Auditing Standards” published by the Comptroller General of the United States (“Audit Standards”). Under Audit Standards, a financial audit provides an independent assessment of whether an entity’s reported financial information is presented fairly in accordance with recognized criteria. Under Audit Standards, a performance audit provides objective analysis to assist management and those charged with governance and oversight by using audit recommendations to improve program performance and operations, initiate corrective action, and contribute to public accountability. While Revenue and Taxation Code section 30130.56, subdivision (a) uses the term financial audit, the reviews, purposes, and recommendations required suggest that the State Auditor conduct a performance audit. Therefore it is necessary to clarify the type of audits that the State Auditor shall conduct as required by the Act. The way the term is defined by the proposed regulation, it makes it clear that an audit conducted by the State Auditor pursuant to Revenue and Taxation Code section 30130.56, subdivisions (a) and (b) and Revenue and Taxation Code section 30130.57 may consist of elements of a financial audit, a performance audit, or both.

Proposed Section 61201, subdivision (e) defines the term “capital outlay” as used in the proposed regulations. This term defines a category of expenditures included as part of the criteria for determining what constitutes an administrative cost for a number of state agencies receiving applicable funds under the Act. The definition is based on the definition provided by the Department of Finance in its *Finance Glossary of Accounting and Budgeting Terms*, which reflects how this term is used in the Governor’s Budget, the Governor’s Budget Summary, and the annual Budget. By establishing this term and giving it a particular meaning, the proposed regulation

provides clarity, allows easy reference to a state agency or local agency, and helps avoid ambiguity in the proposed regulations.

Proposed Section 61201, subdivision (f) defines the term “department central services costs” as used in the proposed regulations. This term defines a category of expenditures included as part of the criteria for determining what constitutes an administrative cost for a number of state agencies receiving applicable funds under the Act. The definition is based on a definition provided by the *State Administrative Manual*. By establishing this term and giving it a particular meaning, the proposed regulation provides clarity, allows easy reference to a state agency or local agency, and helps avoid ambiguity in the proposed regulations.

Proposed Section 61201, subdivision (g) defines the term “department direct costs” as used in the proposed regulations. This term defines a category of expenditures included as part of the criteria for determining what constitutes an administrative cost for a number of state agencies receiving applicable funds under the Act. The definition is based on a definition provided by the *State Administrative Manual*. By establishing this term and giving it a particular meaning, the proposed regulation provides clarity, allows easy reference to a state agency or local agency, and helps avoid ambiguity in the proposed regulations.

Proposed Section 61201, subdivision (h) defines the term “department indirect costs” as used in the proposed regulations. This term defines a category of expenditures included as part of the criteria for determining what constitutes an administrative cost for a number of state agencies receiving applicable funds under the Act. The definition is based on a definition provided by the *State Administrative Manual*. By establishing this term and giving it a particular meaning, the proposed regulation provides clarity, allows easy reference to a state agency or local agency, and helps avoid ambiguity in the proposed regulations.

Proposed Section 61201, subdivision (i) defines the term “financial audit” as used in the proposed regulations. While Revenue and Taxation Code section 30130.56, subdivision (a) uses the term “financial audit”, the reviews, purposes, and recommendations required by Revenue and Taxation Code section 30130.56, subdivisions (a) and (b) and Revenue and Taxation Code section 30130.57, subdivision (b) suggest that the State Auditor conduct a performance audit. Therefore it is necessary to clarify the types of audits that the State Auditor shall conduct as required by the Act. The way the term is defined by the proposed regulation, in conjunction with the way the term “audit” is defined above, makes it clear that an audit conducted by the State Auditor pursuant to Revenue and Taxation Code section 30130.56, subdivisions (a) and (b) and Revenue and Taxation Code section 30130.57 may consist of elements of a financial audit, a performance audit, or both. By establishing this term and giving it a particular meaning, the proposed regulation allows easy reference to a state agency or local agency and helps avoid ambiguity in the proposed regulations.

Proposed Section 61201, subdivision (j) defines the term “Fund” as used in the proposed regulations. By establishing this term and giving it a particular meaning, the proposed regulation provides clarity, allows easy reference to a state agency or local agency, and helps avoid ambiguity in the proposed regulations.

Proposed Section 61201, subdivision (k) defines the phrase “local agency” as used in the proposed regulations. It limits the term “local agency” to local public entities and makes clear that the definition of local agency does not include any privately created entities. As a result, insofar as the proposed regulations pertain to local agencies, they are applicable only to local government agencies and are not applicable to privately created entities. This proposed regulation also maintains consistency as to how this term is defined for purposes of all of the State Auditor’s regulations, including regulations pertaining to the High Risk Local Government Agency Audit Program. By establishing this term and giving it a particular meaning, the proposed regulation allows easy reference to a state agency or local agency and helps avoid ambiguity in the proposed regulations.

Proposed Section 61201, subdivision (l) defines the phrase “local assistance” as used in the proposed regulations. This term defines a category of expenditures included as part of the criteria for determining what constitutes an administrative cost for a number of state agencies receiving applicable funds under the Act. The definition is based on the definition provided by the Department of Finance in its *Finance Glossary of Accounting and Budgeting Terms*, which reflects how this term is used in the Governor’s Budget, the Governor’s Budget Summary, and the annual Budget. By establishing this term and giving it a particular meaning, the proposed regulation provides clarity, allows easy reference to a state agency or local agency, and helps avoid ambiguity in the proposed regulations.

Proposed Section 61201, subdivision (m) defines the term “state agency” as used in the proposed regulations. This proposed regulation maintains consistency as to how this term is defined for purposes of all of the State Auditor’s regulations, including regulations pertaining to the State High-Risk Government Agency Audit Program. By establishing this term and giving it a particular meaning, the proposed regulation allows easy reference to a state agency or local agency and helps avoid ambiguity in the proposed regulations.

Proposed Section 61201, subdivision (n) defines the term “state operations” as used in the proposed regulations. This term defines a category of expenditures included as part of the criteria for determining what constitutes an administrative cost for a number of state agencies receiving applicable funds under the Act. The definition is based on the definition provided by the Department of Finance in its *Finance Glossary of Accounting and Budgeting Terms*, which reflects how this term is used in the Governor’s Budget, the Governor’s Budget Summary, and the annual Budget. By establishing this term and giving it a particular meaning, the proposed regulation

provides clarity, allows easy reference to a state agency or local agency, and helps avoid ambiguity in the proposed regulations.

[Sections 61202 to 61209, inclusive, are reserved.]

Proposed Section 61210 identifies which of the California Department of Education’s (“Education”) expenditures constitutes an administrative cost for purposes of Revenue and Taxation Code section 30130.57, subdivision (f). Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to promulgate regulations defining administrative costs for purposes of the Act. When defining administrative costs, Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to take into account the differing nature of the agencies or departments receiving funds pursuant to the Act.

Revenue and Taxation Code section 30130.55, subdivision (b)(2) directs Education to use any funds it receives pursuant to the Act for school programs to prevent and reduce the use of tobacco and nicotine products by young people. According to the Governor’s Proposed Budget for fiscal year 2017-2018, 95 percent of the funds Education receives pursuant to the Act are classified as local assistance and the remaining five percent are classified as state operations. According to Education, the funds classified as local assistance represent program costs to be spent entirely on the program’s competitive grants and the funds classified as state operations represents Education’s administrative costs. According to the *State Administrative Manual*, unless statutory language specifically allows otherwise, once classified as either a state operation, local assistance, or capital outlay expenditure, a program or activity must follow that classification’s expenditure rules. While the Governor’s Proposed Budget for fiscal year 2017-2018 does not contain a line item for capital outlay with respect to the funds Education receives pursuant to the Act, the proposed regulation provides for this potentiality. This proposed regulation defines what expenditures constitute an administrative cost for Education with respect to funds it receives pursuant to the Act by taking Education’s unique circumstances into account.

Proposed Section 61211 identifies which of the California Department of Health Care Service’s (“Health Care Services”) expenditures constitutes an administrative cost for purposes of Revenue and Taxation Code section 30130.57, subdivision (f). Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to promulgate regulations defining administrative costs for purposes of the Act. When defining administrative costs, Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to take into account the differing nature of the agencies or departments receiving funds pursuant to the Act.

Revenue and Taxation Code section 30130.55, subdivision (a) directs Health Care Services to use any funds it receives pursuant to the Act to increase funding for certain existing healthcare programs and services. According to the Governor’s Proposed Budget for fiscal year 2017-2018,

100 percent of the funds Health Care Services will receive pursuant to the Act is classified as local assistance and will be used to provide medical care benefits and services. According to the *State Administrative Manual*, unless statutory language specifically allows otherwise, once classified as either a state operation, local assistance, or capital outlay expenditure, a program or activity must follow that classification's expenditure rules. Since local assistance funds will be spent entirely for the support of local government or other locally administered activities, they do not constitute administrative costs for Health Care Services. While the Governor's Proposed Budget for fiscal year 2017-2018 does not contain a line item for state operations or capital outlay with respect to the funds Health Care Services receives pursuant to the Act, the proposed regulation provides for this potentiality and characterizes any such expenditures to be administrative costs as such costs would be administrative in nature. This proposed regulation defines what expenditures constitute administrative costs for Health Care Services with respect to funds it receives pursuant to the Act by taking Health Care Service's unique circumstances into account.

Proposed Section 61212 identifies which of the California Department of Justice's ("Justice") expenditures constitutes an administrative cost for purposes of Revenue and Taxation Code section 30130.57, subdivision (f). Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to promulgate regulations defining administrative costs for purposes of the Act. When defining administrative costs, Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to take into account the differing nature of the agencies or departments receiving funds pursuant to the Act.

Revenue and Taxation Code section 30130.57, subdivision (e)(1) directs Justice to distribute any funds it receives pursuant this subdivision to local law enforcement agencies to support and hire front-line law enforcement peace officers for programs, including, but not limited to, enforcement of state and local laws related to the illegal sales and marketing of tobacco to minors, and increasing investigative activities and compliance checks to reduce illegal sales of cigarettes and tobacco products to minors and youth. According to the Governor's Proposed Budget for fiscal year 2017-2018, 100 percent of the funds Justice will receive pursuant to this subdivision are classified as local assistance. According to the *State Administrative Manual*, unless statutory language specifically allows otherwise, once classified as either a state operation, local assistance, or capital outlay expenditure, a program or activity must follow that classification's expenditure rules. Since local assistance funds will be spent entirely for the support of local government or other locally administered activities, the funds Justice receives pursuant this subdivision do not constitute administrative costs for Justice. Further, since the funds Justice receives pursuant this subdivision are required to be distributed to local law enforcement agencies, none of these funds may be used for state operations or capital outlay.

However, Revenue and Taxation Code section 30130.57, subdivision (e)(4) directs Justice to directly use the funds it receives pursuant to this subdivision for certain activities the California

Attorney General conducts, including but not limited to, enforcing laws that regulate the distribution and sale of cigarettes and other tobacco products. According to the Governor's Proposed Budget for fiscal year 2017-2018, 100 percent of these funds are classified as state operations and are not set aside for local assistance. In this context Justice is directly engaging in program activities. Generally, when an agency directly engages in program activities, some of its expenditures will be specific to the program and some of its expenditures will not be specific to the program. Costs that solely benefit the specific program are department direct costs and costs that do not solely benefit the specific program include both department indirect costs and department central services costs. Because department indirect costs and department central services costs are not specific to the program, they constitute administrative costs. This proposed regulation defines what expenditures constitute an administrative cost for Justice with respect to funds it receives pursuant to the Act by taking Justice's unique circumstances into account.

Proposed Section 61213 identifies which of the California Department of Public Health's ("Public Health") expenditures constitutes an administrative cost for purposes of Revenue and Taxation Code section 30130.57, subdivision (f). Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to promulgate regulations defining administrative costs for purposes of the Act. When defining administrative costs, Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to take into account the differing nature of the agencies or departments receiving funds pursuant to the Act.

Revenue and Taxation Code section 30130.55, subdivision (b)(1) and Revenue and Taxation Code section 30130.57, subdivision (d) direct Public Health to use any funds it receives pursuant to these subdivisions in part for local assistance. According to the Governor's Proposed Budget for fiscal year 2017-2018, 95 percent of the funds Public Health receives pursuant to these subdivisions is classified as local assistance and the remaining five percent is classified as state operations. According to the *State Administrative Manual*, unless statutory language specifically allows otherwise, once classified as either a state operation, local assistance, or capital outlay expenditure, a program or activity must follow that classification's expenditure rules. Since local assistance funds will be spent entirely for the support of local government or other locally administered activities, they do not constitute administrative costs for Public Health. Funds Public Health receives pursuant to these subdivisions that are classified as state operations constitute administrative costs. While the Governor's Proposed Budget for fiscal year 2017-2018 does not contain a line item for capital outlay with respect to the funds Education receives pursuant to the Act, the proposed regulation provides for this potentiality.

Revenue and Taxation Code section 30130.55, subdivision (e)(3) directs Public Health to both provide local assistance and to engage in program administration. According to the Governor's Proposed Budget for fiscal year 2017-2018, 62 percent of these funds are classified as local assistance and 38 percent are classified as state operations. According to the *State Administrative*

Manual, expenditures for the support of state government include both department direct costs, department indirect costs, and department central service costs. Since local assistance funds will be spent entirely for the support of local government or other locally administered activities, they do not constitute administrative costs for Public Health. However, with respect to the remaining 38 percent that is appropriated as state operations, Public Health is directly engaging in program activities. Generally, when an agency directly engages in program activities, some of its expenditures will be specific to the program and some of its expenditures will not be specific to the program. Costs that solely benefit the specific program are department direct costs and costs that do not solely benefit the specific program include both department indirect costs and department central services costs. Because department indirect costs and department central services costs are not specific to the program, they constitute administrative costs. This proposed regulation clarifies that with respect to any funds Public Health receives pursuant this subdivision that are classified as state operations costs and that constitute a department indirect cost or department central service cost are administrative costs.

Proposed Section 61214 defines actual costs incurred for audits conducted by the State Auditor pursuant to the Act and states that actual costs incurred shall not constitute an administrative cost for purposes of Revenue and Taxation Code section 30130.57, subdivision (f). By its nature, the State Auditor does not engage in program activities as the office does not administer any programs. Thus, all of State Auditor’s costs are administrative. However, unlike other state or local agencies receiving funds pursuant to the Act, the State Auditor’s receipt of such funds is limited to the amount needed to reimburse the State Auditor annually for actual audit costs incurred or \$400,000, whichever is less. Thus, the State Auditor will not be receiving funds in excess of the State Auditor’s actual audit costs incurred and the risk that the State Auditor will spend the funds the office receives pursuant to the Act for purposes unrelated to the required audits is mitigated. Therefore, to give full effect to the language of Revenue and Taxation Code section 30130.57, subdivision (b), actual audit costs incurred does not constitute an administrative cost for purposes of Revenue and Taxation Code section 30130.57, subdivision (f). The calculation of actual costs incurred uses the same methodology that the State Auditor uses when it directly bills state agencies for other audit costs pursuant to Government Code section 8544.5. This proposed regulation takes the State Auditor’s unique circumstances into account.

Proposed Section 61215 identifies which of the California State Board of Equalization’s or any successor entity (“Board of Equalization”) expenditures constitutes an administrative cost for purposes of Revenue and Taxation Code section 30130.57, subdivision (f). Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to promulgate regulations defining administrative costs for purposes of the Act. When defining administrative costs, Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to take into account the differing nature of the agencies or departments receiving funds pursuant to the Act.

The Board of Equalization has a specific methodology that it uses to apportion the Board of Equalization's personal services and operating expenditures to the various tax and fee programs administered by it, including its Cigarette and Tobacco Products Program and its Cigarette and Tobacco Products Licensing Program. According to the Governor's Proposed Budget for fiscal year 2017-2018, all of the funds transferred to the Board of Equalization pursuant to the Act will be used to for the Cigarette and Tobacco Products Program. The Board of Equalization's methodology for apportioning expenditures to the various tax and fee programs is done in two phases. The first phase takes the expenditures as entered into Board of Equalization's financial accounting system and then distributes those expenditures to the Board of Equalization's payroll units. The second phase allocates those distributed costs to the various tax and fee programs. To accomplish this, the payroll units are separated into three categories: direct program, indirect program support, and distributed administration (overhead). Direct program units are those units that work directly on programs. Indirect support units are those units without primary program responsibility but that have a specific method to allocate their costs to the various tax programs. Examples of these units include legal, investigations, and cashiers because these units use methods such as time reporting or cashier transactions that allow for specific allocation of the expenditure to a specific program. Distributed administration (overhead) units are those units that support the Board of Equalization and that do not have a distinct method for allocating their costs. Examples of these units include the board members' offices, the executive director's office, accounting, human resources, administrative support, external affairs, and outreach services.

With respect to any funds transferred to the Board of Equalization pursuant to the Act, this proposed regulation follows the Board of Equalization's cost allocation approach with respect to how it allocates its expenditures to the various tax and fee programs administered by Board of Equalization. Because expenditures allocated to direct program units and indirect support units have a distinct method for allocating their costs to a specific program, these units costs are not administrative costs. However, distributed administration (overhead) unit costs do not have a distinct method for allocating their costs to a specific program. Thus, any such costs constitute an administrative cost. This proposed regulation defines what expenditures constitute an administrative cost for the Board of Equalization with respect to funds it receives pursuant to the Act by taking the Board of Equalization's unique circumstances into account.

Proposed Section 61216 identifies which of the University of California's ("University") expenditures constitutes an administrative cost for purposes of Revenue and Taxation Code section 30130.55, subdivision (c) and Revenue and Taxation Code section 30130.57, subdivisions (c). Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to promulgate regulations defining administrative costs for purposes of the Act. When defining administrative costs, Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to take into account the differing nature of the agencies or departments receiving funds pursuant to the Act.

With respect to any funds transferred to the University from the California Healthcare, Research and Prevention Tobacco Tax Act of 2016 Fund pursuant to Revenue and Taxation Code section 30130.55, subdivision (c), this proposed regulation follows the University's cost allocation approach with respect to its Research Grants Program. First, the proposed regulation excludes local agencies that receive applicable funds through grants or contracts awarded because, according to the University, it will administer these funds in accordance with the Tobacco-Related Disease Research Program as set forth in Health and Safety Code sections 104500 through 104545. Health and Safety Code sections 104500 through 104545 provide that any local agencies receiving funds pursuant to these code sections shall be reimbursed their full direct and indirect costs. Thus, there cannot be a cap on direct or indirect costs for any grants or contracts awarded pursuant to these code sections and neither type of cost is considered to be an administrative cost for any local agency recipient. Second, personnel costs and University recharges directly associated with research evaluation program activities and for dissemination program activities do not constitute administrative costs. Third, any other expenditure of these funds by the University constitutes an administrative cost. This methodology is generally consistent with the accounting methodology that the University uses with respect to other research programs administered by the University.

With respect to any funds transferred to the University from the California Healthcare, Research and Prevention Tobacco Tax Act of 2016 Fund pursuant to Revenue and Taxation Code section 30130.57, subdivision (c), this proposed regulation identifies indirect and recharge costs as administrative costs. These types of costs are to be determined according to the University's policies and procedures. These funds are to be used to provide funding to the University for the purpose of increasing the number of certain physicians in California. In this context the University is directly engaging in program activities. Generally, when an agency directly engages in program activities, some of its expenditures will be specific to the program and some of its expenditures will not be specific to the program. Costs that solely benefit the specific program are direct costs and costs that do not solely benefit the specific program include both indirect costs and recharges. Because indirect costs and recharges are not specific to the program, they constitute administrative costs. This proposed regulation defines what expenditures constitute an administrative cost for the University with respect to funds it receives pursuant to the Act by taking the University's unique circumstances into account.

Proposed Section 61217 identifies which costs incurred by a local agency constitute an administrative cost for purposes of Revenue and Taxation Code sections 30130.55, 30130.56, and 30130.57. Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to promulgate regulations defining administrative costs for purposes of the Act, including for local agencies. When defining administrative costs, Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to take into account the differing nature of the agencies or departments receiving funds pursuant to the Act.

This proposed regulation excludes local agencies that receive applicable funds through grants or contracts awarded pursuant to Health and Safety Code sections 104500 through 104545 from its terms. As noted above, these code sections provide that any local agencies receiving funds pursuant to these code sections shall be reimbursed their full direct and indirect costs. Thus, there cannot be a cap on direct or indirect costs and neither is considered an administrative cost. With respect to any other applicable funds passing to a local agency from a state agency, administrative costs means the indirect costs allowed by the terms of the applicable grant or contract. This general language is necessary as local agencies will be receiving applicable funds from a variety of different healthcare, research, and tobacco prevention related programs. Each program is subject to its own terms and conditions. This language allows for a consistent means of determining administrative costs for local agencies receiving applicable funds, while still allowing the unique terms that govern each program to remain in effect.

[Sections 61217 to 61240, inclusive, are reserved.]

OTHER REQUIRED SHOWINGS–GOVERNMENT CODE SECTION 11346.2, SUBDIVISIONS (b)(2)-(4)

Economic Impact Assessment – Government Code section 11346.2, subdivision (b)(2): This proposed regulatory action will not have an economic impact on California business enterprises or individuals as the regulatory action relates entirely to the accounting and auditing of state government agencies and local government agencies. Accordingly, the proposed regulatory action will not affect:

- The creation or elimination of jobs within the state;
- The creation of new businesses or the elimination of existing businesses within the state;
or
- The expansion of businesses currently doing business within the state.

However, the proposed regulatory action will benefit California residents by promoting greater economy, efficiency, transparency, and effectiveness in the operation of state and local government by establishing certain rules for cost accounting and auditing purposes for state and local government agencies.

Studies, Reports, or Documents Relied Upon–Government Code section 11346.2, subdivision (b)(2): In proposing this regulatory action, the State Auditor was informed by past experience

auditing California state and local government agencies and the following studies, reports, or documents:

- *California's 2017-18 Governor's Proposed Budget*, California Department of Finance (<http://ebudget.ca.gov/budget/2017-18/#/Home> as of June 19, 2017).
- *California's 2017-18 May Revision to the Governor's Budget*, California Department of Finance (<http://ebudget.ca.gov/budget/2017-18MR/#/Home> as of June 19, 2017).
- *California State Administrative Manual*, California Department of General Services (<http://sam.dgs.ca.gov> as of June 19, 2017).
- *California School Accounting Manual* (2016 Edition), approved by the California State Board of Education, published by the California Department of Education, September 2016.
- *Accounting Manual*, University of California Office of the President (<http://policy.ucop.edu/manuals/accounting-manual.html> as of June 19, 2017).
- *Contract and Grant Manual*, University of California Office of the President (<http://www.ucop.edu/research-policy-analysis-coordination/resources-tools/contract-and-grant-manual/index.html> as of June 19, 2017).
- *Manual of State Funds*; California Department of Finance (http://www.dof.ca.gov/accounting/manual_of_state_funds/ as of June 19, 2017).
- *Finance Glossary of Accounting and Budgeting Terms*, California Department of Finance (http://www.dof.ca.gov/budget/CA_budget_information/budget_faq/GlossaryofBudgetTerms.pdf as of June 19, 2017).
- *Board of Equalization Cost Allocation Plan*, California State Board of Equalization, December 11, 2015.
- *UCOP Rate and Recharge Guidelines*, University of California Office of the President (http://www.ucop.edu/ucop-budget/_files/recharge_gl.pdf, June 27, 2017).

Reasonable Alternatives Considered–Government Code section 11346.2, subdivision (b)(3)(A): The State Auditor considered various alternatives when drafting these proposed regulations. The alternatives included those alternatives presented by interested persons during informal, pre-rulemaking sessions held in 2017.

Reasonable Alternatives That Would Lessen the Impact on Small Businesses–Government Code section 11346.2, subdivision (b)(3)(B): This proposed regulatory action will not impact small business as it relates entirely to the cost accounting and auditing state government agencies and local government agencies. Therefore, no reasonable alternatives were suggested or available regarding lessening the impact on small businesses.

Evidence Relied Upon to Support the Initial Determination that the Regulations Will Not Have a Significant Adverse Economic Impact on Business–Government section 11346.2, subdivision (b)(4): The proposed regulations further implement and make specific Revenue and Taxation Code section 30130.56, subdivisions (a) and (b) and Revenue and Taxation Code section 30130.57, subdivisions (b), (f), and (g), relating to state government agencies and local government agencies. Because of the limited scope of these regulations, the State Auditor determined that none of the regulations would have a significant adverse impact on business.

Public Discussions of Proposed Regulations – Government Code section 11346.45, subdivision (a): This proposed regulatory action does not involve complex proposals or a large number of proposals that cannot easily be reviewed during the public comment period prescribed by Government Code section 11346.4. The State Auditor therefore encourages the submission of written comments to improve the quality of the proposed regulations from persons who would be subject to the proposed regulations and from the public during the comment period.